University of North Dakota

UND Scholarly Commons

Theses and Dissertations

Theses, Dissertations, and Senior Projects

7-1973

Recent Liability Case -- Implications for Accountants

Rona J. Sessions

How does access to this work benefit you? Let us know!

Follow this and additional works at: https://commons.und.edu/theses

Recommended Citation

Sessions, Rona J., "Recent Liability Case -- Implications for Accountants" (1973). *Theses and Dissertations*. 5399.
https://commons.und.edu/theses/5399

This Independent Study is brought to you for free and open access by the Theses, Dissertations, and Senior Projects at UND Scholarly Commons. It has been accepted for inclusion in Theses and Dissertations by an authorized administrator of UND Scholarly Commons. For more information, please contact und.commons@library.und.edu.

University of North Dakota Libraries

RECENT LIABILITY CASES--IMPLICATIONS FOR ACCOUNTANTS

By

Rona J. Sessions

Bachelor of Science, University of North Dakota 1972

ARCHIVAL COPY

An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the degree of

Master of Science

Grand Forks, North Dakota

July

1973

TABLE OF CONTENTS

Chapter

I. INTRODUCTION 1

II. THE CONTINENTAL VENDING CASE 7

III. THE RHODE ISLAND HOSPITAL TRUST CASE 12

IV. THE 1136 TENANTS' CORPORATION CASE 19

V. OTHER RECENT COURT CASES 27

VI. SUMMARY 49

BIBLIOGRAPHY 53

TABLE OF CONTENTS

Chapter

I. INTRODUCTION 1

II. THE CONTINENTAL VENDING CASE 7

III. THE RHODE ISLAND HOSPITAL TRUST CASE 12

IV. THE 1136 TENANTS' CORPORATION CASE 19

V. OTHER RECENT COURT CASES 27

VI. SUMMARY 49

BIBLIOGRAPHY 53

I. INTRODUCTION

An accountant's responsibility arises in every situation in which he enters into a contractual obligation to perform an audit. This obligation, based on what is known as privity of contract, exists between the accountant and his client. He undertakes to perform, in an acceptable professional manner, the audit of the clients books. This is a private agreement between the client and the accountant and questions of liability are, as a rule, confined to performance of the agreement between the two principal parties. Yet, it must be recognized that the accountant is holding himself out to the public as an expert, a qualified professional, and his certification attached to the statement of the client lends weight and credence which the general public is entitled to rely upon.

The problem of legal responsibility is, therefore, expanded beyond the question of privity of contract and confers right on third parties as well. Creditors are generally considered as third parties.

The Federal Securities Act of 1933 provides for civil liability of independent accountants in connection with a false registration statement. If any part of the registration statement, when such part becomes effective, contains an untrue statement of a material fact or omits a material fact that is required to be stated therein or necessary to make the statements not misleading, any person acquiring such

security may sue. Suit can be maintained against any person who (1) signed the registration statement, (2) was director or partner at the time of filing, (3) was named in the registration statement as about to become director or partner, (4) was an accountant, engineer or appraiser having prepared or certified any part of the registration statement or (5) was an underwriter of the security.

The Securities Exchange Act of 1934 is concerned primarily with trading in securities as contrasted with the Securities Act of 1933 which deals primarily with disclosure in the registration statement and prospectus of a new security issue. Under this act, accountants may be held liable to investors who, in reliance upon false or misleading statements filed with the Securities Exchange Commission, purchased or sold a security at a price which was affected by such statement. The person sued shall not be held liable if he proves he acted in good faith and had no knowledge that such statement was false or misleading.

The American Institute of Certified Public Accountants (AICPA) publishes professional guidelines specifying auditing standards and procedures. These Statements on Auditing Procedures (SAP's) are to aid the auditor in his field work and in his reporting. By adhering to these policies of reporting and field work, the auditor should be able to avoid liability. However, there are no easy answers and professional issues are seldom black and white.

The AICPA also publishes opinions of the Accounting Principles Board (APB). The principal objective of the committee has been to

narrow areas of difference and inconsistency in accounting practices and to further the development and recognition of generally accepted accounting principles. These opinions are directed primarily to business enterprises organized for profit. In order for the auditor to give a clean opinion, the procedures followed by the company must be in accordance with generally accepted accounting principles.

When an accountant enters into an agreement with his client to make an audit, he undertakes to make the audit in accordance with prevailing auditing standards. Failure to exercise care required under the accepted auditing principles would constitute negligence. Beyond negligence, assuming a very thin and indeterminate line divides the two, lies fraud. The basic significance of the difference between negligence and fraud is that negligence may give rise to liability between the accountant and the client, whereas fraud may create liability or responsibility to third parties. However, if the specific identity of the third person is known to the accountant, then the latter has the same duty of care toward such identified third party as he has to his client, and he is liable for damage caused to such third person by his ordinary negligence.[1]

In dealing with this question of negligence or fraud, it is important to understand that the accountant does not necessarily have to know that the statement he is issuing is false. The extent of negligence or fraud arises out of failure to use the necessary degree of care and this will help to determine the liability of the accountant in a suit by either the client, creditors, or stockholders.

If the accountant does not know the specific identity of the third person to whom his professional opinion is to be made available, then his liability to such third person is only for actual fraud or gross negligence amounting to constructive fraud.[2] Actual fraud exists when there is an actual intent to mislead, while constructive fraud exists when there is reckless disregard for the truth.

The basic structure underlying present financial reporting and certification by independent accountants dates from the early 1930's when, in the aftermath of the 1929 stock market collapse and business downturn, the New York Stock Exchange, the Securities and Exchange Commission and the organized accounting profession collaborated in working out a statement that essentially is still in use today. The short-form opinion of independent accountants adopted at that time has only been moderately changed.[3]

In the 1931 landmark case of Ultramares Corp. v. Touche,[4] Judge Cardozo held that auditors could be liable to third parties for fraud, such as certifying statements without making an audit. He held that an accountant was ordinarily liable for negligent misrepresentations solely to the person who retained him or to the person who was known to be the primary beneficiary of the information. The court went on to say, however, that an accountant could be held liable by a broader group if his conduct was fraudulent or so grossly negligent as to amount to fraud.

Ultramares has been widely followed for more than three decades, and it has effectively blocked negligence action by third parties under common law. However, the vitality of the common law privity

doctrine has been tested. A federal district court applying Rhode Island law in the 1968 decision of Rusch Factors, Inc. v. Levin held that an auditor is liable for negligence to a foreseen third party lender. A similar result was reached by the Civil Appeals Court of Texas in its 1971 decision in Shatterproof Glass Corporation v. James. In the 1969 decision of Ryan v. Kanne, the Iowa Supreme Court adopted the Restatement[5] view (the accountant would be responsible only to classes of persons who he knows will rely on his reports for the type of transaction resulting in loss). They held the accountant responsible for negligence to a third party reliant who was specifically identified to the accountant prior to the engagement.

In recent years, the accounting profession has witnessed a substantial outbreak of litigation directed principally against the larger firms. Many cases arose in the federal courts under the Securities Act of 1933 and the Securities Exchange Act of 1934. Also, many of the court decisions enlarged the gambit of professional responsibility and imposed new and higher standards of professional conduct upon the accounting profession. With the best data and the best intentions, financial reporting for large complex business enterprises depends heavily on estimates and human judgment and, thus, can never achieve the status of certainty.

Footnotes to Chapter I

[1] Joseph L. Frascona, C.P.A. Law Review (Homewood, Illinois: Richard D. Irwin, Inc., 1972), p. 969.

[2] Ibid.

[3] A. Carl Tietjen, "Financial Reporting Responsibilities," The Journal of Accountancy, (January, 1971), p. 69.

[4] Ultramares Corporation v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931).

