

2011

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Recommended Citation

Thomas C. Pearson, *Potential Litigation Against Auditors for Negligence*, 5 Brook. J. Corp. Fin. & Com. L. (2011).
Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol5/iss2/4>

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POTENTIAL LITIGATION AGAINST AUDITORS FOR NEGLIGENCE

*Thomas C. Pearson**

This Article addresses potential litigation against auditors for negligence, an especially important topic because such litigation is likely to increase in future years. Several reasons exist for more litigation on negligence. First, in the 2010 Supreme Court case reviewing the status of the Public Company Accounting Oversight Board (PCAOB), both sides accepted the PCAOB as a government regulatory agency, at least for some purposes. This implies that the auditing standards as approved by the Securities and Exchange Commission (SEC) should have some legal status. Second, three major reforms of relevant professional standards are occurring. Because the new standards leave more room for judgment, they are likely to increase litigation against auditors. Third, the auditing industry's fundamental duties of care to avoid negligence are extensive and illustrated primarily by inspection reports and enforcement cases presented by the PCAOB. Fourth, recent attempts to limit auditors' liability have failed. Thus, real steps by the auditing profession are needed primarily to raise the quality within the profession to help limit potential future litigation against auditors.

INTRODUCTION

Auditing plays an essential role for society's capital markets.¹ The auditing profession is expected "to bring integrity, independence, objectivity, and professional competence to the financial reporting process."² The auditor is not an insurer of the financial statements, but does provide reasonable assurances to management's representations in financial statements.³ Auditing of public companies⁴ has become increasingly

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1. The U.S. Supreme Court has even summarized the important role of auditing. *See* *United States v. Arthur Young & Co.*, 465 U.S. 805, 810–11, 817–18 (1984).

2. U.S. GOV'T. ACCOUNTABILITY OFFICE, GAO-08-163, AUDITS OF PUBLIC COMPANIES: CONTINUED CONCENTRATION IN AUDIT MARKET FOR LARGE PUBLIC COMPANIES DOES NOT CALL FOR IMMEDIATE ACTION 7 (2008), *available at* www.gao.gov/new.items/d08163.pdf.

3. It is important to remember that "[a]uditors do not make the business decisions or create the external events that cause a company's failure." Rod Phelan & Gavin R. Villareal, *Issues in Accountant Liability Litigation Arising from Business Failures* (Tex. Trial Lawyers Ass'n Commercial Litig. Seminar, Discussion Draft, 2006), *available at* <http://www.bakerbotts.com/infocenter/publications/?page=81> (follow "Issues in Accountant Liability Litigation Arising from Business Failures" hyperlink).

4. An audit of a public company is "an examination of the financial statements of any issuer

intertwined with the law⁵ in the decade following the Sarbanes-Oxley Act of 2002 (SOX).⁶ Dramatic developments in the profession,⁷ Congress, regulatory agencies, and the courts, have affected the environment for auditing and litigation against auditors.

SOX was landmark legislation which expanded upon the duty for internal controls for public companies.⁸ SOX also added penalties for financial crimes,⁹ including interference with an audit or government investigation.¹⁰ It substantially improved corporate governance and the “tone at the top” of public companies.¹¹ SOX has also produced some improvements in internal controls, financial reporting and disclosure, and the performance of auditors, and has enhanced government enforcement.¹²

The PCAOB, created by SOX,¹³ replaced self-regulation of the audit profession,¹⁴ and led to stronger oversight of financial reporting.¹⁵ The United States government encouraged other countries to establish similar quasi-governmental oversight over auditors, independent from the

by an independent public accounting firm in accordance with the [PCAOB] rules . . . for the purpose of expressing an opinion on such statements.” See Sarbanes-Oxley Act of 2002 § 2(a)(2), 15 U.S.C. § 7201(2) (2006).

5. In leading capital market countries, more auditing authorities have become law in order to increase accountability of public companies, their auditors, and the standard setters in auditing and accounting. See generally Thomas C. Pearson, *Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)*, 31 N.C. J. INT’L L. & COM. REG. 65 (2005).

6. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, and 29 U.S.C.).

7. Audit methods have evolved during the past couple decades, such as increased “risk based auditing.”

8. 15 U.S.C. § 7262 (2006).

9. Penalties for financial crimes added by SOX include financial fraud, white collar crime, and improper certification of financial statements by the Chief Executive Officer and Chief Financial Officer. See 18 U.S.C. §§ 1341, 1501 (2006).

10. 15 U.S.C. § 7242(a) (2006); 18 U.S.C. § 1512 (2006).

11. For example, an enhanced audit committee role has occurred as a result of SOX. 15 U.S.C. § 78j-1 (2006).

12. Cf. U.S. GEN. ACCOUNTING OFFICE, GAO-03-419SP, GAO FORUM ON GOVERNANCE AND ACCOUNTABILITY: CHALLENGES TO RESTORE PUBLIC CONFIDENCE IN U.S. CORPORATE GOVERNANCE AND ACCOUNTABILITY SYSTEMS (2003), available at <http://www.gao.gov/new.items/d03419sp.pdf> (identifying “challenges facing regulators, the accounting profession, and boards of directors and management of public companies in effectively implementing the Sarbanes-Oxley Act of 2002 and related regulatory actions to improve public confidence in U.S. corporate governance and accountability systems”).

13. 15 U.S.C. § 7211 (2006).

14. See Daniel L. Goelzer, *Auditing Under Sarbanes-Oxley: An Interim Report*, 7 J. BUS. & SEC. L. 1, 4, 5 (2007). See generally James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L. Q. 301, 304 (2003).

15. See Goelzer, *supra* note 14, at 1, 2, 4 (discussing how the unreliability of financial information was painfully evident after uncovering massive amounts of fraudulent financial statements of major companies in the early 2000s).

profession. Such changes in overseeing the auditing profession have made it possible for more global interaction of regulatory authorities.¹⁶

Inspections of financial audits are among the powers delegated to the PCAOB.¹⁷ The quality of such inspection reports has been the PCAOB's real success to date.¹⁸ These reports have revealed that many deficient audits exist, with a substantial number of audits having failed at least once to apply a basic generally accepted accounting principle (GAAP) or by implication, generally accepted auditing standard (GAAS).¹⁹ The preface of each PCAOB inspection report shows that the PCAOB believes its reports are merely produced for remedial educational purposes, not for any legal uses.²⁰

In 2010, in *Free Enterprise Fund v. PCAOB*,²¹ the Supreme Court accepted the PCAOB's legal status as a governmental agency.²² Although

16. See PRICEWATERHOUSECOOPERS LLP, 2008 SECURITIES LITIGATION STUDY 53 (2009), <http://10b5.pwc.com/PDF/NY-09-0894%20SECURITIES%20LIT%20STUDY%20FINAL.PDF> [hereinafter PWC 2008 STUDY] (“[R]egulators around the [world have] becom[e] more active and [are] increasing cooperation [with the SEC].”). In 2008, the SEC assisted with over 590 requests from foreign regulators as a result of “several bilateral and multilateral arrangements that the SEC has entered into in recent years.” U.S. SEC. & EXCH. COMM’N, 2008 PERFORMANCE AND ACCOUNTABILITY REPORT 5 (2008), www.sec.gov/about/separ/separ2008.pdf.

