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Examining the Current Legal Environment Facing the Public Accounting Profession: Recommendations for a Consistent U.S. Policy

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Abstract

We examine the recent history and trends of U.S. auditor liability to third parties to help regulators and legislators develop policies to protect and maintain audit quality while limiting auditor liability exposure. Although the United States has yet developed a formal policy to address auditor liability, some European Union member countries and Australia, in varying degrees, support such limitation. Thus, we also explore current EU and Australian policies as examples of potential recommendations to U.S. policy makers. In light of a litigious environment, U.S. Certified Public Accounting firms generally accept potential clients only after analyzing potential risks, dismiss many risky clients, raise their total or hourly fees, spend more time examining attestation evidence, and perform other procedures to reduce their litigation risk. This risk arises largely from the federal and state legal systems, assuming that auditors can better absorb and control losses from misleading financial statements than can financial statement users. While culpable, this litigious environment led to the demise of two large international Certified Public Accounting firms—Arthur Andersen and Laventhol & Horwath. Is the global economy better off having fewer accounting firms with the capacity to perform international audits? A Public Company Accounting Oversight Board's recent Exposure Draft would require auditors of issuers to expand significantly their audit reports beyond current Pass/Fail standards, which could increase audit firms' disclosures and resultant liabilities. After examining U.S. federal and state statutes plus court decisions regarding auditor liability, we suggest methods to protect the public while allowing audit firms to thrive in these environments.

Keywords

auditor liability, auditor reports

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The auditing profession faces many challenges in serving its clients profitably while concurrently facing lawsuits and increasing damage awards, reviewing the implementation of their clients' International Financial Reporting Standards (IFRS) and extending professional judgment to additional services. Reilly (2006) notes that the European Commission (EC) found that Big-Four audit practices' judgments, settlements, legal fees, and other related expenses rose to US$1.3 billion, or 14.2% of their revenues, up from 7.7% in 1999. Overall, from 1996 to 2008, the six largest auditing firms paid out US$5.66 billion to resolve 362 cases related to audits and other nonaudit services, with 65% related to public company audits (Advisory Committee on the Auditing Profession [ACAP], 2008). Big-ticket settlements, verdicts, and judgments against accounting firms have continued in more recent years, such as the following:

- a settlement agreement of about US$30 million between the Metropolitan Mortgage & Securities Co. investors' trust and PriceWaterhouseCoopers (PWC) in 2008 (Stucke, 2008);
- a settlement agreement between PWC and Tyco International investors for US$225 million in 2007 (*International Herald Tribune*; Auditing Firm Settles Claims of Tyco Investors, 2007);
- Deloitte & Touche settled an investor lawsuit over its audit of Philip Services for US$50 million in 2007 (Reuters, 2007);
- a US$85.6 million judgment against Deloitte & Touche in favor of the creditors of Livent, a theater company, in 2014 (Hasselback, 2014); and
- a PWC-agreed US$97.5 million settlement of a class-action securities fraud lawsuit involving American International Group in 2008 (Practical Accountant, 2008).

These data represent some of the legal liability exposure that auditing firms have incurred since the beginning of 2007. According to some EC economic modeling, partners' capital accounts of even the strongest of the Big-Four firms could absorb (only) up to US$1.8 billion of losses without collapse—and the real survival risk threshold falls below that amount (Peterson, 2007). Russell (2011) adds that liability risk threatens the profession's viability—a problem that could prevent large audit firms from attracting the ''best and brightest'' students to the profession.

Implementing the Sarbanes–Oxley (SOX) Act of 2002 and enforcing the Foreign Corrupt Practices Act have increased potential auditor liabilities (Shearman & Sterling, 2014).[1] As the United States adopts principles-based professional judgment accounting standards, limiting auditor liability exposure becomes more imperative, as principle-based standards increase auditor liability risk (Quick, 2013).[2] Some current, major reforms of relevant professional standards include adjusting to new U.S. Generally Accepted Accounting Principles (GAAP), moving toward IFRS, and likely requiring private firms to use a subset of accounting standards (Pearson, 2011). Lawyers and judges second guessing could well lead to more auditor litigation where fewer precise standards exist (Pearson, 2011).

While the above factors seek to increase audit quality, especially in complex environments, negative consequences could follow unrestrained auditor liability exposure, including the bankruptcy of a Big-Four accounting firm, reduced competition in the audit services market, the profession's inability to sustain audit capacity, audit firms' refusal to render services to certain firms, financial reporting delays, increased audit fees, further erosion of professional liability insurance availability, departure of talented employees from the profession, and refusal of persons to enter the profession (Donelson, 2013).

DeFond and Francis (2005) ask whether the ''extreme'' litigation facing the U.S. auditing profession after passage of SOX will generate an appropriate level of audit quality, as countries such as Canada and Australia appear to have credible auditing without imposing such a brutally litigious environment. This study has two major purposes. We first examine recent history and trends of U.S. auditor liability, emphasizing liability to third parties. We also analyze examples of current U.K., European Union (EU), and Australian laws and policies to serve as context to provide input to spur a policy debate on how to best reduce auditors' liability exposure to sustain the auditing profession, while still maintaining audit quality. We then offer policy recommendations to regulators, state and federal legislators, shareholders, creditors, corporate leaders, accountants, and legal professionals to help shape liability reforms to ensure the auditing profession's viability, yet still hold auditors accountable for malpractice. An informed policy debate and focus on auditor liability risk reduction is paramount given the importance of this issue.

In 2006 and 2007, the U.S. Securities and Exchange Commission (SEC) considered whether and how to create safe harbors to shield auditors from legal liability, for example, compel firms to submit auditor disputes to arbitration (Johnson, 2007). The SEC was also involved in allowing KPMG to pay a US$456 million settlement to avoid a criminal indictment over improper sales of tax shelters (Weil, 2005), a settlement that impaired but did not bankrupt this Big-Four Certified Public Accounting firm. In contrast, many EU members provide environments to help limit auditor liability (Commission of the European Communities, 2008; London Economics Report, 2006).

After reviewing key categories of U.S. auditor liability and litigation effects on the auditing profession, we examine how auditors could limit their liability exposure. We then review current auditor liability in the EU, United Kingdom, and Australia to suggest how the United States may adopt policies that reduce auditor liability, while supporting both audit quality and industry capacity.

Categories of U.S. Auditor Liability

The current U.S. auditor legal environment arises from many sources or lines of legal authority, including liability to clients, liability to third persons under state common law and statutes (primarily negligent misrepresentation, fraud, and breach of fiduciary duty), civil liability under the federal securities laws, SOX, the FCPA, and the Racketeer Influenced and Corrupt Organizations (RICO)[3] Act and criminal liability under various state and federal statutes. We briefly summarize some key parts of U.S. statutes affecting auditors, which comprise a minority of cases, but the majority of damage paid by auditors. We further discuss in depth state law third-party liability against CPA firms. Gaver, Paterson, and Pacini (2012) stress that unlike federal statutory law, auditor common law liability to third parties is based on court cases and legal precedents that are decided at the state level. While the vast majority of clients are not publicly traded and thus unaffected by federal securities laws, third parties associated with audit reports often sue using the theory of negligent misrepresentation. Thus, most lawsuits against auditors rely more on the tort of negligent misrepresentation than on federal securities laws. Moreover, DeFond and Lennox (2011); Habib, Jiang, Bhuiyan, and Islam (2014); and many others have studied auditors' liabilities under federal law, but few have examined such liabilities under state law.

State Liability to Clients and Third Parties

Auditors face civil liability to clients in state courts for committing a breach of contract (usually to clients and other named parties in engagement letters) or for torts. Clients certainly have a right to sue an auditor as the two are in privity or have a direct connection. Auditors' greatest exposure, however, emanates from potential tort liability to third parties.

Torts relevant to auditor liability to nonclients are fraud and negligent misrepresentation. Plaintiffs need not be in privity to sue auditors for fraud, and many states do not require privity for plaintiffs to sue auditors for negligent misrepresentation. Auditors face 50 state and four U.S. territory jurisdictions, each with the authority to decide the legal standard to determine which third parties can sue an auditor for negligent misrepresentation. Similar to the EU, U.S. states apply various legal standards, which can serve as a basis to ascertain potential legal reforms.

Four legal standards have evolved to judge when auditors owe a duty to nonclients: (a) privity, (b) near privity, (c) known users or the *Restatement* approach, and (d) the reasonable foreseeability rule. Applying different standards to the same set of facts can produce different legal outcomes—for example, see *Performance Motorcars v. Peat Marwick* (643 A. 2d 39; N.J. Super. 1994). Understanding various legal rules allows auditors to better assess liability exposure (i.e., auditor litigation risk). Examining statewide malpractice insurance premiums, Linville (2001) shows increased auditor litigation risk in nonprivity states than in privity ones. Assessing liability exposure to nonclients for negligent misrepresentation is important given the many instances of auditor lawsuits involving only or mainly state law claims (Pacini, Hillison, & Sinason, 2000).

