**Chapter 04**

**Legal Liability of CPAs**

**True / False Questions**

1. Fraud is defined as failure to use reasonable care in the performance of services.
**FALSE**

2. Most of the burden of affirmative proof is on the defendant under common law.
**FALSE**

3. The Ultramares v. Touche case held that auditors could be held liable to any foreseen third party for ordinary negligence.
**FALSE**

4. The Securities Exchange Act of 1934 offers recourse against the auditors to a far greater number of investors than does the Securities Act of 1933.
**TRUE**

5. The precedent set by the Hochfelder v. Ernst case is generally believed to have increased auditors' legal liability.
**FALSE**

6. The auditors can be held liable for negligence in audits of financial statements, but in reviews of financial statements.
**FALSE**

7. The results of the Continental Vending Corporation case included the criminal prosecution of auditors for gross negligence.
**TRUE**

8. Most charges made against auditors under common law are criminal.
**FALSE**

9. The Securities Act of 1934 includes provisions for criminal charges against persons violating the Act.
**TRUE**

10. The use of engagement letters is generally designed to prevent lawsuits by third parties against the auditors.
**FALSE**

**Multiple Choice Questions**

11. A CPA issued an unqualified opinion on the financial statements of a company that sold common stock in a public offering subject to the Securities Act of 1933. Based on a misstatement in the financial statements, the CPA is being sued by an investor who purchased shares of this public offering. Which of the following represents a viable defense?
A. The investor has not proven CPA negligence.
B. The investor did not rely upon the financial statement.
C. The CPA detected the misstatement after the audit report date.
**D.** The misstatement is immaterial in the overall context of the financial statements.

12. Which of the following is a correct statement related to CPA legal liability under common law?
A. CPAs are normally liable to their clients, the shareholders, for either ordinary or gross negligence.
**B.** CPAs are liable for either ordinary or gross negligence to identified third parties for whose benefit the audit was performed.
C. CPAs may escape all personal liability through incorporation as a limited liability corporation.
D. CPAs are guilty until they prove that they performed the audit with "good faith."

13. Under Section 10 of the 1934 Securities Exchange Act auditors are liable to security purchasers for:
A. Lack of due diligence.
**B.** Existence of scienter.
C. Ordinary negligence.
D. Auditors have no liability to security purchasers under this act.

14. Jones, CPA, is in court defending himself against a lawsuit filed under the 1933 Securities Act. The charges have been filed by purchasers of securities covered under that act. If the purchasers prove their required elements, in general Jones will have to prove that:
A. He is not guilty of gross negligence.
B. He performed the audit with good faith.
**C.** He performed the audit with due diligence.
D. The plaintiffs did not show him to be negligent.

15. An auditor knew that the purpose of her audit was to render reasonable assurance on financial statements that were to be used for the application for a loan; the auditor did know the identity of the bank that would eventually give the loan. Under the Restatement of Torts approach to liability the auditor is generally liable to the bank which subsequently grants the loan for:
A. Lack of due diligence.
B. Lack of good faith.
C. Gross negligence, but not ordinary negligence.
**D.** Either ordinary or gross negligence.

16. An auditor knew that the purpose of her audit was to render reasonable assurance on financial statements that were to be used for the application for a loan; the auditor did know the identity of the bank that would eventually give the loan. Under the foreseeable third party approach the auditor is generally liable to the bank which subsequently grants the loan for:
A. Lack of due diligence.
B. Lack of good faith.
C. Gross negligence, but not ordinary negligence.
**D.** Either ordinary or gross negligence.

17. Which of the following forms of organization is most likely to protect the personal assets of any partner, or shareholder who has been involved on an engagement resulting in litigation?
A. Professional corporation.
**B.** Limited liability partnership.
C. Partnership.
D. Subchapter M Incorporation.

18. Under which common law approach are auditors most likely to be held liable for ordinary negligence to a "reasonably foreseeable" third party?
A. Due Diligence Approach.
B. Ultramares Approach.
C. Restatement of Torts Approach.
**D.** Rosenblum Approach.

19. Assume that $500,000 in damages are awarded to a plaintiff, and the CPA's percentage of responsibility established at 10%, while others are responsible for the other 90%. Assume the others have no financial resources. As a result the CPA has been required to pay the entire $500,000. The auditor's liability is most likely based upon which approach to assessing liability?
A. Absolute liability
B. Contributory negligence
**C.** Joint and several liability.
D. Proportional liability.

20. Assume that $500,000 in damages are awarded to a plaintiff, and the CPA's percentage of responsibility established at 10%, while others are responsible for the other 90%. Assume the others have no financial resources. The CPA has been required to pay $50,000. The auditor's liability is most likely based upon which approach to assessing liability?
A. Absolute liability.
B. Contributory negligence.
C. Joint and several liability.
**D.** Proportional liability.

21. Assume that a client has encountered a $500,000 fraud and that the CPA's percentage of responsibility established at 10%, while the company itself was responsible for the other 90%. Under which approach to liability is the CPA most likely to avoid liability entirely?
A. Absolute negligence.
B. Comparative negligence.
**C.** Contributory negligence.
D. Joint Negligence.

22. In which of the following court cases was a precedent set increasing liability to third parties arising from audits under common law?
**A.** Rosenblum v. Adler.
B. Hochfelder v. Ernst.
C. 1136 Tenants Corporation v. Rothenberg.
D. Continental Vending.

23. The burden of proof that must be proven to recover losses from the auditors under the Securities Exchange Act of 1934 is generally considered to be:
A. Less than the Securities Act of 1933.
B. The same as the Securities Act of 1933.
**C.** Greater than the Securities Act of 1933.
D. Indeterminate in relation to the Securities Act of 1933.

