8-1975

Accountants Legal Liability

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ACCOUNTANT'S LEGAL LIABILITY

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Bachelor of Science
University of North Dakota 1974

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 Science

Grand Forks, North Dakota

August
1975

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Chapter

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CHAPTER I

INTRODUCTION

The rapid growth of the public accounting profession during the past several years has been accompanied by a sharp increase in the number of court cases involving public accountants. The man or woman entering public accounting today should be aware of the legal liability inherent in the practice of public accounting.[1]

As a member of a profession the auditor has a legal liability under common law and statutes to those who use and rely on his reports. Resourceful claimaints and their attorneys are attempting to increase the theories under which the auditor may be held liable. As a result, the number of parties to whom an auditor may have to answer and the period of time over which he may be held responsible is being extended.

The question of legal liability of an auditor usually arises when someone sustains a loss as a result of relying upon financial statements which are covered by an auditor's report and are later found to be misleading or to contain material errors. Several questions must be asked to determine if the auditor is to be held financially responsible for any losses incurred.[2]

1. Was the auditor guilty of fraud, of negligence, or merely of an honest error in judgement?

2. Was the fraud localized and small in relation to the total operations or so widespread as to make the financial statements false and misleading when viewed as a whole?

3. Is the injured party the client who engaged the auditor or is he a third party with whom the auditor had no contractual relationship?

4. Was the audit made in connection with an issuance of securities and subject to the rules of the Securities and Exchange Commission?[2]

For the accounting profession, the late 1960's was a time of prosperity and a time of peril. Each year accountants posted new highs in earnings, but at the same time they were subjected to an unprecedented number of lawsuits. A staff reporter for The Wall Street Journal opined that nearly 100 lawsuits were pending against auditors in late 1966. More recently an associate editor of Fortune reported that as many claims for damages were filed against accountants in 1968 as in the previous 12 years.[3]

Lawsuits have frequently involved the accounting profession's most prestigious firms and four cases were particularly qualified to capture the profession's attention: <u>BarChris</u>, <u>Continental Vending</u>, <u>Yale Express</u>, and <u>Westec</u>. These cases collectively have the following three significant characteristics:

1. Recent and pending interpretations of federal securities laws appear likely to give plaintiffs not in a contractual relationship with accountants easier access to accountants than was heretofore the case under common law.

2. Judges and juries composed of laymen, not experts in the field of accounting, are beginning to render decisions interpreting accounting principles as well as auditing procedures.

3. The responsibilities of officers, directors, and other professionals for financial statements appearing in prospectuses and related documents have received judicial comment for practically the first time; the result is a new awareness of responsibilities and risks and a related request for accountants to expand their attest function.[4]

The public accountant must accept full responsibility for the service he renders. Legally, an auditor is required only to measure up to the qualifications of an ordinarily skillful auditor. His moral responsibility is higher than his legal responsibility because he must perform his duties in a manner that conforms to the best practices of the profession. Therefore, it is essential that an auditor have a thorough understanding of accounting principles, auditing standards, laws of contracts, and rules of professional conduct.

The recent developments in the area of the auditor's legal liability have been most significant and have raised some fundamental and crucial issues. This independent study will discuss these crucial issues and the present status of the auditor's liability in a number of legal areas. It will also discuss the auditor's responsibility to the public, his client, government, reporting agencies, and the accounting profession.

END NOTES

[1]Walter B. Meigs, E. John Larsen, and Robert F. Meigs, Principles of Auditing (Homewood: Richard D. Irwin, Inc., 1973), p. 65.

[2]Ibid.

[3]Henry B. Reiling and Russell A. Taussig, Readings in Auditing, ed. J. Herman Brasseaux and John D. Edwards (Cincinnati: South-Western Publishing Co., 1973), p. 148.

[4]Ibid., p. 149.

CHAPTER II

RESPONSIBILITIES OF MANAGEMENT AND THE AUDITOR

In 1972 the Committee on Auditing Procedure of the American Institute of Certified Public Accountants issued Statement on Auditing Procedure No. 33. This release distinguishes between the responsibilities of management and the auditor. To management is assigned the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. Management has direct knowledge and control of business transactions and the statements themselves remain the representations of management.[5]

An auditor's responsibility in the ordinary examination of financial statements is confined to the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. The auditor states whether his examination has been made in accordance with generally accepted auditing standards. These standards also require him to state whether accounting principles have been consistently applied in the preparation of the statements of the current period in relation to those of the preceding period.[6]

An independent auditor may make suggestions as to the form or content or assist in the drafting of the financial statements, but the auditor shouldn't make any management decisions or take a position which might impair his objectivity as an independent auditor.

