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THE LIABILITY OF COMPANY AUDITORS: INJUSTICE OR THE FAILURE OF PROFESSIONALISM?

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While state imposed monopolies are a common feature in professional fields, few are as lucrative as that enjoyed by the Australian accounting profession in respect of company audits. This profession, comprising members of the Australian Society of Certified Practising Accountants (ASCPA) and the Institute of Chartered Accountants in Australia (ICAA), enjoys not just a monopoly over the provision of company audit services but also an assured demand for such services.[1] The essential function of the auditor's work is to express an independent opinion on the 'truth and fairness' of company financial statements under section 331B (1) of the Australian Corporations Law. Sudden and dramatic corporate collapses, of the kind evident in Australia during the 1980s, have often made manifest "the lack of correspondence between audited accounts and the actual financial condition of companies prior to collapse" (Wolnizer, 1995:51). This lack of correspondence, along with other allegations of audit failure, has been reflected in the substantial

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1 The exclusive right of members of the ASCPA and ICAA to register as company auditors is contained in section 1280 of the Australian Corporations Law. Section 327 of the same legislation requires that all companies (with the exception of certain proprietary companies) appoint an auditor.

number of legal actions subsequently initiated against auditors.[2] Faced with this unpalatable accountability for its performance, the Australian accounting profession has been engaged in an extensive lobbying process aimed at restricting the extent of the liability of its members.

The purpose of this paper is to review this lobbying process and suggest that the accounting profession's liability crisis is largely attributable to its failure to provide the effective self-regulation expected of professional groups. As an apparently willing accomplice in the propagation of the creative accounting practices that have dramatically compromised the effectiveness of corporate governance, the accounting profession has been forced to seek protection from its *own* contribution to the excesses of corporate Australia.[3] The granting of further professional privileges in such circumstances could be explained only by the perpetuation of the notion that the "exclusivity, power and authority of the professions has largely been accomplished and legitimated by the unquestioning support of the state" (Makkai, 1991:332).

Theories of the professions

Commencing particularly from the 1970s, the literature on the sociology of the professions has been marked by the development of a body of

2 MacDonald (1995) records that the courts are "flooded" with allegations of auditors' negligence or breach of duty and that outstanding legal claims against Australian accounting firms total approximately $6 billion. Among the more prominent claims against auditors are those relating to Tricontinental ($1.1 billion, settled out of court for $136 million), the State Bank of SA ($3.1 billion), Rothwells ($40 million), Beneficial Finance Corporation ($1.1 billion), Farrow Finance Corporation (unspecified), Adelaide Steamship ($340 million in a joint action against former directors and auditors) and the National Safety Council of Australia ($263 million, settled out of court for $2 million).

3 Creative accounting has been defined as "(1) the process of manipulating accounting figures by taking advantage of the loopholes in accounting rules and the choices of measurement and disclosure practices in them to transform financial statements from what they should be, to what preparers would prefer to see reported, and (2) the process by which transactions are structured so as to produce the required accounting results rather than reporting transactions in a neutral and consistent way" (Naser, 1993:59).

'critical' theory (prominent examples include Johnson, 1972; Larson, 1977; Freidson; 1986). In this literature "professionalism is not regarded as a reflection of the distinctive technical and social functions performed by professional workers. Instead, it is understood as a strategy for controlling an occupation, involving solidarity and closure, which regulates the supply of professional workers to the market" (Willmott, 1986:558). Additionally, professions are deemed to derive power from being "involved with and supported by more powerful groups in society, whether the state or powerful corporations" (Perks, 1993:15).

These critical perspectives have challenged the validity of the social contract implied by conventional functionalist interpretations which presumed that "in exchange for ethical and non-exploitive control of highly esoteric and complex bodies of knowledge of great importance to society, professions were ... to be granted a privileged social and economic position which included the right to self regulation" (Saks, 1983:2). The more plausible explanation of professional behaviour offered by the critical theorists denies altruistic motives and emphasises that professional groups are primarily motivated by a desire to improve and consolidate their privileged status. This involves actions to impound the privileges of professionalism within the vocational group while mitigating or socialising the costs and burdens of professional responsibility. Attempts by the Australian accounting profession to achieve a restriction on the extent of its liability stand as a significant example of such behaviour. While the accounting profession clothes itself with the conventional rhetoric espousing notions of professional responsibility, including mottos of 'integrity', and 'without fear or favour',[4] it is clear that its intense actions in seeking to restrict the extent of its liability are an attempt to diminish its public accountability below even that of the providers of more general goods and services. It defies the fundamental precept that in recognition of the privileges granted to professional groups, *more* is demanded from the provider of professional services, not less.

