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A BASIS FOR EVALUATING THE CONSEQUENCES  
OF THE 1136 TENANTS CASE

By

Dawn Atchison Chesarek

B.S., Eastern Montana College, 1971

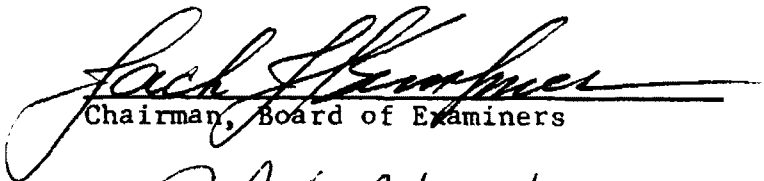
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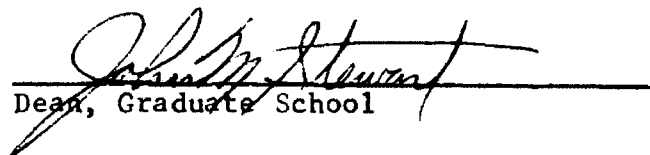
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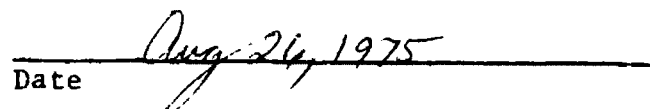
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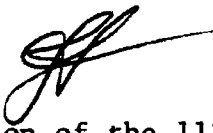
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ABSTRACT

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Business

A Basis for Evaluating the Consequences of the 1136 Tenants Case (94 pp.)

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It was inferred in the decision of the 1136 Tenants' Corp. v. Max Rothenberg & Co. (1136 Tenants) case that the American Institute of Certified Public Accountants (AICPA) was no longer the authoritative source of what procedures an accountant should employ when performing accounting services. Alarmed, certified public accountants (CPAs) sought advice as to what procedures they should employ to avoid future litigation in this area. The AICPA responded to their pleas by appointing a task force to study the matter. This study group determined the AICPA's standards were adequate but needed to be elaborated upon in certain areas. It thus issued the Guide for Engagements of CPAs to Prepare Unaudited Statements.

Since the court determined the AICPA's standards were only minimal requirements, it is necessary for CPAs to be aware of procedures in addition to those recommended and required by the profession. Members of the profession have written many articles recommending additional procedures which a CPA, in his judgment, may deem necessary. However, few of these articles place any emphasis on the CPA's need to acquire a historical background of his legal liabilities.

The evolution of the accounting profession's standards has been greatly influenced by the demands of society expressed through the courts. Historically society has viewed accountants with skepticism and has demanded others review their records. The development of these review procedures and society's influence on them has been evolving since 4500 B.C. A CPA possessing a knowledge of this evolvment and the courts' tendency to expand his legal liabilities will be better equipped to judge what course of action he must take to avoid future litigations.

The ultimate responsibility has been placed upon the individual CPAs for the profession has been unwilling to accept the court's declarations in the 1136 Tenants case. It has thus been deemed necessary to provide them with a synopsis of the accounting profession's evolution and a compilation of recommended procedures to be implemented in the area of unaudited statements.

## ACKNOWLEDGMENTS

I acknowledge my husband and son for coping with a messy house, a crabby wife and a mean mommy during the course of this thesis' preparation.

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## Chapter 1

### INTRODUCTION

Unaudited financial statements are the oldest and most commonly utilized form of financial reporting (Brown, 17:27). They have been in existence approximately six thousand years (Chatfield, 10:22); yet prior to 1967 very little information pertaining to them was available. Textbooks were virtually void of any data on them, and the American Institute of Certified Public Accountants (AICPA) made only brief reference to them in its Code of Professional Ethics and its Statement on Auditing Procedure No. 33 (SAP No. 33) entitled "Auditing Standards and Procedures" (Brown, 17:27). Due to its lack of clarity, much criticism was directed at this Statement's section pertaining to unaudited financial statements, and in 1964 the AICPA's committee on auditing procedures began an intensive review of the subject. After three years of study, "...1,005 pages of correspondence, and 16 drafts of...[a] proposed Statement (Nest, 36:63)," the AICPA issued SAP No. 38 entitled "Unaudited Financial Statements."

This Statement was ironically issued at the same time that a Certified Public Accounting (CPA) firm, Max Rothenberg and Co., was in the throes of a lawsuit concerning its responsibilities of association with unaudited financial statements. This famous case of 1136 Tenants (78) has had a tremendous effect upon the accounting profession for it contains opinions which are not in agreement with the AICPA's standards. These opinions have stunned and alarmed the accounting profession for they could lead to the inference that the courts may no longer rely upon the AICPA's established procedures in determining whether or not a



CPA has adequately performed his services. The trial court of this case also suggested procedures which contradicted those outlined in the AICPA's newly issued SAP No. 38.

As a direct result of this case, the profession appointed a task force to review SAP No. 38. The outcome of the task force's study was the issuance of a Guide for Engagements of CPA's to Prepare Unaudited Financial Statements (Guide). In addition to the recommendations in the Guide, members of the profession have submitted numerous articles to professional journals delineating other procedures to provide additional protection in preventing the occurrence of a similar incident. Others have responded with the hope that this case will be treated as an isolated one and not a precedent for future court decisions (AICPA, 6:62). However, this conjecture may not be accurate for the courts have been historically expanding the CPA's liabilities to clients and third parties. A review of certain court cases affecting an accountant's liabilities will substantiate this fact. Such a review will also provide the CPA with a better working knowledge of his legal liabilities, an area which has been sorely neglected in the academic training of accounting students, and the institutions of higher education have been much criticized for this. It is felt by some members of the profession that many of the lawsuits, which are rapidly increasing, could be partially avoided if CPA's were better versed in the area of their legal responsibilities (Linowes, 31:47). This attitude was eloquently expressed by Mr. Manual Cohen, a previous SEC chairman, when he remarked "Our investigations often leave us with the feeling that each generation of auditors learns only by its own sad experiences

rather than from earlier cases (Metz, 14:14)."

Today a sound background of legal responsibilities is much needed for we are living in an era of consumerism which has erupted at such a rapid and forceful pace that it has been referred to as a revolution (Seidler, 43:38). Dissatisfaction with the current "social, political and economic" institutions has been expressed by people all over the world who are demanding that these institutions assume more responsibilities toward the public (Teitjen, 49:69). The accounting profession has not been untouched for during the 1960's accountants found themselves faced with an unusual rash of litigation (Causey, 9:xvii). This should not be too surprising for Americans have historically relied upon the courts to accomplish changes. This reliance was so aptly described by de Tocqueville who stated "Scarcely any question arises in the United States which does not become, sooner or later, a subject of judicial debate (Sommer, 45:33)."

Prior to examining the American cases, a brief review of some English cases is pertinent since the antecedent of American law is English law (Causey, 9:33). English cases are particularly appropriate upon examining the evolvement of an auditor's liabilities because the accounting profession of the United States was directly preceded by the British profession which is attributed with some of the most significant contributions in the development of the present theories in auditing (Causey, 9:11).

The evolution of these auditing and accounting theories was largely determined by significant historical events which had a great impact upon the development of commerce, and, in turn, placed new

demands upon the accounting profession. A review of the historical events will provide the accountant of today with a background which will better enable him to predict and influence future events affecting his profession, in general, and specifically his association with unaudited financial statements for "...all events, conditions, institutions, personalities, come from immediately preceding events, conditions, institutions, personalities (Littleton, 11:Preface to the 2nd ed.)." A historical knowledge is essential to the accountant for "...accounting is still in evolution - it may be even in the midst of its greatest movement - and we are poorly equipped to understand its trend if our historical perspective is weak, we are badly poised to assist the wiser movements of the development if the trend is too dimly perceived. Even in the busy present, therefore, we need some knowledge of the interesting past of ...accounting (Littleton, 11:Preface)."

Since a historical background has been deemed so necessary for a better understanding of the current and future events in the accounting profession, this thesis will open with a treatise of the subject. It will also provide a brief review of certain court cases demonstrating the courts' tendencies to expand auditors' legal liabilities. The 1136 Tenants case and its effects upon the accounting profession and the business community will be discussed concurrent with proposals for reducing the auditor's exposure to future litigation in the area of unaudited financial statements. Since this case is so recent, its total impact is as yet unknown; therefore, the proposed recommendations are incomplete. However, an awareness of the case and its short-range

effects should assist the auditor in determining his future course of action.

## Chapter 2

### A HISTORICAL SYNOPSIS OF THE PUBLIC ACCOUNTANT'S ROLE

#### Society's View of the Accountant

Accounting systems have been traced to as early as 4500 B.C. Archeologists have found clay tablets in the Mesopotamian Valley which indicate that the scribes of the ancient Babylonian and Assyrian civilizations were the modern day accountants' predecessors. The scribes were entrusted with recording the accounts of the land. They were highly respected members of the community since many times they were the only ones who could read or write and knew the laws of the land (Chatfield, 10:12-20).

This highly esteemed, unchecked position of the accountant's predecessor was short-lived. As we trace the evolution of the profession, we find an alarming attitude of fear and distrust extended toward accountants. In A.D. 68, the Governor of Egypt, Tiberius Julius Alexander, stated:

I have also reviewed the unlimited power of accountants, because they are accused by everyone of making very many illegal entries at their own pleasure. Hence it has come about that they grow wealthy while Egypt is laid waste (Mueller, 13:38).

In his *Historia Naturalis*, Pliny the Elder (A.D. 23-79) expresses the same view:

In each man's account book, Fortune makes out two pages (Mueller, 13:38).

Man has long felt the need to review and verify the records maintained by another. Auditing systems were thus established and have existed since ancient times, but little advancement was accomplished

in establishing well defined accounting and auditing systems until the Renaissance. Prior to this intellectual movement, the people existed in an environment of poverty and conflict. The church was their only source of enlightenment (Chatfield, 10:26).

When the Turks captured Jerusalem in 1075, the European civilizations united to regain the Holy Sepulchre. The Crusades developed an interest in the European nations for the goods produced in the Middle East. The city-republics of Northern Italy were ideally suited as trade centers for the Italian government permitted private ownership of property and had established a monetary economy (Chatfield, 10:26).

Prior to the Crusades, most of the wealth was possessed by a few people who hoarded their assets in jewelry and castles. The communities were usually self-sustaining, and bartering was the most common means of trading. Instead of placing their wealth into non-productive assets, the Italians invested their capital into ships and goods in hopes of making a profit. One ship would frequently contain goods belonging to many traders, and a need for an accurate means of recording and reporting arose.

The Italians responded by devising the double-entry method of recording, which was first published in Frater Lucas Bartolomes Pacioli's Summa de Arithmetica, Geometria, Proportioni et Proportionalita around the end of the fifteenth century. This treatise was the most significant treatment of accounting prior to the nineteenth century (Chatfield, 10:40-47). However, it did not discuss systems employing auditing and internal control techniques. This was an area in which the English played an important role. Since the immediate

antecedents of the American accounting profession are the English accountants, a close review of their contributions is warranted.

After William the Conqueror invaded England, he took possession of all property, which he taxed in the name of the crown. He assigned the Exchequer the task of collecting the taxes from the sheriff who was responsible for managing the crown's lands (Chatfield, 10:31).

Twice a year, the sheriff reported to the Exchequer. At Easter he paid approximately half of the assessed taxes. He was then issued a tally stick which represented his payment, and the Exchequer kept a foil whose notches corresponded with those on the tally stick. "An incision the width of a man's palm represented a thousand pounds; a hundred pounds was a thumbs-width cut; twenty pounds the width of a little finger; a pound the thickness of a grain of ripe barley; a shilling just a notch; a penny a simple cut with no wood removed; and a half-penny a punched hole (Littleton, 53:78)." At Michaelmas, the sheriff was submitted to an audit when he paid the remaining assessment. The procedure employed by the Exchequer follows:

Final settlement takes place across a table laid with the checkered cloth after which the Exchequer is named. On one side is the sheriff with his collections, his tally and his disbursement vouchers. The treasurer reads from the Exactory Roll on which the current year "farms" of all the counties are written. Across the table from the sheriff an official called calculator sets out on the checkered square counters representing the whole year's payment due the crown. This total being agreed to by both parties, the calculator lays out another row of counters showing the amount paid by the sheriff at Easter. The sheriff's tally stick and the Exchequer's foil are fitted together to verify that the notches and cuttings correspond. As the treasurer calls the amounts due, the sheriff's Michaelmas collections are set out in the squares on his side of the calculating board and "blanched" by the accountant, who has assayed the coin and now subtracts the necessary number of pence in the pound. A new tally will be made for the adjusted amount. Crown

vouchers for the sheriff's allowances and expenses are placed on the board as further deductions from the amount due. When all the crown's counters are balanced by payments, tallies, and allowance vouchers, the sheriff is quit. He swears to the marshall of the Exchequer that he has made his lawful account according to his conscience, and is dismissed (Stenton, 56: xv-xvii).

