

1999

Limiting Auditors' Liability

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Limiting Auditors' Liability

Abstract

Much of the previous literature relating to auditor liability has focused on individual issues in isolation. This paper aims to integrate the key issues, considering the rationale, cost and implications of the audit liability regime and overviewing the current calculus used to assess damages and reforms suggested to limit liability. It is submitted the current liability regime as it applies to auditors is too severe, inequitably imposing substantial costs on auditors. Consistent with recent literature, it is argued that a better solution would appear to be the introduction of a proportional liability regime accompanied by a mandatory requirement that directors hold professional liability insurance as well as reform to the calculus used to assess damages.

Keywords

liability of auditors, corporate governance, corporate law

Cover Page Footnote

I would like to thank Angus Corbett for his feedback, encouragement and inspiration.

LIMITING AUDITORS' LIABILITY

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Introduction

In recent times, audit liability has become a matter of increasing concern, attracting the attention of practitioners and academics alike. In the face of large claims and the escalating cost of indemnity insurance cover in North America, Europe and Australia, there has been a great deal of lobbying by firms and institutes for changes in the law, focused on the principle of joint and several liability in particular. In addition, a refocus on issues of corporate governance and a general perception that directors should take a more proactive role in corporate management has further elevated the issue.¹

Auditing is a critical element of the contemporary corporate marketplace. A substantial body of empirical research has documented the importance of auditors and audit quality.² However, in recent years, challenged by stagnant

* I would like to thank Angus Corbett for his feedback, encouragement and inspiration.

1 This renewed interest in corporate governance issues reflects a number of factors including the experience of the 1980s which, according to the Hoare Panel, 'left deep residual concerns about standards of corporate governance, the reality of legal enforcement and the integrity of company disclosure', prodding from institutional shareholders, increasing internationalisation, deregulation, and ever-changing competitive environments. See, for example, International Capital Markets Group, *International Corporate Governance: Who Holds the Reins?* (1995) ICMG, London; Hoare Panel, *Report to the Attorney-General* (1994) April; Pozen R, 'Institutional Investors: The Reluctant Activists' (1994) January-February, *Harvard Business Review*, 140; Gibson R, and Kraakman R, 'Reinventing the Outside Director: An Agenda for Institutional Investors' (1991) 43 *Stanford Law Review* 863; Ramsay I and Hoad R, 'Disclosure of Corporate Governance Practices by Australian Companies' (1997) 15 *Company and Securities Law Journal* 454 at 456.

2 An influential body of literature relating to auditor switching and the economics of auditing underscores the practical significance of auditors. Findings from empirical research in this area indicates that the selection of auditors can be used strategically as a signalling device:

- Companies wishing to signal increased growth prospects will switch to a larger, higher quality auditor: Feltham G, Hughes S, and Simunic D, 'Empirical Assessment of the Impact of Auditor Quality on the Valuation of New Issue's' (1991) 14 *Journal of Accounting and Economics* 375; Menon K and Williams D, 'Auditor Credibility and Initial Public Offerings' (1991) 66 *The Accounting Review* 313.
- Firms increasing (decreasing) company debt will seek to select a replacement auditor of a higher (lower) quality: DeFond M, 'The Association Between Changes in Client Firm Agency Costs and Auditor Switching' (1992) 11 *Auditing: A Journal of Practice and Theory* 16. Audit firm size is generally used as a proxy for quality.
- Companies switching auditor prior to a new securities issue, will change from a local CPA firm to a larger auditor: Simunic D and Stein M, 'The Impact of Litigation Risk on Audit Pricing: A Review of the Economics and the Evidence' (1995) Unpublished Research Manuscript.
- Selection of a similar or a higher quality auditor would be an indication of management utilising the most efficient set of accounting policy choices: Craswell A, Taylor S, and Woolcott S, 'Do Firms that Switch Auditors Manage Earnings' (1996) Unpublished Research Manuscript, University of Sydney.
- Risky clients are more likely to seek and switch to a larger, Big Five auditor with 'deep pockets': Palmrose Z, 'Audit Fees and Auditor Size: Further Evidence' (1986) 24 *Journal of Accounting Research* 97; Clarkson P and Simunic D, 'The Association Between Audit Quality, Retained Ownership and Firm Specific Risk in US v Canadian IPO Markets' (1994) 17 *Journal of Accounting and Economics* 207.

revenues, increased competition, broader sources of information, more sophisticated and reliable accounting software and greater on-line access to databases, auditors have been forced to reinvent their services. The evidence in relation to fee revenue highlights the slow decline in the importance of the statutory financial statement audit from the perspective of the public accounting firm. The Elliott Committee reports that over the last seven years real accounting and auditing revenues for the top 60 firms have been flat despite growing GDP.³ Elliott concludes:

The market seems saturated; there is overcapacity and price competition; and the inherent reliability of accounting data has increased with improvements in business information systems.⁴

Figure 1: Accounting and auditing revenue for the top 60 US firms 1989-1995

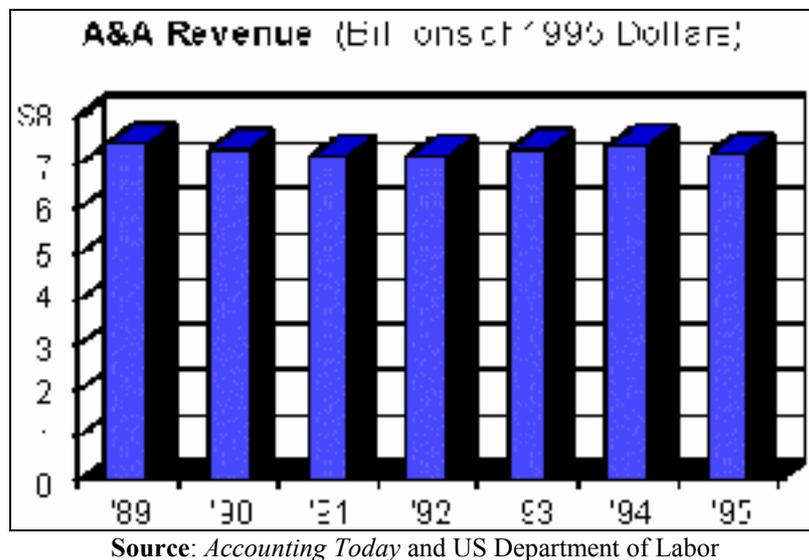


Figure 2 below, displaying the fees paid by the 100 largest listed Australian companies in 1995 for the period 1982 to 1995, is consistent with a decrease in emphasis of financial report auditing among large audit firms. In nominal terms, audit and other fees have increased steadily over the entire period except for 1991 in which both audit and other fees declined. However, Figure 2 graphically illustrates the increasing significance of other fees to public accounting firms.⁵

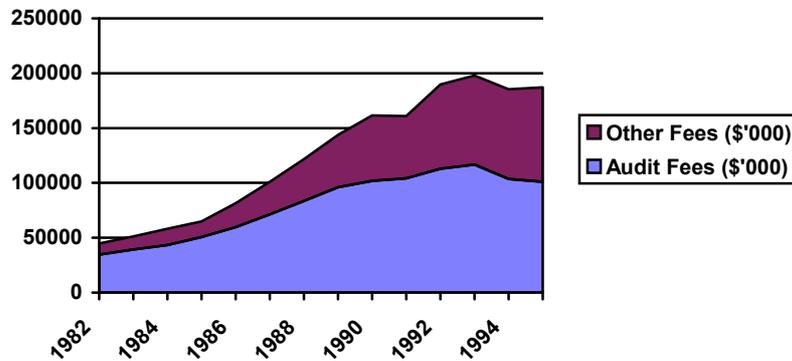
In short, studies examining the characteristics of firms with audit switching have found that switches to Big Five firms were associated with size, leverage and growth increases