[5] Restatement of the Law Second: Torts: Tentative Draft No. 1214 (1966), p.14.

II. THE CONTINENTAL VENDING CASE

The Continental Vending case[1] adds the threat of criminal action to the legal hazards of accountancy. In this case, the defendants, two partners and a manager in Lybrand, Ross Bros. & Montgomery, were charged with drawing up and certifying false or misleading financial statements of Continental Vending Machine Corporation for the year ended September 30, 1962. Continental's founder and president, Harold Roth held 25 percent of its outstanding stock. Roth was also an officer, director, and major stockholder of Valley Commercial Corporation, which was thereby an affiliate of Continental.

Roth from 1958 to 1962 borrowed large amounts of money from Continental which he used for financing his personal stock transactions, much of which he repaid by the end of each fiscal year. Instead of borrowing directly, he had Continental lend to Valley; Roth then borrowed from Valley. During 1962, Roth informed the auditors that Valley was unable to repay Continental since he was unable to repay Valley. Consequently, Roth agreed to post adequate collateral. However, 80 percent of the securities pledged were the common stock and convertible debentures of Continental itself.

The defendant's opinion on the 1962 financial statement represented that the financial statements "present fairly the financial position of Continental . . . in conformity with generally accepted accounting

principles." The financial statements disclosed the loans to Valley, the fact that Roth was an officer, director and stockholder of Valley, and that the loans were secured by Valley's equity in "cetain marketable securities." The financial statements showed a large net loss, and trading in Continental stock was suspended shortly after the annual report containing the financial statements was issued.

The defendants were indicted on three counts of mail fraud and conspiracy for asserted deficiencies in the 1962 financial statements of Continental. The government charged, among other things, that Continental's balance sheet should have disclosed that Valley had made loans to Roth, that Roth was unable to pay them, and that collateral to secure Valley's indebtedness to Continental consisted substantially of Continental securities pledged by Roth. It was further charged that the defendants knew that without these disclosures the statements were false and misleading and had conspired to make them so with intent to defraud.

Eight experts for the defense testified that none of the disclosures was required by generally accepted accounting principles and that the statements taken as a whole did present the financial position and results of operation fairly in accordance with generally accepted accounting principles. Two prosecution experts testified to the contrary although they could point to no specific rule or precedent to support their position. After two trials (the first ended in a hung jury) the defendants were convicted. Post trial motions for acquittal and new trial were denied; the judge fined the defendants $5,000 to $7,000 each.

The case is significant in what it says about the weight that the courts will give, where liability is concerned, to the standards of the accounting profession. The Continental's balance sheet, which was charged to be fraudulent, fairly presented the financial position in conformity with generally accepted accounting principles according to eight expert witnesses of the defendants.

> Defendants asked for two instructions which, in substance, would have told the jury that a defendant could be found guilty only if, according to generally accepted accounting principles, the financial statements as a whole did not fairly present the financial condition of Continental at September 30, 1962, and then only if this departure from accepted standards was due to willful disregard of these standards with knowledge of the falsity of the statements and an intent to deceive.[2]

However, the trial court gave instructions to the jury which said the "critical test" was whether the balance sheet fairly presented the financial position without reference to generally accepted accounting principles. The trial court said in its instructions that evidence of compliance with generally accepted accounting principles would be very persuasive, but not conclusive. It also gave other instructions which the jury might have taken as an invitation to test the fairness of presentation, not against generally accepted accounting principles, but against their idea of what an investor or other layman might want to know. These differences in perspective may frequently produce differences between the meaning of "fair presentation" in a layman's view and the meaning of "fair presentation" under generally accepted accounting principles. So far as diligent research discloses, this is the first case, criminal or civil, to hold that conduct governed

by professional standards may be measured otherwise than by those standards.[3]

For the profession the case points out the advantage in having professional standards spelled out. Had there been specific rules or prohibitions governing the matters about which there was dispute among expert witnesses to which the defendants could refer, it is quite probable the result would have been different.[4] The Court of Appeals' opinion enumerates only one general rule that is a new one as far as standards of professional conduct are concerned. The rule is that where the auditor knows of or suspects a dishonest diversion of funds sufficiently large to imperil his client's solvency, there must either be exceptional disclosure or exceptional measures to make it good and to prevent a recurrence.[5]

When an accountant discovers a diversion he should consider every action he takes thereafter, every disclosure or nondisclosure, and every contact with the client, in the light of how it may subsequently appear in a court of law. In order to protect himself he also should exercise an extraordinary degree of caution.

Footnotes to Chapter II

[1] United States v. Simon, 425 F. 2d, 796 (2d Cir. 1969) cert. denied, 397 U.S. 1006 (1970).

[2] United States Court of Appeals, "Continental Vending Decision Affirmed," The Journal of Accountancy (February, 1970), p. 65.

[3] American Institute of Certified Public Accountants, "AICPA Brief in Continental Vending," The Journal of Accountancy (May, 1970), p. 71.

[4] David B. Isbell, "The Continental Vending Case: Lessons for the Profession," The Journal of Accountancy (August, 1970), p. 36.

[5] Ibid., p. 39.

III. THE RHODE ISLAND HOSPITAL TRUST CASE

Many accountants believe that by disclaiming an opinion on financial statements, they can relieve themselves of liability for errors unless a plaintiff can show that the accountant had knowledge of such an error. However, this was not found to be so concerning the Rhode Island Hospital Trust case.[1]

In this case the plaintiff, Rhode Island Hospital Trust National Bank sued Swartz, Bresenoff, Yavner, and Jacobs, a firm of certified public accountants, each of the partners of the firm and the estate of a deceased partner. The bank alleged that the accountants had negligently audited the financial statements of International Trading Corporation and related companies (Borrower). Consequently, the bank had made loans to Borrower which was unable to repay them and the bank sustained a loss in excess of $100,000.

The nonjury district court dismissed the complaint after concluding that the evidence failed to establish fraud or collusion on the part of the accountants, any lack of good faith, misrepresentation, breach of duty, negligence, or failure to use reasonable care in the preparation and issuance of the financial statements. However, this was reversed by the Court of Appeals.

In 1963 Borrower sought long-term financing of leasehold improvements from the Rhode Island Hospital Trust National Bank, but the

bank was unwilling to lend on this basis. The bank did agree, however, that credit would be given if Borrower could assure them that economies from savings on labor costs expected to result from bulk handling would enable Borrower to operate more profitably and to meet greater loan obligations.

In June, 1964, Borrower represented to the bank that during 1963 it had spent $212,000 for leasehold improvements to its facilities at various cities.[2] The work was purportedly done by the accountant's client, using its own labor and materials. In fact, the claimed 1963 leasehold improvements were totally fictitious. The labor expenses claimed to have been incurred were incurred as operating expenses of handling and storing cement. No materials were purchased. An inspection in 1964 of all three facilities disclosed that they were in the same condition as they were at the end of 1962.

The audited financial statements along with the long form disclaimer of an opinion were presented to the bank to enable the bank to make a loan to the accountant's client.

> It was shown that of the $610,000 total expenditures made during 1964, $212,000 was attributed to improvements made by Borrower. The capitalization of these improvements accounted for approximately two-thirds of the company's net worth shown on the balance sheet and resulted in the statement of operations showing a $9,000 profit rather than a substantial loss.[3]

The bank asserting reliance on the audited statements and opinion gave the loan to the International Trading Corporation in belief that actual improvements had been made though the accountant's report stated uncertainty as to the <u>amount</u> spent.

