NORTHERN ILLINOIS UNIVERSITY

The Impacts of Recent Legislation on Accountants' Liability

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ABSTRACT (100-200 WORDS):

Liability has recently become a popular issue among the accounting profession. The increasing number of claims against public accountants from various financial statement users have caused accountants to search for ways to protect themselves. Many accounting firms have converted to limited liability companies or limited liability partnerships, both of which only recently have been allowed as entity choices. Also, recent legislation, such as the Private Securities Litigation Reform Act, has been enacted to provide protection against such claims, many of which are very weak. However, while accountants feel that this protection is necessary, some members of the public feel that it may cause the profession to act differently when performing its job. The purpose of this paper is to examine the various types of liability that accountants may encounter, provide ways that the profession can reduce this liability, and discuss recent developments that have been provided to offer the protection that accountants desire.

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Introduction

In recent years, there has been a trend of increasing liability for all professionals, the most publicized being that of doctors. The irony is that doctors are liable only to one person during a given course of action, the patient, which results in a lower number of claimants than certain other professionals, such as accountants. Accountants, when performing audits or preparing financial statements, can be sued not only by the client but also by any third party who was affected by the error. Also, accountants need to be concerned not only with their own performance and liability, but also that of others in their profession.

Liability is a major issue for all public accountants, considering that their daily work could have significant impact on companies, shareholders, creditors, and other users of financial information. Accountants' work must be done thoroughly and accurately to ensure that the information that they examine is a correct and sufficient portrayal of the company being audited. One small overlook by the accountant could have profound financial affects on both the users of the statements and the accountant or accounting firm that inspected the statements. Because of this, accountants should know the types of liability that they may encounter throughout their career and actions that they can take to prevent or protect them from possible user claims.

There are several types of liability that an accountant must consider when preparing financial statements or performing audits for clients. The four main components of accountant liability are general client, third party, civil statutory, and criminal statutory liability. All four of these components contain separate provisions and guidelines

explaining the different ways that accountants can be sued and why. Another aspect of accountant liability that is very important, especially with increased litigation, is that of insurance. Accountants must be aware of whether or not their actions are insurable. Also, they should know the types of insurance that is available to them and their firm so that they receive the best protection.

There have been several recent events that are greatly affecting the impact that liability has on accountants and the firms that they work for. The fairly recent widespread use of limited liability companies and limited liability partnerships has been a large influence on the way accounting firms are being set up and operated. Also, there have been many changes in legislation, especially regarding tort reform. These changes are being focused on making the liability system less vulnerable to abuse and achieving equity in liability. These new events have also had some impact on accountants and CPA firms in terms of the quality of work and the cost of audits.

Review of Accountants' Liability

Accountant liability is made up of four separate components: general client, third party, civil statutory, and criminal statutory. The main component is general client liability, which encompasses basic liabilities for which the accountant is liable. General client liability is broken down into four subcategories, which involves liability for breach of contract, liability for negligence, the role of generally accepted accounting principles (GAAP), and the role of generally accepted auditing standards (GAAS).

The relationship between accountants and their clients must be bound by some type of contract that defines the responsibilities of each party. Normally the engagement

letter serves this purpose, by specifying what type of work is to be done, who will be performing the work, and for whom the work is being done. It also specifies the time period in which the procedures must be performed and the amount of fees that will be charged. If any part of the contract is not met by the accountant, such as the failure to meet a deadline, then the accountant has breached the contract and is liable for any damages that the client has encountered as a result of this breach. If, however, the accountant has committed breach of contract due to circumstances that were not anticipated or controllable by either party, then the accountant will not be held liable.

The second component of general client liability is the accountant's liability for negligence. Just as in any other type of contractual relationship, the contract between an accountant and his or her client must involve the exercise of due care by each party. Due care is a "common law duty to perform with care, skill, reasonable experience and faithfulness" the act which is promised to be performed. (Epstein & Spalding, 1993) The failure of one or both of the parties to perform this duty is considered to be a breach of contract and could also constitute a tort in negligence. Whether it is based on an action in tort or contract, an accountant's liability for negligence represents a "departure from a uniform standard of care", which is characterized by the "reasonable person." (Epstein & Spalding, 1993)

Four elements must exist for liability for negligence to be imposed on an accountant. First, there must be a duty to follow a uniform standard of care and conduct. Second, there must have been a failure by the accountant to follow this standard. Third, there must be a substantial connection between the client's damages and the accountant's

breach of duty. And finally, the client must have sustained actual damages or loss. (Epstein & Spalding, 1993) If all of these elements exist, then a jury may award the client damages. However, if any one of these elements do not exist, then the accountant is not liable under Common Law.

