Audited Financial Statements: The Accountant's
Responsibility, Liability,
and Precautions Against Litigation

An Honors Thesis (ID 499)

By

Judith Ann Culy

Thesis Director

Ball State University
Muncie, Indiana
May 1984

Graduation Date: May 1984
I. Introduction
   A. Brief History
   B. The Past 20 Years - Impact on Auditing
      1. Increase in negligence
      2. Increase in liability

II. General Responsibility of Auditors
   A. The View of the Profession
      1. Clients
         a. GAAS
         b. confidentiality
         c. misconceptions of clients
         d. management responsibility
      2. Other users of financial statements
   B. The Profession's Response to the View of Others
      1. The Cohen Commission
         a. conclusions
         b. recommendations
   C. The View of the Government
      1. The Securities and Exchange Commission
         a. concerned with disclosure
         b. promulgates standards and rules

III. Legal Liability of Auditors
   A. Important Concepts
      1. Negligence
      2. Fraud
      3. Burden of Proof
   B. Common Law
      1. Client
         a. auditor's liability
         b. civil action
         c. burden of proof
         d. defenses
      2. Third Parties
         a. classes of third parties
         b. auditor's liability
         c. civil action
         d. burden of proof
         e. defenses
   C. Statutory Law
      1. Securities Act of 1933
         a. requirements of the act
         b. auditor's liability
         c. burden of proof
         d. Escott v. BarChris Construction Corp.
      2. Securities and Exchange Act of 1934
         a. requirements of the act
         b. section 10(b)
            1) auditor's liability
2) burden of proof
3) Hochfelder v. Ernst & Ernst
   c. section 18
      1) auditor's liability
      2) burden of proof
3. Other Federal and State Statutes
   a. Federal False Statements Act
   b. Federal Mail Fraud Act
   c. Federal Conspiracy Statute
   d. State Laws
D. Criminal Liability
   1. Description & Comparison to Civil Liability
   2. United States v. Simon

IV. Precautions Against Litigation
A. Accounting Standards
   1. Knowledge and compliance
   2. Beyond the Standards - Good Judgement
B. Recommendations by the Profession
   1. Client acceptance and retention
   2. Engagement letter
   3. Quality control
   4. Balancing growth and quality control
   5. Defensive auditing
   6. Legal advice

V. Conclusion
A. Summary
B. New Areas Presenting New Legal Questions
   1. Compilation and review
   2. Forecasts
C. Thoughts on the Future
Auditors help to preserve economic freedom. This statement might surprise some people, but it is the truth. One of the major characteristics of our free economy is our quest for perfect competition. Perfect competition requires efficient markets supplied with complete information. A portion of this information is provided by audited financial statements and other reports supplied by accountants. As a result, accounting and auditing functions have become an essential element in maintaining our free and competitive society.

American auditing originated from Scottish and British accountants who came to the United States during the late 1800s to check on British investments in American industries. They audited books by checking in detail the additions and postings in an attempt to detect fraud, but fraud was usually not found because it was accomplished by leaving cash receipts out of the books. By the early 1930s, the number of investors in corporate stocks and bonds had increased dramatically. Auditors had to change their audits to accommodate stockholders and investors. The emphasis changed from the balance sheet to the income statement. With the establishment of the federal securities laws of 1933 and 1934 came the first audits required by law. Throughout the 40s and 50s, many accountants, accounting organizations, and the SEC were disappointed in the slowness of the accounting profession in establishing accounting principles. A lack of
understanding and agreement on the basic postulates and principles underlying the accounting practice contributed significantly to the delay. Ever since the principles have been established, they have been criticized as being too broad. They permit the management to influence the impression conveyed by financial statements by allowing them to choose between several accounting methods. The effect of this influence can be misleading to the users of the financial statements.

