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Carleton H. Griffin

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HOW TO DEFINE THE LIMITS OF RESPONSIBILITY

by CARLETON H. GRIFFIN

We are living in a particularly difficult business environment. A combination of economic recession and severe inflation has brought widespread business failures and investor losses. But also significant is what has been exposed in their wake: a disturbing amount of improper conduct in the corporate world.

It is perhaps not surprising to hear of misdeeds in such circumstances, or even the sheer volume and size of what has been discovered. Recent economic troubles have been pervasive and serious. But what is more noteworthy is the amount of collusive misconduct unearthed at high corporate levels. The greatest mischief, moreover, has not been mundane defalcations—where the perpetrator's benefits are direct. It has been the highly sophisticated manipulation of accounting records and procedures to produce indirect benefits, through influencing stock prices or job status. Thus, we learn of not only the age-old problems of altered inventory records and fictitious vendors, but also such cooperative sleight-of-hand as hidden loan guarantees and contributed capital masquerading as sales revenue.

Backwash from the Watergate era has added another dimension—the revelation of substantial corporate political gifts which were "laundered" through fictitious expense classifications and disguised expenditures of currency. In many instances, these practices have apparently been carried on for some time and are just now coming to light.

The latest development—which followed the dramatic death leap by the chief executive of one of the nation's largest companies—is the burgeoning series of disclosures concerning payments made by multinational concerns in order to secure foreign business. These practices—whether bribes, kickbacks, or commissions—are at odds in varying degrees with US and foreign laws, as well as with business ethics. They are accomplished in much the same way as political gifts, though usually in a more complicated fashion. Their discovery has caused not only corporate embarrassment and the resignation or dismissal of some top executives—but also the closing down of operations in foreign lands. It has even triggered international crises.

General economic ills and Watergate cannot explain all of these developments, although they have been substantial factors. So too has the new tide of consumerism, which has focused attention on old misdeeds and made them new problems. And as fuzzy policies and their unenthusiastic administration have created a permissive atmosphere in business, competitive pressures have made it easy to rationalize that "it can't be really wrong if everyone else is doing it." Add computerized accounting to the size and complexity of many businesses, and you aggravate the problem—providing increasingly inviting opportunities for inventive minds to cloud the real nature of transactions.

These developments are causing difficulties for a great many people. Investors have been damaged or feel threatened. Regulatory officers are asserting their official concern. And there is a group in the middle—corporate board members and officers, together with independent auditors—who are being asked with increasing frequency such questions as: "Where were you when . . .?" "Why didn't you . . .?" "Who is going to cover my losses?"

Auditors Challenged First

To date, auditors have been the most beleaguered targets of such challenges. Their principal antagonists appear to be lawyers who make careers out of representing large groups of faceless investors in class action lawsuits. In the name of consumerism, these lawyers wield the threat of spectacularly large claims, unhindered by any realistic responsibility for the defendant's costs of protecting himself. The technical auditing and accounting issues involved, and the unpredictability of judge or jury in the event of carrying the case to trial, can make the threat of a staggering loss very real to the auditor-defendant, creating in turn great pressure for an out-of-court compromise. And, unfortunately, the auditor's problem is compounded with distaste when he senses that the plaintiff's counsel is less interested in winning a court verdict for the claimed damages than in a settlement whose acceptability is measured by the size of a contingent legal fee.

The courts are also adding to the legal difficulties of the auditor. For example, decisions in recent years indicate that a plaintiff suing an accountant under the federal securities laws probably needs to prove only that the financial statements in question were misleading and negligently audited. That is, in contrast with the ordinary requirements of proving a negligence case, it is not necessary for the plaintiff to establish his reliance on such statements. In another step, the courts have greatly expanded the breadth of people to whom CPAs are responsible for deficient actions. It now appears that in many states (and until recently under the federal securities laws), the auditor can be held liable to a large group of unknown third persons for mere negligence. This contrasts with the longstanding *Ultramares* rule that the accountant owed a duty to such parties only in case of reckless and wanton misconduct.

To the extent these developments go, the courts have concluded that CPAs occupy a role akin to that of a *guarantor* of the financial statements with which they are associated. That is indeed a staggering burden to carry.

The SEC is another source of concern to auditors. Apparently it is uneasy about its ability to carry out its own policing role when mischief so abounds. Clearly it is attempting to use the independent accounting firms as its enforcement arm as much as possible. This is apparent in its strong assertions about the high duty of auditors to uncover embezzlements and financial misrepresentations during the ordinary course of an audit. In addition, the commission is attempting to make independent accounting firms public whistle blowers for matters far beyond their responsibility concerning financial statements.

The most striking example of this pertains to illegal foreign payments. The SEC apparently expects the auditor 1) to disclose all illegality, irrespective of the magnitude of the transaction involved and its impact on the client's statements, and 2) to disclose material transactions that are only suspected to be illegal. This responsibility would be particularly onerous for the auditor, since not even the SEC has developed any measurable standards defining the kinds of acts which it believes should be subject to disclosure.

Although the focus of all of these challenges—by lawyers, the courts, and the SEC—has been largely concentrated on the independent auditor, the field is rapidly widening. Parallel responsibility is being pressed on corporate directors and officers. They are being named as defendants with increasing frequency by investors who have found in them an additional source of recoverable funds.

Similarly, the SEC has recently charged several directors of one large company with failure to supervise adequately the management of that ill-fated enterprise. In another case, the commission has criticized outside directors for their failure to become informed about and exercise control over the accounting principles applied by a company whose financial statements were deemed to be false and misleading. The commission has also begun, through its enforcement powers, to require some directors to be replaced by persons who are responsible for mandated change in corporate policy. In doing so, it demonstrates its view of the duty a corporate board has to a broadly defined public.