When the accountants transmitted the financial statments to their client, they wrote a covering letter expressing certain reservations about the fairness of the accompanying statements. The letter discussed the crucial item concerned in the litigation--the leasehold improvements and set forth the following:

> Additions to fixed assets in 1963 were found to include principally warehouse improvements and installation of machinery and equipment in Providence, Rhode Island, Brunswick, Georgia, and Palm Beach, Florida. Practically all of this work was done by company employees and materials and overhead were borne by the International Trading Corporation and its affiliates. Unfortunately, fully complete detailed cost records were not kept of the capital improvements and no exact determination could be made as to the actual cost of said improvements. (Emphasis added.)

and concluded by saying:

> Because of the limitations upon our examination expressed in the preceding paragraphs and the material nature of the items not confirmed directly by us, we are unable to express an opinion as to the fairness of the accompanying statements.[4]

Because of the death of the accounting partner concerned with the engagement, the proof was not complete as to what examination and what inquiries had been made. The workpapers gave no indication that the improvements had been inspected or had asked correspondent accountants, who had been used for other purposes, to do so. The workpapers showed that the accountants had examined labor costs purportedly attributed to the improvements but did not identify material costs, which would have been incurred if such improvements had been made. Since the accounting partner concerned with the engagement had died, the working papers were an important part in the case.

As of the date of receipt of the financial statements, the bank had lent the accountants' client $220,000. There was undisputed testimony that if it had known on the date that $212,000 of leashold improvements were fictitious, it would have refused further loans and immediately begun efforts to effect collection of the outstanding amount. Since the bank claimed that it did not know this crucial fact, the loan balance was allowed to increase during the summer of 1964 until it reached the level of $336,685.61 on September 24, 1964, the date of the adverse report of the bank's analysis department.[5] After the report was received, no further loans or commitments were made.

By application of the rule, "accountants owe a duty to their employer, and others whom they know or expect to rely on the report, to make the report in good faith without fraud or collusion and with care and caution of experts," the accountants were found liable. The accountants not only knew but acknowledged that the bank had sought Borrower's financial statements. Thus, the rule, "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actual foreseen and limited classes of persons,"[6] was applied.

By application of the above rule, the Court of Appeals thought that the accountants were liable on either of two alternate inferences which may be drawn. First, the accountants, having identified some of the purported labor costs of the purported leasehold improvements, failed, from pressure or other reason, to search for material costs.

Second, the accountants having identified some of the purported labor costs, searched for material costs and, not finding any, failed to conduct any independent investigation of the existence of the leasehold improvements and their value and failed to disclose that there was not verification that the leasehold improvements were in process. In either event, the accountants certified the financial statements, saying overall only that they could not express an opinion with regard to fairness. There was no reservation about the existence of the improvements but only about their precise value. Whether the accountants failed to look or, having looked, failed to find, they were guilty of actionable negligence if the bank, in reliance on the statements made further loans. The bank's reliance on the report was shown and is once more on appeal to the Court of Appeals.

Chapter 10, paragraph 1, of the Statement on Auditing Procedure No. 33 reads, "the report shall either contain an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated." The accountants failed to state that they either did not look for or could not find evidence of material costs for the purported leasehold improvements, and either would have been more than a simple limitation upon their examination.

The general principle, the court stated is that "while industry standards may not always be the maximum test of liability, certainly

they should be deemed the minimum standard by which liability will be determined;" and the court looked to SAP No. 33 to determine what the industry standard is. The court's formulation is one that accountants should keep in mind. Some lessons that can be learned from this case are:

1. Make sure the working papers are complete.
2. An accountant disclaiming or qualifying an opinion, or otherwise seeking to give notice to a reader of limitations on the responsibilities he is assuming, should do his best to be sure that the language he uses will make those limitations clear even to an uninformed and unsophisticated reader.
3. The description of the scope of the examination in the accountants' report should not be interwoven with comments on the financial statements or comments on the operations of the company; any such comments that are needed should be footnoted, which are representations of the company not the accountant.[7]
4. The report should state that the examination was performed in conformity with generally accepted auditing standards except for certain specific procedures which should be enumerated in the report. The alternative practice of enumerating the procedures performed, as was followed by the accountants in the case under discussion, is fraught with too may hazards of hindsight interpretation.[8]

Footnotes to Chapter III

[1] Rhode Island Hospital Trust National Bank v. Swartz, 455 5.2d 847 (4th Cir. 1972).

[2] United States Court of Appeals for the Fourth Circuit, "Rhode Island Hospital Trust Decision," The Journal of Accountancy (April, 1973), p. 63.

[3] David B. Isbell and D. R. Carmichael, "Disclaimers and Liability--The Rhode Island Trust Case," The Journal of Accountancy (April, 1973), p. 37.

[4] U.S. Court of Appeals, "R.I. Hospital Trust Decision," p. 64.

[5] Ibid.

[6] Ibid., p. 65.

[7] Isbell and Carmichael, "Disclaimers and Liability," p. 39.

[8] Ibid.

IV. THE 1136 TENANTS' CORPORATION CASE

Until recently, unaudited financial statements received little attention in accounting literature because of more interest in problems inherent in reporting on examinations leading to the expression of an opinion on financial statements. The extension of the legal liability of accountants to unaudited statements, as shown in the <u>1136 Tenants' Corporation</u> case,[1] makes it imperative for auditors engaged in the extensive field of write-up work, and of statement preparation with minimal or no audit, to exercise greater vigilance in protecting themselves against this new hazard.

The case of 1136 Tenants' Corporation against Max Rothenberg & Co. was an action against a firm of Certified Public Accountants to recover for the firm's alleged failure to uncover defalcations of the plaintiff's funds by plaintiff's managing agent, I. Jerome Riker. Riker had failed to pay obligations of plaintiff, a cooperative apartment corporation, that he had reported as having been paid.

Sometime in 1958, Riker and others purchased the premises of 1136 Fifth Avenue, in New York City, and then incorporated the plaintiff, 1136 Tenants' Corporation, which became the owner thereof and proceeded to sell the apartments therein. Riker and Co., Inc., acted as managing agent of plaintiff's property under a contract to that effect.

It was discovered early in March, 1965, that Riker & Co., Inc.,

was in financial difficulties. Certain obligations of the plaintiff reported as paid on the managing agent's, Riker's, monthly statements to plaintiff were, in fact, not paid.

The 1136 Tenants' Corporation thereupon commenced action based on two alternate theories: breach of contract to perform an audit or negligence in failing to exercise due care in performance and to meet generally accepted accounting standards.

Allegations centered around the question of what the accountants had been hired to do. This factual question arose because the retainer involved was oral. The plaintiff maintained that the accountants were hired to do an audit. However, the accountants contended that they were retained merely to perform a "write-up" service, which is, simply stated, the bookkeeping process augmented by the formulation of adjusting and closing entries, and the preparation of the required tax returns and financial statements.[2]

The defendant accountants in their letter transmitting the financial statements stated:

> "Pursuant to our engagement, we have reviewed and summarized the statements of your managing agent and other data submitted to us by Riker & Co., . . ." and "the following statements were prepared from the books and records of the corporation. No independent verifications were undertaken thereon."[3]

Herbert Benton, the plaintiff's expert testified that the accountant's financial statements and workpapers contained comments appropriate to an audit rather than a mere write-up, such as:[4]

"Confirmation of mortgages"
"listing of paid bills which were not examined"

"send bank confirmations"
"examined bank statements--O.K."
"1136 Tenants' Corp. missing invoices"
"Vouch invoices--none vouched for period 1/1/64--6/30/64"
"Audit notes" stated in workpapers.
"Audit fee" shown in statements.

These terms were used to support and confirm the plaintiff's claim. The defendants failure to carry through their checking and vouching process constituted a failure to exercise professional due care.