Occurences in the past twenty years have had a significant impact on auditing. Controversies, such as the broadness of accounting principles discussed above, along with criticisms by the SEC, members of the accounting profession, and other interested parties, nurture an almost continual interest by the financial press in accounting principles and the accounting profession. (2) Numerous scandals in the late 60s which resulted in courts ruling that auditors had been negligent in their duties, plus the general distrust of the system by the public due to Watergate caused auditors to lose their credibility. The profession had to consider the adequacy of quality control and professional discipline. Also, it was time to reconsider the historical idea that an auditor is not responsible for searching out fraud. Courts and governmental agencies decided it was time to be tougher on auditors and place more liability on their shoulders. All of this caused the accounting profession to be greatly
concerned. One author stated, "Today, with fraud cases becoming more common, and with investigations by governmental agencies and resulting litigation exploding in all directions, this disturbing trend is becoming a major factor in the operation of accounting firms."(3)

Accountants are taking extra precautions because they are no longer sure what they will be held liable for. This paper explores the general responsibility and legal liability of accountants with regard to audited financial statements. Precautions that accountants should take against litigation will be included, along with auditing trends for the future.

There are many different opinions of what an auditor's responsibility is toward his clients and other users of financial statements. The profession's view based on the AICPA Professional Standards is that, "A certified public accountant should be fair and candid with his clients and serve them to the best of his ability, with professional concern for their best interests, consistent with his responsibilities to the public."(4) First, it is important to look at what accountants have established as their responsibility to clients. When accepting an audit engagement, the auditor has taken on the task of examining financial statements and related supporting information to form an opinion on whether or not the financial statements are presented fairly and conform with generally accepted accounting principles that have been consistently applied.
It is his duty to follow generally accepted auditing standards. Under GAAS, he has the responsibility to properly plan his examination, to search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in conducting his examination. As long as the audit has been performed in accordance with GAAS, the auditor has fulfilled his professional responsibilities. He does not guarantee or insure against errors or irregularities.

A CPA also has the responsibility to keep client information confidential. Generally, he cannot disclose confidential information without the client's consent, but this does not prevent him from complying with GAAP and GAAS. As a result, it would not be a violation of responsibility to a client if an auditor qualified his opinion on the client's financial statements and disclosed that the client had not complied with GAAP. Also, maintaining confidentiality does not apply in all cases. Some situations in which an accountant may be required to disclose confidential information include compliance with a valid subpoena or summons, a voluntary quality review under the authorization of the AICPA, an inquiry made by the ethics division or Trial Board of the AICPA or a similar state CPA society, or an inquiry made under state statutes.(5)

There has been a misconception in the past that an auditor's main objective in performing audits is the
detection of fraud. As is stated above, the accounting profession maintains that the purpose of an audit is to determine if financial statements are presented fairly. The margin between the perceived and actual responsibilities assumed by an accountant in performing an audit is commonly referred to as the "expectation gap."

With the drastic increase in management fraud that has occurred in the past twenty years, clients, governmental agencies, and users of financial statements have wanted to increase this gap by requiring more responsibility for detecting fraud during audits. The Statement on Auditing Standards No. 1 issued by the AICPA sets forth the auditor's responsibility for the detection of fraud. It states that normal audit examinations are not primarily designed to disclose fraud and should not be relied upon to do so. Also, if the discovery of all fraud were an objective of the auditor's examination, the amount of work required would increase the cost to a point where no one could afford an audit. Even then there would be no assurance that any existing fraud had been detected because of the nature of fraudulent acts such as unrecorded transactions, forgeries and collusion.

Auditors do have responsibilities to the client in the conduct of an audit, but infallibility and clairvoyance are not included. It is reasonable for an auditor to rely upon the truthfulness of certain documents and the genuineness of certain documents provided by management. This is why
some of the responsibility must be shifted to management. Management should be held responsible for the misrepresentation and withholding of material information from the auditor. If an accountant follows customary auditing procedures, those procedures do not disclose any misrepresentation, and no apparent reason exists to expand the audit procedures, the accountant should not be held responsible for the misrepresentation.

Along with responsibilities to the client, the accounting profession realizes that it also has a responsibility to promote public welfare. Auditors carry out this responsibility by expressing opinions on the fairness of financial statements of publicly traded firms. This helps to ensure that financial information available to investors and other users of financial statements is fair and relevant. The exchange of reliable financial information is an essential element of our free market system.

