CHAPTER 4

Legal Liability of CPAs

Review Questions

4–1 There are several reasons why the potential legal liability of CPAs for professional "malpractice" exceeds that of physicians and other professionals. One reason is the vast number of people who may sustain damages. If a physician or attorney commits a serious error, the number of injured parties generally is limited to one individual patient or client. When a CPA's report is in error, literally millions of investors may sustain losses.

Second, the federal Securities Acts regarding CPAs' liability are unique in that much of the burden of proof is shifted to the defendant. Normally, defendants are "presumed innocent until proven guilty." Under the federal Securities Acts, however, CPAs charged with "malpractice" must prove their innocence.

Finally, when investors sustain losses in the many millions of dollars, the economics of the situation dictates bringing suit against the CPAs even if the prospects for recovery appear remote. When the possible dollar recovery is smaller, which usually is the case in other professional malpractice suits, the plaintiffs are more likely to be deterred from filing suit simply by the costs of litigation.

4–2 Ordinary negligence means lack of reasonable care. Gross negligence means lack of even slight care, indicative of reckless disregard for duty. An oversight by a CPA resulting in a misstatement in a financial statement might be considered ordinary negligence, whereas if a CPA failed substantially to comply with generally accepted auditing standards the charge might be gross negligence.

4–3 Privity is the relationship between parties to a contract. A CPA firm is in privity with the client which it is serving, as well as with any third party beneficiary, such as a creditor bank named in the engagement letter (the contract between the CPA firm and its client). Under common law, if the auditors do not comply with their obligations to the client, resulting in damages, the client may sue and recover its losses by proving that the auditors were negligent in performing their duties under the contract.

4–4 A third-party beneficiary is a person other than the contracting parties who is named in the contract or intended by the contracting parties to have definite rights and benefits under the contract. For example, a bank would be a third party beneficiary if the auditors and the client agreed that the purpose of the audit was to provide the bank with an audit report to make a bank loan to the client.
4–5 Common law is unwritten law that has developed through court decisions; it represents judicial interpretation of a society's concept of fairness. Statutory law is law that has been adopted by a governmental unit, such as the federal government.

4–6 The primary difference between the Ultramares and the Restatement approaches relates to whether the CPA has liability for ordinary negligence to third parties not specifically identified as users of the CPA's report. Under the Ultramares approach a CPA may be held liable for ordinary negligence to a third party only when that CPA (1) was aware that the financial statements were to be used for a particular purpose by a known party or parties, and (2) some action of the CPA indicates such knowledge. Under the Restatement approach the specific identity of the third parties need not be known to the CPA to establish liability for ordinary negligence. However, such liability for ordinary negligence is only to a limited class of known or intended users of the audited financial statements.

4–7 In Ultramares v. Touche, the New York Court of Appeals ruled that auditors could be held liable to third parties (not in privity of contract) for gross negligence or fraud, but not for acts of ordinary negligence. In Rosenblum v. Adler, the New Jersey Supreme Court ruled that auditors could be held liable for ordinary negligence to any "foreseeable" third parties who utilize the financial statements for "routine business purposes."

4–8 The Credit Alliance Corp. case embraced the landmark Ultramares v. Touche & Co. precedent. The court stated that before the auditors may be held liable for ordinary negligence to a third party, (1) the auditors must have knowledge of reliance on the financial statements by that party for a particular purpose, and (2) some action by the auditors must indicate that knowledge.

4–9 Under common law, auditors are liable to their clients for ordinary negligence as well as for fraud and breach of contract. Auditors are liable to third party beneficiaries (and in some jurisdictions to foreseeable third parties) for fraud and for ordinary negligence. Auditors are liable for gross negligence and fraud to other third parties.

4–10 Under joint and several liabilities one defendant may be required to pay the losses attributed to the actions of other defendants who do not have the financial resources to pay. Thus, if two parties were negligent and found to each be 50 percent liable, if one was unable to pay, the other party could be required to pay the entire 100 percent. Under proportionate liability a defendant is liable only for his or her proportion of fault. Using the previous example, neither defendant could be required to pay more than 50 percent of the damages.