3 AICPA Elliott Committee, *The Elliott Report* (1997) at <http://www.aicpa.org/assurance>.

4 Elliott R, 'The Future of Assurance Services: Implications for Academia' (1995) 9(4) *Accounting Horizons* 118 at 118.

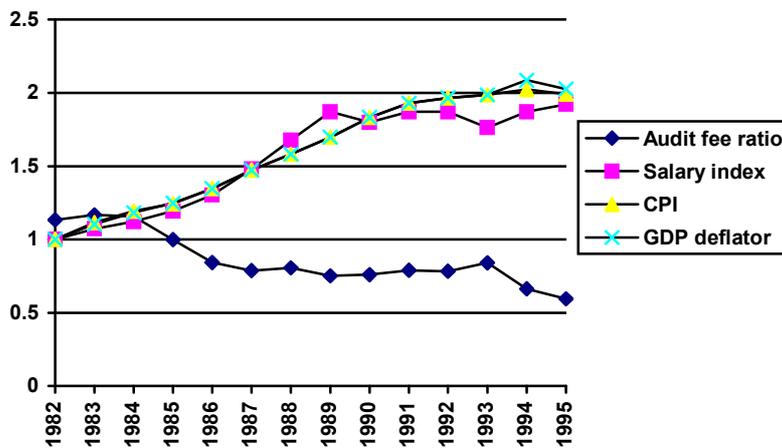
5 Adapted from Craswell A, *Who Audits Australia?* (1996) The Accounting Foundation within the University of Sydney.

Figure 2: Fees Paid to Auditors by the One Hundred Largest Listed Australian Companies 1982 - 1995 (nominal terms)



Further, the audit fee ratio reported in Figure 3 below (measuring the average of the ratio of audit fees to company assets where assets are measured in thousands of dollars) evinces a decline from 1.134 in 1982 to 0.595 in 1995, indicating that there has been a real decline in returns to auditors.⁶

Figure 3: Changes in Audit Fees and Economic Indicators⁷



6 As Craswell points out, changes in the professional regulation in the early 1980s led to an increase in price competition among auditors. With the relaxation of professional rules which inhibited competition among members of the professional bodies, audit fees adjusted downward. The real decline in returns to auditors has also been attributed, in part, to changes in audit methodology during the decade of the eighties. Craswell points out that auditors embraced a more risk-based approach and there was an increase in the use of computers to analyse client data. This enabled auditors to reduce costs by substituting capital for labour and by using labour more efficiently. See Craswell A, *Who Audits Australia?* (1996) The Accounting Foundation within the University of Sydney.

7 The Salary Index is calculated using median starting salaries for accounting graduates published by the Careers and Appointments Service of the University of Sydney. The CPI (all groups weighted average for eight capital cities, base 1982 = 1.000) and the GDP deflator (implicit price deflator, gross domestic product, base 1982 = 1.000) have been extracted from the Australian Bureau of Statistics.

As indicated in Figure 3, the decline in the audit fee ratio from 1982 to 1995 occurred at a time when auditors were experiencing increasing costs, in the form of increases in salaries and inflation.⁸

Many commentators have called for a widening in the scope of assurance and many audit firms appear (or at least purport) to be actively reengineering their approach in an effort to provide value beyond the audit opinion. Given the imminent expansion of assurance services (and therefore exposure to litigation), an investigation of liability schemes is particularly timely and germane.

Audits have been said to be 'admission tickets'⁹ for investors and creditors. It has been widely argued that investors and lenders tend to treat business failures as audit failures, and often look to the auditor when searching for a solvent party from whom losses may be recovered.¹⁰ Although auditors may be comforted by recent decisions in relation to liability to third parties,¹¹ the potential scope of the liability to companies and liquidators remains broad. As Lord Bridge classically stated in *Caparo Industries v Dickman*:

In advising the client who employs him, the professional man owes a duty to exercise that standard of skill and care appropriate to this professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of the duty.

In addition, auditors are subject to several heads of potential liability for the discharge of their statutory functions, including liabilities pursuant to ss 52 and 74 of the *Trade Practices Act 1974 (Cth)*¹² and the various State *Fair Trading*

⁸ The main costs of auditing are labour, office accommodation, litigation and technology.

⁹ Scherl J, 'Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences' (1994) 44 *The American University Law Review* 255 at 257.

¹⁰ Ibid at 257; Chaffee N, 'The Role and Responsibility of Accountants in Today's Society' (1988) *Journal of Corporation Law* 863 (discussing the 'expectation gap' that leads the public to 'characterise business failures as audit failures'); Connor J, 'Enhancing Public Confidence in the Accounting Profession' (1986) July, *Journal of Accountancy* 76. The California Supreme Court in *Bily v Arthur Young & Co*, 834 P2d 745, 763 (Cal.), modified, 3 Cal 4th 1049a (1992) explained that the accountant becomes a prime target when a creditor claims economic loss because the accountant is the solvent party who had direct contact with the business enterprise.

¹¹ In *Esanda Finance Corporation Limited v Peat Marwick Hungerfords* (1997) 188 CLR 241, the High Court majority judgment in relation to the liability to third parties was highly conservative (reflecting the fear of indeterminate liability classically enunciated by Cardozo CJ in *Ultramares Corporation v Touche* (1931) 174 NE 441 at 444 some 60 years previously). In endorsing the limiting principles of assumption of responsibility and intention to induce reliance, the Court drew from local precedents as well as the House of Lords decision in *Caparo Industries Plc v Dickman* [1990] 1 All ER 568. The High Courts judgment stands as a clear statement to parties who consult a company's published audit opinion that the opinion should not be used without support from other information in making lending and investment decisions. See Anderson H, 'Australia's New Conservative Approach to Auditors' Liability' (1998) 19(3) *The Company Lawyer* 85-88 at 85.

¹² s52 *Trade Practices Act 1974 (Cth)* states that 'a corporation shall not in trade in commerce engage in conduct that is misleading or deceptive or likely to mislead or deceive'. An incorrect audit report may be regarded as misleading or deceptive. For a plaintiff to succeed in holding an auditor liable, each element of the section must be satisfied. See Godsell D, 'Professional Liability under the TPA and FTAs' (1992) *Law Institute Journal* 804. Note that there are doubts as to whether the expression of an audit opinion is within the ambit of the term 'misleading or deceptive conduct'. The Full Court of the Federal Court held in *Global Sportsman Pty Ltd & Anor v Mirror Newspapers Pty Ltd & Anor* (1984) 2 FCR 82:

An expression of opinion which is identifiable as such conveys no more than that the opinion expressed is held, and perhaps that there is basis for the opinion. At least if those conditions are met, an expression of opinion, however erroneous, misrepresents nothing.

See Anderson H, 'A Different Solution to the Auditors' Liability Dilemma' (1996) 8 *Bond LR* 72.

Acts.¹³ The settled *Lintner Group v Price Waterhouse* and *Government of Victoria v KPMG Peat Marwick (for Tricontinental)* litigation were both initiated under the Trade Practices legislation. Globally, auditor liability is unlimited in only a handful of the developed countries, including Australia, Canada and the United States.¹⁴ Ultimately, the theoretical problem of auditor liability is to design an optimal mechanism which provides incentives to auditors not to shirk without amounting to an excessive burden.