It would be fruitless and, to a large extent irresponsible, for auditors, directors, and corporate officers to attempt to hold their lines of responsibility to the narrower bounds of yesterday. Investors, the courts, and the general public are asserting themselves to the contrary—and must be heard.

The Limits of Responsibility

A realistic line must be drawn, however, in setting these new responsibilities. What is outside this line, and is beyond the limit of acceptability, is the following:

Auditors as guarantors. Outside auditors can be viewed neither as quasi-guarantors of their client's financial statements nor as indemnifiers of investor losses. The enforcement of such a rule would soon eliminate the profession. No sensible person would remain in or enter public accounting if such risks were virtually limitless. Indeed, to defend itself against unmerited litigation, the profession needs to come up with a sensible way of minimizing the legal risk which an auditor can face. One method might be the statutory limitation on liability now being studied as a proposed amendment to the federal securities laws.

Exposure of Illegal Corporate Acts. Auditors and corporate directors cannot be expected to reveal to the investing world, or to its regulators, *all* illegal or otherwise questionable corporate acts *regardless* of the effect of such acts on a company's financial statements. Responsibility must be realistically confined to matters having a significant impact on a company's financial affairs.

On the other hand, acceptable limits of responsibility include:

Standards for corporate conduct. Directors and officers should be responsible for defining, with reasonable clarity, corporate standards of conduct for such transactions as political contributions and foreign payments. They should also take reasonable steps to enforce adherence to those standards. Their auditors, in turn, should be responsible for reviewing such standards and measuring compliance in the course of their professional work.

Corporate duty to uncover fraud. Directors and officers should recognize that the prime duty to thwart and uncover fraudulent activity within the corporation rests upon themselves, not on their auditors. This calls for a strong commitment to sound internal controls and effective internal auditing, both of which are subject to review and evaluation by the outside accountant.

Auditing for illegal transactions. Auditors must recognize their duty to take reasonable steps to uncover illegal or unauthorized transactions whenever doing so will have a material effect on the audited financial statements. Certain transactions—for example, collusive defalcations, or misrepresentations by management—may be impossible to detect, but the auditor cannot resign himself to non-discovery because of the lack of an assured result.

What Must an Auditor Do?

Concerning his responsibility to discover illegal or unauthorized transactions, what expanded procedure should an auditor follow? Given a particular client, and circumstance of time and place, he should first focus on likely areas of exposure, then design appropriate examination steps, and finally apply his professional skills thoroughly to the facts. Of course, detection of some wrongdoing may escape the best investigation possible.

For example, in the wake of Watergate a great deal of attention has been focused by the press and the government on domestic and foreign corporate influence payments. Under the circumstances, audit procedures which have not been customary in the past should be performed if additional conditions exist which raise a concern that corporate management may have committed an illegal act. Such a presumption could arise, for example, if the corporation has been a party to the kind of transactions that have received widespread public criticism in its particular industry or in foreign areas where the client operates. The transactions to be examined should be those that are material to the financial statements. Particular scrutiny, of course, should be given in situations involving substantial consequences to the company, such as when the continuation of a material earnings stream appears to depend on the future concealment or repetition of the illegal acts in question.

The essence of the auditor's conduct in such circumstances is to be alert to unusual internal and external factors which indicate a high likelihood of illegal or unauthorized transactions. Whether the concern be for illegal influence payments, defalcations, or financial misrepresentations, the auditor's approach and attitude should be fundamentally the same—that of making a thorough professional investigation.

No matter what form they may ultimately take, the burgeoning duties of the auditor are becoming substantial indeed. Taking on those duties in a world poised to claim malperformance only intensifies the seriousness of his responsibility. Clearly, to meet the challenge, a public accounting firm must give the closest possible attention to the quality of its work.

A Logical Proposal

Quality requires not only recruiting able people and updating their training; it also requires continuous evaluation of the firm's policies and procedures, the correction of any deficiencies, and the adoption of improved techniques. But while this has been carried on by many firms for many years—with each firm reviewing its work internally—the day has now come when it is apparent that these internal audits must be supplemented by the engagement of qualified people from the outside. I am referring to "peer reviewers." The profession's new exposure to liability makes this extra measure of objective quality control imperative. The public will no longer accept the strictly private self-discipline we have been practicing on ourselves. Clearly, just as other professions have improved the quality of their service in this way, so can auditors as they strive to fulfill their obligations to the public.

What is actually being done within the profession today in keeping with expanded audit responsibility and improved quality control procedures? Speaking for this firm, our auditing effort has been augmented over the past two years by a substantial set of guidelines which attempt to ferret out fraudulent transactions, particularly where corporate management is involved in material transactions. These guidelines are now being amplified to cover the broader area of illegal corporate payments, reflecting that newly arising set of problems. In addition, the principle of peer review is embodied in a present commitment to expose the firm's policies and procedures to a team of outside auditors. These actions are positive steps toward one firm's faithful discharge of its duty to clients and to the public.

Conclusion

The days are difficult. New duties are being thrust upon many people. The independent auditor has been increasingly made aware of this reality for several years, and corporate directors and officers are becoming similarly exposed. It is easy for all of us to react with indignation and profess an inability to assume a higher duty. Some of the newly defined responsibilities do seem clearly impossible to assume, but others would satisfy reasonable public expectations which can and should be met. The essential problems are to determine which of those new duties should be assumed and then earnestly to pursue them. Otherwise, we may find somebody else on the job. ▵