Chapter 5

Legal Liability

■ Concept Checks

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1. Several factors that have affected the increased number of lawsuits against CPAs are:

- The growing awareness of the responsibilities of public accountants on the part of users of financial statements.
- An increased consciousness on the part of the SEC regarding its responsibility for protecting investors' interests.
- The greater complexities of auditing and accounting due to the increasing size of businesses, the globalization of business, and the intricacies of business operations.
- Society's increasing acceptance of lawsuits.
- Large civil court judgments against CPA firms, which have encouraged attorneys to provide legal services on a contingent fee basis.
- The willingness of many CPA firms to settle their legal problems out of court.
- The difficulty courts have in understanding and interpreting technical accounting and auditing matters.

2. Business failure is the risk that a business will fail financially and, as a result, will be unable to pay its financial obligations. Audit risk is the risk that the auditor will conclude that the financial statements are fairly stated and an unmodified opinion can therefore be issued when, in fact, they are materially misstated.

When there has been a business failure, but not an audit failure, it is common for statement users to claim there was an audit failure, even if the most recently issued audited financial statements were fairly stated. Many auditors evaluate the potential for business failure in an engagement in determining the appropriate audit risk.

3. The difference between fraud and constructive fraud is that in fraud the wrongdoer intends to deceive another party whereas in constructive fraud there is a lack of intent to deceive or defraud. Constructive fraud is highly negligent performance.

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1. The four major sources of auditor legal liability are:

- Liability to clients.
- Liability to third parties under common law.
- Civil liability under federal securities laws.
- Criminal liability.

2. Liability to clients under common law has remained relatively unchanged for many years. If a CPA firm breaches an implied or expressed contract with a client, there is a legal responsibility to pay damages. Traditionally the distinction between privity of contract with clients and lack of privity of contract with third parties was essential in common law. The lack of privity of contract with third parties meant that third parties would have no rights with respect to auditors except in the case of gross negligence.

That precedent was established by the *Ultramares* case. In subsequent years, some courts have interpreted *Ultramares* more broadly to allow recovery by third parties if those third parties were known and recognized to be relying upon the work of the professional at the time that the professional performed the services (*foreseen users*). Still others have rejected the *Ultramares* doctrine entirely and have held the CPA liable to anyone who relies on the CPA's work, if that work is performed negligently. The liability to third parties under common law continues in a state of uncertainty. In some jurisdictions, the precedence of *Ultramares* is still recognized, whereas in others there is no significant distinction between liability to third parties and to clients for negligence.

3. Under the 1934 act, the burden of proof is on third parties to show that they relied on the statements and that the misleading statements were the cause of the loss. The principal focus of accountants' liability under the 1934 act is on Rule 10b-5. Under Rule 10b-5, accountants *generally* can only be held liable if they intentionally or recklessly misrepresent information intended for third-party use. The possible defenses available to the auditor include nonnegligent performance, lack of duty, and absence of causal connection. The lack of duty defense necessary will depend on the jurisdiction and whether the courts follow the decision in the *Hochfelder* case, or determine gross negligence or reckless behavior is sufficient to hold the auditor liable.

■ Review Questions

5-1 The most important positive effects are the increased quality control by CPA firms that is likely to result from actual and potential lawsuits and the ability of injured parties to receive remuneration for their damages. Negative effects are the energy required to defend meritless cases and the harmful impact on the public's image of the profession. Legal liability may also increase the cost of audits to society, by causing CPA firms to increase the evidence accumulated.

5-2 Audit risk is the risk that the auditor concludes, after conducting an audit in accordance with the relevant auditing standards, that the financial statements were fairly stated when in fact they were materially misstated. Audit failure occurs when the auditor issues an incorrect audit opinion because it failed to comply with the relevant auditing standards. There is some level of audit risk on every audit engagement because it would be prohibitively costly for auditors to test every transaction and balance. Auditors gather evidence on a test basis, and thus may fail to detect a misstatement even though they comply with auditing standards. In addition, a well-orchestrated fraud can be extremely difficult to detect.

5-3 The prudent person concept states that a person is responsible for conducting a job in good faith and with integrity, but is not infallible. Therefore, the auditor is expected to conduct an audit using due care, but does not claim to be a guarantor or insurer of financial statements.