The role of accounting principles plays a very important part in accountants' liability. GAAP define the very rules and procedures that should be followed to provide an accurate representation of a client's financial condition. Throughout the performance of audits, accountants must constantly determine whether or not the client has conformed to all of the accounting principles. The main topic of GAAP that is very important in the liability of accountants is that of the going concern, the issue of whether or not the accountant believe that the client will remain in business for very long. During the course of an audit, the accountant must professionally assess the client's going concern, especially if the business is having financial trouble. This assessment is very important because if the auditor issues an unqualified opinion and the company becomes insolvent after the audit, the auditor will be faced with problems from most of that client's financial statement users, including investors and creditors. The auditor can be protected from this type of litigation by expressing in the financial report any going concern problems that he or she may find.

The final component of general client liability for accountants is the role of auditing standards. An audit is the process of examining a client's accounting records and supporting documents to determine if the client has correctly followed all accounting principles and then issuing an opinion on these findings. GAAS must be followed by the auditor during the conduct of an audit to ensure that all standards are applied. Also, by

conducting an audit based on GAAS, the auditor can ensure that he or she is taking the necessary steps to avoid litigation.

GAAS are composed of three sections: general standards, standards of field work, and standards of reporting. The general standards are those standards the overall main items that must be followed by the auditor. First, the auditor must have adequate technical training. Second, the auditor must be independent of the client. This means that there can be no relationship between the auditor and client that may in some way influence the opinion that the auditor issues. The third general standard is that the auditor must exercise due professional care.

The field work standards compose the second section of GAAS. These standards define how the auditor is to conduct the actual audit and have three characteristics. First, the audit work needs to be correctly and adequately planned, and assistants need to be supervised. Second, the internal control structure of the client must be evaluated by the auditor to ensure that the accounting information is being properly entered and processed by the system. The final field work standard involves the auditor obtaining sufficient, competent evidence during his or her observations, inquiries, and examinations to issue a correct opinion.

The final section of GAAS is the standards of reporting, which define the necessary steps that must be taken when the auditor actually issues the financial report. First, the report must state whether or not the financial statements are in accordance with GAAP. Second, an opinion must be issued by the auditor. Third, there must be adequate disclosure in the notes of the financial statements that should highlight important issues.

Finally, there must be consistency between the financial statements of the current year and past years. (Rittenberg & Schwieger, 1994)

The second component of accountants' liability is third party liability, which is also composed of four separate parts: privity of contract, negligence, fraud, and gross negligence. Privity of contract is the concept that "the rights or obligations that exist under a contract are between the original parties to that contract, and failure to perform with due care results in a breach of that duty to only those parties." (Epstein & Spalding, 1993) This concept held true in early common law but, since the 1922 case of Glanzer v. Shepard, privity has not been a strong issue in liability cases. In the case of Glanzer v. Shepard, a public weigher, who was employed by a merchant seller of bags of beans, overstated the weight of the beans of a particular buyer. The weigher furnished certificates of weight to both the buyer and seller, which was normal conduct for the weigher. The weigher was held liable for the overpayment by the buyer, who was a third party. (Epstein & Spalding, 1993) As a result of this case, the courts began to hold certified public accountants and other licensed professionals accountable to nonclients.

The negligence component of third party liability continues where privity of contract leaves off. Where privity of contract only allows the accountant to be liable for those who are directly included in the contract, negligence broadens these plaintiffs to include foreseen and foreseeable users. Foreseen users are those whom the accountant knows will be receiving the audited financial statements and will be basing decisions on this information. This foreseen user approach is used by a majority of states and is found under the Restatement Second Jurisdictions. Foreseeable users include not only the

primary beneficiaries of the audit and users who are actually known by the accountant, but also any other party who will foreseeably use the financial information. This foreseeable user approach is only found under a minority of jurisdictions. The type of jurisdiction in which a liable accountant falls depends on the state in which he or she practices.

For an accountant to be liable for fraud, the third component of third party liability, five conditions must be met. First, there must be a "false misrepresentation of a material fact." Second, the defendant must have the knowledge or belief that the representation is false. Third, there must be an "intent to deceive and induce" the plaintiff to rely on the misrepresentation. Fourth, the plaintiff must have exhibited justifiable reliance. And finally, the plaintiff must have suffered damages resulting from this reliance. (Epstein & Spalding, 1993) If all of these factors are met, the accountant is liable to all those whom he or she should have reasonably foreseen would suffer damages as a result of the misrepresentation.