4 'Integrity' and 'Nec Timens Nec Favens' (without fear or favour) are the respective mottos of the ASCPA and the ICAA.

Auditors and company financial statements

Under the Australian Corporations Law, the directors of public companies have responsibility to ensure the preparation of financial statements, the contents of which effectively become public information. It is a provision designed to promote some accountability from such organisations and it is appropriate given the extent of power they wield within the community. As well as the predictable use of company financial statements within the investment community, other groups whose interests derive from social rather than financial imperatives may rely on such information (for example, environmental groups, employees, governments and regulatory agencies).[5] However, unverified representations by companies would need to be treated with caution: it would be facile to suggest that companies would voluntarily subjugate their private economic incentives in favour of the altruistic provision of accurate and reliable information concerning their financial affairs. Hence the need for company financial statements to be subject to audit: "the means of authenticating an account of fiscal events and conditions given by one party to another" (Wolnizer, 1987:35). When properly operating, the audit function serves an important social role. It operates as a quality control mechanism that lends credence to the financial information released by companies and allows those who use such reports to rely on them with some degree of confidence (or at least be aware of the limitations of the information when the auditor issues a 'qualified' opinion[6]). Where audit opinions have been found to have an inadequate basis (particularly in circumstances where financial statements described as 'true and fair' are subsequently shown to not

5 The importance of accounting information is perhaps not generally appreciated. Naser (1993:1) gives some indication of the extent of its influence: "Accounting is not important because it is a product of its environment, but rather because it reshapes its environment and plays a significant role in the conduct of economic, social, political, legal and organizational decisions and actions. It provides information for the re-evaluation of social, political and economic objectives as well as the relative costs and, more specifically, publicly reported accounting numbers influence the distribution of scarce resources."

6 Ultimately the auditor has authority to state that a company's financial statements are not 'true and fair'.

demonstrate such qualities) it has been common for aggrieved parties to initiate legal action against auditors. It is in response to the current flurry of such legal actions that the accounting profession has been active in seeking legislative intervention to protect it from liability.

Lobbying for a restriction on liability: the profession's case

The contention that auditors are deserving of some restriction on the extent of their liability has been vigorously stated in recent accounting literature (Small, 1986A; Small, 1986B; Cohen 1987A; Rennie, 1988; Godsell, 1991; Grice, 1993; Paton, 1993). In addition, there has been an intense lobbying process, aimed at state and federal governments which have been subject to a variety of submissions and petitions.[7] The statements made have often been emotionally expressed. For example, a past president of the ICAA made the following comment concerning claims against auditors:

> The magnitude of these ... claims ... is horrifying and as recently as even five years ago would have been beyond the wildest imagination of most accountants and auditors and their clients. They represent audacious attempts by aggrieved parties to claw back losses from ANY party believed to have money (or access to it), irrespective of their degree of responsibility. They represent an attack on the very existence of an independent and competent auditing profession, an attack it is vital we repel. ("President's Message", 1992:60)

7 This lobbying of governments has included a "report prepared for state and federal attorneys general on auditors' liabilities" prepared by a joint committee of the ASCPA and ICAA (Miller, 1993). In addition, Baxt has observed that the NSW Government's Occupational Liability Bill of 1990 (not enacted) was "aimed at allaying the growing concern of professional bodies for liability for negligence to be contained" and was "driven to a large extent by the push from the accountancy profession to have some limitation introduced by legislation on liability for negligent audits and related services" (1991:23). The intense nature of the lobbying process has been acknowledged by a past president of the ICAA who has referred to the "enormous volume of time and energy ... expended in making representations to and consulting with the NSW Government" and the "Detailed representations and submissions ... made to the Federal Attorney General" ("President's Message", 1992:61).

