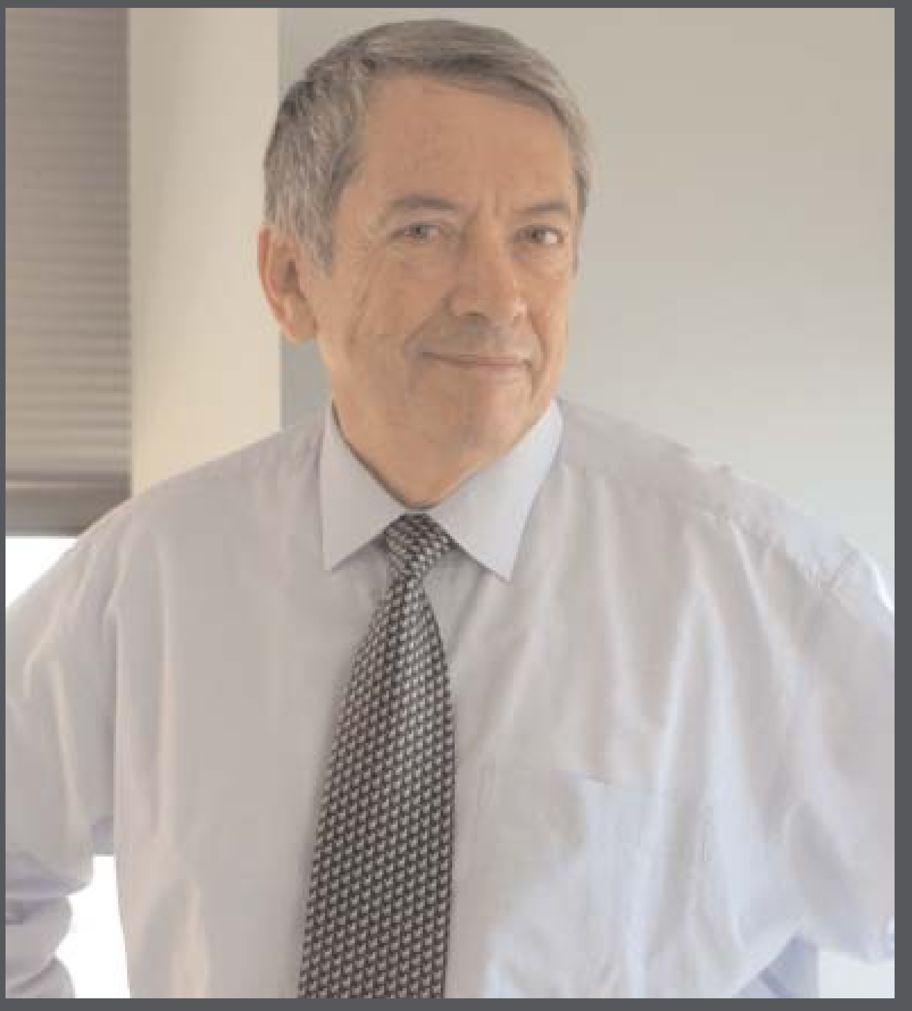
Big players pushing for liability change

By GUNDI JEFFREY



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Canada's accountants have won a battle in the war for limiting professional liability, but not the war itself. However, according to a long-time industry watchdog, it would be a serious mistake to further shield the industry.

As of August 1, a new Ontario law gives partners of the province's audit firms what is called 'full shield protection.' Bill 152 decrees that audit partners will no longer be held liable for the errors of others in their firm over whom they have no supervisory control. But this protection does not extend to their firms overall.