The final component of third party liability is that of gross negligence. The courts have stated that a "refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who" have relied on the financial statements. (Epstein & Spalding, 1993) If this type of behavior is exhibited by the accountant, then both the accountant and the accounting firm in which he or she works will be liable for the damages suffered by both clients and foreseeable users of the financial statements.

The third component of accountants' liability is civil statutory liability, which has three parts: Federal Securities Laws, Foreign Corrupt Practices Act, and Civil RICO

Liability. These three types of legislation have been developed to address nationwide financial problems and regulate the accounting profession. The accounting profession can avoid civil statutory liability by reacting to the changes that have occurred due to the three types of legislation.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the two main Federal Securities Laws. The passage of these Acts greatly increased the amount and type of liability that accountants were subjected to compared to that which existed under common law. The main objectives of the Securities Act of 1933 were to provide "(f)ull and fair disclosure of a material nature in the public offer of securities and the prevention of misrepresentation and fraudulent practices in their sale". (Epstein & Spalding, 1993) As part of a new offering of securities to the public, a registration statement and prospectus are required to be filed with the SEC. The prospectus contains the audited financial statements, which are the responsibility of the accountant. Any false or omitted statements of material fact that cause the financial statements to be misleading may allow purchasers of these registered securities to sue the accountant who prepared the report. The auditor may be held liable to securities purchasers for negligence, fraud, and/or gross negligence, and the purchaser only needs to prove that a loss was incurred and the financial statements were misleading, not that they relied on the statements. (Rittenberg & Schwieger, 1994)

The Securities Exchange Act of 1934 is mainly concerned with the regulation of the trading of securities after their initial issuance in the secondary market. The regulations are similar to that of the Securities Act of 1933 in that the accountant is held

responsible for any false or omitted statements of material facts that are important when relying on the financial statements. However, under the 1934 Act the auditor may only be liable for fraud in the sale or purchase of securities. (Rittenberg & Schwieger, 1994)

The Foreign Corrupt Practices Act is another part of civil statutory liability. This act is an antibribery law which depends on the existence and effectiveness of corporate codes of ethics and internal accounting controls of U.S. businesses. The Foreign Corrupt Practices Act prohibits bribery and imposes strict requirements on record-keeping, making corporations keep accounts, records, and books in reasonable detail. In addition, the corporations are to accurately and fairly show transactions that involve asset disposition. Developing and maintaining adequate internal control systems is another requirement under this act. If any of these requirements are violated, huge fines for the company or an individual and even imprisonment can result. In most cases, accountants are called upon to audit the internal control systems and accounting records to assist in the overseeing of this act.

The final part of civil statutory liability is Civil RICO (Racketeer-Influenced and Corrupt Organizations) Liability, which has been greatly used as a weapon against accountants. It provides plaintiffs with both civil and criminal sanctions for some types of illegal activities. RICO prohibits people from acquiring interest in entities which are engaged in activities that affect foreign or interstate commerce through the use of racketeering. Racketeering activity is "any of a number of 'predicate acts' included in a list of major state felonies and federal crimes." (Epstein & Spalding, 1993) Civil RICO

liability is most frequently alleged against accountants for federal crimes of mail or wire fraud.

The final component of accountants' liability is that of criminal statutory liability. For accountants to be prosecuted under criminal liability, there must be some type or element of intent, which is very hard to both prove or disprove. The Federal Securities Laws uphold criminal liability if a person willfully makes false statements or omits statements when filing registration statements. There are also mail, wire, and other fraud statutes that deal with criminal liability. Federal and state tax laws can involve civil liability penalties for fraud, negligence, failure to pay taxes, or failure to file a return. These penalties are always imposed on the taxpayer, who may then sue the accountant to recover damages incurred. However, the accountant can be liable for criminal tax provisions for crimes such as fraudulent returns, failure to obey summons, or attempts to interfere with administration of internal revenue laws. Jail terms, fines, and loss of state certification can result from criminal conviction.

Liability Insurance

Liability insurance is an accountant's major source of protection against clients that sue. Insurance provides protection for compensatory damages that result from breach of contract or negligence on behalf of the accountant. However, punitive and other damages that result from fraudulent or criminal behavior are not covered. To determine exactly what types of actions are covered by one's liability policy, coverage provisions and exclusions should be read carefully. Also, the accountant may wish to buy riders for the

policy, such as consulting or computer service coverage, to increase the amount of protection that they have.