In making the ordinary examination, the auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as a result of defalcations and similiar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud if sufficiently material, may affect his opinion on the financial statements, and his examination gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similiar irregularities, although their discovery may result. An auditor's responsibility for failure to detect fraud arises only when such failure clearly results from failure to comply with generally accepted auditing standards.[7]

Reliance for the prevention and detection of fraud is placed principally upon an adequate accounting system with appropriate internal control. An auditor must be alert to any indication of fraud or embezzlement and the findings should be reported to an appropriate company official or representative of the client.

If the auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding as to whether the auditor or the client, subject to the auditor's review, is to make an investigation necessary to determine the extent of the fraud. If, on the other hand, the auditor concludes that any such fraud couldn't be so material as to affect his opinion, he should refer the matter to the client with the recommendation that it be pursued to a conclusion.[8]

END NOTES

[5] Committee on Auditing Procedure, Statement on Auditing Standards (New York: AICPA, 1973), p. 2.

[6] Ibid., p. 1.

[7] Ibid., p. 3.

[8] Ibid., p. 4.

CHAPTER III

LIABILITY TO CLIENTS AND THOSE IN PRIVITY

A contractual relationship between the client and the auditor is the foundation of the auditor's rights and responsibilities. This relationship between parties is defined as privity of contract and makes an auditor liable for breach of contract and negligence in the performance of his contractual obligations. An auditor must accept full responsibility for the service he renders and he must perform his tasks with that care and skill which will satisfy his own high standards as an ordinary skillful auditor.

Malpractice is a broad term describing the failure of a professional person to render services up to the standards of his profession. Cooley on Torts (4th ed., vol. 3, p. 335) describes the concept of professional responsibility in James Cashin's book, Handbook for Auditors.

> Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on this public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith or dishonesty, but not for losses consequent upon mere errors of judgement.[9]

An accountant has been well defined as a person competent to design and control the systems of accounts required for records of multifarious transactions of business, trade, and finance. If he serves more than one employer as an independent contractor, he is a public accountant.[10] Joseph L. Frascona in his book, C. P. A. Law Review states:

> The public accountant is a professional person and an independent contractor, except as he changes his status. An independent contractor is a person who contracts to render an agreed performance for another called an employer, does not act on his employer's behalf, has no authority to deal with third persons, and whose manner of performance is not subject to any right of control by the employer. A public accountant renders professional services of a specialized nature involving the exercise of judgement not subject to his client's control, and he comes within the class of an independent contractor.[11]

The activities of a public accountant are the result of his relationship with his client and often affect third persons. Before undertaking any audit engagement, the auditor should have a meeting with the client to discuss the nature of the audit required. To avoid a misunderstanding between the parties a written contract should be formed. This contract should indicate the period covered by the audit, type of audit report, date the report is to be delivered, period of performance, fees, and responsibility to conduct the audit in accordance with generally accepted auditing standards.

A public accountant has the legal duty toward his client to exercise reasonable care, in good faith, without fraud or collusion, and to follow standard accounting practices. Except as otherwise provided by law, he exercises reasonable care when he employs that knowledge, skill, judgement, and discretion usually employed by public accountants in that particular locality under similar circumstances. Since he is in privity of contract with his client, he is liable to his client for damages for breach of contract and for loss proximately caused to his client by his ordinary negligence.[12]

A client who has suffered damages as a result of an improperly conducted or an incomplete audit may attempt to hold the auditor liable on the theory of breach of contract. Auditing contracts are usually to be performed in accordance with generally accepted auditing standards and if an auditor has made an imcomplete audit he has breached his agreement with his client.

Negligence is failure to do that which a reasonable and careful person ordinarily would have done under similar circumstances, or it is the performance of an act which a reasonable and careful person wouldn't have done under similar circumstances.

According to Arthur W. Holmes and Wayne S. Overmyer in their book, Auditing Principles and Procedure:

> The purposes of an audit and the extension of audit procedures may limit or extend the contractural obligation existing between the auditor and the client, and thereby assist in fixing the degree of legal responsibility. To be liable for ordinary negligence under a contract, the auditor: (1) must owe a duty to the client plaintiff, (2) must have violated or breached that duty, (3) must have caused an injury to the plaintiff resulting directly from

the negligence, or (4) must have caused the injury by ignoring contributory negligence on the part of the client. Contributory negligence is not a defense if it has not contributed to the accountant's failure to perform and report.[13]

If the negligence is "gross" negligence, it may be held to be constructive or technical fraud. Gross negligence may be described as flagrant or reckless departure from the standards of competence and due care in performing or reporting on professional engagements; intentional concealment or misstatement need not be present.[14]

Even though an auditor acted in good faith and conducted a proper audit, but made an error in judgement, he may still be held liable to the client. He is responsible when he makes errors through failure to exercise his skills properly. To be held liable, it must be shown that he failed to exercise the quality of judgement that might reasonably be expected from one in a skilled profession.