Much of the previous literature relating to auditor liability has focused on individual issues in isolation. This paper aims to integrate the key issues, considering the rationale, cost and implications of the audit liability regime and over-viewing the current calculus used to assess damages and reforms suggested to limit liability. It is submitted the current liability regime as it applies to auditors is too severe, inequitably imposing substantial costs on auditors. Consistent with recent literature, it is argued that a better solution would appear to be the introduction of a proportional liability regime accompanied by a mandatory requirement that directors hold professional liability insurance as well as reform to the calculus used to assess damages. The next section locates auditing in its social and legal context. This is followed by a appraisal of the current calculus to assess damages. The rationale and the appropriate level of liability is then considered, followed by a critical evaluation of proposals suggested to limit liability in Australia. The final section summarises the major themes and concludes the article.

Background

Auditing has historically been concerned with the faithful and accurate accounting of economic resources. This concern arises from the imperative of maintaining accountability in the presence of agency conflicts between the management and owners of a firm.¹⁵ Over time, this notion of accountability has expanded as new standards of performance were established by interest groups.¹⁶ The underlying philosophy has, however, remained constant: essentially one of

13 *Fair Trading Act 1987 (NSW); Fair Trading Act 1992 (ACT); Consumer Affairs and Fair Trading Act 1990 (NT); Fair Trading Act 1989 (Qld); Fair Trading Act 1987 (SA); Fair Trading Act 1990 (Tas); Fair Trading Act 1985 (Vic); Fair Trading Act 1987 (WA).*

14 For example, France operates under a system of proportionate liability, in Germany there is a statutory cap on liability for damages due to auditor negligence for statutory audits, in Japan, there are no punitive damages and in Netherlands courts freely assess proportional liability and contributory negligence. The wide variation in practice across jurisdictions demonstrates the complexity of the issue with recent international changes generally tending away from joint and several liability.

15 Jensen and Meckling classically posit that the demand for auditing results from a desire to reduce the management shirking that results from information asymmetries between managers and owners. They demonstrate that managers will voluntarily increase the observability of their actions by hiring independent auditors to monitor their behaviour: Jensen, M, & Meckling W, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) October, *Journal of Accounting and Economics* 305. See also Chow C, 'The Demand for External Auditing: Size, Debt and Ownership Influences' (1982) April, *The Accounting Review* 272; Benston G, 'The Market for Public Accounting Services: Demand, Supply and Regulation' (1985) 4 *Journal of Accounting and Public Policy* 33.

16 In addition to agency theory, a number of theoretical frameworks have been put forward to more completely explain the demand for auditing services and the behaviour of auditors. These include information theory, insurance theory, legislated demand theory and contracting theory.

ensuring that accounting records have been kept and verifying compliance with generally accepted accounting principles.¹⁷

The audit report, the most tangible output of the process, adds credibility to the published financial statements. Pursuant to ss 331A(1)(a) & 315(2) of the Corporations Law, a public company's auditor must report on the financial statements for an accounting period which must be presented to the annual general meeting. The report must extend to the company's accounting records and any other records that relate to those financial statements (which encompasses the consolidated accounts (if any) of the company): s 331A(1)(b). For large proprietary companies and certain small proprietary companies which are not disclosing entities, the auditor must give the report to the company's directors soon enough for the directors to comply with their obligations to provide eligible shareholders with copies of the financial statements, directors report and statement and auditors report prior to the deadline for a financial year: ss 331A(2), 315(3A). According to the Corporations Law, an auditor's report must state whether or not, in the auditor's opinion, the financial statements are properly drawn up:

- (i) so as to give a true and fair view of the statutory matters with which they are required to deal: s 331B(1)(a)
- (ii) in accordance with the Corporations Law: s 331B(1)(b); and
- (iii) in accordance with applicable accounting standards: s 331B(1)(c).

A number of empirical studies from Australia and abroad reveal an upsurge in audit litigation in the past decade.¹⁸ Globally, important factors in the escalation of litigation include the economic recession of the late 1980s, with the accompanying increase in the number and size of corporate failures and an increase in the range of parties seeking compensation in some jurisdictions, to include shareholders and creditors.¹⁹ In the United States, the impact of class

17 See Flint D, *Philosophy and Principles of Auditing: An Introduction*, Macmillan, London (1988) at 20.

18 KPMG, for example, recently revealed that it is now paying A\$21 million (£11 million) a year in practice protection internationally¹⁸. Further, in Australia in 1996, the Australian Securities and Investment Commission was successful in reopening its civil action on behalf of Deloitte's former audit client, the ill-fated Adelaide Steamship, alleging faulty auditing of Adsteam's 1990 financial statements. The ASIC action against the firm totals around A\$340 million. In addition, Arthur Anderson remains the subject of a suit for A\$272 million by the remnants of Bond Corporation over faulty auditing of the company's 1988 accounts. Another recent suit to receive substantial publicity was that against second-tier firm Grant Thornton (formerly Thompson Douglas) in Sydney regarding its auditing of the now defunct Westmex corporation in a claim totalling in excess of A\$60 million.¹⁸ In the US in the mid-1990s, accountants faced over 5,000 litigation suits in which judgments were sought exceeding \$30 billion. See Lawson M, 'Upheaval Down Under' (1996) October, *The Accountant* 13. In 1994, Boreham documented six claims in excess of \$20 million. See Boreham T, 'Tricon Ups The Ante on Indemnity' (1994) 7 February, *Business Review Weekly* 77.

19 A comprehensive study of US evidence (Lys T, and Watts R, 'Lawsuits against Auditors' (1994) 32 *Journal of Accounting Research* 65) between 1955 and 1994 concludes that litigation generally arises because of bankruptcy and is instigated by shareholders:

actions combined with contingent fees and constructive fraud under the *Securities and Exchange Act* 1934 has greatly increased the amount of litigation and resulted in some substantial verdicts.²⁰

The Calculation of Damages

It is trite law that a duty of care will be owed by the auditor only if it is foreseeable that if the advice is negligent, the recipient would be likely to suffer damage, and there is a sufficiently proximate relationship between the parties and it is just and reasonable to impose the liability. An auditor owes a duty of care to a third party if the auditor makes a statement with the intention of inducing the third party, or a class which includes that third party, to act or refrain from acting in a particular way in reliance on the statement.²¹ A court, in determining an auditor's duty of care, will be influenced by the professional opinion and evidence of competent and experienced auditors in reference to practices and standards of the profession.²²

The calculus of damages for pure economic loss is the same as for other kinds of damage - the objective of the compensation in tort is to restore the plaintiff to the position which they would have been in if there had been no tort.²³ Where 'damage' is defined in terms of a purchase of an asset or equity induced by negligent misrepresentation, damages are assessed by reference to the full loss incurred by the plaintiff - the amount which the representee would have had

Relative frequencies of sources of US lawsuits against auditors (1955-94)	
Bankruptcy	47.8%
Acquisition	12.9%
Sale of securities	21.7%

Relative frequencies of US lawsuits by type of plaintiff (1955-94)	
Client	16.7%
Creditor	19.8%
Shareholder	48.7%
SEC	9.3%

Similarly, in an analysis of in excess of 1,000 instances of litigation against auditors, Palmrose reports that auditor litigation is most prevalent in conjunction with client bankruptcy, larger companies, companies reporting net income prior to bankruptcy and companies with SEC enforcement actions. She finds that fraud is a common characteristic of both bankrupt and nonbankrupt clients with litigation against auditors: Palmrose Z, 'Who Got Sued?' (1997) March, *Journal of Accountancy* 67.