The general public and some courts have expressed a slightly different view of the responsibility of accountants. This is apparent from the recent criticism of the accounting profession due to the increase in cases brought against auditors for failure to detect misrepresentations in financial statements. The Commission on Auditor's Responsibilities, also called the Cohen Commission, was established by the AICPA in 1974 to respond to criticism about the auditing profession. The Commission
did a study based on legal cases against auditors. The final report which was issued in 1978 was considered to be a landmark. The results lead to some very significant conclusions. The study found that a significant percentage of financial statement users consider fraud detection to be one of the most important objectives of the audit. Also, a frequent cause of audit failures is the incorrect interpretation or implementation of accounting or auditing pronouncements. The profession is concerned about the Commissions verification that courts have shown a willingness to hold auditors responsible for material misrepresentations in financial statements. The study also found that auditing failures were not a result of a deficiency in auditing standards and these failures can never be totally eliminated because human error will always exist.(6) Some of the recommendations by the Commission include a report by management in the annual report to acknowledge management's responsibility for the financial statements and to describe the status of internal control, and an expanded auditor's report that will focus on the company's representations contained in the report by management. The expanded report would require the auditor to expand his evaluation of internal control. The Commission also concluded that it is the auditor's responsibility to actively search for fraud rather than simply being alert for it.(7)

The government also has a view of the responsibility
of auditors that differs from the view of the accounting profession. The Securities and Exchange Commission is generally the agency that speaks for the government with regard to auditing matters. The SEC can be described as a regulatory agency with vast quasi-legislative and quasi-judicial powers whose rules and regulations have a direct and significant impact on the accounting profession, especially regarding accountant's liability. The SEC takes the position that the public accountant's duty is to safeguard public interest and this duty takes precedence over any duty to the client. The accountant's duty is carried out by verifying and communicating material information from financial statements. If following GAAP and GAAS does not result in the disclosure of such material information, the SEC maintains that it has the power to promulgate additional standards and rules.

Now that the general responsibilities of auditors have been examined, the next thing to explore their legal liability. First, some important terms that are frequently encountered when discussing legal liability will be clarified. These terms are negligence, fraud, and burden of proof. Negligence can be classified as ordinary or gross. Ordinary negligence is the failure to use reasonable care when performing services. Gross negligence is the failure to use even minimum care when performing services. Negligence can result from a specific act or from a failure to act. It is often predicated upon a lack
of honesty and loyalty. In order for an accountant to be considered negligent, he must fail to perform all services in accordance with what a reasonable accountant would do under similar circumstances.

Fraud goes beyond negligence in seriousness. Fraud is the intentional misrepresentation of a material fact which deceives and then injures another party. According to the courts, fraud must usually include a willful intent to defraud. Four requirements that need to be present for fraud to occur are the intention to mislead which is referred to as scienter, a false representation or the concealment of a matter of fact that is material to the transaction in question, justifiable reliance by the plaintiff on the false statement, and injury as a result of the reliance. The lack of any of these requirements can be used as a defense in fraud cases.

Burden of proof means the burden of coming forward with evidence to prove or disprove a relevant and material fact that is being disputed. In litigation against an auditor, there are four elements that determine the auditor's liability. The burden of proving any or all of these elements rests on different parties in different situations. These elements are damage or loss resulting from reliance upon financial statements or advice, misstated financial statements or erroneous advice, reliance upon financial statements or advice, and a deficiency in the auditor's conduct. In civil cases, which
include negligence cases, the party with the burden of proof must only provide evidence that weighs greater in his favor to win the case. This is different than in criminal cases where guilt or innocence must be proven beyond a reasonable doubt.

The legal liability of auditors can either be classified as common law liability or statutory law liability. Common law is derived from legal precedents established by decisions in legal cases. As a result, common law reflects the values of society at the time the decisions were made. Under common law the liability to the client is for ordinary negligence, gross negligence, or fraud. This liability is based on the contractual relationship between the client and the auditor (privity of contract), and on the auditor’s independence from client control. The contract does not have to be formally written. It may be implied.

When a client believes that an auditor has failed to properly carry out the duties of the contract, he may seek a civil action of breach of contract or tort. Under breach of contract, the auditor has usually violated generally accepted accounting standards or the confidential relationship between himself and the client and may be subject to monetary damages. One case that set an important precedent with regard to breach of contract was 1136 Tenants’ Corp. v. Max Rothenberg & Co. In this case, the auditor was hired to perform services for the client,
but no engagement letter was prepared. When it was
discovered that a former manager had embezzled funds, the
client sued the auditor because an audit had not been
performed. In defense, the auditor claimed that he had not
been hired to do a complete audit, only a write-up. The
court found in favor of the plaintiff. In its opinion, the
court stated that a write-up engagement requires certain
definitive audit procedures, hiring a CPA presumes an
audit, an audit may be adequately performed without
independent verification, and accountants have a duty to
detect defalcation. The first three of these could have
been eliminated by preparing a proper engagement
letter.(10)

Tort liability occurs when an accountant breaches a
noncontractual duty resulting in injury to another person.
Monetary damages may be awarded. If the tort was
intentional, the victim is also entitled to punitive
damages. In addition to the tort liability of the
accountant, the firm also is liable if the tort is
committed within the scope of the accountant’s employment.

