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Legal liability : an epidemic plaguing the accounting profession

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Legal Liability:

An Epidemic Plaguing the Accounting Profession

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ABSTRACT: Currently, accounting firms have become the target of the investors and creditors of failing or bankrupt companies. Under the legal doctrine of joint and several liability, auditors are being brought to court not because they are at fault for poor investment decisions but because they are the only defendants with "deep pockets." The highly litigious atmosphere surrounding the public accounting profession is creating an adverse impact on public accounting firms and the U.S. economy. Tort reform is necessary if the accounting profession is going to continue to thrive. By conducting research with professional journals and interviewing professionals, I explored the possible remedies for the present litigation crisis. Replacing joint and several liability with proportionate liability is one of the more popular proposals. Other proposed reforms include enacting the privity standard, altering the audit function, and allowing for public accounting firms to incorporate. All proposals must be individually examined and the best ones made into laws because tort reform is no longer a matter of consideration for public accounting firms but a matter of survival.

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INTRODUCTION

Presently, the public accounting profession is being plagued with a seemingly endless stream of lawsuits. The litigation facing public accounting firms is an area of major concern; however, a much larger problem lies in the fact that many of these lawsuits are without merit. The stockholders and creditors of failing or bankrupt companies are attempting to recover losses incurred on the basis of poor decision making by targeting the auditors who are often the only "deep pocket" defendants. In an effort to avoid paying ridiculously high judgements and additional legal fees, many public accounting firms are being forced to make settlements on these cases. If this practice continues, the survival of the public accounting profession will be seriously threatened.

In order to preserve the public accounting profession, the U.S. legal system must be reformed and the expectation gap between the auditors of financial statements and the users of the financial statements must be narrowed. Several reforms have been proposed by members of the accounting profession that would help to alleviate the current liability plague. The reform with the greatest support of the public accounting profession is proportionate liability. By eliminating joint and several liability and enacting proportionate liability, auditors would have to pay judgements only to the degree to which they are at fault. A second reform would be to enact the privity standard which would greatly limit the auditor's liability to nonclient third parties. Having the plaintiffs pay the defendants legal fees in failed claims is another of the proposed reforms that aim to eliminate unwarranted lawsuits. Another suggestion is to change the audit function to include qualitative disclosures, financial analysis of the future, and value-based financial statements. By altering the audit function to include these elements, the expectation gap would be lessened. A final reform would allow for the incorporation of public accounting firms and thus, for the protection of the public accounting partners' personal assets.

None of these proposed reforms would entirely eliminate the liability crisis. Additionally, none of the reforms are without their faults or weaknesses. Nonetheless, the liability crisis plaguing the public accounting profession must be addressed and proposing these reforms is a step in the right direction. The implementation of any of the proposed reforms will be a long and laborious task. However, it is now a necessary task if the accounting profession is to be preserved and trust in the audit function is to be restored.

THE LITIGATION CRISIS

The present epidemic of litigation that is plaguing the public accounting profession is threatening the independent audit function, the financial reporting system, and the economy of the United States. In the fiscal year 1991, $477 million was spent by public accounting firms to settle and defend lawsuits. This enormous figure represents an increase of $73 million over the

1990 figure of $404 million (Arthur Andersen & Co. 1992). If this present crisis is to subside, the expectation gap between auditors and the public must be reconciled. An agreement must be reached so that the public will receive the information they want from auditors without imposing an unbearable amount of responsibility on the auditors.

Unfortunately, the expectation gap has had an adverse impact on the public accounting profession. The high cost of settlements and legal fees has driven liability insurance for public accounting firms to heights so unbearable that many smaller public accounting firms cannot afford their annual premiums. In addition, public accounting firms are being extremely selective when accepting new clients so as to reduce their risk of litigation. Finally, the present litigious atmosphere is detering students from choosing accounting as a profession and is making it hard for public accounting firms to attract new recruits. The world of corporate accounting appears far more attractive at this time as corporate accountants' exposure to liability is much less than public accountants'.

THE EXPECTATION GAP

Much of the impending litigation against accounting firms arises from what is known as the expectation gap. The expectation gap results from a discrepancy between what the public perceives the auditors' responsibilities to be and what the auditors believe their responsibilites are. In a Wall Street

Journal survey of 500 CPAs in public accounting firms of 50 or more accountants, ninety-two percent of the accountants believed their responsibilities were limited to ensuring financial statement accuracy. Seventy-seven percent of the accountants surveyed said the limits of their responsibilities included the independent evaluation of a company's financial situation. Finally, only three percent of the CPAs believed that they were responsible for guaranteeing a company's financial stability (Berton 1992). Unfortunately for the accountants, society tends to agree with the small three percent of the surveyed accountants in believing that an unqualified opinion attached to a company's financial statements is a guarantee of the company's future financial stability. On the contrary, a company with a net loss can receive an unqualified opinion.