4–11 Legal actions under common law require the plaintiffs to bear most of the burden of affirmative proof. The plaintiffs must prove they sustained losses, that they relied upon financial statements that were misleading, that this reliance caused their losses, and that the auditors were guilty of a certain degree of negligence. In legal actions brought under the Securities Act of 1933, the burden of proof is shifted to the auditors, who must show that they were not negligent (the due diligence defense) or that misleading financial statements were not the proximate cause of the plaintiffs' losses.

4–12 The Securities Act of 1933 regulates the initial sale of securities in interstate commerce (new issues), and the Securities Exchange Act of 1934 regulates trading of securities after initial distribution.

4–13 The Hochfelder v. Ernst decision is regarded as a "victory" for the accounting profession because it is one of the few decisions to limit, rather than expand, auditors' legal liability to third parties. In this decision the U.S. Supreme Court ruled that ordinary negligence was not a sufficient degree of misconduct for auditors to be held liable to third parties under Rule 10b-5 of the Securities Exchange Act of 1934.
4–14 The *Continental Vending* case was unusual in that it involved criminal charges against the CPAs for violating provisions of the Securities Acts. Although there was no intent to defraud on the part of the CPAs, they were convicted of criminal fraud on the basis of gross negligence. The president of the United States later pardoned the three CPAs.

4–15 The Racketeer Influenced and Corrupt Organizations Act was passed by Congress to prosecute mobsters and racketeers who influence legitimate businesses. It has been of concern to CPAs because the act broadly defines the term "racketeering activities" to include fraud in the sale of securities. Therefore, the act was used successfully in a small number of cases against CPAs. Of particular concern is the Act's provision that allows treble damages to be awarded. Concern about the RICO Act has been reduced based on the United States Supreme Court ruling in *Reves v. Ernst & Young*. In that case, the court decided accountants could not be held liable unless it can be proven that they actually participated in the operation or management of the organization.

4–16 The SEC has issued Rules of Practice to govern the appearance and practice before the commission of CPAs, attorneys, and others. Rule of Practice 2(e) gives the power of suspension or disbarment to the SEC. In addition, the Public Company Accounting Oversight Board (under the authority of the SEC) may conduct investigations and disciplinary proceedings regarding both registered public accounting firms, and professional employees (including owners). Board sanctions include monetary damages, suspension of firms and accountants from working on engagements for publicly traded companies, and referral of criminal cases to the Justice Department.

4–17 In the *1136 Tenants' Corporation* case, the client contended that the auditors had been retained to perform all necessary accounting and auditing services. The CPAs argued that they had been retained to do "write-up" work only, consisting of maintaining accounting records and preparing financial statements and tax returns. This difference was critical because the client contended the CPAs had been negligent in not discovering a defalcation. The case illustrated the importance of an engagement letter to define the services to be performed.

4–18 Engagement letters are important both for audits and for accounting and review services performed by CPAs. Oral arrangements are unsatisfactory when a dispute arises as to the services to be rendered by the CPAs.

4–19 No. Rogers and Green appear to be guilty of gross negligence, which often is considered tantamount to constructive fraud. However, actual fraud involves knowledge of misrepresentation within the financial statements and an intention to deceive users of those statements. Although Rogers and Green failed substantially to comply with generally accepted auditing standards, there is no indication that they knew of misrepresentation in the statements or intended to deceive third parties.

Gross negligence may be considered constructive fraud, because the auditors are misleading the public as to the degree of credibility that they are able to add to the statements. While such conduct is highly unprofessional, it is still quite different from attesting to the "fairness" of financial statements known by the auditors to be misleading.
Questions Requiring Analysis

4–20 CPA liability to clients may be based on (1) breach of contract, (2) a tort action for negligence, or (3) both. Under common law, in general, the client must prove the following to establish CPA liability:

- Duty—the CPA accepted a duty to exercise skill, prudence, and diligence.
- Breach of duty—the CPA breached that duty.
- Loss—the client suffered a loss.
- Causation—the loss resulted from the CPA's negligent performance.

In this circumstance it would seem that the above elements might be proven in a case against Herd & Irwin. This seems particularly likely given the fact that inexperienced staff assistants operated without sufficient supervision.