In <u>State Street Trust Company v. Ernst</u> (278 N.Y. 104, 15 N.E. 2d 416, 1930), the Court held that there was sufficient evidence to support a charge of gross negligence where the auditor reported receivables at their face amount even though he uncovered extensive evidence of unsatisfactory collection. Despite the fact that he had made an adequate investigation he was guilty of a crucial error in judgement in failing to provide an allowance for doubtful accounts.[15]

An auditor isn't legally liable for honest mistakes which a normal accountant in similar circumstances would have made. He doesn't make a complete and detailed examination of all records and transactions. His examination is based upon a study and evaluation of the client's system of internal control. On the basis of this examination he expresses an opinion on the financial postition and operating results of a company.

An auditor is responsible to his client for any fraud he may commit. If he knows financial statements are untrue or he doesn't substantiate the statements sufficiently to establish their truthfulness, he may be liable for fraud. If an auditor fails to recognize and report any evidence of fraud existing in documents or records selected in the process of sampling, he would be subjected to potential legal liability on the basis of negligence.

Because of the confidential relationship existing between the public accountant and his client, communications between them in connection with the employment are confidential and ethically are not to be disclosed by the public accountant without his client's permission. However, unless such communications are recognized and privileged by statue, the public accountant can be compelled to testify in court concerning such communications. Such communications were not privileged at Common Law.[16]

As a rule litagation initiated by a client will be for one of two reasons:[17]

1. It may be alleged that the client has sustained a

loss as a result of reliance on the audited statements. An example of this would be when dividends are paid out or a major acquisition made as a result of erroneous figures.

2. Because of an auditor's failure to discover a defalcation, the client has sustained additional losses. One example of this is, Maryland Casualty v. Cook (35 Fed. Supp. 160, 1940). In this case the auditor's were held liable for negligence in failing to discover the defalcations of the city treasurer. The Court found the auditors negligent in the following respects: they failed to discover crude alterations, no attempt was made to investigate delinquent tax accounts or audit the separate control accounts, and the auditors made no attempt to balance the city books or advise the city of errors in account balances. The Court went on to state that the negligence of the auditors was the proximate cause of many of the shortages by reason of their failure to discover the fraud at an earlier date.

One of the most ominous developments in recent court cases is that of charging the auditor with criminal conspiracy in the issuance of financial statements. The Continental Vending Machine Corporation is unprecedented in the area of accountant's legal liability and is certain to have a far reaching impact on the accounting and auditing profession.

In 1968 a federal district court jury found two partners and a manager of a national firm of certified public accountants guilty of criminal fraud in issuing an unqualified opinion on the September 30, 1962 financial statements of Continental Vending Machine Corporation. The verdict of guilt was affirmed by the U.S. Court of Appeals in 1969 and the U.S. Supreme Court refused to review the case.

The U.S. government's case of fraud hinged upon a footnote to Continental's financial statements. This dealt with the reporting of loans by Continental to its affiliate, Valley Commercial Corporation. The president of Continental dominated both Continental and Valley. From 1958-1962 he borrowed large amounts of money from Continental for his personal stock market dealings. Instead of borrowing directly, he had Continental lend to Valley and then he borrowed from Valley. At September 30,1962, the receivable from Valley resulting from the president's borrowing amounted to $3.5 million. Since the president was unable to repay Valley he agreed to post adequate collateral. However, 80 per cent of the collateral produced consisted of the president's holdings in Continental.

During the court proceedings the defendants requested instruction for acquittal if the balance sheet was presented in conformity with generally accepted accounting principles. This request was denied because the "critical test" the Court felt was whether or not the statements were fairly presented.

This was a critical decision because the weight of law attached to the standards of the accounting profession. For the profession this case points out the advantage of having professional standards spelled out. For the individual practitioner this opinion suggests the desirability of adopting a procedure whereby a special review is made to determine whether disclosures are adequate and understandable from a laymen's point of view.[18]

In defending himself in an action brought by a client, certain defenses can properly be asserted by the accountant:

1. The scope of the engagement didn't call for an examination of the area in question so he is not responsible for the damages sustained.

2. He isn't an insurer or guarantor of the accuracy of the financial statements and his opinion relates only to substantial accuracy. Thus an excellent employee embezzlement may go undetected despite an adequate examination.

3. The auditor performed an examination in accordance with generally accepted auditing standards and with a reasonable degree of care.

4. The client himself is guilty of contributory negligence.

5. The client's negligence contributed to the auditor's failure to perform a proper examination. i.e. -client's refusal to permit an observation of the inventory taking.

6. Simple errors of judgement should not be identified with lack of skill or negligence.[19]

Contributory negligence has been pleaded as a bar to recovery in some cases involving alleged negligence of auditors.