In addition to this form of governmental accounting, the English nurtured another termed "manorial accounting." Manors were the large estates of lords who assigned management duties to stewards. The stewards were required to maintain accurate records which were used by the lords to determine that the stewards were fulfilling their duties.

The lords realized the need for good internal controls to assure them that all was running smoothly during their absence. There was included a technique much used today, that is, a separation of duties. One person would assess the amounts due the lord; another would collect, and another would make disbursements. At Michaelmas, an auditor would examine and summarize the stewards' accounts. If the manor were large, the auditor was usually an independent audit official appointed by the lord. The auditor's task was to determine the stewards' efficiency. A charge and discharge statement was then prepared and verified by the auditor. The Annual Declaration of the Audit was a reading of the charge and discharge statement. It was necessary to read the statement orally for the majority of the people were illiterate (Chatfield, 10:34-47).

Although the English did not use the double-entry accounting system during the Medieval Era, they did develop internal control and auditing systems which can be traced to modern accounting techniques.



Ancient man was aware of the need for them, but it was the English who established written documents and procedures which sped the accounting profession's advancement in this area.

During the seventeenth century, the self-sustaining English manors began to be replaced by towns. The Industrial Revolution brought about one of the greatest periods of growth the accounting profession has experienced. Great sums of money were invested by numerous people into corporations. Dispersed and absentee ownership created a need for a revision in the accountant's techniques. Pacioli's treatise had dealt primarily with determining a profit upon completion of a project. This type of reporting was unsuitable for the corporate form of business.

Since the world was agriculturally oriented, time was based upon the annual movements of the sun. The need for annual business reports evolved from this concept and has persisted to modern reporting. The absentee owners thus required annual reports on profits, and accountants needed a means by which to allocate costs to unfinished projects. Business was now on a continuous basis (Chatfield, 10:10).

By the nineteenth century, the need for more efficient means of recording and reporting transactions had reached such an apex that accountants began to realize Pacioli's treatise was inadequate. Corporate accounting was thus developed, and concurrent with this development was the need for more sophisticated audits. Several historical factors contributed to their growth. During the 1800's business experienced alternating periods of prosperity and depression. Due to these occurrences, the British were hesitant in recognizing the corporate entity. In 1844 the British Parliament passed the Joint Stock

Act which gave the corporate form of business impetus for it permitted the existence of the corporate entity and the transfer of ownership. To be recognized by Parliament, corporations were required to be registered and to "...keep books of account; to present a 'full and fair' balance sheet at each ordinary meeting of shareholders; to appoint auditors whose duty it would be to report on the balance sheet, whose report would be read at the meeting, and who were entitled to examine the book and question officers of the company (Chatfield, 10:136)." The British sufficiently displayed their awareness of the need to protect investors due to their experiences with the periods of depression.

The Companies Clauses Consolidation Act of 1845 revised the Joint Stock Act which included an important feature that had a great effect upon the development of the present public accounting practices. Section 108 of this Act stated:

It shall be lawful for the auditors to employ such accountants and other persons as they may think proper, at the expense of the company, and they shall either make a special report on the said accounts, or simply confirm the same; and such report or confirmation shall be read together with the report of the directors at the ordinary meeting (Littleton, 11:289).

Although the statutes provided for the optional use of outside experts, the audits themselves were nothing more than comparisons of the balance sheets to the ledgers and a check of clerical accuracy (Littleton, 41:290). It should also be noted that the auditors were not required to issue an opinion.

In 1862 the Companies Act was passed. It recommended that the auditors of registered companies express an opinion on the balance sheets. However, the statute's recommendations were not compulsory.

Parliament had also dropped the compulsory audit, which was not reenacted until the late 1800's (Causey, 9:11).

Unknown to the British at the time, these statutes enacted for the protection of the investing public provided a premise for the rapid growth of the accounting profession, and concurrent with a growth in the demand for a profession's services is the formation of professional organizations. The first formal recognition was granted by Queen Victoria's Court to the Society of Accountants in Edinburgh, Scotland. In 1880, the Institute of Chartered Accountants in England and Wales was granted a charter (Chatfield, 10:157-58). Members of these chartered organizations found it necessary to review British investments in America, and thus the British influence on the accounting profession in the United States. This influence on the auditing procedures employed in the United States was very noticeable during the 1800's. The audits of this time period were appropriately termed "bookkeeper audits" for they were very limited in scope and full of unnecessary detail. Employing such techniques resulted in the auditor receiving little professional recognition from society "...because the matters which were referred to him were relatively unimportant and this unimportance tended to reduce him to the level of a clerk (Montgomery, 54:316)."

By the turn of the nineteenth century, American auditors began to realize that the benefits of an audit could be derived without the unnecessary detail. Several factors greatly influenced this adaptation of British audits. Unlike British law, America did not have statutory audits. The accounting profession therefore had to tailor its audits

to satisfy the needs of the clients. The American auditors also found it very difficult to review every transaction recorded in the records of the large corporations merging at this time. Since "bookkeeper audits" were too costly and too time consuming, the auditors found it necessary to employ the technique of sampling the clients' records which led to the need and eventual implementation of stronger internal controls. However, it was not until 1912 that the American auditing objectives began to progress independently of the British audits. The change was first printed in Robert H. Montgomery's Auditing Theory and Practices, which noted:

In what might be called the formative days of auditing, students were taught that the chief objects of an audit were:

1. Detection and prevention of fraud.
2. Detection and prevention of errors, but in recent years there has been a decided change in demand and service. Present-day purposes are:
  - (1) To ascertain actual financial condition and earnings of an enterprise.
  - (2) Detection of fraud and errors, but this is a minor objective (54:13).

It was not, however, until the famous McKesson and Robbins matter involving fictitious inventories and accounts receivable that the auditors began to implement these objectives. At that time, auditors realized they could not be primarily concerned with the detection of fraud. Instead, they ascertained that their objective was to determine the fairness of financial statements. The American auditing techniques, objectives, and attitudes had evolved into the form of auditing which we recognize today (Causey, 9:15-17).

This metamorphosis, however, was not totally developed within the profession. Many external factors influenced its development.

Included is the sway of the courts, which has persuaded the accounting profession to alter some of its auditing procedures. These alterations were due to the demands of society which has traditionally expressed desired changes through the courts (Sommer, 45:76).

### The Changing Attitudes of the Courts

Since the courts have played such a significant role in the development of the accounting profession, a brief review of certain court cases is deemed worthy. This review will first provide a general working knowledge of the accountant's liability to his client, include a brief examination of certain court cases which have influenced the accounting profession, followed by a review of the accountant's liability to third parties and relevant cases.

### Liability to the Client

An accountant is liable to his client if his services are performed in a defective manner or there is a complete nonperformance of contracted duties. A client may bring a tort action or a contract action against the accountant depending upon the circumstances surrounding the defective performance. However, much confusion exists in determining whether a case involves a contract or a tort action. This stems from the fact that the early English laws made no distinction between the two. Although distinctions have been made, there still is some overlapping. Both actions have been held against accountants, and may now be jointly presented in a suit (Lusk, 12:50,289-99; Causey, 9:33).

### Breach of Contract

"A contract is a promise or a set of promises for the breach of which the law gives a remedy or the performance of which the law in some way recognizes a duty (Law, 51:85)." When an accountant enters into a contract with a client, he may perform the agreed upon services in one of three ways, that is, by complete or satisfactory performance, by substantial performance, or by a material breach of contract. The laws take into consideration that man has limited potentials and perfection of a task is not always possible. They therefore consider a contract as completely performed if it satisfies reasonable expectations. A substantial performance is the completion of services in which trivial omissions occur, and the consideration agreed upon in the contract is adjusted accordingly. A material breach of contract occurs if the performance of the accountant's services fails to reach the degree of perfection which may be expected under the circumstances. If one party fails to perform the contract, "...the injured party is ...to be put ...in the same position ...he would have occupied ...(if) the contract had been (satisfactorily) performed .... The remedy usually granted is the remedy of damages," and the courts will aid in collecting the damages if necessary (Lusk, 12:298-99,313).

### Torts

"A tort is a breach of duty, other than a duty created by contract, for which the wrongdoer is liable in damages to the injured party. The basis of a person's liability in tort is his breach of duty owed to a fellow member of society (Lusk, 12:50-51)."

Negligence is classified as a nonintentional tort and is the most common basis of a tort action brought against an auditor. It "...has been defined as the omission to do something which a reasonable man ... would do, or doing something a reasonable man would not do (Lusk, 12:1200)." The phrase "reasonable standard of conduct" is a nebulous one. The modes of society are ever changing and what may be termed as reasonable conduct by one court on any given day will not necessarily be defined as such by another court at a future date.

In a tort action the defendant may submit as a defense the assumption of a foreseeable risk and contributory negligence. These are not acceptable defenses in a breach of contract action. When a person enters into a noncontractual relationship with another and he openly, or by his behavior, agrees to assume foreseeable risks, he absolves "...the other party from legal responsibility ... (Lusk, 12:69)." Contributory negligence is the occurrence of an injury due to both parties' negligence. The defendant bears the burden of proof in a tort action. All the plaintiff must prove is that the defendant negligently controlled the instrument which caused the injury (Lusk, 12:69). Unlike damages granted in a breach of contract action, tort action remedies do compensate the plaintiff for his loss. This could include the remedy of punitive damages.

One of the major reasons for the confusion existing between the two types of actions is the term "defective performance." A contract action may be initiated if the auditor dispatched the contract with a defective performance or a complete nonperformance. A tort action may also be based upon the auditor's defective performance. "Some courts

characterize a complete nonperformance as a breach of contract and distinguish it from a defective performance, which is said to be both breach of contract and negligence (Prosser, 55:614,618-19)." Sometimes it is said that negligence in the relationship between auditor and client is a tort because an auditor assumes the obligation to exercise due care, and by law his responsibilities are:

In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment (Cooley, 52:33).

In a tort action of malpractice expert testimony is required to show that the auditor failed to exercise the degree of skill commonly possessed by fellow members of his profession. In a contract action it is only required that the auditor be proven negligent in performing his duties, and expert testimony is not required (Causey, 9:32).

Another important distinction between the two types of action is the statute of limitations "...which commences running in a contract action at the time of the breach," but begins running when the injury occurs in a tort action (Causey, 9:32). This may be a vital point as is shown in the case of American Indemnity Co. v. Ernst and Ernst (57:38), (1937) where it was determined that a charge of negligence in failing to discover embezzlement was a tort action and due to the statute of limitations was barred from the court. However, the courts



have not always viewed such negligence as a tort. For a contrasting view, one need but look at the case City of East Grand Forks V. Steele (60:32) decided in 1913. The court held negligence was a breach of contract and not a tort action. The defendant was therefore not liable for the embezzlement losses but was liable for the audit fee. Yet, in another case, Dantzler Lumber and Export Co. v. Columbia Casulty (61:38) decided in 1934, the court held that although a contract creates a duty it does not preclude the plaintiff from ensuing a tort action against the defendant for negligently performing the duty.

#### Liabilities Imposed by the Courts

Upon observing the dates of these cases, one observes that the area of tort law is developing. This is partially due to the trend in society of placing greater responsibilities upon individuals and institutions. Instead of nurturing the growth of businesses, citizens are now looking towards them to fulfill a new role, that of maturing into responsive organizations - responsive to the public that nurtured their growth. This change in attitudes is not a new phenomena. As early as 594 B.C., this conflict between the general public and business existed in Greece. The peasants at the time had deeply indebted themselves with land mortgages. For fear of a revolt, Solon cancelled all land mortgages (Seidler, 43:39). Today society, through the courts, is demanding more of the accountant as evidenced by the 1136 Tenants case. To understand better the courts' decisions in this case, some earlier court cases involving an auditor's liability to his client will be reviewed.