4–21 A client has a valid claim to recover its losses from a CPA firm if it can prove the CPAs were negligent and this negligence was the proximate cause of the client's loss. However, in this case, Jensen, Inc. may be held guilty of contributory negligence for not having followed the CPAs' recommendations for improving internal control. Such contributory negligence might cause a court to prohibit the client's recovery from the CPA firm, or limit the losses recovered from the CPA firm through the concept of comparative negligence.

4–22 Yes. Creditors usually are third parties not in privity of contract with the auditors. Under common law, these "other" third parties may recover from the auditors any losses proximately caused by the auditors' gross negligence, or, in some jurisdictions, ordinary negligence. In this situation, whether the courts adhere to the Ultramares, Restatement, or Rosenblum approach is not an issue; the auditors were guilty of gross negligence tantamount to constructive fraud. Small exhibited a reckless disregard for his professional responsibilities by falsifying the audit working papers. As stated in our discussion of professional ethics, CPAs are responsible for the acts of their assistants; thus, the firm of Hanson and Brown is liable for Small's gross negligence.

4–23 The facts clearly indicate negligence by Scott & Green. Auditors have a responsibility to design their audit to provide reasonable assurance of detecting material misstatements due to errors and fraud. Once evidence of even immaterial fraud is brought to the auditors' attention, they are obligated to disclose the situation to the client. Scott & Green could be held liable for losses that result from failure to disclose their suspicions to the client.

4–24 Sparks, Watts, and Wilcox, CPAs are liable to their client for damages caused by the negligence of the senior auditor. The assistant auditor selected a sample of 60 transactions in her test of controls for handling purchases, receiving, vouchers payable, and cash disbursements. When auditors rely upon a sample to form an opinion about an entire population, they must examine each item in the sample carefully. In this case, the assistant auditor found numerous indications of fraud (missing receiving reports), but the in-charge auditor took no action. This conduct by the senior auditor clearly shows lack of the "due professional care" required by generally accepted auditing standards, and is thus indicative of ordinary negligence.

The tests of controls made by the auditors are part of their further audit procedures. When the tests disclosed weaknesses in internal control that may allow material fraud to occur, the auditors have two specific responsibilities. They should:
(1) Communicate the situation to the appropriate levels of the client's management including the audit committee of the client's board of directors.

(2) Expand their audit procedures to determine if material fraud actually has occurred and, if so, the effects of this fraud on the financial statements.

The dollar amount of the CPAs' liability will depend upon what portion of the client's $700,000 loss was proximately caused by the auditors' negligence. The auditors almost certainly will be liable for the $500,000 loss occurring after the completion of the audit. In addition, they may be held responsible for all or part of the $200,000 loss occurring earlier, depending upon whether this loss might have been prevented or recovered had the auditors taken prompt and appropriate action.

(a) The stockholders could initiate the lawsuit under the Securities Exchange Act of 1934.

(b) The Private Securities Litigation Reform Act of 1995 establishes a form of proportionate liability under the 1934 Securities Exchange Act. When all defendants are able to pay their share each party pays its pro-rate share. Accordingly, Sawyer and Sawyer would be liable for $250,000 (5% * $5,000,000).

(c) If management (or any other liable party) is unable to pay its share each other defendant may be required to pay 50 percent over its pro rata share. Sawyer and Sawyer would be liable for a maximum of $375,000 (the original $250,000 plus $125,000). Because management is responsible for $3,500,000 of the total (70% * $5,000,000) and is unable to pay, Sawyer and Sawyer will probably end up paying the entire $375,000. Also, this amount may increase somewhat due to the Act’s requirements that the losses of certain small investors be entirely paid if possible.

4–26  
(a) The unique aspect of this case is that the CPA firm of Arthur Andersen was found guilty of the felony of criminal destruction of documents. The indictment named only the firm and not any individual partner or professional staff. The conviction caused the demise of this international accounting firm.

(b) This case illustrates how the actions of a few individual partners and employees can lead to disastrous results for the firm. However, it should be noted that the conviction was overturned by the U.S. Supreme Court based on the instructions given to the jurors.

4–27  
(a) The case should be dismissed. In the Hochfelder case, the U.S. Supreme Court held that action for damages under Section 10(b) and Rule 10b-5 was not warranted in the absence of intent to defraud (scienter) on the part of the CPA firm. Although Gordon & Moore was negligent in the performance of its audits, the firm was unaware of the existence of the scheme, and therefore not guilty of fraud under Section 10(b) of the Securities Exchange Act of 1934.

