The Advocate
FOR INSTITUTIONAL INVESTORS

Can Private Litigation Redeem The Accounting Profession?

By Francine McKenna

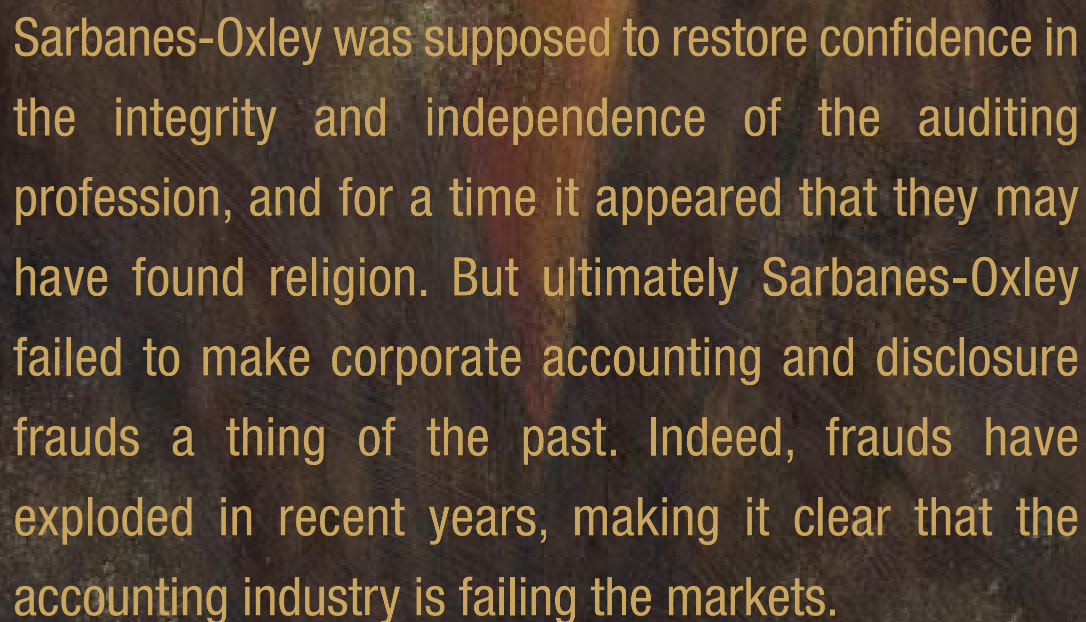
It's never been easy to bring lousy auditors to justice, but in the last 35 years, it's become harder than ever.

The law was supposed to restore confidence in the integrity and independence of the auditing profession, and reduce the number and severity of corporate and accounting frauds like the ones at Enron and WorldCom. And for a time it appeared that the auditing profession may have found religion. But, ultimately, Sarbanes-Oxley failed to make corporate accounting and disclosure frauds a thing of the past. Indeed, frauds have exploded in recent years, making it clear that the accounting industry is failing the markets.

Auditors of public companies are supposed to perform a public duty. The auditor's true clients, according to statute, are shareholders, not company executives. There is an inherent conflict in the way we pay for an audit, however. Similar to the conflict that ratings agencies have, shareholders have very little say in how the relationship between the company and its audit firm is managed because their proxy votes are only advisory. The company, through the Audit Committee of the Board of Directors, hires, pays, and evaluates an "independent" audit firm and its work. Auditors risk losing clients when they object to deliberate accounting manipulation or possible illegal acts favored by client management. Perversely, auditors more often keep their jobs even when shareholders sue them repeatedly for lapses that allowed fraud and failure to occur.

Legislators with short memories also conveniently forgot how Arthur Andersen lost its independence and objectivity at Enron because of the hundreds of millions it earned from consulting to its audit client. Unfortunately, company executives, and the audit committees that serve

Continued on next page.



Sarbanes-Oxley was supposed to restore confidence in the integrity and independence of the auditing profession, and for a time it appeared that they may have found religion. But ultimately Sarbanes-Oxley failed to make corporate accounting and disclosure frauds a thing of the past. Indeed, frauds have exploded in recent years, making it clear that the accounting industry is failing the markets.

Legislators with short memories conveniently forgot how Arthur Andersen lost its independence and objectivity at Enron because of the hundreds of millions it earned from consulting to its audit client.

them, have regained the upper hand in the auditor-company relationship.