17. 15 U.S.C. § 7214 (2006). Other PCAOB powers include regulating the industry through registration of audit firms of public companies, standard setting, and enforcement actions against registered accounting firms performing audits of public companies. *See id.* §§ 7212, 7215, 7218.

18. *See generally* Thomas C. Pearson & Gideon Mark, *Investigations, Inspections, and Audits in the Post-SOX Environment*, 86 NEB. L. REV. 43, 84–85 (2007) (discussing the effects of the PCAOB inspections and reports). Compared to prior peer reviews conducted within the industry, “PCAOB’s inspections are more rigorous, more technical, and more intense.” *See id.* at 81.

19. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., REL. NO. 2007-010, REPORT ON THE PCAOB’S 2004, 2005 AND 2006 INSPECTIONS OF DOMESTIC TRIENNALLY INSPECTED FIRMS (2007), http://pcaobus.org/Inspections/Documents/2007_10-22_4010_Report.pdf [hereinafter REPORT ON PCAOB].

20. *See, e.g.*, PUB. CO. ACCOUNTING OVERSIGHT BD., REL. NO. 104-2005-082, INSPECTION OF BECKSTEAD & WATTS, LLP (2005), http://pcaobus.org/Inspections/Reports/Documents/2005_Beckstead_and_Watts.pdf [hereinafter INSPECTION OF BECKSTEAD & WATTS]. “[R]eferences [to violation of laws, rules, or professional standards] are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability.” *Id.*

21. *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138 (2010). A constitutional challenge to the PCAOB’s legal status was started after a small boutique audit firm received a critical inspection report from the PCAOB. *Id.* at 3149. A non-profit public interest organization, Free Enterprise Fund, joined the audit firm as plaintiffs in the litigation. *Id.* The Court of Appeals in a 2-1 decision held that there was no constitutional problem. *Id.* The Supreme Court held in a 5-4 decision that the only unconstitutional aspect was the double removal clause, an easily fixable problem. *Id.* at 3146, 3151, 3161, 3164. For the accounting perspective on the case, see Ronald R. King, *The PCAOB Meets the Constitution: The Supreme Court to Decide on the PCAOB’s Conformity with the Separation of Powers Doctrine and Appointments Clause*, 24 ACCT. HORIZONS 79 (2010). For details of the investigation that launched the case, see INSPECTION OF BECKSTEAD & WATTS, *supra* note 20, at 3 (finding that in half of the audits inspected, the audit firm did not obtain “sufficient competent” evidence to support its audit opinion).

22. *Free Enter. Fund*, 130 S. Ct. at 3163–64.

the case's real significance is its effect on administrative law,²³ indirectly, the case reveals how the auditing profession's audits of public companies are legally regulated. The majority opinion of the Court of Appeals for the D.C. Circuit was based on the reasoning that the PCAOB is subject to pervasive SEC control.²⁴ The SEC's control over the PCAOB includes the SEC's power to approve the PCAOB's budget.²⁵ Also, while the PCAOB can propose rules, the SEC decides whether to adopt them.²⁶

Part I of this Article discusses major developments in professional standard reforms that impact litigation against auditors for negligence. These new standards include the adjustment to new U.S. GAAP, the movement toward international accounting standards, and a likely subset of accounting standards for private companies. These accounting changes also enable more second guessing by litigators as to whether an accountant and an auditor have properly applied the appropriate accounting standards.

Part II analyzes potential negligence by auditors. Specifically, duties of care that auditors owe are revealed through breaking down the professional standards into fundamental material duties. Breaches of these duties are often illustrated in the PCAOB's releases for inspection reports of firms and enforcement actions.

Part III examines the audit industry's failed recent pursuit of legal liability limitations. The failure of the auditing industry to gather any significant support for liability limitations is an additional development suggesting how the public views litigation as one means to accountability.

Part IV proposes reforms both in the law and the auditing profession in response to the real need of the auditing profession to raise the audit quality to prevent potential litigation. The public expects high audit quality and the

23. See Richard H. Pildes, Free Enterprise Fund, *Boundary-Enforcing Decisions, and the Unitary Executive Branch Theory of Government Administration*, 6 DUKE J. CONST. L. & PUB. POL'Y 1 (2010). See generally Steven G. Calabresi & Christopher S. Yoo, *Why Professors Bruff and Pildes Are Wrong About the PCAOB Case*, 62 VAND. L. REV. EN BANC 133 (2009); Michael A. Carvin, Noel J. Francisco, & Christian G. Vergonis, *Massive, Unchecked Power by Design: The Unconstitutional Exercise of Executive Authority by the Public Company Accounting Oversight Board*, 4 N.Y.U. J. L. & BUS. 199 (2007); Michael R. Keefe, *The Constitutionality of the Double For-Cause Removal Restriction: Free Enterprise Fund v. Public Company Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. 2008), 77 U. CIN. L. REV. 1653 (2009); Gary Lawson, *The "Principal" Reason Why the PCAOB Is Unconstitutional*, 62 VAND. L. REV. EN BANC 73 (2009); Donna M. Nagy, *Is the PCAOB a "Heavily Controlled Component" of the SEC?: An Essential Question in the Constitutional Controversy*, 71 U. PITT. L. REV. 361 (2010); Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975 (2005); Richard H. Pildes, *Putting Power Back Into Separation of Powers Analysis: Why the SEC-PCAOB Structure is Constitutional*, 62 VAND. L. REV. EN BANC 85 (2009).

24. *Free Enter. Fund*, 130 S. Ct. at 3149. The SEC plays an essential role in the auditing environment, due to its role in letting the private sector set accounting standards for public companies. Also, the SEC can establish accounting practices for public companies, such as Application of Regulation S-X, 17 C.F.R. § 210 (2010).

25. 15 U.S.C. § 7219 (2006).

26. *Id.* § 7217(b)(2).

profession needs to take more self-help steps to minimize likely litigation against the industry in the future. Conclusions are presented at the end.

I. REFORMS OF PROFESSIONAL STANDARDS ASSIST LITIGATORS' ATTACKS

Standards in accounting and auditing exist to encourage corporate management and their accountants to exercise due professional care in the performance of their duties.²⁷ Due care imposes a professional responsibility on the auditors to follow generally accepted auditing standards and apply generally accepted accounting principles in auditing the financial statements of a client entity.²⁸

A serious problem for the auditing profession was that the increased complexity of accounting standards had overwhelmed the capacity of most accounting and auditing professionals.²⁹ Furthermore, a confusing set of multiple sources existed for GAAP. In 2009, the Financial Accounting Standards Board (FASB) sought to help by creating the Accounting Standards Codification (ASC), a single source for U.S. GAAP.³⁰

In the process of creating the ASC, U.S. GAAP is now shorter, more principled, and easier to research than old U.S. GAAP. Litigation over application of professional standards should once again generate a demand for more detailed accounting and auditing rules. Since finding appropriate authority is much easier work than previously, these changes make it more likely that litigators can and will conduct accounting and auditing research. They can find the appropriate accounting authority that should have applied to the financial statements under scrutiny in the litigated case. One area of the ASC of particular concern is the likely increase in disclosure for certain loss contingencies.³¹ The fear is that increased disclosure will likely lead to

27. See CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 113, §§ 150.02, 230.01 (Am. Inst. of Certified Pub. Accountants 2006).