Privity Rule

Strict privity is the most restrictive standard that requires an existing contractual relationship or direct connection between an auditor and the third party for the latter to hold the auditor liable for negligent misrepresentation. Applicable only in Pennsylvania and Virginia, strict privity first became a legal standard in 1919 in *Landell v. Lybrand* (107 A. 783 [Pa. 1919]).

Near Privity

The near privity rule was first applied to determine the auditor's scope of duty to third parties for negligent misrepresentation in *Ultramares Corp. v. Touche* (174 N.E. 441 [N.Y. 1931]). The New York Court of Appeals denied plaintiff *Ultramares*' negligence claim but fashioned an exception to the strict privity standard—now called the primary benefit rule. To prevail, the plaintiff must be an intended beneficiary of an auditor–client's contract.

In 1985, the New York Court of Appeals clarified the near privity standard in *Credit Alliance v. Arthur Andersen & Co.* (483 N.E. 2d 110 [N.Y. 1985]). Its three-prong test for a third party to recover for negligent misrepresentation requires the (a) accountant to have known that financial reports would be used for a particular purpose, (b) known parties intended to be able to rely on the reports, and (c) accountant's conduct to be linked to the relying party. Twelve states follow a near privity approach by statute or by court decision: Arkansas, Idaho, Illinois, Indiana, Kansas, Louisiana, Maryland, Nebraska, New Jersey, New York, Utah, and Wyoming.

Restatement Standard

A 1968 Rhode Island federal district court first expanded auditor liability for negligent misrepresentation to foreseen or known users in *Rusch Factors v. Levin* (284 F. Supp. 85 [D.R.I. 1968]). The court applied §552 of the *Restatement (Second) of Torts*. Thus, an auditor who audits or prepares client financial information owes a duty to the client and to any other person or one of a class of persons whom the accountant or client intends the information to influence if that person justifiably relies on the information in a transaction that the accountant or client intends the information to influence, and such reliance results in a pecuniary loss for the person.

The near privity rule and *Restatement* standard differ primarily in that the latter does not require the auditor to know the specific persons' identity; it instead requires only that the third parties be members of a limited class of persons known to the auditor (Gossman, 1988). Liability does not attach if the auditor had no reason to believe the information would be made available to third parties or if the information's use changes so that audit risk increases materially. Thirty-three states now follow some version of the *Restatement* standard.[4]

Reasonable Foreseeability Rule

Auditor liability to third parties expanded in 1983 with the *Rosenblum v. Adler* (461 A. 2d 138 [N.J. 1983]) decision. Under this decision, auditors owe a duty to all those whom they should reasonably foresee as receiving and relying on audited financial statements. The duty extends only to those whose financial statements were obtained from the audited entity, and such statements influenced the users' decision. This standard causes the broadest scope of third-party liability for the accountant. Presently, only Mississippi and Wisconsin apply this standard.

Table 1 summarizes all 50 states' legal standards and the legal basis or authority for that standard, placing our findings on an auditors' liability continuum.

Emergence of a Trend

Until the mid-1980s, most court cases reflected a propensity toward expanding auditor liability to third parties for negligent misrepresentation. Starting in 1986, when Illinois enacted an accountant privity statute, a trend emerged toward an increasingly narrow scope of duty to nonclients. The trend continued but slowed in the early 21st century. Various statutes (Arkansas, Illinois, Kansas, Louisiana, Michigan, New Jersey, Utah, and Wyoming) limited accountants' liability to third parties for negligent misrepresentation. Also, 15 states have judicially rejected the reasonable foreseeability rule or reaffirmed limitations on auditor liability to third parties (Arizona, California, Florida, Hawaii, Idaho, Massachusetts, Nebraska, New York, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia, Washington, and West Virginia). Only Alabama and Montana have expanded auditor liability to third parties in the last 20 years, respectively, going from the near privity rule to the Restatement standard in 1994 and 2010.

Auditor Liability Law Severity and Business Friendliness

We performed additional analysis to examine potential relationships between state ''business friendliness'' variables and legal position on auditor liability to third parties for

Table 1. State Positions on Accountant Liability to Third Parties for Negligent Misrepresentation.

Continuum of accountant liability regimes to third parties for negligence								
1	2	3	4	5	6	7	8	9
Privity		Near privity	Restatement §552—Restrictive view	Restatement §552—Typical view		Restatement §552—Expansive view		Reasonable foreseeability

State	Liability index	Case name and citation/statute	Standard	Notes
Alabama	5	*Boykin v. Arthur Anderson & Co.*, 639 So. 2d 504 (Ala. 1994); *Fisher v. Comer Plantation, Inc.*, 772 So. 2d 455 (Ala. 2000).	Restatement §552	In 1994, expanded accountant liability to third parties by shifting from the *Credit Alliance* standard to the *Restatement* rule. The *Restatement* rule was affirmed in *Fisher v. Comer Plantation*.
Alaska	4	*Seldon v. Burnett*, 754 P. 2d 256 (Alaska, 1988).	Restatement §552 but not to the extent that it is inconsistent between the public and private capacities of accountants. The court held that when an accountant, in the course of giving personal tax advice, recommends a certain investment to a client, the accountant owes a duty to third parties only if he intends the third parties to invest relying on his advice and only if he makes his intent known.	
Arizona	5	*Standard Chtd. v. Price Waterhouse*, 945 P. 2d 317 (Ariz Ct. App. 1996), *as corrected* January 15, 1997, *review denied* October 21, 1997; *Sage v. Blagg Appraisal Co., Ltd*, 209 P. 3d 169 (Ariz Ct. App. 2009).	Restatement §552	

(continued)

Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Arkansas	1.5	Ark. Code. Ann. §16-114-302 (2013). *Swink v. Ernst & Young*, 908 S.W. 2d 660 (Ark. 1995); *McDonald v. Pettus*, 988 S.W. 2d 9 (Ark. 1999).	Near privity	The *Swink* interpretation of the state statute severely restricts accountant liability to third parties.
California	4	*Bily v. Arthur Young*, 834 P. 2d 745 (Cal. 1992); *Murphy v. BDO Seidman, LLP*, 6 Cal. Rptr. 3d 770 (Cal. App. 2003).	Restatement §552	The accountant must know with substantial certainty that the nonclient or the limited class to which the nonclient (specifically intended beneficiaries) belongs will rely on the accountant's work product (for negligent misrepresentation).
Colorado	5	*Marquest Medical Products v. Daniel, McKee & Co.*, 791 P. 2d 14 (Colo. App. 1990); *Mehaffy, Rider, Windholz & Wilson v. Central Bank of Denver*, 892 P. 2d 230 (Colo. 1995; law firm).	Restatement §552	
Connecticut	NA	*Retirement Programs for Employees of the Town of Fairfield v. NEPC, LLC*, 2011 Conn. Super. LEXIS 3083 (Conn. Super. December 8, 2011); *Stuart v. Freiberg*, 2011 Conn. Super. LEXIS 1893 (Conn. Super. July 15, 2011); *Dudrow v. Ernst & Young, LLP*, 1998 Conn. Super. LEXIS 3117 (Conn. Super. November 4, 1998).	*Credit Alliance* or near privity standard and Restatement §552	No appellate court decision has been reported. State trial courts have split on the appropriate legal standard. Some courts have looked to Credit Alliance for guidance, while others have followed Restatement §552.

(continued)

Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Delaware	5	*Carello v. PricewaterhouseCoopers, LLP*, 2002 Del. Super. LEXIS 180 (Del. Super. Ct. May 23, 2002); *Lundeen v. PricewaterhouseCoopers, LLP* (2006 Del. Super. LEXIS 351 August 31, 2006), *affd*. 919 A. 2d 561 (Del. 2007).	Restatement §552	
Florida	5	*First Florida Bank, N.A. v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990); *Gilchrist Timber Co. v. ITT Rayonier, Inc.*, 696 So. 2d 334 (Fla. 1997). *Deloitte & Touche v. Gencor Industries, Inc.*, 929 So. 2d 678 (Fla. App. 5th DCA 2006).	Restatement §552	
Georgia	5	*Badische Corp. v. Caylor*, 356 S.E. 2d 198 (Ga. 1987); *Mindis Acquisition Corp. v. BDO Seidman, LLP*, 559 S.E. 2d 111 (Ga. App. 2002).	Restatement §552	
Hawaii	5	*Kohala Agriculture v. Deloitte & Touche*, 949 P. 2d 141 (Haw. Ct. App. 1997).	Restatement §552	
Idaho	2.5	*Idaho Bank & Trust Co. v. First Bancorp*, 772 P. 2d 720 (Idaho 1989); *Blahd v. Richard B. Smith, Inc.*, 108 P. 3d 996 (Idaho 2005).	Near privity	
Illinois	3.5	225 Ill. Comp. Stat. 450/30.1 (2013); *Kopka v. Kamensky & Rubenstein*, 821 N.E. 2d 719 (Ill. App. 2004); *Bank of America v. Knight*, 725 F. 3d 815 (7th Cir. 2013).	Near privity	An accountant may be liable to a third party when a person, partnership, or corporation was aware that a primary intent of the client was for the professional services to benefit or influence the particular person bringing the action.