Another issue was whether the defendant's suspicions should have been aroused by missing invoices. The accountants admitted that on occasion it examined certain of plaintiff's bills and invoices. They argued, however, that such examinations were made for very limited purposes such as: classifying expenditures as expense or capital items, assembling records in connection with an application for rent increase, or determining that plaintiff had no taxable income as the result of insurance recovery.[5] The accountants argued that it was undisputed that the missing invoices were irrelevant for these purposes, and thus, their absence could be ignored. The "missing" invoices were not in fact actually missing, for they were presented in evidence at the trial. The invoices merely had not been furnished when requested, and since the accounting classification could be independently determined, the defendant did not pursue them further. The term "missing" was an unrealistic worksheet notation by the staff accountant and at the trial was given undue importance.

The New York lower court held that the accountants had undertaken to perform an audit and awarded $174,066.93 on its cause of action

together with interest, costs and disbursement, for a total of "237,278.83.[6] The court said that even if the accountants had been engaged for write-up work or to prepare unaudited statements, they nonetheless were obligated to perform auditing procedures sufficient at least to uncover the defalcations like those in issue. Thus, the opinion states, among other things, that a "certain amount of auditing procedure is required even in a 'write-up';" that "whether the scope of the defendant's retainer agreement with the plaintiff was to perform a 'write-up' or an 'audit,' certain definite auditing procedures were necessitated and mandated;" and that "regardless of whether defendant received /certain of plaintiff's records/ . . . for purposes of an audit or otherwise, it had a duty to detect defalcations. . . ." Yet, in Statement on Auditing Procedure No. 38 in paragraph 2 it states: "The certified public accountant has no responsibility to apply any auditing procedures to unaudited financial statements."

The basic conclusion of the trial justice, acting as judge and jury by stipulation of the parties, was that the defendants were retained to perform an audit. A few of the conclusions stated in the opinion were that:[7]

> ... A write-up requires certain definitive audit procedures;
> ... Accountants have a duty to detect defalcations;
> ... The hiring of a Certified Public Accountant presumes an audit;
> ... An audit may be adequately performed without independent verification.

The trial court's decision in this case seemed to ignore the substantial and important differences between audited and unaudited financial

statements in respect to the procedures followed and responsibilities assumed.[8]

The Appellate Division affirmed the lower court's conclusions, but not its specific language. The Appellate Court agreed with the lower court that the defendant was engaged to perform an audit. The Appellate Division placed great weight on the missing invoices. They stated:

> ". . . even if defendant were hired to perform only 'write up' services, it is clear, beyond dispute, that it 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."

The precedential force of the lower court's decision is considerably weakened in that the Appellate Division did not adopt the lower court's view of the obligations of accountants in connection with a write up. The court's dictum with respect to the obligation of accountants to follow auditing procedures in connection with a write up and to detect defalcations can in no sense be said to have been approved by the upper court.

The Court of Appeals, New York's highest court, affirmed the Appellate Division's decision without any further opinion of its own. They did hold, in confirmation, that: there was a contract, a retainer for an audit, and the defendants did not exercise due care and professional competence in the work performed.

Until another case comes along on a similar situation, the foregoing is probably the precedent for responsibility. The self-serving

statements in accounting reports denying responsibility by adopting professional language from the American Institute's Statements on Auditing Procedures, are not always accepted by the public and to the courts as binding.[9]

Accountants must always observe due care and exercise the skills associated with and expected of the profession, which is generally described as professional competence. This applies to unaudited statements and the write-up engagement. It is quite obvious that the scope of the retainer and the uses to which the financial statements are to be put should be understood between the CPA and his client. The best way to do this is by something in writing initiated by both parties. Even if limited accounting work such as a "write up" is contemplated, it is necessary to specify the procedures to be followed and whether the statements are intended for use by third parties.

The scope of the engagement is a matter that requires considerable thought at the outset. By reducing the terms of the engagement to writing, including specified procedures to be followed, accountants can be sure they may be called to account if these specified procedures are not followed. If one underestimates the work or procedures to be followed in setting forth the scope of the engagement, he may have trouble collecting fees for additional but necessary work which he performs.

Except in the case of the "unqualified opinion" audit engagement, accountants should refrain from using the word "audit" in the work-papers, on review notes, in work file heading in designations of expenses

or costs or accrued expenses, in client statements or on fee invoices. The 1136 Tenants' Corporation case is a good example of why this certain protective procedure should be followed. Another protective procedure accountants may learn from this case is that when one observes circumstances that could conceivably be or become a "suspicious circumstance," or note a deficiency in control of money or asset accountability, advise the client in writing, for the record.

Accountants should use the word "unaudited" on statements, report covers, etc., even if they feel it necessary nevertheless to explain that some work was done but that it did not, according to their engagement or retainer, attain the full scope of generally accepted auditing principles and practice as required by the rules of their profession. Also, disclaim an opinion in such cases.

A very important protective procedure for the accounting profession would be to discriminate among their clients with respect to financial risks, fee limitations, and work limitations. Accountants should size up the character of the people involved and the risks that look possible, then act accordingly.

Footnotes to Chapter IV

[1] 1136 Tenants' Corp. v. Max Rothenberg & Co., 27 App. Div. 2d 830, 277 N.Y.S. 2d 996 (1967); 21 N.Y. 2d 995, 290 N.Y.S. 2d 919, 238 N.E. 2d 322 (N.Y. Ct. App. 1968); 36 App. Div. 2d 804, 319 N.Y.S. 2d 800 (N.Y. Ct. App. 1972).

[2] Emanuel Saxe, "Unaudited Financial Statements: Rules, Risks & Recommendations," The CPA Journal (June, 1972), p. 460.

[3] Norman J. Elliott, "Another View of the 1136 Tenants' Corporation Case," The CPA Journal (December, 1972), p. 1002.

[4] Ibid.

[5] Irwin Schneiderman, "1136 Tenants' Corporation v. Max Rothenberg and Co.--Some Legal Considerations," The CPA Journal (June, 1972), p. 466.

[6] Emanuel Saxe, "Accountants' Responsibility for Unaudited Financial Statements," The New York Certified Public Accountant (June, 1971), p. 421.

[7] Elliott, "Another View," p. 1004.

[8] Saxe, "Accountants' Responsibility," p. 421.

[9] Elliott, "Another View," p. 1005.

V. OTHER RECENT COURT CASES

The Yale Express Case

The Yale Express case[1] involves independent accountants, who have expressed an opinion on financial statements in a 10-K[2] and subsequently discovered, during the course of a management services engagement, material errors and omissions from these statements. The accountants' dilemma arose from the dual responsibilities it assumed: that of an independent public accountant and that of an accountant employed by Yale Express (Yale). Should they have disclosed to the public these material errors?

An action was brought against an accounting firm, Peat, Marwick, Mitchell and Co. (PMM), for damages in connection with a corporation's financial statements, which the accounting firm had certified, and interim statements issued by the corporation. The plaintiffs were the stockholders and debenture holders of Yale Express Systems, Inc. The plaintiffs claimed damages from errors and omissions in three sets of financial statements, namely: (1) the unaudited statements appearing in the prospectus for an August 20, 1963, debenture offering; (2) the audited statements for the year ending December 31, 1963; and (3) unaudited interim statements issued during 1964.

Sometime early in 1964, PMM acting as independent public accountant undertook the job of auditing the financial statements of Yale, a

national transportation concern. The statements were released by the defendant accountants on March 31, 1964, and the annual report was released to the stockholders on or about April 9, 1964. On June 29, 1964, the 10-K was filed containing the same financial statements as were included in the annual report.

Following the certification, PMM switched its role to that of an accountant employed by Yale to undertake special studies which were necessitated by business demands rather than by statuatory or regulatory requirements. The public accountants discovered, some time during the course of the year 1964, that the figures contained in the 1963 annual report were substantially false and misleading. This discovery was made during the "special studies" of Yale's past and current income and expenses performed by PMM. PMM did not disclose its finding to the Securities Exchange Commission or public until May, 1965, when the results of its management studies were released. The litigants differ on when the discovery was made. The plaintiffs contended that discovery occurred before the SEC and others received the annual report while PMM contended discovery occurred a after the report was filed.