English cases. The previously cited Companies Act of 1862<sup>1</sup> (replaced by the Companies Act of 1890) not only increased the accountant's duties, it also increased his liabilities. The British statute provided "...for recovery by the liquidator of a company against the promoters, directors, and other officers [including auditors] for misfeasance ['the improper doing of an act which a person might lawfully do (Lusk, 12:1299).'] or breach of trust (Section 73:66)." The auditor was also liable under his contractual duties to report an independent opinion of the company's financial condition.

The first English case involving an auditor was Leeds Estate, Building and Investment Co. v. Shepherd (67:34), which was decided in 1887. The assets reported on the company's balance sheet had been overstated by the manager which resulted in a reduction of the investor's capital when dividends were distributed. This was specifically prohibited in the Companies Act of 1862. The company was eventually liquidated, and the liquidator brought suit against the directors, managers, and auditor who was aware of the illegal distribution but did not report it to the stockholders. The auditor contended he had satisfactorily performed his duty which was merely verifying the balance sheet's comparability to the company's records. The court rejected this defense upon referring to the company's articles of incorporation which assigned the auditors with the duty of ascertaining "whether in their opinion the balance sheet is a full and fair balance sheet containing the particulars required by these regulations [which

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<sup>1</sup>For a detailed discussion of this matter see pp. 11-12.

included restricting dividend payments to profits], and properly drawn up so as to exhibit a true and correct view as to the state of the company's affairs (67:34)." The auditor was found guilty of breaching his duty to the company for not reporting this irregularity.

In 1895 an auditor of a banking company was found negligent for failing to communicate properly to the stockholders the status of the company's loans and securities. The auditor did report that "the value of the assets as shown on the balance sheet is dependent upon realization (London, 68:35)." The court found him guilty of breaching his duty for his report merely aroused suspicion and did not convey the facts.

Another important English case which greatly influenced the American courts and accounting profession was the In re Kingston Cotton Mill (66:145-48) case decided in 1896. The auditors were unaware that the inventory sheets certified by the manager were overstated. This resulted in a payment of dividends out of capital. The auditors were not held liable for the court determined an auditor was not "...bound to be a detective, or...to approach his work with suspicion ...that there is something wrong. He is a watch-dog, but not a bloodhound (66:35)." Unlike the Leeds Estate Building and Investment Co. v. Shepherd case, the auditors of this case were unaware of the overstatement. The English courts had thus established the precedent of not holding the auditor liable for failing to uncover such acts.

American cases. The first American case involving an auditor's liability to his client was the Smith v. London Assurance Corp. (74:148-49) case decided in 1905. This was a contract action raised

by the auditors who were suing the client for their fees. In a counterclaim, the defendants argued the contract, which they had entered into with the plaintiff, specifically stated the auditors were to check frequently into the cash account of the defendant's New York branch office. Upon learning their New York cashier had embezzled large sums of money, the defendants refused to pay the auditors' fee on the basis that their negligence prevented the discovery of fraud which resulted in sustaining further losses. The auditors were held liable for the losses which the court determined could have been prevented if the auditors had performed their contracted duties with due care and skill.

Of great significance to the accounting profession is the McKesson and Robbins case, which was settled without litigation. Regardless, it is a very important case for several reasons. One, which was previously discussed, was its influence in changing the auditors' attitudes towards their primary objective.<sup>1</sup> Prior to McKesson and Robbins, auditors had difficulty switching their primary objective from detecting fraud to determining the financial statement's fairness. This case made it very clear to auditors that they could no longer be concerned with every little detail and must learn to rely on tests of the client's records and good internal controls.

McKesson and Robbins also played a significant role in implementing other major developments within the accounting profession. Before this case occurred, the Federal Reserve Board and the Federal Trade Commission had expressed dissatisfaction with the type of audits performed by members of the profession. A request was made to standardize

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<sup>1</sup>For a full discussion of this matter see p. 13.

accounting procedures and an Institute Committee was appointed to study the matter. The outcome was a memorandum which was issued by the Federal Reserve Board in 1917 in a pamphlet entitled "Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board." It included auditing procedures to be implemented when reviewing a company's balance sheet and income statement. In 1936 a third revision of this memorandum entitled "Examination of Financial Statements by Independent Public Accountants" was issued by the Institute, but it still did not include the observation of inventories or confirmation of receivables as procedures to be implemented during the auditor's review. It was due to the McKesson and Robbins case that the Institute appointed the Committee on Auditing Procedures "...to examine into auditing procedures and other related questions in the light of recent public discussion [which included the facts of the McKesson and Robbins case] (AICPA, 1:202)." Its first official pronouncement was issued in October 1939, and it required the observation of inventories and the confirmation of accounts receivable (AICPA, 1:14-16).

Another important result of the McKesson and Robbins case was the SEC's suggestion to the AICPA, then called American Institute of Accountants, that a distinction be made between auditing standards and auditing procedures. It was not, however, until 1947 that the Institute's committee submitted its report entitled "Tentative Statement of Auditing Standards - Their Generally Accepted Significance and Scope." In this report auditing standards were defined as pertaining to the "...quality of performance and objectives to be attained ...[and procedures were defined to] relate to acts to be performed (Causey,

9:17)." Included in this report, were the ten generally accepted auditing standards (GAAS) which have essentially remained unchanged.

National Surety Corp. v. Lybrand (69:149-54) is a case in which the cashier of a brokerage firm embezzled \$329,300 by "kiting" and "lapping" over an extended period of time. The plaintiff was the surety company which paid for the losses incurred by Halle and Stieglitz, which had engaged various accounting firms over a period of nine years to audit their records. During this time period, the firm maintained twenty-seven bank accounts and over 2,500 accounts receivable. Wallace, the confessed embezzler, was a cashier in the main office and had access to many of the firm's records. His embezzlement was accomplished by taking money from petty cash which "...was concealed by delaying and substituting bank deposits from day to day and, when outside audits were made by 'kiting' checks from one bank to another on the audit date (69:149)."

The court held the auditors liable and determined the auditors were negligent in exercising reasonable care and skill. The significance of this case is it established the verification of cash as an implied duty, and it based its decision upon publications of the accounting profession's members that had already established techniques for detecting such methods of embezzlement.

The courts determined in the Cereal Byproducts Company v. Hall (58:44) case that confirming accounts receivable was also to be another implied duty assumed by an auditor. Although the McKesson and Robbins case led to the accounting profession's official pronouncement extending audit procedures to include confirming accounts receivable, this

case is significant in that it established a precedent for the inclusion of a professional procedure in the role of an implied duty. Similarly, the case of Stanley L. Bloch, Inc. v. Klein (75:24) established that the observation of physical inventories was an implied duty. It also determined that accountants must adhere to their profession's accepted standards even if they were not members of the AICPA.

In contrast, the courts presiding over the 1136 Tenants case went so far as to determine that this adherence to professional standards was a minimal performance requirement. This case and its effects will be discussed later,<sup>1</sup> but it is important to include it at this point to emphasize the courts' changing attitudes towards the accounting profession. Instead of upholding the English precedent that auditors are liable to their clients for failing to convey sufficient information but not for failing to uncover defalcations, the American courts are holding auditors liable for failing to uncover defalcations even when they subscribe to the accounting profession's standards.

### Liability to Third Parties

#### English Precedent and Early American Law

This trend of increasing the auditor's liability to his client has also been expanded to include liabilities to third parties. The English traditionally held that only parties to a contract could enforce it, but this view was retained by the American courts for only a brief time. The history of this viewpoint's demise should begin with

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<sup>1</sup>For a full discussion of this matter see pp. 33-68.

the English case of Derry v. Peek (62:60) which has had a great influence on the American courts. It determined that a negligent statement made carelessly could constitute fraud, but if it was made with honesty then fraud was absent.

In 1916, Judge Cardozo's court extended third party "...liability to manufacturers of articles which would be dangerous if negligently made... (Causey, 9:63)." Upon further following Judge Cardozo's career, it is observed that his view is vastly different from his English predecessors. His opinion in Glanzer V. Shepard (65:180-81) extended third party liability to public weighers who did not have a contract with the plaintiff but knew he was purchasing the product the seller requested them to weigh.

#### Liable for Deceit but not Negligence

This famous judge appears again in the case of Ultramares Corp. v. Touche (Ultramares) (77:181-89). The case involved the 1923 balance sheet of Fred Sterns and Co., Inc. which had been prepared and certified by public accountants who had not verified \$706,000 of fictitious assets. At the time of the engagement, the auditors were aware the balance sheet would be shown to third parties but did not know they would be shown to the plaintiff, a business that made loans on receivables. The plaintiff had no prior association with Fred Sterns and Co. Inc., and the auditors had no basis for believing it would have any in the future.

In reference to the English precedent of Derry v. Peek, Cardozo remarked:



No such charity of construction exonerates accountants, who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries (77:64).

Judge Cardozo thus established the precedent that accountants are liable to third parties for deceit, but since the defendant showed a lack of proximity and foreseeability in this case, he determined:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class (77:65).

This rejection of the English precedent was not sustained in the case of O'Connor v. Ludlam (70:65). The plaintiffs were stockholders who had purchased their stock in reliance of a balance sheet certified by the defendants. The court, unlike that of Ultramares which determined that a misstatement of a part of the audit could constitute gross negligence, was of the opinion the whole audit must be proved fraudulent before the auditor could be held liable.

#### Liable for Gross Negligence

The effects of this decision were short-lived, for in 1938, the State Street Trust Co. v. Ernst (74:66-68) (State Street) decision was based upon Ultramares and determined:

Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and

reckless disregard of consequence may take the place of deliberate intention (76:66).

This case is significant for it places the auditor in the position of being liable to third parties for gross negligence but not for ordinary negligence. Upon reflecting, a definite trend towards increasing the auditor's liability to third parties can be observed. The Ultramares case held that gross negligence or deceit may be evidence of fraud, and an auditor is liable to identifiable third parties for fraud even if he is unaware of the falseness of his representations. State Street, however, indicated that gross negligence alone could be a fraudulent act, and the auditor could be held liable to third parties for gross negligence.

#### Liability to Foreseen and Limited Classes of Persons

More recent court decisions have liberally interpreted the Ultramares and State Street cases. One, C.I.T. Financial Corp. v. Glover (59), "...held that auditors are liable to third parties for ordinary negligence if the reports are for the 'primary benefit' of plaintiff (Causey, 9:67)." Its decision was based upon the premise that State Street did not preclude liability to third parties for ordinary negligence but merely failed to define the circumstances under which ordinary negligence would apply.

This view was also assumed in Ryan V. Kanne (72) which went so far as to remove the "primary benefit" requirement and extended ordinary negligence liability to an auditor if the recipient of the reports was identified prior to the audit. The plaintiff was the accountant acting for his fees. The defendant was the enterprise which had based its

decision to incorporate with the CPA's client upon the unaudited balance sheet. A counterclaim of negligence was raised for the balance sheet understated the accounts payable section by \$21,000. The court did grant the CPA his fees but sustained a judgment of \$23,042.94 against them. Included in this amount was \$1,380 for the cost of a "reaudit" (72). It is interesting to note that although the court was well aware the engagement was not one of an audit, it repeatedly referred to the second examination as a "reaudit." It was, in fact, not a "reaudit" for there had never been an audit in the original engagement. Although this may appear to be a unworthy point of the case, this problem of semantics became a vital issue in the 1136 Tenants case. It should have provided a forewarning to the profession that a communication's gap was occurring between the courts and the profession in the area of unaudited financial statements.

In 1968, a Federal District court extended an auditor's liability to "actually foreseen and limited classes of persons (Causey, 9:202)." The case of Rusch Factors, Inc. v. Levin (71) involved an audit engagement requested by a commercial banking and factoring corporation prior to lending funds to the CPA's client. The accountant certified the client's financial statements which reported the company as solvent. After obtaining \$337,000 from the banking corporation, the audited client went into receivership.

The defendant raised a lack of privity of contract defense which the court dismissed stating it was "...no defense in a fraud action." Prior to this court case, no appellate court had "...held an accountant liable in negligence to reliant parties not in privity." The

presiding Judge Pettine suggested "the reluctance of the courts to hold the accounting profession to an obligation of care which extends to all reasonably foreseeable reliant parties is predicated upon the social utility rationale first articulated by Judge Cardozo in the Ultramares case." Judge Pettine added his thoughts that the cost of the added liabilities would not affect the profession for it could merely pass the cost on to its clients (71:203).

