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THEORY AND PRACTICE

Current Studies and Concepts

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ACCOUNTANTS' LEGAL LIABILITY

A few months ago, The American Institute of Certified Public Accountants conducted a seminar on accountants' legal liability in New York City. Leonard Savoie, Executive Vice President of AICPA, chaired the session. One of the principal speakers was David B. Isbell, a partner in the law firm of Covington & Burling, legal counsel to the AICPA.

Much of Mr. Isbell's talk was devoted to establishing an understanding of the historic Continental Vending criminal case, a subject in which many of this magazine's readers are undoubtedly interested.

Background

Continental Vending Machine Corp. manufactured automatic vending machines of various types and operated vending machines in plant cafeterias and other locations throughout the country. It became a client of Lybrand, Ross Bros. & Montgomery in the early 1950s.

Valley Commercial Corporation was a finance company formed by the president of Continental, Harold Roth, and certain other shareholders of Continental for the purpose of financing the sale of machines produced by Continental and for other factoring and financing business. Valley's accounts were examined by a small New York firm of certified public accountants.

The actions brought against Lybrand and its personnel relate to Continental's financial statements for the year ended September 30, 1962. The important problem in certifying the accounts was the collectibility of a \$3.5 million receivable from Valley for monies loaned by Continental to Valley. Lybrand was informed late in the Continental audit that Valley's audited financial statements would not be available, that Valley was unable to pay the amount due to Continental and that Roth would collateralize the debt. When Roth submitted evidence of furnishing of collateral (stocks and bonds including significant holdings of securities in Continental) against the receivable in mid-February 1963, the accounts were released and mailed to shareholders.

By the end of February when an extension for filing the Company's Form 10K expired, the value of the collateral had decreased considerably. Also the Internal Revenue Service had taken steps to obtain a lien on Continental's assets. Accordingly, Lybrand took the position that it could not sign its report in the Company's Form 10K.

In mid-March 1963, the SEC halted trading in Continental's securities. Announcements in the press revealed that Continental had loaned \$3.5 million to Valley which in turn had loaned similar amounts to Roth, and that Roth was unable to repay his borrowings which precluded Valley from repaying Continental.

In April 1963, based on the SEC's contention that Continental's funds had been misappropriated, a conservator was appointed to conduct the affairs of the company

A court-ordered reexamination of Continental's accounts, performed by Main LaFrentz & Company, led to special write-offs of \$12,275,000 (including the Valley loan), thereby increasing the company's fiscal 1962 loss to \$13,425,000 and eliminating the shareholders' equity in the company. The adjusted financial statements were reported in Continental's form 10K. On July 15, the company was placed into reorganization under Chapter 10 of the Federal Bankruptcy Act.

In July 1965 the court-appointed trustee for the bankrupt company filed a civil suit against Roth, Lybrand and Meadow Brook National Bank (one of the banks that had provided Continental with temporary funds in September 1962), charging embezzlement and claiming damages of \$41,000,000. The suit charged the defendants with a "scheme to defraud" and with "concealment and misrepresentations" in the company's reports from 1958 to 1962.

This suit, as it related to Lybrand, was settled in October 1967 by Lybrand's payment of \$1,950,000 and release of \$140,000 of claims against Continental. Lybrand consistently denied the allegations under this action and said it agreed to the settlement solely to avoid the expense of protracted litigation. (About a year earlier, Meadow Brook had settled the claim against it by payment of \$150,000 and forgive-

ness of \$1,843,739 owed to the bank by Continental.)

The Criminal Case

The indictment

In October 1966, Carl Simon and Robert Kaiser, partners in Lybrand, and Melvin Fishman, a manager with the firm and Roth were indicted on charges of conspiracy to defraud stockholders and creditors. The Lybrand firm was mentioned as a co-conspirator but not a defendant. Charges under the indictment were as follows:

1. The defendants and their co-conspirators conspired (with each other and the co-conspirators) to commit offenses against the United States and, in matters (annual report to shareholders and Form 10K) within the jurisdiction of an agency of the United States (SEC), conspired to make false and fraudulent statements and to conceal material facts. Further, for the purposes of executing the scheme and artifice, the parties caused matter to be delivered to the Post Office Department to be deposited in post offices.

2. The defendants and their co-conspirators devised a scheme to defraud Continental's stockholders, debenture holders and creditors (including those prospective) and the financial community. As a part of this scheme Lybrand would report on Continental's financial condition shown by its balance sheet which was false and misleading.

3. The defendants, for the purpose of executing the scheme to defraud, did willfully and knowingly place annual reports to stockholders in the Post Office to be mailed to various named individuals and brokerage firms.

Certain of the charges concerning the use of the Post Office Department to mail copies of the annual reports and certain details of the other charges were subsequently withdrawn.

Accounting and reporting considerations

The central issues in the case related to the disclosures made in Note 2 to the 1962 financial statements, which reads as follows:

"The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable."

