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AUDITOR ON TRIAL:

A GROWING CONCERN

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Capstone Project
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"I believe this is a critical time in the history of the accounting profession in this country. A failure to come to grips with these problems will be the harbinger of a measure of regulation that can only stifle innovation, competition, opportunity, and professionalism."¹

These harsh words are those of AICPA Public Oversight Board Chairman Arthur M. Wood. The problem referred to by Mr. Wood: the onslaught of public criticism directed at the public accounting profession as evidenced by the increasing number of law suits filed against public accounting firms in recent months. Hardly a week goes by without the report of a new suit involving huge sums of money, some in excess of \$150 million, being filed against a public accounting firm with a charge of negligence. The sums involved are so large that as one critic recently noted, "It is no longer inconceivable that one or more firms could go broke directly as a result of one big mistake on an audit." In fact, at present, it is reported that the total amount of outstanding claims against the Big Eight firms exceeds \$2 billion, approximately four times the estimated equity of the eight firms. Indeed, the litigation issue can no longer be considered simply an irritant, as it has in the past.

THE AUDITOR'S CLAIM TO MANAGEMENT

The first step in examining the problem of expanding audit liability is to understand the claim the auditor makes to management upon completing an audit. This claim is contained in the auditor's report, which is signed by the auditor and represents the end-product of the audit process.

The standard report (unqualified opinion) is generally divided into two sections. In the first paragraph, the auditor claims to have examined specified financial statements. The inclusion of this phrase implies that the financial statements were prepared by management and are management's responsibility.

The auditor also notes that his examination was performed in accordance with Generally Accepted Auditing Standards (GAAS), which acknowledges the existence of professional standards and the fact that these standards were met in the performance of the audit.

The first paragraph also includes the phrase "such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances." This clause underscores the nature and extent of the auditor's examination. The word test is used purposely to imply that less than a 100 percent examination was made of the transactions summarized in the financial statements. The phrase "as we considered necessary in the circumstances" indicates that professional judgment was used by the auditor in determining the nature and extent of auditing procedures applied.

The second paragraph of the standard report contains the actual auditor's opinion. An unqualified opinion, which is given when the financial statements are not affected by any major uncertainty, would read as follows: "In our opinion, the financial statements present fairly the financial position, results of operations and changes in financial position in conformity with Generally Accepted Accounting Principles applied on a consistent basis."

The first item which should be noted about this phrase is the word "opinion." The report does not state, "we certify," "we guarantee," or "we

are certain." Thus, all that is supplied to management is the opinion of an experienced professional.

Also note that the report does not contain words such as accurately, factually, or correctly, but rather, "present fairly." The intended connotation of "present fairly" is "in all material respects." This is specified due to the existence of estimates in the financial statements and the limited nature and extent of the audit examination.

In sum, a standard auditor's report simply states that an examination was made of specified financial statements in accordance with GAAS and that in the professional opinion of the auditor, the financial statements are presented fairly in accordance with GAAP.

LEGAL DEFINITIONS OF LIABILITY

With the audit function defined in the auditor's report, one need reference the law books to find the legal definitions of liability.

Under common law, the auditor is under a direct contractual agreement with the client company. As such, an auditor may be held liable for breach of contract given one of the following:

1. The auditor issues a standard report when he has not made an examination in accordance with GAAS.
2. The auditor does not deliver the audit report by the agreed-on date.
3. The auditor violates the confidential relationship inherent within the contractual agreement.

An auditor may also be liable under tort law, given one of the following:

1. Ordinary negligence -- failure to exercise the degree of care which a person of ordinary prudence would exercise in the same circumstances.
2. Gross negligence -- failure to exercise even slight care in the performance of the audit.

3. Fraud -- intentional deception, such as nondisclosure of a material fact, that results in injury to another.

In the past, the courts have restricted the extent of auditor's liability to suits involving circumstances closely related to the legal definitions of liability. Recently, however, the courts have applied the concept of auditor's liability to much broader circumstances. This expansion of the application of liability is best illustrated through a series of actual court decisions that have been handed down over the years.

In a suit in 1919 (*Landell v. Lybrand*), the court held that "absent the intent to deceive," the auditor is not liable for negligence.

By 1931, the courts had relaxed their position somewhat. In *Ultramares v. Touche*, the court held that the auditor is not liable for ordinary negligence to unforeseen third parties, but may be liable to named third parties. In addition, the auditor is liable when negligence is so gross as to constitute fraud.

In 1968, the expansion continued. In *Rusch Factors, Inc. v. Levin*, the court concluded that auditors are liable for ordinary negligence to foreseen and limited classes of unidentified persons. The unidentified class includes all individuals entitled to receive the auditor's report, but not shareholders or bondholders.