An unqualified opinion merely indicates that the company's financial statements present fairly, in all material aspects, the financial position of a company, in accordance with generally accepted accounting principles. The unqualified opinion makes no judgement on that financial position or as to whether or not the company would make a good investment. The expectation gap originates from the prevelant misconception that an auditor's opinion is a guarantee of a company's financial security. Therefore, when a company that has received an unqualified opinion fails, the auditors often get targeted in lawsuits by investors who feel the auditors have not upheld their end of the bargain.

THE LAWSUITS' IMPACT ON ACCOUNTING FIRMS AND THE ECONOMY

The growing number of lawsuits against public accounting firms is creating an adverse impact on both the firms themselves and the U.S. economy. Naturally, these lawsuits are going to hurt the public accounting firms financially. According to a statement of position issued by the Big Six accounting firms, which consist of Arthur Andersen & Co., Coopers and Lybrand, Deloitte and Touche, Ernst and Young, KPMG Peat Marwick, and Price Waterhouse, the average claim against the public accountant in fiscal year 1991 averaged $85 million. Settling the case outside of court averaged $2.7 million, which is only 3% of the average claim - an indicator that the amount of the original claim was most likely unwarranted. Lastly, the average legal fees for each claim were $3.5 million (Arthur Andersen & Co. 1992). The cost to settle and defend lawsuits in 1991 amounted to 9% of auditing revenues and 16% of partners' capital of the Big Six firms.

Furthermore, the costs incurred in these lawsuits are driving liability insurance costs to ridiculous heights. An estimated 40% of U.S. public accounting firms are without liability insurance simply because the annual premiums are just too expensive. Since 1985, insurance premiums have risen by 300% and deductibles have risen by 600% (Arthur Andersen & Co. 1992).

In order to cover the costs of settlements, legal fees, and liability insurance, public accounting firms must raise their audit fees. In addition to raising their audit fees, public accounting firms are being very cautious in selecting audit clients. Many are taking defensive measures by screening prospective clients and "weeding out" high-risk clients. Clients that do business in high-risk industries, that are in financial trouble, or that are involved in suspicious activities are usually avoided. Also, those clients who have a reputation of being uncooperative, who have been involved in many lawsuits, or who have switched accountants frequently in the past years should be looked upon with extreme caution. Today, many accounting firms will not audit companies that appear to have "trouble areas" because the risk of lawsuits is too high, whereas two decades ago, virtually any company would have been audited by a public accounting firm. Some of the smaller public accounting firms do not perform audits at all these days due to the high risk of litigation.

Those public accounting firms that still do perform audits are taking a number of actions to decrease their risk of liability according to the Wall Street Journal survey. All of the surveyed firms are performing internal professional reviews of their audit work. Ninety-eight percent of the firms are implementing new risk management procedures by defining the scope of the CPA's job within engagement letters to their audit clients. Also, ninety-eight percent are upgrading their internal control standards. Additionally, eighty-seven percent include in their opinions disclaimers that identify the appropriate use of their work. Finally, seventy-nine percent of the public accounting firms surveyed are limiting the services they offer and fifty-six percent are limiting the industries they will serve (Berton 1992). Overall, public accounting firms are implementing new programs to minimize their risk of litigation.

The most extreme impact of the litigation stampede against public accounting firms can be witnessed by the 1990 demise of Laventhol and Horwath, once the seventh largest public accounting firm in the United States. In describing the firm's collapse, former Laventhol and Horwath CEO Robert Levine said, "It wasn't the litigation we would lose that was the problem. It was the cost of winning that caused the greatest part of our financial distress." (Arthur Andersen & Co. 1992)

If these seemingly unwarranted claims against public accounting firms do not cease, the existence of the accounting profession is not the only thing that will be at stake, but the entire U.S. economy will be in jeopardy. Who would perform the necessary audit function if public accounting firms are forced into bankruptcy as a result of uncontrollable litigation? The Big Six accounting firms are responsible for auditing 494 of the Fortune 500 industrial companies as well as ninety percent of publicly-traded companies with annual revenues in excess of one million dollars (Arthur Andersen & Co. 1992). Without proper audits to inspect the validity, accuracy, and completeness of companies' financial statements, the U.S. economy would be in a state of disarray.