20 To this end, Vick reports that:

...between 1985 and 1986 every major insurance carrier stopped writing liability insurance policies for California accountants. Premiums in California have skyrocketed, increasing approximately 1480% [from 1984 to 1993], despite the profession's efforts to keep premiums down by creating and running its own non-profit carrier.

See Vick S, 'Bily v Arthur Young & Co: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?' (1993) 26 *Loyola of Los Angeles Law Review* 1337.

21 See *R Lowe Lippmann Figdor & Franck v AGC (Advances) Ltd* [1992] 2 VR 671 [8 ACSR 380; 10 ACLC 1,168] (App Divn), drawing on obiter in *San Sebastian Pty Ltd v Minister Administering Environmental Planning & Assessment Act 1979* (NSW) (1986) 162 CLR 340 [61 ALJR 41; 60 LGRA 405; 68 ALR 161], Gibbs CJ, Mason, Wilson and Dawson JJ at 355; *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) 71 ALJR 448 (HC).

22 *Pacific Acceptance Corp Ltd v Forsyth* (1970) 92 WN (NSW) 29 at 74-75; *Northumberland Insurance Ltd (in liq) v Alexander* (1984) 8 ACLR 882 at 899-900. See also *AWA Ltd v Daniels v/as Deloitte Haskins & Sells* (1992) 7 ACSR 759 at 803.

23 'There is no doubt that this, the restoration of the status quo ante, is the meaning which generally attaches to the principle of compensation in this context' per Tilbury M, *Civil Remedies: Remedies in Particular Contexts* (1993) Butterworths, Sydney, Vol 2 at 395-396.

available as at the date of exit from the investment, had the investment not been made.²⁴

In Australia, the system of liability for auditors is the result of the 'interaction of a statutory regime regulating the disclosure of financial information by companies²⁵ with the liability principles embodied in the common law'²⁶. It has been suggested that the legislative scheme which creates the statutory duty of care is aimed at ensuring the disclosure of information rather than the attribution of fault. This argument suggests that using the statutory duty to allocate blame is misplaced; formulated without reference to either the actual services provided by auditors or to the 'damage' caused by the auditor's breach of duty. One commentator states:

It is this disjuncture between the formulation of the duty of care and the identification of the damage which has exposed auditors to indeterminate levels of liability...The underlying problem with the system of liability for auditors has therefore been a set of absolute statutory duties on the one side and the probability that breach of those duties will produce indeterminate levels of liability on the other side. In this context, there is no principled way in which the ordinary methods of the common law can be used to identify the 'damage' caused by auditors' negligence.²⁷

Corbett argues compellingly for a relational or constitutive model of legal responsibility, producing outcomes in which there is a rational nexus between fault and liability. He proposes a new liability regime based on information costs which preserves Common Law duty of care principles but defines damages in terms of the 'deprivation of opportunity' rather than actual physical or monetary loss'. The central element of the proposal for reform is that the measure of damages be equal to the cost to the plaintiff of obtaining information of a better quality from an alternative source.²⁸ The aim of this proposal is to produce a

24 *Kenny & Good Pty Ltd and Lance Kenny v MGICA (1992) Limited* (1997) 147 ALR 568; affirmed in *Moloney & Anor v ANZ Life Assurance Co Ltd* [1997] 1271 *cf* the House of Lords in *Banque Bruxelles Lambert SA v Eagle Star Insurance Co Ltd* [1997] AC 191, where it was held that a valuer's liability was limited to the amount by which the assessed value exceeded the true value at the time of valuation. Lord Hoffman, who delivered the major judgment invoked common sense and said it was not fair and reasonable that the valuer should be liable for a loss that would have occurred even if the assessed value had been the correct value (that is, due to market forces).

25 The regulatory scheme for the disclosure of financial information is both detailed and complex. Financial statements are required to comply with regulations included in Schedule 5 of the Corporations Law which vary according to the level of 'public involvement': s 297. Every member is entitled to a copy of financial statements (comprising the profit and loss statement and the balance sheet, directors' statements) (s 316) which must be audited and contain an audit report: s 296. Within one month of an annual general meeting every company must submit an annual return to the ASIC providing basic information regarding the status of the company, the identity of its directors, its registered office and its share capital: s 225; *Corporations Regulations* 1990 (C'th) reg 3.8.01. Further layers of regulation are imposed by the Australian Stock Exchange (ASX) on listed companies. LR 3.1 demands that once a disclosing entity (which includes listed companies) becomes 'aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information'.

26 Corbett A, 'The Rationale for the Recovery of Economic Loss in Negligence and the Problem of Auditors' Liability' (1994) 19 *Melbourne University Law Review* 814 at 841.

27 *Ibid* at 842.

28 *cf* the restoration approach recently affirmed by the Federal Court in *Kenny & Good Pty Ltd v MGICA (1992) Ltd* (1997) 147 ALR 568:

As *Shaddock* shows, the measure of damages is the amount of money necessary to restore MGICA to the position it was in before the statement was made, subject to the loss being foreseeable...there being no issue that the loss

new system of liability which ‘mimics’ the operation of the Common Law in circumstances in which the Common Law has been irremediably modified by operation of the Corporations Law. While this argument is theoretically attractive and sustainable in principle, its practicability is questionable and it is difficult to envisage parties being comfortable with adducing evidence along these information cost lines.

Where to Draw the Line - Reassessing the Proper Allocation of Liability

The question of audit liability is a complex and controversial one, invoking a range of considerations and responses. In a review of proposals aimed at limiting the liability of auditors, Langfield-Smith states that a major deficiency of much of the debate and discussion of the issue is the failure to establish that there is a need to limit the liability of auditors.²⁹ This section considers the cost and implications of the liability regime and sets out a policy framework in favour of a reduction in the severity of audit liability.

From an economic perspective, a stringent audit liability regime has several ramifications. Firstly, it may provide an incentive to auditors to increase their effort and perform more thorough audits (to the extent that this reduces their expected liabilities).³⁰ Alternatively, as a defensive measure, auditors may change the nature of the audit they conduct and avoid expressing an opinion on matters which might expose them to a potential liability, thereby reducing the information content of the audit report. A related impact is that auditors may seek to minimise liability by selecting their clients carefully. Further, shareholders and creditors may have reduced incentives to exercise their corporate control rights as a result of being implicitly insured by the audit liability regime. In summary, while the presence of audit liability is an important motivating mechanism, some aspects of a severe liability system may motivate suboptimal behaviour, and potentially result in adverse effects on corporate governance and capital market efficiency; problems of command and control regulation.³¹

attributable to the fall in value of the property was foreseeable, the damages should compensate for the whole of MGICA's loan, including that portion attributable to the fall in the property market.

29 Langfield-Smith I, ‘Limiting the Liability of Auditors - A Review’ (1986) November, *Company and Securities Law Journal* 252.

30 An audit relationship will be governed by some combination of private contract, legislation, regulations and standards set by the audit profession itself; despite these constraints, auditors will always have a significant amount of discretion in how they conduct audits. The adoption of generally accepted standards for audit does not remove the need for auditors to exercise good judgment in how audits are conducted; audit can never be fully mechanised. Appropriate incentives guard against loss of independence, and underpin the credibility of independent audit. However, it should be noted that in addition to the incentives provided by litigation, other important incentive mechanisms impinge on auditors including reputational incentives for the audit firm and career concerns of individual auditors.

