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Accountants call for reform in liability laws

Big Four firms warn more major players could fall in class actions if outdated rules aren't changed

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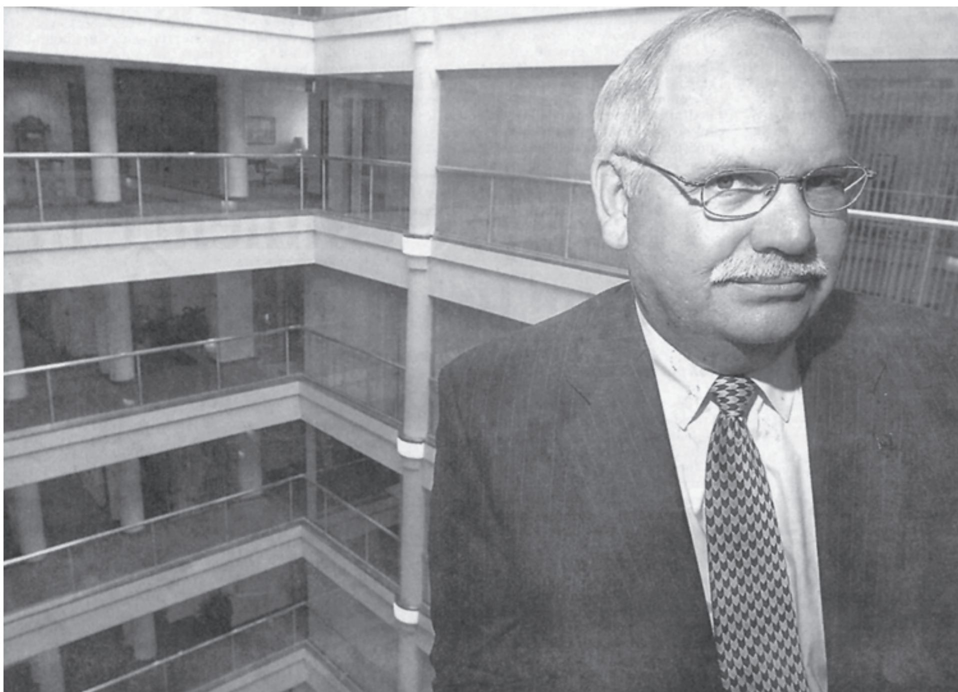

Brian Hunt of the Institute of Chartered Accountants of Ontario would like to see Ontario follow the lead of B.C. in extending full-shield protection.

While there has been much effort and expense directed at reforming governance practices to avoid another Enron, Canada's big chartered accounting firms say not enough is being done to prevent the sort of catastrophe that befell that other Goliath of the Enron debacle, Arthur Andersen LLP.

Because of what they say are outmoded corporate liability laws that make professional advisers disproportionately liable for a company's financial negligence, the Big Four firms, which audit on most corporate financial statements, warn they may soon become known as the Big Three if bloodthirsty shareholders get their way. A major class-action suit, they say, could vaporize another global accounting firm even if just one less-than-thorough accountant plays a modest role in the mess.

"The profession has always been prepared to take responsibility and accept its share of losses where it is to blame," says Kevin J. Dancey, Canadian senior partner and chief executive officer of PricewaterhouseCoopers LLP. "But, unfortunately, we are currently held accountable for other people's errors, and that is not appropriate."

Mr. Dancey and his counterparts at other major audit firms are lobbying to strike down an arcane but influential legal rule in Canada known as joint-and-several liability. It says that not only are a corporation and its directors responsible for damages due to shoddy or deceptive bookkeeping, but so are its outside advisers who attest to the financial viability of the company, including auditors, lawyers and share underwriters.

What's more, those outside advisers -- most notably the deep-pocketed global accounting firms -- can be left holding the bulk of the bill if the corporation's assets are insufficient to cover the court-awarded damages.

Audit firms want that legal structure replaced with a less-onerous system of so-called proportionate liability, which would limit each party's burden to its share of culpability as determined by a court. If an accounting firm is found to be 5-per-cent liable, it's penalty should not exceed 5 per cent of damages, they say.

In supporting their case for a move to proportional liability, auditors point to what they say is a growing global retreat away from joint-and-several liability. Australia, for example, recently instituted a system of proportionate liability, as have many U.S. states, bringing the total number of proportionate-liability states to 38. Britain, too, has begun to study the option.
A change in Canada's liability rules would theoretically benefit all self-regulated professions that provide vital assurance to corporations, but chartered accountants have been especially vocal in lobbying for change since bookkeeping misdeeds brought down giant Texas energy trader Enron Corp.

Audit firms say that the concept of joint-and-several liability may have served its purpose at a time when businesses tended to be smaller and threat of huge shareholder class actions practically non-existent. But given the size of recent law suits -- such as a $4.6-billion (U.S.) claim against Ernst & Young LLP for work related to British life insurer Equitable Life, which almost collapsed in 2000 -- that rule has outlived its relevance.