THE ACCOUNTING FIRMS' RESPONSE TO THE LITIGATION CRISIS

It should now be obvious that the enormous number of lawsuits against auditors, whether legitimate or not, are taking their toll on public accounting firms of all sizes. For the first time ever, the Big Six accounting firms and the American Institute of Certified Public Accountants have joined forces by creating the Coalition to Eliminate Abusive Securities Suits. The coalition is lobbying Congress for a change in securities laws that would replace joint and several liability with proportionate liability for professional organizations. Their lobbying efforts also include a proposal that would require the plaintiff's lawyers to pay the defendant's legal fees if they lose their case. Other reforms aimed at easing the escalating liability crisis have been suggested by different organizations and individuals.

Each proposition has its advantages and disadvantages and should be examined individually to decide whether the benefits of the proposal outweigh the costs.

PROPORTIONATE LIABILITY

As was mentioned earlier, the reform with the greatest backing among public accountants is proportionate liability (Telberg 1992). Joint and several liability makes auditors easy targets for lawsuits since this legal doctrine may require the auditors to pay the entire amount of a judgement even if they are only partly responsible for the damages. Joint and several liability makes several defendants jointly responsible for paying the entire judgement in a liability case. For example, if a plaintiff, such as a creditor, were to sue a financially troubled corporation, which was 80% liable for losses incurred, and its auditors, who were liable for the other 20% of the losses incurred, the auditors would have to pay for 100% of the damages if the corporation had no money. Therefore, joint and several liability makes the auditors responsible for 100% of the judgement regardless of their degree of culpability. It is no wonder that "deep pocket" defendants, such as auditors, are included in almost all of the lawsuits involving financially troubled or bankrupt companies, since under the doctrine of joint and several liability plaintiffs most likely will be able to collect the entire judgement if they win.

Clearly, the doctrine of joint and several liability is unfair towards the auditors because the auditors end up paying all or a percentage of the damages far greater than that for which they are responsible. On the other hand, proportionate liability would allow the plaintiffs to recover damages from the auditors but they could collect only the percentage of the damages for which the auditors are liable. In the example above, the auditors would only have to pay 20% of the damages under proportionate liability despite the corporation's insolvency and inability to pay the remaining 80% of the judgement. Proportionate liability would not only bring back a sense of equality and justice to the U.S. legal system but would also deter plaintiffs from filing groundless claims in hopes of recovering their entire losses from "deep pocket" defendants who might be only partially at fault.

Admittedly, investors and creditors will not feel that justice has been served under proportionate liability because they may be able to recover only a portion of their losses. However, some of the responsibility should fall on the shoulders of the investors and creditors, and they should be accountable for the business decisions they have made. It seems that possibly these third parties do not have the right to recover all of their losses from auditors who may be only marginally responsible for incurring those losses. In this case then, proportionate liability might be an answer to the problem.

Unfortunately, replacing joint and several liability with proportionate liablity will not be an easy task. Lobbying Congress to change laws is a long and tedious process. Additionally, enacting proportionate liability for professional organizations only, as the Coalition to Eliminate Abusive Securities Suits is trying to do, is impractical. Instead, the proportionate liability doctrine would have to include all facets of society and not administer special treatment to professionals only. However, in most instances, it only seems fair that parties involved should pay only their proportionate share of damages incurred, no more and no less. Thus, first priority should be given to getting proportionate liability passed through Congress despite the amount of frustration and time it may take.

THE PRIVITY STANDARD

Another factor contributing to the litigation problem for public accountants deals with the auditor's responsibility to nonclient third parties. Naturally, auditors should be held liable for their mistakes when they cause harm to a client. However, how far does the auditor's responsibility extend beyond the client? There exists an endless number of potential users of the client's audited financial statements, leaving open the possibility of an endless number of lawsuits against the auditors if a legitimate mistake is made. It would seem unfair for the auditors to be held accountable to the unlimited number of nonclient third parties especially if the auditors do not specifically know who will be using their client's audited financial statements or for what specific purpose those statements will be used. The concept of limiting lawsuits against auditors to their actual clients is known as the privity standard.

The privity standard is definitely beneficial for public accountants since it would ease worries that unforeseen lawsuits could arise from plaintiffs whose reliance on the financial statements is unknown to the auditors. In addition, the privity standard would prevent nonclient third parties from recovering losses from the "deep pocket" auditors under the doctrine of joint and several liability.

Nevertheless, as good as the privity standard may sound from the public accountant's point of view, it can also be extremely detrimental to the accounting profession. The greatest argument against the privity standard is that it makes the auditors look like they do not want to be held responsible for their audit work or for the mistakes that may have arisen from their audit. Consequently, the public will lose faith in the audit function. Nonclient third parties who use the audited financial statements of other companies will have a genuine concern as to whether they will be able to trust the accuracy and validity of the financial statements if the auditors appear to be hiding from their responsibilities.