(continued)

Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Indiana[a]	2.5	*Thomas v. Lewis Engineering, Inc.*, 848 N.E. 2d 758 (Ind. Ct. App. 2006); *Essex v. Ryan*, 446 N.E. 2d 368 (Ind. Ct. App. 1983).	Near privity	A professional owes a duty to a third party outside of a contractual relationship only if the professional has actual knowledge that the third party will rely on the professional's opinion or service.
Iowa	5	*Ryan v. Kanne*, 170 N.W. 2d 395 (Iowa 1969); *Eldred v. McGladrey, Hendrickson & Pullen*, 468 N.W. 2d 218 (Iowa 1991); *Freeman v. Ernst & Young*, 516 N.W. 2d 835 (Iowa 1994).	Restatement §552	
Kansas	2.5	Kan. Stat. Ann. §1-402 (2013); *Sparks v Cbiz Accounting, Tax & Advisory of Kansas City, Inc.*, 142 P. 3d 749 (Kan. 2006).	Near privity	
Kentucky[a]	5	*Ingram Industries, Inc. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981); *Presnell Construction Managers, Inc. v. EH Construction, LLC*, 134 S.W. 3d 575 (Ky. 2004).	Restatement §552	
Louisiana	2.5	La R. S. 37:91 (La. 2013); *Solow, Stolier, and Katz v. Heard McElroy & Vestal, LLP and Swanson*, 7 So. 3d 1269 (Ct. App. La. 2009).	Near privity	
Maine[a]	5	*Bowers v. Allied Investment Corp.*, 822 F. Supp. 835 (D. Me. 1993); *Allied Investment Corp. v. KPMG Peat Marwick*, 872 F. Supp. 1076 (D. Me. 1995); *Diversified Foods, Inc. v. First Nat'l Bank*, 605 A. 2d 609 (Me. 1992).	Restatement §552	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Maryland	2.5	*Walpert, Smullian, & Blumenthal, P.A. v. Katz*, 762 A. 2d 582 (Md. 2000).	Near privity	
Massachusetts	4	*Nycal Corp. v. KPMG Peat Marwick*, 688 N.E. 2d 1368 (Mass. 1998); *Imprimis Investors, LLC v. KPMG Peat Marwick, LLC*, 868 N.E. 2d 143 (Mass. App. 2007).	Restatement §552	
Michigan	4	Mich. Comp. Laws §600.2962 (MSA 27A.2962); *National Association of Credit Management, Inc. v. Deloitte & Touche*, 1998 Mich. App. LEXIS 1821 (Ct. Apps. Mich. June 30, 1998).		Under a statute, a certified accountant may be liable for a negligent act . . . if the "certified public accountant was informed in writing by the client at the time of the engagement that a primary intent of the client was for the . . . accounting services to benefit or influence the person bringing the action . . . The CPA may be held liable only to each identified person, generic group, or class description."
Minnesota	7	*Bonhiver v. Graff*, 248 N.W. 2d 191 (Minn. 1976); *Norham Investment Services, Inc. v. Stirtz, Bernards, Boyden, Sundel, & Larter, P.A.*, 611 N.W. 2d 372 (Ct. App. Minn. 2000).	Reasonable foreseeability rule	The Minnesota appellate courts apply the Restatement standard in a broad fashion that it seems to include a class of third parties almost as wide as the reasonable foreseeability rule.
Mississippi	9	*Touche Ross v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *Great American E&S Insurance Co. v. Quintairos, Prieto, Wood & Boyer, P.A.*, 100 So. 3d 420 (Miss. 2012).	Reasonable foreseeability rule	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Missouri	5	*Aluma Kraft Manufacturing Co. v. Elmer Fox & Co.*, 493 S.W. 2d 378 (Mo. App. 1973); *Mark Twain Kan. City Bank v. Jackson Brouillette, Pohl, & Kirley, P.C.*, 912 S.W. 2d 536 (Mo. App. 1995); *Dueker and Dueker and Shannon v. Gill, Midwest Bank of Poplar Bluff, N.A., Shain, Miller, and Miller*, 175 S.W. 3rd 662 (Mo. App. 2005).	Restatement standard	
Montana	5	*Western Security Bank and Glacier Bancorp v. Eide Bailly LP*, 249 P. 3d 35 (Mont. 2010).	Restatement standard	The Montana Supreme Court decided to apply the *Restatement* rule to negligent misrepresentation cases involving accountants. The state used to apply a liberal version of the near privity rule enunciated in *Thayer v. Hicks*, 793 P. 2d 784 (Mont. 1990).
Nebraska	3	*Citizens National Bank of Wisner v. Kennedy & Coe*, 441 N.W. 2d 180 (Neb. 1989); *St. Paul Marine & Fire Ins. Co. v. Touche Ross*, 507 N.W. 2d 275 (Neb.1993).	Near privity	
Nevada[a]	5	*Stremmel Motors, Inc. v. First Nat'l. Bank of Nevada*, 575 P. 2d 938 (Nev. 1978); *Barmettler v. Reno Air, Inc.*, 956 P. 2d 1382 (Nev. 1998); *Goodrich & Pennington Mortgage Fund, Inc. v. J.R. Woodland, Inc.*, 101 P. 3d 792 (Nev. 2004).	Restatement standard	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
New Hampshire	5	*Spherex, Inc. v. Alexander Grant & Co.*, 451 A. 2d 1308 (N.H. 1982); *Demetracopoulos v. Hodgdon & Wilson*, 640 A. 2d 279 (N.H. 1994); *Plourde Sand & Gravel Co. v. JGI Eastern, Inc.*, 917 A. 2d 1250 (N.H. 2006).	Restatement standard	
New Jersey	2.5	N.J.S.A. 2A: 53A-25 (2013); *Cast Art Industries, Inc. et al. v. KPMG, LLP et al.*, 36 A. 3d 1049 (N.J. 2012).	Near privity	
New Mexico[a]	5	*Garcia v. Rodey, Dickason, Sloan, Akin & Robb*, 750 P. 2d 118 (N.M. 1988); *Leyba v. Whitley*, 907 P. 2d 172 (N.M. 1995); *Vigil v. State Auditor's Office and Dennis Kennedy, P.C.*, 116 P. 2d 854 (Ct. App. N.M. 2005).	Restatement standard	New Mexico appellate courts have applied the Restatement standard to liability of professionals (other than accountants) to third parties.
New York	2.5	*Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E. 2d 110 (N.Y. 1985); *James Sykes et al. v. RFD Third Avenue I Associates LLC et al.*, 938 N.E. 2d 325 (N.Y. 2010).	Near privity	
North Carolina	5	*Raritan River Steel v. Cherry et al.*, 367 S.E. 2d 609 (N.C. 1988); *Marcus Bros. Textiles, Inc. v. Price Waterhouse*, 513 S.E. 2d 320 (N.C. 1999).	Restatement standard	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
North Dakota[a]	5	*Bourgeois Construction Company v. Montana-Dakota Utilities Co.*, 466 N.W. 2d 813 (N.D. 1991); N.D.C.C. §9-03-08(2).	Restatement standard	North Dakota courts recognize negligent misrepresentation under a statute that reads "the positive assertion, in a manner not warranted by the information of the person making if, of that which is not true, though he believes it to be true," but it has not been applied to accountants.
Ohio	4.5	*Haddon View Investment Co. v. Coopers & Lybrand*, 436 N.E. 2d 212 (Ohio 1982); *Banc Ohio National Bank v. Schiesswohl*, 515 N.E. 2d 997 (Ohio App. 1986).	Restatement standard	
Oklahoma	5	*Stroud v. Arthur Andersen & Co.*, 37 P. 3d 783 (Okl. 2001); *Bank of Oklahoma v. PricewaterhouseCoopers, LLP*, 251 P. 3d 187 (Okl. Civ. App. 2011).	Restatement standard	
Oregon[a]	5	*Onita Pacific Corp. v. Trustees of Bronson*, 843 P. 2d 890 (Or. 1992); *Lindstrand v. Transamerica Title Insurance Company*, 874 P. 2d 82 (Or. App. 1994).	Restatement standard	
Pennsylvania	1	*Landell v. Lybrand*, 107 A. 783 (Pa. 1919); *Williams Controls, Inc. v. Parente, Randolph, Orlando, Carey, & Associates*, 39 F. Supp. 2d 517 (M.D. Pa. 1999).	Privity	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Rhode Island	5	*Rusch Factors v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Anjoorian v. Arnold Kilberg & Co. et al.*, 2006 R.I. Super. LEXIS 166 (Super. Ct. R.I. November 27, 2006).	Restatement standard	
South Carolina	5	*ML-Lee Acquisition Fund, L.P. v. Deloitte & Touche*, 463 S.E. 2d 618 (S.C. Ct. App. 1995), *affd.*, 489 S.E. 2d 470 (S.C. 1997).	Restatement standard	
South Dakota[a]	5	*Littau v. Midwest Commodities, Inc.*, 316 N.W. 2d 639 (S.D. 1982); *Mid-Western Electric, Inc. v. DeWild, Grant, Reckert, & Associates*, 500 N.W. 2d 250 (S.D. 1993).	Restatement standard	
Tennessee	5	*Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W. 2d 592 (Tenn. 1991); *Ritter v. Custom Chemicides, Inc.*, 912 S.W. 2d 128 (Tenn. 1995).	Restatement standard	
Texas	5	*Grant Thornton, LLP v. Prospect High Income Fund, ML CBO IV (CAYMAN), Ltd., et al.*, 314 S.W. 3d 913 (Tex. 2010).	Restatement standard	
Utah	2.5	Utah code annotated §58-26a-602 (2014).	Near privity	
Vermont[a]	5	*Silva v. Stevens*, 589 A. 2d 852 (Vt. 1991); *Kramer v. Chabotz*, 564 A. 2d 292 (Vt. 1989).	Restatement standard	