The same author then proceeded to describe the following "solution" which has been lobbied for by the ICAA and the ASCPA:

> The solution proposed by the Institute and the ASCPA is for the liability of auditors and accountants to be capped. Those liabilities to be capped would exclude those which accrued as a result of fraud or a breach of fiduciary duty and, consequently, would relate basically to liabilities arising out of negligence. ("President's Message", 1992:61)

It has even been claimed that such a statutory cap on auditors' liability would benefit the wider community:

> Such a solution would provide certainty of the amount of damages which could be recovered by a client against his auditor or accountant; there would also be certainty of recovery in view of the compulsory insurance cover. These are the two distinct community benefits which accrue through limitation of liability, and they appropriately enhance the merits of this solution. ("President's Message", 1992:61)

These arguments of community benefit are spurious. First, there would seem to be little comfort for claimants in knowing the maximum damages they may receive when their actual loss may be significantly more than that amount. Second, compulsory insurance cover can obviously exist independently of a cap on liability. In fact ASCPA and ICAA members in public practice are currently required to have professional indemnity insurance.

Central to the claim for protection from liability is the view that auditors are being made to bear an unfair burden of responsibility. It is contended that they are being asked to indemnify losses that are attributable to other parties:

> Certainly the accountancy profession does not wish to escape its proper and equitable liability for negligence. We do however

> object to being unjustly liable for the negligence or incompetence of others and wish to restrict our liability within the limits which are commercially insurable at affordable cost and which represent a recognition of the contribution of all relevant parties to any damages award. ("President's Message", 1992:61)

There is also said to be a 'deep pockets syndrome' operating under which auditors are targeted in legal actions because they "have professional indemnity insurance and are being held accountable because they are the easiest people to sue" (Alfredson, cited in Moran, 1994:7). The inference is that the law is somehow idiosyncratic and unjust in dealing with auditors, but exactly how this is so is left unexplained. Continued reference has also been made to the doctrine of joint and several liability under which it is said that "auditors can be held totally responsible for the entire costs of a corporate failure" (Cohen, 1987A:73).

However, representations that auditors are burdened with excessive responsibility fail to grasp the essence of the role expected of auditors and their privileged professional status. Members of the accounting profession enjoy a legislatively imposed exclusive right to act as company auditors. The only rationale for granting such a monopoly is that this professional group exclusively controls the expertise necessary for defining the technical qualities of 'true and fair' financial statements. The implication, typically omitted in discussions on auditor liability, is that auditors must bear exclusive responsibility for their work. It is true that company directors are also required to issue a statement stating that they believe their accounts to be 'true and fair'. However, it must be expected that the an opinion provided by an independent, well-remunerated and supposedly expert auditor will take precedence over that offered by directors (who are not independent and who are not required to have expertise in accounting matters). If there are defects in company financial statements that are described by auditors as being 'true and fair', then it is the auditors, as independent and professional experts, who must bear primary responsibility for such circumstances.

In addition to claims of being made liable for the acts of others, there has been continued reference in contemporary accounting literature to an 'expectation gap': it is commonly insinuated that the wider community misunderstands and has unreal expectations of the function of an auditor

(Cohen 1987B). However, the profession's own study, *A Research Study on Financial Reporting and Auditing - Bridging the Expectation Gap*, admits that a fundamental cause of the expectation gap is inadequate accounting practices. There is reference to:

> the need for consistency in accounting policies adopted by and between reporting entities;
>
> the existence of too many optional accounting treatments;
>
> the need for current value rather than historical cost information to improve relevance and comparability;
>
> the need for timely information (ASCPA and ICAA, 1994:52).

Yet these are simply a list of old criticisms of accounting practice and the most tell-tale indictment of the accounting profession is that it has been either unable or unwilling to remedy them. Edwards comments that "Accounting history is littered with examples of financial information used as a means of deception" (1989:143). With each crisis "The immediate reactions of the business community and investing public are outrage and the demand for more strict controls" (Edwards, 1989:143). The reaction of the accounting profession has been equally predictable: to either set up a committee or acquiesce to a government inquiry. Commitments to reform accounting practice are then generously made but not acted upon.