In the 1980's, the liability has been extended to the shareholders as well. In November of 1984, for example, Arthur Andersen paid \$45 million to the management and shareholders of Chase Manhattan Corporation due to huge losses suffered by the company, the causes of which allegedly went undetected by the auditors.²

As can be seen from these examples, auditor's liability has expanded drastically: once limited to an intent to deceive, the liability now

extends to suits filed by shareholders of any company suffering huge losses who believe the auditors to be negligent.

CAUSES OF EXPANSION

The expansion of auditor's liability is easy to see: pick up almost any Wall Street Journal, skim through it, and you may discover the announcement of a new multi-million dollar suit filed against a public accounting firm. However, the causes of this expansion are not as visible. Mentioned below are a few of the major contributors to the problem.

One major obstacle faced by the profession is the so-called "Public Expectation Gap." This gap is defined as the difference between the public's perception of the auditor's responsibility and what the auditor claims responsibility for. In many cases, the members of the public are not aware of the inherent limitations of an audit examination: the existence of estimates, cost/benefit need for testing, professional judgment, etc. At heart is a basic lack of understanding as to the fundamental difference between an audit failure and a business failure.

Another major problem involves the alleged practice of "opinion shopping." Opinion shopping is described as the occurrence of a company literally shopping from audit firm to audit firm searching for the opinion they desire. The criticism leveled against the profession is that firms are often so fearful of losing huge million dollar clients that in order to retain the audit, their professional judgment may be compromised.

The economic conditions of the time also play a role in the increase of litigation against public accountants. The two major waves of litigation in the early 1970's and 1980's correspond precisely with the large number of business failures due to the deep recession of the period. A current view applies the "deep pocket theory" to the liability issue.

This theory holds that since the audit firms are often the only solvent entities following the collapse of a business, they are prime targets from which shareholders and creditors hope to recover their investments.

A related phenomenon which may contribute to the increase in litigation is the perceived readiness of public accounting firms to settle out-of-court. In many cases, the cost of defending the propriety of audit work performed far exceeds the amount of the suit. Thus, some firms have opted to settle out-of-court in order to save this money, regardless of the strength of their case. The public (and legal profession) may regard this attitude as very attractive when attempting to recover investments.

Some firms have been accused of contributing to the litigation problem through poor client selection. These critics claim that, in an attempt to gain market share in such a competitive environment, some firms have accepted companies as clients that other firms have rejected. These firms are considered high-risk clients by the profession and often end in bankruptcy, thus increasing the possibility of litigation.

One final contributor to the litigation problem that has been suggested is the possibility of independence compromise due to the growth in management consulting services. Critics in this area claim that a serious conflict of interest develops when the auditors are forced to review systems designed by consultants of their same firm. However, to date, there have been no suits filed based on this assumption.

EFFECTS ON THE PROFESSION

With all of the recent public criticism and the huge suits being filed, the litigation problem is necessarily going to impact the profession.

A direct consequence of the liability expansion is a substantial

increase in the cost of malpractice insurance for auditors. Due to the increase in both the number and dollar amounts of suits filed, the cost of insurance premiums has already increased dramatically and is expected to skyrocket in the near future.

A related phenomenon is the declining pool of insurance carriers available to each firm. As each firm requires greater coverage, the large insurance firms, such as Lloyd's of London, may soon be straining to provide adequate coverage. In fact, Lloyd's has hinted in recent months that it may discontinue insurance coverage in the United States due to the extremely aggressive litigation environment in the U. S. as compared to the environment in England.

Another question which has been raised concerns the profession's ability to attract talented personnel in the future. Due to declining credibility and increased risk of personal exposure at the partner level, it has been suggested that skilled professionals may become more hesitant to pursue a career as a partner in a public accounting firm. This recruiting problem, if realized, would have an obvious effect on the quality of future service.

PROPOSED METHODS TO COMBAT THE EXPANSION

The principal organization within the profession, the American Institute of Certified Public Accountants (AICPA), must involve itself in the liability issue if the problem is to be resolved.

The AICPA is currently in the process of developing several proposals aimed at limiting the liability of accounting firms. Presently, the Institute is discussing three options:

1. The creation of limited liability corporations in place of the existing partnership form.

2. Retaining the partnership structure, but limiting potential exposure to a multiple of fees earned.
3. Developing new forms of insurance.

The incorporation option was first examined by the AICPA during the first major wave of litigation in the early 1970's, but was rejected as being impractical. Incorporation could offer several advantages to firms, not only in the limitation of liability, but also in terms of raising large sums of capital to fund investment and expansion.