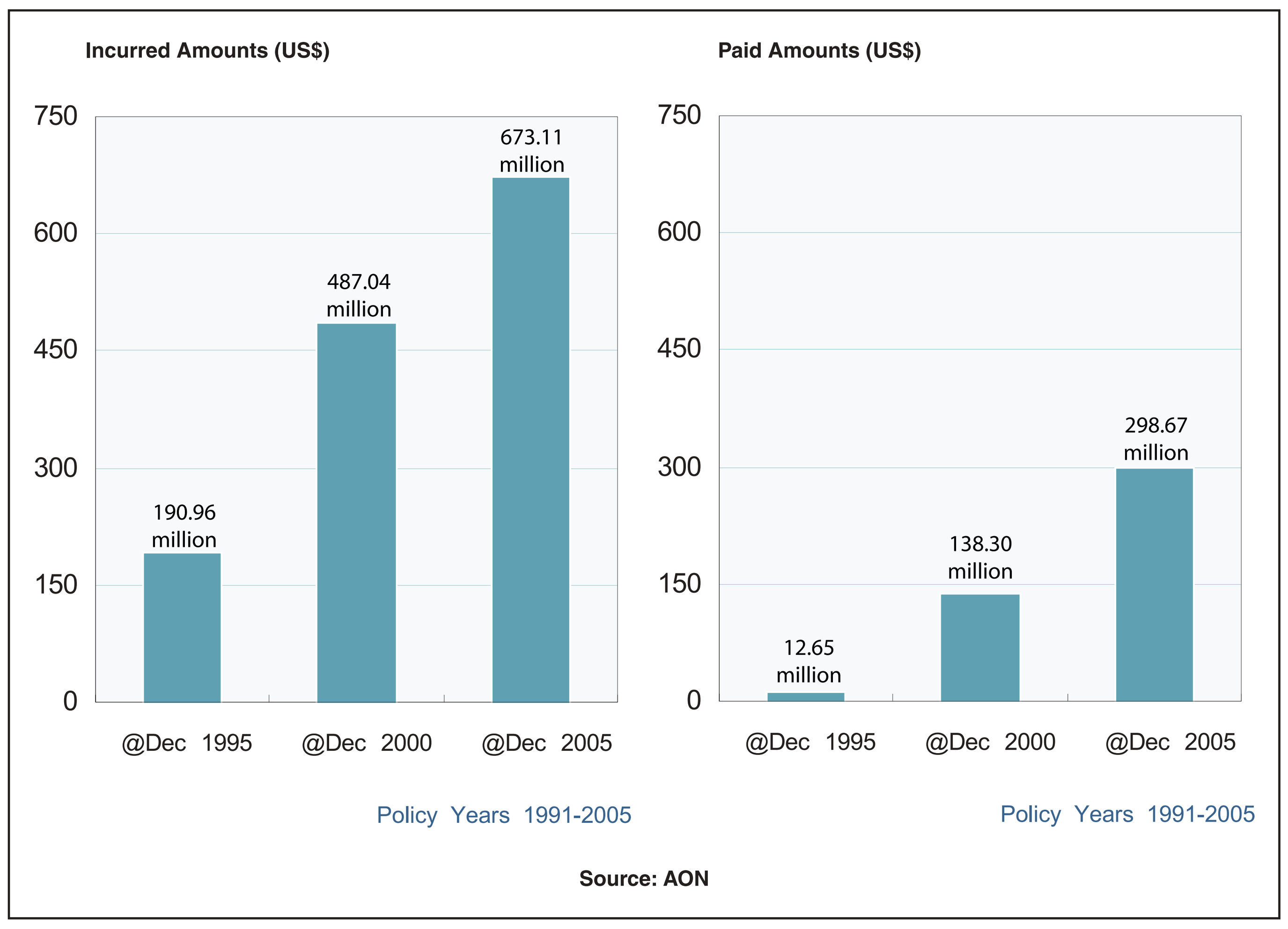
"Previously, under so-called partial shield LLPs, a partner could have been held liable for acts or omissions committed by people over whom they did not even have direct supervisory responsibility," says Peter Varley, vice-president of public affairs for the Institute of Chartered Accountants of Ontario.

"Meaning they likely had no way of knowing of the act in the first place and, therefore, would have no opportunity to prevent it or otherwise deal with it. This has now properly been changed with the advent of full-shield LLPs to ensure partners are only held to account for wrongful acts, or errors undertaken by people under their direct supervisory control. Which is as it should be. Nevertheless, we still need provincial and federal legislators to implement proportionate liability."

Agreed, adds Chris Clark, CEO of PricewaterhouseCoopers LLP. "The current liability model of joint and several liability is inherently unfair, particularly given the changes of the past few years and the increased expectations of auditors.

"This is an issue not only for auditors, but for all stakeholders involved in the financial reporting process (audit committee members, other directors and senior officers). An unfair liability regime does not improve audit quality and may, on the contrary, impede access to quality audit services."

However, "Out-of-court settlements already factor in the auditor's proportionate responsibility," argues Toronto forensic accountant Al Rosen, a long-time watchdog and financial industry critic.