28. Enforcement of professional standards relies primarily on the responsible individual or organization, secondarily upon the accounting professionals, thirdly on auditors, fourthly on investigation by the overseeing government agency, and lastly by litigation in the courts.

29. See FIN. ACCOUNTING STANDARDS BD., NOTICE TO CONSTITUENTS (V 4.1) ABOUT THE CODIFICATION 5 (2010).

30. *Id.* The SEC is authorized to determine the accounting principles for the financial reporting by public companies, such as application of Regulation S-X, 17 C.F.R. § 210.1-01 (2010). However, the SEC usually defers to the FASB to create accounting standards. See Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, 68 Fed. Reg. 23,333, 23,335 (May 1, 2003).

31. "In July 2010, the FASB issued an Exposure Draft, *Contingencies ([ASC] 450): Disclosure of Certain Loss Contingencies*." Randall D. McClanahan, *Law and Accounting Committee Summary of Current FASB Developments*, JOHNSTON BARTON ATTORNEYS (2010 ABA Annual Meeting, San Francisco, CA), Aug. 7, 2010, at 1; FIN. ACCOUNTING STANDARDS BD., FINAL ACCOUNTING SERIES, CONTINGENCIES (TOPIC 450): DISCLOSURE OF CERTAIN LOSS CONTINGENCIES (2010). The proposed changes increase the required disclosures. See McClanahan, *supra*. For a discussion of loss contingencies, see Kenneth E. Harrison & Thomas C.

more litigation.³²

International financial reporting standards (IFRS) are the product of the International Accounting Standards Board (IASB).³³ In 2007, the IASB was recognized by the SEC as an official standard setter in accounting.³⁴ The initial roadmap for convergence of accounting standards has evolved into a comprehensive IFRS “work plan” to permit U.S. public companies to use IFRS.³⁵ It is possible that U.S. public companies will start using IFRS in 2015.³⁶ Initially, the change from U.S. GAAP to IFRS creates an increased chance of litigation because of the “greater risk of misunderstanding and of improper application of” the standards, given unfamiliar rules.³⁷ Adoption of the IFRS will also create an expanded litigation risk for auditors and accountants because of fewer rules and more decisions based on the auditor’s judgment.³⁸ Professional judgment requires reasoning based on a

Pearson, *Communications Between Auditors and Attorneys for the Identification and Evaluation of Litigation, Claims, and Assessments*, 3 ACCT. HORIZONS 76 (1989).

32. See Letter from Thomas W. White (Chairman of the ABA’s Law and Accounting Committee), et al., to International Accounting Standards Board, on Measurement of Liabilities in IAS 37: Proposed Amendment to IAS 37 (May 19, 2010), <http://www.abanet.org/buslaw/blt/content/2010/11/0005.pdf>.

In-house attorneys particularly may face pressures to disclose sensitive legal advice. In their financial statements, reporting entities will need to disclose, with respect to recognized liabilities that are subject to estimation uncertainty, the expected timing of payments and an indication of the uncertainties about the amount or timing of such payments.

Id. at 3.

33. About the IFRS Foundation and the IASB, IFRS FOUND., <http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm> (last visited Feb. 9, 2011). International accounting standards are included within the IFRS. *Id.*

34. Thus, foreign companies may now file their financial statements with the SEC using IASB’s IFRS without reconciling to U.S. GAAP. See Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, 73 Fed. Reg. 986 (Jan. 4, 2008) (to be codified at 16 C.F.R. pts. 210, 230, 239, 249).

35. See Matthew E. Kaplan & Steven J. Slutzky, *Goodbye Roadmap, Hello Work Plan: SEC Continues to Consider Use of IFRS by U.S. Issuers*, ACCT. POL’Y & PRAC. REP. (BNA), May 14, 2010, available at 2010 WL 1917096.

36. OFFICE OF THE CHIEF ACCOUNTANT, U.S. SEC. & EXCH. COMM’N, WORK PLAN FOR THE CONSIDERATION IF INCORPORATING FINANCIAL REPORTING STANDARDS INTO THE FINANCIAL REPORTING SYSTEM FOR U.S. ISSUERS 2 (2010), <http://www.sec.gov/spotlight/globalaccountingstandards/globalaccountingstandards.pdf>. See also Commission Statement in Support of Convergence and Global Accounting Standards, 75 Fed. Reg. 9,494, 9,495 (Mar. 2, 2010).

37. Jay Epstein & Susan Cheng, *Broader Acceptance of IFRS in U.S. Capital Markets: Implication for Attorneys*, 14(1) SEC. LAW (Int’l Bar Ass’n Legal Practice Div., London, U.K.), Apr. 2008, at 21, 22, available at <http://www.int-bar.org/images/downloads/Newsletters/SecuritiesLawApril2008.pdf>. See generally William W. Bratton & Lawrence A. Cunningham, *Treatment Differences and Political Realities in the GAAP-IFRS Debate*, 95 VA. L. REV. 989 (2009); Roberta S. Karmel, *The EU Challenge to the SEC*, 31 FORDHAM INT’L L.J. 1692 (2008); Neal F. Newman, *The U.S. Moves to International Accounting Standards—A Matter of Cultural Discord—How Do We Reconcile?*, 39 U. MEM. L. REV. 835 (2009).

38. See Bratton & Cunningham, *supra* note 37; Karmel, *supra* note 37; Newman, *supra* note 37. See also Epstein & Cheng, *supra* note 37.

documented analysis of the issues.³⁹ Furthermore, since “IFRS includes a much greater degree of qualitative analysis than U.S. GAAP,”⁴⁰ expanded litigation risk exists under IFRS.

Private sector accounting is also likely to change. In 2009, for mid-sized and smaller companies the IASB has created even fewer accounting rules to simplify the accounting knowledge needed to prepare the financial statements.⁴¹ The American Institute of Certified Public Accountants (AICPA), together with the oversight body for FASB, created a Blue Ribbon Panel to study this development for application to the U.S. private sector.⁴² More second guessing by lawyers and judges is likely to occur when fewer rule-oriented accounting standards exist.

II. PROFESSIONAL DUTIES AFFECTING LITIGATION FOR NEGLIGENCE

Negligence against an auditor is based on state law.⁴³ Negligence generally requires the plaintiff prove a duty owed to the plaintiff, a breach of that duty, causation (both factual and proximate), and damages.⁴⁴ To whom a duty is owed (whether a duty is owed to third parties) has received extensive attention.⁴⁵

39. If detailed analysis exists, some believe that “[n]egligence is even more difficult to prove when the accountant’s subjective judgment is in issue.” *Accounting, Practice & Responsibility Portfolio 5500: Preparing for and Defending Accounting Liability Litigation*, TAX MGMT. PORTFOLIOS (BNA), 2006, § V.B.2, available at 2006 WL 2624270 [hereinafter *Accounting, Practice & Responsibility Portfolio*].

