Vincent C. Ross Institute of Accounting Research
New York University Stern School of Business

Ross Roundtable on Professional Liability:

Has the Pendulum Swung Too Far?

January 28, 2008

Claire Eckstein, Research Reporter

> **1931:** The Ultramares case establishes the principle that auditors have liability to their clients for simple negligence. In cases thereafter, liability extended to third parties relying on the auditor's report, and enjoying privity under certain conditions. The AICPA eliminates the word **"certify"** and replaces it with **"examined**" to emphasize the report was an opinion, not a guarantee.
>
> **1938:** A firm records fictitious receivables and nonexistent inventory in warehouses, leading to an auditing standard requiring the observance of physical inventory and the direct confirmation of accounts receivable, and tests of the internal control.
>
> **1968:** The Continental Vending Case establishes that the auditor must disclose improper activities of the client or the client's officers when such activities are known to the auditor and may reasonably affect the audited financial statements; and that compliance with GAAP is not a conclusive defense against criminal liability.
>
> **2002:** Sarbanes-Oxley Act (SOX) states that the CEO and CFO of each issuer shall **"certify"** that the statements, and other financial information included in the report, fairly present the financial condition and results of operations. The CEO and CFO have "legal" responsibility and could face up to a five-year prison sentence, fines, and other disciplinary action.
>
> **2006:** "Often the pendulum swings too far and we need to go through a period of readjustment. The challenge before us now is how to achieve the right regulatory balance to allow us to be competitive in today's world while guarding against the recurrence of past abuses" Treasury Secretary, Hank Paulson

On January 28, 2008 the Ross Roundtable convened a distinguished group representing a broad spectrum of professions and regulatory policy makers to both discuss the problems associated with the "pendulum" of professional liability having swung too far, and how to achieve a balance between maintaining the credibility of our financial reporting system while remaining competitive in an increasingly global market..

The underlying premise for legislating "legal" responsibility (SOX) was to provide assurance to shareholders that wrongdoing will not go unpunished, and raise the stakes for providing misleading reports. This is a complete reversal from how securities fraud cases were handled in the past.

What should the professional liability framework be? If the conduct of the professional is under the jurisdiction of the states, there is a problem of comparability. Some states extend professional liability beyond known or intended recipients to anyone in whose hands the audit report came. On the Federal level, we have the securities laws. The basic objectives of the "Securities Act" (1933,1934) was that investors receive financial information concerning securities being offered for public sale and to prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC required that the information provided be accurate; it did not guarantee it. The law stipulated “**recovery rights”** if investors can prove that there was incomplete or inaccurate disclosure of important information. Supreme Court rulings have been based on “intent” and not on negligence. However, SOX has changed the rules, and the accounting profession and their clients are currently faced with the specter of being accused of criminal acts, in addition to liability for restitution of staggering amounts. If our objective is to lobby for reforms in the current liability regime, it would have to be at the Federal level.

What is the purpose of professional liability? If the purpose is to insure a standard of care in order to protect the investor, then the recovery rights for the investor, stipulated by the Securities Act, make sense if due care was not exercised. The next question we ask is:

Who is the target of professional liability? The person who committed the act? The auditor? The partner in charge? The auditing firm? The firm that is being audited? What objectives are being met by punishing the auditors for crimes committed by their clients? The “gatekeeper” theory places the liability with the auditor. Professor Segal (NYU Law) believes that we are aiming at the wrong target, and disagrees with the “gatekeeper” theory as currently practiced. Lynn Turner (SEC) disagreed with Professor Segal, stating that in hiring an expert to provide services, there is an expectation that due professional care will be exercised. If they fail, it is appropriate to make them accountable. He further stated that it is the executives, and not the auditors, who have been indicted for criminal offenses. “Should we give a free pass to auditors for billion dollar misses”?