At the same time, the Supreme Court has made it harder and harder for private investors to hold auditors accountable. Notwithstanding these obstacles, today the Big Four audit firms — Deloitte, KPMG, Ernst & Young, and Pricewaterhouse-Coopers — are under intense scrutiny by regulators and institutional investors for consulting practices that have again grown so large that they again have threatened audit quality. In fact, it is the institutional investor community that may hold the key to redeeming the accounting profession.

The Challenges to Accounting Accountability

It has never been easy to bring lousy auditors to justice, but in the last thirty-five years it has become harder than ever. In 1975, the U.S. Supreme Court decided in *Ernst & Ernst v. Hochfelder* that securities litigation requires an allegation of "'scienter' — an intent to deceive, manipulate, or defraud." The "scienter" requirement is notoriously difficult to meet in an auditor liability case without a whistle-blower or a "smoking gun." Because Congress's 1995 Private Securities Litigation Reform Act ("PSLRA") prohibited investors from discovery without getting past a motion to dismiss, many cases against auditors are, therefore, dismissed before the first witness can be deposed or the first document requested. In addition, in a series of decisions that culminated in the 2008 opinion in *Stoneridge Investment Partners v. Scientific-Atlanta*, the Supreme Court sharply curtailed the ability of investors to bring cases against auditors for "aiding and abetting" securities fraud even where there is definitive proof that an auditor actively conspired with a company to commit fraud.

All hope to bring auditors to justice for securities fraud is not lost, however. Theoretically, where auditors issue public statements themselves (like certifying a company's public financial statements), plaintiffs can attempt to satisfy the requirement of auditor scienter. To do so, the auditor must be "reckless." The "reckless" standard established by the Supreme Court's 1975 *Ernst* decision requires more than just a misapplication of accounting or auditing principles. Plaintiffs must prove that the auditing was so deficient that the audit amounted to "no audit at all" or "an egregious refusal to see the obvious, or to investigate the doubtful," or that the accounting judgments which were made were such that no reasonable auditor would have made the same decisions if confronted with the same facts.

Proving that an audit amounted to "no audit at all" is increasingly difficult these days, because companies are refusing to restate their past audited financials. Instead, when companies misstate financial information, intentionally or not, they are using a "revision" approach more and more to fix it without filing a Form 8-K with the SEC or formally restating and refiling prior financials. Fewer formal restatements means it is harder for shareholders to bring any case, let alone one against a third-party such as auditors, because without a formal restatement it's difficult to quantify the harm to investors prior to discovery. When a case can be filed, auditors, and their lobbyists, have

made it very difficult to prevail. As a result, auditors are left off the list of class action defendants or dropped once judges signal acceptance of the common, but professionally embarrassing, auditor defense: "We were duped, too."

Making matters worse, if audit firms paid for failure at all, it was typically a fraction of what other defendants paid. There's a rule of thumb heard repeatedly in settlement discussions: Big Four firms won't pay more than 10% of what the company paid.

Meaningful Prosecutions on the Rise

Auditors have only sparingly been named as defendants in securities cases, including in the recent financial crisis lawsuits. But that is beginning to change. In March of 2010, the Lehman Bankruptcy Examiner used the word "fraud" in his report and implied that Ernst & Young, Lehman's auditor, was complicit in Lehman's misconduct.

While securities cases have recently been brought against auditors, such cases are rarely, if ever, going to trial. Especially since Andersen's high-profile demise, the Big Four global audit firms settle securities litigation before trial both because they fear a judgment large enough to threaten their solvency and because they don't want their mistakes aired in public. Indeed, if there is substance to a claim, or negligence or complicity by an audit partner and his firm, the case usually settles before any facts are made public.

For example, New Century Financial was a subprime mortgage originator that failed early in the crisis. The bankruptcy trustee and private investors in a class action suit both sued auditor KPMG successfully. The cases settled in spite of — or perhaps because of — very specific examples of reckless auditor behavior documented by the New Century bankruptcy examiner. Thus, the allegations against KPMG will never be heard in open court.

Similarly, in 2011, Price Waterhouse India, Price Waterhouse International Ltd. and PwC U.S. settled for $25.5 million for the massive Satyam accounting fraud, a $1 billion scam that involved falsified bank confirmations. Shareholders alleged the auditor was "reckless" in carrying out its duties. Price Waterhouse India also paid $7.5 million in fines to the Public Company Accounting Oversight Board, the audit regulator, and the SEC who alleged Price Waterhouse India had aided and abetted the Satyam fraud and there had been "no audit at all." In 2012, Deloitte agreed to pay $19.9 million to settle claims for its work at JPMorgan Chase & Co. (JPM)'s Bear Stearns unit after plaintiffs successfully argued "no audit at all" allegations.

