Chapter 04

Legal Liability of CPAs
Scope of CPA Liability

- Potential liability may exceed that of other professions (such as physicians) because:
  - Number of parties suffering significant losses.
  - Possibly millions of investors as well as firm creditors.
  - Amounts can be excessive in some cases exceeding the limits of professional liability insurance.
Some cases are obviously a result of less than adequate audit performance.

In many cases, some of the many estimates made in the preparation of financial statements are, in hindsight, proven wrong:

- A case often argues, in hindsight, that the amounts were unreasonable.

Other cases may be due to other factors such as the ability of the CPA firm to pay ("deep pockets").
CPA Liability

- **Common Law**
  - Develops through case decisions
  - Generally arising due to
    - Breach of contract,
    - Negligence
    - Fraud

- **Statutory liability**
  - Develops when governmental unit passes laws and regulations imposing liability on CPAs
Primary Sources of CPA Liability

1. Breach of Contract

2. Negligence - tort
   - Ordinary – violation of legal duty to exercise a degree of care that an ordinary prudent person would exercise under similar circumstances
   - Gross – lack of even slight care, indicative of a reckless disregard for one’s professional responsibilities
3. Fraud

- Misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured

- Constructive fraud – does not involve a misrepresentation with intent to deceive (gross negligence)

4. Statutory

- Securities Act of 1933
- Securities Exchange Act of 1934
Other Sources of CPA Liability

- Criminal statutes
  - Most lawsuits allege violations of federal securities acts
  - Usually class action lawsuits by investors

- RICO Act
  - Racketeer Influenced Corruption Organizations Act
Elements of Proof by Client Under Common Law

- Duty—CPAs accepted a duty of due professional care
- Breach of duty—CPAs breached that duty
- Losses—Suffered by plaintiff
- Causation (proximate cause)—Losses were caused by CPAs’ performance
Elements of Duty and Breach of Duty

Duty
- Defined by GAAS, the engagement letter and legal considerations

Breach of duty
- Auditor did not perform obligations listed in the engagement letter or
- Performance did not meet professional standards
- *Does not* imply auditors were negligent whenever misstatements due to errors or fraud are later found
Elements of Losses and Causation

➢ Losses
  ● Damages to the plaintiff
  ● Depend on the nature of the engagement

➢ Causation.

➢ Defenses
  ● Negligence not proximate cause
  ● Contributory negligence
  ● Comparative negligence

➢ Liability
  ● Proportionate
  ● Joint and several
Third Parties

- Must establish that losses resulted from CPAs’ performance
- CPA breached a duty of due professional care
- Typical case:
  - Third party seeks to establish that it sustained a loss caused by relying on misleading financial statements which included an audit report that was inadequate
  - Gross negligence will establish liability
  - Ordinary negligence depends on jurisdiction
### Summary of Third-Party Common Law Liability for Ordinary Negligence

<table>
<thead>
<tr>
<th>Approach</th>
<th>Requirements for a Third Party to Recover Losses Due to CPAs’ Ordinary Negligence</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Ultrimares</em> approach</td>
<td>The auditors knew that the audited financial statements were for use for a <em>particular purpose by a known user</em> (third-party beneficiary).</td>
</tr>
<tr>
<td>(known user approach)</td>
<td></td>
</tr>
<tr>
<td><em>Restatement</em> approach</td>
<td>The auditors knew the audited financial statements were for use for a <em>particular purpose</em>, but the auditors <em>did not necessarily know the specific user</em> (e.g., the financial statements were known to be for use in helping to sell the business to an unidentified purchaser).</td>
</tr>
<tr>
<td>(foreseen user approach)</td>
<td></td>
</tr>
<tr>
<td><em>Rosenblum</em> approach</td>
<td>The auditors should have realized that it was <em>reasonably foreseeable</em> that the financial statements would be used by this user.</td>
</tr>
<tr>
<td>(foreseeable user approach)</td>
<td></td>
</tr>
</tbody>
</table>
Ultramares Approach to Auditor Liability

Selected Cases

*Ultramares Corporation v. Touche* (1931)--A landmark case under common law in that it established that auditors could be held liable to third-party beneficiaries for ordinary negligence and to other third parties for gross negligence.

*Credit Alliance Corp. v. Arthur Andersen & Co.* (1985)--A common-law decision establishing that auditors must demonstrate knowledge of reliance on the financial statements by a third party for a particular purpose to be held liable for ordinary negligence to that party.

Observation

Auditors must have been aware that the financial statements were to be used for a particular purpose by a known third party to be liable to that party for ordinary negligence.
Restatement of Torts Approach to Auditor Liability

Selected Case

*Rusch Factors, Inc. v. Levin* (1986)--A common-law decision in which the auditors were found liable for ordinary negligence to a third party not specifically identified to the auditors, although the auditors were aware of the intended use of the financial statements.

Observation

To be held liable for ordinary negligence, the auditors must have been aware that the financial statements were to be used for a particular purpose, although the identity of the third party need not necessarily be known.
Rosenblum Approach to Auditor Liability

Selected Case

*Rosenblum v. Adler* (1983)--Established that the auditors could be held liable for ordinary negligence to all third parties that the CPAs could reasonably foresee as users of the financial statements for routine business purposes.