An alternative to the privity standard would be to put a cap on the amount for which a nonclient third party could sue an auditor. This alternative would restore trust in the audit function and would prevent auditors from paying judgements totally out of proportion to their degree of responsibility to those unknown third parties. If a claim against the auditors were limited to five times the audit fee, for instance, ridiculous lawsuits such as the $338 million claim filed by Standard Chartered Bank against Price Waterhouse would not be a concern (Lochner 1992).

PLAINTIFFS PAYING THE DEFENDANT'S LEGAL FEES IN FAILED CLAIMS

In proposing these various reforms, the auditors are not trying to shun their responsibilities or dismiss cases in which the auditors made a legitimate error. Instead, as stated in a statement of position issued by the Big Six accounting firms, "the firms seek equitable treatment that will permit them and the public accounting profession to continue to make an important contribution to the U.S. economy." (Arthur Andersen & Co. 1992) Making the plaintiff pay for the defendant's legal fees in failed claims is one way the Big Six firms believe they will receive equitable treatment. This proposal is aimed at putting an end to the practice of including the "deep pocket" auditors in lawsuits even when the auditors are marginally culpable or not responsible for any losses whatsoever.

Presently, the U.S. legal system allows for the auditors to be victimized by plaintiffs who are trying to recover their losses from one of the few defendants with a substantial amount of money left in the aftermath of a finacial failure. This increasingly common practice is very costly for the public accountants since they are usually forced to make settlements out of court in order to prevent being exposed to more legal fees and the possibility of paying for the entire court judgement even if they are only marginally at fault. Having the plaintiff pay for the defendant's legal fees in failed claims would make a plaintiff think twice before bringing suit against an auditor. It would also deter lawyers from accepting cases without any merit.

Although the practice of recovering legal fees from the plaintiff in failed claims would decrease the amount of questionable cases against auditors, it would also scare plaintiffs with authentic claims from filing lawsuits. Plaintiffs with little money would fear the financial consequences of paying not only their own legal costs but also the legal costs of the defendants if they should lose. The U.S. legal system is set up so that every citizen has an opportunity to settle their grievances in court. However, this proposed reform may make it advantageous only for plaintiffs with substantial financial backing to bring their cases to court.

One way of achieving the same goal and retaining equal opportunity in the U.S. courts would be the creation of a "triage" system based on merit for all cases brought before the courts. Under the "triage" system, trivial cases with claims of questionable quality would be immediately dismissed allowing for cases of more importance and credibility to be heard.

CHANGES TO THE AUDIT FUNCTION

As mentioned previously, the increasing amount of litigation against public accounting firms stems, in part, from the expectation gap. Society expects more than an opinion from auditors but the auditors do not want to be held responsible for anything more than issuing an opinion. In order to curb the growing number of unreasonable lawsuits against auditors and to restore faith in the audit function, certain accounting procedures and the audit itself could be altered to meet public expectations.

Value-Based Financial Statements

One potential change to the audit function might be the development of value-based financial statements. Currently, all financial statements are based upon historical costs and past transactions. However, financial statements based on current market values may be more valuable to financial statement users especially in industries where historical costs may be outdated quickly, such as real estate (Mednick 1991). Value-based financial statements would be particularly helpful to investors in predicting risk and the possible future values of certain items. It should be noted that this reform does not propose to replace historical cost-based financial statements with financial statements based on current market values. Instead, the value-based statements would supplement the historical cost statements.

Although value-based financial statements would be extremely beneficial in predicting future values and assessing risk, the process of determining the current value of all the items presented in the financial statements would be difficult and expensive. Since the management of a company most likely would not have the needed expertise or capacity to make an independent assessment on the current value of the company's assets and liabilities, an outside appraiser would have to be hired to make the valuations. Ultimately, the additional costs incurred in issuing value-based financial statements would be absorbed by the public. Whether or not these costs outweigh the benefits derived from the value-based statements will have to be decided by the public.

Also, an inherent risk involved in producing financial statements based on current market values is the possibility that the information on those statements will quickly become obsolete due to fluctuations in market values. Outside factors beyond the control of management will cause market values to fluctuate daily. Additionally, the degree of fluctuation is unpredictable and could range from immaterial to significant. Thus, value-based financial statements would be useful only for a short period of time after they are issued.

