University of North Dakota

UND Scholarly Commons

Theses and Dissertations | Theses, Dissertations, and Senior Projects

1-1970

Accounting Liability in Auditing and Financial Reporting

Wayne Skalicky

How does access to this work benefit you? Let us know!

Follow this and additional works at: https://commons.und.edu/theses

Recommended Citation

Skalicky, Wayne, "Accounting Liability in Auditing and Financial Reporting" (1970). *Theses and Dissertations*. 5099.
https://commons.und.edu/theses/5099

This Independent Study is brought to you for free and open access by the Theses, Dissertations, and Senior Projects at UND Scholarly Commons. It has been accepted for inclusion in Theses and Dissertations by an authorized administrator of UND Scholarly Commons. For more information, please contact und.commons@library.und.edu.

50

University of North Dakota Libraries

ACCOUNTANTS LIABILITY IN AUDITING AND

FINANCIAL REPORTING

by

Wayne G. Skalicky

Bachelor of Arts, Minot State College 1966

An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the degree of

Master of Arts

Grand Forks, North Dakota

January

1970

ARCHIVAL COPY

This Independent Study submitted by Wayne G. Skalicky in partial fulfillment of the requirements for the Degree of Master of Arts from the University of North Dakota is hereby approved by the Faculty Advisory Committee under whom the work has been done.

Permission

Title ACCOUNTANTS LIABILITY IN AUDITING AND FINANCIAL REPORTING

Department Accounting

Degree Master of Arts

In presenting this Independent Study in partial fulfillment of the requirements for a graduate degree from the University of North Dakota, I agree that the Library of this University shall make it freely available for inspection. I further agree that permission for extensive copying for scholarly purposes may be granted by the professor who supervised my Independent Study work or, in his absence, by the Chairman of the Department or the Dean of the Graduate School. It is understood that any copying or publication or other use of this Independent Study or part thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to the University of North Dakota in any scholarly use which may be made of any material in my Independent Study.

Signature ____________________

Date ____________________

TABLE OF CONTENTS

Page

Chapter

I. INTRODUCTION 1

II. RELATIONSHIP OF ACCOUNTANTS TO STATEMENT USERS 2

III. A DISCUSSION OF CASES 7

IV. UNIFORMITY AND ACCOUNTANTS LIABILITY 14

REFERENCES 19

CHAPTER I

INTRODUCTION

The purpose of this Independent Study is to give the reader an insight into the scope of an Accountants Liability.

I will begin by writing about the increasing number of investors in the United States and how their reliance on figures in financial reports is increasing the number of lawsuits involving accountants.

Chapter III will discuss some of the significant cases of Accounts Liability, these cases involve mainly the large Public Accounting firms.

Chapter IV will discuss the lack of uniformity in financial statements. This lack of uniformity has caused some problems because investors are not aware or do not always understand the methods that are used to arrive at the figures on the financial statements and as a result may have cost money because of a misleading statement.

This chapter also involves another case and states also that there is no basis to the fact, that because there has been an increase in Liability suits the profession is not about to be inundated by a flood of lawsuits.

CHAPTER II

RELATIONSHIP OF ACCOUNTANTS TO STATEMENT USERS

The financial services rendered by the accounting profession to the business community, consist not only of auditing and financial reporting, but also of tax practice and management consulting. The primary function of the profession, however, still remains the examination of the financial statements of the clients and the expert opinion--in the form of a report--on the fairness with which they present financial positions and results of operations.

It is on these reports that the entire business community relies in conducting its affairs. Because of the great reliance placed on such reports, impartiality of authorship is often a requisite: accordingly, the principal burden of preparing or certifying such reports. To recoup resultant losses, the aggrieved party often seeks redress from the person benefited, and lately with greater frequency, has in addition sought to impose liability on the calculator of the figures, the accountant. Presently, there are approximately one hundred such suits (involving many millions of dollars) pending against certified public accounting firms alone. These suits have been instituted by disgruntled investors and creditors who contend that the auditor failed to perform their watchdog function properly and, as a result, cost them money.

Various reasons have been suggested in an attempt to explain this rash of suits: (1) the hope of banks and other financial institutions to make accounting firms a source of salvage when credit losses occur; and (2) the general growth of the American economy and the related increase in loss potential in the event of a business failure. Regardless of the reasons, however, the plain fact remains that the cost of liability coverage sold to accounting firms has risen by as much as 30 per cent and more. Moreover, many of the insurers who wrote such coverage freely in the past, now handle it as an accommodation for big accountants or in a limited manner.