Observation

Opens the door to liability for ordinary negligence to virtually all third parties who rely on the financial statements.
Common Law Liability to Third Parties

Approach
- Ultramares
- Restatement of Torts
- Rosenblum

Parties That May Recover for Ordinary Negligence
- Third party beneficiary
- Limited class of known or intended users
- Any third party the auditors could reasonably foresee as user
**Figure 4.2** Summary of Auditor Civil Liability under the 1933 Securities Act (Section 11) and the 1934 Securities Exchange Act (Sections 10 and 18)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1933 Securities Act— Section 11</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Auditor must prove due diligence.</td>
</tr>
<tr>
<td>1934 Securities Exchange Act—Section 10</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Third party must prove existence of scienter (auditors’ intent to deceive, manipulate, or defraud).</td>
</tr>
<tr>
<td>1934 Securities Exchange Act—Section 18</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Auditor must prove good faith.</td>
</tr>
</tbody>
</table>
Civil Liability Under the Securities Act of 1933

*Escott et al. v. Bar Chris Construction Corp. et al.* (1968)--The first significant case brought under the Securities Act of 1933. The auditors were unable to establish their due diligence, especially with respect to the S-1 review for subsequent events up to the effective date of the registration statement.
Civil Liability Under the Securities Exchange Act of 1934

*Ernst and Ernst v. Hochfelder et al.* (1977)---
Established that the auditors could not be held liable under Rule 10b-5 of the Act for ordinary negligence. The U.S. Supreme Court concluded that the auditors’ knowledge of the fraud must be proved before damages can be recovered under this provision of the Securities Exchange Act of 1934.
Proportionate Liability under 1934 Act

Private Securities Litigation Reform Act of 1995

- Placed limits on amount of auditors’ liability by establishing proportionate liability
  - If one of more defendants are not able to pay their share of losses,
    - to certain small investors only, auditors have unlimited joint and several liability
    - To other investors, auditors liability limited to an amount not to exceed 50% of the auditors’ proportionate share of the losses
Among the activities included as "racketeering activities" are mail fraud and fraud in the sale of securities.

Used against CPAs who knew or should have known of material misstatements of financial statements.

Allows triple damages in civil cases.

1993 – Reves v. Ernst & Young

- Court decided accountants cannot be held liable under RICO act unless they actually participated in the operation or management of the organization.
Criminal Liability

Selected Case

*United States v. Simon* (Continental Vending) (1969)-
-A highly publicized case in which auditors were held criminally liable for gross negligence. Two audit partners and a manager were convicted of filing false statements with a government agency, mail fraud, and violating Section 32 (a) of the Securities Exchange Act of 1934. This case also was largely responsible for the development of required disclosure of related party transactions (originally issued as SAS No. 6, and now contained in FASB Statement No. 57).
United States v. Arthur Andersen (2002)—Arthur Andersen was accused of the wholesale destruction of documents relating to the Enron Corporation collapse. The jury found, based primarily on an email message that an Arthur Andersen attorney advised a partner to revise a memo to omit certain information, including a comment that an Enron press release that included an earnings announcement was misleading. Loss of this case effectively put Arthur Andersen out of business. The conviction was overturned by the U.S. Supreme Court.
Has power to prohibit CPAs from reporting on SEC registrants’ financial statements.

Can take punitive action against public accounting firms

- Consent decrees which can enforce certain penalties or restrictions

Auditors are forced to report illegal acts by clients to SEC if the client fails to report them
May conduct investigations and disciplinary proceedings on registered CPA firm and professional employee

Sanctions can include:

- Monetary damages
- Suspension of firms and accountants from engagements for publicly traded companies
- Referral of criminal cases to the Justice Department
Unaudited Financial Statements of Nonpublic Companies: What are they?

- Compilation of financial statements
  - Preparation of financial statements based upon information provided to CPAs by client
  - Not intended to lend any assurance as to statements’ reliability

- Review of financial statements
  - Consists of limited verification procedures, substantially less in scope than an audit
  - Provides limited assurance as to statements’ reliability
Selected Case

1136 Tenants Corporation v. Max Rothenberg and Company (1971)--A landmark case for accountants’ liability when they are associated with unaudited financial statements. The case demonstrated the importance of engagement letters to clearly establish an understanding with the client regarding the nature of the services to be provided. It also illustrated the need to follow up on unusual findings even when the CPAs are not performing audits.
Lessons from 1136 Tenants’ Corp. Case

- CPAs who prepare unaudited financial statements should
  - adhere closely to Rules of Conduct 102 and 202 of AICPA Code of Professional Conduct
  - Engagements letters are essential
  - Should still be alert for and follow up on unusual items such as missing invoices
  - Report clearly and concisely using standardized language in SAS and SSARS
## Legal Liability: A Summary—Common Law

<table>
<thead>
<tr>
<th>Plaintiff</th>
<th>Plaintiff Must Prove</th>
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<tbody>
<tr>
<td>Client</td>
<td>Loss, Auditor negligence, Reliance, &amp; Proximate cause</td>
</tr>
<tr>
<td>Third-party beneficiary</td>
<td>Loss, Auditor negligence, Reliance, &amp; Proximate cause</td>
</tr>
<tr>
<td>Limited class of foreseen parties</td>
<td>Loss, Auditor negligence or gross negligence (depending upon the theory used by the court), Reliance, &amp; Proximate cause</td>
</tr>
<tr>
<td>Other third parties</td>
<td>Same as above</td>
</tr>
</tbody>
</table>
Preventing Litigation

- Place emphasis within the firm on complying with GAAS and professional ethics
- Retain legal counsel that is familiar with CPA’s legal liability
- Maintain adequate professional liability insurance
- Investigate prospective clients thoroughly
- Obtain a thorough knowledge of the client’s business
Use engagement letters to prevent misunderstandings with clients

Carefully assess the risk of errors and irregularities, including those indicated by weaknesses in internal control

Exercise extreme care in audits of clients that have a high degree of business risk, as indicated by such factors as financial difficulties

Carefully prepare and review working papers