Information provided by the Institute of Chartered Accountants of Ontario

"Auditors already have the *Hercules Case* (won by Ernst & Young in 1997), which makes shareholder lawsuits against auditors very difficult to set up."

Varley doesn't buy that argument. "Canada's major trading partners in the U.S., Europe and elsewhere are moving toward new legal liability models, such as proportionate liability, to protect their capital markets."

"At heart, it's also an issue of fairness. Audit professionals are, and always have been, prepared to accept their degree of responsibility for a financial loss. But, under the current system of joint and several liability, a party to such a loss found to be just one per cent responsible can be held to account for fully 100 per cent of a claim."

This, he adds, "makes audit firms in Canada today the de facto insurers of our capital markets, which is as unreasonable as it is unsustainable – especially in view of the competitive edge that Canada stands to lose if we do not keep pace with liability reforms underway elsewhere."

Varley says the numbers speak for themselves. The estimated number of suits claiming damages of over $100 million filed in the last 10 years in Canada is 12, and the estimated number of suits claiming damages of over $1 billion filed in the last 10 years in Canada is three.

"It's important to note that we don't have a figure for the total amount of damages claimed in all actions that include auditors, as this kind of information is not always made public. And, while some of these much larger suits may have been or may yet be settled for less, any one of them has the potential to do serious damage to the audit industry or to cause the failure of an audit firm."

In the U.S., recent research by Chicago-based AON Corporation cited 20 claims of more than $1 billion US against auditors in that country as of September 2005.

And a study released in September 2006 by the European Commission noted the cost of settlements, judgments and legal fees has risen to 14.2 per cent of revenue in 2004 from 7.7 per cent in 1999.

These types of findings have prompted several high-profile committees to speak out on behalf of auditors.

For example, the Commission on the Regulation of U.S. Capital Markets in the 21st Century recommended, in March, that the U.S. Congress, government agencies and market participants "engage in serious discussion about proposals made by others – including safe harbors or damage limits in specified circumstances – to address the risk of losing another large audit firm."

The commission said that independent auditing firms play a "critical" role in capital markets by providing reasonable assurance on the financial statements of public companies. But the viability of the audit function is threatened by a variety of factors, including:

- Unrealistic expectations about the precision of financial statements, as well as the inherent limits on an auditor's ability to detect collusive frauds;
- Criminal indictment of audit firms rather than responsible audit partners;
- Catastrophic litigation claims in a market in which commercial insurance simply is not available to the firms in adequate amounts to cover such claims;
- Multi-jurisdictional regulation and enforcement activities that pose a barrier to interstate and global service.

The Global Public Policy Committee, made up of the CEOs of the world's six largest accounting firms, warned last November that "our firms are not and can never be the insurers of last resort for the capital markets, where capital flows each day are orders of magnitude larger than our combined capital bases, and where the market value of each of many large enterprises easily exceeds our combined capital by many times.

"There are limits to what auditors can reasonably do, given the limits inherent in today's audits," said the committee. An "expectations gap" arises because "many investors, policy makers and the media believe that the auditor's main function is to detect all fraud and thus, where it materializes and auditors have failed to find it, the auditors are often presumed to be at fault.

"Given the inherent limitations of any outside party to discover the presence of fraud, the restrictions governing the methods auditors are allowed to use, and the cost con-

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Industry not looking for a ‘gimme,’ says Varley

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straints of the audit itself, this presumption is not aligned with the current auditing standards.”

In March, the committee released survey results jointly with the International Corporate Governance Network showing that investors worry that unlimited liability translates into higher than necessary audit fees.

Sixty-five per cent of the investors polled thought auditors should have proportionate liability, and almost 70 per cent feared that a large liability claim could wipe out one of the large global networks – and that the second-tier networks would not be capable of stepping into the breach.

PwC’s Clark believes that “the public’s interest is not served when excessive litigation and unreasonable settlement costs for resolving lawsuits result in auditors looking for ways to reduce their scope of services and limit their liability, rather than (at) how they can enhance the current financial reporting model.”