(b) The plaintiffs might have filed suit under common law for negligence. Their prospects for success would depend upon two factors:

(1) Whether the jurisdiction in which the suit was brought recognized ordinary negligence as sufficient misconduct for holding auditors liable to third parties not in privity of contract (the Rosenblum approach).
Whether the court considered these investors to be "reasonably foreseeable third parties using the financial statements for routine business purposes."

**Objective Questions**

4–28 Multiple Choice Questions

_a._ (2) A CPA will be liable to third parties who were unknown and not foreseeable for gross negligence. It should be pointed out that if the third party had been "foreseeable," liability might be established for ordinary negligence under a court following the *Rosenblum v. Adler* decision.

_b._ (2) The *Rosenblum* approach provides more third parties the ability to recover damages from the CPA who has performed an engagement with ordinary negligence, and accordingly, is least desirable from the perspective of the CPA. The *Ultramares* approach is most desirable, and the *Restatement* approach (also known as the Foreseen User approach) is between the two extremes.

_c._ (2) The plaintiffs need not prove that the CPA made a false statement, it is enough to prove losses and breach of a duty that the CPA had.

_d._ (4) Negligent tax advice would ordinarily result in a suit brought under common law. Note that the client is not covered under the Securities Act of 1933 or the Securities Exchange Act of 1934.

_e._ (1) The *Credit Alliance Corp. v. Arthur Andersen & Co.* case reaffirmed the principles in the *Ultramares* case by clarifying the conditions necessary for parties to be considered third-party beneficiaries.

_f._ (1) Contributory negligence, negligence on the part of the plaintiff, may be used as a defense and the court may limit or bar recovery by a plaintiff whose own negligence contributed to the loss.

_g._ (3) The *Private Securities Litigation Reform Act of 1995* amended the Securities and Exchange Act of 1934 to place limits on the amount of the auditors’ liability through establishing proportionate liability.

_h._ (4) A CPA may avoid liability under the 1933 Act by proving that their negligence was not the proximate cause of the plaintiff's loss. Accordingly, a finding that the false statement is immaterial would in all circumstances represent a viable defense.

_i._ (3) A CPA may be found liable to a client when due care has not been exercised.

_j._ (3) Under the Securities Act of 1933 purchasers of securities who sustain losses need only prove that the financial statements contained in the registration statement were misleading. Then the burden is shifted to the auditors to prove that they performed the audit with "due diligence."

_k._ (1) The *Continental Vending* case was a landmark in establishing auditors' potential criminal liability under the Securities Exchange Act of 1934. The case involved
audited financial statements, was brought under statutory law, and did not involve registration statements (which are covered by the Securities Act of 1933).

l. (2) The 1136 Tenants case was a landmark case concerning auditors' liability when they are associated with unaudited financial statements.

4–29  

a. True. The Securities Act of 1933 regulates interstate offerings of securities to the public.

b. True. The effect of the Securities Act of 1933 is to give to third parties who purchase registered securities the same rights against the auditor as are possessed by the client under common law.

c. False. Section 11(a) of the Securities Act of 1933 specifically bars recovery by anyone knowing of an untruth or omission in a registration statement.

d. True. The Securities Act of 1933 shifts the burden of proving that the audit was conducted properly to the defendant auditors.

e. True. An accountant successfully asserting the "due diligence" defense can avoid liability.

f. True. The accountants' defense will usually include efforts to establish that there were other causes for the plaintiffs' losses.

g. False. The SEC does not pass on the merit of securities, nor does it defend accountants.