40. See Vincent J. Love & John H. Eickemeyer, *IFRS and Accountants’ Liability*, CPA J., Apr. 2009, at 54.

41. INT’L ACCOUNTING STANDARDS BD., A GUIDE TO THE IFRS FOR SMES (2010), <http://www.ifrs.org/NR/rdonlyres/4308000F-FAC8-41F3-BC15-E594E8058EB6/0/GuideToIFRSforSMES2010Oct.pdf>. See also *IFRS for SMEs Fact Sheet*, INT’L ACCOUNTING STANDARDS BD. (July 9, 2009), <http://www.ifrs.org/NR/rdonlyres/FBAE7BA8-8B32-43F8-AE3C-D4DA92D046C6/0/IFRSforSMESfactsheet2.pdf>.

42. *Panel to Address Accounting Standards for Private Companies*, J. OF ACCT., Dec. 17, 2009, <http://www.journalofaccountancy.com/Web/20092429.htm>. The eighteen member Blue Ribbon Panel has a mixture of financial statement “users, creditors, lenders, owners of businesses, and preparers.” Denise Lugo, *Private Company Reporting: Blue Ribbon Panel to Weigh Launching Standard Setter for U.S. Private Companies*, ACCT. POL’Y & PRAC. REP. (BNA), Apr. 16, 2010, available at 2010 WL 1510529.

43. Minor variations exist among states in the explanation “of the elements of professional negligence.” See *Accounting, Practice & Responsibility Portfolio*, *supra* note 39, at V.B. n. 89.

44. DAN L. GOLDWASSER & THOMAS ARNOLD, ACCOUNTANTS’ LIABILITY §§ 4-1-4-2 (PLI Corp. & Sec. L. Libr. 1996); see also RESTATEMENT (SECOND) OF TORTS § 328A (1965).

45. See generally John W. Bagby & John C. Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 GA. L. REV. 149 (1987); Willis W. Hagen II, *Accountants’ Common Law Negligence Liability to Third Parties*, 1988 COLUM. BUS. L. REV. 181; Carl Pacini, Mary Jill Martin & Lynda Hamilton, *At the Interface of Law and Accounting: An Examination of a Trend Toward a Reduction in the Scope of Auditor Liability to Third Parties in the Common Law Countries*, 37 AM. BUS. L.J. 171 (2000); Jodi B. Scherl, Note, *Evolution of Auditor Liability to Noncontractual Third Parties: Balancing the Equities and Weighing the Consequences*, 44 AM. U. L. REV. 255 (1994).

At issue is the nature of the duty when the accountant does not fully comply with applicable professional standards. The nature of the legal duty of care owed has rarely received much analysis. An auditor has the duty to use the skill and knowledge possessed by an accountant in good standing.⁴⁶ “Expert testimony is usually necessary to establish the standard of care required of an accountant since the matter is ‘beyond the realm of ordinary lay knowledge.’”⁴⁷ Proof of the duty normally occurs through work-papers, audit manuals, records, and expert testimony.⁴⁸ The plaintiff’s expert generally identifies the duty of care and points out any material departure from that duty.

“Professional standards are commonly looked to as evidence of the appropriate standard of care in a negligence case”⁴⁹ The failure of applying any fundamental auditing duty in a material way should lead a jury to conclude that it was a material departure and negligent breached of duty.⁵⁰ The question for the jury for negligence too often is when this part of the auditor’s material conduct falls outside professional standards. The jury needs further guidance as proposed in the forthcoming tables.

Ten fundamental audit standards provide a framework for the responsibilities of auditors based on generally accepted auditing standards.⁵¹

46. *Cf.* RESTATEMENT (SECOND) OF TORTS § 299A (1965) (requiring that “one who undertakes to render service in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities”).

47. GOLDWASSER & ARNOLD, *supra* note 44, § 4-2, at 4-36 (quoting *Kemmerlin v. Wingate*, 261 S.E.2d 50, 51 (S.C. 1979)).

48. See Leo R. Beus, *Workpapers, Audit Materials, Personnel Records and Expense Account Information Can Often Provide Helpful Information in an Audit Malpractice Case*, SN073 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 139 (2008).

49. GOLDWASSER & ARNOLD, *supra* note 44, § 4-2, at 4-39.

50. Some courts require articulation of relevant duties of care under GAAS and how they were breached at the pleading stages. See, e.g., *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 712 (3d Cir. 1996).

51. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 113 § 150.02 (Am. Inst. of Certified Pub. Accountants 2006). These ten standards are:

General Standards

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Field Work

1. The auditor must adequately plan the work and must properly supervise any assistants.

The Statements of Auditing Standards (SASs) expand upon the GAAS framework.⁵² The PCAOB adopted the 2003 version of the Codification of the Statements on Auditing Standards (AU) as interim audit standards.⁵³ The duties from all these standards are not yet, arguably, law in the audit of public companies because the standards are not effective until approved by both the PCAOB and SEC.

The PCAOB's inspection reports separate negligent audit failures from any legal implications. "[The PCAOB inspection report] reviews . . . certain aspects of selected audits performed by the firm and reviews . . . other matters related to the firm's quality control system."⁵⁴ Deficiencies in auditing or accounting are raised in the PCAOB's inspection reports.⁵⁵ Insights into the variable quality of the audits of public companies are provided in these inspection reports.⁵⁶

Enforcement actions by the PCAOB occur if either: (A) "intentional or knowing conduct . . . violat[es] . . . applicable statutory, regulatory, or professional standard[s];" or (B) there are "repeated instances of negligent conduct."⁵⁷ Thus, the PCAOB has lower standards of enforcement than should exist in negligence lawsuits in the courts.

Tables 1 to 3 provide examples of auditors' duties and cases where an entity has breached the auditing standard duty of care.⁵⁸ Simplified

2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control

3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with [GAAP].

2. The auditor must identify in the auditor's report those circumstances in which [GAAP] principles have not been consistently observed

3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

4. The auditor must either express an opinion regarding the financial statements . . . or state that an opinion cannot be expressed, in the auditor's report.

Id.

52. SASs were created and codified by the AICPA.

53. PCAOB History, PUB. CO. ACCOUNTING OVERSIGHT BD., <http://pcaobus.org/About/History/Pages/History.aspx> (last visited Feb. 9, 2011).

54. INSPECTION OF BECKSTEAD & WATTS, *supra* note 20, at 2.

55. *Id.* at 2–3.

56. *Id.*

57. 15 U.S.C. § 7215(c)(5) (2006).

