Tort Reform, SAS58, And Auditor Liability: Is There an Interaction?

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Abstract

One of the major concerns of the auditing profession is its increasing exposure to litigation, particularly with parties not historically considered to have privity under contract law. A major reason for the increase in lawsuits against accounting firms is that they are often the only survivors in a multiparty action when a company fails. In an attempt to reduce the disparity between the perceptions of the profession and the public as to the responsibilities of an independent auditor, the AICPA issued SAS58, one of the "Expectation Gap" auditing standards. SAS58 changed the wording of the standard unqualified auditor's report, but did not alter the underlying audit process or the auditor's responsibility for the audited financial statements. Previous research suggests that jurors' assessments of liability in audit failure suits have not been affected by SAS58. However, this research was based on a "joint and several" liability model, and did not address the possibility that SAS58, in conjunction with tort reform legislation, may modify jurors' perceptions of auditor liability. The present study was designed to explore that interaction.

Introduction

A major concern of the auditing profession is the alarming rate of growth in the number of lawsuits and size of negligence awards that has occurred in recent years. The largest judgment to date is that against Price Waterhouse for \$338 million involving an Arizona bank auditing case for which total audit fees were less than \$280,000.¹ Audit failure suits of troubled savings and loan institutions have generated judgments of \$150 million against Deloitte & Touche, \$100 million against KPMG Peat Marwick, and \$63 million against Ernst & Young.² A Texas court awarded \$200 million in punitive damages against Coopers & Lybrand to holders of MiniScribe convertible debentures.³ In Colorado, defendants in the MiniScribe case have agreed to pay \$128.1 million to settle shareholders' and general creditors' claims.⁴

Liability awards are causing firms to limit the range of services offered to clients. It is becoming more difficult to engage accounting firms for initial public offerings, and fear of liability exposure is making it tougher for high-risk businesses to obtain audits. The proportion of

small CPA firms that accept audit engagements has dropped from 61% to 53% in the past two years.⁵ The decrease in acceptance of audit engagements is accompanied by an increase in less risky work: more firms are specializing in accounting for nonprofit organizations, and in litigation support where accountants testify increasingly for the plaintiffs in malpractice suits. As fewer firms provide audit services, audit fees increase, and are currently 20% to 30% higher than five years ago.

Large liability awards have already caused the collapse of several substantial accounting firms, including Laven-
thol & Horwath, Spicer & Oppenheim, and Pannell, Kerr, Forster.⁶ Liability insurance premiums have increased tenfold in the past seven years, and accounting firms now face \$20 million deductibles with \$100 million policy limits.

The AICPA has long resisted the shift away from personal liability for professionals. However, in January of 1992, its membership agreed to accept any form

of business organization allowable in the accounting firm's main business location.⁷ Although many accountants maintain that professionals should personally back their work through the unlimited liability feature of partnership organization, others believe that a legal system that allows judgments so grossly in excess of any risks reasonably assumed by the auditor suggests that the system is out of control.

Tort Reform

Accounting firms are seeking support to press federal and state lawmakers to promote tort reform legislation that would curb damages in liability awards. Shocked by soaring commercial insurance rates, Colorado began reforming its civil system six years ago. Though many states have enacted laws to limit civil suits and damage awards, none has done more than Colorado.⁸ In a movement away from the "deep pocket" effect of joint and several liability, Colorado passed the Uniform Contribution Among Tortfeasors and the Damages Acts of 1987. Accordingly, in situations involving contributory negligence, the jury may determine the percentage of negligence or fault attributable to each of the parties, and limit a defendant's liability to that pro rata portion of the award.⁹