Rusch Factors, Inc. v. Levin clearly weakened the Ultramares precedent which was further weakened by the Fischer v. Kletz (64) case that held an auditor liable to anyone relying upon reports which the auditor, after their issuance, discovers are false or misleading. The onset of this case was an audit engagement performed by Peat, Marwick, Mitchell and Co. (PMM) for Yale Express System, Inc. (Yale) of their financial statements for the year ended December 31, 1963. The certified statements were issued to Yale's stockholders and the SEC. Following the audit, PMM was engaged to perform "special studies" for Yale. During the engagement, PMM became aware of information which had a material effect upon the previously certified statements' fairness. It was not until the completion of the "special studies" engagement that PMM disclosed the findings (64).

Another important fact is that Yale issued interim statements which were based upon the inaccurate figures its accounting department had derived. PMM was aware of this but would not permit Yale to use its "special studies" figures. The plaintiffs, stockholders and debenture holders, claimed PMM was liable for failing to disclose that

the certified financial statements and Yale's interim statements were grossly inaccurate (64).

The court held the defendant did not have a duty towards the interim statements but held it liable for negligence resulting from its silence of the facts pertaining to the certified statements. This decision provided a precedent that silence could be an element of deceit. The accounting profession responded by issuing its Statement on Auditing Procedure No. 41 (SAP No. 41) entitled "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report." The courts, once again, were influencing the profession's standards.

#### Liability Under Federal Law

Another area of liability for the CPA is his civil liability under the Federal Securities Laws. Due to the market crash of 1929, the investing public's need for protection became evident. It was thus determined necessary to require companies selling securities in interstate commerce to register with a governmental agency. The Securities Act of 1933 dealt with new stock issues and required each registering company to include in its prospectus financial statements certified by an independent auditor.

The Securities Exchange Act of 1934 delegated the administrative responsibilities of the 1933 Act to the SEC. This Act required the annual submission of certified financial statements and was amended in 1964 to extend its jurisdiction to all issuers of securities if their assets exceed \$1,000,000 and its equity securities are "...held by five hundred or more persons (Causey, 9:84)."

Pertinent to 1136 Tenants is a suit filed against PMM under the Securities Act of 1933. The plaintiffs in the case of Escott v. BarChris Construction Corp. (63) (Escott v. BarChris) were debenture holders. The main issues brought before the court were to determine if the registration statements were false, and if false, were the facts material (63).

BarChris dealt primarily with the construction of bowling centers. Upon receiving a downpayment from a customer, BarChris would proceed to build the facilities. The remaining balance due from the customer was paid in installment notes which were factored by BarChris (63).

Another method of financing was a sale and leaseback arrangement in which BarChris would build and furnish a center. The inside furnishings were then sold to James Talcott, Inc., which would either lease the interior to a BarChris customer or a BarChris subsidiary which would in turn lease to a customer. Obviously the construction costs created a heavy burden upon BarChris' cash supply. To satiate its need of cash, BarChris filed a registration statement with the SEC for the sale of debentures. At the same time, BarChris was having trouble collecting from its customers. On October 29, 1962, BarChris filed bankruptcy (63).

Since the prospectus filed with the SEC included an audited balance sheet, the auditors were included as defendants in the suit. In his review of the audit procedures employed by them, Judge McLean determined the auditors had been negligent for not delving into the suspicious area of the sale and leaseback arrangements. Due to this negligence, BarChris' financial troubles were not properly reflected in

the balance sheets. However, most importantly, McLean stated that "accountants should not be held to a standard higher than that recognized in their profession (63:228)," and emphasized that his decision was not to be interpreted otherwise. A direct result of this case was the AICPA's issuance of the Accounting Principles Board's Opinion No. 5 entitled "Reporting of Leases in Financial Statements of Lessee."

## Chapter 3

### SPECIFICALLY SPEAKING, UNAUDITED FINANCIAL STATEMENTS

Upon reflecting it can be determined that the courts have definitely expanded the auditor's liability to his client and third parties. English precedent permitted only those in privity of contract to bring action against an auditor for negligence and only if the auditor was negligent in failing to inform them of defalcations which had come to his attention but not for failing to uncover defalcations. Today the courts have gone so far as to hold an auditor liable for ordinary negligence to third parties who can be foreseen. The courts have even determined that the profession's standards are minimal requirements and their observance does not absolve an accountant from a negligence judgment. This was so held in 1136 Tenants.

#### Official Pronouncements

Prior to discussing this much publicized case, a review of the AICPA's pronouncements pertaining to unaudited financial statements will ensue.

#### SAP No. 33

In December 1963, the AICPA's committee on auditing procedure issued SAP No. 33. The authority of this committee and its pronouncements is clearly recognized by the AICPA which states it is "...the senior technical committee of the Institute designated to express opinions on auditing matters, ...and the burden of justifying departures from the committee's recommendations must be assumed by those who adopt other practices (2:Notes)." Pertaining to a CPA's association with



unaudited financial statements, it states:

When no audit has been performed, or the auditing procedures performed are insignificant in the circumstances, any financial statements with which the independent auditor is in any way associated should be clearly and conspicuously marked on each page as unaudited, whether accompanied by his comments or not. It is preferable that a disclaimer of opinion accompany all such statements; when they are accompanied by comments the independent auditor must issue a disclaimer of opinion. Such a disclaimer of opinion may read as follows:

The accompanying balance sheet as of November 30, 19\_\_ and the related statements of income and retained earnings for the year then ended were not audited by us and we express no opinion on them.

Phrases which may cause the reader to believe an examination was made should be avoided in any such disclaimer.

The independent auditor should refuse to be associated in any way with unaudited financial statements which he believes are false or misleading ... 2:60).

#### SAP No. 38

Ironically, the accounting profession was in the process of reviewing SAP No. 33's treatment of unaudited statements at the same time the CPA firm of Max Rothenberg and Co. (Rothenberg) was performing "unauditing" services for a client, 1136 Tenants' Corp., a cooperative apartment corporation. It was not until September 1967, that the committee published the final result of their review. By that time Rothenberg was in the throes of judicial debate. SAP No. 38 was too late to help Rothenberg but in time to be of assistance to the Supreme Court of New York County, which was the first court to preside over the case. This new pronouncement was published for the purpose of clarifying paragraphs seventeen and eighteen in chapter ten of SAP No. 33, but has since been criticized for its lack of clarity. This is most likely a direct result of 1136 Tenants.

Specifically, it defined unaudited financial statements as those which "...the certified public accountant a) has not applied any auditing procedures to ... or b) has not applied any auditing procedures which are sufficient to permit him to express an opinion (3:53-54)." The definition is much like that of SAP No. 33; however SAP No. 38 specifically states that upon performing such services, the CPA is not deemed by the profession to assume any responsibilities for applying auditing procedures.

Another area which SAP No. 33 did not clearly define was the determination of when a CPA was associated with unaudited financial statements. After much discussion, the committee deemed a CPA to be associated "...when he has consented to the use of his name in a report, document or written communication setting forth or containing the statements (3:54)." He is considered to be associated when he prepares or assists in their preparation regardless of whether or not he presents his comments in a covering letter or uses plain paper. Unlike SAP No. 33, a disclaimer of opinion is required in all cases of association as defined by SAP No. 38. The recommended disclaimer reads:

The accompanying balance sheet of X Company as of December 31, 19\_\_ and the related statement(s) of income and retained earnings for the year then ended were not audited by us and accordingly we do not express an opinion on them (3:54).

Due to events following the issuance of this statement, the recommended disclaimer has been altered. These modifications will be discussed later.<sup>1</sup>

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<sup>1</sup>For a full discussion of this matter see pp. 37-39.

The profession was also dissatisfied with paragraph eighteen in chapter ten of SAP No. 33 which required a CPA "...to refuse to be associated in any way with unaudited financial statements which he believes are false or misleading (2:60)." Due to this statement, it was frequently asked "How can a CPA know unaudited financial statements are false and misleading?" In its subsequent pronouncement, the committee determined that a CPA is responsible for following minimal professional standards, and he should be alert to any unusual items appearing or not appearing on the statements. SAP No. 38 states:

... if the certified public accountant concludes on the basis of facts known to him unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, ...he should insist ...upon revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion (3:55).

If the client will not agree to the CPA's recommended revision or refuse to accept the amended disclaimer, the CPA should refuse to be associated with the statements. SAP No. 38 further recommends a CPA to refuse to provide reproductive services in such a case (3:55).

The committee determined that the inclusion of any description of audit procedures employed should be eliminated from the disclaimer for this may cause confusion. An exception is the case of letters for underwriters or engagements pursuant to a purchase or sale. Such statements must, however, be clearly marked for restricted use (3:56).

As in audited financial statements, this statement requires that unaudited financial statements display the proper footnotes and disclosure unless restricted for internal use only, and the disclaimer appropriately reflects the omissions.

It is also required in this statement for a CPA, who examines a current year's financial statements which are presented with the prior year's unaudited statements, to mark each page unaudited or to reflect this fact in his disclaimer. This is unnecessary if the statements were already marked unaudited, unless the CPA has reservations as to their fairness. In such a case, the disclaimer should disclose his reservations (3:56-57).

The final paragraphs of this statement deal with documents filed with the SEC, which require annual reports be audited but do not require other reports be audited. In the latter case, the CPA need not attach a disclaimer to the reports, nor is it necessary when submitting data to the taxing authorities.

#### Subsequent Pronouncements

Following the publication of this pronouncement, numerous events occurred which have altered it. These modifications have since been consolidated with SAP Nos. 33-54 into Statement on Auditing Standards No. 1 (SAS No. 1) entitled "Codification of Auditing Standards and Procedures." Although these subsequent alterations do not pertain directly to the 1136 Tenants case, they are pertinent to the subject of unaudited financial statements. They will be discussed as excerpts from SAS No. 1 instead of their individual SAP publications.

The recommended disclaimer of SAP No. 38 has been amended to comply with the requirement that a statement of changes in financial position be included with the financial statements. SAS No. 1 has included the course of action to be followed if this statement is omitted. If the reports are for internal use, the CPA must note the

omission in his disclaimer. If they are not so restricted, he must add to the disclaimer that the statements are not in conformity with generally accepted accounting principles (GAAP) (1:90).

If a CPA does not have an independent mental attitude towards his engagement, SAS No. 1 precludes him from expressing an opinion. His disclaimer of opinion should be amended to include a statement of his lack of independence, and each page of the financial statements should be marked as unaudited (1:92-93).

In compliance with the SEC requirements, many of the CPA's clients must file audited and unaudited financial statements. In concurrence with these filings, the CPA is frequently asked to prepare letters for underwriters which are referred to as comfort letters. These letters may contain information pertaining to "unaudited financial statements and schedules in the registration statement (1:141)." These comments are recommended by the profession to be expressed in a manner which does not overshadow the auditor's disclaimer of opinion. He may, however, describe the procedures employed by him while associated with the unaudited statements. It is additionally required that a CPA, who prepares a comfort letter which includes a comparison of the current year's interim statements with the previous year's unaudited interim statements, should make it clear that the prior year's statements are unaudited (1:147-148).

The sections of SAS No. 1 dealing with long-term investments remind the CPA that he cannot express an unqualified opinion on an investor's financial statements if his scope is limited due to a lack of competent evidential matter verifying the treatment of these investments. In

particular, if he is only able to examine unaudited financial statements of the investee or is unable to apply auditing procedures to such statements, he should either issue a qualified opinion or a disclaimer depending upon the materiality of these assets (1:101).

With reference to the much debated topic of internal control reports, this pronouncement states that their usefulness to the general public is a matter to be decided by the management of the client "...and/or any regulatory agencies having jurisdiction (1:177)." The committee does emphatically compel the CPA not to allow any internal control reports to be issued with unaudited statements.