PMM moved to dismiss those parts of the complaint dealing with the 1963 annual report and the 1964 interim reports. The plaintiffs opposed the motion alleging that the accountants were liable because of their failure to disclose promptly that the 1963 annual report contained false and misleading figures which violated common law deceit doctrines.

PMM was attacked in the complaint because it wore two hats in conducting its business relations with Yale during the period in question. PMM worked as an independent public accountant by auditing and certifying the statements in the 1963 annual report, whose responsibility "is not only to the client who pays his fee, but also to investors, creditors, and others who may rely on the financial statements" which he certifies. The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client.

Following the certification, PMM switched its role to that of an accountant employed by Yale to undertake special studies. In this sense it can be seen that during special studies, PMM's primary obligations, under normal circumstances, were to its client and not the public. PMM maintained, therefore, that any duty to the investing public terminated once it certified the relevant financial statements. Plaintiffs contended to the contrary.

The court held that the public accountant has a duty to the public apart from any duty that he may owe his client. The court expressly held that the public accountant had a duty to promptly disclose information that rendered the 1963 financial statements inaccurate and misleading. The court rejected the argument that this duty to disclose rested on the possibility of financial or other advantages to the public accountants. The defendant's contention that the plaintiffs must plead and prove intent to deceive by silence on the part of the accountants was rejected by Judge Tyler.

During the course of the accountants' "special studies" and subsequent to the completion of the 1963 audit, Yale mentioned to PMM of its intention to issue interim statements. The defendants advised Yale that figures derived from special studies could not be used as a basis for these interim statements and recommended that the figures developed by Yale through its internal accounting procedures be used. It was subsequently discovered that these interim statements were materially false and misleading.

The court held that there could be no basis for direct liability on the part of the accountants since there was no allegation that PMM had compiled, audited or certified any of the interim statements nor was there any indication that any of the statements contained material which an investor could justifiably attribute or relate to PMM.

The plaintiffs claimed PMM aided and abetted Yale in two ways: first, by remaining silent when it was known that the interim statements were false and, second, by recommending or sanctioning the issuance of the reports. However, Judge Tyler found no similar independent duty imposed on the accountants with respect to interim statements, and therefore, rejected this basis for imposing liability.

The District Court held that the complaint against accountants for failure to disclose after acquired information that the statements were false was sufficient, as against motion to dismiss, under Securities Exchange Act provision relating to manipulative and deceptive devices. This was held even though the accountants did

not gain from nondisclosure and despite lack of privity between plaintiffs and accountants. Motion to dismiss was denied.

Judge Tyler observed in this case that an auditor is not only responsible to the client but also to investors, creditors, and others who may rely on the financial statements which he certifies. The accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client.

After the hearing of this case, in October, 1969, the AICPA came out with Statement on Auditing Procedure No. 41 which deals with "subsequent discovery of facts existing at the date of the auditor's report." SAP 41 states: "When the auditor becomes aware of information which relates to financial statements previously reported on by him, but which was not known to him at the date of his report, . . . he should . . . undertake to determine whether the information is reliable and whether the fact existed at the date of his report." In this connection the auditor should discuss the matter with his client at whatever management levels he deems appropriate.

If the discovered information is found to be reliable and to have existed at the date of the auditor's report and it affected the financial statements he should advise his client to make appropriate disclosure of the newly discovered facts to persons who are known to be currently relying, or who are likely to rely, on the financial statements and the auditor's report. If the client refuses to make the disclosures, he should take appropriate steps to prevent future

reliance upon his report. Unless the auditor's attorney recommends a different course of action, the auditor should, when applicable: (a) notify client; (b) notify regulatory agencies, and/or (c) notify each person known to the auditor to be relying on the financial statements. The Securities and Exchange Commission and the stock exchanges are appropriate agencies for (c) as to corporations within their jurisdictions. In many instances it would not be practicable for the auditor to give appropriate individual notification to stockholders or investors at large, whose identities ordinarily are unknown to the auditor.

The BarChris Case

The Securities Act of 1933 does not leave the accountant against the world. He is provided with a number of defenses. If he wishes he may disavow the registration statement and the contents of it either before or after it becomes effective if he follows certain procedures to inform the Securities and Exchange Commission and the public of his disavowal. He has a defense if those portions of the registration statement included on his authority do not fairly represent his statement. The most significant defense, and the one which was of consuming importance in the BarChris[3] is this one: ". . . he had after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . ."

The dimensions of this defense are clear. There must be a reasonable investigation, there must be actual belief that the statements made by the accountants were true and that there was no material omission, there must be reasonable ground to believe in the truth and completeness of the statements.

Action was brought by purchasers of BarChris debentures against BarChris Construction Corporation which issued the debentures, signers of the registration statements for the debentures, underwriters, and the corporation's auditors, Peat, Marwick, Mitchell & Co., for damages sustained as a result of false statements and material omissions in prospectus contained in the registration statements. The District Court held that the prospectus contained material falsities and omissions, and that the defendants failed to sustain the burden of proving the due diligence defenses asserted or that damage suffered by each plaintiff had been caused by factors other than the material falseties and omissions.

The plaintiffs purported to sue on their own behalf and on behalf of all other present and former holders of the debentures. When action was begun on October 25, 1962, there were only nine plaintiffs. Others were subsequently permitted to intervene. At the trial, there were over sixty.

The courts discussion with respect to the accountants' liabilities breaks into two parts: their audit of the 1960 figures, and their S-1 review from the balance sheet date, December 31, 1960 to the effective date of the registration statement May 16, 1961. The questions

discussed by the court were: (1) did the auditors make mistakes, (2) were the mistakes material, (3) did they use due diligence, i.e., make a reasonable investigation. There is a lengthy opinion of this case and only the action brought against the certified public accountants is dealt with here.

BarChris was engaged primarily in the construction of bowling centers which contained not only alleys but also, in most cases, bar and restaurant facilities. In May of 1962 BarChris made an attempt to raise money by the sale of stock because they experienced some difficulty in collecting amounts due from some of their customers. Although BarChris continued to build alleys in 1961 and 1962, it became increasingly apparent that the industry was overbuilt. BarChris filed with the Securities and Exchange Commission a registration statement for the stock issue which it later withdrew. In October, 1962, it filed in the court a petition for an arrangement under the bankruptcy act. BarChris defaulted in the payment of the interest due on November 1, 1962 on the debentures.

The registration statement involved contained audited financial statements as of December 31, 1960 and unaudited stub figures for the period ended March 31, 1961. The nonjury court analyzed the accounting principles applied and the investigations made by various parties as to the accuracy of the information contained in the prospectus including the content of the financial statements. The court concluded that the accounting principles applied were, in many cases, erroneous and that the audit procedures applied by the accountants

were inadequate. The court never really dealt with the adequacy of the financial statements "as a whole." Rather, it applied the test of materiality to individual accounts, such as cash, accounts receivable, reserve for doubtful accounts and contingent liabilities. The court fragmented the statements for the purpose of determining materiality and then did the same thing in dealing with the issue of due diligence. As a result, the court held that some erroneous accounts were not material for purposes of determining liability, but were material in the sense that the accountants' failure to discover them indicated a failure to exercise due diligence.[4]

The court found that the accountants' S-1 review was inadequate. The question arose because the accountants tried to establish the due diligence defense under the Securities Act of 1933. Therefore, they had to prove that when the registration statement became effective they had, as a result of a reasonable investigation, reason to believe and did believe that the expertised statements were not misleading. The court felt that the objective of an S-1 review is "to ascertain whether any material change has occured in the company's financial position which should be disclosed in order to prevent the balance sheet from being misleading."[5] The accountant had been negligent in failing to discover that there had been a material change for the worse in BarChris's financial position, subsequent to the balance sheet date, so as to render the 1960 figures misleading at the time the registration statement became effective.