The burden of proof in cases concerning common law
liability to the client is placed on the plaintiff. Recall
that the plaintiff has the burden of proving the four
elements of auditor’s liability:  damage or loss, the
financial statements were misstated or erroneous advice
given, reliance on financial statements or erroneous
advice, and deficient auditor conduct. Defenses can be built on the weakness or nonexistence of any of these elements. The defenses used depend primarily on the circumstances of the case, but there are a few that are frequently used. Two such defenses are due diligence and contributory negligence. The defendant's due diligence defense is that he did not know and in the exercise of reasonable care would not have discovered the omission or misrepresentation of information. The defense of contributory negligence can be used to limit auditor liability when the client's negligence has contributed to the accountant's failure to perform the contract and to report true information.

Auditors have a liability to third parties under common law as well as clients. Third parties are parties who have an interest in audited financial statements, but don't have a contract with the accountant who audited the statements. There are three classes of third parties: primary beneficiaries, foreseen beneficiaries, and foreseeable third parties. A primary beneficiary is not a client but will receive an audit report that has been prepared expressly for his benefit. An example of a primary beneficiary is a bank which requires audited financial statements from customers who want to take out a loan. Foreseen beneficiaries are not specifically identified to auditors, but their general identity and specific purpose for relying on the audited financial
statements are known. Foreseeable third parties are not specifically or generally identified, but still might be expected to rely on audited financial statements. Investors and potential investors would fall into this category.

The common law liability of auditors to each of the third party classes varies directly with how far each is removed from a contractual agreement with the auditor for audit services. Since a primary beneficiary is specifically identified to the auditor by the client, the liability to the primary beneficiary and the client are the same, namely ordinary negligence, gross negligence, and fraud.

Foreseen beneficiaries are farther removed from the contractual agreement than primary beneficiaries, so the auditor’s liability to them is not as great. Traditionally, auditors have been liable to foreseen beneficiaries for gross negligence and fraud, but in a few cases they have been liable for ordinary negligence. The decisions in two cases in particular, Rusch Factors, Inc. v. Levin and Ryan v. Kanne, support ordinary negligence as one of the auditor’s liabilities to foreseen beneficiaries. This is just one example that supports the current trend to increase the liability of accountants.

Since foreseeable third parties are the furthest removed from a contractual liability, auditors have the least amount of liability to this group. Auditors are
liable to foreseeable third parties for gross negligence and fraud.

The case of Ultramares Corp. v. Touche has been the primary case for setting a legal precedent for an auditor's liability to primary beneficiaries and foreseeable third parties. During an audit, Touche failed to uncover a material amount of fictitious accounts receivable. Ultramares took action against Touche for negligence. The court ruled that the auditor was liable to primary beneficiaries for ordinary negligence, but gross negligence or fraud must occur for the auditor to be liable to foreseeable third parties.

The civil action that can be taken against auditors, the burden of proof, and the damages that can be awarded are the same for all third parties. Tort is the civil action that can be taken. The burden of proof is on the plaintiff for the four elements of auditor's liability. A third party can receive both monetary and punitive damages.

Besides the due diligence defense explained earlier, auditors can use the defenses of lack of privity and justifiable reliance in cases involving third parties. Lack of privity means that the auditor is not liable to the third party because there is no contract between them. The justifiable reliance defense can be used when the defendant believes that the plaintiff was not reasonably justified in relying on the financial statements.

Statutory law is "written law" that is established by
federal and state legislative bodies. The primary federal statutory laws that have an affect on the accounting profession are the Securities Act of 1933 and the Securities and Exchange Act of 1934. By passing these acts, Congress was attempting to make accountants more liable to third parties. The Securities Act of 1933 regulates the original offering and sale of securities. The sale of securities after the first issuance are not covered under this Act. The Act requires that in order for an entity to publicly sell its securities, that entity must file a registration statement (usually an S-1) and a prospectus with the SEC. This is done in an attempt to promote full and fair disclosure and prohibit fraudulent misrepresentation regarding the original issuance and sale of securities.