58. While some of the sources provided in the tables give the precise section in the AU, other sources lack the reference but are discernable by their description of the audit problem.

standards in the tables are presented for purposes of explaining them to a jury of non-accountants. Other standards exist, but they have rarely led regulators to cite them for violation. These examples are presented primarily through PCAOB inspection reports and enforcement actions. U.S. standards are shaped by U.S. legal jurisprudence and SEC requirements.⁵⁹ International standards on auditing (ISA) generally evidence the same fundamental duty.⁶⁰

Table 1: Selected Field Work Duties Under Generally Accepted Auditing Standards

AU §	ISA comparable	Example of Auditors' Duties Under GAAS Which if Breached Creates Negligence	Example(s) of a Breach of Duty
312	320	Duty to determine the appropriate audit risk and materiality levels of important items that may impact the financial statements	AAER 2779, 13
313	500	Duty to use substantive tests on the financial statement assertions, prior to the balance sheet date	PCAOB Rel. No. 104-2010-025, 4
316	240	Duty to evaluate the risk of fraud in the financial statements	AAER 3099, 3 PCAOB Rel. No. 104-2007-087, 5
316	240	Duty to evaluate transactions which appear fraudulent	PCAOB Rel. No. 104-2005-120, 9
316	240	Duty to consider whether a change in auditing procedures is needed to obtain more reliable evidence because of a higher risk of fraud	PCAOB Rel. No. 105-2007-002, 7
317	250	Duty to design the audit to provide reasonable assurance of detecting material misstatement arising from illegal acts that could have a direct and material impact on the financial statements	PCAOB Rel. No. 105-2007-009, 12
319		Duty to consider internal control for purposes of the financial statements	PCAOB Rel. No. 104-2008-249, 4 PCAOB Rel. No. 104-2006-203, 6
324	402	Duty to consider the effect of	PCAOB Rel. No. 104-

Comparable international standards on auditing (ISA) provisions are provided because more than 100 countries are either using ISAs or have declared their intent to use them. International Standards on Auditing, ESTANDARDSFORUM, http://estandardsforum.org/about_standards/international-standards-on-auditing (last visited Jan. 27, 2011).

59. Because of the different legal environment in the United States, U.S. "standards are often more directive and procedures oriented" than ISA. James M. Sylph, Technical Director, Int'l Auditing & Assurance Standards Bd., Speech at American Accounting Association Auditing Section 2005 Mid Year Conference: Global Convergence—Near or Far? (Jan. 14, 2005) (transcript available at <http://press.ifac.org/speech/2005/01/global-convergence-near-or-far>).

60. See INT'L FED'N OF ACCOUNTANTS, HANDBOOK OF INTERNATIONAL QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE, AND RELATED SERVICES PRONOUNCEMENTS (2010), <http://web.ifac.org/publication>.

		service organizations , such as payroll handlers, on the entity's internal control	2006-003, 3
326	530	Duty to review samples of the underlying accounting data and corroborating information	
328	545	Duty to test management's fair value measurements and disclosures	PCAOB Rel. No. 104-2009-069, 6 PCAOB Rel. No. 104-2008-231, 4
150 329	500	Duty to obtain sufficient competent evidential matter obtained through inspection, observation, inquiries, and confirmation so as to create a reasonable basis for an audit opinion	PCAOB Rel. No. 104-2009-069, 6 PCAOB Rel. No. 104-2005-138, 7
330	Cf. 580	Duty to obtain and evaluate confirmations and other evidence collected from third parties about management's financial statement assertions	AAER 3146, 4 PCAOB Rel. No. 104-2005-138, 7
330	505	Duty to maintain control over the confirmation requests and responses	PCAOB Rel. No. 104-2006-002, 12
331	501	Duty to test appropriately for the existence, completeness, and valuation of inventory	PCAOB Rel. No. 104-2009-157, 4
333	580	Duty to investigate if audit evidence contradicts a representation made by management	PCAOB Rel. No. 105-2010-003, 11
334	550	Duty to seek to identify related party relationships and transactions	AAER 3116A, 6 PCAOB Rel. No. 104-2008-219, 4
336	620	Duty to evaluate any relationships and findings from a specialist , such as a valuation expert	PCAOB Rel. No. 104-2010-077, 4 PCAOB Rel. No. 104-2006-079, 4
337	501	Duty to obtain appropriate and timely responses from the entity's attorneys considering litigation, claims, and assessments	PCAOB Rel. No. 104-2009-157, 4 PCAOB Rel. No. 104-2009-149, 4
341	570	Duty to determine if substantial doubt exists about an entity's ability to continue as a going concern for the next year	PCAOB Rel. No. 104-2010-081, 4
342	540	Duty to evaluate the reasonableness of significant accounting estimates made by management, including the methodology and assumptions used	PCAOB Rel. No. 104-2006-203, 10
342	540	Duty to consider the historical experience of the entity in making past estimates to assess the reliability of the process in making current estimates	PCAOB Rel. No. 105-2007-006, 8
350	530	Duty to make a sample size sufficiently large to obtain reasonable assurance to detect	PCAOB Rel. No. 104-2006-202, 9 PCAOB Rel. No. 104-

		misstatements	2006-205, 4
350	530	Duty for a sample to represent the population from which the sample was selected and project misstatements from the sample to the population	SEC Administrative Proceeding No. 3-12208
380	260	Duty to inform the board of directors' audit committee about any material disagreements with management	
390		Duty to assess important audit deficiencies identified after the date of the audit report	PCAOB Rel. No. 105-2006-001, 3

Table 2: Selected Other Duties Under Generally Accepted Auditing Standards

AU §	ISA comparable	Example of Auditors' Duties Under GAAS Which if Breached Creates Negligence	Example(s) of a Breach of Duty
150	200	Duty to have sufficient knowledge of the relevant audit standards	AAER 3027, 5
210	220	Duty to have adequate technical training and proficiency as an auditor	PCAOB Rel. No. 104-2010-102, 3
220	200	Duty to ensure that the auditors are free of personal impairments to independence	AAER 3122, 2
230	200	Duty to exercise due professional care and professional skepticism in the performance of the audit	AAER 3146, 4 PCAOB Rel. No. 104-2006-181A, 6
230	220	Duty to supervise properly those involved in the audit, based on their level of knowledge, skill, and ability to evaluate the audit evidence	PCAOB Rel. No. 105-2007-005, 5
410	230	Duty to report whether the financial statements are in accordance with GAAP	PCAOB Rel. No. 104-2009-069, 4
431	200	Duty to adequately disclose the information in the financial statements	PCAOB Rel. No. 105-2009-001, 8 PCAOB Rel. No. 104-2005-119, 4
435	501	Duty to determine if additional accounting segment information is needed	PCAOB Rel. No. 104-2005-119, 4
508	700	Duty not to express an unqualified audit opinion if the auditor has not performed the audit in accordance with PCAOB standards	PCAOB Rel. No. 105-2009-001, 4
543	600	Duty to assume responsibility for the work of another auditor or reference the audit of the other auditor and indicate the division of responsibility	PCAOB Rel. No. 104-2005-138, 6
550	560	Duty to determine whether the financial statements, the audit	PCAOB Rel. No. 105-2009-005, 7

		report, or both require revision when a material inconsistency exists with the financial statements	
560	560	Duty to evaluate events after the balance sheet date, but prior to the issuance of the financial statements, which provide additional evidence about conditions that existed at the balance sheet date	PCAOB Rel. No. 105-2007-006, 10
561	560	Duty to consider the impact of subsequent events after the balance sheet date but before the date of the auditor's report on the financial statements	PCAOB Rel. No. 105-2009-001, 9

Table 3: Selected Duties Under PCAOB's New Audit Standards

Rule or standard	Example of Auditors' Duties Which if Breached Creates Negligence	Examples of a Breach of Duty
Rule 4006	Duty not to provide misleading documents	PCAOB Rel. No. 105-2009-002, 4
Rule 5102	Duty to cooperate with a PCAOB(or applicable regulatory agency) investigation	PCAOB Rel. No. 105-2010-005, 2 PCAOB Rel. No. 105-2010-004, 2
AS No. 1	Duty to conduct the audit of a public company in accordance with PCAOB standards	PCAOB Rel. No. 105-2010-006, 5
AS No. 3	Duty to prepare audit documentation in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached	PCAOB Rel. No. 2005-138
AS No. 3	Duty to indicate the date information was added, the author of such documentation, and the reason for adding it	PCAOB Rel. No. 105-2009-002, 5
AS No. 5	Duty to test management's assertion of internal control	PCAOB Rel. No. 105-2009-006

GAAP became more principled in the 2009 creation of the ASC. As a consequence, accounting duties of care became easier to detect. Theoretically, accounting standards are part of auditing law because any departure from GAAP is a violation of GAAS.⁶¹ GAAS are the auditing standards used by the PCAOB and formally recognized by the SEC.⁶² Two sets of accounting standards are recognized by the SEC and AICPA. These standards are U.S. GAAP by the FASB and IFRS⁶³ by the IASB.⁶⁴

61. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards No. 113 § 150 (Am. Inst. of Certified Pub. Accountants 2006).