The court held that the public accountant did not establish the due diligence defense because of failure to spend adequate time on the S-1 review and accepting glib answers by management. The judge seemed content that the auditor could foresee the need for further checking:

> Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. Berardi's review did not come up to that standard. He did not take some of the steps which Peat, Marwick's written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries.

Part of the program required that the auditor "inquire as to changes in material contracts." Although, Berardi, the in-charge accountant, asked the controller about uncompleted contracts and secured a list of them, he did not actually examine each contract. The court ruled this inquiry to be inadequate because of the absence of prices from some examined contracts which should have prompted further investigation. The court specifically held the accountants to the standards of the professions with respect to their S-1 review. Because the court found that these standards had not been met, the accountants were held liable.

Ryan v. Kanne

An example of affirmative representations overriding a disclaimer is the case of Ryan v. Kanne.[6] This is a case involving accountants who had prepared unaudited financial statements. They adequately marked the statements as such and appended to them a disclaimer of

opinion substantially in the form required by SAP No. 38--but also represented in an accompanying letter that they had confirmed accounts payable--trade, and, in addition, orally represented them to be correct within $5,000. These accounts proved to be materially understated, and it was shown that the accountants had not adequately confirmed them.

Action was brought for accounting fees by plaintiff-accountants, Ryan and Snyder, with a counterclaim filed by one of the defendants, Kanne Lumber and Supply, Inc. The lower court resulted in a judgment againest all defendants for accounting services in the sum of $3,434.67 and a judgment in favor of Kanne for damages in the sum of $38,685.81. All parties appealed but the Iowa Supreme Court modified and affirmed the lower court's decision.

The Iowa Supreme Court in agreement with the trial court's judgment upon the accountants' claim for services rendered against Kanne was affirmed in the sum of $3,434.67 plus interest and costs. The court recognized that minor errors in the report will not avoid the fee, and that under some circumstances substantial value from the audit may remain in spite of its errors. The trial court concluded that this was the situation in this case and the Iowa Supreme Court agreed.

In consideration of the counterclaim of Kanne for damages due to the accountants' negligence in performing their contract, the court found that the accountants were advised and knew that, if the audit were favorable, the Kanne lumber businesses were to be

incorporated. James A. Kanne owned and operated certain businesses including lumber companies. He had incurred considerable indebtedness in connection therewith, his accounting procedure left much to be desired, and he was in need of further financing. He, therefore, sought the services of an accountant. Particular attention to the item of accounts payable--trade was directed and became the critical part of plaintiffs' undertaking. Ryan guaranteed the accuracy of their statement as to that item within $5,000. It was later disclosed that there was a discrepancy of $33,689.22 in accounts payable--trade.

The accountants' position was that an accountant is not liable in negligence to reliant parties not in privity and they cited, among others, the leading Ultramares case.

The court held that when an accountant is aware that the balance sheet to be prepared is to be used by a certain party or parties who will rely thereon in extending credit or in assuming liability for obligations of the party audited, the lack of privity should be no defense to a claim for damages due to the accountants' negligence. The court could see no good reason why accountants should not accept the legal responsibility to known third parties who reasonably rely upon financial statements prepared and submitted by them.

The court also found that plaintiffs were advised and knew that, if the audit was favorable, the Kanne lumber businesses were to be incorporated and the corporation was to assume the assets and liabilities of those businesses. It was also held that an officer of Mid-States

did use the balance sheet which the plaintiffs had submitted near the end of November, 1965, to solicit subscribers to this corporation stock, and that they relied upon the balance sheet submitted for their examination.

The plaintiffs financial statement showed accounts payable--trade was $33,689.22 less than the corrected report. From this figure the court took $5,000 which the court found the plaintiffs had limited its warranty of correctness and added thereto the fair and reasonable costs of the corrected report in the sum of $1,380, and arrived at the sum of $30,069.22. The court held that this figure represented the loss to Kanne Lumber and Supply, Inc.

This amount was later amended and supplemented by a reduction of $7,026.28 which had been included in the accounts payable--trade but was actually a note payable and not properly listed. The modified judgment was, therefore, reduced to $23,042.94.

In summary, the Iowa Supreme Court in its 1969 decision held the accountants responsible for negligence to a third party reliant who was specifically identified to the accountants prior to the engagement.

Rusch Factors, Inc. v. Levin

In the Ultramares case, Judge Cardozo held that an accountant did not have liability to third parties for ordinary negligence. However, Rusch Factors, Inc. v. Levin[7] extended the liability of the accountant. The allegation distinguished this case from Ultramares, where the plaintiff was a member of an undefined, remote class of lenders and equity holders not actually foreseen but only foreseeable.[8] In the

Rusch case, there was an allegation in the compalint that the plaintiff was a single party whose reliance on the financial statements had actually been foreseen by the defendant accountant.

Action was brought by Rusch Factors, Inc. (Rusch) against Leonard M. Levin, accountant to recover damages allegedly sustained as a result of alleged misrepresentations by the accountant and alleged negligence in preparation of financial statements upon which Rusch Factors, Inc. relied in lending money.

In late 1963 and early 1964, a Rhode Island corporation sought financing from the plaintiff, Rusch. To measure financial stability of the corporation, the plaintiff requested certified financial statements. The defendant accountant, Levin, prepared the statements which represented the corporation to be solvent by a substantial amount. In fact, the corporation was insolvent. On or before February 10, 1964, the corporation submitted the statements to Rusch. The plaintiff relying on the statements, loaned the corporation a sum in excess of $337,000. Subsequently, the corporation went into receivership, and the plaintiff had been able to recover only a portion of the loan.

The plaintiff complained that it had been injured in an amount in excess of $121,000 as a result of its reliance upon the fraudulent or negligent misrepresentations in the certified financial statements. The defendant moved to dismiss on two grounds: (1) that the Rhode Island statute of limitations for personal injuries or injuries by spoken word bars the plaintiff's action, or (2) that the absence of

privity of contract between the defendant accountant and the plaintiff reliant party is a complete defense.

The court determined that pecuniary loss resulting from reliance upon fraudulent or negligent misrepresentation is not an injury to the person or injury by spoken words. Thus, the defendant's motion to dismiss with respect to the statute of limitations was denied.

Privity of contract is clearly no defense in a fraud action. An intentionally misrepresenting accountant is liable to all those persons whom he should have reasonably foreseen would be injured by his misrepresentation. Neither actual knowledge by the accountant of the third person's reliance nor quantitative limitation of the class of reliant persons is a requisite to recovery for fraud. The same broad perimeter prevails if the misrepresenter's conduct is heedless enough to permit an inference of fraud.[9] There are several reasons which support the broad rule of liability for fraudulent misrepresentation. First, liability should extend at least as far in fraud, an intentional tort, as it does in negligence cases resulting in personal injury of property damage. Second, the risk of loss for intentional wrongdoing should invariably be placed on the wrongdoer who caused the harm rather than on the innocent victim of the harm. Finally, a broad rule of liability may deter future misconduct. The District Court determined for the above stated reasons that the plaintiff's complaint was sufficient in so far as it alleges fraud.

With respect, then to the plaintiff's negligent theory, the District Court held that the accountant should be liable in negligence

for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons. According to the plaintiff's complaint in the case, the defendant knew that his certification was to be used for the reliance of potential financers of the Rhode Island corporation. The defendant's motion to dismiss, therefore, was denied.