“Numbers in the billions are being thrown around with impunity now,” says Bruce Jenkins, national director of professional practice at Deloitte & Touche LLP. “That’s not something we saw 10 years ago.”

Paul Weiss, Canadian managing partner of audit at KPMG LLP, says that the joint-and-several system came into being “a hundred years ago or more, when businesses were fairly small and the professional advisory firms, including the accounting firms, may have consisted of one or two or three partners, and you knew who each other was and you worked with each other and you shared responsibility.”

Today, he says, the accounting firms that perform most public company audits have grown to a size where “many of the partners are in fact nameless and faceless as far as the other partners are concerned.”
Indeed, the asset risk of those firms in shareholder class-action suits has become so large they can no longer obtain professional indemnity insurance for all their risk.

“There is no insurer who would insure us for a billion,” Mr. Jenkins says.

Some accountants also argue that, with just four major firms performing most of the world’s audit work after Andersen’s collapse, one more implosion could significantly narrow the competitive landscape.

“Is it really in the public interest for there to be only three? I don’t think so,” says David Knight, chairman of the national liability reform task force, a co-operative effort of the Canadian Institute of Chartered Accountants and Canada’s six largest accounting firms (Deloitte & Touche, PricewaterhouseCoopers, KPMG, Ernst & Young, Grant Thornton LLP and RSM Richter). Mr. Knight is lobbying governments on the issue at both the federal and provincial level.

Mr. Knight adds it’s likely liability concerns will render it harder for some corporations to secure the services of the most established accounting brands. “Auditing firms the world over are looking very closely at who they have as clients,” Mr. Knight says. “There will be situations where companies can’t find a Big Four.”

Corporate liability reform isn’t the only change auditors are seeking. They also want an amendment to the “limited liability partnership” designation of most accounting firms so that the personal assets of each partner is protected against seizure. Currently, the LLP designation protects the personal assets of innocent partners in the event of a lawsuit but enables a plaintiff to go after the assets of the firm as well as the personal assets of the accountants directly responsible for a questionable audit.

Brian Hunt, president and chief executive officer of the Institute of Chartered Accounts of Ontario, wants to see this so-called partial-shield LLP expanded to full-shield protection, which would indemnify the personal assets of even the culpable partners. *

“British Columbia has introduced it and it is a model for the rest of the country. We’re working with the Ontario government to see if we can’t get it implemented in Ontario. Many companies are looking at registering in B.C. because of the legislation there. It does protect the individual assets of the other partners in a firm.”

Not all accountants are in favour of further limits to liability, however. Many certified general accountants, who have been lobbying to gain access to audit work historically limited to chartered accountants, argue the current structure acts as a strong incentive to ensure accurate audits.

“I get concerned about the consumer. The consumer has to have some means of recovery,” says Ralph Palumbo, director of government relations and legislative affairs for the Certified General Accountants of Ontario.

CGAs have long argued that they would be more than willing to enter the audit business to fill any shortages caused by attrition of chartered accountants unwilling to assume liability.

Forensic accountant and corporate governance watchdog Al Rosen of Accountability Research Corp. in Toronto also opposes the move. He says chartered accountants in Canada have already been given too much self-policing power, and with that power they should be forced to assume a high degree of responsibility. He says accountants have already won concessions

on the liability issue, most notably a Supreme Court of Canada decision in 1997 known as Hercules Management Ltd. v. Ernst & Young, which limited the scope of auditor liability to shareholders in the secondary market.

Even the Canadian Public Accountability Board, the new oversight body formed to regulate auditors in the wake of Enron, he says, is largely made up of accountants with close ties to the profession and, in his view, will serve the interests of accountants more than it will protect shareholders.

“If there wasn’t a Hercules and if they weren’t allowed to set the accounting rules and they weren’t allowed to have the oversight committee and they didn’t already have these protections, then I would have some sympathy for them,” he says. “You can’t call it greed because it’s way beyond greed.”

Perhaps the biggest challenge facing the audit firms in their push for proportional liability will be bureaucratic. Because public companies in Canada are governed variously by federal and provincial corporations acts and by securities rules, each of which imposes various degrees of liability, the task would require a major co-operative effort.

Still, the momentum would appear to be with the auditors. In Ontario, Premier Dalton McGuinty circulated an open letter to accountants during his 2003 election campaign that indicated his willingness to entertain a move toward proportional liability.

“I further commit to working toward a resolution of the proportionate-liability issue, which achieves fairer legal liability exposure for practitioners, while ensuring that the public interest is protected,” he wrote.

** This article incorrectly states the position of the Institute of Chartered Accountants of Ontario in regard to expansion of partial-shield LLP to full-shield protection.*

The statement of Brian Hunt should read “wants to see this so-called partial-shield LLP expanded to full-shield protection, which would indemnify the personal assets of the non-culpable partners who do otherwise hold an overall management position but no direct involvement in an engagement.”