#### The 1136 Tenants Case

Now that a basic knowledge of a CPA's liabilities and his profession's standards for association with unaudited financial statements has been provided, the 1136 Tenants case and its ramifications can be more fully understood. This case has had a tremendous effect upon the profession in that it involved an increase in the accountant's liabilities to his clients based upon the revolutionary idea that the courts, and not the accounting profession, would determine whether or not procedures approved by the profession and employed by the CPA would be deemed sufficient. This case involved a contract and a tort action for negligence against a CPA firm in New York State. The plaintiffs of the case were owners of a cooperative apartment corporation which was managed by an agent, Riker and Co., Inc. Some important facts about the case are that the plaintiff was not a publicly held client, and unlike many suits, was not an unrelated third party. The defendant was not a large national CPA firm but was a local practitioner typical of

many of the small CPA practices of today. These facts are important for they assist in demising the age old adage that the small practitioners which deal with unlisted public corporations are not in the "hot seat" like the large public firms which have faced many liability suits primarily based upon the federal securities acts of 1933 and 1934. This case hits close to home.

The defendant, Max Rothenberg and Co., was engaged in August 1963, by Jerome Riker of Riker and Co., Inc., which was the apartment corporation's managing agent, to perform certain accounting services. The engagement was an oral agreement and included a \$600 fee for the accountant's annual services, which were provided during 1963, 1964 and 1965. In March 1965, it was learned that material defalcations had been performed by Riker in that he had not paid certain obligations which were reported as paid in the statements prepared by the accountant. During the course of the engagement, the accountant had learned that some reportedly paid invoices were missing as evidenced by his workpapers which included a page entitled "Missing Invoices, 1/1/63-12/31/63." The amount of the missing invoices totalled over \$44,000, but the accountants did not delve into the matter and did not inform the 1136 owners. It should also be noted that the managing agent provided similar services to other clients and had commingled their funds into one bank account. Riker eventually admitted embezzling approximately \$130,000 of the corporation's funds.

Justice Riccobono presided over the Supreme Court of New York County trial without a jury. The plaintiffs contended the defendant had engaged to perform accounting and auditing services which he failed

to do and was therefore in complete disregard of his contractual duties. The contention specifically stated the accountants failed "...to examine and audit the books, records, invoices, bank statement and cancelled check vouchers of plaintiff and Riker and Co., the Managing Agent (Saxe, 41:420)." As a result, the plaintiff contended the defalcations were undisclosed and were allowed to continue.

The defendants raised the point that the scope and nature of its contractual duties were limited to bookkeeping services, the preparation of unaudited statements, and preparation of a letter informing the tenants of their "...tax deductions for mortgage interest and real estate taxes ... (Saxe, 41:420)." The defendant prepared statements from the managing agent's monthly statements and attached to the unaudited financial statements a letter of transmittal which began:

Pursuant to our engagement, we have reviewed and summarized the statements of your managing agent and other data submitted to us by Riker and Co., Inc., pertaining to 1136 Tenants' Corporation ...

[and ended]

The following statements (i.e. the financial statements and appended schedules) were prepared from the books and records of the corporation. No independent verifications were undertaken thereon ... (Saxe, 41:420).

Each page of the unaudited financial statements was marked "Subject to comments in letter of transmittal (Saxe, 41:420)." Since the plaintiffs (directors and stockholders) had reviewed and accepted the statements for the year 1963 and the first six months of 1964 at their respective meetings without comments, the defendant held that was proof it had satisfactorily performed its contractual duties. However, upon hearing the defendant's motion for a dismissal based upon this fact,



the pre-trial judges denied its request noting that the defendant did not attach to the stockholders' annual tax deduction reports the legend stating "No independent verifications were undertaken thereon (1136 Tenants, 78:158)."

One of the most incriminating facts of the case was the defendant's reference to its services in the client's income statement as an audit. In addition, Rothenberg's invoices stated the billings were for an audit. The specific issues were determined by the trial court to be:

1. What was the nature and scope of the defendant's engagement?
2. Did defendant perform its duties pursuant to such retainer agreement (Saxe, 41:421)?

In his decision, Justice Riccobono determined the defendant was engaged to "...act as an independent voice to verify and confirm books and records of its [plaintiff's] managing agent and to establish the authenticity thereof (Saxe, 41:421)," and it had failed to impart this duty in a manner in compliance with accepted professional standards. The judge even went so far as to establish standards which were not recognized by the profession when he stated:

...the need for a certain amount of auditing procedures is required even in a "write-up." This is especially true where an accountant is called upon to perform accounting services for a cooperative apartment venture. It is in this type of situation, where even a minimal amount of internal auditing procedures would have revealed whether major expenditures and liabilities of the plaintiff cooperation had been met and paid and therefore this type of procedure is mandated as a necessary prerequisite, albeit to an adequate "write-up" (Saxe, 41:421-22).

Even more alarming, was the judge's referral to the profession's duty of detecting fraud. Specifically, he declared:

...regardless of whether defendant received the invoices for purposes of audit or otherwise, it had a duty to detect

defalcations and on the basis of the evidence adduced could have and should have, noted these defalcations ... (Saxe, 42:421-22).

This statement is most distressing for the AICPA, the authoritative body of the accounting profession, does not hold with this viewpoint. SAP No. 33 did not professionally require Rothenberg to apply any auditing procedures and emphasized that "the responsibility of the independent auditor for failure to detect fraud ... arises only when such failure clearly results from failure to comply with generally accepted auditing standards (GAAS) (2:11)." Since it is a GAAS that no auditing or insufficient auditing procedures are applied on unaudited statements, it is thus evident that a responsibility for the detection of fraud does not hold when preparing such statements. Perhaps, the judge's reasoning will be better understood upon reviewing the plaintiff's expert witness Benton's testimony which follows:

- Q. Restricting ourselves to the years '63, '64 and '65 and referring to unaudited statements would you as a professional certified public accountant say that a certified public accountant had at that time no responsibility to apply any auditing procedure to unaudited financial statements? And would you answer that yes or no, if you can, sir?
- A. No. He had responsibilities. That is - the negative - I'm not sure - It's a double negative there, but he had responsibilities there toward unaudited statements.
- Q. As a certified public accountant, would you say that financial statements are unaudited if the certified public accountant has (a) not applied any auditing procedures to them; or (b) has not applied auditing procedures which are sufficient to permit him to express an opinion concerning such statements?
- A. Yes, sir.
- Q. So that is a fair definition of unaudited statements, is it?
- A. As in regard to statements, financial statements, yes.

Q. You have told us that a statement is unaudited if the certified public accountant has not applied any auditing procedures to such statements, have you not?

A. Yes, sir.

Q. And you have also told us, have you not, that a certified public accountant has a responsibility to apply auditing procedures to unaudited financial statements, have you not?

A. Yes, sir (Chazen, 23:44).

This testimony not only contradicts itself but also contradicts the standards of the profession. In the second to the last answer, the witness affirms the question asking if an unaudited statement has not had any auditing procedures applied to it, then in the last answer he agrees that a CPA has a responsibility to apply auditing procedures to the statement which has had no audit procedures applied to it. Unquestionably the witness was confused and no doubt confused the rationale of the presiding judge.

In addition to this testimony, other evidence was introduced to the court which indicated that the defendants themselves were confused about the scope of the engagement. This evidence included Rothenberg's invoices billing for an audit, Rothenberg's inclusion of the word "audit" in the client's income statement, and one of Rothenberg's senior partner's testimony indicating he himself was unsure of the exact nature of the engagement (Causey, 9:42). To add to this confusion, Riker who had testified in a pre-trial hearing that the defendant was not engaged to perform an audit changed his testimony at the trial and stated the defendant was engaged to perform an audit.

In light of this evidence, the trial court of the 1136 Tenants case held the defendant liable for failing "...to properly perform its

duties (AICPA, 8:57)," and granted \$174,066.93 in damages to the plaintiff. This is quite a remarkable sum when considering the defendant's fee per annum was only \$600. This decision was appealed to the Appellate Division of the Supreme Court of the State of New York. The AICPA and the New York State Society of CPA's (NYSSCPA) submitted to the Appellate Division a brief as amici curiae (a party who volunteers advice). Regardless of the arguments presented in the brief, the Appellate Division upheld the lower court's decision by a four-to-one affirmation. In its decision, the Appellate Division endorsed Justice Riccobono's finding that an audit was intended and the defendant had been negligent in performing its duties. It did soften the lower court's statement that a duty to detect fraud was inherent in an audit or a write-up by proclaiming that:

...it is clear, beyond dispute, that it [defendant] did become aware that material invoices purportedly paid by Riker were missing and accordingly, had a duty to at least inform plaintiff of this. But even this it failed to do. Defendant was not free to consider these and other suspicious circumstances as being of no significance and prepare its financial reports as if same did not exist (46:67).

Justice J. J. Steuer dissented from the decision and submitted a brief in which he stated his objections, primarily based upon the premise that "...the proof was overwhelming that the hiring was as defendants claim." Since the hiring was so, Steuer felt the defendant had not breached its contract and to hold it liable for failing to uncover the defalcations "...would expand the obligation [of defendant and other CPA's] from bookkeeping to criminal detection (46:67-68)."

The Appellate Division's decision was appealed to the Court of Appeals of the State of New York, that state's highest court. Once

more, the AICPA and NYSSCPA submitted a brief as amici curiae to the court, and once again, the Court completely disregarded the profession's attempts to regain its authoritative position upon affirming the lower courts' decisions. This court's affirmation was issued in March 1972 without an opinion.

The effect of these court decisions upon the accounting profession has been tremendous. Justice Riccobono declared that a CPA has a duty to apply some auditing procedures when engaged to prepare unaudited financial statements, and equally important he proclaimed a CPA has a duty to detect defalcations when performing an audit or accounting services. Overall the decisions have the potential of adversely affecting the future quality of unaudited financial statements for if the risk is too high, CPAs may refuse to be associated with them.

In both briefs of amici curiae submitted to the courts, the AICPA and NYSSCPA responded to the lower court's decision that a CPA must perform some auditing procedures when engaging in write-up services by delineating the difference between audited and unaudited financial statements. They also referred to several court cases which had previously substantiated the AICPA's recognition as the primary authoritative body of the profession. The previously discussed case of Escott v. BarChris Construction Corp.<sup>1</sup> was quoted for its proclamation that "... [a] accountants should not be held liable to a standard higher than recognized in their profession..." They again substantiated the prominence of the profession's standards upon referring to Stanley L. Bloch V. Klein case which declared that "...without any doubt [the

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<sup>1</sup>For a full discussion of this matter see pp. 31-32.

AICPA's Code of Professional Ethics] fixes the existing and accepted standards of [the] profession, and that 'applicable law ...requires ...adherence to accepted professional standards' (8:60)."

Having demonstrated itself to be the legally recognized regulating force of the profession, the AICPA proceeded to provide the courts with its standards for each type of engagement. It was emphatically pointed out that there are marked differences in the procedures implemented and the responsibilities assumed when a CPA engages to perform either service.

It is worthy to note that upon arguing the fact that the CPA firm of Max Rothenberg and Co. was not engaged to perform an audit, the briefs mentioned as evidence Rothenberg's disclaimer and his notation on each page. They indicated that the defendant's disclaimer and notation were acceptable means of informing the users of the financial statements' unaudited status. Upon closely reviewing the letter of transmittal prepared by Rothenberg and submitted with the unaudited statements, one observes that it was not of the format recommended by the AICPA in SAP No. 33. In addition Rothenberg blatantly ignored the profession's recommended procedure of marking each page "unaudited" when submitting comments. Instead, he merely marked each page "Subject to comments in letter of transmittal (Saxe, 41:42)." Apparently the AICPA and NYSSCPA did not deem these irregularities to be serious transgressions of the profession's standards. This could have been due to the fact that their prime concern was to make the courts aware of the profession's new pronouncement, SAP No. 38. However, it may be projected that the briefs could have possessed more influence upon the

courts if the profession had suggested their decisions be based upon Rothenberg's violation of the profession's standards instead of new standards determined by the courts. If the briefs had been so presented, the plaintiffs would have been given their "blood" and the courts would have been given an honorable means of retracting formidable statements which indicate that they know best what the accounting profession should or should not do.

In response to the courts' acceptance of the embezzler's testimony, the briefs referred to the meager \$600 fee. They also stated that the referral to "audit fees" in the income statement and Rothenberg's invoices did not overshadow the weight of the evidence proving that the engagement was not intended to be an audit. Included in the evidence was the client's acceptance of the unaudited statements, and Rothenberg's unusual disclaimer and notation. It again appears unusual that the briefs did not make mention of the fact that Rothenberg was not acting in accordance with the profession's standard which requires a CPA to employ due care and skill. It was unnecessary for the profession to prove Rothenberg's innocence. Instead, it may be proposed that the profession should have tackled the simpler task of providing the courts with a new basis for determining Rothenberg's guilt of negligence, i.e. failing to adhere to the profession's standards of due care and skill and failing to follow the profession's recommended means of informing the public that the statements were unaudited.