Accountants come under the 1933 Act when they aid in the preparation of registration statements and prospectuses. The specific on which most litigation against accountants is based is Section 11. Under Section 11, an accountant generally qualifies as an expert and will incur liability as to an omission or false statement of a material fact unless he had, after a reasonable investigation, reasonable ground to believe and did believe that the statements were true and that no material facts were omitted. If an accountant violates Section 11, he may be liable to the purchasers of securities for ordinary negligence.
The burden of proof under the Securities Act of 1933 does not rest solely upon the plaintiff or the defendant. The plaintiff must prove that he suffered damages and loss, and that the financial statements were materially misstated or erroneous advice was given. The defendant must prove that he acted with due diligence and that the plaintiff did not rely on the financial statements.

The case of Escott v. BarChris Construction Corp. had great influence upon the accounting profession with regard to liability under Section 11 of the 1933 Act. In the case, an S-1 review was required to examine the events that had occurred between the balance sheet date and the effective date of the registration statement. Peat, Marwick, Mitchell & Co. performed the S-1 review because they had audited the most recent financial statements. The senior who was in charge of the review was not yet a CPA and was working on his first engagement as a senior. After the sale of the securities, BarChris filed for bankruptcy. Peat, Marwick claimed a due diligence defense. The court ruled that accountants should not be held to a standard that is higher than the one established by the profession, but in this case the accountants did not maintain that standard. The defendant had the burden of proving the due diligence defense and did not effectively do so. The court's opinion prompted the issuance of Statement on Auditing Procedure No. 47, "Subsequent Events," as well as setting a precedent that auditor's could be held liable for
ordinary negligence under the Securities Act of 1933.

The Securities and Exchange Act of 1934 takes over where the 1933 Act leaves off. It regulates the trading of securities that have previously been issued. The purpose of the Act is to promote fair and adequate disclosure of publicly held companies on a continuing basis. Entities are required to submit periodic information as well as a registration form (commonly form 10) to the SEC. They are also required to enlist the services of a Certified Public Accountant. The liability of CPAs under this Act stems from their involvement in the disclosure process. An accountant is liable for errors in financial statements contained in a prospectus or other filed report even though it is unaudited if there are errors which he knew or reasonably should have known.

A purchaser or seller of a security usually brings action against a CPA under either Section 10(b) or Section 18 of the 1934 Act. Most litigation is under Section 10(b). In fact, this section is "the most rapidly expanding area of liability under federal securities laws for firms as well as directors, officers, and public accountants."[11] According to Section 10(b) and Rule 10b-5, it is unlawful to use mails, any instrumentality of interstate commerce, or any national securities exchange to defraud any person in connection with the purchase or sale of any registered or unregistered security. The liability under these provisions is very broad because the provisions
cover any false or misleading statement, regardless of whether or not it is filed with the SEC. A CPA may be liable to sellers or purchasers for gross negligence or fraud for not complying with this section of the 1934 Act.

The burden of proof under section 10(b) rests entirely on the plaintiff. The plaintiff must prove that he suffered damage or loss, the statements were materially mistated or erroneous advice was given, he relied on the false statements or advice, and the auditor's conduct was deficient.

Hochfelder v. Ernst & Ernst has been a landmark case regarding accountant's liability under Rule 10b-5 of the Securities and Exchange Act of 1934. The case resulted from the discovery that the president of First Securities Corporation was using the funds of investors for his own use. Investors had sent funds directly to him with the understanding that he would deposit the funds in an escrow account. He kept his fraud a secret by establishing the "mail rule" which prohibited anyone else from opening his mail. When the fraud was discovered, the accountants were sued for negligence. After rulings in favor of Ernst & Ernst in District Court and against them in the Court of Appeals, the case reached the Supreme Court. The Court decided that since Hochfelder had only alleged negligence and not the "intent to deceive, manipulate, or defraud," Ernst & Ernst was not liable.(12) The Court pointed out that Congress intended for Rule 10b-5 to apply to something
much stronger than negligence and that 10b-5 clearly states scienter, and not mere negligence, will suffice. The decision in Hochfelder did limit the accountant's liability somewhat, but the Court left some questions unanswered by not addressing the question of whether or not reckless behavior can result in liability under Section 10(b) and Rule 10b-5.