In these cases, the client's negligence was such that it related to the auditor's failure to discover embezzlement and thus it was a contributing cause to the injury suffered. An example of the successful defense of contributory negligence is the case International Labs v. Dewar (3 D.L.R. 665, 41 Manitoba R. 329, 1933). In this instance, an auditor advised his client to set up an improved system of internal control. The client failed to comply and instructed the auditor to limit his scope in subsequent audits. The auditor failed to detect a clever employee fraud. In a lawsuit for damages, the Court held that the acts of the client constituted a complete defense for the auditor and he was exonerated.[20]

The measure of damages in a lawsuit is still a largely unsettled question. Judges and juries normally consider damages in light of each individual case, and the nature of any breach of contract. The majority of courts have set the recovery at the amount of the defalcations taking place subsequent to the time of the audit in question. Other court cases have merely limited damages to the extent of the auditor's fee.

END NOTES

[9] James A. Cashin, Handbook for Auditors (New York: McGraw-Hill Book Company, 1971), p. 5-2.

[10] Joseph L. Frascona, C.P.A. Law Review (Homewood: Richard D. Irwin, Inc., 1972), p. 965.

[11] Ibid.

[12] *Ibid.*, p. 967.

[13] Arthur W. Holmes and Wayne S. Overmyer, *Auditing Principles and Procedure* (Homewood: Richard D. Irwin, Inc., 1971), p. 69.

[14] *Ibid.*, p. 70.

[15] Cashin, *loc. cit.*, p. 5-5.

[16] Frascona, *loc. cit.*, p. 968.

[17] Cashin, *loc. cit.*, p. 5-4.

[18] David B. Isbell, "The Continental Vending Case: Lessons For The Profession," *The Journal Of Accountancy*, CXXX (August, 1970), p. 40.

[19] Benjamin Newman, *Auditing A CPA Review Text* (New York: John Wiley & Sons, Inc., 1964), p. 165.

[20] Cashin, *loc. cit.*, p. 5-7.

CHAPTER IV

LIABILITY TO THIRD PARTIES

Bankers, creditors, investors, and other third parties utilize a company's financial statements in order to make important decisions. Often these statements must be audited by public accountants. Third parties are relying upon the accountant's professional opinion on the fairness with which the financial statements present financial position, results of operations, and any changes in financial position in conformity with generally accepted accounting principles. The exact state of the common liability of the accountant to third parties remains to be clarified. Most authorities state that the accountant will be held liable only in situations in which actual fraud or gross negligence can be shown. Other authorities suggest that where the auditor knows or should know that his report is being relied upon by a third party, such third party may hold the auditor liable for ordinary negligence.

The accountant's liability to third parties is based on the following considerations:

1. The accountant cannot be sued under any contract because third persons aren't parties to the client's contractual agreement.

2. Therefore, the accountant isn't liable to third parties for ordinary negligence because this would expose him

to an indeterminate liaility.

3. The auditor is liable to third parties for fraud.

4. Fraud implies intent to misrepresent material facts. Gross negligence may be construed as the equivalent of fraud.[21]

While a public accountant has duties towards his client because of their privity of contract, since no such privity of contract exists between the public accountant and third persons there is no duty of care owing to them, with one exception. When the public accountant has reason to believe that his accounting services which he has rendered to his client (e.g., a certified balance sheet) will be made available by his client to third persons, then a legal duty of care is imposed upon the public accountant. If the specific identity of the third person is known to the accountant, then the latter has the same duty of care toward such identified third person as he has to his client, and he is liable for damage caused to such third person by his ordinary negligence. However, if he doesn't know the specific identity of the third person to whom his opinion is to be made available, his liability to such third person is only for actual fraud, or for gross negligence amounting to constructive fraud. A mere mistake in the balance sheet which is the result of negligence only is not ordinarily a basis for recovery by a third party, but a representation certified as true to the knowledge of the accountant when there is no knowledge, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there is no genuine belief in its truth, is a sufficient basis for liability.[22]

Third parties who rely upon an auditor's report can recover damages from the auditor if it can be shown that he was guilty of fraud or gross negligence in the performance of his professional duties. Fraud is obviously present if the auditor surrenders his independence and cooperates with the client to give outsiders a false impression of the financial position and operating results of the business.

The responsibility of the auditor to third parties who may rely upon the audit report has evolved through four significant cases: Ultramares v. Touche & Co., State Street Trust Co. v. Ernst, C.I.T. Financial Corp. v. Glover, and Rusch Factors, Inc. v. Levin.[23]

Under the common law, auditors have almost never been found liable to those not in privity on the theory of ordinary negligence. This is a result of the decision in the case of Ultramares Corp. v. Touche (255 N.Y. 170, 174 N.E. 441, 1931). The plaintiffs in this case brought an action in tort for damages based upon misrepresentation due to negligence and fraud. The defendant CPAs issued an unqualified opinion on the balance sheet of Fred Stern & Company who was engaged in the importation and sale of rubber. In reliance upon the auditor's report, the plaintiff, a factor made loans before Stern went into bankruptcy.[24]