31 Franz, Crawford and Johnson develop a model whereby litigation against an audit firm affects the market value of all its publicly traded clients (including the market value of the firm's clients that are not involved in the litigation). The authors suggest that this result is driven by two factors: first the allegation of audit failure damages the audit firms' reputation for providing quality services which adversely affects the perceived quality of its clients' audited financial statements and second that the initiation of a lawsuit against an audit firm creates the possibility of a significant decrease in the audit firm's financial resources. See Franz D, Crawford D, and Johnson E, ‘The Impact of Litigation Against an Audit Firm on the Market Value of Nonlitigating Clients’ (1998) Spring, *Journal of Accounting, Auditing and Finance* 117-134.

Indeed, the use of risk management and client screening procedures is now firmly rooted. This is supported by anecdotal observation,³² professional announcements³³ and empirical research.³⁴ IFAC, for example, reports that the selective acquisition of clients is pervasive.³⁵ Exactly what this implies needs careful examination, since increased screening of clients may have important economic consequences.³⁶ For example, the failure of embryonic firms to obtain an audit from a high reputation auditor is likely to frustrate their access to capital markets. This is particularly germane in IPOs. It may mean that innovative firms could be forced to delay obtaining a public listing as a result of difficulties in obtaining an audit from an auditor with high reputational capital.

Notwithstanding client screening, evidence suggests that the cost of practice protection measures are an increasing proportion of auditors' overall costs.³⁷ Table 1, for example, displays sensitive practice protection data released by the International Federation of Accountants (IFAC).³⁸

Table 1: Big Six US accounting and audit practice protection costs³⁹
(US\$ millions)

	1990	1991	1992
Gross accounting and audit revenues	\$5,257m	\$5,319m	\$5,470m
Costs of judgements, settlements and legal costs	\$367m	\$485m	\$783m
Gross costs as % of revenues	7.0%	9.1%	14.3%
Insurance premia net of insurance recoveries	\$27m	-\$8m	-\$185m

- 32 A recent International Federation of Accountants report documents numerous examples of client screening. Examples include:
- Arthur Andersen no longer audits companies listed on the UK's Alternative Investment Market. Such companies by the nature of their innovative activities and infancy are riskier to audit than those with conventional listings;
 - Charities in the UK are experiencing problems accessing high reputation audits. Due to less rigorous internal controls and the use of voluntary staff, charities are perceived by auditors as being a significant liability risk.
 - Coopers and Lybrand (currently Price Waterhouse Coopers) in the UK dropped the computer games software company Eldos in 1997 after it failed to implement improvements to corporate governance arrangements (including reviewing the effectiveness of financial controls).
- 33 London Economics, *The Economics of Audit Liability*, A Report for the International Federation of Accountants (1998); Big Six White Paper, *The Liability Crisis in the United States: Impact on the Accounting Profession* (1992) Position Statement of the 'Big Six' Accounting Firms (August 6).
- 34 See, for example, *A Disproportionate Burden of Liability*, Big Six submission to the US Securities and Exchange Commission (SEC) on 11 June 1993.
- 35 See Sixth Jerusalem Conference on Accountancy, *Is the Auditor Liable as Business Agent or a Professional?* November 12 (1996) at 15.
- 36 Client firm characteristics identified by risk management partners as favouring liability claims include fast growth, high risk of bankruptcy, high accruals/receivables, recent auditor change, size in relation to the auditor (since a client representing a large portion of an auditor's business may create independence issues), complexity of business, international operations (London Economics, *The Economics of Audit Liability*, A Report for the International Federation of Accountants (1998)).
- 37 For a discussion of the behaviour of public accounting firms regarding the decision to acquire professional liability generally, see Schaefer J, and Zimmer M, 'Liability Insurance Decisions and Premium Charges Among CPA Firms: An Empirical Analysis' (1997/98) 14(1) *Journal of Applied Business Research* 69.
- 38 Indeed, at present, audit reports are fairly non-descriptive, terse and homogeneous.
- 39 Big 6 submission to the US Securities and Exchange Commission (SEC), 'A Disproportionate Burden of Liability' on 11 June 1993 at 2.

	1990	1991	1992
Net audit practice protection costs	\$404m	\$477m	\$598m
Net costs as % of revenues	7.7%	9.0%	10.9%

Furthermore, a 1990 survey of small CPA firms in California found that only 53% were willing to do audit work (down from 61% in 1988). Of these, 32% were discontinuing audits in perceived high-risk sectors.⁴⁰ This raises issues about the long-term viability of the small/medium size audit market and the ability to obtain and retain qualified individuals.

It is thus clear that the liability regime is imposing huge costs on audit firms. In the US, the 1992 Big Six White Paper argued that the accounting profession is the subject of a significant amount of nonmeritorious litigation.⁴¹ Defending claims is difficult, time-consuming and financially burdensome. Palmrose provides evidence from 1972 to 1992 in the US indicating that it took an average of 3.7 years to conclude suits that resulted in either charges being dismissed or auditors making no payments to plaintiffs.⁴² Taking an extreme position, IFAC submits that professional indemnity insurance may even have the perverse effect of attracting litigation by increasing the pot of money potentially available for settlements.

From a policy point of view, there are important qualifications to the role of the auditor as a 'reputational intermediary'.⁴³ One is that participants in the market receive information about the company from a variety of sources before it is released in a formal manner to shareholders at each annual general meeting.⁴⁴

40 Ibid.

41 Big Six White Paper, *The Liability Crisis in the United States: Impact on the Accounting Profession* (1992) Position Statement of the 'Big Six' Accounting Firms (August 6). Palmrose provides some support to this proposition, finding that between 40 and 50% of all lawsuits against large accounting firms resulted in either the case being dismissed or settlement with the auditors paying nothing to the plaintiffs: see Palmrose Z, above n 19 at 67. In Australia most settlements represent only a small fraction of the initial claim. Psaros J, *The Audit Litigation Crisis: Critique* (1995) 19(1) Accounting Forum 3. For example, the 1995 claim by the Victorian State Government in respect of the Tricontinental audit by KPMG Peat Marwick was for \$1.1 billion, but the subsequent settlement was \$136 million (approximately 12%).

42 Using a common US defence attorney gauge of costs of \$1 million per year per lawsuit, Palmrose argues that this 3.7 year suit translates into average defence costs of \$3.7 million. Figures from the US Big 6 Position Statement indicate that in 1991 the average legal expense per claim was approximately \$US800,000 greater than the average cost of settlement. For a discussion of the effect of alternative legal cost allocation systems - the so-called American rule (where the plaintiff and the defendant pay their own litigation costs regardless of the outcome of the lawsuit) versus British rules (where the loser of the lawsuit pays the litigation costs of both parties) - on the value of audits see Boritz J and Zhang P, 'The Implications of Alternative Litigation Cost Allocation Systems for the Value of Audits' (1997) Fall, *Journal of Accounting, Auditing and Finance* 353.

43 See Corbett A above n 26. However, it should be noted that accounting and auditing profession has, through the development and publication of accounting concepts, statements and standards, encouraged a view that general purpose financial reports are prepared with a view to provide a broad group of 'users' with their respective information needs. Statement of Accounting Concepts 2 includes resource providers, recipients of goods and services and parties performing a review of oversight function within the definition of 'users': Australian Accounting Research Foundation, *Statement of Accounting Concepts SAC 2: Objective of General Purpose Financial Reporting* (1990) paras 16-19. Such a view of the function of financial statements, about which auditors form an opinion, is obviously incongruous with the notion, associated with the *Caparo* case, that auditors form opinions on financial statements with a limited function and this opinion is intended for a limited audience.