4–30  

a. Liable

b. Not liable

c. Liable

d. Liable

e. Liable

f. Liable

g. Not liable

4–31  

a. (5)

b. (3)

c. (7)

d. (1)

e. (6)

f. (2)

g. (4)

4–32  

a. (3) Section 11 of the Securities Act of 1933 imposes liability on auditors for misstatements or omissions of a material fact in certified financial statements or other information provided in registration statements. Similarly, under Section 10(b), Rule 10b-5 of the Securities Exchange Act of 1934, the plaintiff must prove there was a material misstatement or omission in information released by the company, such as audited financial statements.

b. (3) Under both Section 11 of the 1933 Act and Section 10(b) of the 1934 Act, the plaintiff must allege or prove that s/he incurred monetary damages.

c. (4) Under Section 11 of the 1933 Act, the burden of proof is shifted to the defendant, accountant. The accountant may then defend himself or herself by establishing due
diligence—the security purchaser need not prove a lack of due diligence by the CPA. The plaintiff does not have to show lack of due diligence by the CPA. Under Section 10, the plaintiff must prove scienter.

d. (4) The plaintiff does not have to prove that s/he was in privity with the CPA under either section.

e. (2) Under Section 10(b), the plaintiff must prove justifiable reliance on the financial information. This is not true under Section 11 in which the plaintiff need prove only the items in items (a) and (b) discussed above.

f. (2) The plaintiff does have to prove that the CPA had scienter under Section 10(b) of the 1934 Act. Scienter is not needed under the 1933 Act.

4–33 Definitions

a. 12 Securities Act of 1933
b. 10 Proportionate liability
c. 9 Proximate cause
d. 1 Breach of contract
e. 11 Scienter
f. 5 Fraud
g. 3 Constructive fraud
h. 2 Common law
i. 7 Negligence
j. 14 Statutory law

Problems

4–34 SOLUTION: Wilson and Wyatt (Estimated time: 20 minutes)

a. The first basis for liability would be to assert ordinary negligence by Wilson and Wyatt. The failure to meet the standards of the profession would be indicative of ordinary negligence. Since the purpose of the audit was the purchase of the treasury stock, Risk Capital is a third-party beneficiary under the contract between Wilson and Wyatt and Florida Sunshine. Therefore, Wilson and Wyatt would be held liable for ordinary negligence to Risk Capital.

The second basis for liability is constructive fraud. Here Risk Capital must show that the accountants either knew the financial statements were incorrect or examined them without regard for due professional care; that is, that their negligence was so great (i.e., grossly negligent) as to constitute constructive fraud. If fraud is proven, privity is not necessary for recovery by a third party.

b. Yes. In this case Risk Capital is clearly a third-party beneficiary. Therefore, Risk Capital could recover losses, if it can be established that the firm of Wilson and Wyatt is guilty of ordinary negligence.
4–35 SOLUTION: Seavers & Dean CPAs (Estimated time: 20 minutes)

a. Yes, but only to the extent of $70,000. Busch is a third-party beneficiary of the contract between Meglow and its auditors, and may therefore recover from the auditors' losses caused by the CPAs' ordinary negligence. However, the original $50,000 loan was made prior to Busch's reliance upon the negligently audited financial statements. Thus, the auditors' negligence was not the proximate cause of this portion of Busch's loss. The auditors' negligence may, however, be considered the proximate cause of the $70,000 loss incurred as a result of reliance upon the misleading statements.

b. The prospects for Maxwell's recovery of its $30,000 loss are substantially less than those of Busch. Maxwell was not a third-party beneficiary to the contract. Thus, in many jurisdictions following Ultramares, Maxwell cannot recover losses attributable to the CPAs' ordinary negligence. Similarly, it is doubtful that Maxwell would qualify as a foreseen third party as necessary under the Restatement approach. Even in a jurisdiction accepting the Rosenblum precedent, which allows third parties to recover losses caused by the auditors' ordinary negligence, Maxwell would have to prove that it was a "foreseeable third party relying upon the financial statements for routine business purposes." It is questionable whether the loan by Maxwell was either "reasonably foreseeable" or "routine," as Maxwell was a customer of Meglow, not a lender.

4–36 SOLUTION: Thomas & Ross, CPAs (Estimated time: 15 minutes)

a. (1) Under common law in a jurisdiction that adheres to the Ultramares doctrine, the stockholders must show that they incurred losses, that the CPAs were grossly negligent, and that this gross negligence was the proximate cause of the stockholders' losses.

(2) Under common law, the defendant is "presumed innocent until proven guilty," and therefore bears no burden or affirmative proof. The auditors will, however, introduce evidence refuting the plaintiffs' allegations.

b. (1) In a suit brought under the Securities Act of 1933, initial purchasers of the security must show only that they had a loss and that the financial statements were misleading.