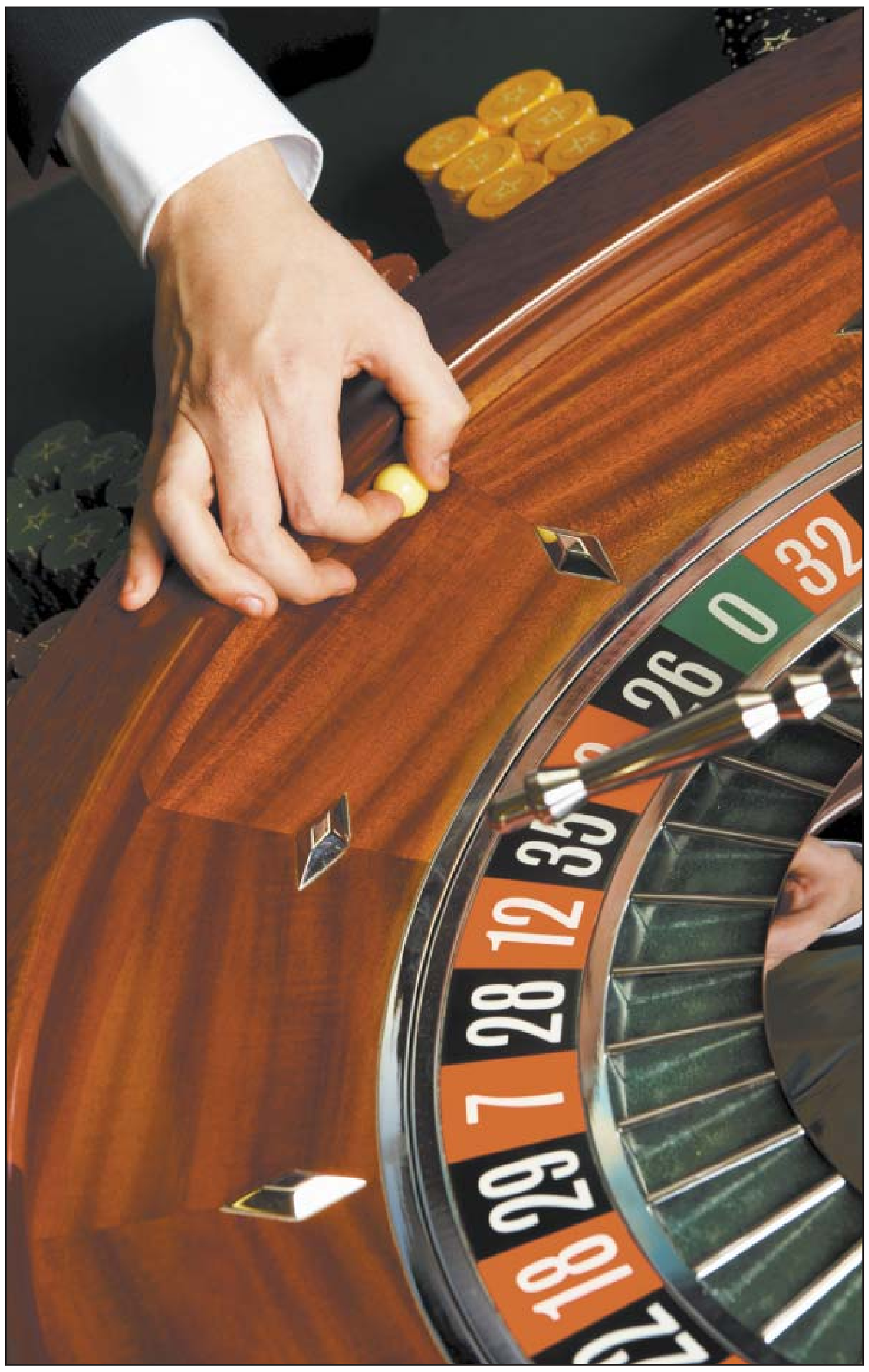
Securities and Exchange Commission (SEC) chief accountant Conrad Hewitt agrees that auditor liability has been a concern for some time, and continues to be one, especially since the demise of Arthur Andersen.

“The issue does not appear to be the number of meritless lawsuits that are filed, but the fact that potential claims against the major accounting firms can be so large that a judgment in any one case might force a firm into bankruptcy, and result in further consolidation of the audit profession with fewer firms.”

Hewitt mentions that five European countries solved the problem with a liability cap – Germany, Austria, Belgium, Greece and Slovenia. Britain is introducing the concept of proportionate liability – limiting the auditor’s damages to those caused by their own mistakes and not their clients. And, in February, the European Commission issued a policy paper stating that the big audit firms should be given legal protection against damage claims.