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Table 1. (continued)

State	Liability index	Case name and citation/statute	Standard	Notes
Virginia	1	*Ward v. Ernst & Young*, 435 S.E. 2d 628 (Va. 1993).	Privity	
Washington	5	*Esca Corp. v. KPMG Peat Marwick*, 959 P. 2d 651 (Wash. 1998).	Restatement standard	
West Virginia	5	*First National Bank of Bluefield v. Crawford*, 386 S.E. 2d 310 (W.Va. 1989); *Cordial v. Ernst & Young*, 483 S.E. 2d 248 (W.Va. 1996).	Restatement standard	
Wisconsin	8	*Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W. 2d 361 (Wisc. 1983).	Reasonable foreseeability rule	
Wyoming	3	Wyo. Stat. Ann. §33-3-201 (2013).	Near privity	

Note. LLP = limited liability partnership; LLC = limited liability company; CPA = Certified Public Accountant.

[a]These states have no direct appellate court ruling or state statute dealing specifically with accountant liability to third parties for negligent misrepresentation. For these states, we assume that the liability standard for nonaccountant professionals (e.g., lawyers and engineers) also applies to accountants.

Table 2. State Positions for Negligence/Friendliness to Business Rankings: Spearman's Correlation Values.

State factors	*r*	*p* value
Overall	−.03111	.83020
Workforce	.18991	.18652
Cost of doing business	−.08307	.56628
Infrastructure	−.25289	.07641
Economy	−.14645	.31019
Quality of life	−.13804	.33910
Technology/innovation	.16287	.25844
Education	.27233	.05571
Business friendly	.02668	.85408
Cost of living	.00711	.96093
Access to capital	.17392	.22708

negligent misrepresentation. Specifically, we measured the correlation between states' positions on auditor liability to third parties (see Table 1) and states' ratings for ''friendliness'' to businesses using a Spearman Rho correlation analysis. The 2015 CNBC's *Best States to Do Business Index* (see www.cnbc.com/2015/06/24/americas-top-states-for-business.html) includes an overall ranking and 10 subaggregate categories for each of the 50 states. CNBC uses 60 measures of competitiveness to create the 10 subaggregate categories (e.g., cost of doing business, access to capital, support for higher education, tax rates, infrastructure) to score each state. The 10 categories were then summarized to derive each state's overall ranking. Table 2 (see jaaf.sagepub.com/XXX) lists the correlation values for the overall and individual variables. No significant correlations were found between state liability positions and their corresponding business friendliness rating or the overall aggregate factors rating. The *r* value between auditor liability law severity and business friendliness is .02668 ($p = .854$). The correlation between auditor liability law severity and the overall ranking factors ranking is −.03111 ($p = .830$).

Despite the lack of statistically significant results in the Spearman correlation analysis, some extant research supports the notion that states are cognizant of third-party protection and use auditors as gatekeepers to curtail managerial indiscretion. Gaver et al. (2012) provide evidence that the legal standard in a state for auditor liability to third parties is associated with the quality of audits conducted within its borders. While sampled firms were not subject to federal statutory law, the results involve only the property-casualty insurance industry.

Federal Securities Laws

Federal regulation of the U.S. securities markets arose mainly from the 1929 stock market crash. In the mid-1930s, Congress enacted two key laws to restore public confidence in the securities markets: the Securities Act of 1933[5] and the Securities Exchange Act of 1934,[6] both giving the SEC rulemaking and enforceability powers. Both laws sought to offset the informational asymmetries that market participants often encountered vis-à-vis company insiders and other market players (Cosenza, 2008; S. Rep. No. 73-392). The 1933 Act provides investors with much enhanced disclosure regarding material information in initial

public offerings (IPOs), and the 1934 Act focuses on protecting investors. Auditors can be liable under both Acts.

Section 10b—Securities Exchange Act of 1934

Section 10b, the 1934 Act's key provision, authorizes the SEC to prohibit fraud relating to buying or selling any security.[7] In 1942, the SEC promulgated Rule 10b-5 to delineate types or classes of deception outlawed by §10b, whose wording parallels Rule 10b-5. While Rule 10b-5's three sections indicate conduct that violates §10b, the regulation provides no details on the elements or conduct that constitutes a violation of §10b. Moreover, §10b and Rule 10b-5 are coextensive: If Rule 10b-5 does not give rise to liability, neither does §10b and vice versa. Section 10b actions do not require privity. Also, the scienter (intent to deceive) requirement means that the defendant accountant's mere negligence is insufficient to impose liability under this section.

Despite Congressional interest in protecting investors, neither §10b nor Rule 10b-5 provide a cause of action for a plaintiff injured by securities fraud. *Kardon v. Nat'l. Gypsum Co* (73 F. Supp. 798 [E.D. Pa. 1947]) first recognized the implied private right of action. A §10b private cause of action includes these elements:

1. a material misrepresentation or omission;
2. intent to deceive (scienter);
3. connecting the misrepresentation or omission with the security's purchase or sale;
4. reliance;
5. economic loss; and
6. loss causation (i.e., connecting the material misrepresentation and the loss).[8]

A single actor rarely violates §10b and Rule 10b-5. Before the mid-1990s, accountants, underwriters, lawyers, and other ''deep pocket'' defendants were often named as aiders and abettors in §10b cases,[9] which, in turn, were pursued under Rule 10b-5(b). Sections (a) and (c) of Rule 10b-5 were not used against accountants and other secondary actors (pre-1994).[10]

The U.S. Supreme Court's *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A*[11] decision changed the legal landscape in holding that a private plaintiff may not maintain an aiding-and-abetting claim under §10b, adding that §10b and Rule 10b-5(b) can only be used in lawsuits against primary violators. But the Court did not hold that secondary actors, such as accountants, were immune from all §10b liability. The *Central Bank of Denver* decision shifted the debate to when secondary actor conduct rises to the level of primary liability.[12] Without providing any guidance on what conduct rises to the level of primary liability under §10b/Rule 10b-5, the Supreme Court failed to clarify secondary actor liability (Cosenza, 2008).

Plaintiffs often alleged ''primary liability'' for conduct underprior aiding-and-abetting violations (Siamas, 2004). Federal courts use many tests—often focusing on *reliance*—to distinguish between secondary ''aiding or abetting'' parties and primary culprits of Section 10b-5(b) liability who engaged in securities fraud.[13] Hence, an auditor could be primarily liable for 10b-5(b) securities fraud in one state (or federal circuit) but not be liable in another jurisdiction.

Federal law §10b application varies nationwide. Five distinct legal criteria help determine whether accountants and other secondary actors are primarily liable under Rule

Table 3. Legal Standards for Secondary Actor Primary Liability Under Rule 10b-5(b).