The scope of liability under Section 18 of the Securities and Exchange Act of 1934 is much narrower than Section 10(b) because it applies only to statements filed with the SEC. Under this section, persons who make false and misleading statements in filed documents are liable to purchasers and sellers of securities who relied upon these statements if the price of the securities was affected by the statements. In order for a CPA to be liable, he must have been grossly negligent.

The burden of proof under this section is split between the plaintiff and the defendant. The plaintiff must prove that damage or loss was incurred, the statements were misstated or erroneous advice given, and he relied on the misstated statements or erroneous advice. The defendant can avoid liability by proving that he acted in good faith and had no knowledge of any false or misleading statements (due diligence).

There are other federal statutes besides the Securities Acts which might affect the liability of accountants. These statutes are the Federal False
Statements Act, the Federal Mail Fraud Act, and the Federal Conspiracy Statute. A person may become liable under the Federal False Statements Act if he knowingly and willfully makes false statements to any department or agency of the federal government. Accountants come under the jurisdiction of this act when their auditing reports accompany financial statements in reports filed with the SEC.

The Federal Mail Fraud Act prohibits the fraudulent use of the postal service. This act applies to accountants when they certify financial statements that they know or should know are false and will be used in violation of the statute. Liability under the Federal Conspiracy Statute arises when two or more individuals agree to commit a crime against the United States. Accountants may be prosecuted for conspiracy to violate any of the four federal statutes previously mentioned.

Since statutes vary from state to state, it would not be practical to discuss them in depth in this paper, but some statutes that are common to many states should be mentioned. Most states have enacted statutes that would make an accountant criminally liable for obtaining money by false pretenses and for willfully falsifying reports. State accountancy laws have been established to revoke or suspend an accountant's right to practice if he has engaged in unethical conduct. Many states have adopted section 101 of the Uniform Securities Act which is very similar to SEC
rule 10b-5 which is described above. (13) Various states have also enacted laws permitting CPA firms to practice in the form of a professional corporation. These laws provide limited liability to the corporation. However, each professional person remains personally liable for work that he personally performs. (14)

Criminal liability involving auditors has not occurred very often in the past few years. There have been very few cases where auditors have been held criminally liable. Most involve civil liability. Criminal liability is different from civil liability in that criminal liability involves a willful violation of a statute. Specific intent requirements will vary according to precedents set for each particular statute. While the plaintiff in a civil case usually wins if all the evidence leans slightly in his favor, the plaintiff in a criminal case will not win unless the defendant’s guilt is proven beyond a reasonable doubt. Most criminal cases against accountants are prosecuted under federal law.

The case of the United States v. Simon is significant to the accounting profession because it established an auditor’s criminal liability.

This case, which is also referred to as the Continental Vending case, was brought against the accountants by the government because it was alleged that they willfully prepared false or misleading financial statements. The auditors used the defense that they were
free of criminal liability because they had followed generally accepted accounting principles. The court convicted the auditors of willfully making a false and misleading statement and for using the postal service to distribute this statement. The auditors received a pardon from President Nixon. This case imposes a duty upon accountants to disclose what they know when they have reason to believe that a business entity to a material extent is operating for the private benefit of its management rather than in the interest of its stockholders. The accounting profession was very concerned about the decision because it felt that compliance with GAAP and GAAS should be a strong defense.

Within recent years, the number of cases against accountants has increased and as a result, more precautions are being taken. One of the first things an accountant should do to avoid litigation is make sure he knows and complies with accounting standards and pronouncements. These are the guidelines of the profession, and an awareness of them is essential to provide quality service and reduce exposure to litigation. Continuing professional education is an excellent way to keep current on the ever-changing standards of the accounting profession.

Most accountants and the AICPA believe that if the professional standards are followed, an accountant should not be subject to liability because courts cannot impose higher standards than the standards of the profession. To
do this would impose liability even if the accountant did
everything he ought to do. Lawyers of plaintiffs disagree
with this because they believe that the profession might
have set standards too low to provide adequate care.
Courts have also ruled, as in United States v. Simon, that
compliance with GAAS and GAAP may not prevent an accountant
from being liable. The SEC promulgates new rules and
regulations when it feels that accounting standards are not
adequate. Because of these views, it is important for
accountants to comply with the standards, but also go
beyond the standards and apply their good judgement.