The Supreme Court[1] declined to impose liability on a third party that did not itself commit a deceptive act, but who took part (knowingly or unknowingly) in the transaction that gave rise to a primary violation. Knowledge of a primary violation alone was insufficient to turn a party engaging in a legitimate deal into a primary violator. Thus, the Supreme Court provided protection against unlimited exposure

What are the economic consequences of the current liability regime? The direct costs in terms of time and effort to comply with the rigorous auditing standards have been exorbitant, and are ultimately paid by the client. The critical indirect costs, which cannot be measured, are the costs of being overly conservative. The tradeoff between relevance and reliability, between timeliness and verifiability, in the current litigious regime has never been more profound. When errors in judgment may be perceived as criminal, reliability will replace relevance.

Financial reports prepared using IFRS and GAAP are now competing in U. S. capital markets. The professional liability regime in this country puts us at a major disadvantage. In countries that are our major competitors it is almost impossible for investors to file class-action law suits. The company (client) can sue the auditor for poor performance. However, law suits against professionals are very rare. The costs of litigation, which ultimately impact returns, are a major factor in causing the flow of capital to overseas markets. The higher costs of a stricter regulatory regime in the U. S. are another factor leading to the flow of capital to foreign markets.

There exist both high incentives and unique opportunities to perpetuate fraud. Transactions involving exotic financial instruments, and off-balance sheet schemes of complex, intricate designs that are perhaps readily discernable by only a few financial gurus, provide the opportunity. The “$billion payoffs” provide the incentive. It is the auditors’ obligation to unearth and disclose fraudulent accounting transactions. However, “The auditor… should have

[1] Central Bank

known" requires re-examination. Auditor responsibility should be limited to accounting transactions that fall within the purview of their required education and training.

Cost/benefit analysis has resulted in a significant decline of CPA's willing to audit publicly traded firms. Brendan Dougher, (PWC[2]) commented that multi-national accounting firms are finding that the costs of litigation are simply too high to undertake a "risky" client. He further stated that a vast majority of the claims are settled out of court, not based on merit, because juries are unable to comprehend the issues. The litigious nature of our society leads to a search for deep pockets, in the nature of the audit firm and the highly compensated CEOs. The probability of winning in court is not very high. Where does that leave a client that requires the expertise that only a multi-national firm can provide?

The claims by members of the accounting profession that "liability exposure was measured by the impact on the market, rather than the service provided," was contested by representative of the regulatory commissions.

What, if anything, can we learn from the liability regime in other professions? There are substantive differences between professions, and therefore different liability regimes are required. The accounting profession differs from law and medicine in that the auditor's duty extends to their client and the investors. Potential liability is greater. If, as has been the case, that the entire firm is held liable for the performance of their employees, they are defacto insurers. One suggestion[3] for improving the current regime was to have the auditor provide explicit, rather than implicit, insurance. In return the auditor would be granted immunity. The risk-based premium would be public information and provide a signal to the market on the quality of management.

Some participants believe that censuring the bad-acting professional to assure a standard of care was adequate. Whereas others were of the opinion that facing the risk of awarding large settlements provided an incentive for producing high-quality audits. In any profession asking a client difficult question creates friction. These tensions exist. Raymond Beier (PWC) said that although the accounting firms are continuing to make substantial investments in training, technology, and improving the quality and capability of their staff, they find that expectations continue to increase.

Where do we go from here? What can we do to help insure the relevance and reliability of financial reports and preserve the integrity of our capital markets, without resorting to the criminalization of lack of "due care" or inadequate performance. Harsh penalties have severe economic consequences that impact our ability to compete with foreign markets. "Trickle down economics"-- honesty, morality, integrity, and other positive attributes of mankind have to start at the top. The moral fiber of our country is being eroded by questionable activities of our elected representatives; the very same individuals who are enacting our laws. "Do as I say—not as I do" may have worked in the 19th century; it backfires dramatically in today's day and age. Congress can keep cranking out legislation, but there is one thing on which all participants agreed:

you cannot legislate integrity.

---

[2] PricewaterhouseCoopers.

[3] Joshua Ronen, NYU Stern.