5-4 Many CPA firms willingly settle lawsuits out of court in an attempt to minimize legal costs and avoid adverse publicity. This has a negative effect on the profession when a CPA firm agrees to settlements even though it believes that the firm is not liable to the plaintiffs. This encourages others to sue CPA firms when they probably would not to such an extent if the firms had the reputation of contesting the litigation. Therefore, out-of-court settlements encourage more lawsuits and, in essence, increase the auditor's liability because many firms will pay even though they do not believe they are liable.

5-5 Contributory negligence used in legal liability of auditors is a defense used by the auditor when he or she claims the client or user also had a responsibility in the legal case. An example is the claim by the auditor that management knew of the potential for fraud because of deficiencies in internal control, but refused to correct them. The auditor thereby claims that the client contributed to the fraud by not correcting material weaknesses in internal control.

5-6 An auditor's best defense for failure to detect a fraud is an audit properly conducted in accordance with auditing standards. The Principles in auditing standards (see Chapter 2) note that the objective of an audit is to obtain reasonable assurance that the financial statements are free of material misstatement, whether due to fraud or error. Thus, auditors design audit procedures to provide *reasonable assurance* that material misstatements due to fraud are detected. However, because reasonable assurance is not absolute assurance, a properly designed and executed audit may not detect a material misstatement due to fraud.

5-7 An engagement letter from the auditor to the client specifies the responsibilities of both parties and states such matters as fee arrangements and deadlines for completion. The auditor may also use this as an opportunity to inform the client that the responsibility for the prevention of fraud is that of the

5-7 (continued)

client. A well-written engagement letter can be useful evidence in the case of a lawsuit, given that the letter spells out the terms of the engagement agreed to by both parties. Without an engagement letter, the terms of the engagement are easily disputed.

5-8 In more recent years, the auditor's liability to a third party has become affected by whether the party is known or unknown. Now a known third party, under common law, usually has the same rights as the party that is privy to the contract. An unknown third party usually has fewer rights. The approach followed in most states is the *Restatement of Torts* approach to the foreseen users concept. Under the *Restatement of Torts* approach, foreseen users must be members of a reasonably limited and identifiable group of users that have relied on the CPA's work, even though those persons were not specifically known to the CPA at the time the work was done.

5-9 The differences between the auditor's liability under the securities acts of 1933 and 1934 are because the 1933 act imposes a heavier burden on the auditor. Third party rights as presented in the 1933 act are:

1. Any third party who purchases securities described in the registration statement may sue the auditor.
2. Third party users do not have the burden of proof that they relied on the financial statements or that the auditor was negligent or fraudulent in doing the audit. They must only prove that the financial statements were misleading or not fairly stated.

In conjunction with these third-party rights, the auditor has a greater burden in that he or she must demonstrate that:

1. The statements were not materially misstated.
2. An adequate audit was conducted.
3. The user did not incur the loss because of misleading financial statements.

The liability of auditors under the 1934 act is not as harsh as under the 1933 act. In this instance, the burden of proof is on third parties to show that they relied on the statements and that the misleading statements were the cause of the loss.

The principal focus of accountants' liability under the 1934 act is on Rule 10b-5. Under Rule 10b-5, accountants *generally* can only be held liable if they intentionally or recklessly misrepresent information intended for third-party use. Many lawsuits involving accountants' liability under Rule 10b-5 have resulted in accountants being liable when they knew all of the relevant facts, but merely made poor judgments. In recent years, however, courts have decided that poor judgment doesn't necessarily prove fraud on the part of the accountant.

5-10 The auditor's *legal liability to the client* can result from the auditor's failure to properly fulfill his or her contract for services. The lawsuit can be for breach of contract, which is a claim that the contract was not performed in the manner agreed upon, or it can be a tort action for negligence. An example would be the client's detection of a misstatement in the financial statements, which would have been discovered if the auditor had performed all audit procedures required in the circumstances (e.g., misstatement of inventory resulting from an inaccurate physical inventory not properly observed by the auditor).

The auditor's *liability to third parties under common law* results from any loss incurred by the claimant due to reliance upon misleading financial statements. An example would be a bank that has loans outstanding to an audited company. If the audit report did not disclose that the company had contingent liabilities that subsequently became real liabilities and forced the company into bankruptcy, the bank could proceed with legal action against the auditors for the material omission.

