Liability under Common Law

An accountant may be liable under common law due to negligence or fraud.

**Negligence**

A loss due to negligence occurs when an accountant violates the duty to perform professional services in a competent manner. **Negligence** may consist of

- Nondisclosure of information to a client
- Errors previously discovered not being corrected
- GAAP not being followed

Best defense to common law negligence is that appropriate professional standards were followed.
**Negligence (continued)**

Simple negligence

- Careless mistakes
- Defense of lack of privity may be available
  - But client and intended third-party beneficiaries have privity
  - Foreseen third parties have privity in majority of states under tort law
  - Foreseen third parties lack privity in states conforming to Ultramares case

Gross negligence

- Reckless disregard for the truth
- Lack of privity not valid as defense
**Fraud**

Fraud refers to conduct that involves all of the following:

- Material **false** representation of fact
- Justifiable **reliance** on the information
- Awareness of the false information by the accountant
- The falsity was made with the ultimate intent to deceive
- The party must have suffered **damages**

**Scienter** refers to the accountant’s knowledge of a false representation or material omission of fact with the intent to deceive.

Potential defenses against fraud include

- Lack of intent to deceive
- Immateriality

Lack of privity is not a valid defense
Liability under Federal Securities Regulations

Auditors are liable under both the Securities Act of 1933 (33 Act) and the Securities Exchange Act of 1934 (34 Act).

**Liability under 33 Act**

Accountants are liable under Section 11 of the 33 Act

- Liable if financial statements contain untrue statement or material omission
- Liable to anyone acquiring security without knowledge of error

To be successful, the plaintiff need not prove

- Privity
- Scienter
- Reliance

Defenses the accountant may use include

- Plaintiff’s knowledge of the error
- Due diligence in performance of services
**Liability under 34 Act**

Accountants are liable under Rule 10b-5 of the 34 Act

- Liable for oral or written misrepresentations of fact
- Liable for wrongful act committed through mail, interstate commerce, or a national securities exchange

To be successful, the plaintiff must prove

- Scienter
- Reliance

Defenses the accountant may use include

- Plaintiff's knowledge of the error
- Lack of reliance by plaintiff
Summary of Auditor Liability

Elements in action taken against an accountant

1) There is a misstatement or omission of a material fact
2) Plaintiff has reasonably relied upon the information
3) Plaintiff suffered a loss
4) Accountant was in error
### Auditor Common Law Liability

<table>
<thead>
<tr>
<th>Who may bring action</th>
<th>Contracts</th>
<th>Negligence</th>
<th>Gross Negligence or Fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client or an intended user</td>
<td>Breach of contract</td>
<td>Carelessness</td>
<td>Anyone injured</td>
</tr>
<tr>
<td>Client or (usually) foreseen user</td>
<td>All 4 elements</td>
<td>All 4 elements</td>
<td>Recklessness or intentional misconduct (sciente)</td>
</tr>
</tbody>
</table>

**Accountant’s error resulting in action**

**Plaintiff must prove**

All 4 elements

All 4 elements

All 4 elements
<table>
<thead>
<tr>
<th><strong>Auditor Liability under Federal Securities Laws</strong></th>
<th><strong>1933 Act Section 11</strong></th>
<th><strong>1934 Act Rule 10b-5</strong></th>
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<tr>
<td>Who may bring action</td>
<td>Any purchaser</td>
<td>Any purchaser</td>
</tr>
<tr>
<td>Accountant’s error resulting in action</td>
<td>Lack of due diligence</td>
<td>Recklessness or intentional misconduct (scienter)</td>
</tr>
<tr>
<td>Plaintiff must prove</td>
<td>Elements 1 &amp; 3 only</td>
<td>All 4 elements</td>
</tr>
</tbody>
</table>
Private Securities Litigation Reform Act of 1995

Requires auditor of publicly held company to include specific substantive procedures designed to

- Identify illegal acts, including management fraud, having a direct and material effect on the financial statements
- Identify significant related-party transactions
- Determine if there is substantial doubt related to the entity’s ability to continue as a going concern

Illegal acts must be reported to management and board of directors must be notified

Board of directors must

- Notify the SEC within 1 business day
- Provide auditor with copy of report to SEC

If auditor not notified

- Resign from engagement
- Notify SEC within 1 business day of board’s failure to meet deadline
Private Securities Litigation Reform Act of 1995 (continued)

Responsibilities under the Sarbanes-Oxley Act

- CPAs and CPA firms may be criminally prosecuted for destroying or falsifying records
- Created the Public Company Accounting Oversight Board (PCAOB)
  - Registers CPA firms that audit public (issuer) companies
  - Sets standards on auditing, quality control, independence for registered CPA firms
  - Restricts the types of services that a CPA firm may perform for an issuer audit client
  - Requires rotation of audit partner every 5 years
  - Requires audits of internal control over financial reporting
- Public companies must disclose whether they have adopted code of ethics for company’s officers
- For audit committees of the board of directors
  - All members must be independent
  - Must have at least one financial expert
- Requires the CEO and CFO to certify to company’s financial statements
**Liability as a Tax Preparer**

**Penalties**

Actions by an accountant preparing a client’s tax return can result in penalties

- Not providing client with copy of return
- Failing to sign return as a preparer
- Endorsing & cashing client’s refund check

**Liability to Client**

Other actions may create a liability to a tax client

- Failing to file a return timely
- Not advising client of tax elections
- Neglecting evaluation of joint versus separate returns
Regulation of Accountants

- State boards of accountancy issue licenses to practice in a state
  - Investigate violations of professional standards and ethics
  - May revoke license to practice
- AICPA and state societies of CPAs
  - Investigate violations of professional ethics through Joint Ethics Enforcement Program (JEEP)
  - May admonish, sanction, suspend, or expel a member
- The AICPA Uniform Accountancy Act (UAA)
  - Provides guidance to states in establishing accountancy laws
  - Contains rules for education, reciprocity, continuing education, etc.
- The Securities Exchange Commission
  - Investigates CPAs and CPA firms that violate SEC rules
  - May disbar an accountant or firm from auditing public (issuer) companies
Regulation of Accountants (continued)

- The Public Company Accounting Oversight Board (PCAOB)
  - Registers and performs inspections of firms that audit public (issuer) companies
  - Firms that audit more than 100 issuers are inspected every year
  - Firms that audit 100 or less issuers are inspected every three years
  - For substandard performance the PCAOB may:
    - Prescribe remedial actions such as improvements in quality control
    - Suspend an individual or firm from auditing issuers
Standards for Consulting Services

When performing consulting services, a CPA must adhere to certain general standards

• Professional competence
• Due professional care
• Planning & supervision
• Obtaining sufficient relevant data

Specific standards related to consulting services include

• Serving the client
• Establishing an understanding with the client as to the nature, scope, & limitation of services
• Communicate with the client about conflicts of interest, scope of services, or benefits to be derived
Standards for Tax Practice

A CPA performing tax services

- May not recommend a tax position that lacks merit
- Must make a reasonable effort to answer applicable questions on the return
- May rely on client information when preparing the return
- Must make reasonable inquiries about questionable or incomplete information
- May use estimates