Regarding Justice Riccobono's dictum that a CPA has a duty to apply auditing standards which would detect defalcations, such as those

involved in the 1136 Tenants case, regardless of the type of services he is performing, the briefs reminded the courts this idea was contrary to the profession's standards. They did not, however, provide the courts with a complete understanding of the effect this concept could have. They failed to inform the courts that the imposition of such a duty would increase the scope of the auditor's examination to the point he would have to return to the type of audit employed in the 1800's. These "bookkeeping" audits were found to be ineffective for they were checks of clerical accuracy and entailed verifying nearly every entry made in a client's records.<sup>1</sup> Upon emphasizing the fact that a CPA is not a guarantor but an individual who is skilled in the specialized area of, but not limited to, reviewing financial statements for the purpose of determining that they are prepared in conformity with GAAP, and upon determining this, no material errors or fraud were observed, the briefs may have had a greater impact upon the courts. It should also have been emphasized that an audit is in no way meant to imply that errors or fraud do not exist. Obviously the courts were unaware of this effect, and the profession could have provided them with this information. Both briefs suggested to their respective courts that the opinions of the lower court(s) could adversely affect the accounting profession and the public for CPAs could discontinue providing accounting services if the risks are too high.

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<sup>1</sup>For a detail discussion of this matter see pp. 12-13.



## Chapter 4

### PROFESSION'S RESPONSE TO THE 1136 TENANTS CASE

Irrespective of these briefs and their contents, the courts affirmed the original decision of the trial court. The attempts of the AICPA to justify Rothenberg's actions and to maintain its position as the profession's authoritative source were not even referred to by the courts. This has thus left the profession with the ultimate task of reviewing its standards in this area.

#### AICPA Task Force

The AICPA responded by appointing a task force of the auditing standards division to review SAP No. 38. The chairman of the committee on auditing procedures specifically charged the members of the task force:

1. To consider the ramifications of the 1136 Tenants' decision and its effects on the CPA profession.
2. To consider the best method of informing the profession of the significance of this case.
3. To determine if the practitioner requires additional guidance in preparing unaudited statements.
4. To determine if the current literature required additional clarification on unaudited statements.
5. To prepare the material determined necessary to assist the profession in the area of unaudited statements (AICPA, 6:62-63).

#### Interim Report

In response to these objectives, the task force issued an interim report which stated it had determined the 1136 Tenants case had been sufficiently publicized. It also concluded a major revision of

SAP No. 38 was unnecessary. This view was derived in light of the fact that the trial court's decision requiring the implementation of some audit procedures when engaged to perform an accounting service was not reinstated by the Appellate Division.

The task force responded to its third objective by delineating the following areas which required additional guidance:

1. Engagement letters.
2. Distinction between audit procedures and accounting services.
3. Distinction between unaudited engagements and engagements involving limited audit procedures which also lead to a disclaimer of opinion.
4. Content of working papers.
5. Normal or minimum inquiries an auditor should make with respect to unaudited financial statements with which he is associated, including a sample checklist.
6. Auditor's course of action in the event he learns of error in unaudited statements after they have been issued.
7. The need for and extent of client's representations, in writing.
8. "Internal use" statements as contemplated by paragraph 5 of SAP No. 38.<sup>1</sup>
9. The application of SAP No. 38 to tax returns and other governmental forms which are used as financial statements for other purposes (6:62-63).

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<sup>1</sup>SAP No. 38, paragraph 5 states:

"A certified public accountant may be retained by his client to perform routine bookkeeping services or to prepare financial statements for the client's internal use only, possibly on a monthly or quarterly basis. For such statements, it might not be necessary to include all footnotes or other disclosures that might otherwise be desirable. Under the circumstances, the accountant should add to the disclaimer of opinion a sentence to the effect that the financial statements are restricted to internal use by the client and therefore do not necessarily include all disclosures that might be required for a fair presentation in conformity with generally accepted accounting principles (3:55)."

Guide for Engagements of CPAs to Prepare  
Unaudited Financial Statements

The task force replied to the fourth and fifth objectives delineated by the committee on auditing procedure by issuing its Guide for Engagements of CPAs to Prepare Unaudited Financial Statements (Guide). The Guide is endorsed by the AICPA which informs its members "...that they may have to justify a departure from a guide if the quality of their work is questioned (5:Notes to Readers)," but it is not to be interpreted as a supersession of SAP No. 38. It is a supplement to the AICPA's previous literature dealing with unaudited financial statements.

It is recommended in the Guide that upon being engaged to perform an accounting service, a CPA should first discuss with the client his intent and the purposes for which the statements will be used. This discussion is very important because it will aid the client in understanding what he wants for some clients are unaware of the distinctions between unaudited and audited statements. This was evidenced in the case of 1136 Tenants where one of the corporation's directors testified he was of the impression that an audit was to be ensued because he had heard the word "audit" in one of the discussions with the defendant (Bab, 16:44). This communication gap between the CPA and his client should be closed before the CPA begins to perform his services. To enhance further the understanding between the CPA and his client, the Guide also recommends the preliminary interview include a discussion of the time period which the statements will cover, the date the engagement is to be completed, the assistance to be provided by the client and the CPA's fees.

The CPA is then ready to prepare the engagement letter which should include the fact that the services to be provided are accounting services and not those of an audit; the fact that a disclaimer will be issued and will "...include any reservations he has regarding departures from generally accepted accounting principles of which he becomes aware (AICPA, 5:11);" and a comment stating the purpose of these services is not to detect fraud or defalcations. Included in the Guide is an illustration of an engagement letter (Refer to Appendix A) which is to be addressed to whomever retained the CPA and should not include a description of procedures to be employed unless certain procedures were requested by the client.

The Guide emphatically reminds the CPA that he is not precluded from exercising the standard of due care and skill when associated with unaudited financial statements merely because he is not required by SAP No. 38 to apply any auditing procedures. Due to his professionalism, the CPA is required to use his skilled judgment in determining what procedures are appropriate in an engagement providing accounting services. To assist him in his decision, the Guide provides two basic areas of consideration:

1. Do accounting records actually exist, and
2. Are generally accepted accounting principles appropriately applied in the records (5:18)?

The second consideration is the area which will, at times, tax the CPA's judgment. Being aware of this, the Guide suggests the CPA approach the matter by first directing inquiries to management and personnel. If his questions are then unanswered or create more questions, it is suggested that "...the CPA, ...may wish to make further

inquiries or to consult the client's records to gain a better understanding of the information (5:19)." It does not, however, require a CPA to perform additional procedures if his preliminary questions are satisfactorily answered. A checklist of procedures to be employed is illustrated in the Guide (Refer to Appendix B). It is a recommended means of evidencing work performed, but the CPA is cautioned to abstain from referring to such checklists as "audit programs." Another checklist entitled "financial statement presentation checklist" was described as a useful means for determining whether or not the statements provide adequate disclosures.

The Guide also discusses the distinctions between an accounting service disclaimer and an audit disclaimer and emphatically recommends the CPA not alter the wording of the disclaimer. As was previously noted, Rothenberg had deviated from the disclaimer recommended in SAP No. 33 which made it difficult for the profession to argue his case in its briefs to the Appellate Division and the Court of Appeals.<sup>1</sup> To vary the wording could result in a similar demonstration of a "communication gap." Variations are recognized in cases where the statements are found to depart from GAAP; however, SAS No. 1 and the Guide provide illustrations of the recommended disclaimers which include the CPA's reservations and their "...effects, if known to him, on the financial statements (5:24)."

If the CPA acquires information which existed at the time of his engagement and which indicates the statements are not in conformity with GAAP after he has submitted them to the client, the Guide

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<sup>1</sup>For a full discussion of this matter see pp. 47-48.

recommends the CPA consult his attorney and his client. Upon doing so, it is recommended the CPA consider the procedures employed for a similar occurrence with audited statements. If a revision is determined appropriate and the client agrees, the CPA should issue revised statements and a revised disclaimer.

In conclusion, the Guide provides examples of various items which may be included in the working papers. Their content, however, will be determined by the

- 1) ...agreed upon scope of the engagement,
- 2) The purpose and contemplated use of the unaudited statements ...and
- 3) The nature and condition of the client's books and records (5:34).

#### Recommendations by Individual Members of the Profession

Although it took nearly five years for the profession to issue its pronouncement reflecting the effects of the 1136 Tenants case, concerned members of the profession had been actively publishing their own recommendations. Some extend beyond those of the Guide. Since the courts have been historically increasing the CPA's liabilities, caution against negligence suits in all engagements, particularly in the area of unaudited financial statements, is deemed necessary. Upon considering the trial court's declaration that the profession procedures were only minimal levels of performance, it is deemed a necessary caution for the CPA to be aware of procedures, in addition to those in the Guide, which he may judge necessary in order to protect himself against future litigation in this area.

### Engagement Letters

Some members have suggested including in the engagement letter a copy of the proposed disclaimer to be issued (Guy, 27:556). This recommendation has its merits for it will familiarize the client with the disclaimer and could prevent future misunderstandings when the engagement is completed. A negative aspect of this would occur if the CPA has to amend his disclaimer, such as if he learns during the engagement the statements are not in compliance with GAAP. This could be prevented upon including a statement forewarning the client that the disclaimer may be amended.

Although the Guide places little emphasis upon obtaining the client's signature, some members of the profession urge the CPA to acquire the signature (see e.g., Bab, 16; Carmichael, 21; Horwitz, 30). This would have the advantage of precluding a client who has lost or mislaid his copy of the engagement letter from testifying he never received one. Upon recalling the courts' overwhelming acceptance of the clients' testimony in the 1136 Tenants case and the Ryan V. Kanne case, it would not be too earth shattering to learn in the future that the courts will not accept the CPA's unsigned copy of the engagement letter. Is this any better than an oral agreement?

Upon obtaining a legal viewpoint of this matter it is learned that the client's signature is one of the more important aspects of the engagement letter (Davis, 24:56). The influence of the signed agreement upon the courts is adequately demonstrated in the case of Stephens Industries v. Haskins and Sells (79) where the courts overwhelmingly accepted the signed agreement over the plaintiff's testimony.

Another recommended inclusion is a statement suggesting the client not refer to the CPA's services in his records as an audit (Guy, 27:556). This is a direct result of the 1136 Tenants case, and it may be deemed by some as an unnecessary procedure. However, it should be noted that the 1136 Tenants case and the facts surrounding it are not all that well known by many members of the accounting profession, and are probably unknown to most non-accountants. This is based upon the results of a survey of engagement letters conducted in 1972 which indicated only forty percent of the sampled accounting firms were familiar with the 1136 Tenants case (Guy, 35:48). Even more informative was the number of firms, particularly small firms, which were unaware of the case and did not employ engagement letters. This is alarming for the survey's findings indicate the smaller firms are the ones usually associated with unaudited financial statements. Of the responding firms only eleven percent utilized an engagement letter all the time. Forty-eight percent responded that they never employed engagement letters. A definite correlation between the firms' familiarity to the case with the utilization of engagement letters was found. However, more significant was the finding that fifty-two percent of the firms very familiar with the case utilized engagement letters only part of the time. It was reasoned by such firms that older clients would be offended. Most of these firms did issue engagement letters for new clients (Guy, 35). In response to this line of thinking, an alternative has been suggested which recommends that the essential elements of the engagement letter be incorporated with the representation letter at the close of the engagement (Fritzemeyer, 32). The signed



representation letter would provide the CPA with better evidential matter of the intent of the engagement than an unsigned copy of an engagement letter. A disadvantage of this procedure, is its failure to have the intent and purpose of the engagement in writing prior to the conclusion of the CPA's services.