If a Big Four audit firm ever does go to trial again for a major fraud, we may finally close the "expectations gap," the infamous gulf between what investors think auditors do and what auditors actually do, and say they do. There are a few cases where this remains a possibility:

- There's a trial scheduled to start in June 2013 against Deloitte as auditor for Taylor, Bean & Whitaker (TBW), another financial crisis era mortgage originator fraud where plaintiffs allege there was "no audit at all."

Auditors have only sparingly been named as defendants in securities cases, including in the recent financial crisis lawsuits. But that is beginning to change. In March of 2010, the Lehman Bankruptcy Examiner used the word "fraud" in his report and implied that Ernst & Young, Lehman's auditor, was complicit.

While securities cases have recently been brought against auditors, such cases are rarely if ever going to trial. Especially since Andersen's high-profile demise, the Big Four global audit firms settle securities litigation before trial both because they fear a judgment large enough to threaten their solvency and because they don't want their mistakes aired in public.

© Copyright 2002 Mike Lane – All Rights Reserved.

- PwC is the last defendant standing in a class action for the Colonial Bank failure, pending a decision soon on a motion to dismiss.

- In the class action case related to the Lehman failure, Ernst & Young is one of two remaining defendants. Barring a last minute settlement, we may finally see some of the facts of that case given a public airing.

This willingness to hold auditors liable for their role in the crisis, and in several of the non-crisis related corporate frauds that have occurred since, did not come soon enough to change the law or judges' minds. Attempts to restore private plaintiffs' right to allege aiding and abetting by auditors, specifically an amendment introduced by Senator Arlen Specter in 2010 during the Dodd-Frank financial reform bill debates, failed.

Shareholders Can Reform the Accounting Industry

Investor action can be a powerful tool to effect change in boardrooms and at the Big Four accounting firms. What can investors do when auditors behave more like lapdogs of management than watchdogs?

1 Pay attention to the proxy. Support corporate governance initiatives such as "tender or explain" for long-term relationships between auditors and companies. When auditors serve the same client for decades there's bound to be a negative impact on independence and objectivity.

2 Vote your proxy. When auditors are sued or suspected of negligence or complicity in frauds or accounting manipulation, don't allow your broker to reelect them. Attend the annual meeting and voice your concerns.

3 Support activist investor and corporate governance initiatives to actively monitor companies that spend more with their auditors on tax and consulting services than the audit. Put pressure on the SEC and PCAOB to discipline auditors for breaking the rules on prohibited services by an auditor.

4 Board directors, and especially Audit Committee members, should monitor the work of the audit firm closely. Don't take the auditor's word that it's independent. Don't allow the CFO to make all decisions or be the only one to debate accounting issues. Ask your auditor about PCAOB inspection results and push back on excuses for poor quality.

5 When frauds occur, pursue valid claims against the audit firms all the way to trial if necessary. Hire a great lawyer who will fight as hard as the auditors do to successfully overcome the traditional obstacles to auditor litigation. If you stay the course, you'll likely recover your losses.

When investors force auditors to play their statutory role in the regulatory infrastructure — and stop being handmaidens to management — frauds can be stopped earlier and losses mitigated. Shareholders pay the accounting industry billions of dollars to keep their portfolio companies honest and open. They deserve more bang for their auditing buck. ◆

About the Author

Ms. McKenna is a freelance writer and C.P.A. with more than twenty-five years of experience in consulting and professional services, including tenure at two Big Four auditing firms in the U.S. and abroad. She is a columnist for both *Forbes* ("Accounting Watchdog") and *American Banker* ("Accountable"), and prior to that was a weekly columnist at GoingConcern.com. Her other writing credits include *Financial Times, Accountancy Age, Accountancy Magazine, The Columbia Journalism Review, Boston Review, the FEI Blog*, and various other financial, media, and technology blogs.

When investors force auditors to play their statutory role in the regulatory infrastructure — and stop being handmaidens to management — frauds can be stopped earlier and losses mitigated. Shareholders pay the accounting industry billions of dollars to keep their portfolio companies honest and open. They deserve more bang for their auditing buck.