

Auditing Assurance & Services

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Executive Summary

A lawsuit claiming any deficiency in the engagement performance by an auditor can cause damage to the audit firm significantly. There are many cases in the past where audit firms faced damage due to the potential liability they incurred due to which financial crises of 2008 is briefly discussed in the study. Moreover, two types of potential liability have been identified that are criminal liability and civil liability that are explained with the help of different cases in history. Lastly, there are recommendations that can help audit firms to manage their potential liability.

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Introduction

The following report highlights the potential liability of auditing firms after the financial crisis of 2008. Although there are many cases in the past that cost up to millions of dollars for the auditing firms that might lead to bankruptcy. For example the case of Arthur Andersen who were the auditors of Enron Corp (Carnegie and Napier, 2013). After the fall of Enron Corp, they voluntarily surrendered their license to practice audit. Hence, there are many kinds of potential liability that can cost an auditing firm a big litigation that are; criminal and civil liability (Samsonova-Taddei and Humphrey, 2015). Criminal liability comes under the parameter of the laws and regulation of the county in which the auditing is being practiced. Hence an auditing firm is liable in the case where the auditor practice fraud and insider trading (Haron et al, 2013). Moreover, as mentioned in the study of Simunic, Ye and Zhang (2016) civil liability is faced by the auditor in the case where its decision leads to affect its client or any third party (Law of Tort).

Discussion

Financial crisis of 2008

The Financial crisis of 2008 revolves around a global financial service firm named Lehman Brothers. This firm was the fourth largest investment bank in U.S. it was in this business for about 158 years. On September 15th, 2008, they filed a case for bankruptcy protection where they incurred big losses for their clients due to their involvement in the sub-prime mortgage crisis, casualness, and malfeasance (Nelson and Katzenstein, 2014). Their bankruptcy is the largest filed case in the history of United States.

The financial crisis of 2008 occurred due to two factors namely as Subprime mortgage

bubble and Banking crisis (Foote and Willen, 2016).

The subprime mortgages policy was developed by the government of U.S. to support poor in mortgaging their houses. These loans were backed by the government hence it was an attractive investment for the banks. Moreover, this created a case of moral hazard where bankers started giving mortgage loans to many risky loans (Arentsen et al, 2015). This cause the banks to develop a new tool where a mortgage can be sold as a low-risk security for the banks and it can be further used to take a loan from the banks. The high rate of defaults led to the financial crisis (Acolin et al, 2016).

Due to the approval of high mortgage rate, demand for houses increased that appreciated the price of the houses. Due to the rising of single-family residential mortgages delinquency rate, the bubble of the rise in the prices burst. The prices of the houses went down drastically and the banks that were heavily invested in mortgage security loan were in a liquidity crisis. This resulted in the bankruptcy for Lehman brothers (Fawley and Neely, 2013). This was a huge alerting sign for the government which leads to bailout plans by the government which cost them trillions of dollars.

The wide consequence of financial crisis leads to fall of stock market worldwide, the housing industry suffered resulting in foreclosures, evicting and unemployment. It had a huge impact in the fall of consumer wealth leading to a downturn in economic activity that is great recession 2008-2012 and contributing to European sovereign-debt crisis (Wisman, 2013). The real cause of the financial crisis of 2008 was an undisclosed conflict of interests of the management and lack of supervision by the auditing firms.

Potential Liability Faced by the Auditor

Liability to an auditor comes in two forms namely as a criminal and civil liability. There are different litigation processes and amounts that auditors have to pay to their clients or any other person affected by the decisions that are discussed below.

Criminal Liability

All the organization and individual auditors are all liable to work under the parameters set by the country in which they are operational (Bigus, 2015). Hence, under these laws, an auditor is liable under criminal liability for the acts such as insider trading and fraud. The audit also comes under the jurisdiction of Companies Act 2006. This act provides details about auditors that what are the steps to hire, removal and functions of an auditor.