Legal standard	Description
Bright line test	An accountant or other secondary actor can be primarily liable for a misrepresentation only if he or she signed the document (e.g., SEC filing or earnings press release) containing the misrepresentation, is named in the document, or is otherwise identified by investors at the time of the misrepresentation's dissemination to the public. *Wright v. Ernst & Young*, 152 F. 3d 169 (2nd Cir. 1998). This is the strictest standard (i.e., the toughest standard to meet to hold an accountant or other secondary actor primarily liable).
Anixter test	Under this legal test, for an accountant's misrepresentation to be actionable as a primary violation, there must be a showing that the CPA knew or should have known the representation would be communicated to potential investors. This standard does not mandate that the statement be attributable to the accountant at the time of dissemination. This test emphasizes whether the investor relied upon the statement. *Anixter v. Home-Stake Production Co.*, 77 F 3d 147 (10th Cir. 1996).
Global Crossing test	This test requires that attribution of a statement to an accountant or other secondary actor be made on a case-by-case basis. Any attribution determination must consider whether interested investors would attribute to the defendant a substantial role in preparing or approving an allegedly misleading statement. *In re Global Crossing Ltd. Sec. Litig.*, 2008 U.S. Dist. LEXIS 5459 (S.D.N.Y. January 24, 2008).
Substantial participation test	Under this standard, the accountant or other secondary actor need not make misleading statements but merely "substantially participate" or be "intricately involved" in their preparation. This test does not require that the accountant sign the document containing the misrepresentation, distribute the misrepresentation to investors, or otherwise be identified by investors. The plaintiff must prove he or she relied on the misrepresentation regardless of whether there is attribution to a specific speaker. *In re Software Toolworks, Inc. Litig.*, 50 F. 3d 615 (9th Cir. 1994).
Creator or coauthor test	Under this test, a plaintiff must show that (a) the accountant or secondary actor knew (or was reckless in not knowing) that the statement would be relied on by investors, (b) the secondary actor was aware (or reckless in not being aware) of the material misstatement, (c) the accountant or other secondary actor played such a significant role in the creation of the misrepresentation that he or she could be characterized as the author or coauthor of the misrepresentation, and (d) the other requirements for primary liability have been met. *In re Enron Sec. Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002); *Carley Capital Group v. Deloitte & Touche*, 27 F. Supp. 2d 1324 (N.D. Ga. 1998); Caskey, 2006.

Note. SEC = U.S. Securities and Exchange Commission; CPA = Certified Public Accountant.

10b-5(b). These five legal approaches form the bright line test, *Anixter* test, *Global Crossing* rule, substantial participation standard, and the creator/co-author rule (Table 3; see jaaf.sagepub.com/XXX). Divergent legal standards can cause different outcomes under identical facts. Applying different post-1994 legal tests created a high level of legal

uncertainty for auditors in the securities fraud area. In Table 3, we identify and summarize evolving Rule 10b-5(b) legal standards that hold secondary actors liable for securities fraud to underscore key implications of variations in interpreting and applying §10b and to minimize legal exposure for federal securities fraud.

Impacts of Increased Auditor Litigation Risk on the Auditing Profession

As noted above, auditors face increased litigation risk. Russell (2011) finds judges will increasingly not dismiss lawsuits against auditors, grant fewer motions for summary judgment favoring auditors, and auditors and their lawyers must perform more discovery to reach a settlement. Increased litigation risk increases auditors' legal expenses, which they often ''pass on'' to clients as higher fees, and often cause audit firms to settle cases because large legal claims can cause judgments that could destroy the firm (ACAP, 2008). The current legal environment impairs auditors from obtaining sufficient professional liability insurance coverage at an affordable price (Reilly, 2006) and increases litigation risk (Grubbs & Ethridge, 2007).

A third impact is a greater number of auditors leaving the profession or limiting their practice to nonaudit services, thereby leaving fewer talented individuals in the profession (ACAP, 2008; Grubbs & Ethridge, 2007). Higher litigation risk inhibits the proper use of professional judgment, causing overly cautious audits (ACAP, 2008)—which could be even more significant if auditors face IFRS or other principles-based accounting standards. Also, large auditing firms now more aggressively refuse to render services to high-litigation risk clients. Hogan and Martin (2009), Kaplan and Williams (2012), and Cassell, Giroux, Myers, and Omer (2013) find that second-tier firms have taken on more risky clientele, predominantly clients shed by the Big-Four audit firms.

Empirical research indicates that auditors now support more conservative financial reporting from higher risk clients in higher litigation risk environments. For example, Schmidt (2009) finds that after litigation, auditors require more conservative client financial reporting by constraining income-increasing financial reporting behavior. Gaver et al. (2012) document that auditors demand more conservative financial reporting for weaker property-casualty insurers in states possessing greater litigation risk involving auditor liability to third parties for negligent misrepresentation. While client demand for more conservative financial reporting implies more auditor effort and possibly overauditing, it provides stronger financial reporting.

Methods/Efforts in the United States to Minimize Auditor Litigation Risk

New Laws

In response to the litigation crisis, the auditing profession has sought to change how to minimize liability (Donelson, 2013). During the last 20 years, most states now permit auditing firms to operate as limited liability partnerships (LLPs), limited liability companies (LLCs), or other organizational forms that reduce or eliminate unlimited liability. Passage of two important federal laws, the Securities Litigation Uniform Standards Act (SLUSA)[14] and the Private Securities Litigation Reform Act (PSLRA),[15] has diminished liability exposure in federal securities law cases by introducing particularized pleading requirements and proportionate liability. Defendant auditors can argue that they exercised due professional

care during an audit and followed all applicable auditing standards. In a trial, adherence to Public Company Accounting Oversight Board (PCAOB) auditing standards, Generally Accepted Accounting Standards (GAAS), GAAP, IFRS, or International Standards on Auditing (ISA) is only persuasive evidence—which does not release an auditor from potential liability. Also, the PSLRA limits the use of joint and several liabilities and limits the damages that accountants face, while requiring a plaintiff bringing a Section 10b action to prove that material misstatements or omissions actually caused the plaintiff's loss.

Client Acceptance/Retention

In response to heightened litigation risk, auditors adopted an engagement risk approach to auditing that incorporates the auditor's legal environment into client acceptance and retention decisions and setting audit fees (Basioudis, 2007; Khalil, Cohen, & Schwartz, 2011). Engagement risk entails the client's business risk (i.e., client's financial condition and industry), audit risk, and the auditor's business risk (i.e., probability the auditor will experience a loss in the engagement, including litigation risk). Auditors thus assess the risks and related litigation costs from an alleged audit failure of a current or potential client (Johnstone, 2000). Auditors use engagement risk analyses to screen out undesirable clients (Johnstone, 2000), often called minimizing litigation risk.

Engagement Letters, Including Limited Liability Clauses and Alternative Dispute Resolution (ADR)

Effective engagement letters provide the first line of defense against auditor litigation. Parties contract how to execute the promised work, both parties' responsibilities, and could include conflict resolution procedures should discord arise (Reinstein, Green, & Beaulieu, 2013). The PCAOB and AICPA suggest that engagement letters fully describe auditor and client responsibilities, and those services specifically excluded to reduce any possible misunderstanding between the parties (AICPA, 2012; PCAOB, 2006). AU-C 210.A24 permits auditors to restrict their liabilities when not prohibited by federal or state.

Many engagement letters mandate arbitrating all engagement disputes, which is generally completed faster and cheaper than lawsuits, often lessens bad publicity and punitive damages, allows wider ranges of evidence, and is often more conducive to pretrial settlement (Bryan & Shapiro, 2013a). Clauses could also require the parties to mediate disputes before arbitration and consent to resolve any dispute per jurisdictional laws encompassing the auditor's main office (Bryan & Shapiro, 2013a). Other potential provisions include the following: (a) ''hold harmless'' or indemnification clauses that hold auditors harmless from losses arising from deliberate management misrepresentation, and (b) ADR clauses that mandate using arbitration rather than the courts to resolve disputes. A legal fee shifting provision requires the client to reimburse the auditor when the auditor prevails in a lawsuit. But accounting regulators generally prohibit auditors using ADR and liability-limiting clauses.

The SEC, PCAOB, and other regulatory bodies limit auditors' use of risk-reducing engagement letter clauses, claiming that such clauses impair auditor independence and might cause auditors to perform inadequate testing (Reinstein et al., 2013). The AICPA Code of Professional Conduct (ET§§191.94 and .95) allows auditors of nonpublic firms to use ADR and various indemnification clauses that hold auditors harmless from liabilities connected to deliberate management misrepresentations.

Efforts by the EU, the United Kingdom, and Australia to Limit Auditor Liability

The United States and EU, the United Kingdom, and Australia auditor liability rules balance high-quality audits with the risk of losing another public accounting firm (industry capacity), but use diverse legal systems. U.S. state courts primarily handle U.S. civil matters, but only 15 states limit auditor's liability for negligence to third parties. Much variation exists among the other 35 states. Federal securities law extends auditor liability, making them liable as secondary actors under Section 10b. Still, five position variations affect primary liability of secondary actors. Individual EU countries also have substantial variations in auditor liability. The major difference is that the EU has supported limited auditor liability, focusing on industry capacity, while the United States focuses instead on audit quality. While many legal, governmental, and cultural differences arise between United States and individual EU countries, United Kingdom, and Australia, their experiences offer potential recommendations.