In this landmark case the court said that negligence is evidence to sustain an inference of fraud. The court also suggested that where an auditor recklessly certifies financial statements without taking the proper procedures to determine whether or not, the financial statements fairly reflect financial position of a company, an auditor may be found guilty of fraud and liable to parties not in privity of contract. The court found that the auditors were grossly negligent in not discovering obvious material overstatements of sales and receivables, and that consequently the factor, though not a third party beneficiary in the case, could recover his losses from the auditors. As a result of the landmark Ultramares case, the defense of privity is invalid in the event of gross negligence.[25]

In <u>State Street Trust Co. v. Ernst</u> and in <u>C.I.T. Financial Corp. v. Glover</u> the doctrine established in the Ultramares case was strengthened and the defense of privity was further weakened. <u>Rusch Factors, Inc. v. Levin</u> went even further than the previous cases; the court declared that an accountant who committed fraud in issuing a report is liable to all third parties he could foresee being injured, despite his lack of knowledge of actual third parties who might rely upon his report.[26]

An auditor may raise the following third party defenses:[27]

1. The misrepresentation wasn't material.

2. The third party didn't rely on the misrepresentation in pursuing the course of action which resulted in the loss.

3. The auditor's opinion was on an examination which if anything, can be associated with ordinary not gross negligence or fruad.

4. The auditor acted in accordance with generally accepted auditing standards and had a reasonalbe basis for his opinion.[27]

END NOTES

[21]Newman, loc. cit.

[22]Frascona, loc. cit., p. 969.

[23]Meigs, loc. cit., p. 68.

[24]Cashin, loc. cit., p. 5-9.

[25]Meigs, loc. cit., p. 69.

[26]Ibid.

[27]Newman, loc. cit.

CHAPTER V

UNAUDITED STATEMENTS

A significant part of the services provided by the accounting profession today results in the issuance of unaudited financial statements. Engagements to prepare unaudited statements and the accountant's related responsibilities represent a critical area of concern for a large segment of the profession, yet one which is still subject to much confusion and misunderstanding.

The preparation of unaudited financial statements is an accounting service and shouldn't be held in the same light or subjected to the same requirements as an audit engagement.

The AICPA Committee on Auditing Procedure took on the task of preparing guidelines for this unchartered area and issued in September 1967, Standards on Auditing Procedure (SAP) Number 38 entitled, "Unaudited Financial Statements."

SAP Number 38 instructs the practitioner that an unaudited engagement is one in which the accountant has applied:

1. no auditing procedures, or
2. procedures insufficient to warrant the use of one of the accountant's reports described in SAP Number 33.[28]

SAP Number 38 also requires a disclaimer of opinion on any unaudited financial statement with which the Certified

Public Accountant is associated, regardless of whether there are comments accompanying the statements or not. This disclaimer should accompany the unaudited statements or be placed directly on them. Each page of the statements should be clearly marked unaudited. If a client won't make appropriate revision or accept the disclaimer, an auditor should refuse to be associated with the financial statements, and if necessary, withdraw from the engagement. It also states that the accountant has no responsibility to perform any auditing procedures in the case of an unaudited engagement.

According to SAP Number 38, a Certified Public Accountant (CPA) is associated with unaudited financial statements when either of two situations exist:

1. The auditor has consented to the use of his name in a report, document, or written communication setting forth or containing the statements.

2. The auditor has prepared or assisted in the preparation of the statements.[29]

> Association does not arise if the accountant, as an accommodation to his client, merely types on plain paper or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client.[30]

From the point of view of the legal risks involved, auditors would undoubtedly be far better off if they could totally disassociate themselves from any unaudited statements.[31]

In the case Block v. Klein (258 N.Y.S. 2d. 501, 1965) a company brought suit against its own auditors based on an unaudited statement issued to them without a disclaimer. Because of an inflated inventory figure, the company's gross profit was grossly overstated. The company relied on these figures and as a result, suffered additional operating losses.

The auditors defended that they had always relied on the inventory figures supplied by the client and that the client knew or should have known this. The court held that the auditors were negligent in failing to place a disclaimer on every page of the financial statements. However, damages were limited to the audit fees for one year, plus the cost of hiring new auditors to prepare new unaudited financial statements.

The accountant today is confronted with a built-in hazard which has been brought into prominence by the decision in the 1136 Tenant's Corporation case. In this landmark case, the plaintiff was awarded damages of $237,278.83 and the initial audit fee was only $600. Facts of the case are as follows:

The plaintiff (1136 Tenant's Corporation), brought an action against Max Rothenberg & Co. for the defendant's failure to uncover certain alleged defalcations of plaintiff's funds by Riker & Co. Inc.

In August 1963, the plaintiff, via. I. Jerome Riker, who was their managing agent, engaged the Rothenburg firm to perform certain accounting services under an oral retainer agreement providing for payment in the amount of $600 per annum.

In March, 1965, substantial defalcations by Riker & Co. were disclosed when certain obligations of 1136 shown on the accountant's statements as being paid, were found to be unpaid.