62. Pearson, *supra* note 5, at 109.

63. IFRS includes International Accounting Standards (IAS).

64. See *supra* note 33.

Table 4 extracts various duties of care from GAAP, recognizing that professional judgment under GAAP sometimes accepts a range of accounting treatments. These basic rules became more obvious with the revision of GAAP in 2009 into the FASB's Accounting Standards Codification. Auditors help to ensure that client management follows the applicable accounting standards.

Table 4: Selected Duties Under Generally Accepted Accounting Principles

FASB ASC	IASB IFRS	Example of Auditors' Duties to Recognize What GAAP Requires	Examples of a Breach of Duty
250-10-50-1	IAS 8	Duty to disclose nature of an accounting change and the reason for it	PCAOB Rel. No. 105-2008-004, 8
225-10-S99-1(c)		Duty to evaluate an accounting conversion to/from U.S. GAAP	PCAOB Rel. No. 105-2009-001, 7
Glossary (capitalize)	IAS 8	Duty not to capitalize an expense	PCAOB Rel. No. 105-2008-004, 13
820-10-30	IAS 8	Duty to evaluate whether the value of material property is properly assigned	PCAOB Rel. No. 2007-010
350-20-35-1 350-30-35-14	IAS 38	Duty to test annually for impairment of an intangible asset which is not subject to amortization, such as goodwill	PCAOB Rel. No. 104-2010-081, 5
360-10-35	IFRS 5	Duty to test long-lived assets for recoverability when events indicate possible non-recoverability	
605-15-25-3		Duty to establish a reserve for estimated future returns if revenue is recognized at the time of shipment	PCAOB Rel. No. 105-2007-001, 9-10
310-10-30		Duty to test whether option rights would result in probable economic benefits for asset reporting	PCAOB Rel. No. 105-2005-003, 4
810-10-1	IFRS 3	Duty to consolidate all majority-owned subsidiaries	PCAOB Rel. No. 105-2008-001, 8
740-10-30	IAS 12	Duty to determine deferred taxes separately for each tax-paying consolidated entity in each tax jurisdiction	
ASC > 900	IAS 41	Duty to apply industry specific guidance	PCAOB Rel. No. 2007-010
230-10-45-9	IAS 7	Duty not to report non-cash activities in a statement of cash flows	PCAOB Rel. No. 105-2007-002, 6
942-810-S99-1		Duty to assess whether the risks and rewards of ownership were transferred in a nonperforming asset	PCAOB Rel. No. 105-2007-001, 5

“Improper professional conduct” by accountants and auditors is classified by the SEC into two groups.⁶⁵ The first class is “[a] single instance of highly unreasonable conduct.”⁶⁶ The second class is “[r]epeated instances of unreasonable conduct.”⁶⁷ These classes help the SEC analyze the appropriate sanction to impose. Litigators might use these classes to distinguish degrees of negligence.

III. AUDIT INDUSTRY’S FAILED PURSUIT OF LEGAL LIABILITY LIMITATIONS

High insurance costs,⁶⁸ settlement costs,⁶⁹ and litigation costs plague the auditing industry.⁷⁰ Among securities class action lawsuit settlements, accounting-related settlements are significantly higher than non-accounting settlements.⁷¹ The number of securities class action lawsuits involving accounting has dropped to the lowest level post-SOX with them accounting for only 40% of the securities class action cases in 2008.⁷² Yet, the auditing profession has remained very concerned that even a few lawsuits could cripple a major accounting firm.⁷³

65. SEC Rules of Practice, 17 C.F.R. § 201.102(e)(1) (2010).

66. *Id.*

67. *Id.*

68. Lack of access to adequate insurance coverage helped motivate the auditing profession to seek liability reform. Insurance coverage had decreased while premiums paid for coverage had increased, in part because the high loss ratio of claims incurred exceeding premiums received. For example, insurance premiums rose five-fold from 1984 to 1987 while the number of insurers dropped “from twelve in 1980 to three in 1986.” Gary Lawson & Walter Olson, *Civil Justice Memo No. 16, Caveat Auditor: The Rise of Accountants’ Liability*, MANHATTAN INST. FOR POL’Y RES. (May 1989), http://www.manhattan-institute.org/html/cjm_16.htm.

69. High settlement costs are shown in a table with the top fifty all time accounting malpractice settlements 1991–2008, based on audit analytics. See Mark L. Cheffers, *Accounting Malpractice Scorecards*, SN073 A.L.I.-A.B.A CONTINUING LEGAL EDUC. 369 (May 15, 2008). Some say “insurmountable pressure” exists for settlement, especially after class action certification. See John Gibeau, *An Outside Shot at Securities Fraud*, A.B.A. J., June 2007, at 20.

70. See Thomas Lys & Ross L. Watts, *Lawsuits Against Auditors*, 32 J. ACCT. RES. 65 (1994). Selected portions of the audit industry are more likely to incur litigation. Lawsuits against auditors are more likely “when client firms are larger, experience financial difficulties and poor stock performance, and receive qualified audit reports. A lawsuit is also more likely if the auditor employs an unstructured audit technology and if the client represents a relatively larger proportion of the auditor’s revenues.” *Id.* at 65.

71. PWC 2008 STUDY, *supra* note 16, at 23. The accounting firm average settlement in 2008 was approximately \$51.7 million. *Id.* at 24. However, “[t]he highest nine [securities class action] settlements [in 2008] were exclusively accounting-related settlements.” *Id.* at 5.

72. *Id.* at 9.

73. See Steven Taub, *Support for Limiting Auditor Liability*, CFO.COM (Jan. 18, 2005), http://www.cfo.com/article.cfm/3574746/c_3574770?f=home_todayinfinance. Commercial insurance could cover less than 5% of large claims against some audit firms. See LONDON ECON. & RALF EWERT, STUDY ON THE ECONOMIC IMPACT OF AUDITORS’ LIABILITY REGIMES: FINAL REPORT TO EC-DG INTERNAL MARKET AND SERVICES (MARKT/2005/24/F) xxxiii (2006), http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf.