A similar result was reached by the Civil Appeals Court of Texas in its 1971 decision in Shatterproof Glass Corp. v. James. Shatterproof alleged that the defendants, James Guinn and Head, a Certified Public Accounting partnership, were negligent in the preparation of audit reports and as a result of such negligence, Shatterproof sustained damages in excess of $400,000. This court also held that an auditor is liable for negligence to a foreseen third party lender.

Stephens Industries, Inc. v. Haskins and Sells

So far, there has been discussion about different cases in which the accountants were found liable. However, this is not always true as was shown in Stephens Industries, Inc. v. Haskins and Sells.[10] By giving adequate disclosure of material information and qualifying their opinion, the auditors avoided liability.

Action was brought by a buyer of car rental businesses, Stephens Industries, Inc., against public accountants for alleged misrepresentation of accounts receivable in the audit. The United States District Court rendered judgment for the accountants.

The sellers contracted and employed Haskins and Sells, and a complete audit was commenced. Soon, however, it became apparent that the accounts receivable records had been poorly maintained, and a significant discrepancy appeared between the accounts receivable ledger cards and the general ledger. After spending considerable time unsuccessfully attempting to reconcile the figures, the accountants met with their clients to tell them of their difficulty encountered and to inform them of the added cost if the accounts receivable were to be audited.

Haskins and Sells was then shown the purchase contract which specifically stated that the accounts receivable were not to be adjusted to reflect uncollectibility. In accordance with the instructions, the accounts receivable were not audited and the general ledger was adjusted downward to coincide with the accounts receivable ledger figures.

The U.S. Court of Appeals agreed with the trial court that the accountants were not liable. The court held that Haskins and Sells did not fail to exercise the care and competence in disclosing the audit results which appellants were justified in expecting. First, evidence did not support the allegation that Haskins and Sells knew that certain accounts receivable were "obviously uncollectible." It was shown that the accountants were not instructed to do a full audit on the accounts receivable, and any conclusion about their uncollectibility would be irresponsible and in violation of accepted accounting procedures.

The sellers contracted and employed Haskins and Sells, and a complete audit was commenced. Soon, however, it became apparent that the accounts receivable records had been poorly maintained, and a significant discrepancy appeared between the accounts receivable ledger cards and the general ledger. After spending considerable time unsuccessfully attempting to reconcile the figures, the accountants met with their clients to tell them of their difficulty encountered and to inform them of the added cost if the accounts receivable were to be audited.

Haskins and Sells was then shown the purchase contract which specifically stated that the accounts receivable were not to be adjusted to reflect uncollectibility. In accordance with the instructions, the accounts receivable were not audited and the general ledger was adjusted downward to coincide with the accounts receivable ledger figures.

The U.S. Court of Appeals agreed with the trial court that the accountants were not liable. The court held that Haskins and Sells did not fail to exercise the care and competence in disclosing the audit results which appellants were justified in expecting. First, evidence did not support the allegation that Haskins and Sells knew that certain accounts receivable were "obviously uncollectible." It was shown that the accountants were not instructed to do a full audit on the accounts receivable, and any conclusion about their uncollectibility would be irresponsible and in violation of accepted accounting procedures.

Second, the language in the purchase agreement between the car rental corporations and appellants leaves no doubt that the latter did not expect the accounts receivable to be adjusted to reflect uncollectibility.

Third, it was testified that due to the expense of a full audit, and other representations of the then owners, the accounts receivable were not expected to be audited.

And fourth, the care and competence of Haskins and Sells, is reflected in the notes attached to the balance sheet and in the separate accountant's qualified opinion. In both places the accountants explicitly recited that the accounts receivable had not been adjusted to reflect collectibility. The accountant's opinion stated:

> Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures . . . as we considered necessary in the circumstances, excepting that in accordance with your instructions we did not request any of the customers to confirm their balances nor did we review collectibility of any trade receivables.

The notes to the balance sheet stated:

> The balance shown on the balance sheets is the total of the daily accounts receivable records of the companies and has not been adjusted to reflect uncollectible accounts, the amount of which was not determined at December 31, 1964.

From this evidence the Court of Appeals was satisfied that appellees, Haskins and Sells had exercised the care and competence of their profession.

Equity Funding Corporation of America

One of the biggest scandals in the history of the insurance industry started to break, late March and early April, 1973, around

the parent company, Equity Funding Corp. of America, a financial service with a speedy growth record in insurance sales. The scandal centers in Equity Funding Life Insurance Co. (EFLIC), a key subsidiary. The parent company which has four life insurance subsidiaries reported total life insurance in force of $6.5 billion at the end of 1972, Equity Funding Life accounted for half of that.

The Equity Funding scandal is far more massive than anyone at first suspected. It involves more than $120 million in nonexistant assets and more than $2 billion bogus insurance policies. This scandal has been going on since 1964.

How did this scheme work? Equity funding Life Insurance Co. sold a pack that involved both life insurance and mutual fund shares. The purchaser agreed to invest a certain amount of money in a mutual fund. The shares he got were then used as collateral for a loan from Equity Funding that was used to pay the premium on the insurance policy. The next year the purchaser would buy more shares. This would go on for ten years, when he would cash in enough of his fund shares to pay off his total debt--leaving him, it was hoped, with some fund stock remaining and a policy with a tidy cash value to it. The company, meanwhile, was selling the insurance policies for cash to the various reinsurers.[11]

In 1970, someone at the company decided that it would be easy to create phony policyholders, sell them phony insurance and peddle this to the reinsurers.

The customers didn't exist. Their mutual fund shares didn't exist. The funded loans didn't exist. The phony customers' phony

pledges of their phony fund shares to buy phony insurance ultimately became numbers on a computer tape, which then printed out phony assets for Equity Funding Corporation's phony books.[12]

Equity Funding filed for reorganization under Chapter 10 of the Federal Bankruptcy Act on April 5, 1973. Robert Loeffler, trustee in bankruptcy said in a federal court hearing that he is "reasonably confident" the scandal-ridden company's audited balance sheets will show assets "at least equal to scheduled liabilities." However, his appraisal didn't take into account Equity Funding's contingent liabilities seeking millions in alleged securities fraud. The trustee said at least 43 class action suits have been filed against Equity Funding. Action has also been brought against leading accounting firms: Wolfson, Wiener, Patoff, and Lapin; Haskins and Sells; Seidman and Seidman; and Peat, Marwick Mitchell & Co.

It appears that the accounting firms may be held liable. It was said that once a forgetful auditor left his black bag unlocked overnight. An EFLIC executive, in full sight of others, grabbed the audit plan and was able to anticipate the accountants' moves. Another time, an auditor wanted to send out policy confirmation letters to a sampling of policyholders. EFLIC official, eager to help, did some of his clerical chores for him. The letters wound up addressed to branch sales managers and agents, who dutifully filled out the forms themselves.

Team after team of auditors had come and gone at EFLIC over the past years without uncovering this bogus business. This has not gone to court yet but it is quite possible that the accountants may be found

liable. Accountants are not always liable if they fail to detect fraud. However, they can be held liable if they fail to detect the fraud if it was caused by ordinary negligence, gross negligence, or constructive fraud on their part.

Equity Funding Life appears to have about 33,000 genuine insurance policies totaling about $1.28 billion and the legitimate policy holders appear safe.[13] The Equity Funding Corporation unit had claimed 97,000 policies totaling about $3.2 billion.

Footnotes to Chapter V

[1]Fisher v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

[2]Form 10-K, Annual Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934.

[3]Escott v. Barchris Construction Corp., 283 F. Supp. 643 (1968).

[4]Donald Stuart Bab, "Current Thoughts About the Legal Liability of the CPA," The New York Certified Public Accountant, June, 1971, p. 441.