Rothenburg's position was that they had been engaged to perform bookkeeping services or "write-up" work and to draw up unaudited financial statements, solely from information furnished by Jerome Riker. They denied any obligation to go beyond these reports and audit the books and records of 1136 Tenant's Corporation and Riker & Co., Inc.

1136 Tenant's Corporation contended that it had engaged the Rothenburg firm as an auditor, not as a bookkeeper, to check the accountants of Riker & Co., Inc. by performing an audit thereof.

The court found that Rothenburg & Co. breached its duty in performing the contract for services for which it was retained. In support of this position, the majority opinion stated that one of the defendant-accountants' senior partners admitted that his firm had performed services which went beyond the scope of "a write-up". Rothenburg's working papers indicated that they examined the plaintiff's bank statements, invoices, and bills. One of the worksheets disclosed invoices missing from the records of Riker & Co., Inc. totalling more than $44,000, dated 1/1/63 - 12/31/63. This should have alerted the auditor of wrong doing or at least of impending financial difficulities. Finally, Rothenburg's auditors failed to use an engagement letter and in the income statement of 1136 Tenant's Corporation and in their separate billings for services they refered to their work as "audit expense".[32]

The 1136 Tenant's Corporation case has serious implications for the accounting profession.

> The trial judge has, by dictim, indicated a need to perform "certain definitive auditing procedures" even though SAP Number 38, as the epitome of our professional standards in this case, unequivocally states that the accountant has no responsibility to perform any auditing procedures in an unaudited engagement.
>
> However, there are ominous overtones emanating from the trial judge's opinion in Rothenberg, where he concluded that the size of the retainer has no bearing on the defendant's duty to perform his work according to the standards imposed by law.[33]

The following preventive measures are offered for consideration to the accountant performing professional services in the area of unaudited financial statements and concerned about minimizing his risk:

1. Before a CPA accepts an engagement he should become familiar with his client and the client's background.

2. The CPA must have some knowledge of the type of business the client is engaged in to satisfy his professional requirements.

3. An engagement letter should be utilized for all engagements.

4. A letter of transmittal should accompany the delivery of unaudited financial statements in every instance.

5. Obtain a representation letter signed by the client.

6. The CPA should educate his clients so that they

understand the nature and limitations of the work being performed.

7. The client should be requested not to use the word "audit" on his financial statements or in describing the nature of the services of his accountant, and he should never use the word when he prepares his bills.

8. The CPA should be familiar with the official pronouncements of the AICPA and follow them faithfully.

9. The CPA has a professional responsibility to resolve any questionable matters that arise during an engagement.

10. The use of a standard program or checklist of minimum procedures should be avoided.

11. It is advisable for the CPA to carry adequate liability insurance for his protection.[34]

END NOTES

[28]Committee on Auditing Procedure, "Unaudited Statements," Statement On Auditing Procedure, XXXVIII (September 1967), p. 53.

[29]Ibid., p. 54.

[30]Ibid.

[31]Cashin, loc. cit., p. 5-15.

[32]Emanuel Saxe, Readings in Auditing, ed. J. Herman Brasseaux and John D. Edwards (Cincinnati: South-Western Publishing Company, 1973), p. 196.

[33]Charles Chazen and Kenneth I. Solomon, "The Unaudited State Of Affairs," The Journal Of Accountancy, CXXIV (December, 1972), p. 44.

[34]Robert H. Saunders, Jr., "Procedures In Minimizing Risk When Associated With Unaudited Financial Statements," The Connecticut CPA, XXXVI (March, 1973), p. 26.

CHAPTER VI

FEDERAL SECURITIES ACTS

Recent developments imply an expansion in the legal hazards facing accountants under statutory law. Since passage of the Federal Securities Act of 1933 and the Securities Exchange Act of 1934, the federal securities laws have represented a potentially effective way for litagants to reach accountants when blocked at common law by Ultramares or the difficulty of proving fraud. These Acts place heavy responsibility on independent public accountants who prepare or examine any part of a registration statement or periodic report and the inclusion of an untrue statement of a material fact, or failure to state a material fact opens the door to legal action by any person acquiring the security.

Under the Federal Securities Act of 1933, an auditor may become liable to security investors for misstatements of, or failure to state, material facts in audit reports prepared by him that are used in connection with new issues of securities to be sold to investors by mail or other means of communication in interstate commerce.[35]

The registration statement must be filed with the Securities and Exchange Commission before securities can be issued and this includes audited financial statements which appear in the prospectus released to the public. This is designed to prevent misrepresentation, deceit, and fraud in the sale of securities.

This Act has made the accountant liable to third party investors, not only for fraud but also for innocent, though negligent misrepresentations. The auditor may be held guilty for negligence or fraud and the plaintiff need not prove reliance on the financial statements.

The accountant's liability under the Securities Act of 1933 is set forth in Section II (a) in the statute as follows:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security... may, either at law or in equity...in any court of competent jurisdiction, sue...every accountant...who has with his consent been named as having...certified any part of the registration statement...[36]

The auditor is liable only for that portion of the registration statement he has certified. His responsibility applies to the financial statements and his written opinion.