The accountant's relationship with the client arises out of a contract though his undertakings may differ greatly from retainee to retainer.

While the retainer may set forth the duties to be performed, incorporated into every such contract of his employment "is the duty to perform the accounting services bargained for with the skill to be expected of a reasonably prudent man with his training and knowledge." Should the accountant conduct fall below these professional standards, "he may be liable to his client for breach of contract, or in tort for breach of the general duty to exercise due care arising out of the contract relationship."[1]

It might be useful to consider what has until recently been considered as the general area of the public accounts liability.

---

[1]Fordham Law Review, "Accounts third party liability. How far do we go," Constantine v Katsouis, XXXVI (December 1967-1968), p. 191.

ACTIONS BY CLIENTS. With respect to the general audit areas, the public accountant was considered to be liable to some limited extent to his client for the failure to discover and disclose defalcations by employees. Even here, at least as far as the profession is concerned, this is not an absolute liability nor, indeed the liability of an insurer. Damages were measured by the direct loss resulting from the defalcation and presumably by the fees paid to the public accountant during the period that the audit was performed. The articulated theory on which the public accountant was held liable to his client was his failure to exercise reasonable care or, expressed another way, his negligence in performing the various audit procedures required in the particular situation.

The public accountants also have to deal with liability arising from their failure to perform specific contractual undertakings such as the filing of timely tax returns or the making of appraisals of equity securities or specific businesses for estate purposes or in connection with the prospective sales or purchases. Here, the loss has been measured by the penalty and/or interest assessed in connection with the failure to file timely tax returns and, in a limited number of cases, by the loss of profit on the purchase or sale of a business. In each of these situations the public accountant is probably also liable for any fee paid.

ACTIONS BY THIRD PARTIES. Insofar as third parties were concerned, there has been a continuing debate as to the identity of the third parties to whom the public accountant may be liable and a considerable disagreement as to the standard of care the public

accountant is required to observe insofar as third parties are concerned. It has become increasingly clear that the third party who relies on the opinion of the public accountant under circumstances where the public accountant knows or should know that such third party will rely, need only show that the public accountant was guilty of simple negligence.

Where the third party is simply a member of a class which the public accountant should know may rely on the statements, then the thinking has been that the measure is gross negligence. The public accountant, it has been thought, will be held liable to third parties in this class only where his conduct is such that it evidences a reckless disregard for the truth of the statements on which he renders an opinion.

Even this theory has not always been generally accepted, and the recent British case of Hedley Byrne, which was discussed at length in two recent issues of the Journal of Accountancy, has cast some doubt on the proposition that the third party is required to show gross negligence or reckless disregard for the truth by the public accountant in order to recover. The measure of damages in these third party cases may well result in recoveries in excess of those which arise in defalcation cases. Since there are generally defaulted loans and/or lost equity investments involved, it become apparent, it would seem, that the public accountant's liability to third parties may be far greater in terms of dollar amounts than it will normally be in the case of a loss by the client itself.

This recitation of situations which result in claims against public accounts is not intended to imply that either the theories of

liability as expressed are acceptable or established or that the public accountant undertakes responsibilities in the areas described.

The fact is, however, that claims are being made based on these statements and the outcome of such claims is at this point much in doubt.[2]

[2]New York Certified Public Accountant, "The Public Accountant's Legal Liability to Clients and Others," XXXVIII (January, 1968), p. 24.

CHAPTER III

A DISCUSSION OF CASES

A study of American cases to date suggests that an accountant will almost never be liable to a non-client at common law except upon proof of actionable fraud. The great majority of courts relying upon the decision in Ultramares vs Touche, Niven and Company hold that the accountant's duty runs only to those in privity with him.

But some writers and judges in the United States and other Common Law Jurisdictions have began to evaluate the virtually total protection given the accountant against liability to third parties injured by relying on his assurances. Broader liability may result from an expansion of the class of people to whom the accountant owes a duty of care or from a redefinition of fraud to encompass conduct previously considered morally wrong but not legally wrong.

