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LESSONS FROM SOUTH OF THE BORDER

U.S. AUDITORS, THEIR CLIENTS AND LAWYERS GRAPPLE WITH DISPROPORTIONATE LIABILITY

United States federal securities laws have long exposed auditors to liability far in excess of their audit fees. While recent court decisions and legislative changes in the U.S. are improving the situation, disproportionate liability faced by accounting firms has resulted in significant impacts that continue to resonate well beyond the financial services sector.

Many accounting firms have become hesitant to do audit work for U.S. public companies. Many smaller firms are turning away this business because insurance costs and potential litigation exposure are too great to justify the audit fees.

Statistics show that the Big Four firms now audit over 80 per cent of all U.S. public companies, which themselves account for 99 per cent of the revenue generated by these same companies. This is because the large firms are best able to manage the risk of disproportionate liability.

But even the Big Four firms are telling their medium-sized clients to go elsewhere, because the fees paid by these clients are too small to justify the audit risk. This risk has resulted in increased audit fees across the board. Audit firms are becoming much more selective about who they accept as clients, which in turn requires a thorough and potentially costly investigation of the client before starting work. Accounting firms also have to change their litigation strategies to suit this new environment.

In the U.S., accountants are liable in two ways: expressly under subsection 11 of the Securities Act of 1933, and impliedly under subsection 10 and Rule 10b-5 of the Securities Exchange Act of 1934. Accountants have started using new litigation tactics to minimize their potential liability.

The 1933 Act regulates the offer and sale of securities to the public. It requires that an issuer file a prospectus with the U.S. Securities and Exchange Commission containing financial statements and other disclosures that a prospective investor would find important in deciding whether to buy the issuer's stock. The financial statements are audited by outside accountants, who then certify that they are accurate and not misleading.

Section 11 provides that accountants who prepared or certified any part of the prospectus may be held liable for any material misrepresentations or omissions that they certified. The only legitimate defence is to show due diligence. To prove this, auditors must show, among other things, that i) after conducting a reasonable investigation, ii) they had reasonable grounds iii) to believe and iv) did believe that v) the statements in the prospectus which it certified were true and vi) that they did not fail to state any material facts. Although there are cases and official guidelines interpreting this defence, each situation requires an expensive factual investigation and often a trial to resolve this type of factual defence.

Section 10 and Rule 10b-5 of the 1934 Act make it unlawful in connection with the purchase or sale of securities to make any untrue statement of a material fact or omit to state a material fact necessary in order to make a statement not misleading.

Even though the U.S. Supreme Court ruled that only the actual maker of a misleading statement is liable, accountants are still named as defendants. Recent decisions have limited outside auditors' liability to situations where significant "red flags" indicate a potential problem. The rationale is that an accountant's exhaustive audit procedures should put it on notice to investigate potential irregularities.

Although recent U.S. legislation and court decisions are reducing accountants' exposure, there is still a discrepancy between an audit firm's fees and its potential liability. Auditors need to make a decision about whether they want to accept this kind of work, and if so, what they can do to limit their potential exposure. The focus should be on ensuring high-quality and thorough work while remaining sensitive to warning signs that a client may be giving it false or misleading data. When all else fails, the auditor should be ready to take a strong litigation posture and to aggressively pursue others to dilute their potential liability. □