44 Theoretically anyone who makes a decision based largely on the results of an auditor's report and suffers a loss due to negligence in preparation by the auditor deserves compensation. Realistically, however, this is not usually the case. Most participants in the financial markets receive information from a number of sources

Another is that there are a number of other ways in which participants in the securities market can verify the accuracy of the information available to them.⁴⁵ Each of these factors has the effect of reducing the extent of the role of the auditor as the person responsible for verifying the accuracy of financial information held by participants in the market. Practically, the client is in the expert position and also in the position to disseminate the audit report to any entity it chooses and the auditor does not control who receives the work product. As Scherl notes, 'in essence, despite a limited role in the process, the auditor potentially faces 'massive' liability in a negligence suit by nonclients'.⁴⁶

There is recent judicial recognition of the need to strike a more even balance. The essence of this policy is demonstrated by Rogers J in *Brown & Hatton v National Australia Bank*:

I think I should make it clear that it is a matter of profound concern that directors should bear their proper share of responsibility with respect to losses suffered by their company. It is socially and commercially unjust and inappropriate that directors should escape liability completely and that the full burden of responsibility should rest on auditors.

Indeed, it is no coincidence that the courts allowed the defence of contributory negligence to auditors in the same decision in which they raised the standard of due care and diligence of directors.⁴⁷

Acemoglu and Gietzmann have shown that an intermediate level of legal liability has a positive role to play as a commitment device for auditors to signal their intentions to perform their duties with care.⁴⁸ It is submitted that the current regime as it applies in Australia exceeds this intermediate level and suggestions for reform should not be dismissed as motivated by crude self-interest alone.⁴⁹ The evidence with respect to client screening, practice protection measures and recent litigation trends support this view. Moreover, liability is a blunt,

prior to the formal release of financial statements by companies. According to the Efficient Markets Hypothesis, formal financial statements do not provide investors with new information which can be traded for profit. There are many means through which information reaches the securities market. The immediate consequence of this is that auditors when they verify the accuracy of the information provided to shareholders at each annual general meeting they are for the most part verifying the accuracy of information already in circulation and impounded into share price.

45 Corbett argues that 'the first amongst these is that *all* participants in the securities markets are forced to rely on the effectiveness of a company's system of corporate governance. See Corbett A above n 26.

46 The Californian Supreme Court in *Bily v Arthur Young & Co* at 763 noted that with the possibility that the client has liquidated or filed for bankruptcy, the auditor sits 'center stage as the remaining solvent defendant and is faced with a claim for all sums of money ever loaned to or invested in the client. Yet the auditor may never have been aware of the existence...of the third party transaction that resulted in the claim'.

47 *AWA Ltd v Daniels* (1992) 10 ACLC 1643. The decision of the New South Wales Supreme Court in this litigation availed the defence of contributory negligence to the auditing profession, overturning long existing precedents and reassessing corporate morality. It is submitted that this is a positive outcome which more fairly apportions blame and the costs associated with corporate losses.

48 Acemoglu D and Gietzmann M, 'Auditor Independence, Incomplete Contracts and the Role of Legal Liability' (1997) 6(3) *European Accounting Review* 355. The authors claim at 372:

In our model, if the legal liability is set too high, the audit market may collapse because it becomes more expensive to hire auditors who must insure against possibly very high legal liability claims. Set too low, market existence issues may also arise because there comes a point when shareholders do not value audits because they no longer have a clear reason to believe in the independence of auditors and the value of audited financial reports (unless such independence can be ensured by means of private contracts).

49 *cf* Lee T, 'The Audit Liability Crisis: They Protest Too Much!' (1992) December, *Accountancy* 102.

unsophisticated instrument for providing appropriate incentives to auditors. Independently, audit firms' concern for their own reputational capital and partners' career concerns pose substantial incentives. The audit profession also has structures in place to police audit quality.⁵⁰ Reforms may reduce the need for defensive audit, ease the pressure on auditors to select among and reject potential clients, improve the information content of audit reports and the incentives for other parties in the corporate governance process and give rise to a more defensible nexus between damage and damages.

An Overview of the Proposed Schemes to Limit the Liability of Auditors

Fundamental to the issue of the litigation is the doctrine of joint and several liability, which allows a plaintiff to recover entirely from any of the tortfeasors who caused the loss independent of their relative culpability. The fundamental purpose of joint and several liability is no doubt intended to provide the maximum opportunity for damaged parties to recover their losses. However, it is submitted that this principle causes injustice where insured auditors are sued rather than the more blameworthy but less attractive player. Small suggests that it substitutes one inequity for another:

It is difficult to see the fairness of a system that imposes a liability on a defendant out of all proportion to that defendant's actual responsibility for the damage suffered. This is merely replacing one inequity - that of a plaintiff being unable to fully recover damages - with another: a defendant having to pay far more than is just.⁵¹

The auditing profession, both in Australia and overseas, has responded to a perceived 'litigation crisis' by lobbying for schemes to limit the liability of auditors. A recent report published by the Auditor's Legal Liability Task Force of the International Federation of Accountants (IFAC) details a range of mechanisms by which a limitation of auditor liability might be achieved.⁵² The aim of this section is to overview some of the proposals attracting the most prominence in Australia: capping the amount of liability, incorporation of the firms of auditors, reforms to the law of joint and several liability and the introduction of limited liability partnerships.

50 IFAC argues, somewhat unconvincingly, that the Czech experience is indicative of the efficacy of the reputational mechanism. There is no liability for auditors in this jurisdiction. Substantially, Big 5 auditors deal with major assignments. IFAC goes on to draw an analogy with the forms of certification services:

An interesting analogy can be drawn with other forms of certification services. Credit rating agencies, for example, make judgements concerning the financial strength of companies and so there are some similarities to auditors. However, they do not incur any liability in providing this information to users. Like an auditor, a credit rating agency's services are only of value if the information it offers is credible. Although liability does not provide an incentive for the information issued to be accurate, the reputation mechanism does.

51 Small B, 'When the Well Runs Dry' (1994) June, *Charter* 14.

52 These include replacing joint and several liability with proportionate liability, allowing audit firms wider organisational options, providing for the limitation of liability in contract, putting in place penalties to discourage plaintiffs filing 'frivolous' suits, enacting statutory requirements for adequate insurance cover of both company directors and auditors, introducing statutory limits to auditor liability to third parties in negligence, reducing the auditors' professional responsibilities to third parties, strengthening privity standards and tightening the statute of limitations.