The Ultramares Corporation was a finance company which had made loans to the Fred A. Stein Company, a total of $165,000, on the basis of financial reports submitted to it by Touche and Company, a certified public accounting firm. Touche certified the company had net worth of over a million dollars in 1924, and on January 2, 1925, Stein Company was declared bankrupt and Ultramares Corporation attempted to collect their losses, but could not because the certified public accountant was found not liable to third persons.

The Ultramares case held that an accountant could be liable for negligent misrepresentation only to the person who hired him or to a person whom the accountant, at the time he prepared the statement, knew would rely on it. The only third party to whom the accountant owed a duty, was one "in effect if not in name, a party to the contract" under which the accounting services were performed.

This is not the case however, in fraudulent misrepresentations. There can be no doubt that an accountant who fraudulently prepares a financial statement will be liable to an investor who relies upon it in the type of transaction in which the accountant intended to influence his conduct. The problems are to decide what conduct is fraudulent and when liability to a particular plaintiff is justified.[3]

In Fisher vs Kletz, Peat, Marwick and Mitchell acting as an independent public accountant, undertook the job of auditing the financial statements of the Yale Express System, a transportation concern. On March 31, 1964, they certified the figures on the financial statements.

Early in 1964, shortly after completion of the audit, Peat, Marwick and Mitchell was engaged to do special studies for Yale Express. In the process of these studies, they discovered that the figures in the annual report for 1963 were substantially false and misleading.

Plaintiffs sued on the ground that Peat, Marwick and Mitchell was silent after it had discovered the inaccuracies in the report.

---

[3]Columbia Law Review, "Accounting Liability for False and Misleading Financial Statements," LXVII (December, 1967), p. 1438.

They contend the auditors had the duty to inform and expose to the public of these false and inaccurate statements.

Peat, Marwick and Mitchell had the Yale Express showing a substantial profit while in fact they lost almost two million dollars.

In this case no decision was reached. The case was dismissed until all evidence was in, but the motion to dismiss suggested that accountants are not as safe as they used to be from the common law.[4]

A court decision of unusual importance was handed down March 29, 1968 (Escott, et al vs Bar Chris Construction Corporation, et al. United States District Court, Southern District of New York). It is one of the most comprehensive actions brought so far under Section 11 of the Securities Act of 1933, and will undoubtedly be widely discussed in law journals.

Defendants included not only the corporation and its auditors, but officers and directors, underwriters, and legal counsel who was also a director.

Plaintiffs were sixty purchasers of debentures issued by the corporation, joining in a "class action."

The court ruled all defendants responsible to some extent, but reserved decision on the extent of liability attaching to each, which involved consideration of cross-claims filed among the defendants.

The case involved a number of accounting and auditing questions of significance to the accounting profession. For example

---

[4]Ultramares Case 266 Federal Supplement 180, Fischer vs Kletz.

the court held that the percentage-of-completion method of accounting for construction in progress was permissible. The adequacy of reserves for uncollectible receivables and the propriety of classifying certain items as current assets were also considered. The court dismissed a contention of plaintiffs that a certain contingent liability was incorrectly computed.

With respect to one specific reserve, the court said: "The amount of such reserve is a matter of accounting judgment. The evidence does not convince me that the accountant's judgment here was so clearly wrong that the balance sheet can be found to be false or misleading for lack of a higher reserve"; and later, significantly, " . . . these matters are always more clearly discerned in retrospect than they are at the time." On the other hand, one of the items upon which liability was based was a failure to set up a reserve for a partially secured receivable of doubtful collectibility.

Of special interest to accountants is the judge's decision on the question of materiality.[5]

The only audited financial statements included in the registration statement were those for 1960. An accompanying table presents the most relevant amounts from these statements. The court found that the misstatements in the income statement were not material. Of primary significance is the criterion for this decision. The court reasoned as follows:

---

[5]Journal of Accountancy, New Feature, CXXV (June, 1968), p. 20.

These debentures were rated "B" by the investment rating services. They were thus characterized as speculative, as any prudent investor must have realized. It would seem that anyone interested in buying these convertible debentures would have been attracted primarily by the conversion feature, by the growth potential of the stock. The growth which the company enjoyed in 1960 over prior years was striking even on the corrected figures. It is hard to see how a prospective purchaser of this type of investment would have been deterred from buying if he had been advised of these comparatively minor errors in reporting 1960 sales and earnings.