[5]Escott v. BarChris Construction Corp., 283 F. Supp., 643, 701 (S.D.N.Y. 1968).

[6]Ryan v. Kanne, 170 N.W. 2d 395 (Iowa 1969).

[7]Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (R.I. 1968).

[8]Bab, "Current Thoughts," p. 439.

[9]State St. Trust Co. v. Ernst, 278 N.Y. 104, 15N. E.2d 416, 120 A.L.R. 1250 (1938).

[10]Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357 (10 Cir. 1971).

[11]"Digging Deeper: Equity Scandal Grows, Involves $120 Million in Non Existant Assets," Wall Street Journal, April 24, 1973, p. 1.

[12]Ibid.

[13]"Equity Funding Life Audit Confirms Extent of Scandal: Real Policyholders Appear Safe," Wall Street Journal, June 25, 1973, p. 8.

VI. SUMMARY

As the cases indicate, the scope of the accountants' responsibility has been extended in the past few years, and it does not appear that this trend towards greater responsibility is abating. In the 1136 Tenants' Corporation case the court took the position that a firm of certified public accountants negligently performed "write up services" since, according to the court, a write up requires the accountants to perform certain auditing procedures, and had the accountants performed auditing procedures, they would have or should have discovered defalcations by the bookkeeper.

In some recent cases the courts are setting the standards in SEC review for the accounting profession. It should be noted, however, that the courts are doing so only where the accounting profession, in the opinion of the court, has been deficient in not adequately providing its own standards, e.g., BarChris case. The accounting profession witnessed an expansion of its responsibilities for a previous audit report to include informing the public of findings discovered in an entirely separate and different kind of engagement undertaken even after the audited financial statements had been filed and distributed. This was found in the Yale Express case.

The courts are going to judge accountants in accordance with standards of materiality and full disclosure which have been developed

under the federal securities laws, and not necessarily in accordance with standards developed by the accounting profession. Moreover, the courts judgment will be based on hindsight not available to the certified public accountant at the time he performs the services subsequently questioned. By the time the dispute about the accountants responsibility reaches the court, there has been an opportunity to examine every aspect of the engagement performed.

The court in the Continental Vending case said that when an auditor knows or suspects a dishonest diversion of funds sufficiently large to imperil his client's solvency, there must be exceptional disclosure or exceptional measures to make it good and to prevent recurrence. In this case, the conflict of experts pointed out the advantage of having professional standards spelled out. The Rhode Island Trust case showed the advantage of stating all the reasons why an overall opinion cannot be expressed and the importance of working papers. Through the cases that have gone to court, accountants can learn from other professional's mistakes.

Concepts of accountants' legal liability are changing. The changes are generally in the direction of greater responsibility, and therefore, greater exposure to liability to the public. Neither the regulatory agencies, the accounting profession nor the courts have been entirely consistent in this area.

A court can find liability on the part of the accountant if there was anything in the record, including the work papers on which the court could conclude that (a) if the auditor had investigated further

he might have discovered the problem, and (b) his failure to investigate further was a result of the negligent performance of his engagement. This was shown in the BarChris case. The judge felt the accountant failed to spend adequate time on the S-1 review and accepted glib answers from management instead of investigating further.

There does not appear to be any short, simple and mechanical way for the auditor to resolve his problems of when auditing procedures should be extended, or of materiality and fair presentation, including fair disclosure. In each case, the auditor must exercise his judgment in the light of the circumstances, the criteria set forth in the court cases and the best experience he can bring to the question.

SELECTED BIBLIOGRAPHY

B I B L I O G R A P H Y

Books

Frascona, Joseph L. C.P.A. Law Review. Homewood, Illinois: Richard D. Irwin, Inc., 1972.

Magazines and Newspapers

American Institute of Certified Public Accountants. "AICPA Brief in Continental Vending." The Journal of Accountancy, May, 1970, pp. 69-73.

"Attorney Questions Suits Against Profession." The Journal of Accountancy, June, 1971, pp. 12, 14.

Bab, Donald Stuart. "Current Thought About the Legal Liability of the CPA." The New York Certified Public Accountant, June, 1971.

Bakay, Virginia Hicks. "A Review of Selected Claims Against CPAs." The Journal of Accountancy, May, 1970, pp. 54-58.

Burke, Henry G., and Black, Robert W. Jr. "A CPA's Day in Court." The Maryland CPA Quarterly, June, 1968, pp. 3-20.

Causey, Denzil Y. Jr. "Foreseeability as a Determinant of Audit Responsibility." The Accounting Review, April, 1973, pp. 258-267.

Coakley, Walter J. "Accountants' Legal Liability." The Journal of Accountancy, July, 1968, pp. 58-61.

Committee on Auditing Procedure of the American Institute of Certified Public Accountants. Statement on Auditing Procedure No. 41. New York, New York: AICPA, October, 1969.

Elliott, Norman J. "Another View of the 1136 Tenants' Corporation Case." The CPA Journal, December, 1972, pp. 1001-1007.

Isbell, David B. "The Continental Vending Case: Lessons for the Profession." The Journal of Accountancy, August, 1970, pp. 33-40.

Isbell, David B., and Carmichael, D. R. "Disclaimers & Liability--The Rhode Island Trust Case." The Journal of Accountancy, April, 1973, pp. 37-42.

"Landmark Decision on Liability." The Journal of Accountancy, June, 1968, p. 20.

Linowes, David F. "The Accountants Enlarged Professional Responsibilities." The Journal of Accountancy, February, 1973, pp. 47-51.

Olson, Norman O. "The Auditor in Legal Difficulty--What's the Answer?" The Journal of Accountancy, April, 1970, pp. 39-44.

Reiling, Henry B., and Taussig, Russell A. "Recent Liability Cases--Implications for Accountants." The Journal of Accountancy, September, 1970, pp. 39-50.

Saxe, Emanuel. "Accountants' Responsibility for Unaudited Financial Statements." The New York Certified Public Accountant, June, 1971, pp. 419-423.

Saxe, Emanuel. "Unaudited Financial Statements: Rules, Risks & Recommendations." The CPA Journal, June, 1972, pp. 457-464.

Schneiderman, Irwin. "1136 Tenants' Corporation v. Max Rothenberg & Co.--Some Legal Considerations." The CPA Journal, June, 1972, pp. 465-467, 512.

Terrell, Junius H. "Minimum Standards for Unaudited Financial Statements." The Journal of Accountancy, May, 1973, pp. 54-59.

Tietjen, A. Carl. "Financial Reporting Responsibilities." The Journal of Accountancy, January, 1971, pp. 69-73.

United States Court of Appeals. "Continental Vending Decision Affirmed." The Journal of Accountancy, February, 1970, pp. 61-69.

United States Court of Appeals for the Fourth Circuit. "Rhode Island Hospital Trust Decision." The Journal of Accountancy, April, 1973, pp. 63-66.

Wall Street Journal. "A Scandal Unfolds: Some Assets Said to be Missing, Some Insurance Called Bogus at Equity Life," April 2, 1973.

Wall Street Journal. "Digging Deeper: Equity Scandal Grows, Involves $120 Million in Nonexistant Assets," April 24, 1973.

Wall Street Journal. "Equity Funding Trustee Says He Believes Audit Will Show Assets to Cover Liabilities," June 5, 1973.

Court Cases

Escott v. BarChris Construction Corp., 283 F. Supp. 643, (S.D.N.Y. 1968).

Fisher v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.C.R.I. 1968).

Ryan v. Kanne, 170 N.W. 2d 395 (Iowa 1969).

Shatterproof Glass Corp. v. James, 466 S.W. 2d 873 (Tex. Civ. App.--Fort Worth 1971).

Stephens Industries, Inc. v. Haskins & Sells, 438 F.2d 357 (10 Cir. 1971).