Points relating to Note 2, emphasized by the prosecution throughout the proceedings in-

cluded (1) the error in referring to a netting of the affiliated receivables (\$3.5 million) and payables (\$1.2 million) when the affiliate had discounted the payable (its receivable from Continental) and the receivables and payables were shown gross on the balance sheet, (2) the inadequacy of the value of the collateral (\$2.9 million) in relation to the receivables from Valley, (3) the lack of marketability of the collateral due to the need for a registration statement to sell much of it, (4) the failure to disclose that the collateral included a substantial amount of Continental's stocks and bonds and (5) the failure to disclose that the monies loaned to Valley had flowed to Roth.

The prosecution contended that Lybrand should have examined the books of Valley, a procedure which would have revealed the disposition of the funds.

Outcome

The first trial of the Lybrand people resulted in a hung jury. Their second jury trial resulted in conviction. At the time this material is being written, appeals are pending. Roth pleaded guilty to the conspiracy charge prior to the accountants' first trial and testified for the government at both trials.

Observations of Mr. Isbell and lessons that he believed the case taught were as follows:

1. The case points out the exposure of accountants to criminal sanctions for conduct not governed by specific, well-recognized professional requirements. (Requirements that the reporting accountants examine the books of an affiliate and that the nature of collateral be disclosed in the notes to the financial statements do not exist).
2. Juries, which either party in a suit can demand, may not be able to comprehend technical matters such as were presented in this case, and may suffer from the prohibition against notes, questions and discussion among themselves as the case progresses.
3. A conspiracy charge need not be supported by evidence that someone was injured or that the objective of the conspiracy was accomplished. Evidence that a scheme existed and that there had been overt action to effect the scheme is the only support that is needed. A civil action based on the facts presented in the Continental case probably would not have succeeded.
4. The hazards of inconsistencies in testimony in successive legal proceedings (the Lybrand people had testified in many legal proceedings prior to their indictments) can be reduced by taking maximum precautions to testify correctly and by admitting to a lack

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cated. Subsequent deficiencies due to a Federal examination came within the purview of the contested liability rule and as such, were deductible in the year paid.

The position presently being taken, based on cases quoted in the ruling, denies the "contest" theory unless there is an overt act involved, such as the lodging of a protest or the institution of Court proceedings. State tax deficiencies arising as the result of a Federal audit will now be treated as relating back to the year for which they were imposed.

In all future examinations by the Treasury Department the agent will have to compute and allow as a deduction the State tax deficiencies predicated on his other adjustments to taxable income. While this presents no great problem, to the extent that there are additional State taxes included in the year under review relating back to years beginning January 1, 1965 through the year immediately preceding the year being examined, such deductions presumably will have to be eliminated and claims for refund filed for the proper year.

This necessitates an analysis of the tax expense account of any returns of accrual basis taxpayers that have not as yet been examined by the Treasury Department. If the amount involved is of sufficient materiality to warrant further action, the filing of protective claims for prior years is indicated.

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- of knowledge whenever this is the case.
- Working papers should always be left in order with the answers to all questions and doubts clearly documented and all extraneous material eliminated. A careful post-audit review should aid in achieving these ends. Auditors have a current responsibility for information contained in prior years' working papers to the extent pertinent to the current examination.
 - Unsavoury clients can be a problem to an accountant.
 - If the appeals in the Continental case are unsuccessful, the AICPA may have to establish guidelines in matters such as indirect loans to officers and the use of a company's stock as collateral for recorded assets.
 - See your legal counsel early and often. Never testify in court or in pre-trial proceedings without your attorney and a witness being present.

"INFORMATION SYSTEMS FOR MANAGEMENT PLANNING AND CONTROL," Thomas R. Prince, Richard D. Irwin, Inc., Homewood, Illinois, 1966, 408 pages, approximately \$11.50.

Ever since the computer revolution, the accounting literature has discussed the future role of the accountant as an expanded one, with the accountant responsible for a total information system rather than just an accounting system. Or, as Thomas R. Prince states, the transition is from "a traditional *accounting system* to an *economic activity system* which encompasses all types of economic data."

INFORMATION SYSTEMS FOR MANAGEMENT PLANNING AND CONTROL will provide the accountant with an understanding of a total information system and will do so on a broad, conceptual basis without burdening the reader with all the minute, technical details accompanying mathematical formulas and computer programs. It is both easy to read and to understand.

Written by an accountant, its approach is to start with a discussion of traditional information systems—responsibility accounting systems and profitability accounting systems. The book next treats information systems for production, inventory management, inventory control, marketing management, sales analysis, and credit control. From there, the reader is introduced to total information systems and simulation. Problems of internal control and external audit of these advanced information systems are also discussed.

To fully appreciate the book, a reader should have a background in cost accounting (including standard costing), budgeting, and business organization. The book is not intended to make him technically competent to write a computer program for a simulation of his firm. It does provide a good basic background and understanding of a total information system and equips the reader with a more knowledgeable appreciation for the accountant's future role.

The author is honest and practical in his approach. He cites examples of firms whose computerized information systems were anything but successful and tells why. Cases are provided at the end of each chapter so that the reader can apply the theoretical discussion in the chapter to a practical situation.

For the accountant interested in his future, this book is definitely worthwhile.

Dr. Bernadine Meyer
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