Civil liability under the Securities Act of 1933 provides the right of third parties to sue the auditor for damages if a registration statement or a prospectus contains an untrue statement of a material fact or omits to state a material fact that results in misleading financial statements. The third party does not have to prove reliance upon the statements or even show his or her loss resulted from the misstatement. An example would be stock purchased by an investor in what appears, based upon audited financial statements, to be a sound company. If the financial statements are later found to be inaccurate or misleading, and the investment loses value as a result of a situation existing but not disclosed at the date of the financial statements, the investor could file legal proceedings against the auditor for negligence.

Civil liability under the Securities Act of 1934 relates to audited financial statements issued to the public in annual reports or 10-K reports. Rule 10b-5 of the act prohibits fraudulent activity by direct sellers of securities. Several federal court decisions have extended the application of Rule 10b-5 to accountants, underwriters, and others. An example would be an auditor knowingly permitting the issuance of fraudulent financial statements of a publicly held client.

Criminal liability of the auditor may result from federal or state laws if the auditor defrauds another person through knowingly being involved with false financial statements. An example of an act that could result in criminal liability would be an auditor's certifying financial statements that he or she knows overstate income for the year and the financial position of the company at the audit date.

5-11 The SEC can impose the following sanctions against a CPA firm:

1. Suspend the right to conduct audits of SEC clients.
2. Prohibit a firm from accepting any new clients for a period.
3. Require a review of the firm's practice by another CPA firm.
4. Require the firm to participate in continuing education programs.

5-12 The Sarbanes-Oxley Act of 2002 made it a felony to destroy or create documents to impede or obstruct a federal investigation. As a result of the Sarbanes-Oxley Act, a person may face fines and imprisonment for altering or destroying documents.

5-13 Some of the ways in which the profession can positively respond and reduce liability in auditing are:

1. Continued research in auditing.
2. Standards and rules must be revised to meet the changing needs of auditing.
3. The AICPA can establish requirements that the better practitioners always follow in an effort to increase the overall quality of auditing.
4. Establish new peer review requirements.
5. CPA firms should oppose all unfounded lawsuits rather than settling out of court.
6. Users of financial statements need to be better educated regarding the attest function.
7. Improper conduct and performance by members must be sanctioned.
8. Lobby for changes in state and federal laws concerning accountants' liability.

■ Multiple Choice Questions From CPA Examinations

5-14 a. (1) b. (4) c. (3)

5-15 a. (3) b. (2) c. (4)

■ Multiple Choice Questions From Becker CPA Exam Review

5-16 a. (4) b. (3) c. (2)

■ Discussion Questions and Problems

5-17
1. The plaintiff will most likely not be able to seek restitution from Brogan's personal assets given the firm operates as a limited liability partnership (LLP), Brogan was not involved in the engagement in question, and she did not rely on the work of the other partner.
2. Hockaday's primary defense tactic should demonstrate that there was no negligence on his part and that there was no intent on his part to deceive. Given he is confident that he fully complied with auditing standards, he should be able to demonstrate a lack of recklessness.

5-17 (continued)

3. West's bankruptcy is an example of a business failure that does not necessarily imply the presence of audit failure. Audit failure occurs when the auditor issues an incorrect audit opinion because it failed to comply with the requirements of auditing standards. There is no indication that the West financial statements are materially misstated. Thus, there is no evidence of audit failure, despite the company's subsequent bankruptcy.
4. Under common law, CPAs do not have the right to withhold information from the courts on the grounds that the information is privileged. Confidential discussions between the client and the auditor cannot be withheld from the courts. Some states do have statutes that permit privileged communication between the client and auditor; however, the privilege would not extend to federal courts. Thus, Weaver and Jones will most likely need to provide the documentation requested by the subpoena.
5. Spencer Cullen will most likely be liable for gross negligence for failure to obtain sufficient appropriate evidence to examine the valuation of securities. Accepting the client's valuation without corroborating evidence will most likely be viewed as displaying a lack of even slight care or as reckless behavior.