Section II (b) provides that an auditor may employ two affirmative defenses in order to escape liability in a suit brought under Section II (a):

1. He may establish that, prior to the effective date of the Registration Statement or on his becoming aware of its effectiveness, appropriate steps to sever his relationship with the issuer had been taken by him. Also he advised the Securities and Exchange Commission and the issuer of such steps and he wouldn't be responsible for that statement attributable to him and appropriate reasonable notice had been given to the public by him.

2. The auditor may show that he had after reasonable investigation, reasonable grounds to believe and did believe, at the time such part of the Registration Statement became effective, that the statements therein were true and there was no omission to state a material fact required to be stated therein and necessary to make the statements therein not misleading.[37]

In accordance with the act the recovery of the plaintiff is limited to the difference between the price paid for the security (not in excess of the public offering price) and
1. the value at the date the suit was instigated, or
2. the price at which the plaintiff sold the security before he filed his suit, or
3. the price at which the plaintiff sold the security after filing his suit but before judgement.[38]

The burden of proof is placed upon the accountant, and his liability also attaches to prospectuses issued in connection with a proposed security sale as well as to the registration statement.

Section 13 of the 1933 act provides:

No action shall be maintained to enforce any liability created under Section II...unless brought with one year after the descovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence...In no event shall any such action be brought to enforce a liability created under Section II... more than three years after the security was bona fide offered to the public.[39]

The Securities Exchange Act of 1934 deals with companys whose securities are traded on the stock exchanges. In accordance with provisions of this act, Section 18 (a) provides the following liability for misleading statements:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this...(Act) or any rule or regulation thereunder..., which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.[40]

In addition, Rule 10b-5 promulgated by the Securities and Exchange Commission under the 1934 act reads as follows:

> It shall be unlawful for any person, directly or indirectly...
> 1. to employ any device, scheme, or artifice to defraud,
> 2. to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made...not misleading, or
> 3. to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[41]

Rule of Practice 2(e) of the Securities and Exchange Commission which gives the SEC the power of suspension and disbarment of CPAs, attorneys, and others who appear before it has the following wording:

> The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found (1) not to possess the requisite qualifications to represent others, or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct.[42]

The Securities Exchange Act of 1934 imposes upon the plaintiff the duty to show reliance and to establish that such reliance was in fact the primary cause of his losses.

This Act permits an auditor to use the defense that he acted in good faith and had no knowledge that such statement was false or misleading. This places a greater burden of proof upon the plaintiff.

In the case Escott v. BarChris Construction Corporation, (283 F. Supp. 643, 1968), an action was undertaken by the purchasers of BarChris's registered debenture bonds under Section II of the Federal Securities against the directors, underwriters, and independent auditors of BarChris.

This case is certain to have legal significance for accountants. BarCris, a builder of bowling alleys, issued the registered 15-year debentures and later became bankrupt. The plaintiffs claimed that the registration statement for the debentures contained material false statements and material ommissions; the defendents all countered with "due diligence" defenses. The court found that the registration statement was false and misleading and that with a few exceptions none of the defendents had established their due diligence defenses. The court found the defendents guilty because they were negligent in the following respects: The auditors failed to examine BarChris's uncompleted contracts, earnings were overstated 14 per cent, current ratio was overstated 16 per cent, the inaccurate recording of both a sale and a leaseback and a loan as a sale which the auditor's failed to discover, sales and cash were overstated, current and contingent liabilities were understated, and the court found that the auditors conducted an incomplete "S-1" review (special investigation conducted to determine events subsequent to balance sheet date, but before the date of the auditor's report).

As a result of BarChris, directors, underwriters, and their attorneys recognize that for them to secure maximim protection under the "due diligence" defense of Section II (b) as much as the prospectus as possible must be covered by an opinion by independent accountants. This case also suggests that the standards for S-1 reviews need to be re-examined and made more specific. The accounting profession should also reconsider its position regarding comfort letters since they are done in conjunction with the S-1 review.

The accountant has the following defenses against loss resulting from misrepresentation in the financial statements submitted for registration.

1. Proof that the financial statements filed with the Commission were not fair copies of the statements prepared by the accountants.

2. Proof that prior to the registration date, written notice was given to the Commission that the accountant wouldn't be responsible for financial statements filed with the registration statement.

3. Proof that the statements were true and proper and contained no ommission or misstatements.

4. Proof that the financial statements were used with the registration statement without knowledge of the accountant.

5. Proof that the investor possessed knowledge of incorrectness in the statements at time of their purchase.

6. Proof that the investor's loss was caused by reasons other than the accountant's error.

7. Proof that the accountant acted in good faith in conformity with the Securities and Exchange Commission.

8. Proof that the accountant relied upon a technical expert on a phase of the financial statements and he had no reason to question the accuracy of the figures supplied to him.