(2) The auditors, in order to avoid liability, must prove either that they performed their audit with "due diligence" (that is, were not negligent) or that their negligence was not the proximate cause of the plaintiffs' losses.

c. (1) In a suit brought under the Securities Exchange Act of 1934, the plaintiffs normally must prove reliance upon the misleading financial statements, as well as that they sustained a loss and that the statements were misleading.

(2) To avoid liability, the auditors must prove either that they "acted in good faith" (were not grossly negligent), and that their gross negligence was not the proximate cause of the plaintiffs' losses.
4–37 SOLUTION: Charles Worthington, CPA (Estimated time: 20 minutes)

Craft has stated that the CPA firm has "reviewed the books and records of Flack Ventures," when in fact no such "review" has occurred. A "review" of financial statements consists of limited investigatory procedures designed to provide statement users with a limited degree of assurance that the financial statements are in conformity with generally accepted accounting principles. Craft's actions are similar to issuing an auditors' report without first performing an audit. Such an action may well be considered an act of criminal fraud, intended to mislead users of the financial statements. In addition, Craft's actions violate Rules 102, 202, and 501 of the AICPA Code of Professional Conduct. If the financial statements of Flack Ventures turn out to be misleading, there is little doubt that any court would find the CPA firm guilty of at least constructive fraud and liable to any third party who sustains a loss as a result of reliance upon the statements.

The fact that Craft violated Worthington's policy of submitting all reports for Worthington's review would not lessen the CPA firm's liability. The concept of mutual agency allows Craft, as a partner, to commit the firm to contracts, including auditors' reports and accountants' reports. The fact that this report was not submitted for Worthington's review might be introduced as evidence against Craft in the event he is accused of criminal fraud.

4–38 SOLUTION: Unaudited Statements (Estimated time: 30 minutes)

a. The compilation (preparation) of financial statements is quite different from an audit, and it is important that the client understand this. Oral commitments, such as telephone conversations, can often be misunderstood and should be followed up by a written engagement letter spelling out the nature and limitations of the services to be performed.

b. Even a regular audit cannot be relied upon to disclose defalcations, and in an engagement involving the compilation of unaudited financial statements, the CPAs do not even perform any audit procedures. The fact that the CPA intends to perform no investigative procedures and will rely upon the representations of the managing agent should specifically be set forth in the written engagement letter.

Of course, if the CPA has reason to suspect that the representations of the managing agent are erroneous, the concept of due professional care requires that she inform her client of her reservations.

c. The word "Audit" should be avoided in referring to all engagements other than audits. Otherwise, it may appear that the CPAs have led the client to believe that they were acting as auditors, in which case they may be held accountable for conducting their work in accordance with generally accepted auditing standards. The CPA should explain this situation to the client and persuade the client to change the account title to "Accounting Fees."

d. While Day does not have a responsibility to perform audit procedures when compiling unaudited financial statements, he does have a responsibility to exercise due professional care. This would include advising the client of any situation that might suggest a problem for the client.

The CPA should alert his client to the missing invoices in writing and advise the client to follow up on the matter, or, if the client wishes, the CPA could investigate the matter as an additional accounting service. The key point is that the CPA must not fail to alert the client to the underlying potential for fraud.
4–39 SOLUTION: Mark Williams, CPA (Estimated time: 20 minutes)

a. CPAs as members of a profession are obligated to exercise due professional care. Thus, a
   CPA may be held liable to the client for the damages resulting from the CPA's ordinary
   negligence.

   Since Jackson Financial was the client, Jackson can recover losses proximately caused
   by Williams' negligence. It would appear that Jackson Financial could also recover the audit
   fee as damages because of Williams' breach of contract.

b. The first argument, which Williams' attorney would make, is that Apex had no rights under
   the contract between Jackson and Williams. In most jurisdictions, an "other" third party is
   able to recover losses attributable to the auditor's gross negligence, but not ordinary
   negligence.

   A second argument is that Williams' negligence was not the proximate cause of Apex's
   loss. The loss apparently occurred prior to the audit by Williams and could not have been
   prevented even if Williams had discovered the defalcations. Finally, the attorney would
   argue contributory negligence on the part of Apex. Normally losses are allocated between the
   parties when both parties are negligent.