Qualitative Disclosures

In conjunction with issuing value-based financial statements, the public is demanding the inclusion of qualitative disclosures in the financial statements as well as quantitative disclosures. Qualitative disclosures would include items such as managerial commentary, long-term strategic plans, and short-term goals. Two-thirds of participants in a 1985 Lou Harris and Associates survey for the Financial Accounting Standards Board agreed that "qualitative information presented outside the financial statements...often can be more useful than quantitative measures included in the financial statements." (Mednick 1991) The qualitative disclosures may, indeed, be extremely valuable in predicting the future financial condition of a company. The inclusion of new research developments, new products, market growth, and other performance indicators in financial statements may be more informative and meaningful to the public than historical cost financial statements.

Like value-based financial statements, the additional costs incurred in gathering and issuing qualitative disclosures will have to be paid by the public. Also, although the inclusion of qualitative disclosures in the financial statements undoubtedly would be useful in assessing the future financial condition of a company, the information contained in the qualitative disclosures could not be trusted entirely. There is no guarantee that what management says in these disclosures will be exactly what management does. External influences may also contribute to the alteration of some of management's short-term goals or long-term stategic plans. Additionally, managers are usually hesitant about disclosing strategic plans to the public since competitors would also have access to these disclosures. Consequently, one must consider these risks when making decisions based on qualitative disclosures.

Financial Analysis of the Future

The final recommended change in accounting and auditing procedures also accomodates the public's growing need for more predictive information. As a guide to making more informed investment decisions, a financial analysis of a company's future could be provided to shareholders. Public accountants already conduct thorough financial analyses of prospective acquisitions for clients. Making this type of critical financial analysis part of the traditional audit may be useful. It would also expose problem areas and provide early warning signals to management and shareholders alike.

As with all of the proposed reforms, there are risks and drawbacks associated with financially analyzing a company's future. First, predicting the future results of a company's operations is very difficult and requires careful judgement on the part of the accountant. Additionally, how would these financial projections be audited? Although there are standards for financial analysis, they are not as extensive or complete as generally accepted auditing standards. Therefore, the projections made during the financial analysis of a company may be slightly exaggerated in favor of the company. Likewise, these projections would have to be based partially on what management's strategic plans for the future are. These plans may be altered or not followed at all, thus, rendering the projections potentially useless and inaccurate.

THE INCORPORATION OF ACCOUNTING FIRMS

Unfortunately, the highly litigious atmosphere surrounding auditors has had damaging consequences on the accounting profession and on the public itself. Society's present grim view of auditors coupled with the fact that the liability of public accounting partners extends beyond work to include their personal assets has had a detrimental effect on morale and recruiting in public accounting firms. Although allowing public accounting firms to incorporate would not hinder lawsuits against the firms, it would limit the personal liability of partners and restore confidence in the accounting profession. Incorporation would also help to increase the morale of partners in public accounting firms as they would not have to worry about losing their personal assets for the alleged negligence of another partner during an audit. However, critics of incorporation say that it is just one more thing that the partners of a public accounting firm can hide behind. Once again, public accountants are caught between a rock and a hard place. They do not want to appear as if they are shunning their responsibilities, but they do not want to risk losing their personal assets every day they go to work.

TURNING PROPOSALS INTO LAWS

At this point, all of the reforms discussed are merely ideas and not yet realities. If these proposals are to become realities, three things will be necessary: contact with legislators, support of public accountants, and large sums of money. First, CPAs must be in constant contact with their legislators. Every public accounting firm should appoint one or two people from within their organization to remain in contact with legislators on a regular basis. If these reforms are to become laws, legislators must be aware of the existing problems in the public accounting profession. They must also know the severity and disastorous effects of the litigation crisis. Next, large numbers of CPAs must back these proposed reforms. State CPA societies must inform their members of current issues and involve their members in the reform efforts. Finally, the process of turning these proposals into law must be well funded. Without proper funds, lobbying Congress will be ineffective and the reform effort will die.

CONCLUSION

"Today we are seriously threatened by a system out of control." (Telberg 1992) This statement regarding an imbalanced U.S. liablity system was made be Deloitte and Touche chairman Mike Cook at the annual meeting of the National Association of State Boards of Accountancy. It should now be clear that the liability crisis faced by the public accounting profession is an extremely serious issue. Addressing the severity of the problem, Cooper and Lybrand's Gene Freedman asserted, "We know we have a job to do and we haven't always been perfect. But our survival is at stake." (Telberg 1992) With the survival of the accounting profession at stake, tort reform seems to be inevitable if equity is to be restored in U.S. courts. Although each proposed reform does have some drawbacks, the U.S. liability system cannot continue in the direction that it is presently heading without inflicting serious damage on the public accounting profession and the entire United States economy. Each proposed reform must be individually examined and the best ones must be made into laws because tort reform is no longer a matter of consideration for public accounting firms but a matter of survival.

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