MacNeal's 1939 analysis of then contemporary accounting practices led him "unavoidably to a conclusion that the great majority of contemporary certified [i.e. audited] financial statements must necessarily be untrue and misleading due to the unsound principles upon which modern accounting methods are based" (1939:vii). The compendium of criticisms made by MacNeal included a lack of consistency in accounting principles, optional treatments for the same items, the withholding of current values and the promulgation of out of date information (1939, chapter 2). It is, of course, the very same list of deficiencies admitted to by the Australian accounting profession in its own report (and quoted above) to still be operative more than 50 years later. It led one commentator to state in connection with the profession's study that "Failure to explore issues to which attention has been drawn time and time again is the major weakness" (Hogan, 1994:63).

This provides the crucial clue to comprehending the present liability crisis: *the accounting profession has exclusive independent authority to testify as to whether or not company financial statements are true and fair, but it has failed to adopt any coherent and workable specification of the technical qualities of true and fair financial statements.* It points to the increased litigation pressure that auditors have been subject to having arisen primarily as a consequence of the accounting profession's own technical failings. As a willing accomplice in the entrenchment of creative reporting practices, the accounting profession has engendered its own crisis. To petition for protection from liability in such circumstances is to fail to address the cause of the liability crisis and risk the further institutionalisation of accounting procedures that serve to conceal and distort rather than disclose and enlighten.

Creative accounting and the avoidance of accountability

Professional groups are expected to be self-regulating. In connection with the provision of audit services the essence of the task and the self-regulation required is evident. An audit involves expressing an opinion on whether or not a company's financial statements are 'true and fair' and provisions requiring such an attestation have long been a feature of the law relating to companies (Wolnizer, 1987:119). In recognition of the audit task having been assigned to a professional group, the statutes have traditionally declined to define in detail the technical qualities of 'true and fair' financial statements. Instead "the accounting methods underlying the reports remained the responsibility of the accounting profession" (Peirson and Ramsay, 1983:287-8).[8] The intended mechanism for ensuring corporate accountability is clear: the legislation

8 With the support of the accountancy profession, the federal government established an Accounting Standards Review Board in 1984 that had power to give legislative backing to 'approved' accounting standards. However, it seems doubtful that this compromised the independence of the accountancy profession (see Walker, 1987).

would require the preparation of financial statements and there would be reliance on the specialist knowledge and self-regulation of the accounting profession to determine whether such statements were 'true and fair'. In exchange, the accounting profession would be granted the privilege of a monopoly over the provision of company audit services. *However, the accounting profession's continued tolerance of creative accounting practices casts doubt on the ability of 'professionalism' to operate as an effective regulatory mechanism.*

Recent claims against auditors have typically been prompted by unexpected and substantial losses being suffered by investors as a consequence of sudden corporate collapses that were not signalled by 'true and fair' financial statements. A number of examples might be used to illustrate that such circumstances are simply the expected outcome of current accounting practices, but the most compelling relates to the definition and valuation of assets. In common usage the word is easily understood - the *New Shorter Oxford Dictionary* defines it as "any property or effects available to meet the debts of a testator, debtor or company". This reference also acknowledges that the word is used in a *figurative* sense, where it means a "thing or person of value". Note, however, the accounting profession's own definition of assets as contained in its *Statement of Accounting Concepts No. 4* (SAC4):

> "Assets" are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events (para. 12).

Such a definition has little to do with present debt paying capacity. Rather, it is entirely imaginary: "service potential" and "future economic benefits" relate to what accountants and auditors *think might* happen in the future. The definition of assets adopted by the accounting profession bears closer resemblance to the figurative use of the word than its usual and well established meaning in a financial setting. Not surprisingly, companies have been quick to exploit the vagaries of the profession's definition. Balance sheets are littered with 'figurative assets' such as goodwill, future income tax benefits,[9] research and development costs, exploration and evaluation expenditures and other deferred costs which have no present debt-paying capacity.

The problem is further compounded by the fact that companies are permitted to revalue assets to their 'recoverable amount':

> "recoverable amount" means, in relation to an asset, the net amount that is expected to be recovered through the cash inflows and outflows arising from its continued use and subsequent disposal (AASB 1010, para. 9).