   Whether the first argument that Jackson has no rights under the contract will prevail is
   an interesting question. There is little authority on the precise situation in the problem.
   Although Apex is not the client and is not mentioned as a beneficiary in the engagement
   letter, it is the company whose financial statements were audited. Whether this fact creates
   the duty of care owed by Williams to Jackson Financial is, at present, unclear.

c. No. A CPA firm is not prevented from recovering against its insurer. This is precisely the
   purpose of this type of insurance; it serves to protect the insured firm from its own
   negligence. CPAs may be barred from recovering from their insurers, however, if they are
   found guilty of criminal fraud.

4–40 SOLUTION: Cragsmore & Company, CPAs (Estimated time: 20 minutes)

The legal problems for Cragsmore & Company involve possible criminal liability, as well as civil
liability, for fraud. The facts in the Marlowe Manufacturing, Inc. audit bear marked similarities to the
facts in the Continental Vending case. In Continental Vending, the court found two partners and a
manager of a CPA firm guilty of criminal fraud for failing to insist upon adequate disclosure of the
uncollectibility of a substantial receivable from an affiliate. Mr. Cragsmore's conduct has
implications of a conspiracy with management and owners of Marlowe to conceal the related-party
aspects of the lease between Marlowe and Acme Leasing Company. Although the inadequate
disclosure of the facts of the lease is not the proximate cause of losses to Marlowe's creditors because
of the company's bankruptcy, it is conceivable that a finding of fraud against Cragsmore & Company
with respect to the lease disclosure would lead to recovery of damages against the CPA by the
creditors of Marlowe.

Generally, there is no requirement that financial statements or notes disclose the lack of fire
insurance. Many companies do not obtain insurance coverage by choice; others cannot obtain
coverage because of the hazards of their products or locations. Accordingly, the unqualified opinion
of Cragsmore & Company does not appear to be inappropriate because of Marlowe's lack of
insurance coverage.
In-Class Team Case

4–41 SOLUTION: Geiger Co. (Estimated time: 50 minutes)

a.  
1. Yes. Since Willis is liable to a client for ordinary negligence, it is likely that it will be found liable to Geiger.

2. Uncertain. Liability to the bank involved is dependent upon whether the bank can establish itself as a third-party beneficiary, and thereby recover for ordinary negligence. To accomplish this the bank will have to establish that the auditors had been aware that the financial statements were to be used by that particular bank as a basis for granting the loan. If it is unable to accomplish this, it is unlikely that it will be able to recover since other third parties must prove gross negligence.

3. No. The shareholders are considered third parties who ordinarily must establish that the audit was performed with gross negligence.

4. Answer 2 is most likely to be affected since the Restatement of Torts approach expands third-party liability to a limited class of known or intended users whose specific identity need not be known by the CPA. Accordingly, a bank that was unable to establish itself as a third-party beneficiary under the Ultramares approach might be able to establish itself as a foreseen third party under the Restatement of Torts approach and thereby recover for ordinary negligence. Differences between the Restatement of Torts and Ultramares approaches relate to common law liability to third parties, and accordingly, liability to the company itself is unaffected. Shareholders have not ordinarily been able to establish themselves as foreseen third parties under the Restatement of Torts Approach.

b.  
1. No. The 1933 Securities Act offers protection only to a limited group of investors—those who purchase a security offered or sale under the registration statement. Accordingly, the company itself will not ordinarily be able to recover.

2. No. The 1933 Securities Act offers protection only to a limited group of investors—those who purchase a security offered or sale under the registration statement. Accordingly, the bank will not ordinarily be able to recover.

3. No. The 1933 Securities Act offers protection only to a limited group of investors—those who purchase a security offered or sale under the registration statement. Since the shareholders here did not purchase securities, they will not ordinarily be able to recover. Finally, the securities had been outstanding for 10 years, which far exceeds the three-year statute of limitations.

4. Answer 3 would change as it is doubtful that the auditors would be able to establish that the audit had been performed with due diligence when ordinary negligence is involved. Accordingly, the shareholders might well be able to recover their losses.
c. (1) No. The Securities Exchange Act of 1934 offers protection only to purchasers and sellers of securities registered with the SEC.

(2) No. Unless the loan was an SEC registered security (or should have been, which is unlikely here) the bank will not be able to recover under the Securities Exchange Act of 1934.