The second option, limiting liability to a multiple of fees earned, is one that American doctors have been discussing for years. In fact, legislation in some states has placed a ceiling on the size of medical negligence actions which may be filed. The same sort of idea is being considered by the Institute.

The third option, new forms of insurance, would provide public accounting firms with greater coverage. However, one potential drawback to the plan concerns passing the additional costs of insurance coverage on to client companies in an already price-conscious environment.

Others within the profession stress the importance of educating the courts and the public as to the nature and extent of an audit examination. A broad public education program is being suggested which would stress the judgmental aspect of financial reporting. The main thrust of such a campaign is to narrow the public expectation gap referred to earlier.

Another proposal deals with changes within the profession. The peer review process utilized by the profession is being reexamined and amendments are being discussed. Other ideas include more SEC involvement and investigation into litigation cases. Second partner review of audit work could also be expanded to more engagements.

The latest recommendation concerns expanding the audit process in

attempts to become more effective in detecting fraud. This proposal, suggested by Price Waterhouse, is somewhat of a break from the position of the remainder of the profession. The rationale behind such a suggestion is that the solution to the litigation problem must come in part from changes by the profession.

Evaluation of Current Proposals

An evaluation of each of the aforementioned proposals in relation to their effectiveness follows:

The first AICPA proposal, which deals with incorporation of existing accounting firms, provides the firms with the benefit of limited liability, but does not address the heart of the problem. Thus, this suggestion is more of a reaction than a solution. Additionally, such a reaction could cause further public pressure, as it seems to suggest vulnerability, if not an admission of guilt. Any effort to protect the financial interests of the firms rather than a direct response to the problem would only further aggravate the situation.

The second AICPA consideration, that of limiting liability to a multiple of fees earned, shares many of the same drawbacks of the first suggestion. It too is a protective reaction rather than a direct solution to the problem. Additionally, legislation to this end would be extremely difficult to pass. American medical doctors have been pressing for similar protection in malpractice cases for many years, but have made only minimal progress. One further issue that would have to be addressed when considering this proposal is the problem of differentiating between large clients versus small clients. It seems difficult to justify that major shareholders of smaller entities are entitled to relatively lesser compensation simply because the audit fees are smaller.

The third AICPA proposal, creating new forms of insurance, is a measure that may be needed simply for the firms to survive in the intense litigation environment. With Lloyds of London threatening to completely retreat from American coverage because of the liberal litigation atmosphere, new forms of insurance will be needed to adequately prepare accounting firms to effectively conduct business. However, although new forms of insurance may be a necessity, it does not provide a solution to the problem. Again, this suggestion falters in the same respects as the prior two: it is a reaction to the problem which may infer admission of guilt rather than a direct solution to the problem.

Broad public education/awareness programs have also been suggested. In evaluating this proposal, it is apparent that such a measure would be the most difficult to implement, the most costly and the slowest to take effect. Cooperation would be needed from the AICPA as well as the state societies. The Big Eight firms, because of their prominence and exposure to the public, would also have to commit the necessary resources to make the program effective. However, such action would address the problem head on. Since the public expectation gap is a major contributor to the problem, measures are needed to close the gap. The public awareness program could accomplish this if implemented effectively.

The next proposal noted deals with changes within the profession to enhance credibility and independence. Measures such as increased peer review and second partner review would increase the quality of audit work performed. The question is whether the brunt of the problem stems from lack of quality audit work. Certainly, the profession must accept its share of responsibility for the litigation problem, but increased quality, ethics and independence may not be enough to solve the problem. Essentially, such changes would only be noticed to those within the

profession and those outside the profession who are already knowledgeable enough in audit matters to appreciate the changes. As such, changes within the profession may not be far-reaching enough to have a great effect on the problem.

The Price Waterhouse position, that of expanding the audit to strengthen fraud detection, is very controversial. The profession has maintained for some time that a GAAS audit is not designed to detect fraud, and thus, the auditor has limited responsibility for the detection of fraud.

Results of Survey

In order to obtain a reaction to the issues described above as contributors and possible solutions to the problem of increasing litigation, a questionnaire (see Appendix A for questionnaire and cover letter) was sent to audit partners at the following 13 firms:

Arthur Andersen & Co.
Arthur Young & Co.
Alexander Grant & Co.
Peat, Marwick, Mitchell & Co.
Price Waterhouse
Ernst & Whinney
Coopers & Lybrand
Touche Ross
Deloitte, Haskins & Sells
Laventhol & Horwath
Altschuler, Malvoin & Glasser
Seidman & Seidman
KMG Main Hurdman

The cover letter included with the questionnaire presented the position that the public expectation gap is the major contributor to the litigation problem and described a public education program to reduce this gap. The program described in the letter is the one described previously, involving public relations/promotional efforts by the AICPA, state

societies, and the major public accounting firms. Other components of the plan described include:

- educating all business students as to the nature and limitations of an audit while still in college.
- increased disclosure by the auditor in the annual report describing the test nature of the audit and other limitations.