9. Proof that the plaintiff's actions were brought subsequent to three years from the date on which the security was offered to the public.

10. Proof that the plaintiff's action was brought subsequent to one year from the date the plaintiff learned of the accountant's misrepresentation.[43]

END NOTES

[35]Joseph A. Silvoso and Royal D. M. Bauer, Auditing, (Chicago: South-Western Publishing Company, 1965), p. 36.

[36]Ibid.

[37]Cashin, loc. cit., p. 5-12

[38]Holmes, loc. cit., p. 76.

[39]Frascona, loc. cit., p. 973.

[40]Meigs, loc. cit., p. 70.

[41]Ibid. p. 71.

[42]Ibid.

[43]Holmes, loc. cit., p. 76.

CHAPTER VII

SUMMARY

In addition to the court cases discussed in this independent study, several other actions against public accountants, under both common law and the securities acts, are pending trial. For every case that goes to court there are several others settled out of court. Many public accounting firms would rather lose a client and pay damages, than go to court and pay expensive legal fees and risk bad publicity. It is apparent that lawsuits will continue to plague the public accounting profession as they have the legal and medical professions. The question thus is: What should be the public accountant's reaction in this "age of litagation"?[44]

According to John C. Burton of the Securities and Exchange Commission, "The fear of legal liability, not liability itself, poses the greatest threat to CPAs, because the fear blocks the profession from taking on new tasks."[45]

Recent characteristics present in significant court cases raise at least five long-range planning questions for the accounting profession:

1. Must fee structures be adjusted to reflect the greater potential liability which appears to be emerging from recent lawsuits against public accountants?
2. What are the dangers in allowing courts to assume leadership in the pronouncement of accounting principles?
3. How can the accounting profession properly restrict its legal hazards?
4. Should accountants extend their attest function to financial information not now included in certified statements, and certify interim financial statements that are unaudited?

5. What are the advantages and pitfalls for accountants in accepting a new role regarding financial statements?[46]

The public needs more and more to expect the public accountant to provide protection against management and boards of directors that fail to discharge properly their stewardships.

The accountant today has come into his own as a part of the mechanism of government-control. Effective accounting rules are made without effective submission to criticism, with little guaranty against arbitrary determination, and without the continuous and open self-examination which must go into rulings which attain to the sanction and dignity of law.

There is a need for more comprehensive judicial recognition of the accounting profession's own standards. Both the profession and the individual practitioner has certain responsibilities to meet. Guidelines for accepted accounting practice must be established, and these must be adhered to by all members of the accounting profession. Changes and refinements in accounting principles and auditing procedures, new legislation, and judicial action may be required to establish these guidelines.

David Isbell offers some practical rules when a problem of a potentially serious nature is discovered by an accountant:

1. The accountant shouldn't be rushed by supposedly urgent deadlines.

2. The accountant shouldn't rely on promises made by

the client's officers as to important matters.

3. The accountant shouldn't rely on representations made by the client if they are matters the accountant can check for himself.

4. The accountant should consult with a colleague who can bring objectivity before he issues his opinion.

5. It may be useful to consult an attorney on legal matters.[47]

There are seven positive actions helpful to public accountants in withstanding threats of possible lawsuits:

1. Greater emphasis upon compliance with the public accounting profession's generally accepted auditing standards and Code of Professional Ethics.

2. Emphasis on professionalism rather than growth. Rapid growth may place too heavy responsibilities on beginning auditors.

3. Thorough investigation of prospective clients.

4. Use of engagement letters for all professional services.

5. Exercising extreme care in audits of clients in financial difficulties.

6. Avoidance of engagements involving unaudited financial statements and substancial client restrictions.

7. Maintenance of adequate liability insurance coverage.[48]

The greatest role must be played by the practitioner himself. The ultimate responsibility is his and he bears the greatest exposure. He should face this reality by becoming and continuing to be fully informed in the standards imposed by the accounting profession, not only those imposed by SAP No. 38 and the other Statements on Auditing Procedure, but by all of the pronouncements of the profession, and by considering these as the minimum acceptable for the purpose of achieving a high quality performance in the conduct of all phases of his practice.[49]

Accountants have been held legally liable for losses caused by misleading financial statements. Consequently, they mustn't ignore the ever-present threat of legal liability as they make an appraisal of the standards and hazards of the public accounting profession.

END NOTES

[44]Meigs, loc. cit., p. 79.

[45]"Fear of Legal Liability Is Greatest Threat To CPAS," The Journal of Accountancy, CXXXV (February, 1973), p. 10.

[46]Reiling, loc. cit., p. 149.

[47]Isbell, loc. cit.

[48]Meigs, loc. cit., p. 79.

[49]Charles Chazen and Kenneth I. Solomon, "The Unaudited State Of Affairs," The Journal Of Accountancy, CXXXIV (December, 1972), p. 45.

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