Possibly the firms which are hesitant to issue engagement letters will alter their policies with the issuance of the Guide which recommends employing engagement letters. This, however, could be an erroneous assumption. To elaborate, SAP No. 38 requires a CPA to issue a disclaimer whenever he is associated with unaudited financial statements. In the statement, which recommends each page of the statements be marked unaudited, are illustrations of recommended disclaimers for various situations. A survey of audit reports conducted three years after SAP No. 38 was issued found accountants were not following the profession's recommendations in that "...synonyms and euphemisms are sought and used instead of a direct declaration that they have not audited the financial statements presented; they are reluctant to note the statements as prepared without audit when in fact this is so and their ethical code as auditors requires it; and even on occasion they resort to assuring the reader that nothing came to their attention which would raise doubts as to the validity of the statements they have not examined (Smith, 44:51)." These findings indicate that accountants will comply with requirements but tend to deviate from recommendations of the profession, particularly in the area of unaudited statements.

#### Public Companies v. Small Businesses

The results of these surveys are alarming. Even more astonishing

is the fact that the engagement letter survey, (Guy, 28) which indicated that a majority of the responding firms, particularly the smaller firms, were not familiar with the 1136 Tenants case, was published in the same issue of The Journal of Accountancy where the Task Force's Interim Report stated the 1136 Tenants case had been adequately publicized (6). Two viewpoints may be inferred from this conclusion of the task force. One possibility is that maybe Mohen was not such a lunatic when he implied accountants fail to learn from their fellow practitioners' experiences<sup>1</sup>; or maybe the case was not sufficiently publicized (i.e. the smaller CPA firms were not properly informed). Upon referring to the bibliography of this thesis, it is noted that only a small percentage of the sources referring to the 1136 Tenants case were published prior to December 1972. This leads one to question the attitude of the task force towards smaller CPA firms and their small business clients.

In this area of questioning the profession's disregard for the needs of small businesses, Betty T. McGill has been very verbal about her opinion that the AICPA is so preoccupied with public trading companies' requirements that it imposes restrictions which are irrelevant or burdensome to the smaller privately held businesses. She feels the profession is ignoring the requirements of small businesses (i.e. total assets under \$500,000) which constitute approximately ninety percent of the companies filing income tax returns in 1968 (33:81). Specifically she states:

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<sup>1</sup>For a full discussion of this matter see pp. 2-3.

This fetish of trying to equate financial reporting of listed corporation with unaudited financial situations of unlisted corporations and unincorporated businesses is having the effect of placing dissenting AICPA members on a collision course with the APB [The Accounting Principles Board (APB) has since been replaced by the Financial Accounting Standards Board (FASB).] (33:81-82).

This view is substantiated by discussing the AICPA's recommendation that CPA's avoid referring to their association as a preparation of the statements. It is asked:

Have you ever tried to convince a client that you did not prepare his statements when, in the full service accounting program you are providing the client you have maintained the books of account and prepared the statements (McGill, 33:82)?

In reference to the communication (responsibility) gap between the profession and the public,<sup>1</sup> it is felt that the profession is propagating the gap by requiring the same standards for public traded companies and small businesses. The topic of internally restricted unaudited reports is a suitable example of the gap for as Ms. McGill states:

Clients do not always fully understand the limitations attached to them even though it's thoroughly explained to them.... A more humorous aspect is encountered when the client asks if he's supposed to swallow his "internal use only" statement with water or chew it (33:82).

She also lashes out at the section of SAP No. 38 pertaining to the unaudited financial statements' conformity to GAAP. It is suggested that no mention of GAAP be made for it could "...cause the reader ...to place undue reliance upon them." In addition, she asserts the AICPA is "straightjacketing professionals in matters of irrelevancy ... (33:82-83)."

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<sup>1</sup>For a full discussion of this matter see Wallace E. Olson, "A Look at the Responsibility Gap," The Journal of Accountancy, 139 (Jan. 1975), pp. 52-57.

It is recommended by Arnstein (33) that the profession's reporting requirements make allowances for these small businesses and requirements be established which are practical. He recommends that the existing pronouncements be modified to reflect these exemptions, and future pronouncements be written to include these exemptions. It is even suggested that CPAs wishing to practice under the SEC's requirements be issued a license by that governmental agency (McGill, 32). Since the smaller businesses need reports they can understand, such a licensing practice would permit "...SEC-FASB [to] reserve their complicated gobbledygook for the financial analysts and stockholders of public companies, bless their souls (McGill, 32:88)."

Other members of the profession argue that all businesses, public or not, are interacting elements of the same environment and their reporting techniques should be aligned on the same stratum. This is felt necessary since many times large public firms and creditors request financial statements from the smaller nonpublic businesses (Naus, 34). Ms. McGill and Mr. Arnstein respond to such arguments by counterattacking that the best way to communicate on this basis is through the media of audited financial statements (Naus, 34).

#### GAAP - Technical versus Moral

Others agree with Ms. McGill's and Mr. Arnstein's opinions that the profession's GAAP need revising and criticize the profession for reacting to these complaints by issuing "cookbook" standards (Tietjen, 49:71). It is generally recognized by the critics that some form of guidance is essential, but they feel the members of the profession should be permitted to display their judgment. They argue that it is

not a problem of too many alternatives but one of failing to see "the forest for the trees," i.e. failing to remember the profession's prime objective is the determination of the fairness of the financial statements' overall presentation. It is felt this objective can be more effectively achieved upon closely examining the "...moral and ethical aspects of financial reporting, ... for if management or independent accountant or both deviate from the broad objective, the quality of reporting suffers (Tietjen, 49:71)." The recommended solution is to raise the level of standards to that of quality instead of "nit picking" practices.

### Checklists

The Guide recognizes and emphasises this importance of employing professional judgment when a CPA determines what review procedures should be employed when performing accounting services. Determination of such procedures was one of the main considerations of the task force and has been widely dealt with by various members of the profession. These review procedures are usually compiled into schedules entitled "checklists," which the Guide recommends be included in the accountant's workpapers for they substantiate that the CPA employed due professional care and skill. Again, it should be emphasized that the implementation of these procedures does not indicate that an audit has been performed;<sup>1</sup> that is provided only if an audit was the client's intent or the CPA determines through the course of his engagement that an audit is in order. In this case, the CPA would need the client's permission

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<sup>1</sup>For a full discussion of this matter see pp. 34-35.

prior to conducting an audit and the engagement letter should be altered (AICPA, 5:506).

In addition to the procedures illustrated in the Guide (see Appendix B), Charles Chazen, a member of the Task Force on Unaudited Financial Statements, and Kenneth Solomon recommend the accountant:

1. Review a draft of the financial statements with the chief executive or chief accountant officer.
2. Inquire whether any subsequent transactions or events have occurred which must be reflected in the financial statements or accompanying notes (Chazen, 22:31).

This latter procedure could include a review of the client's bank accounts and cash accounts for unique transactions (Guy, 27:558).

Although the Guide illustrated examples of situations which a CPA should be cognizant of in his process of inquiry and a checklist of procedures which could be employed if the accountant's inquiries and/or observations are unsatisfactorily answered, it does not mention a significant procedure. That is observing the client's internal controls (see e.g., Guy 27; Saxe, 42), primarily the accounting controls which would provide the CPA with a basis for enlightening himself on the unaudited statements' conformity with GAAP. This procedure is a GAAS and is described in SAS No. 1 as follows:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted (1:13).

Possibly the Guide intended the inquiry and observation process to include a brief review of internal control systems, but as has been demonstrated, recommended or inferred procedures are frequently ignored

by members of the profession.<sup>1</sup> A casual study would also provide a basis for determining what other review procedures should be employed. True, the Guide wisely left this decision up to the CPA's judgment who is to be cognizant of his professional standards, but this vital and significant procedure warrants attention and should have been emphasized.

Another procedure which the Guide omitted is the review of the client's minutes; it did include some inquiries pertaining to the equity accounts which could be ascertained from the minutes but could also be obtained by questioning the client in the inquiry process. When a CPA is performing accounting services, especially if he is fulfilling the dual role of internal accountant and external independent accountant, he needs to peruse certain items which he would expect a client's chief accountant and controller to be familiar with, such as, "...the minutes of board meetings, articles of incorporation and other pertinent documents (Terrell, 48:56)."

Other procedures deemed worthy of attention but omitted from the Guide's illustration are the optional procedures of checking mathematical accuracies; scanning accounts for unusual transactions, computing various ratios for comparison with the previous year's annual or interim financial statements; reviewing the client's aged schedule of receivables and discussing their collectibility with the client (see e.g. Guy, 27:558; Saxe, 42:461; Terrell, 48:55). Finally all CPAs are urged by their fellow practitioners "to carry plenty of liability insurance (50:25)."

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<sup>1</sup>For a full discussion of the matter see p. 58.

### Disclaimer

The Guide includes a lengthy distinction between an audit disclaimer of opinion and an accounting service disclaimer. This was due, at least in part, to the number of letters sent to the Institute indicating many practitioners are using the disclaimer of accounting services for limited scope audit engagements (Carmichael, 20:74). There has also been criticism directed at their similarity, and some members feel the requirement that a disclaimer be issued for all accounting services should be dropped for it causes the reader to place undue reliance upon them. It is felt that unaudited statements "...would be more beneficial to all concerned if the emphasis in ... [accountants'] reports was placed on what ... [they] did rather than what ... [they] did not do (Brown, 17:35-36)." This theory of including employed procedures has been rejected by the task force when preparing engagement letters for it believes the mention of any procedures employed would confuse the readers and cause them to surmise that an audit was conducted (AICPA, 5:13). Expanding this reasoning to encompass disclaimers, it may be surmised that this technique would make it very difficult for an accountant of one particular accounting service engagement to defend why he did not use the same procedures employed by another accountant in a dissimilar situation. It is foreseeable that users of the unaudited statements lacking the professional expertise of an accountant could attempt legal action if he felt the accountant's review procedures were inadequate. In the past, lawsuits were usually based upon negligence after a business failed (Olson, 40:52). Including a description of procedures in the disclaimer might provide a



premise for the expansion of legal actions if the reader of a flourishing business's statements felt the accountant's procedures were inadequate. Such a formidable prediction could result in accountants perpetually facing lawsuits.

Instead of issuing a disclaimer it has been suggested that the profession "...explore defining various types of reviews designed to provide levels of assurance that fall short of that intended by opinion audits. This would require the development of sets of review procedures and new forms of reports to fit individual types of engagements (Olson, 40:57)." This is not to be confused with negative assurances which are permitted in letters for underwriters and are limited to a statement "that nothing came to their [accountants] attention as a result of specified procedures that caused them to believe that specified matters do not meet a specified standard ... (AICPA, 1:139)." Instead, this would consist of a total revamping of the standards for association with unaudited statements. Such a scheme would require reeducating the members of the profession and educating the courts and the public. This would be a difficult task for the profession has been unsuccessful in its attempts to educate the courts about its current standards for unaudited statements, as can be substantiated by the SEC v. National Student Marketing Corp. case. In December 1974, this case was decided by a trial jury which found two CPA's "...guilty of having made false and misleading statements in a proxy statement ... (39:69)." The decision has been appealed to the Court of Appeals, and the AICPA has submitted a brief as amicus curiae. This case and the AICPA's brief are significant to the area of unaudited financial statements for the

conviction was based on the falseness of two types of statements, one audited and the other unaudited. Unlike the briefs in the 1136 Tenants case,<sup>1</sup> this brief does not attempt to prove the innocence of the National Student Marketing defendants. Its main objective is to clarify the judge's instructions to the jury which did not make a distinction between the accountants' responsibilities when preparing audited statements and unaudited statements. The AICPA states in its brief that "a decision in this case eliminating the distinction between the responsibility of independent accountants with respect to audited and unaudited financial statements would have a significant adverse impact upon such accountants, their clients, and the investing public (39:69)." The trial judge's failure to distinguish between the two types of engagements exemplifies how unsuccessful the profession has been in educating the courts in this area.

Another important feature of this case is the SEC's implication that accountants are responsible for informing the general public and the SEC of information pertaining to unaudited financial statements learned subsequent to their preparation (Causey, 9:88). In the case of Fischer v. Kletz<sup>2</sup>, the courts determined an auditor was not liable for failing to inform the stockholders and SEC of subsequently learned facts affecting the unaudited interim statements' fairness. However, the SEC is still demanding that accountants assume this responsibility but realizes accountants are hesitant for fear of added liabilities (see e.g. Garrett, 37; Burton, 38). In response to this fear factor

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<sup>1</sup>For a full discussion of this matter see pp. 47-49.

<sup>2</sup>For a full discussion of this matter see pp. 29-30.

Chairman Garrett states it "...will erode the value of the professional practice (37:16)." This attitude is also held by John C. Burton, chief accountant of the SEC, who feels "the fear of legal liability, ...poses the greatest threat to CPAs ...(38:10)."