RELEVANT FIGURES FROM BARCHRIS' FINANCIAL STATEMENTS

		Actual
Balance Sheet (1960)		
Current Assets	$4,524,021	$3,924,000
Current Liabilities	2,413,867	2,478,000
Current Ratio	1.9	1.6
Income Statement (1960)		
Sales	9,165,320	8,511,420
Net Operating Income	1,742,801	1,496,196
Earnings per Share	75 cents	65 cents
Comparative Earnings (1959)		
Sales	3,320,121	. . . . .
Net Operating Income	441,103	. . . . .
Earnings per Share	33 cents	. . . . .

Reported earnings per share in 1960 were 75 cents, while the actual earnings were 65 cents per share. The court emphasized the point that in 1959, earnings per share were 33 cents. The implicit basis of comparison for determining materiality seems to be the growth

in earnings. Instead of the reported 127% increase in earnings, the actual increase was 97%. However, the balance sheet errors, which caused the current ratio to be 1.6 instead of the reported 1.9, were found to be material even to the presumed growth-oriented investor.

The most significant feature of these judgments on materiality seems to be the use of the characteristics of the security as a key to the motivation of an "average prudent investor."[6]

The auditors were found in some respects not to have proved that they made a "reasonable investigation," but to have sustained that burden of proof in regard to other items which were challenged. The court appears to have regarded their most serious omissions as those occurring in the review of events subsequent to the data of the "certified balance sheet." In SEC terms this is known as the "S-1 review," prior to the filing of a registration statement. The court said, "The scope of such a review, under generally accepted auditing standards, is limited. It does not amount to a complete audit"; and later in the opinion, "Accountants should not be held to a standard higher than that recognized in their profession." Despite its finding that the written program for the S-1 review was in accord with generally accepted auditing standards, the court found that the review actually conducted was deficient in the circumstances.

The court found that there were a number of errors and omissions in the registration statement, some in the audited financials

---

[6]New York Certified Public Accountant, "The Bar Chris Case - a Landmark Decision on the Auditors Statutory Liability to Third Parties," XXXVIII (November, 1968), p.

for the year prior to filing of the registration statement, some in the unaudited stub period financials, and some in textual portions of the prospectus. The errors found to be chargeable to the auditors were in the audited financials only.

The liability of the auditors as to each of these errors rested upon ordinary negligence alone: an error of judgment, or an insufficient degree of diligence. There is not, in the court's opinion, the slightest suggestion of collusion with management, of willful concealment or misstatement, or of gross negligence.

The decision is far too lengthy to be reprinted in this paper, and far too complex to be summarized adequately. Legal counsel for the American Institute of Certified Public Accountants is studying it, and no doubt the technical committees will consider its implications.[7]

---

[7]Journal of Accountancy, New Feature, CXXV (June, 1968), p. 20.

CHAPTER IV

UNIFORMITY AND ACCOUNTANTS LIABILITY

The multiplicity of sources of accounting principles such as the (1) American Institute of Certified Public Accountants, (2) Government Agencies, (3) Accounting Principles Board, (4) Court Decision, (5) Tax requirements, etc., has resulted in proliferation of accounting methods and widespread doubt about the adequacy of present-day financial accountanting to the needs of the business and investment communities.

Various factors such as the diversity of accounting principles for alternative application, the wide degree of flexibility in the form of presentation, and the managerial decision to disclose or not, may have made accounting the art of the illusionist rather than that of the meaningful communicators. In the various methods of alternative and ingenious presentations of financial data, the auditors unqualified opinion, with its assurance of the statement's conformity with "generally accepted accounting principles," may have become a trap for the unwary.

The accounting profession is attempting to narrow the areas of inconsistency and is attempting to make accounting practice more uniform through the Accounting Principles Board.

The Accounting Principles Board was given the specific authority to make or approve public pronouncements on accounting principles. Unfortunately, the American Principles Board has not been successful in achieving its goal and on occasion has been unable to maintain its published opinion in the face of defiance by accounting practitioners.

Perhaps the major reason for the multiplicity of principles is that accountants do not take a judicial approach to establishing and applying accounting theory. The accountant, in deciding which principals he will follow, is generally acting in a partisan fashion. He reaches his decision in the light of his clients' business and the practices of his associates. Perhaps this kind of bias precludes any justifiable reliance by the legal system on the individual's accounts selections of principles and practices.