The deceit is thereby complete. In the history of commercial enterprise a strategy of investing against the security of assets was always viewed as prudent; to invest with only the security of expected future cash flows was inherently risky. But in contemporary accounting practice investors have been sold a wholesale lie: expected future cash flows *are assets* and the folly of this has been repeatedly demonstrated in connection with recent Australian corporate failures where actual debt paying capacity has fallen dramatically short of reported assets. In May of 1994 it was announced that the creditors of Bond Corporation were expected to be paid one tenth of one cent for every dollar owed. The liquidator of the failed group has been able to ascertain assets of only $4.7 million (Mychasuk, 1994). In the case of Christopher Skase's Qintex empire, the $3 billion of assets reported in the Qintex accounts subsequently realised just over $1 billion (Farouque, 1995). In the United States where accountants have shown a similar tolerance for 'figurative' rather than

9 Future income tax benefits are perhaps the most contrived of all accounting assets. They have no obvious correspondence with any real world commercial phenomena and have been described as "balancing items" that are "primarily the products of the opinions of mangers as to the expected financial benefit ... as a consequence of recognising tax deductible expenditures and taxable revenues in different periods for taxation and financial reporting purposes." (Wolnizer, 1995:52)

real assets[10] the Chief Accountant of the Securities and Exchange Commission was moved to make the following comment concerning accountants' definition of assets:

> The definition does not discriminate and help us to decide whether something or anything is an asset. [The] definition describes an empty box. A large empty box. An empty box with sideboards. Almost everything or anything can be fit into it. Some even want to fit losses into the definition. (Schuetze, 1993:67)

Inevitably, when the definition of assets is so inherently vague and expectational, the ability of financial statements to defy meaningful audit and to conceal and distort debt-paying capacity is inevitable. Wolnizer (1995:51) has pointed out that "solvency is a real world condition, discoverable only from real world data - from the amount of money commanded and owed, and the (money) prices assets would fetch in an orderly market." When assets are defined as expectations - which are inevitably personal and without empirical referents - the audit process is rendered ineffectual:

> The statutes have sought to ensure that accounts meet the specified quality standard by requiring that they be audited by persons who are independent of the influence and control of managers. The quality thus sought cannot be assured because the information upon which auditors base their report may be significantly influenced by the same managers whose performance they are reporting on. (Wolnizer, 1987:120)

In essence the role of the auditor has been reduced to the largely gratuitous function of *expressing opinions on other opinions*. The procedures that have nourished creative accounting practices have

10 See Briloff for an expose of the American accountancy profession's failures in connection with the savings and loans industry which was "floating on a sea of tenuous accounting numbers" (1990:8). Subsequent attempts by the accounting profession in the U.S. to escape responsibility for its failures in connection with the savings and loan debacle have been strongly criticised (Committe, 1994; Merino and Kenny, 1994).

starved the audit function of integrity and the blame rests essentially with the accounting profession. There is little scope for concluding other than that the accounting profession has abdicated its professional responsibility to the wider community and instead simply embraced the interests of company managers who benefit from being able to utilise undisciplined accounting practices. At the heart of all such practices is the obfuscation of actual financial position and results:

> The general function of accounting is singular - to get at the truth in financial matters. Only an up-to-date truth will secure that persons entrusted with power over property and the work and prospects of others do not exercise that power ignorantly, or in a wanton or self-serving fashion. Getting at the truth thus has a highly respectable social role. It is a powerful disciplinary influence for good in business, government, and society at large. Trust, honesty and fair dealing between those who trust and those who are entrusted, turn on truthfulness, truthfulness in accounting in particular. It must therefore be of serious concern that disregard for the truth is endemic in modern accounting. (Chambers, 1992:84-5)

That the fiasco of current accounting practice should exist, along with the consequent avoidance of accountability by companies with enormous economic and social power, is a matter of profound social concern. Further, that such a fiasco should be perpetuated under the legislatively empowered and exclusive jurisdiction of the accounting profession casts serious doubt on that profession's ability to discharge its regulatory responsibilities.