In 2005, caps on legal liability⁷⁴ were sought by audit firms in the European Union (EU).⁷⁵ Although some limited support existed for the proposal, the audit industry failed to obtain any protection against potentially large damages. Instead, liability protection varies among the EU member countries.⁷⁶ With the expansion of securities lawsuits within the EU during the last five years,⁷⁷ the problem of the lack of legal liability protection becomes more acute for the auditing profession. In 2008, a report from the European Commission provides some support for auditor liability caps, but again no action has been taken.⁷⁸

In the United States, audit firms have attempted to address the liability problem in various ways.⁷⁹ In 2005, the Big Four audit firms included “punitive damage waivers in their client contracts.”⁸⁰ The PCAOB found

74. James H. Irving, Jeff L. Payne, & Paul L. Walker, *An Empirical Examination of the Impact of Liability Caps on the Auditing Market* 14 (Working Paper Series, Feb. 15, 2010) (citing PUB. CO. ACCOUNTING OVERSIGHT BD., EMERGING ISSUE—THE EFFECTS ON INDEPENDENCE OF INDEMNIFICATION, LIMITATION OF LIABILITY, AND OTHER LITIGATION-RELATED CLAUSES IN AUDIT ENGAGEMENT LETTERS (2006), http://pcaobus.org/News/Events/Documents/02092006_SAGMeeting/Indemnification.pdf), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1490056.

Liability provisions are found in engagement letters between clients and audit firms. . . . The PCAOB uses a . . . classification system of eight groups: indemnification, liability limited to fees, limitations based on time period of claim, limitations related to client’s right to assign or transfer the claim, exclusion of punitive damages, agreements on alternative dispute resolution, unsuccessful party to pay adversary’s legal fees, and auditor liability limited to client losses during the period.

Id.

75. See ON BEHALF OF THE EUROPEAN COMMISSION, A STUDY ON SYSTEMS OF CIVIL LIABILITY OF STATUTORY AUDITORS IN THE CONTEXT OF A SINGLE MARKET FOR AUDITING SERVICES IN THE EUROPEAN UNION 6 (2001), http://ec.europa.eu/internal_market/auditing/docs/liability/auditliability_en.pdf [hereinafter EU STUDY]; Letter from April Mackenzie, Exec. Dir. Pub. Policy, Grant Thornton Int’l, to DG Internal Mkt. & Servs, Unit 4F—Auditing Liab., European Comm’n, Consultation on Auditors’ Liability and its Impact on the European Capital Markets (March 15, 2007), <https://www.gti.org/files/ec%20auditor%20liability%20grant%20thornton%20international%20final.pdf>.

76. EU STUDY, *supra* 75, at 21–22.

77. See CAROL A.N. ZACHARIAS, ACE PROGRESS REPORT: INTERNATIONAL DEVELOPMENTS IN EXECUTIVE LIABILITY 17, 20 (2010), <http://www.aceusa.com/Documents/Articles/ACE%20Progress%20Report-%20Int'l%20Exec%20Liability.pdf>.

78. See Commission Recommendation 473/2008, Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms, 2008 O.J. (L 162) 39 (EC), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:162:0039:0040:EN:PDF>.

79. Academics have also tried to address the liability problem. See, e.g., Lawrence A. Cunningham, *Securitizing Audit Failure Risk: An Alternative to Caps on Damages*, 49 WM. & MARY L. REV. 711 (2007).

80. See *Accounting Firms Seek Liability Protection*, ACCOUNTINGWEB (Dec. 15, 2005, 18:22), <http://www.accountingweb.com/item/101579>; *Accountants Win Battle Over Liability*, WALL ST. J., Mar. 18, 2005, at 1.

such waiver limitations inappropriate, even when authorized by another country, such as the United Kingdom.⁸¹

In 2007, the “Advisory Committee on the Auditing Profession”⁸² to the Department of the Treasury had “extensive discussion regarding the impact of the . . . liability system on audit effectiveness and the . . . auditing profession.”⁸³ “[C]aps on damages paid by auditing firms . . . strengthening [] bankruptcy defenses[, and] . . . government insurance for auditing firms,” were among the potential changes discussed by the Advisory Committee.⁸⁴ The accounting and auditing industries failed to make a persuasive case for any legal reform,⁸⁵ even though audit liability limits were sought to help offset the “deep pocket” syndrome which increases their attractiveness as targets of legal complaints.⁸⁶ Auditors have rarely had success in seeking statutory limits on their liability.⁸⁷

The damages sought against the CPA firms are sometimes huge.⁸⁸ About one-quarter of litigation cases now seek damages exceeding one billion dollars.⁸⁹ However, since 1995, the six largest CPA firms have paid out less than six billion dollars to resolve 362 cases.⁹⁰ Thus, on average, the firms have paid less than 5% of the damages historically sought against them.

A failed attempt to limit their legal liability was made by the accounting and auditing profession in the United States through the Advisory Committee.⁹¹ However, the Advisory Committee did agree to recommend “a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.”⁹² The audit firms had lost their best political opportunity for legal liability limits during the early to mid 2000s

81. REPORT ON PCAOB, *supra* note 19, at 16.

82. U.S. TREASURY DEP’T, ADVISORY COMMITTEE ON THE AUDITING PROFESSION: FINAL REPORT (2008) [hereinafter ADVISORY COMMITTEE DRAFT REPORT].

83. *Id.* at VII: 23.

84. *Id.* at VII: 28.

85. The six largest auditing firms who audit 99% of the U.S. public companies had revealed that they were defendants in ninety private actions related to audits of public and private companies.

86. EU STUDY, *supra* note 75, at 69–70.

87. *Id.* at 74–79. One of the few successes the auditing industry has had in limiting their liability was the Private Securities Litigation Reform Act of 1995 (PSLRA). See Sanford P. Dumain, *Class Action Suits, Auditor Liability, and the Effect of Private Securities Litigation Reform Act of 1995*, SN073 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 167 (2008). The PSLRA established proportionate liability and made it more difficult to pursue class action lawsuits. See Irving, Payne & Walker, *supra* note 74, at 2. However, academic “studies suggest that the reduced [legal] exposure from the PSLRA may have led to less conservative auditing.” *Id.* at 8.

88. Seven of the ninety cases sought damages over \$10 billion. ADVISORY COMMITTEE DRAFT REPORT, *supra* note 82, at VII: 25.

89. *Id.*

90. *Id.*

91. Various countries have discussed limiting auditors’ liability. See, e.g., Clinton Free, *Limiting Auditors’ Liability*, 11 BOND L. REV. 118 (1999).

92. ADVISORY COMMITTEE DRAFT REPORT, *supra* note 82, at VIII: 9.

when Republicans controlled Congress under a Republican President. “[A] Democratic Congress is unlikely to carve out special exemptions for the accounting industry”⁹³

The judicial system simply enforces the requirements for accountants and auditors to exercise due professional care.⁹⁴ Although auditing firms are not insurance companies covering financial losses, if professional negligence or fraud was conducted by the audit firm, responsible individuals and the audit firm should not receive special legal protection.

IV. REFORMS NEEDED TO MINIMIZE LITIGATION AGAINST AUDITORS

Failures in auditing and accounting continue to occur. In discussing the aftermath of SOX, the SEC noted that it continues “to discover both industry-wide and company specific failures of business ethics and of disclosures to shareholders. Such failures are, of course, offensive and unacceptable.”⁹⁵

Legal reform is needed to encourage corporations to cooperate with government investigations, particularly when the investigation concerns the accuracy of financial information provided to the SEC. “Various [worthwhile] prior proposals in Congress and the SEC deserve further consideration.”⁹⁶ Although some financial reform legislation occurred in July 2010, the auditing profession may not welcome any increase in legal exposure. However, the profession should bear a greater risk of legal liability for audit failures when improper financial reporting is evident. Society should not tolerate the grossly negligent failures in auditing which

93. See Carrie Johnson, *Accounting for the Future: Down to Four Big Firms and Fearing the Effects of Even One Major Suit, the Audit Industry Presses for Legal Relief*, WASH. POST, Mar. 9, 2007, at D1.