5-18

1.	c	(fraud)
	i	(gross negligence)
2.	d	(ordinary negligence)
	h	(privity of contract)
3.	a	(due diligence)
4.	b	(reliance on the financial statements)
	k	(material error or omission)
5.	e	(separate and proportionate)
6.	j	(foreseen users)
7.	g	(intent to deceive)
8.	f	(contributory negligence)

5-19

1. Based on the information given, Chad Lewis conducted the audit with due care, or nonnegligent behavior. Given that an audit does not provide absolute assurance, a material misstatement may still go undetected even when an adequate audit is conducted.
2. In this scenario, Maria Marquez willfully violated auditing standards by hiring unqualified assistants and failing to properly supervise them, but likely did not intend to deceive the bank. At a minimum, Marquez's behavior constitutes constructive fraud, which is extreme or unusual negligence without intent to deceive (also called recklessness).

5-19 (continued)

3. Given that the auditors were able to satisfy themselves through alternative procedures that the inventory existed as of the end of the year, their behavior in this instance would be considered nonnegligent.
4. The facts in this scenario suggest fraudulent behavior as there is an intent to deceive. In addition, the Sarbanes-Oxley Act of 2002 made it a felony to destroy or create documents to impede or obstruct a federal investigation, which would make this criminal behavior if subject to the Sarbanes-Oxley Act.
5. In this scenario, Melissa Louis' behavior would be considered fraudulent given that she is knowingly deceiving investors by agreeing to hide a material misstatement.

5-20 a. Yost and Co. should use the defenses of meeting auditing standards and contributory negligence. The fraud perpetuated by Stuart Supply Company was a reasonably complex one and difficult to uncover except by the procedures suggested by Yost.

In most circumstances it would not be necessary to physically count all inventory at different locations on the same day. Furthermore, the president of the company contributed to the failure of finding the fraud by refusing to follow Yost's suggestion. There is evidence of that through his signed statement.

b. There are two defenses Yost and Co. should use in a suit by First City National Bank. First, there is a lack of privity of contract. Even though the bank was a known third party, it does not necessarily mean that there is any duty to that party in this situation. That defense is unlikely to be successful in most jurisdictions today. The second defense which Yost is more likely to be successful with is that the firm followed auditing standards in the audit of inventory, including the employment of due care. Ordinarily it is unreasonable to expect a CPA firm to find such an unusual problem in the course of an ordinary audit. Because the CPA firm did not uncover the fraud does not mean it has responsibility for it.

c. She is likely to be successful in her defense against the client because of the contributory negligence. The company has responsibility for instituting adequate internal controls. The president's statement that it was impractical to count all inventory on the same day because of personnel shortages and customer preferences puts considerable burden on the company for its own loss.

It is also unlikely that First City National Bank will be successful in a suit. The court is likely to conclude that Yost followed due care in the performance of her work. The fact that there was not a count of all inventory on the same date is unlikely to be sufficient for a successful suit. The success of Yost's defenses is also heavily dependent upon the jurisdiction's attitude about privity of contract. In this case, there is unlikely to be a claim of

5-20 (continued)

extreme negligence. Therefore, it would be required for the court to both ignore the privity of contract precedence and find Yost negligent for the suit to be successful.

d. The issues and outcomes should be essentially the same under the suit brought under the Securities Exchange Act of 1934. If the suit were brought under Rule 10b-5, it is certainly unlikely that the plaintiff would be successful, inasmuch as there was no intent to deceive. The plaintiff would likely be unsuccessful in such a suit.

5-21 Yes. Normally a CPA firm will not be liable to third parties with whom it has neither dealt with nor for whose benefit its work was performed. One notable exception to this rule is fraud. When the financial statements were fraudulently prepared, liability runs to all third parties who relied upon the false information contained in them. Fraud can be either actual or constructive. Here, there was no actual fraud on the part of Small or the firm in that there was no deliberate falsehood made with the requisite intent to deceive. However, it would appear that constructive fraud might be present. Constructive fraud is found where the auditor's performance is found to be grossly negligent. That is, the auditor really had either no basis or so flimsy a basis for his or her opinion that he or she has manifested a reckless disregard for the truth. Small's disregard for standard auditing procedures would seem to indicate such gross negligence and, therefore, the firm is liable to third parties who relied on the financial statements and suffered a loss as a result.