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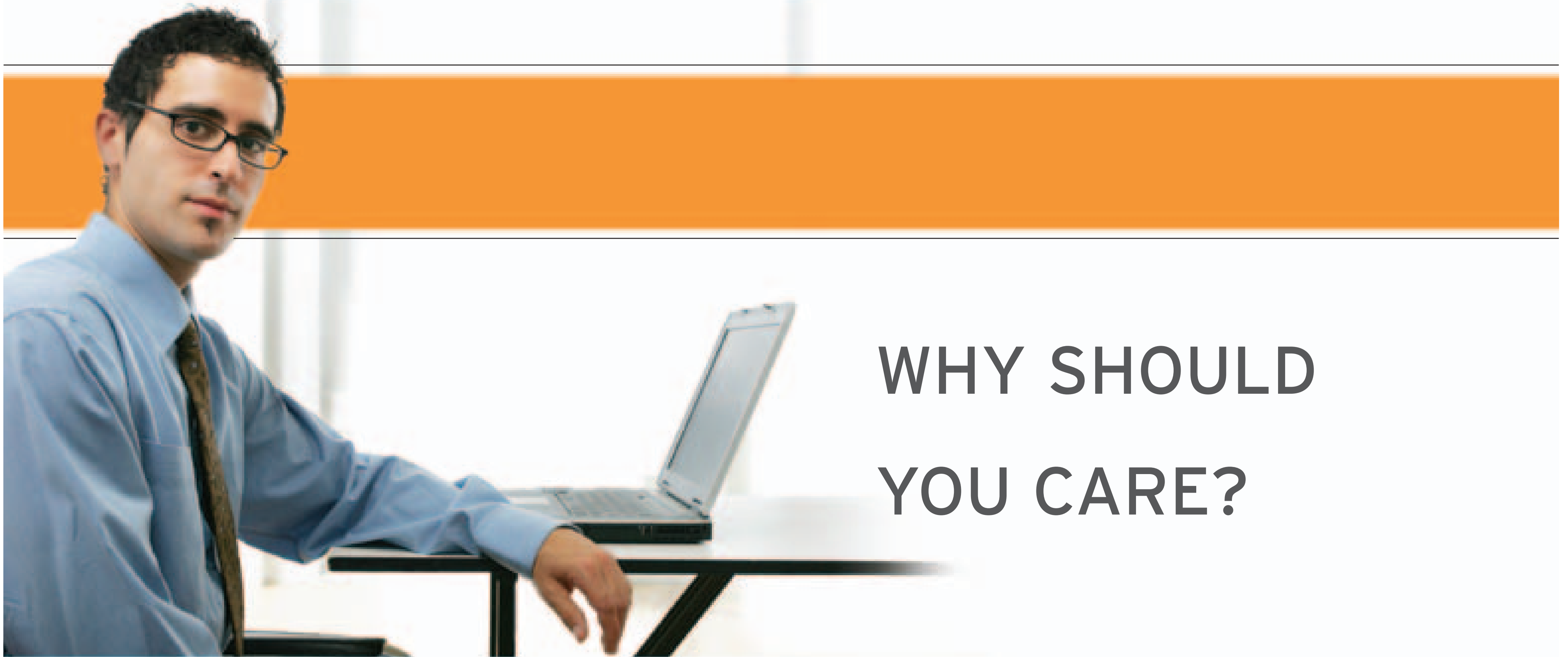

INSURANCE

RISING INSURANCE COSTS HIT BUSINESSES' BOTTOM LINES

As a result of disproportionate liability, many insurers have stopped selling liability insurance to CA firms because the risk can be catastrophic. While the largest firms pool resources to overcome this challenge, smaller accounting firms lack that economy of scale.

The result, says Mindy Paskell-Mede, a lawyer whose practice is principally focused on liability defence and coverage litigation, is that there is significant disincentive for CA firms to venture into certain lines of practice. "For example, firms that don't have a very large audit practice find they aren't able to venture there at all. They are not big enough to self-insure, and what we're seeing in the insurance world is that the more audits you do, or the larger the audits are, and the more public companies you audit, the less likely it is that the insurer is going to offer you an insurance policy at reasonable rates."

This can have a very negative impact on clients, she says. "It means that clients who need those services have to go elsewhere, and as there are fewer and fewer firms offering those services, you don't have a lot of competition happening."

As the premium increases must be factored into the cost of doing business, the result may also be higher financial service costs for the companies that require those services. Alternatively, they may simply purchase less insurance than they would prefer to have. "That means that if something bad happens and there is a lawsuit, the people who were injured may find that they're not going to get fully indemnified anyway, because the firm isn't carrying sufficient limits to cover the losses," says Ms. Paskell-Mede.

The change has occurred over the last decade, as lawsuits have gotten bigger and globalization has created a more risk-laden business climate. "Canada has moved into the high stakes games – our homegrown companies are much larger and we now have Canadian multinationals with subsidiaries in foreign countries," she says. "We have more and more companies that raise capital on American exchanges, and our companies are doing international deals. All these risk factors introduce an international flavour to litigation and this increases the risk significantly.

"Our financial service professionals follow their clients on to the world stage."

For accountants, particularly auditors, insurance costs can be prohibitive – but of equal concern is the patent unfairness that is driving those costs. Joel Cohen, senior partner of RSM Richter, says, "If a business fails, and stakeholders sue, and any one of the defendants can't pay up, the rest of the defendants must pay up. A court could in fact say that the auditors were 20 per cent responsible, and you would think that we should then pay 20 per cent of the award. That is only true if everybody else can meet their obligation."

What that means, says Mr. Cohen, is that accounting firms must be risk averse. "We are very careful. You can't simply rely on insurance and take on any risk, because you'll soon find that if you have too many claims, you'll be uninsurable. Nobody would be comfortable carrying on a public accounting business without indemnity protection. So clearly, fewer companies are able to get access to needed financial advice and services." □