The partners were then asked to evaluate the public education program as well as many other causes and solutions described. In total, 12 questionnaires were returned. The results of the survey are summarized below:

1. The public expectation gap is the major contributor to the problem of increasing litigation.

Strongly agree	3
Agree	4
Slightly agree	3
Neither agree	
nor disagree	1
Slightly disagree	0
Disagree	1
Strongly disagree	0

2. Evaluate the impact of the following as causes of the litigation problem.

	<u>Great Impact</u>	<u>Moderate Impact</u>	<u>Small Impact</u>	<u>Minimal Impact</u>	<u>No Impact</u>
Deep pocket theory	10	1	1	0	0
Client selection	0	4	6	2	0
Opinion shopping	0	2	7	3	0
Quality of audit work performed	3	3	4	2	0
Independence compromise	2	0	1	9	0
Perceived readiness of public accy. firms to settle out-of-court	3	4	2	2	1

3. Evaluate the effectiveness of the following as solutions to the litigation problem.

	<u>Great Impact</u>	<u>Moderate Impact</u>	<u>Small Impact</u>	<u>Minimal Impact</u>	<u>No Impact</u>
Incorporation of public public accy. firms	0	1	0	5	6
Limit liability to a multiple of fees earned	7	2	1	1	1
Create new forms of insurance coverage	0	1	4	4	3
Public education programs	1	4	3	4	0
Increased peer review	0	2	5	3	2
Increased SEC involvement	1	1	5	4	1
Increased emphasis on ethics in CPE	0	0	5	3	4
Expand audit to detect fraud	2	3	4	1	2

4. 5 firms presently have a program in action^{to} respond to the litigation problem.

1 firm plans to implement a program in response.
1 firm is considering implementing a program.
3 firms are not considering any action.
0 firms will not participate.
2 firms did not respond to the question.

5. A public education program as described in the cover letter would be:

Both effective and practicable	3
Effective but not practicable	1
Not effective	7
Did not respond to question	1

6. 5 firms would be willing to participate in such a public education program.

3 firms would not be willing to participate.
4 firms did not respond to question.

The following were mentioned as other causes of the increase in litigation by the respondents:

- litigious society
- irresponsible court/jury findings
- lucrative area for strike attorneys.

The following were mentioned as other solutions to the problem:

- more prudent judicial system
- existence of D&O coverage by clients
- eliminate attorney's contingent fee arrangement and plaintiffs to be responsible for all litigation costs if they lose.

The results of the survey reveal several trends. First, the majority of the partners feel that the public expectation gap is the major

contributor to the litigation problem. The deep pocket theory also appears to be crucial to the increase in litigation.

Second, the results reveal a wide range of responses to the effectiveness of several solutions. Thus, there definitely is no consensus of opinion regarding a remedy. However, legislation to limit liability to a multiple of fees earned received the greatest support. Also, the Price Waterhouse proposal to expand the audit to detect fraud received some favorable support, with five respondents rating it as moderately effective or greater.

Third, the survey confirmed that the major firms are indeed reacting to the problem in a tangible manner. Most of the firms who responded to the question presently have a program in action or plan to implement a program.

Finally, the proposed public education program received mixed support. Although most of the partners rate such a program as ineffective, the majority of the firms who responded to the question would be willing to participate in such a program. As one respondent stated, the program might not be effective, "but it can't hurt."

Summary

In summary, this is indeed a critical time for the public accounting profession. Bombarded by a rash of litigation so huge that it questions the very existence of the Big Eight, the leaders of the profession have been forced to struggle to determine the causes of the increase in litigation and to develop plausible solutions to the problem. When reviewing the causes identified thus far, the public expectation gap must be considered as a major contributor. A public education program designed to educate the business community as to the nature and limitations of an

audit examination in an attempt to narrow this gap has received mixed reviews. However, as more study is done regarding this issue, the profession may decide to resort to such a program to begin to control the massive litigation.