In the following discussion, we examine current examples of several EU countries, plus the United Kingdom and Australia. The United Kingdom and Australia also employ common law, as does the U.S. Continental EU countries generally use code law rather than common law. Yet, countries from both systems, except for the United States, have tried to limit auditor third-party liability.

EU Auditor Liability (Civil or Code Law)

The EU contains 28 countries that often seek to develop uniform standards across the union similar to the 50 U.S. states. In 2006, the EU charged the EC to examine the effects of the differing member states' approaches to auditor liability on their capital markets. This obligation led to the London Economics Report (2006) report supporting the EC (2008) recommendation that member states analyze several possible methods to limit auditor liability.

For example, Belgian law reduced auditors' litigation risk by limiting rights to jury trials, where judges hear cases involving technical accounting evidence (De Poorter, 2008). Denying jury trials can limit findings based on nontechnical evidence. Belgium also disallows legal fees on a contingent basis and class-action lawsuits (as the United States allows), while using more conservative discovery rules (Carcello, Vanstraelen, & Willenborg, 2009). Similar to the United States, Belgium has few restrictions on third-party liability, following the two U.S. states that extend negligence to reasonably foreseeable third parties. But third parties must show that the auditor's negligence damaged the third party who relied on the information, they would not have made the decision without the information, and a different decision would arise in absence of the information. Unlike the United States, Belgium uses a two-tiered liability cap of 3,000,000 Euros for unlisted companies and 12,000,000 Euros for listed companies. Both the difficulty of claimant proof and liability caps further reduces auditor liability (Table 4; see jaaf.sagepub.com/XXX).

Germany's position parallels the United States near privity rule for auditor liability relative to express contracts for negligent misrepresentation. Under the German Commercial Code (GCC Section 323 1986), auditors are also liable to foreseeable third-party users under an implied contract for information. This approach is consistent with a judicial view that auditors are primarily liable to both individual stockholders and to all foreseen financial statement users, including third parties as a group. While the U.S. foreseen user

Table 4. Various Country Positions on Accountant Liability to Third Parties for Negligent Misrepresentation.

Country	Current legal standard and developments
United Kingdom (common law country)	*Caparo Industries PLC v. Dickman* (1990) 2 AC 605. The House of Lords held unanimously that a public company's auditors lacking special circumstances owe no duty of care to an outside investor or an existing shareholder who buys stock in reliance on a statutory audit. A three-pronged test for a duty of care to arise applies the following: (a) foreseeability, (b) proximity must be present between the suing party and defendant, and (c) it must be just and reasonable on a policy basis to impose a duty. Auditor liability for negligent misstatements is confined to cases that can establish that the auditors knew that their work product would be communicated to a nonclient, either individually or as a member of a limited class, and the third party relied on the work product in connection with a particular transaction. This case restricts the auditor's liability to third parties for negligent misstatements. It is still prevailing U.K. law on third-party auditor liability. Recent amendments to the U.K. Companies Act permit auditor liability limitation agreements. A liability limitation agreement is defined in the Act as an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty, or trust occurring in the course of the audit of accounts, for which the auditor may be responsible. The Companies Act requires shareholder approval of auditor liability limitation agreements. Courts can override any element of the agreement that is neither fair nor reasonable and sets a new level of liability. The ability to enter a limitation agreement does not affect third-party liability (Directorate General for Internal Market and Services, *Summary Report Consultation on Auditor's Liability*).
Australia (common law country)	In 1997, the High Court of Australia ruled directly on auditor liability to nonclients for negligence in *Esanda Finance Corporation Ltd. v. Peat Marwick Hungerfords* (1997)188 CLR 241. The High Court judgment, at least in part, had its roots in the early American cases (e.g., *Ultramares*). This Court decided that mere reasonable foreseeability that third parties might rely on audited financial statements was insufficient to give rise to a duty of care. Australian law requires both foreseeability of harm and a special relationship amounting to a "relationship of proximity" for a duty of care to arise. Mere knowledge of an auditor that his or her work product will be communicated to a nonclient is insufficient to create a duty of care. A duty of care to a nonclient, absent an auditor's response to a request for information from a specific third party, is difficult to establish unless the auditor intends to induce reliance on the work product by the nonclient or a limited class of nonclients. Any reliance by the plaintiff must be reasonable under the circumstances. A lack of intent to induce reliance is not necessarily fatal to establishing a duty of care as other factors may establish proximity.

(continued)

Table 4. (continued)

Country	Current legal standard and developments
	In the early 2000s, the High Court set aside using proximity as a yardstick to find a duty of care, turning to or adopting what is known as the "salient features approach." Salient features are simply factors that the Court weighs and balances in determining whether there is a sufficiently compelling reason to attach legal liability to a situation of harm (Stychin, 2012). The High Court views "vulnerability" as a salient feature. In economic loss cases, vulnerability can provide limitations on the duty of care. Regarding commercial parties, vulnerability points away from liability (Stychin, 2012). The salient features approach can be deemed as a drilling down into the concept of proximity (Tan, 2010).
	Australia now caps damages in auditor liability cases. PSL established a framework for LCS. The cap is a multiple of "reasonable charge" for the audit service underlying the cause of action up to a US$75 million maximum. The minimum cap for audit fees below US$100K is US$2 million. For fees between US$500K and US$1 million, the cap is US$20 million. If the fee exceeds US$2.5 million, the cap is US$75 million. A court looks at total fees for the overall service giving rise to the claim. At the time of the filed claim, the accountant must have adequate professional liability insurance for protection under the capping scheme (see www.charteredaccountants.com.au)
France (civil or code law country)	Auditor liability to third parties is based on tort rather than contract law. An auditor is liable to the client and third parties for damages caused by intentional or negligent violations of professional duties. The auditor is not liable for legal violations committed by directors unless the auditor has knowledge of such violations and fails to report them. Third parties need not be specifically foreseen or known to the auditor. Third parties must prove fault, injury, and causation. (Article 234, Section 1, Loi Sure Les Societes Commercials No. 66-537; also see Articles L822-17 and L822–18) of the French Commercial Code and Article 1382 of the French Civil Code). Two elements must be satisfied to demonstrate causality: (a) an auditor mistake must have led to reliance by the third party and (b) the auditor's error must have brought about the plaintiff's action. French courts have rejected third-party claims even when evidence shows that irregularities or fraud would not have been discovered even with auditor due diligence, or events would have unfolded even in the absence of the auditor's fault.
Spain (civil or code law country)	Statutory auditors in Spain had long faced an unlimited liability regime under Section 11.1 of Accounts Audit Act and Section 1911 of the Civil Code. To follow EU standards, based on EU Directive 2006/43/EC, the Spanish government introduced a limitation of responsibility for statutory auditors. Article 11.2 of the Law of 12/2010 of June 30 introduced a proportionate liability regime.

(continued)

Table 4. (continued)

Country	Current legal standard and developments
	Due to an October 14, 2008 Supreme Court ruling on (R/2008/6913), involving PSV housing cooperative's bankruptcy and subsequent legislation, statutory auditors now face liability for direct damages and losses of profits caused by their professional activity to the client or any third party provided by Article 22.2 RLD, 1/2011. Third parties must have relied on the information found in the audit report, and based on that information, incurred financial losses. The auditor is responsible for the amount of damage equal to its share of liability in the event triggering the claim. Auditors and audit firms should also establish a bond to respond to all damages that may arise while they perform their duties.
Germany (civil or code law country)	Germany has two types of auditors: WP and vBP. The vBP's authority is limited to medium-sized firms that need not have their financial statements audited. The regulatory framework consists of the German Civil Code, the German Commercial Code, and the WPO (i.e., a legal act regulating auditing activity and auditors performing such audits). But as no explicit regulation on auditor liability to third parties is in place, German jurisprudence sought to fill the gap by applying different tort law techniques. Tort law doctrines used for resolving auditor liability to third parties are the Auskunftvertrag (implied contracts to third parties or third-party beneficiary contract) and Garantievertrag. German tort law protects third parties from defined type (e.g., certain pension plans) damages. Auditors are liable to third parties when they intentionally violate German law. Auditor liability under protective laws such as certain criminal fraud, investment fraud, economic subsidy fraud, breach of trust, falsification of documents, violation of trade secrets, and bankruptcy offenses requires specific intent proof. The courts have interpreted such intent as an auditor's sufficiently knowing of possible third-party damage due to this conduct (Chung, Farrar, Puri, & Thorne, 2010). German courts have developed two approaches to develop third-party claims against auditors: One approach addresses contracts with protective effects for third parties and the second approach involves an implied contract for information (Chung et al., 2010). The first approach requires proving the existence of these four factors: (a) the third party must be closely connected to the auditor's work product (e.g., creditor; which gives rise to a duty of care to the third party), (b) the third party must rely on the audit opinion in their decision making, (c) the main parties to the contract wish to include or benefit the third parties (e.g., an intended third-party beneficiary contract under the common law), and (d) the auditor must be aware that the audit opinion is for the benefit of the intended third parties (Chung et al., 2010). This is sometimes called a Vertrag mit Schitzwirkung zugunsten Dritter. Comment: This legal standard parallels the near privity standard of various American states (e.g., New York) use.