## Chapter 5

### SUMMARY

Upon referring to the SEC v. National Student Marketing and the 1136 Tenants cases, one wonders how accountants can overcome their fear of legal liability as Garrett and Burton suggest. This is particularly true after following the historical development of the accounting profession which has been greatly influenced by liability suits. These suits arose as society began to make greater demands upon the profession. In ancient times these demands were expressed to the rulers. However, in more recent times these demands have been voiced through the courts.

When businesses began to flourish during the 1700's, little concern developed from the general public who was indirectly affected by the benefits of these businesses' success. It was during the 1800's that businesses began to grow into multiple-ownership corporations, and the public's attitude changed. At this time, struggling businesses faced periods of depression which resulted in losses for the investing public. The British government became concerned and made provisions to protect the public. These statutes included a review process which was to be conducted by auditors who were, at that time, primarily concerned with verifying every entry on the client's records. These "bookkeeper" audits were also utilized by the early American auditors who eventually realized they were too time consuming and too costly. The sampling technique was thus developed and resulted in a need for stronger internal controls. It also made the accounting profession aware that it could no longer be primarily concerned with the detection of fraud.

Another result of the utilization of the sampling technique was the increase in liability suits. Auditors could no longer verify every detail and occasionally would not detect irregularities in their clients' records. The resulting lawsuits usually were based upon the contention the auditors has been negligent in failing to utilize procedures which would have uncovered the errors or defalcations.

Upon referring to British precedent, it is noted that auditors were not held liable on such a contention. Instead, it was determined that only those in privity of contract could sue an auditor for negligence or breach of contract and only if the auditor failed to inform them of errors or fraud he found.

The case of Derry v. Peek, which determined one must knowingly or carelessly make a false statement before negligence could be proven, played a significant role in the American courts. However, as one traces the court decisions in America, it is observed that the liability suits against auditors began to change their character and picked up speed after the Ultramares case determined auditors could be liable to proximate third parties for deceit. The speed of these cases broke into a galloping pace during the sixties. This "neck breaking" speed has been attributed to the consumers' revolution which is demanding businesses assume a greater responsibility towards the public. Subsequently businesses who are "under fire" seek out the accountant for a scapegoat.

One wonders where the accountant is to turn. He inevitably must turn to his profession for guidance since it has been legally recognized as his guiding force (see e.g. 63,75). However, the trial court

of the 1136 Tenants case determined this resource was no longer the ultimate authority. Alarmed by this dictum, the profession's "guiding light" made several unsuccessful attempts to persuade the courts to reserve this formidable decision.

As a result, numerous pleas of help were directed to the AICPA for CPAs were "damned" if they did prepare unaudited statements and "damned" if they did not (McGill, 33:83). In response to its members' dilemma, the AICPA assigned a task force with the duty of reviewing its newly developed standards in light of the 1136 Tenants case.

As a matter of coincidence, the AICPA was in the stages of revamping its old standards in this area at the same time Rothenberg was inserting the scalpel into his patient. It was not until he had completed the operation and had stitched the incision that the profession's new operating standards were published - SAP No. 38. The task force determined if the surgeon would have had access to the new standards, his operation would have been successful and determined SAP No. 38 was adequate if followed to the letter.

The task force did realize that additional guidance was needed in some areas and issued its Guide which in essence prescribed "...sticking Band-Aids on the chest of a man with lung cancer (Tietjen, 49:72)." It consists of a reiteration of the rudimentary procedures previously deduced as necessary by various members of the profession and has omitted items which could prove to be necessary procedures. It contains numerous recommendations but by its very nature cannot make requirements. This was needed, for a survey on audit reports indicated

accountants will normally abide by the profession's requirements but have a tendency to deviate from recommendations.<sup>1</sup>

Upon contemplating the profession's hesitancy to revise SAP No. 38 and to require the procedures recommended in the Guide, one wonders if CPAs should discontinue providing accounting services in order to reduce their exposure to liabilities. Obviously the courts are not going to distinguish between accounting and auditing services as evidenced in the SEC v. National Student Marketing case.<sup>2</sup> The time has therefore arrived for the profession to "wake-up" and reevaluate its standards of association with unaudited statements. It needs to "...flex its muscles and imagination in order to deal with today's technological revolution (Earle, 25:229)." The profession therefore has the choice of:

1. Eliminating accounting services and incurring the demise of the quality of unaudited statements;
2. Closing the communication's gap between the profession and the public;
3. Developing various types of accounting services and providing differing levels of assurance;
4. Remaining stagnate and in court.

The first alternative has the disadvantage of crunching many of the smaller CPA firms who heavily rely upon the business acquired through their accounting services. Another disadvantage, which was discussed in the AICPA-NYSSCPA briefs of the 1136 Tenants case (7,8),

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<sup>1</sup>For a full discussion of this matter see p. 58.

<sup>2</sup>For a full discussion of this matter see "Official Releases: AICPA Brief in Naletli-Scansaroli," *Journal of Accountancy*, 139 (May 1975), pp. 69-76.

is the continued demand for unaudited financial statements whether or not CPAs are associated with them. Consequently businesses will engage other less qualified people to perform these services.

It may be argued that the elimination of some types of the CPA's services would be beneficial, particularly in small firms where every member is expected to perform in numerous capacities, such as, auditing, accounting, tax and management advisory services. The reasoning for this idea rests upon the theory that a CPA cannot keep current in all areas of his profession and should discontinue those in which he is not a specialist.

The AICPA recognizes a CPA cannot be a specialist in all areas and appointed a committee to review the scope and structure of the profession's services. In January 1975, this committee issued a discussion draft (AICPA,4) which does not hold with the idea of restricting the types of services provided by the profession. It does recommend establishing a program under which CPAs could qualify as specialists in various areas. Since the committee's final draft has not been issued, the acceptance of these recommendations is unknown. It may be projected if specialization is accepted, the CPAs qualifying in the area of unaudited financial statements will be more inclined to observe closely both the requirements and recommendations of the profession for association with such statements. It is also hypothesized that they will be highly cognizant of their legal liabilities and court decisions pertaining to this subject and will thus be better prepared to avoid future litigations.

The second alternative recommending closing the communication gap



is also currently being reviewed by the AICPA. A study group has been assigned the duty of determining the nature of the gap between what auditors think their responsibilities are and what the courts think they should be (Olson, 40:53). The findings of this group will hopefully encourage the profession to take definitive steps toward closing the gap. If so, it is possible that the CPA's association with unaudited statements will not be so risky.

Wallace E. Olson (40), author of the third alternative, feels the second alternative of closing the communication's gap could be achieved by establishing various types of services which would fall short of an audit. Differing levels of assurance developed by the profession would be issued with various reviews. Although this theory's advantages and disadvantages have been previously discussed,<sup>1</sup> it is worthy to note that such a scheme would provide a CPA with a greater level of confidence in the unaudited statements' fairness and would provide a strong defense in a lawsuit of negligence. If the profession provides its clients with a "shopping list" of services and requires the client to verify his selected purchase with a signature, the courts would not find it difficult to determine the client was well aware of what he had purchased. Delineating these reviews and applicable procedures for each will pose problems for the profession, but they are not insurmountable.

In conclusion, the profession can continue upholding its current standards; it can continue writing briefs to the courts explaining and justifying its members' actions; it can continue to ignore the demands

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<sup>1</sup>For a full discussion of this matter see pp. 66-67.

of society to mature into a more responsive institution; and it can continue watching its members struggle through one court case after another. It also has the alternative of facing up to the new demands placed upon it by consumers and consider one or more of the preceding alternatives. Only time will tell which path the accounting profession should pursue, but now is the time for it to become aware of the choices it has and to examine them closely. Upon doing so the profession will be better equipped to flow with the sway of the courts. The appointment of certain committees, such as the Committee on Scope and Structure and the Responsibility Gap Study Group, demonstrates that the profession is becoming aware of the need to re-examine its standards and is constructively attempting to answer some of the problems which have appeared in the recent consumers' revolution. Hopefully, the findings of the studies will assist the profession in determining the future of accounting services and aid in alleviating the CPA's legal liabilities when associated with them.

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## SOURCES CONSULTED

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## APPENDIXES

## APPENDIX A

### Sample Engagement Letter

This letter is to confirm our understanding of the terms of our engagement and the nature and extent of the accounting services we will provide.

Our services will not constitute an audit of the financial statements of ABC Company; consequently we will not be in a position to express an opinion on the financial statements and will issue a disclaimer of opinion with respect to them. Our disclaimer will disclose any departures from generally accepted accounting principles of which we become aware.

We will perform the following services:

1. We will prepare without audit a balance sheet for ABC Company as at December 31, 19xx, and related statements of income, retained earnings, and changes in financial position for the year then ended. These statements will be prepared from the general ledger and other information you furnish us. Before issuance, the statements will be subject to your acceptance and approval inasmuch as financial statements are the representations and the primary responsibility of company management.
2. We will discuss with the officers and directors of the company such suggestions and recommendations concerning the accounting methods and financial affairs of the company that may occur to us in the course of our work.
3. We will prepare the federal and (name of state) income tax returns of ABC Company for the year 19xx, and we will advise you on income tax matters upon which you specifically request our advice.

Our engagement will not be designed, and cannot be relied upon, to disclose fraud, defalcations, or other irregularities. However, we will inform you of any matters that come to our attention which cause us to believe that such a condition exists.

Our fees for these services will be computed at our standard rates and will be billed monthly as the work progresses. Bills for services will be due when rendered.

We shall be pleased to discuss this letter with you at any time and to explain the reasons for any items.

If the foregoing is in accordance with your understanding, will you please sign the copy of this letter in the space provided and return it to us (AICPA, 5:13-14).

## APPENDIX B

### Example Checklist

#### General

1. Is trial balance supported by general ledger account balances?
2. Have subsidiary ledgers been reconciled with general ledger control accounts?
3. Have accounting principles been applied consistently?

#### Cash

Have bank reconciliations been prepared?

#### Receivables

1. Has allowance been provided for doubtful accounts?
2. Are receivables from employees, shareholders, affiliated organizations, etc., separately disclosed?
3. Have receivables been discounted, pledged, or factored?

#### Inventory

1. What is the method of determining inventory quantities?
2. What is the basis for pricing inventory?
3. Is there any -
  - a. Obsolescence problem?
  - b. Unrecorded inventory (located at client's premises or elsewhere)?
  - c. Inventory owned by others (consigned, bill-and-hold, etc.)?
  - d. Inventory encumbrance?

#### Property, Plant, and Equipment

1. How stated, cost or other?
2. What depreciation method is used; is it consistent; what is the amount of depreciation expense for the period?
3. Are there unrecorded additions, retirements, abandonments, sales, or trade-ins?
4. Is property mortgaged or otherwise encumbered?
5. What is the policy of capitalizing or expensing repairs and betterments?

#### Other Assets

1. What is the basis for stating prepayments, deferred charges, investments, etc.?
2. What amortization methods are used?
3. Are assets pledged?

## APPENDIX B (Cont.)

### Liabilities

1. Are there unrecorded payables?
2. Are assets pledged as collateral?
3. Are payables to employees, shareholders, affiliated companies, etc. classified separately?
4. Have accruals been recorded?
5. Are there contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, unsettled claims, and taxes in dispute?
6. Have income tax accruals been made?
7. Is debt properly classified as to current portion and long-term portion?
8. What are long-term liability maturities, interest rates, collateral, conversion rates, restrictions; were there defaults with respect to any covenant?
9. Are there contractual obligations for construction or purchase of real property, equipment, etc., commitments to purchase or sell company securities, options, lease commitments, etc.?

### Equity Accounts

1. Were there changes in equity accounts?
2. Are there matters that require disclosure (descriptions and details of capital stock, stock options, warrants, dividend restriction, etc.)?

### Income and Expenses

1. Were cutoffs of sales and purchases, etc., made?
2. Were there abnormal variations between periods in income and expense accounts?
3. What is the method of recognizing income and the proper matching of costs and revenues?

At the completion of the engagement, some CPAs obtain from the client a letter acknowledging that the client accepts responsibility for the financial statements.

Disclosure Checklist. In addition to an inquiry checklist, some practitioners use a "financial statement presentation checklist" for disclosures required by generally accepted accounting principles (AICPA, 5:19-21).