From all this, it would seem to be appropriate to probe the future of the accounting liability on the hypothesis that no large advance in the direction of uniformity will soon be made.

The evidence is in favor of the conclusion that the profession will not embrace any drastic change. As a result the predominant theoretical point of view will continue to stress the naturalness and inevitability of diversity of practice. In fact, diversity may have emerged with new dignity and status as of fundamental principle. There will also be continuing stress on the primacy of managerial responsibility and discretion. A variety of sound and apparently respectable accounting principles applicable to quite similar facts will continue to be available for the selection of the company with the approval of its auditor.

How can all this affect the legal liability of auditors? Against this background it is possible we can speculate about the future of an auditors legal liability.

The long-smoldering dispute over uniformity of accounting principles, invites attention to this question from two vantage points. First of all, in deciding which course to take, the profession naturally wonders about the effect in terms of potential legal liability of a system of substantial uniformity. Would a program involving the formulation of, and the enforcement of adherence to a set of uniform accounting principles pose a new threat to independent public accountants? The opinion of the authors in this article is that no real risk of greater liability would occur as a result of more uniform accounting principles.

Another question stimulated by the uniformity debate is whether the accounting profession is now headed for a sharp increase in the incidence of legal liability based on alleged misrepresentation. The answer is that if things stay as they are, there is a possibility of increased liability and even worse, government interference and rigid regulations set up on how accountants will do their work.[8]

Any assertion that the work of independent public accounting is riddled with intentional or negligent misrepresentation would be unwarranted and extremely unfair. And there is no basis for a prophesy that accountants are to be indunated by a flood of actions for

---

[8] Law and Contemporary Problems, "Auditors Liability and the Need for Increased Accounting Uniformity," XXX, page 898.

misrepresentations arising out of their performance of their auditing function. But the increasing importance of financial statements to more and more people will necessarily cause expectations, with respect to the work of accountants, to rise. There is already some evidence of growing impatience in the next place with what is thought to be slipshod or management-biased work. A recent upsurge in litigation in this area of negligence demonstrates that those who rely on financial statements are working more and more to the auditors in fixing responsibility for the insufficiencies of corporation reports.

An example of the kind of action that might well become more prevalent because of the confused state of affairs regarding "general accepted accounting principles" is Terich vs Arthur Anderson and Company. This was an action in the New York courts by a shareholder who alleged that his investment was not worth what it was represented to be worth because of fraudulent omissions from the corporation's financial statements of data connected with an alleged material change in the company's pension plan. The trial courts favorable ruling on the defendants motion for summary judgment, based upon the absence of punitive damages at the time of the filing of the complaint, was recently reversed and the case remanded for trial. This case raises various interesting issues relevant to this discussion: for example, the obligation to conform to accounting Research Bulletins which deals with pension plans: the materiality of the estimated future charge to be made annually for funding the increased cost of past service pension benefits: the sufficiency of the asserted disclosure of the matter of pensions in the letter which was included in the annual report of the

National Mallable and Steel Costing Company by the president of the company: and the curative effect of disclosure to the S&E Commission. If the courts are moved to the belief that social and economic conditions and the circumstances surrounding the practice of the accounting art, require strict treatment of the work of the auditor, they have at their disposal an abundance of doctrines, principles and rules for use in upholding actions against accountants, based on misleading financial reports.[9]

---

[9]Law and Contemporary Problems, p. 904.

REFERENCES

Columbia Law Review. "Accounting Liability for False and Misleading Financial Statements," LXVII (December, 1967), p. 1438.

Fordham Law Review, "Accounts Third Party Liability. How far do we go?" Constantine v Katsouis, XXXVI (December, 1967-1968), p. 191.

Journal of Accountancy, New Feature, CXXV (June, 1968), p. 20.

Law and Contemporary Problems. "Auditors Liability and the Need for Increased Accounting Uniformity," XXX, page 898, 904.

New York Certified Public Accountant. "The Bar Chris Case - a Landmark Decision on the Auditors Statutory Liability to Third Parties," XXXVIII (November, 1968), p.

New York Certified Public Accountant. "The Public Accountant's Legal Liability to Clients and Others," XXXVIII (January, 1968), p. 24.

Ultramares Case 266 Federal Supplement 180, Fischer vs Kletz.