(continued)

Table 4. (continued)

Country	Current legal standard and developments
	Under the second approach, the courts must conclude that the auditor provided information to the client intending that the client provides it to the third party to influence the latter's decision. The auditor should be liable for the accuracy of the information provided (De Poorter, 2008). WPs and vBPs liabilities for negligent misrepresentation are limited by a monetary cap set in §323, Subsection 2 of the German Commercial Code. It is limited to 1 million Euros, except for firms whose shares are traded on a regulated exchange, where the cap is 4 million Euros. German law states that the limit applies "per audit." The courts and legal literature have not decided whether a "per claim" or "per audit" method should be used to apply the cap (Karako-Eyal, 2013).
Belgium (civil or code law country)	Auditor liability toward third parties involves few restrictions. A Belgian auditor is liable for each interested third party as the audit report is publicly available (De Poorter, 2008). Third parties can rely on published audited financial information. Due to Article 140 of the Belgian Company Code, all certified financial information users can rely on published audited financial information. Few cases of auditor liability involving third parties occur in Belgium. A third-party claimant must prove (a) that the auditor's negligence caused any damage incurred, (b) reliance on the auditor's work product, (c) that the third-party decision would not have been made without it, and (d) she or he would have made a different decision if the auditor's data were presented accurately (De Poorter, 2008). Belgium caps damages at 3 million Euros for statutory audits of unlisted companies and 12 million Euros for listed companies (Karako-Eyal, 2013). Besides monetary caps, the law requires a compulsory insurance policy which ensures that coverage is in line with potential auditor liabilities (Spell, 2010).
The Netherlands (civil or code law country)	Article 393 Book 2 Dutch Civil Code mandates that all firms submit annual financial statements. Its law requires only medium-sized and larger firms to prepare audited, annual financial statements. Audit requirements are variable, depending upon company size. The external auditor should determine whether the annual accounts give a true and fair view in accordance with the relevant financial reporting framework. No specific provision of Dutch law discusses external auditor liability; general rules of civil liability apply (van Bekkum, Hijink, Schouten, & Winter, 2010). Not all external audited financial statements found as misleading or inaccurate lead to auditor third-party liability. This arises only under specific circumstances showing breach of a duty of care owed to third parties; for example, a client's explicit approval to use the financial statements and audit report (van Bekkum et al., 2010). An auditor's duty of care to third parties can only be derived from *Caparo-like* criteria (De Poorter, 2008), thus requiring the third party to meet a near privity-like standard.

(continued)

Table 4. (continued)

Country	Current legal standard and developments
	The Netherlands has no statutory liability cap, but the auditor and client can establish a liability cap in the engagement agreement. Liability for gross negligence or willful misconduct cannot be excluded, and setting a cap has no effect on third parties (van Bekkum et al., 2010).

Note. PSL = Professional Standards Legislation; LCS = Liability Capping Schemes; EU = European Union; EC = European Commission; WP = Wirtschaftsprufer; vBP = vereidigter Buchprufer; WPO = Wirtschaftspruferordnung.

concept appears in both Belgium and Germany, Germany's liability caps limit liability to 1 million Euros for unlisted companies and 4 million Euros for listed companies. While the caps are listed as a ''per audit,'' the courts have not settled on a ''per audit'' or ''per claim'' application.

German auditors have operated with liability caps for over 75 years. Gietzmann and Quick (1998) astutely note that evaluation of any auditor liability regime (to third parties) is meaningful only when considering the overall corporate governance system—where banks have long played a key role, unlike many common law countries. But Germany has moved toward expanded auditor liability to third parties (with caps) due to the growing role of securities markets, pressures for internationalization, and EU directives (Gietzmann & Quick, 1998).

The Netherlands, under civil law, allows auditor liability to third parties following a near privity position similar to some U.S. states (van Bekkum, Hijink, Schouten, & Winter, 2010). While not having statutory caps like Germany and Belgium, auditors can create contractual caps with the client to cover negligence (see Table 4). However, contractual caps may face court modification.

Other countries, such as France, have extended third-party liability similar to some U.S. states, allowing third parties to sue for both intentional acts and negligence (Article 1382 of the French Civil Code). France does not require the third party to be known or foreseen, extending liability to unforeseen third parties. While third parties must prove that the auditors' fault caused the damages, French courts conservatively interpret fault, damage, and causation (see Table 4).

In comparison with France, Spain also extends auditor liability to third parties, similar to the U.S. position of foreseen users. Third parties must show direct damages, causation, and reliance on auditor-provided information. However, unlike many European countries, Spain introduced proportional liability in December 2010 (Article 11.2 of the Law of 12/2010 of June 30). Under proportional liability, losses are limited to the auditor's share of the damage.

U.K. and Australian Auditor Liability (Common Law)

In *Esanda Finance Corporation Ltd. v. Peat Marwick Hungerfords* (1997), Australia's High Court ruling parallels U.S. near privity; it extended ''a duty of care'' to third parties only for foreseeable users with a ''relationship of proximity,'' but uses a high *duty of care* standard. Since the early 2000s, the High Court has moved away from the proximity concept to a ''salient feature approach,'' requiring a sufficiently compelling reason to extend

liability to third parties (Stychin, 2012). This moved Australia from near privity to a restricted form of a Restatement standard. Australia also has established liability caps. Professional Standards legislation caps range from US$2,000,000 for fees less than US$100,000 to US$75,000,000 for fees over US$2,500,000.

In the United Kingdom, Part 16, Chapter 6, ''Auditor Liability,'' of the Companies Act of 2006 (implemented in November 2009) helps to further limit U.K. public accounting firms' liabilities. Auditors had faced joint and several liability scenarios similar to the United States, allowing a plaintiff to sue a firm for all losses regardless of the proportion of auditor blame. Similar to the EU overall, the United Kingdom is concerned with industry capacity if they face the loss of a Big-Four firm. The 2006 Act allows a client and auditor to set an ''agreed-upon'' cap, similar to the Netherlands, through a clause in their engagement letter. The contracted clause limits a firm's liability to a specific year, subject to stockholders' approval, as long as shareholders can recover a ''fair and reasonable'' amount of the loss. Unlike caps based on listed/unlisted scenarios or fees, contracted caps allow the company and auditor to limit liability to a specific assessed audit risk. It further allows auditors to adjust the audit fee to reflect the aggregate risk faced adjusted for the contracted liability cap. Courts can disregard any contractual agreements that limit what they deem less than ''fair and reasonable.'' Firms could present engagement letters with liability caps that simply state a ''fair and reasonable'' amount, a fixed monetary cap, or cap to a proportional liability. While fixed caps give firms some certainty, a court will default to a maximum of ''fair and reasonable.'' Using the default term ''proportional liability'' still leaves public accounting firms with the uncertainty of courts deciding an auditor's extent of blame and amounts of potential losses. Liability limitation clauses do not apply to auditor third-party liability.

Lessons From the EU, U.K., and Australian Experiences

What can U.S. regulators learn from the EU, U.K., and Australian initiatives? The EU has studied both supporting limited auditor liability and high audit quality. Arguments for limited liability focus on the profession's capacity to properly audit large international companies, while arguments for audit quality center on protecting users of public financial statements. EU, U.K., and Australian actions support several options to limit auditor liability with minimal adverse effects on audit quality through continued motivation of auditor due diligence. Unlike the EU, the United States should strive for a harmonized application of auditor liability regulation. While the EU should recognize individual member state's legal systems, U.S. regulation could fall within one border. Harmonized regulation would move the legal environment away from the diverse state-by-state application of laws applied to third-party auditor liability cases. For example, within the EU some member states have instituted some recommended methods of auditor liability reform, while others have remained silent—just as individual U.S. states accept tort reform on a state-by-state basis. The United States may consider some of the following policy options.