(3) Doubtful. While these shareholders are offered some protection under the Securities Exchange Act of 1934, the ordinary negligence of the CPA is unlikely to be sufficient to warrant such recovery as Section 10 requires the existence of scienter (ordinarily gross negligence or even fraud) and Section 18 allows the CPAs to avoid liability by proving that they perform with good faith, which they probably will be able to do in the case.

Research and Discussion Case

4-42 SOLUTION: Mountain Resources and SuperFund (Estimated time: 40 minutes)

This case is closely modeled after the case of The Fund of Funds, Ltd., v. Arthur Andersen & Co. We did not suggest reference material relating to this case to the students because we have found that it totally dominates their conclusions; they opt to avoid the $80 million judgment at all costs.

There are several significant differences between our case and the Fund of Funds case, which may well affect the decision were our case brought before the same court. The most important difference is that our client companies have not signed any agreement regarding the prospective sales price of the properties. Hence, Mountain Resources cannot be deemed in violation of a contract. Also, the same key audit personnel audited Fund of Funds and King Resources Company. In our case, the two clients are audited by different offices of the same firm and, therefore, by entirely different personnel. Finally, in our case the auditors have previously approved a write-down of the carrying value of the unproved properties under FASB ASC 932-360-35. King Resources had not recognized any "impairment" of the properties involved in the Fund of Funds case.

a. The following arguments might be advanced in favor of advising SuperFund as to our opinion of the value of the properties:

- Mountain Resources may be perpetrating a fraud upon SuperFund. If we say nothing, we may appear to be aiding and abetting that fraud.

- If SuperFund pays an excessive price for the properties and subsequently must write them down to an estimated recoverable value, it will sustain a large loss. We have information that may prevent our client (SuperFund) from incurring such a loss. Remaining silent would constitute a lack of professional care with respect to SuperFund.

- SuperFund knows that we, as auditors for Mountain Resources, have information as to the fair value of these properties. Our silence may be viewed as tacit approval of the transaction.

In this situation, we have considerable evidence that the properties do not contain significant oil and gas reserves. This evidence was sufficient for us to agree that Mountain Resources should write these properties down to a carrying value of $9 million to avoid overstatement of assets. As we have knowledge of the impaired value
of these properties, it would be difficult for us to allow SuperFund to not write the asset down to a similar amount.

- If we insist that SuperFund write these properties down to, say, $9 million, SuperFund will probably sue us and allege that our silence was the proximate cause of their loss. Our exposure appears to be approximately $33 million ($42 million – $9 million).

**b.** The following arguments might be advanced in favor of not offering advice to SuperFund:

- Giving SuperFund any information about these properties would violate our ethical responsibilities to Mountain Resources for confidentiality.

- The transaction price in the purchase or sale of assets is a managerial prerogative. It is inconsistent with the role of the independent auditors to intervene because they believe one or the other of the transacting parties is receiving a bad deal.

- We are not experts in the value of oil and gas properties, which is highly speculative by any standards. It may turn out that these properties are a bargain at $42 million.

- As far as we know, Mountain Resources has not made any misrepresentations of fact or violated any laws. We have no right to intervene in a transaction merely because we believe that our client is about to earn a surprisingly large profit.

- If we offer our opinion of the value of the properties to SuperFund, Mountain Resources will probably sue us for breach of confidentiality.

- There is a certain autonomy between offices of a national firm. Mountain Resources is a client of the Denver office, while SuperFund is not. If SuperFund were the client of another CPA firm, it is doubtful that we would even consider the possibility of alerting the other auditors or their client as to our opinion of the economic value of the properties.

**c.** Our opinion:

We consider it to be totally inconsistent with the role of an independent auditor to intervene in a transaction between a company and its customers on the premise that the auditors have a "greater wisdom" than the transacting parties. Mountain Resources is not, to the auditors' knowledge, doing anything illegal. Furthermore, all of the information at the auditors' disposal is confidential. Barring a flagrant violation of the law by one of the transacting parties, we do not believe that auditors have either the legal responsibility or the right to interject their unsolicited opinion into the business transaction of audit clients.

If the auditors had become aware that the client was fraudulently overcharging for the property (as was the case in *Funds of Funds*) our solution would of course, be different.