94. According to the Ninth Circuit Court of Appeals in 2002, it is an open question “[w]hether a GAAP violation makes a financial disclosure misleading per se.” See *Peltz v. Polyphase Corp.*, No. 01-15732, 2002 U.S. App. LEXIS 10849, at *5 (9th Cir. June 5, 2002). Courts have noted that a showing of sub-standard accounting practices is circumstantial evidence that can support an inference of bad faith for a § 10(b) claim under the Securities Exchange Act of 1934. Sub-standard accounting practices should suggest that the representation in the financial statement was so flimsy that there was no genuine belief in the accounting position taken.

95. Donald T. Nicolaisen, Chief Accountant, Office of the Chief Accountant, U.S. Sec. & Exch. Comm’n, Remarks Before the 2004 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 6, 2004).

96. Pearson & Mark, *supra* note 18, at 115. The author has previously noted several potential reforms:

In 2001, the House Judiciary Committee approved the “Financial Services Antifraud Network Act” to create a network linking financial fraud databases. . . . In 2003, Congress considered the “Securities Fraud Deterrence and Investor Restitution Act.” This Act would have [several changes, such as] expand[ing] the maximum potential penalties for securities fraud, allow[ing] the SEC access to grand jury information, and increase[ing] the SEC’s subpoena powers.

Id.

the PCAOB inspection reports revealed. This is a problem many courts have ignored in § 10(b)(5) securities litigation. The global capital markets need professional accounting and auditing work to maintain investor confidence in the integrity of the capital markets.

Recent legislative changes from the Dodd-Frank financial reform legislation strengthened the PCAOB by expanding its jurisdiction to overseeing broker-dealers.⁹⁷ However, further legislation is needed regarding the oversight of financial audits. Congress should prepare legislation that expands the PCAOB's jurisdiction beyond the audit of public companies, and strengthens investors' confidence in relying on audit opinions filed with the SEC.⁹⁸

An adverse judgment in a class action lawsuit based on negligence should cost a firm compensatory damages, but not excessive punitive damages which would jeopardize the firm's ability to continue to exist. Government penalties present a better way to address systematically and more consistently excessive negligence, than exorbitant punitive damages in a court case. Although SOX has penalties to discourage wrongdoing,⁹⁹ the potential rewards of wrongdoing in accounting or auditing may sometimes still exceed the severity of legal penalties, if caught.

The accounting profession should expect that more legal liability concerns in the courts may soon surface. Auditors will need to work with forensic auditors and lawyers more often to help limit potential legal exposure from letting the client maintain an improper accounting position, without the auditors noting the problem in the audit report. "Sustainability of the auditing profession ultimately [depends] upon the conduct of auditing firms themselves, their business model, governance, leadership, and especially their 'tone at the top'—all of which are [extensively] linked to audit quality[,]” as noted by some members of the Advisory Committee.¹⁰⁰

More university education targeted at auditing, accounting, and relevant business areas is needed for the future audit professional to respond to likely future litigation.¹⁰¹ The need for an increased proportion of

97. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 982, 124 Stat. 1376 (2010).

98. Currently, in most states third parties, such as investors, have no standing to rely on the audit opinion of a public company's financial statements.

99. 15 U.S.C. § 7215(c)(4)–(5) (2006).

100. ADVISORY COMMITTEE DRAFT REPORT, *supra* note 82, at VII: 29.

101. Often an auditor has just three hours of auditing and three hours of business law, despite the need for increased knowledge. *See generally* Robert A. Prentice, *The Case for Educating Legally-Aware Accountants*, 38 AM. BUS. L.J. 597 (2001). Future auditors also need more accounting hours to learn how to research and analyze relevant professional standards and authorities. Research skills are especially essential as the volume of accounting and auditing professional standards and related legal requirements generally continues to increase. The educational problem begins with undergraduate accounting education that typically has not taught students how to research relevant professional authorities. More importantly, the education too often has not reinforced the necessary research mentality to find and apply the accurate

professional education at universities arises in part because of increased business complexities and the various professional standards that accountants and auditors of public companies must apply.¹⁰² A mandate by State Boards of Accountancy may be needed to encourage more educational institutions to respond to the professional needs of future accountants and help minimize future litigation against auditors.¹⁰³

The audit profession must adopt a commitment to quality by reducing audit failures and using increased conservatism in issuing unqualified audit opinions.¹⁰⁴ A return to a technical skills—rather than client relation skills—emphasis is needed for future audit partners. Technical knowledge and research skills were often not emphasized at the local level of large firms. In the process, the profession lost part of its commitment to quality.¹⁰⁵

CONCLUSIONS

This Article advances transparent understanding of litigation against auditors for negligence. For the first time, fundamental duties under the auditing and accounting standards are articulated. The auditing profession cannot divorce itself from the law, as some would like to achieve. Instead, further intertwining of the auditing profession with the law is likely. By having failed both in the courts to abolish the PCAOB and in Congress to acquire more liability protection, extensive litigation against auditors for negligence appears likely to remain in the future.

More second guessing of audits of clients' financial statements in the legal environment is likely with the adoption by the FASB of more principled accounting standards. Given how the PCAOB inspection reports have revealed an unacceptable lack of quality in the audit profession's work, it is likely that future reforms of the audit profession will further address improper audits of financial statements. If the audit profession is serious about stopping or even reversing this trend, the profession must take

professional answer. *Cf.* THOMAS R. WEIRICH, THOMAS C. PEARSON, & NATALIE T. CHURYK, ACCOUNTING AND AUDITING RESEARCH: TOOLS AND STRATEGIES (7th ed. 2010) (attempting to correct the problem by developing the readers' research skills).

102. A master's degree is needed for future audit professionals in order for students to pursue real world accounting and auditing research, case courses, and additional knowledge in auditing and accounting. The proposed change would only slightly modify the existing rule for a total 150 hours of university education. Future accountants also need more business knowledge and practice developing skills in information technology and finance to master complex accounting topics, for example those stemming from sophisticated financial products, such as derivatives.

103. *See* Pearson, *supra* note 5, at 116, 118.

104. The profession could also encourage members to seek a Malcolm Baldrige national quality award. *See* Baldrige Performance Excellence Program, NAT'L INST. OF STANDARDS & TECH., <http://www.nist.gov/baldrige/enter/index.cfm> (last visited Jan. 24, 2011).

105. The prior theory was that local partners skilled in client relations would always contact the national office experts for help when questions existed at the local level, despite some differences in economic motivations.

greater responsibility to meet the public's expectations of quality audits of financial statements.

Taking responsibility by the audit profession must include preparing higher quality future audit professionals. However, proposed changes face various obstacles that preserve the status quo. But if the profession does not take increased responsibility, more litigation against auditors is likely.