The profession is desperately trying to avoid precisely the fears expressed by Mr. Wood referred to earlier: regulation which would stifle innovation, competition, opportunity and professionalism. Right now, the House Subcommittee on Oversight and Investigation, chaired by Congressman John D. Dingell, the so-called Dingell Hearings, are in progress. Congressman Dingell and his supporters have been a major force pressing for increased regulation of the accounting profession of late. And as Mr. Dingell warns, "Time is running out for the profession to show it can regulate itself. The system doesn't appear to be working. All is not well. This may be the profession's last opportunity to police itself before somebody else does it for them."³

ENDNOTES

¹Arthur H. Wood, in "POB Chairman Urges Major Changes in Self-Regulatory Program for Accountants," DH&S Review, Deloitte, Haskins & Sells, New York, 1985, May 27, 1985, p. 1.

²Gary Klott, "Uneasy Period for Andersen," The New York Times, November 23, 1984.

³"Accounting Profession's Last Change Hearings Open in Washington," Public Accounting Report, Professional Publications, Inc., Atlanta, 1985, Vol. VIII, No. 3, March, 1985, p. 2.

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December 4, 1985

&add1&
&add2&
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Dear &sal&:

In order to fulfill the requirements of the University Honors Program at Northern Illinois University, I am preparing a project concerning the problem of expanding auditor liability as evidenced by the rash of lawsuits filed against public accounting firms in the past several months. I am pursuing the topic with the assistance of Dr. Curtis Norton, a faculty member of the Northern Illinois University Department of Accountancy.

In conjunction with this project, I am interested in soliciting the views of practicing auditors. Thus, I have prepared the enclosed short questionnaire, which addresses many of the issues related to the increase in auditor liability. Your cooperation in completing the questionnaire would be of great value to my project.

A brief statement of my position regarding this issue should be provided before you complete the questionnaire. As I see it, the major contributor to the problem is what has been called the "Public Expectation Gap." This gap is defined as the difference between what the public perceives the auditor's role to be and what the auditor claims responsibility for.

As a partial solution to the problem, I am proposing a broad public education program to narrow this gap. Briefly, this program would call for public relations/promotional efforts by the AICPA, state societies, and the major public accounting firms. Other components of the plan include:

- educating all business students as to the nature and limits of an audit while still in college.
- increased disclosure by the auditor in the annual report describing the test nature of the audit and other limitations.

Please feel free to provide any additional comments. Your response will remain strictly confidential. Thank you again for your cooperation.

Sincerely,

Barry Kohn

BK:rr

Enclosure

1. The public expectation gap is the major contributor to the problem of increasing litigation.

- ☐ Strongly agree
☐ Agree
☐ Slightly agree
☐ Neither agree nor disagree
☐ Slightly disagree
☐ Disagree
☐ Strongly disagree

Please provide any additional comments: _____

2. Evaluate the impact of the following as causes of the litigation problem.

	<u>Great</u> <u>Impact</u>	<u>Moderate</u> <u>Impact</u>	<u>Small</u> <u>Impact</u>	<u>Minimal</u> <u>Impact</u>	<u>No</u> <u>Impact</u>
"Deep Pocket Theory" (auditor is only source of recovery following bankruptcy)	5	4	3	2	1
Client selection	5	4	3	2	1
Opinion shopping	5	4	3	2	1
Quality of audit work performed	5	4	3	2	1
Independence compromise	5	4	3	2	1
Perceived readiness of public acy. firms to settle out-of-court	5	4	3	2	1
Other (Please specify)	5	4	3	2	1

Please provide any additional comments: _____

3. Evaluate the effectiveness of the following as solutions to the litigation problem:

	<u>Great Impact</u>	<u>Moderate Impact</u>	<u>Small Impact</u>	<u>Minimal Impact</u>	<u>No Impact</u>
Incorporation of public acy. firms	5	4	3	2	1
Limit liability to a multiple of fees earned	5	4	3	2	1
Create new forms of insurance coverage	5	4	3	2	1
Public education programs	5	4	3	2	1
Increased peer review	5	4	3	2	1
Increased SEC involvement into litigation cases	5	4	3	2	1
Increased emphasis on ethics in continuing education programs	5	4	3	2	1
Expand audit to improve fraud detection	5	4	3	2	1
Other (Please specify)	5	4	3	2	1

Please provide any additional comments: _____

4. Our firm

- ☐ presently has a program in action to respond to the litigation problem
- ☐ plans to implement a program in response
- ☐ is considering implementing a program
- ☐ is not considering any action
- ☐ will not participate

Please provide any additional comments: _____

5. A public education program as described in the cover letter would be:

☐ both effective and practicable

☐ effective but not practicable

☐ not effective

Please provide any additional comments: _____

6. Our firm would be willing to participate in such a public education program.

☐ Yes

☐ No

Please provide any additional comments: _____

Thank you for your cooperation. Please place your completed questionnaire in the enclosed postage-paid envelope and mail it at your earliest convenience.