There are two main types of liability insurance, occurrence policy and claims-made policy. The occurrence policy, which was once the most common type, provides for an "unlimited tail or right to extended delivery." (Epstein & Spalding, 1993) This attachment enables the accountant to continue to be insured for acts that were committed prior to the termination of the insurance policy but not discovered or claimed until after the policy had ended. The date that the claim is asserted or the discovery is made is not relevant.

The second type of liability insurance is the claims-made policy, which is available in both an unmodified and modified form. The unmodified form of the claims-made policy contains no attached tails or prior acts coverage. It covers only those liabilities that have been incurred and asserted during the time period covered by the insurance policy. The modified claims-made policy provides for a "right to extended discovery period" (Epstein & Spalding, 1993), which allows coverage for prior acts without knowledge and an option to purchase a tail similar to that available with occurrence policies except for a two to three year limit.

For those accountants not wishing to purchase either of these two types of policies, there are other alternatives available. One such alternative is going bare, which results when an accountant chooses not to purchase any type of liability insurance. Accountants who do decide to take this course of action believe that they can "operate a low-risk accounting practice, render themselves judgment-proof by shifting assets, and

rely upon bankruptcy as a last resort." (Epstein & Spalding, 1993) This strategy can be very risky, so an accountant should consult with an attorney before implementing it.

Purchasing liability insurance is one of the most popular ways to limit liability, however there are many other actions that can be taken to help ensure that an accountant will have no need to use the insurance. Probably the most effective of all ways to limit liability is by limiting aggression during tax practice. This can be done by using reasonable care when deciding whether or not to take a tax position that is favorable to the client, but that is uncertain as to appropriateness. There are two types of aggression that should be limited: issue and evidentiary. Issue aggressiveness is defined as "taking a position favorable to a client in instances where tax authority is unclear." (Bandy, 1996) Evidentiary aggressiveness is very similar to issue aggressiveness, the only exception being that the uncertainty lies not in the tax authority, but in what has actually occurred. By avoiding these situations the accountant can possibly limit errors made on the return.

Another way to limit accountant liability is through risk minimization, which can be accomplished by performing three separate activities: researching, following professional and statutory guidelines, and by implementing client participation. Accountants should research underlying issues to make sure that they know what the authoritative sources have said about the issue. They need to review professional and statutory guidelines to ensure that the aggressiveness level that they are using for a particular client is within the limits allowed. Finally, they should get the client involved through client participation, which should be implemented when a large amount of uncertainty exists as to the correct treatment of an item. Client participation involves letting the client know that, upon

examination, the IRS may raise questions. Also, when aggression is possible, the client should decide whether or not to take an aggressive position, so that they must take the responsibility for their tax return.

There are several other activities that can be performed by an accountant to try to reduce the amount of liability he or she is subject to. Client questionnaires and tax return checklists can be prepared and completed to ensure both that the auditor doesn't forget important questions and the client doesn't forget to disclose important information. Client questionnaires can also eliminate disagreements between the auditor and the client over the causation of errors. Supervisory reviews and file control and retention can be implemented. The firm should practice client selection and retention to avoid clients with histories of risky and problematic behavior, questionable integrity, an argumentative personality that tends to be fault-finding, or weak accounting records and controls. Finally, the accounting firm should implement procedures on staff development and assignment to make sure that accountants are not performing in areas that are outside their expertise.

Limited Liability Companies and Limited Liability Partnerships

When forming an accounting firm, one of the most important issues that must be considered is entity type. Most accounting firms are set up as partnerships, however, two new choices are now available to firms that greatly change the way the firms are treated, in terms of both liability and tax issues. Limited liability companies (LLCs) and limited liability partnerships (LLPs) are fairly new additions to the types of entity choices available

to new and existing firms. Both LLCs and LLPs have advantages and disadvantages that must be weighed to decide which, if either, is the best choice for one particular firm.

LLCs have recently been deemed to be the "new entity of choice." They originated in Germany in 1892, but were not accepted in the United States until 1977, when the first LLC legislation was passed in Wyoming. Not until the IRS ruled that LLCs would be taxed as partnerships, not as corporations, were they considered to be viable entities in the United States. (Cochran, 1996) LLCs are the most common form of business in Latin America and Europe and have become a very popular entity choice throughout the U.S., especially since the recent passing of the "check the box" regulations. This worldwide existence should "encourage foreign investors to engage in more ventures and capital investments in the United States." (Calderon, 1996)

There are several advantages to choosing to form as an LLC. The most important characteristic of LLCs is that they take the best features of both partnerships and S corporations and combine them to produce an entity that has both the pass-through tax benefits and flexibility of a partnership and the S corporation's limited liability. LLC members are liable only to the extent of their capital contributions, no matter how much they participate in the management of the company. No members are personally liable for the LLCs obligations. However, individual members are still liable for their own "negligent or wrongful acts or misconduct that they commit or those under their direct supervision and control while rendering professional services. (O'Toole, 1996) This characteristic is a large benefit compared to both regular partnerships, in which general

partners can be liable for acts of their partners, and limited partnerships, who only have limited liability if they don't participate in the management of the company.