Conclusions

Following a spate of corporate collapses in Australia in the 1960s it was said that the accounting profession required "critical research into the profession's standards, into all that accountants had traditionally done, into the 'tenets of professional faith'". Instead, "the profession's response ... was negligible" (Birkett and Walker, 1971:136). Two decades later it seems that little has changed. The circumstances provide a significant illustration of the ability of professional groups generally to avoid scrutiny: "Rarely ... has there been such an uncritical acceptance of a social movement whose claims have such crucial implications for the whole community" (Boreham et al, 1976:1).

Community presumption of professional competence is so entrenched that the accounting profession has already had some success in its endeavours to restrict liability. Without any significant independent inquiry into the recent performance of the profession having been initiated, legislation providing for the capping of the liability of members of approved professional associations was passed in the parliament of New South Wales late in December 1994. In the official journal of the ICAA it was described as a "Christmas present" (Delaney, 1995:14). Similar legislation is pending in Western Australia (Lucy, 1995). To date the federal government has shown a reluctance to enact such legislation but an intense lobbying process is still operating ("Executive Committee Highlights", 1994; Dobbie, 1994; MacDonald, 1995).

The difficulty with the proposal of the accounting profession to be protected from liability is not just that it risks the further entrenchment of privileges of dubious merit within the professional class and a further reduction in auditor performance (Monroe et al, 1992). The more general risk is that it will further legitimise the avoidance of corporate accountability by sanctioning current accounting practices that conceal actual debt-paying capacity. Such practices are largely based on the myth that the *present* financial position of companies can somehow be determined by reference to a selective combination of past events (historical costs) and expectations (future cash flows) rather than contemporary empirical referents in the 'real world' of commerce (market prices).

In these circumstances it is not regulatory action to shield a profession from its failings that is required, but rather action to properly regulate the profession itself. The refusal of the accounting profession in the UK to take responsibility for its inadequate performance has led to a call that is equally applicable within an Australian context:

> ... it is high time that the claims and practices of this industry were subjected to closer and critical scrutiny and that the pattern

> of indulgence facilitated by the state must be replaced by an independent regulation with the resource and teeth to ensure that the public interest is fully and effectively voiced and safeguarded. (Mitchell et al, 1994:50)

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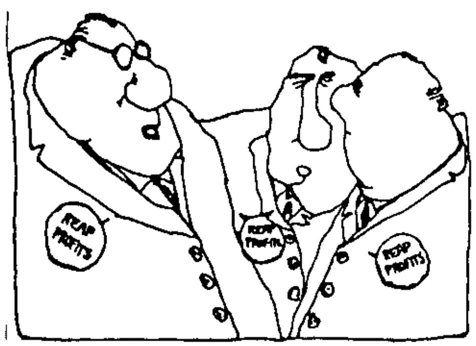

THE LIBERALISATION OF THE AUSTRALIAN WOOL INDUSTRY

Peter Goth

The wool industry is currently experiencing extremely lean times, although it is mature, stable and arguably Australia's oldest export industry. Weak demand for wool during the last four years led to the accumulation of 4.6 million bales of wool (with an associated debt of $2.5 billion) which helped deflate wool prices to less than half of those achieved during the 1980's. Accompanying this downturn was a process of liberalisation (or institutional de-centralisation) of many of the industry's key institutional structures. Important consequences of this process were the abandonment of both the Reserve Price Scheme (RPS) and the introduction of a scheduled release of the accumulated stockpile of wool. The two central controls - the nexus of the industry's centralised institutions - over the price of wool and the supply of wool were abandoned. This process of liberalisation not only further exacerbated growers' difficulties, but also kept reluctant wool buyers away from the uncertain Australian market. Despite the recent restoration of demand levels and the eventual achievement of institutional stability, the lot of growers has not improved, partly because of the drought which has permeated the great bulk of the Australian continent.

This article attempts to explain the inadequacies of the free-market policies which were imposed on the wool industry, and to place these changes in the context of the various forces which were driving the free-market push. The free-market approach was pushed during a period of crisis - during which time growers' hands were more or less tied - so as to relieve the Government of the responsibility of incurring any liabilities in the event of the industry going bankrupt. However, the initial free-