Chapter 4 – Auditor’s Legal Liability
Chapter 4 Overview

Auditor's Legal Liability

- Liability under Common Law
  - Liability to Clients
  - Liability to Third Parties
  - Common Law Defenses

- Liability under Securities Law
  - Securities Act of 1933
  - Securities Exchange Act of 1934
  - Private Securities Litigation Reform Act of 1995
  - Sarbanes-Oxley Act of 2002

- Other
  - Liability under Racketeer Influenced and Corrupt Organization Act
  - Minimizing the Risk of Litigation
Common Law – Liability to Clients

• Contract Law
  – Breach of Contract

• Tort Law
  – Ordinary Negligence
  – Gross Negligence
  – Fraud
Common Law – Liability to Third Parties

• Liability to Primary Beneficiaries

• Liability to Other Beneficiaries
  – Foreseen Class
  – Foreseeable Parties
Liability Under Common Law

- **Liability excluded by privity of contract doctrine**
- Pre-1931

- **Ultramas decision extends liability to primary beneficiaries**
- 1931

- **Rusch Factors decision extends liability to foreseeable class**
- 1968

- **Foreseen class concept adopted in Restatement (second) of Torts**
- 1977

- **Rosenblum decision extends liability to foreseeable parties**
- 1983

- **Credit Alliance decision restricts liability to users acknowledged by auditor**
- 1985

- **Billy decision returns California to Restatement (Second) of Torts for negligent misrepresentation and Ultramas for negligent performance**
- 1992

- **Some states adopt privity legislation restricting liability to users acknowledged by auditor in writing**
- 1993
Common Law Defenses

- Due Care Defense
  - Audit in accordance with GAAS
  - Importance of working papers
  - Inherent limitations of audit process
  - Risk of selective testing
Common Law Defenses

• Contributory Negligence
  – Plaintiff contributed to the injury
  – No basis for recovery
  – Negligence directly contributes to auditor’s failure to perform
1. Failure to exercise even slight care is considered to be:
   A. Ordinary Negligence
   B. Gross Negligence
   C. Fraud
   D. Deception

B. Gross Negligence
2. Under common law, all of the following would be included as a foreseeable party except:

A. The audit client
B. The client’s creditors
C. The client’s present investors
D. The client’s future investors

A. The audit client
3. Which common law defense centers on the inherent limitations of the audit process?

A. Due care defense
B. Contributory negligence

A. Due care defense
Liability Under Securities Law

- Statutory Law
  - Blue Sky Laws

- Securities Act of 1933
  - Audited financial statements with initial registration documents

- Securities Act of 1934
  - File annual reports with audited financial statements
• Securities Act of 1933
  – Bringing Suit under the 1933 Act
    • Plaintiff
    • Defendant

  – Cases Brought Under the 1933 Act
    • Escott v. BarChris Construction Corp.
    • United States v. Simon
Liability Under Securities Law

- Securities Exchange Act of 1934
  - Bringing Suit Under the 1934 Act
    - Plaintiff
    - Defendant

- Cases Brought Under the 1934 Act
  - Ernst & Ernst v. Hochfelder
  - The Fund of Funds Limited v. Arthur Andersen & Co.

- Aiding-and-Abetting
### Differences Between the Acts

**Figure 4-2  ■ Summary of Key Differences in Key Sections of the 1933 and 1934 Acts**

<table>
<thead>
<tr>
<th>Item</th>
<th>1933 Act</th>
<th>1934 Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plaintiff</td>
<td>Any person acquiring the security</td>
<td>Either the buyer or the seller of the security</td>
</tr>
<tr>
<td>Plaintiff must prove reliance</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Defendant liability for ordinary negligence</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
Liability Under Securities Law

- Private Securities Litigation Reform Act of 1995
  - Proportionate Liability
  - Cap on Actual Damages
  - Responsibility to Report Illegal Acts
  - Other Changes Provided by the Reform Act
Sarbanes-Oxley Act of 2002

• Changes for Auditors
  – Performance of audit and nonattest services
  – Regulatory environment

• Changes for Management
  – Certification of Financial Statements
  – Influence on Auditors
  – Restatement Issues
Other Considerations

• Racketeer Influenced and Corrupt Organizations Act (RICO)
  – Auditor Liability
  – Participation Test
  – Auditor Relationship Beyond Traditional Role
Minimizing Risk of Litigation

• Use engagement letters

• Thoroughly investigate prospective clients

• Emphasize quality rather than growth

• Comply fully with professional pronouncements
Minimizing Risk of Litigation (cont.)

- Recognize limitations of professional pronouncements
- Establish and maintain high standards of quality control
- Exercise caution with clients in financial difficulty
- Audit risk alerts
4. Under which Securities Act is the auditor liable for ordinary negligence?

A. Securities Act of 1933
B. Securities Act Act of 1934

A. Securities Act of 1933
5. In minimizing the risk of litigation, which precaution can help minimize the risk of misunderstanding about the contractual obligations?

A. Thoroughly investigate clients
B. Comply with professional pronouncements
C. Use engagement letters
D. Emphasize quality rather than growth

C. Use engagement letters