First, instituting public-supported insurance pools—perhaps combined with fees from CPA firms that undergo PCAOB inspections and increased stock transaction fees—should increase the availability of affordable auditor liability insurance. While insurance does not directly reduce liability risk, the availability of a public risk pool may lower a middle-tier firm's barrier to entering the public company audit market. Implementing public risk pools requires consideration of several public policy issues. First, who should pay to subsidize the insurance pool? Is this a public tax-supported policy that requires user premiums similar

to current U.S. health care laws? Will public companies pay into a pool to supplement public accounting firms' premiums? While a government-administered, subsidized insurance pool would increase the availability of liability insurance, it would not decrease the actual level of auditors' risk.

The second option is to develop reasonable auditor liability caps, such as fixed dollar caps, sliding caps proportional to audit fees, or caps that the audit firm and the company's audit committee contractually accept. While helping many larger firms and perhaps creating entry barriers for middle-market firms, fixed caps, such as those used in Germany, create simplicity in application. While relatively high caps serve as entry barriers for middle-tier firms, lower liability caps could impair audit quality. Caps based on actual losses or a multiple of audit fees lower entry barriers and avoid a one-size-fits-all regulation. Middle-tier firms would benefit from proportional liability caps by allowing them to audit smaller public companies. But proper sliding scale caps would still motivate quality audit work by setting liability caps relative to audit risks faced in the audit. Agreed-upon liability caps, similar to those allowed in the United Kingdom, may face court challenges after the fact. A public accounting firm could face actual liability losses greater than the agreed-upon cap if courts view the cap as unreasonable or not fair. If U.S. courts void an agreed-upon liability cap, then auditor liability regulation would fail.

The third option is proportional liability, similar to Spain and the United Kingdom. The U.S. legal system permits ''joint and several'' liability where auditors can face all the risk even when they are only partially at fault. One argument for ''joint and several'' is higher audit quality, where quality is significantly high due to the auditor's perceived level of risk. But two arguments arise against applying laws based on ''joint and several'' liability; deep pockets and industry capacity. Besides developing the intellectual and physical capacity for many audits of public entities, joint and several liability restricts middle-tier firms from entering the market due to a high risk of loss relative to their responsibility for the loss. Under the deep pockets theory, public accounting firms become the aggregate insurer against all losses, even when they have little or no fault.

This undue and disproportionate level of risk under joint and several liability contributes to the high cost and lack of availability of auditor liability insurance. Under ''proportional'' liability, auditors become responsible for the portion of loss that is their fault, lowering both level of risk, frequency and potential damages from lawsuits. Moving to proportional liability also lowers the risk of losing another Big-Four firm and reduces a barrier to entry for middle-tier firms to help maintain industry capacity. Proportional liability should also temper the public's ''deep pockets'' view of public accounting firms and should uphold audit quality as public accounting firms still face liability for their own—but not for others'—liabilities.

U.S. policy makers should thus consider using proportional liability and sliding liability caps to support audit quality and maintains or expands industry capacity. Industry capacity would increase by lowering the risk of losing a Big-Four firm and reduce a barrier of entry to middle-tier firms. The reduced liability cost could also lower industry liability insurance premiums and increase the availability of insurance, eliminating the need and cost for public insurance pools.

Summary and Conclusion

The Big-Four CPA firm's current legal liability environment seems ''difficult,'' especially because PCAOB standards include requiring different firms to do tax and other ancillary services than those who perform audits and mandatory or client-requested audit firm

rotations. Potential dangers arise in empowering few CPA firms, and attracting and retaining talented CPAs upon seeing the demise and related financial ruin of the partners of another large failed audit firm.

Methods to limit liabilities include liability caps, governmental insurance, engagement letter, or other contract clauses to limit auditor's liability to clients or to third parties, increased requirements to restrict legal standing to initiate civil cases, and moving to proportional liability. Sliding liability caps and proportional liability have the advantage of reducing auditor liability, while maintaining audit quality and industry capacity.

Differences between EU/U.K./Australian and U.S. legal systems include ''loser pays'' in unsuccessful civil trials, banning contingent fees, and a much lower ratio of available lawyers—U.S. policy makers should adopt key parts of other counties' policies to sustain the profession's long-term viability. Adopting U.K./EU/Australian methods provides ideas such as sliding liability caps and contract clauses to help both Big-Four and second-tier firms thrive for the foreseeable future. Also moving away from ''joint and several'' to ''proportional'' liability affects positively the profession's capacity to reduce the publics' ''deep pockets'' view of the profession. While the current contentious national environment impairs Congressional (but not PCAOB, SEC, or other regulatory) action on these matters, perhaps individual state legislatures and other regulators can implement many such provisions. While national action derives a single set of rules, state-by-state implementation would continue the current differences in legal matters facing CPA firms.

Competent accounting firms will likely continue to provide high-quality services regardless of tort reform, primarily due to their strong desire to maintain their professional reputation. For example, Beatty (1989) shows that accounting firms with strong reputations can charge large audit premiums related to IPOs. Also, successful malpractice lawsuits and PCAOB sanctions help improve the target's and other CPA firms' audit procedures. Skinner and Srinivasan (2012) find that after a major Japanese PWC client had an audit failure, PWC significantly improved its local audit practices and stopped auditing many of its weaker clients—all in an environment where legal actions against audit firms rarely occur.

Future research could examine some effects of adopting parts of these European models. Behavioral and empirical studies can examine changes in risk perceptions, audit fees, and the propensity to change auditors when applying parts of non-U.S. models. In any event, U.S. policy makers should adopt efficacious changes before another CPA firm fails and leaves society with an unsustainable Big-Three audit profession, which could even end private-sector audits.

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Notes

1. The U.S. Securities and Exchange Commission (SEC) and Department of Justice issued joint guidance on the auditor's responsibility regarding client violations of the Foreign Corrupt Practices Act (FCPA). *A Resource Guide to the U.S. FCPA* states that ''independent auditors

who discover an illegal act, such as the payment of bribes to domestic or foreign government officials, have certain obligations in connection with their audits of public companies.'' FCPA violations or an inadequate FCPA compliance program could constitute a material weakness in internal controls over financial reporting. Auditors who fail to fulfill these obligations could also face SEC/Public Company Accounting Oversight Board (PCAOB) enforcement actions and civil suits. See *In re Price Waterhouse, Bangalore, Lovelock & Lewes*, PCAOB Release No. 105-2011-002 (April 5, 2011); *In re Kantor, Geisler & Oppenheimer, P.A.*, PCAOB Release No. 105-2007-009 (December 14, 2007).

2. Recent studies have examined the effects on auditor decisions when applying principle-based standards (International Financial Reporting Standards [IFRS]). Quick (2013) examined how U.S. rules-based versus IFRS principle-based accounting standards affected auditors' decisions in applying the standards. She posits that while principle-based standards may allow companies to reflect better the transactions' economic substance, the U.S. legal system can cause uneven applications of standards. She also investigated potential unintended consequences of the United States moving toward principle-based standards without allowing for some form of limited auditor liability.
3. 18 U.S.C. §§1961-1968 (2014).
4. Per Table 1—located at jaaf.sagepub.com/XXX—lists the 33 states that apply some version of the Restatement standard are Alabama, Alaska, Arizona, California, Colorado, Delaware, Florida, Georgia, Hawaii, Iowa, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Washington, and West Virginia.
5. 15 U.S.C. §§77a-77aa (2014).
6. 15 U.S.C. §§78a *et seq.* (2014).
7. Under §10b, it is unlawful for any person, directly or indirectly, to ''use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.''
8. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005).
9. *Ross v. Bolton*, 904 F. 2d 819 (2nd Cir. 1990; claim against brokerage firm); *Fine v. American Solar King Corp.*, 919 F. 2d 290 (5th Cir. 1990; claim against an accounting firm); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F. 2d 490 (7th Cir. 1986; claim against law firm).
10. Plaintiffs rarely invoked Subsections (a) and (c), because, before 1994, the path of least resistance for a plaintiff alleging a fraud involving several actors alleged that one actor misrepresented or omitted a material fact and the accountants or lawyers aided or abetted that fraud. *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 497 (S.D.N.Y. 2005).
11. 511 U.S. 164 (1994).
12. Id. at 191; Apolinsky (2009).
13. Reliance exists where the alleged misstatement or omission (a) influenced the plaintiff to purchase or sell a security, or (b) influenced the terms upon which the purchase or sale was made. Proof of either creates a causal connection between the defendant's alleged misstatement or omission and the plaintiff's injury. See *Atari Corp. v. Ernst & Whinney*, 981 F. 2d 1025 (9th Cir 1992); *Citibank, N.A. v. K-H Corp.*, 968 F. 2d 1489 (2nd Cir. 1992).
14. 15 U.S.C. §78 bb(ff)(1) and (f)(2) (2014).
15. 15 U.S.C. §78u-4, 78u-5, *et seq.* (2014).

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