Capping

As a broad proposition, capping involves the statutory imposition of a limit to the quantum of liability for which a specific party can be held liable. This mechanism may take many forms including calculation as a multiple of the audit fees for a particular audit, or related to the amount of equity in the partnership, the amount of professional indemnity insurance cover or the assets of the partners.⁵³ The multiple of fee charged limit assumes that there should be a nexus between the extent of liability and 'the worth of the task performed as reflected in the fee paid for it'. It has been recognised that such a scheme would result in an incentive for the auditor to charge the smallest fee compatible with covering direct audit costs, and may result in the amount of work undertaken in carrying out the audit being determined by the desire to limit liability regardless of the risks involved in such a course of action.⁵⁴

Internationally, Germany, Austria, Greece and Portugal all currently have fixed statutory caps on liabilities arising from statutory audit work. Ironically, Gietzmann and Quick report that in Germany (where liability is restricted), many auditors are calling for increases in liability.⁵⁵ In Australia, the possible solution of statutory cap on auditors liability was entertained by the Companies and Securities Law Review Committee in 1986. Despite support from some sources, the initiative was not transposed into legislation by the Australian Commonwealth Government. Legislation providing for statutory caps on the liability of all professionals was, however, enacted in New South Wales in December 1994.⁵⁶ Western Australia proclaimed similar legislation in September 1997.⁵⁷

The New South Wales legislation requires approval by the Professional Standards Council of any scheme proposed by occupational associations on behalf of their members.⁵⁸ Under the legislation, a scheme may limit the liability of an action in two ways: it can either state a maximum dollar amount, or a

53 A survey of practitioners from Big Five, second tier and small practitioner firms in Australia predictably found overwhelming support for some form of limitation of the auditors' liability. The two favoured methods of limitation were a prescribed maximum liability as a multiple of fee charged for the audit, and a prescribed maximum liability as a percentage of assessed financial loss arising from the faulty audit: Adams K and Kimber D, 'To Limit or Not to Limit?' (1990) April, *Charter* 48.

54 One method of abuse might be to agree to a low audit fee but charge premium amounts for other work (such as management consulting projects and taxation advice, however clients may not be willing to accept this as it effectively limits any future claims that the client may have against the negligent auditor.

55 Gietzmann M and Quick R, 'Capping Auditor Liability: The German Experience' (1998) 23(1) *Accounting, Organizations and Society* 81-103. The authors find that in practice German auditors were content to increase to liability cap as part of a broader strategy to dilute pressures for an extension of their duties. Like their counterparts in other countries, German auditors were constantly being pushed into new roles with ever greater expectations. Acceptance of a higher liability cap, a seemingly irrational move, was thus a defensive initiative.

56 *Professional Standards Act* 1994 (NSW). Assent was given on 12 December 1994.

57 *Professional Standards Act* 1997 (WA). Assent was given on 18 September 1997.

58 *Professional Standards Act* 1994 (NSW) s 7. The approval process for a particular scheme involves a period of public exposure and comment and possibly a public hearing: ss 8, 9 & 11. Once the Council has considered matters such as the parties who will be affected by the scheme, the history of claims against members of the occupational association and the cost of professional indemnity insurance (s 10), the Council may submit the scheme to the Minister for approval: s 12. Under the Act, the scheme commences two months after its gazettal by the Minister (unless otherwise specified): s 14. Persons adversely affected by proposed schemes can appeal to the Supreme Court for remedy: s 15.

multiple to be applied to the reasonable charge for the services provided to which the action relates.⁵⁹ In return for the benefits accruing from participation in the scheme, professionals may be obliged to carry a prescribed amount of professional indemnity insurance⁶⁰ or maintain a minimum amount of business assets⁶¹ (or some combination thereof).⁶² An occupational association seeking the approval of a capping scheme must also provide the Professional Standards Council with details of proposed risk management strategies.⁶³ The scheme has not been without its critics. A report of the Working Party on the Ministerial Council for Corporations noted that capping in only two states could lead to 'forum shopping' by professionals, and that unless federal legislation was introduced to overcome the effect of the *Trade Practices Act 1974* (Cth), capping may be of little benefit.⁶⁴

Any capping proposal is susceptible to criticism alleging that it is inherently arbitrary. Such a mechanism also fetters the Court's discretion, flexibility and dampens its sensitivity to individual circumstances.⁶⁵ It has also been argued that the imposition of a statutory cap deals only with the excessive damages problem and does not reduce the significant costs of litigation and may undermine the credibility of the audit report.⁶⁶

Incorporation

Section 1279(1) of the Corporations Law restricts the registration of auditors to natural persons. The effect of this section, in conjunction with ss 324 & 327, is that auditors are not permitted to form themselves as limited liability corporations, and can only operate as sole traders or partners. In some jurisdictions, there has been incorporation by auditors, as for example by KPMG in the UK. Enabling incorporation effectively limits claims to the assets of the corporation (including insurance) and protects the assets of 'innocent' partners.

Liebman and Keely argue that incorporation undermines the credibility of the audit report.⁶⁷ Interestingly, in 1993, the Companies and Securities Law Review Committee expressed guarded support for incorporation. The Committee canvassed the possibility of a mandatory maintenance of a minimum level of net

59 Ibid s 23.

60 Ibid s 21.

61 Ibid s 22.

62 Ibid s 25.

63 Ibid s 36.

64 Report of the Working Party of the Ministerial Council for Corporations, *Professional Liability in Respect of the Corporations Law - Consideration of Capping Regime* October (1994) at 23.

65 In 1995, the Victorian Attorney-General, Mrs Jan Wade, indicated that Victoria will not permit the introduction of a statutory cap. She commented:

A cap means persons who suffer losses are not recompensed, and I suppose there is a thing with damages, if you reduce the impact of them, (auditors) are perhaps not as careful as they should be.

66 To this end, Anderson states:

An audit report with capped liability would imply that auditors are saying: The financial statements are true and fair, but only to the extent of our professional indemnity insurance; we are not so convinced of the fact that we will stake our partnership and private assets as well.

See Anderson H, 'A Different Solution to the Auditors' Liability Dilemma' (1996) *Bond LR* 72 at 87.

67 Liebman J and Kelly A, 'Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle' (1992) *American Business Law Journal* 30.

worth.⁶⁸ Other relevant considerations include taxation implications, and the associated increase in public scrutiny which may be unpalatable to audit partners.

Proportionate Liability

Proportionate liability apportions fault amongst all those responsible and may operate in a number of ways; enlivened when a defendant is partly at fault, when a defendant is insolvent or when a defendant's proportionate blame is less than a stated threshold. This effectively means that if one of the defendants is insolvent, the unrecovered loss will fall on the plaintiff, not the remaining solvent defendants.⁶⁹ Significantly, the Report of Stage Two of the *Inquiry into the Law of Joint and Several Liability* recommended the adoption of a scheme of proportionate liability, in all actions in the tort of negligence in which the plaintiff's claim is for property damage or purely economic loss.⁷⁰

However, as several commentators have noted, if proportionate liability is introduced, plaintiffs may be undercompensated in many cases involving claims against auditors, directors and the audited company. Certainly, auditors are often sued for negligent misstatement by shareholders and creditors of companies because those companies are now insolvent and unable to meet their obligations.⁷¹ This has led to several calls for mandatory insurance for directors, which may deflect litigation away from the audit community.⁷² There are strong arguments to support such a regime. Both capping and incorporation diminish the credibility of the audit report, and neither is entirely beneficial to the auditor, nor to financial statement users. Proportionate liability does not involve a reduction of the auditor's responsibilities in relation to the conduct of the audit and the production of the audit report. The liability of auditors is not reduced because proportionate liability allows them to rely blindly on information supplied by management. Rather, the reality that errors in the financial statements are partly due to the negligence of the company and its directors in failing to prevent their inclusion is acknowledged.⁷³ The mandatory requirement

68 Such a suggestion is in no doubt prompted by the practice of entering into schemes and arrangements with the dominant purpose of placing assets outside the reach of possible future judgment creditors.