Another advantage of LLCs is that they are allowed to have many members, allowing up to 500 before losing their pass-through treatment. This characteristic is available to partnerships also, but S corporations cannot have over 35 shareholders. Each of the LLCs members is given an equal voice in the management of the company, which allows "arbitrary control by the majority interest" to be effectively prevented. (Horwood, 1996) Also, LLCs, as well as partnerships, can allow any person or entity to be a member of the company. This is a great benefit compared to S corporations, which cannot have shareholders that are corporations, partnerships, nonresident aliens, pension plans, certain trusts, or charitable organizations.

The amount of maintenance of an entity's tax status is another area in which LLCs have an advantage. The maintenance of an LLCs, as well as a partnership's, tax status usually doesn't depend on the satisfaction of further qualification requirements once the entity is structure for tax purposes. This is not the case for S corporations, which are subject to state corporate statutes and the strict requirements of Subchapter S. If S corporations fail to comply with these rules, they may face an involuntary termination of their status, with possible adverse tax consequences. LLCs and partnerships don't have to worry about these problems.

LLCs, as well as partnerships, can usually distribute appreciated property to their members without triggering income to the recipient owners or gain at the entity level. The same type of distribution by an S corporation does trigger gain at the entity level that

flows through to the shareholders. Also, LLCs, unlike all other entity types, do not have to equally divide their distributions among members, which allows them to target certain members to receive "preferred allocations." (Calderon, 1996) Tax attributes can also be apportioned among members based on the stipulations set forth in the operating agreement. This can be beneficial because members in lower tax brackets can be taxed with a large portion of the company's income and gains, while members who have the highest basis for loss deductions can show a larger part of these losses on their individual returns. (McCarthy & Albretsen, 1996) These advantages allow LLCs to set up structured financial transactions and debt offerings.

Another difference between LLCs and other entities is related to stock requirements. Some entities, such as S corporations, have a single-class-of-stock requirement which eliminates creative opportunities for tax planning because the tax attributes must be apportioned to each shareholder's proportion of stock. LLCs do not have this restriction, allowing them to benefit from divergent ownership interests and flexible allocation rules of partnerships by "granting preferred returns unequal distribution rights, and special income, loss, or credit allocation to specified shareholders." (McCarthy & Albretsen, 1996)

The treatment of a shareholder's basis is another advantage of LLCs over other entities, especially S corporations. Each member of an LLC can increase his or her basis by their relative share of business liabilities. This increase in basis increases the tax-free distributions they can receive and the losses that they can deduct. S corporations do not receive this special basis treatment. Shareholders of S corporations do not receive an

increase in their basis as a result of debts owed by the company to third parties, even is the shareholders personally guarantee the liability. The only time that shareholders of S corporations benefit from these liabilities, by receiving an increase in basis, is when they actually repay the debt. This benefit of LLCs should be a major consideration for shareholders who are deciding which type of entity to own. (McCarthy & Albretsen, 1996)

LLCs have several disadvantages that must be considered before choosing it as a particular company's entity of choice. First, under the majority of LLC acts, an LLC is dissolved upon the death, expulsion, retirement, dissolution, or bankruptcy of a member unless a majority or all of the remaining members consent to continue the business. For a limited partnership, this drawback is not encountered unless the sole remaining general partner is affected by these events. Also, each member's equal voice in the management of the LLC could cause personal conflicts between owners which may be difficult to resolve. This could result in inaction because each member has veto power over every decision.

Another disadvantage of LLCs involves the self-employment tax. In S corporations, active owners must receive reasonable salaries that are taxed by FICA, and any earnings over that amount are taxed as ordinary income, which is not subject to FICA or self-employment tax. LLCs, however, require that any active member be subject to self-employment tax on that member's full income amount. S corporation shareholders are exempt from this tax on their share of the earnings of the company. An LLC member's earnings, however, are subject to the self-employment tax if the member is a

manager and "the LLC could have been formed as a limited partnership in the same jurisdiction, with the member qualifying as a limited *partner in that partnership under* state law." (McCarthy & Albretsen, 1996) This amount, however, can be reduced by an LLC member in a couple of ways. One way to reduce the amount of self-employment tax is to have only a few member/managers in the LLC. Another option is to have a small share of earnings be apportioned to the members/managers within the operating agreement, which would reduce the part of LLC income on which the self-employment tax is levied. Also, nonmembers can be appointed as managers in the agreement, which would cause no income to be taxed. This final option, however, would make the LLC have centralized management, jeopardizing federal taxation as a partnership. (McCarthy & Albretsen, 1996)