Under the section 495 an auditor recklessly or knowingly causing a report to be false, misleading or deceptive in a material particular, is one notable offense i.e. auditor knowingly allows a false representation of an organization in an annual report. This mentions that auditors can be accused and prosecuted in a criminal court for either recklessly or knowingly issuing a false or inappropriate opinion about the report (Dewing and Russell, 2014).

Civil liability

As per the auditing as a profession there are two civil laws that are important and closely related to audit namely as; law of tort and contract law. These laws include the clients of the auditor and any third party who is affected by the opinion given by any auditor about the organization (Laitinen, 2014). Under the contract law, client and any third party both can seek remedy from the auditor for the breach of the contract signed between them. Hence, shareholders can seek remedy and file a case against an auditor for not meeting the required compliance in the

auditing of the financial reports (Alonso, 2014). For example; Tyco filed a case against PWC (among the big four auditing firms of the world) for not meeting the compliance of the auditing. Moreover, under the law of Tort, an auditor can be sued for the negligence if they failed to take proper care while auditing by any third party that faces a loss due to this action of the auditor.

Case History

Under the case of Lehman brother, there was sufficient evidence that the auditing firm was negligent that gives Lehman brother the right to sue their auditing firm for professional malpractice. Lehman auditor is still facing many charges for fraud and many other charges as they failed to allegedly missed the auditing of the firm even after a whistleblower indicated them about the problems that running in the operation of the Lehman brothers claiming that they were misrepresenting the size of their assets (Ball, 2016).

In the case of Sons of Gwalia Ltd. where they were responsible for the negligible behavior and the court of Australia ordered the organization to pool funds in order to repay their shareholders and creditors from the directors, auditors, and company. In 2009, three auditors were accused of not deliberately practicing their auditing tools and accused of negligence and the claim rose to \$67.5 million as they failed to meet the standards of Australian Auditing Standards (Murray, 2016). In 2010, a case of New Zealand, an auditor was forced to pay \$150,000 as a fine, for not disclosing debt of the organization, later this case was opened under the company named Centro, where managers claimed that due to reliance on the auditor's they failed to represent the true image of their organization in their books (Banerjee and Humphery-Jenner, 2016).

Another case of the law of tort is when Caparo accused Touche Ross (later merged with Deloitte and Touche) where they purchased shares of a company named Fidelity Plc. Caparo accuses that these shares were bought under the false accounting principles and prices were overpriced (Standish, 2013). Hence the auditing firm was accused of not taking enough care for the investors of the company under the duty of care. However, the claim was not accepted by the House of Lords as the accounts were prepared by the existing shareholders and auditors had no reasonable knowledge of the purpose of selling to Caparo.

This case proves that there are cases where auditors face a liability under the following conditions:

- Under the law of Fair, just and reasonable a client can claim against the auditor.
- The loss that the client incurred was reasonably foreseeable in the future.
- There is a relationship of “proximity” among the auditor and the client.

Another case that is of importance is the case of PWC and Taylor Bean. This case was filed against PWC for negligence and sued for \$5.6bn in which Taylor Bean filed bankruptcy and there was a huge investment by the trustees. Now PWC is liable to pay \$5.6bn in return for the negligence of the unsatisfied operation of Taylor Bean. PWC was responsible for the auditing of the Taylor Beans and the trustees relied on the auditing of PWC who failed to identify any issue in the operation of Taylor Bean (Friedland, 2016). Another case of PWC where they were accused of bad accounting policies of the firm, this case was against the clients of MF global and PWC. This case was worth \$1 Billion later PWC settled the case at \$65 million in cash with the shareholders and bondholders. In this case, MF Global lost their money in hedging their funds

against the Corzine \$6.3 billion wagers on the European sovereign debt. Later when they faced huge loss, they used the investor's fund to cover their losses keeping the position of the company at a good place. PWC was accused of egregious and extraordinary professional negligence and malpractice. It was again PWC's advice on which their taxes were written off of the value \$119.4 million (Fox, 2014).