69 The report also recommended that claims against professionals for misleading and deceptive conduct under s 52 of the *Trade Practices Act 1974* (Cth) and the state *Fair Trading Acts* also be subject to proportionate, rather than joint and several, liability: *ibid* at 39.

70 Report of Stage Two of the *Inquiry into the Law of Joint and Several Liability* January (1995) at 34.

71 A related concern is the suggestion that a condition precedent for bringing an action against the auditor should be that all existing remedies against those with primary responsibility must have been exhausted: CSLRC Discussion Paper, paragraph 54. However, as Langfield-Smith points out, such a condition precedent would substantially increase the costs of litigation and force delays to be borne by the innocent victims of the neglect of duty on the part of the auditor and management. A more effective solution would be to require the delinquent directors and managers to be made defendants in all actions against auditors.

72 Auditors who are members of the two leading professional societies (the Institute of Chartered Accountants in Australia (ICAA) and the Australian Society of Certified Practising Accountants (ASCPA)) are obliged to have professional indemnity insurance, for the compensation of persons suffering loss as a result of the act or default of an auditor. For example, the Institute of Chartered Accountants in Australia by-laws paragraph 407 provides that each principal in public practice is required by the professional associations to have a minimum level of insurance of \$250,000. Such insurance must cover 'either any civil liability or any act, error or omission of an insured providing the services for a current Certificate of Public Practice is required' and must be maintained for seven years after the person has ceased to practice.

73 See Anderson H, above n 66.

that directors of companies hold a minimum level of insurance increases the appeal of this alternative.

Limited Liability Partnerships

This structure has been described as a 'pseudo-corporation',⁷⁴ in the sense that limited partners are only responsible for the debts and obligations up to the amount they have agreed to contribute to the firm.⁷⁵ The principal advantage of limited liability partnerships is the preservation of unlimited liability of the engagement partner responsible for the audit whilst offering some protection to 'innocent' partners. In this regard Walker notes:

It is plainly inequitable that individuals who may have had no knowledge or involvement with the audit of a particular company should face financial ruin because of the mistakes of their partners.⁷⁶

In the United States in 1994, each of the Big Five auditing firms have taken the opportunity to form limited liability partnerships under legislation enacted in 1994. In Australia, at present Limited Liability Partnership Acts exist in Tasmania, Western Australia, New South Wales, Queensland and Victoria.⁷⁷ These Acts require significant amendment before becoming appropriate vehicles to limit auditor liability in Australia. Limited partners, under these Acts, have no authority to engage in corporate management or bind the limited liability partnership in contract. In addition to this, the liability of any other limited partner involved in quality control activities (including second partner review) would need to be clearly elucidated.

Other Proposals

The effect of the *Corporate Law Reform Act 1993* was to amend the prohibition against companies indemnifying or insuring their officers and auditors against the costs and expenses incurred in legal proceedings (except in the case of wilful breach of duty or a contravention of s 232(5), 232(6)).⁷⁸ It has, however, been

74 Gibson R and Simnett R, 'A Review of Proposed Schemes to Limit the Liability of Auditors' (1995) Unpublished Research Manuscript, UNSW.

75 Under such a structure, a partnership is composed of general and limited partners. General partners have unlimited liability for the debts of the partnerships. Partners with 'limited' status are only held liable for the debts of the partnership to the extent of their contribution to the partnership, unless they are held personally responsible for the judgment action. Limited partners can not play a role in the management of a limited liability firm, and such involvement will forfeit the status of limited liability partnership.

76 Walker B, 'Putting the Cap On Auditors' Liabilities' (1993) 5 *New Accountant* 11.

77 The *Limited Partnership Act 1907* (UK) introduced that form belatedly into England and that legislation was the model for the *Limited Partnerships Act 1908* (Tas) and *Limited Partnerships Act 1909* (WA). Queensland provides for limited partnerships through the *Mercantile Acts, 1867-1974*, ss 53-68 as does the *Partnership Act 1958* (Vic) Part 3 in Victoria. The New South Wales *Partnership Act* was amended in 1991 to introduce the limited partnership form in that State: ss *Partnership (Limited Partnership) Amendment Act 1991 (NSW)*, No 48. New Zealand similarly provides for them under the name 'special partnerships' in the *Partnership Act 1908*, Pt II, ss 48-67. See Redmond P, *Companies and Securities Law* (1992) (2nd ed), The Law Book Co Ltd, Sydney at 1131.

78 s 241A *Corporations Law*. For example, Chua reports that in February 1994, the Vaux Group passed a scheme at its annual general meeting whereby the company permitted its directors to purchase insurance for the purposes of covering its auditor's liability. s 241A raises questions about auditor independence, and some of the shareholders at the meeting objected on the grounds that the company's funds should not be

suggested that this option is unpopular with corporate clients, and the auditing profession is 'struggling to sell the advantages of risk sharing through a division in the cost of insurance'.⁷⁹

Interestingly, several authors have focused on the criminal liability of auditors pursuant to s 1308 of the Corporations Law (which deals with false and misleading statements) for failing to qualify financial statements which presented a distorted picture of a company's financial position.⁸⁰ However, to the author's knowledge, no auditor has yet been convicted under this provision in relation to a major corporate collapse. It has also been suggested that the adoption of administrative sanctions such as those used by the Securities and Exchanges Commission in the United States of America be used to reduce the risk of audit failure.⁸¹

Conclusion

There has been a marked tendency to blame the auditor for the failure of directors and senior management to adequately and properly supervise the business or even warn against unsound business decisions. Needless to say that is not part of the auditing function.

Chief Justice Rogers⁸²

Unequivocally the liability of auditors is a serious and polemic issue. It is clearly on the agenda of professional bodies, it is the subject of law reform inquiries and exercises judicial and legislative bodies internationally. The evidence in this paper suggests that the costs of litigation against accounting firms in recent times has reached unprecedented proportions. Accounting firms appear to face the brunt of very expensive litigation, even when their part in the events which lead to the plaintiff's losses is relatively minor. A more intermediate form of legal liability appears to be a more appropriate model in which to formulate the responsibilities of auditors - promoting responsible conduct on the part of economic players, while taking into account the commercial and economic realities of the marketplace. Consistent with some of the recent literature, it is submitted that the introduction of proportionate liability (and mandatory director insurance) and possibly a reinvention of the calculus of damages would be a sensible start to the process of change.⁸³

deployed for the advantage of its auditors: Chua S, 'More Thoughts on the Auditor's Liability in Negligence in Respect of the Audit Report' (1995) 16(7) *The Company Lawyer* 195.

79 See Gibson R & Simnett R, above n 74.

80 See, for example, Markovic M, 'Auditors' Criminal Liability: Another Approach' (1996) 6 *Australian Journal of Corporate Law* 48-71 and Markovic M and Langton R, 'Directors and Misleading Financial Statements: Another Perspective' (1995) 8 *Corporate and Business Law Journal* 27.

81 This suggestion was made by the Australian Shareholders' Association in its submission to the CSLRC, Discussion Paper No 3. Such sanctions range from the suspension of the registration of an auditor to injunctions preventing an audit firm from accepting new clients.

82 Rogers A, *Today's Plaintiff - Tomorrow's Defendant - A Proper Allocation of Liability* (1992) RJ Chambers Research Lecture, University of Sydney at 2.

83 Should some form of limited liability be introduced, an important challenge is to ensure that satisfactory standards of work are maintained. An accompanying introduction of stricter disciplinary proceedings and a more open review of standards of work by members of the profession (such as external review) would certainly make any limitation more palatable.