That policy paper outlined four ways to help protect the audit industry:

- A fixed monetary cap for auditor liability;
- A cap based on market capitalization of the audited company;
- A cap based on a multiple of the audit fees an auditor charges the client;
- Proportionate liability



Securities and Exchange Commission chief accountant Conrad Hewitt warns that a sort of lawsuit roulette could take place, in which one large legal judgment could bankrupt a major accounting firm, further consolidating the industry.

Hewitt says the European Union will likely adopt one or a combination of these four solutions. Meanwhile, he wants the U.S. “to consider ways to foster the vitality of, and competition within, the profession while ensuring that investors’ interests are protected.” One option, he suggested, “may be for the profession to advance a reasonable proposal to Congress to limit the amount of liability to which an audit firm is exposed for violations of the federal securities laws, in ways similar to those being explored in the European Union. Such liability caps have been used in the U.S. when excessive liability threatens the vitality of other professions.”

And, indeed, the Global Public Policy Committee has been lobbying regulators in the U.S. for liability relief. In early March, members met with SEC officials to plead their case, warning that the demise of another large firm would leave publicly-traded companies with fewer auditor choices.

Varley says the situation in Canada is equally serious. “Because of the large claims outstanding and the accumulated totals of smaller ones, the dollar value of incurred claims against five of the biggest six audit firms in Canada leapt from $190.96 million in the period 1991 to 1995 to $673.11 between 1991 and 2005. That’s an increase of more than 250 per cent. Incurred claims are not the total of damages sought, but instead reflect the amounts firms must set aside in anticipation of prospective case settlements.

“The trend line for the dollar value of amounts actually paid by those audit firms is even more ominous. The amounts paid out during that period shot upward from $12.65 million during the period 1991-1995 to $298.67 million from 1991-2005 – a jump of more than 2,000 per cent.”

Rosen says to keep those figures in perspective because, “One, auditor negligence cases drag on for many years (Castor Holdings, for example, is still in court after 14 years), which discourages plaintiffs. Two, given the roadblock of Hercules and similar cases, dozens of serious allegations never reach the courts, and three, actual settlements often are less than 25 per cent of what plaintiffs claim against auditors.”

Nevertheless, says Varley, the current liability system is “antiquated, inefficient, bad public policy and simply unfair.”

Varley cites U.S. Treasury Secretary Henry Paulson saying in November that 42 cents of every litigation dollar won goes to the shareholders – the rest is eaten up by the lawyers, administration and other costs.

He also stresses that the risk inherent in the current liability regime makes it difficult to attract and retain quality auditors. “This, in turn, limits the number of auditors available, especially for smaller operations. That makes it more difficult for them to access the capital markets, limiting their potential to create jobs – a real ripple effect.”

Last, but not least, says Varley, audit costs go up as firms have to pass along to their clients higher insurance costs and money paid out in legal settlements.

Clark agrees that “good people may also not enter the profession as a result of concern over their firm collapsing through liability. The securities’ regulators and legislators may also feel the need to take some action as a result of the limited choice of auditors and the potential impact on the efficiency of the capital markets.

“All of this points to the need for liability reform to sustain the present competitive environment for audit services. Proportionate liability is in the public interest as it would help make our capital markets more efficient, maintain strong audit firms, manage audit cost, provide more market choice and improve reporting models.”

Rosen thinks that offering auditors more protection would be “a huge mistake, given the serious weaknesses in Canadian GAAP and audits, as per the many (legal) cases I have been involved with.

“More protection will make audits even more pointless for banks, major creditors and shareholders. The product – the audit – will not be worth having if the auditors won’t stand behind their audits. Instead of pouring money into chartered accountant public relations campaigns, auditors must use the dollars to improve the quality of their product.” He says firms need more “corroborative evidence, more supervision, less caving in on GAAP.”

Varley categorically opposes that view.

“We must fight the perception that this is a ‘gimme’ for audit firms. It’s simply not so that joint and several liability enhances the quality of audits. What does the trick is good regulation and strong oversight.

“We’re urging Canada’s federal and provincial governments to follow the examples being set by proposed reforms in the U.S., EU and elsewhere, and work with all stakeholders to address the need for legal liability reform for our Canada’s capital markets. The need is great, the demand is growing and the time is now.”

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