Compliance with professional accounting standards "is
no guarantee that under particular circumstances an auditor
will be held blameless. There is simply no substitute for
vigilance and good judgement when it comes to avoiding
blame."(15)

Besides knowledge of accounting principles and
pronouncements, members of the accounting profession
recommend other precautions that should be taken to avoid
litigation. One of these is client acceptance and
retention. Before accepting a new client, it is important
to do such things as look into the client's background,
find out who the predecessor accountant is, and learn all
about the client's business. Retaining a client decreases
your potential liability because you become more familiar
with his operations as time goes on.

An engagement letter is a very effective precaution.
The letter is actually a contractual agreement that can actually reduce the expectation gap. It is not required by the professional standards, but most accountants use it anyway to spell out the scope of the audit and avoid misunderstandings.

Through quality control, an auditor does his best to apply the same high standards during each engagement. Quality control can be maintained by setting up standard procedures to follow and properly planning engagements. Other things are involved also, like quality personnel that are properly supervised.

Another way to guard against litigation is to balance growth and quality control. Growth brings on things that can damage quality such as limited supervision because the firm is understaffed, excessive deadline pressure, and heavy overtime requirements. Accountants must guard against these things while still allowing growth to happen.

Defensive auditing, another precaution, involves looking for and evaluating indicators of possible problems. An auditor shouldn’t leave himself open to any liability that could be prevented. Among other things, he should document all his work carefully, be very cautious about management representations, and consult with a partner or colleague often.

The last precaution presented here is legal advice. Even though an auditor should have a good idea of whether an act is illegal, the actual determination is usually
beyond his professional competence. This is why he should consult a lawyer when questionable acts surface. One author stated, "Precautionary legal advice, like preventive medicine, may be essential to a CPA firm's continuing 'legal health.'" (16)

This paper has explored the responsibility and potential liability that auditors face with regard to audited financial statements, along with precautions that can be taken to guard against litigation. The drastic increase in management fraud in the past twenty years has been hard on accountants because it has resulted in an increase in their negligence according to court decisions. The increase in their negligence has caused auditors to lose their credibility with the government and the general public who now think that the liability of auditors should be increased. Court decisions and regulations by the SEC tend to reflect an increase in liability. With more liability placed on them, accountants need to take precautions to decrease their chances of being sued.

New areas that will present new legal questions in the near future are compilations and reviews, and forecasts. When performing a compilation and review, the accountant compiles financial information given to him by the client and then prepares financial statements. He then reviews the statements by performing analytical procedures to discover unusual items and determine whether the financial statements appear to conform to generally accepted
accounting principles. A compilation and review is not an audit, so the reviewed statements should be marked "unaudited" on each page. Questions almost definitely arise as to whether or not accountants are liable for these statements, who they might be liable to, and under what circumstances.

The liability of accountants for financial forecasts is uncertain at the present because an accountant's role in the preparation and release of forecasts is uncertain. It is not practical for anyone to expect forecasts to have a high degree of accuracy because they are basically educated guesses. But inevitably, there will be some people that will expect a higher degree of accuracy than they should. The problem will be determining if the auditor has any liability when someone relies on a forecast.

What will auditors be able to expect in the future? Right now, it looks like their liability will continue to increase, unless the values of our society change. It is possible that there will be a great decrease in fraudulent acts, just as there has been a great increase in recent years, but I don't think this will happen in the near future. Instead, auditors will have to do something to improve their credibility. Since there has been some criticism of the broadness of accounting standards, the profession might have to consider modifying them to improve relations with the public. There is also a slight possibility that the government will take control and be
the sole regulator of the accounting profession if the
efficiency of auditors continues to increase. Regardless of
what happens, auditors will have to be very careful in
their auditing procedures and take all possible precautions
to avoid liability, because the liability may become more
than they can bear.
NOTES


(5) Windal, p. 94.


(7) Windal, p. 103.

(8) Windal, p. 258.


(10) Landahl, p. 22.

(11) Causey, p. 95.


(14) Windal, p. 225.

(15) Windal, pp. 142-3.