5-22 The answers provided in this section are based on the assumption that the traditional legal relationship exists between the CPA firm and the third-party user. That is, there is no privity of contract, the known versus unknown third-party user is not a significant issue, and high levels of negligence are required before there is liability.

a. False. There was no privity of contract between Thompson and Doyle and Jensen; therefore, ordinary negligence will usually not be sufficient for a recovery.
b. True. If gross negligence is proven, the CPA firm can and probably will be held liable for losses to third parties.
c. True. See a.
d. False. Gross negligence (constructive fraud) is treated as actual fraud in determining who may recover from the CPA.
e. False. Thompson is an unknown third party and will probably be able to recover damages only in the case of gross negligence or fraud.

Assuming a liberal interpretation of the legal relationship between auditors and third parties, the answers to a. and e. would probably both be true. The other answers would remain the same.

5-23 a. Hanover will likely not be found liable to the purchasers of the common stock if the suit is brought under Rule 10b-5 of the Securities Exchange Act of 1934 because there was no knowledge or intent to deceive by the auditor. However, if the purchasers are original purchasers and are able to bring suit under the Securities Act of 1933, the plaintiffs will likely succeed because they must only prove the existence of a material error or omission.

b. Hanover was aware that the financial statements were to be used to obtain financing from First National Bank. Hanover is likely to be held responsible for negligence to the bank as a known third party that relied on the financial statements.

c. The plaintiffs might state a common law action for negligence. However, they will most likely not prevail due to the privity requirement. There was no contractual relationship between the defrauded parties and the CPA firm. Although the exact status of the privity rule is unclear, it is doubtful that the simple negligence in this case would extend Hanover's liability to the trade creditors who transacted business with Barton Corp. However, the facts of the case as presented in court would determine this.

5-24

1. c Both. Material misstatements must be shown under both acts.
2. c Both. Monetary loss must be demonstrated under both acts.
3. d Neither. Plaintiff does not have to prove lack of diligence under the 1933 act, but the accountant can use due diligence as a defense. Scienter must be demonstrated under the 1934 act.
4. d Neither. Privity applies to common law and not the 1933 and 1934 acts.
5. b 1934 act only. Reliance is not required under the 1933 act.
6. b Scienter is required under the 1934 act, but not the 1933 act.

5-25 The bank is likely to succeed. Robertson apparently knew that Majestic was "technically bankrupt" at December 31, 2015. Reporting standards require the auditor to add an explanatory paragraph to the audit report when there is substantial doubt about an entity's ability to continue as a going concern. She did not include such a paragraph. To make matters worse, it appears that Robertson was convinced not to issue the report with the going-concern paragraph because of the negative impact on Majestic Co., not because of the solvency of the company. That may be interpreted as a lack of independence by

Robertson and may indicate a fraudulent act, potentially a criminal charge that could result in a prison term.

5-25 (continued)

Robertson's most likely defense is that after determining all of the facts, in part through discussion with management, she concluded that the Majestic Co. was not technically bankrupt and did not require an explanatory paragraph in the audit report. She might also argue that even if such a report was appropriate, her failure to do so was negligence or bad judgment, not with the intent to deceive the bank. Such a defense does not seem to be strong given the statement about her knowledge of Majestic's financial condition.

Robertson might also falsely testify that she did not believe that a going-concern problem existed. Such statements would be perjury and are unprofessional and not worthy of a professional accountant. Perjury is also a criminal act and could result in further actions by the courts.

5-26 a. The SEC enforcement release is filed against Diamond Foods, Inc., and its former CEO and former CFO. They are charged with intentionally overstating earnings to meet analysts' forecasts. The CFO directed the effort to understate costs by deferring the costs of walnuts (its largest commodity cost) to later fiscal periods, which had the effect of falsely boosting profits. The former CFO also misled the auditors by providing incomplete and false information. Both the CEO and CFO certified the false financial statements despite knowledge of the fraud.

b. The complaint alleges violations of sections of both the Securities Act of 1933 and the Securities Exchange Act of 1934, including Rule 10b-5, and also for the CFO, Section 304 of the Sarbanes-Oxley Act (requiring forfeiture of certain bonuses and profits).

c. The facts in the enforcement release suggest the auditors were provided with false and misleading information by management. If the auditors conducted their audit with due care, in compliance with the auditing standards, then they should not be liable for damages incurred by investors. If however, standard audit procedures should have uncovered the fraud, then their behavior may be considered negligent.