"Expectation Gap" Auditing Standards

A commonly held belief of the accounting profession has been that if the public better understood the audit function, there would be less litigation holding auditors liable for financial losses incurred by parties not usually considered to have privity under contract law. Citing the disparity between the perceptions of the profession and the public as to the responsibilities of an independent auditor, in 1988 the Accounting Standards Board of the AICPA issued nine "expectation gap" auditing standards (SAS53 through SAS61).¹⁰ Of these nine standards, SAS58 superseded SAS2, the standard which had previously defined both the form and content of the unqualified auditor's report since 1949. In brief, the significant differences in the SAS58 report are: (1) the addition of a title which includes the word "independent;" (2) the addition of an introductory paragraph which differentiates managements' responsibility for the financial statements from the auditor's responsibility to express an opinion on those statements; (3) an explicit acknowledgment in the scope paragraph that an audit provides reasonable assurance within the context of materiality; (4) a brief explanation of what an audit entails; (5) deletion of a reference to consistency; and (6) elimination of "subject to" opinion qualifications.

It is important to note that, although these changes to

the auditor's report are substantial, they do not reflect a significant change in either the underlying process of auditing or in the legal responsibilities of auditors. Rather, they reflect a significant change only in the amount and type of information which is conveyed to the public. Mere changes in information reporting may, however, have significant consequences if the public deems the new information to be useful. There is cause for concern over the potential effects of changes in the standard unqualified auditor's report on the public's perception of legal liability.

Previous Research

Using a fictitious third party suit for damages against the independent auditor, Brougham and Parker¹¹ evaluated SAS58 from a "decision usefulness" perspective. The suit was based on third party losses in bankruptcy resulting from undetected embezzlement. The decision choices available to the surrogate jurors did not allow for the awarding of partial damages, reflecting a pre-tort reform "joint and several" liability model.

Brougham and Parker found that subjects' decisions were not affected by type of audit report and/or type of plaintiff (individual or bank), and concluded that the changes in the unqualified auditor's report mandated by SAS58 have no decision usefulness in the context of third party audit failure suits. SAS58 did not appear to have measurably reduced the expectation gap between auditors' and users' perceptions of the audit product.

Research Question

There is a tort reform movement toward assigning liability to different parties based on relative contributory negligence. If jurors were allowed to allocate responsibility and/or liability to both management and external auditors, would liability assessment be affected by the change in the standard unqualified audit report?

Methodology

The present study used the same audit failure suit as that used by Brougham and Parker, with one change in the subjects' instructions: the original experiment required subjects to select between judgments against the auditor of either \$0 (no liability) or \$750,000 (full damages). In the present study, subjects are allowed to award any amount from \$0 to \$750,000, reflecting the degree to which the auditor is perceived to be responsible. (The audit failure suit and juror instructions were presented in the prior paper, and are not reproduced here.)

The surrogate jurors were 220 students enrolled in a variety of classes at a large, urban, undergraduate institution. They ranged from 18 to 59 years of age. An exit questionnaire revealed no indications that the subjects differed materially from typical jurors.

In summary, as in the original experiment, a 2X2 factorial design was employed to test three null hypotheses: (1) on average, liability assigned in the audit failure case will be equal for the SAS2 and SAS58 unqualified audit reports; (2) on average, liability assigned will be equal for the individual and bank plaintiff cases; and (3) on average, liability will be equal for each type of report by each type of plaintiff (there will be no interaction between type of audit report and type of plaintiff). ANOVA was the method of analysis.

Results and Conclusions

The results of the present study correspond to those of the original Brougham and Parker experiment: no differences in average liability assessments between experimental groups were observed. Subjects' decisions were not affected by type of audit report and/or type of plaintiff.¹² Whether in the context of "joint and several" liability or "proportional" liability, our results suggest that the changes in the unqualified auditor's report mandated by SAS58 have no decision usefulness in third party audit failure suits. The addition of the introductory paragraph differentiating management's responsibility for the financial statements from the auditor's responsibility to express an opinion on those statements did not alter our subjects' perceptions of relative liability. As auditors are increasingly held responsible for third party losses, it is evident that changes in the audit product which are merely cosmetic are unlikely to control auditors' exposure to professional liability.

Footnotes and References

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12. Full results are available from the authors.