Tax-free reorganizations are another area in which LLC lack the benefits of other entities, such as S corporations. LLCs have very few opportunities to enter into these reorganizations, which cause members to face "constructive termination for tax purposes when their LLC interests are involved in mergers or divisions." A risk of constructive termination results if 50% or greater of the profit and capital interests are exchanged or sold within twelve months, which will terminate the LLC for tax purposes. One way to decrease this risk would be to structure the operating agreement to "prohibit transfers that could cause a termination." (Wilburn & Watkins, 1996)

Federal payroll rules are another source of problems for members of a LLC, where partners are normally not considered employees of the partnership unless "payment is made to a partner not acting in the capacity of a partner." The significance of this rule

occurs when a corporation converts to a LLC and officers are used to receiving wages and having taxes withheld. When the company becomes a LLC, the officers no longer receive W-2's. Instead, their wages are in the form of guaranteed payments, which are found on Schedule K-1, and the officers must pay quarterly estimated tax payments. (Becourtney, 1996)

If, through careful consideration and weighing of these advantages and disadvantages, a company decides to become to an LLC, there are a couple of items that must be taken into account before actually converting. Conversion from a partnership to a LLC is common and normally is a tax-free transaction "unless it results in a deemed cash distribution from the partnership in excess of the partner's basis." Conversion from a corporation, however, is not common at all because it results in liquidation of the corporation. This liquidation would accelerate the realization of gain on any transfer of appreciated property to the new LLC and create other undesirable tax consequences. (Calderon, 1996) Also, if the corporation has any net depreciation in its assets, it will realize a net loss that will have tax value only if the company can benefit from a loss carryback.

If a company does decide to convert to an LLC, one of the main items that needs a great deal of attention is the operating agreement, which shows the relationship between members and how income, deductions, gains, losses, distributions, and credits will be shared. The operating agreement should meet the desires and needs of the members and ensure the tax treatment that is most desired. Several items should be controlled primarily by the operating agreement, including income and loss allocations, the ability to make

accounting and tax elections, cash distributions, and the ability to sell or dispose of LLC interests. The operating agreement is prepared by the LLCs attorney, but a CPA should provide input, especially concerning tax issues.

The operating agreement should address four main areas: formation and capital, operations, member relations, and dissolution. The formation and capital issues that should be considered include capital requirements, capital contribution types permitted (services, property, and/or loan guarantees), additional capital needs, and voting rights of the members (based on contributions, capital balances, or other ways). The operating agreement should address whether or not additional capital contributions should be permitted or required and how members who cannot or won't make required payments will be dealt with. Time limits on making these contributions may also be discussed. All of these issues do not specifically have to be addressed, however the more issues that are in the operating agreement, the less confusion and conflict that may arise later.

The two main areas of operational issues that should be addressed are management issues dealing with how daily operations are handled by members and economic issues dealing with the LLCs cash flows, income, and other aspects of business. Decisions should be made about whether or not the company should be managed by managers or members, however if managers are used, limits should be put on their authority and penalties should be imposed if they exceed authority. Whether or not nonmembers can be managers should be determined, as well as the number of managers the LLC will have and the provisions that address the removal and replacement of managers through elections. Other operational issues that may be addressed are the frequency, requirements, and

content of meetings, the ways decisions are made, and whether or not greater consent amounts are necessary for more important decisions.

Member relation and dissolution issues are also very important and should be carefully outlined in the operating agreement. Important member relation issues that should be addressed include the consent level needed to admit new members, members' ability to transfer their interests in the LLC, the responsibilities of members to return distributions that render the LLC insolvent, and the amount of compensation paid to members for services rendered. Finally, dissolution issues are just as an important part of the other three. Events that will cause the termination of the company, the level of consult of the members that is needed to continue the business, and the procedures necessary to complete the dissolution are all important issues that should be addressed. (Mares, Pascarella, & White, 1996)

Due to all of an LLCs strengths, one would think that they are also the "entity of choice" among all firms, including accounting firms. However, this is not the case. LLCs are limited in their use by accounting firms primarily because of their lack of personal liability protection that they provide in some situations. For example, LLCs protect their owners from personal liability to creditors or nonpractice-related tort claimants, but in many states LLCs won't protect a partner from "personal liability to a client for his or her malpractice or for the malpractice of another owner or employee whom the owner has personally supervised." Because of this lack of protection, LLPs were developed and used by a majority of accounting firms throughout the United States. For instance, out of all of