■ Case

5-27 PART 1

a. In order for Thaxton to hold Mitchell & Moss liable for his losses under the Securities Exchange Act of 1934, he must rely upon the antifraud provisions of Section 10(b) of the act. In order to prevail, Thaxton must establish that:

1. There was an omission or misstatement of a material fact in the financial statements used in connection with his purchase of the Whitlow & Company shares of stock.

5-27 PART 1 (continued)

2. He sustained a loss as a result of his purchase of the shares of stock.
3. His loss was caused by reliance on the misleading financial statements.
4. Mitchell & Moss acted with scienter (knowledge of the misstatement).

Based on the stated facts, Thaxton can probably prove the first three requirements cited above. To prove the fourth requirement, Thaxton must show that Mitchell & Moss had knowledge of the fraud or recklessly disregarded the truth. The facts clearly indicate that Mitchell & Moss did not have knowledge of the fraud and did not recklessly disregard the truth.

b. The customers and shareholders of Whitlow & Company would attempt to recover on a negligence theory based on Mitchell & Moss' failure to comply with auditing standards. Even if Mitchell & Moss were negligent, Whitlow & Company's customers and shareholders must also establish either that:

1. They were third-party beneficiaries of Mitchell & Moss' contract to audit Whitlow & Company, or
2. Mitchell & Moss owed the customers and shareholders a legal duty to act without negligence.

Although many cases have expanded a CPA's legal responsibilities to a third party for negligence, the facts of this case may fall within the traditional rationale limiting a CPA's liability for negligence; that is, the unfairness of imputing an indeterminate amount of liability to unknown or unforeseen parties as a result of mere negligence on the auditor's part. Accordingly, Whitlow & Company's customers and shareholders will prevail only if (1) the courts rule that they are either third-party beneficiaries or are owed a legal duty and (2) they establish that Mitchell & Moss was negligent in failing to comply with auditing standards.

5-27 PART 2

a. The basis of Jackson's claim will be that she sustained a loss based upon misleading financial statements. Specifically, she will rely upon section 11(a) of the Securities Act of 1933, which provides the following:

5-27 PART 2 (continued)

> 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 requirement to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) 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 prepared or certified any part of the registration statement.

To the extent that the relatively minor misstatements resulted in the certification of materially false or misleading financial statements, there is potential liability. Jackson's case is based on the assertion of such an untrue statement or omission coupled with an allegation of damages. Jackson does not have to prove reliance on the statements nor the company's or auditor's negligence in order to recover the damages. The burden is placed on the defendant to provide defenses that will enable it to avoid liability.

b. The first defense that could be asserted is that Jackson knew of the untruth or omission in audited financial statements included in the registration statement. The act provides that the plaintiff may not recover if it can be proved that at the time of such acquisition she knew of such "untruth or omission."

Since Jackson was a member of the private placement group and presumably privy to the type of information that would be contained in a registration statement, plus any other information requested by the group, she may have had sufficient knowledge of the facts claimed to be untrue or omitted. If this were the case, then she would not be relying on the certified financial statements but upon her own knowledge.

The next defense available would be that the untrue statement or omission was not material. The SEC has defined the term as meaning matters about which an average prudent investor ought to be reasonably informed before purchasing the registered security. For section 11 purposes, this has been construed as meaning a fact that, had it been correctly stated or disclosed, would have deterred or tended to deter the average prudent investor from purchasing the security in question.

Allen, Dunn, and Rose would also assert that the loss in question was not due to the false statement or omission; that is, that the false statement was not the cause of the price drop. It would appear that the general decline in the stock market would account for at least a part of the loss. Additionally, if the decline in earnings

5-27 PART 2 (continued)

was not factually connected with the false statement or omission, the defendants have another basis for refuting the causal connection between their wrongdoing and the resultant drop in the stock's price.

Finally, the accountants will claim that their departure from auditing standards was too minor to be considered a violation of the standard of due diligence required by the act.