Several and Joint Liability

The liability that an auditor faces under the civil or criminal law, are mainly due to unprofessionalism, negligence or false reporting of the auditing report is an uncontroversial topic. However, the fines and the settlement of such claims are controversial and highly debatable (Chang and Sigman, 2014).

An auditor only faces such claims in the case where he/she have breached their duties to perform work professionally, competently, due care and independently from their clients. Therefore the punishment of an auditor is not a controversial topic as such issues come because of his/her incompetence. The main argument is against the current system that the fines are substantially high for the auditing firm. When such cases occur as per the law of "joint and several liabilities" the client can claim its losses against any one of the parties (De Quidt , Fetzer and Ghatak, 2014).

For example, if a director of Pepsi fraudulently states their financial statement incorrectly, the management of the company failed to identify the issue and auditing firm failed to check and state the problem; all three are liable for the damages that the shareholders incur due to such act. However, the law allows the shareholder to claim such damages from any of the three parties (Gifford and Robinette, 2014).

There are many cases that face such issues when the organization faces financial issues, the examples are cited above, hence auditing firm is usually the sole target of the client as they have the enough assets and resources to pay off such an amount and other parties are not able to pay such heavy amounts.

Hence, such acts create problems for the professional body in the businesses that are in the following:

- These claims are then transferred to the clients of the auditing firm in terms of the auditing premiums.
- This also increases the auditing fees as the firms have to cover such expenses.
- Sometimes, auditing firm failed to cover such claims that results into a bankruptcy (case of Enron)
- It becomes a barrier to entry for the competition.

As per the final point is concerned, it is not a sole reason why there is a lack of competition but it plays a significant barrier to entry as these firms are there only with enough insurance claims that can cover such claim. It is a risky and difficult task for small and medium firms to cover such risks and claims (Giné, Krishnaswamy and Ponce, 2013). The overall claims against such firms' averages around \$300million and a large negligence case bankrupt a medium tier firm.

Conclusion

In conclusion, this report highlights the potential liability for an auditor after the financial crises. This study highlights two kinds of liability that an auditor faces namely as; criminal and

civil liability. Moreover, auditors are liable against the claims of their clients and any third party that has been affected by their opinion. Furthermore, all the liabilities are supported by a number of cases that occurred with the big auditing firms because of such liabilities. This was concluded that due to negligence and fraudulent acts of the auditor, he/she have to face liabilities in the shape of expensive litigation that can be expensive even for the big four auditing firms.

Recommendations

The following are the recommendations to the auditors that can help manage their potential liabilities and help him/her manage the exposure of the liability and they are as follows:

Audit Quality

There are a number of techniques through which an auditor can manage claims of negligence. The only way for the auditor to manage such claims is to practice international standards of Auditing and Code of ethics rigorously for the professional accountants paying due diligence to the condition and terms that were agreed at the time of commencement of the agreement. However, the improvement of the quality control is significantly dependants on the investments of the auditing firms. Since there is a lot of pressure on the auditing firms to lower down their fees and they do not want to rise their cost but in the long run, these cost would help auditors to perform their task with greater competence (Messier Jr, 2016).

Disclaimer of liability

One of the cases that are mentioned above have the exposure to litigation from the third parties as their opinions affects them including those who are not disclaimed from the liability. Hence it is essential of an auditing report to include the limitation of the liability. These disclaimers of liability do not minimize the risk entirely but it reduces the scope of the liability

that is useful at the time of a case in front of the court. However, this disclaimer is helpful in minimizing the scope within the boundaries of the country but it is not workable in the international market (Gimbar, Hansen and Ozlanski, 2015).

Liability limitation agreements

After the financial crisis of 2008, it is permitted to auditors to add the clause of liability limitation agreements (LLA) that reduces the threat of the litigation from their clients. This adds a cap on compensation for the clients in case of any negligence or fraud and any other case. This cap must be approved shareholders and under the article of 'fair and reasonable'. However, there are some issues regarding the implementation of such cap, that what should be the size of the cap and on what basis it should be implemented, are there any conditions that the cap can be ignored etc. (Samsonova-Taddei, and Humphrey, 2015).

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