Chicago's top 25 accounting firms, only one is structured as an LLC. (Janiga & Brockie Leonard, 1996)

LLPs are used as the primary structure among accounting firms because they provide protection of the personal liability of partners for the "obligations of the partnership that arise from a tort of another partner or employee of the partnership." This is true for LLPs in every state, which is a big difference from LLCs, who only have this type of protection in some states. Another difference between the two entity structures is that LLP conversion from a general partnership is much easier that the similar type of conversion to an LLC. The LLP conversion is not perceived as a change in the form of the business since its statutes are derived from those of general partnerships. Because of this, the consent of creditors is not required and the transfer and recordation taxes are avoided. (Janiga & Brockie Loenard, 1996)

Despite the two differences between LLPs and LLCs, they are alike in many ways. First, joint liability for the partnership's contractual obligations are not changed by the statutes of the LLP. Second, a partner's personal liability for his or her own tort is not affected. Also, a contractual or a statutory obligation may be chosen by a partner when contributing their share of partnership liabilities to the partnership. Finally, the protection of LLPs does not apply to torts that occurred before the entity selected the LLP structure. Along with these similarities between the two types of entity structures, LLPs share the remaining LLC advantages and disadvantaged.

Despite the obvious advantage of LLPs over LLCs and other entity choices, much of the public believes that this benefit to the accounting firms is reducing the standard to

which accountants are held and is lowering the status of the profession. They feel that because the accountants will not be held liable for malpractice, they will not work as hard to make sure that everything is correct and accurate. Many feel that the public interest is not properly served by the LLP structure either. For example, when users, such as stockholders and creditors, rely on accounting information, "they are putting their faith in the entire accounting firm that generated or audited that information." If the accounting work was not performed sufficiently, the public feels that they should reasonably expect a full recovery of the damages that they incurred. If the accounting firm is structured as an LLP, this may not occur. Therefore, LLPs have many advantages for the accounting firm itself, but could tarnish the reputation of the accounting profession.

As shown above, accountants do have ways to protect themselves from liability. They can convert their firms to LLCs or LLPs, purchase insurance, use reasonable care, and do a variety of other things to try to insulate themselves from lawsuits. However, even if accountants use all of the protection that they can, claims can still rise against them, many times for no reason. A Big 6 statement of position in 1992 stated that "the accounting profession was the victim of a significant amount of nonmeritorious litigation." Evidence proved this statement correct, showing that, out of all lawsuits against larger accounting firms, between 40% and 50% resulted in either dismissal against the auditors or settled with the plaintiff receiving no payment from the auditor. Both of these outcomes occur frequently with weak claims. (Palmrose, 1997)

The defending of lawsuits that result from weak claims has been time-consuming, difficult, and financially troublesome. The average time a lawsuit of this type takes to

complete is an average of 3.7 years, and attorney costs average out to about $3.7 million. This results in a lot of wasted time and money, that of which could be spent on much more important items. Also, the accountants are not the ones who end up paying the high attorney costs. They usually only end up paying 10% or less of the total amount. Most of the monetary contributions come from the client and their affiliates. (Palmrose, 1997)

Another sample of weak lawsuits against auditors showed that between 30% and 40% of suits were filed by clients that were about to be or already were in bankruptcy. A majority of these claims came from either larger bankruptcy clients or clients who had reported a net income in their financial statements for the year prior to when they declared bankruptcy. Of all the bankrupt clients that issued claims against their auditors, 46% had evidence of client fraud. One defense that an auditor has against these weak claims of bankrupt clients is the use of modified reports. Out of all clients who had reported a net income in the year prior to declaring bankruptcy, "(o)f bankrupt public companies with no auditor litigation, 58% had modified reports, while only 36% of bankrupt public companies with auditor litigation had modified reports." (Palmrose, 1997) However, only modifying the last audit report may not give the accountant sufficient defense against these types of claims.

Recent Legislation - The Private Securities Litigation Reform Act

In response to these numerous weak claims, the Private Securities Litigation Reform Act became law. This act was the first step in "making the liability system less vulnerable to abuse." The reform act's objectives are to "discourage abusive claims of investors' losses due to fraudulent misstatements or omissions by issuers of securities,

provide more protection against securities fraud, and increase the flow of forward-looking financial information." (Andrews & Simonetti, 1996)

To accomplish the objectives of the reform act, many provisions have been enacted. First of all, weak claims will no longer be allowed to be filed. Plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." (Ezzell, 1997) If the defendant believes that the claim is weak, he or she may move for dismissal of the case. Also, sanctions are imposed against those plaintiffs who bring about such frivolous claims against the defendant, amounting to the attorney's fees of the defendant. By implementing this provision, time and money is saved by not trying all weak cases that are brought to court.

A second provision of the Private Securities Litigation Reform Act is that more detailed information is disclosed to the shareholders regarding the settlements. In prior years, professional plaintiffs were hired by the attorney of the actual plaintiffs to act as the lead plaintiff, only in name. However, in this type of situation, the actual plaintiffs had no control over the case whatsoever, and the "lead" plaintiff received a large share of the settlement. Under the reform act, plaintiffs are better assured that their interests will be served. Also, they will be much better informed about the case and the settlement details. A lead plaintiff will still be assigned however, but by the court, not the attorney of the plaintiffs. The lead plaintiff will also only receive the same reward as the other plaintiffs involved. (Andrews & Simonetti, 1996)

A third provision in the reform act "limits the attractiveness of suing 'deep-pocket' peripheral defendants by replacing joint and several liability with proportionate liability."

(Ezzell, 1997) Instead of all defendants being equally liable for the claims, as in joint and several cases, proportionate liability divides the total loss amount based on the percentage of responsibility each defendant has for the loss. Joint and several liability is still used, however, in two cases: where the defendants have been proven to knowingly commit a violation of the securities laws and where small investors have suffered significant losses. If a plaintiff has less than $200,000 in net worth and loses over 10% of this net worth because of a securities fraud, all defendants are jointly and severally liable to the plaintiff. (Andrews & Simonetti, 1996)

Another provision of the reform act is that it creates a safe harbor for forward-looking information. In the past, forward-looking information has been the subject of many abusive claims, so issuers have not been willing to make these disclosures and auditors have not been willing to risk association with them. Because of this, investors have been deprived of this information that gives them ideas of what to look for in their future corporate plans and projections. The safe harbor provision exempts predictions and projections from liability in lawsuits "if they are identified as forward-looking statements and accompanied by 'meaningful cautionary statements' that identify important factors that could cause actual results to differ materiality." (Andrews & Simonetti, 1996) There are, however, exceptions to this provision, such as forward-looking statements contained in historical financial statements or made in connections with initial public offerings.

The final objective of the reform act is to codify "the responsibility of auditors to detect and report fraud." If the accountant determines that an illegal act has been performed by the client, he or she must inform the client's management and audit

committee of the problem. If, after this notification, the act has material effect on the client's financial statements, management has not taken adequate time to remedy the problem, and the failure to take corrective action will reasonably cause departure from the standard audit report, the auditor should discuss the problem with the board of directors. If the board of directors does not contact the SEC within one business day of its receipt of the auditor's report, the provision requires that the auditor should immediately notify the SEC. (Andrews & Simonetti, 1996)

The Private Securities Litigation Reform Act has been a very important first step toward a better liability system, making it less vulnerable to abuse. However, it is only the first step and many more need to follow, especially in the area of state tort reform. The reform act only pertains to federal claims, so state claims are still under the jurisdiction of the same laws as previous federal claims were subjected to. The state level is now where the accounting profession's greatest liability exposure exists, leaving accountants vulnerable to litigation and related abuses under state security laws, Racketeer Influenced and Corrupt Organizations Acts (RICO) laws, and other state statutes.

Conclusion

Liability has been an increasing concern for accountants throughout the United States. The basic concepts that have governed accountant liability in the past still apply, however, many changes have been implemented to provide more protection to the profession. The formation of limited liability companies and limited liability partnerships is now allowed in many states and for most types of companies, including accounting firms. These entity formations give the accounting profession a greater defense against possible

lawsuits that may arise from clients and third parties, both foreseen and foreseeable. Also, the recent passage of the Private Securities Legislation Reform Act has given accountants better protection against clients with weak claims, which usually prove to be expensive, difficult, and very time-consuming.

While the accounting profession views these recent developments as necessary protection against false or weak claims, some members of the public believe that the protection is excessive. Many people feel certain that LLCs, LLPs, and various tort reform will cause accountants to be less worried about detecting errors, making their work less credible. Despite these claims, an increasing number of accounting firms have converted to LLCs or LLPs; and the passage of the Private Securities Legislation Reform Act has paved the way for similar tort reform in the future. Just as the business community is involved in continuous change, the accounting profession also is now and will be experiencing the same type of reformation.

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