24. CPAs should be liable to any party if they perform their services with:
A. Ordinary negligence.
B. Regulatory providence.
**C.** Due professional care.
D. Good faith.

25. The Second Restatement of the Law of Torts provides for auditor liability to a limited class of foreseen third parties for:
A. Only criminal acts.
**B.** Either ordinary or gross negligence.
C. Only gross negligence.
D. Only fraud.

26. A principle that may reduce or entirely eliminate auditor liability to a client is:
A. Client constructive negligence.
**B.** Client contributory negligence.
C. Auditor ordinary negligence.
D. Auditor gross negligence.

27. Under the Securities Act of 1933 the burden of proof that the plaintiff sustained a loss must be proven by the:
**A.** Plaintiff.
B. Defendant.
C. SEC.
D. Jury.

28. A case by a client against its CPA firm alleging negligence would be brought under:
A. The Securities Act of 1933.
B. The Securities Exchange Act of 1934.
C. The state blue sky laws.
**D.** Common law.

29. Assume that a CPA firm was negligent but not grossly negligent in the performance of an engagement. Which of the following plaintiffs probably would recover losses proximately caused by the auditors' negligence?
A. A loss sustained by a client in a suit brought under common law.
**B.** A loss sustained by a lender not in privity of contract in a suit brought in a state court which adheres to the Ultramares v. Touche precedent.
C. A loss sustained by initial purchasers of stock in a suit brought under the Securities Act of 1933.
D. A loss sustained by a bank named as a third-party beneficiary in the engagement letter in a suit brought under common law.

30. Which of the following court cases highlighted the need for obtaining engagement letters for professional services?
A. Ultramares v. Touche.
B. Rosenblum v. Adler.
C. Hochfelder v. Ernst.
**D.** 1136 Tenants Corporation v. Rothenberg.

31. In which type of court case is proving "due diligence" essential to the auditors' defense?
A. Court cases brought under the Securities Exchange Act of 1934.
B. Court cases brought by clients under common law.
C. Court cases brought by third parties under common law.
**D.** Court cases brought under the Securities Act of 1933.

32. Which common law approach leads to increased CPA liability to "foreseeable" third parties for ordinary negligence?
A. Ultramares v. Touche.
B. Restatement of Torts.
C. Rule 10b-5.
**D.** Rosenblum v. Adler.

33. Which of the following is the best defense that a CPA can assert against common law litigation by a stockholder claiming fraud based on an unqualified opinion on materially misstated financial statements?
A. Lack of due diligence.
**B.** Lack of gross negligence.
C. Contributory negligence on the part of the client.
D. A disclaimer contained in the engagement letter.

34. Which of the following must be proven by the plaintiff in a case against a CPA under the Section 11 liability provisions of the Securities Act of 1933?
A. The CPA knew of the misstatement.
B. The CPA was negligent.
**C.** Material misstatements were contained in the financial statements.
D. The unqualified opinion contained in the registration statement was relied upon by the party suing the CPA.

35. A CPA issued a standard unqualified audit report on the financial statements of a client that the CPA knew was in the process of obtaining a loan. In a suit by the bank issuing the loan the CPA's best defense would be that the:
**A.** Audit complied with generally accepted auditing standards.
B. Client was aware of the misstatements.
C. Bank was not the CPA's client.
D. Bank's identity was known to the CPA prior to completion of the audit.

36. The Private Securities Litigation Reform Act of 1995 imposes proportionate liability on the CPA who:
**A.** Unknowingly violates the 1934 Securities Exchange Act.
B. Knowingly or unknowingly violates the 1934 Securities Exchange Act.
C. Unknowingly violates the 1933 Securities Act.
D. Knowingly or unknowingly violates the 1933 Securities Act.

37. Which of the following is correct relating to the Private Securities Litigation Reform Act of 1995?
A. It provides certain small investors better recovery rights than it does large investors.
B. It retains joint and several liability in certain circumstances.
**C.** It makes recovery against CPAs more difficult under common law litigation.
D. It eliminates securities fraud as an offense under civil RICO.

38. A limited liability partnership form of organization:
A. Decreases liability of all partners of a CPA firm.
B. Has similar liability requirements to that of a professional corporation.
**C.** Eliminates personal liability for some, but not all, partners.
D. Eliminates personal liability for all partners.

39. Which of the following is accurate with respect to litigation involving CPAs?
A. A CPA will not be found liable for an audit unless the CPA has audited all affiliates of that company.
B. A CPA may not successfully assert as a defense that the CPA had no motive to be part of a fraud.
**C.** A CPA may be exposed to criminal as well as civil liability.
D. A CPA is primarily responsible, while the client is secondarily responsible for the notes in an annual report filed with the SEC.

40. Starr Corp. approved a plan of merger with Silo Corp. One of the determining factors in approving the merger was the strong financial statements of Silo which were audited by Cox & Co., CPAs. Starr had engaged Cox to audit Silo's financial statements. While performing the audit, Cox failed to discover certain instances of fraud which have subsequently caused Starr to suffer substantial losses. In order for Cox to be liable under common law, Starr at a minimum must prove that Cox:
A. Acted recklessly or with lack of reasonable grounds for belief.
B. Knew of the instances of fraud.
**C.** Failed to exercise due care.
D. Was grossly negligent.

41. Dexter and Co., CPAs, issued an unqualified opinion on the 20X3 financial statements of Bart Corp. Late in 20X4, Bart determined that its treasurer had embezzled over $1,000,000. Dexter was unaware of the embezzlement. Bart has decided to sue Dexter to recover the $1,000,000. Bart's suit is based upon Dexter's failure to discover the missing money while performing the audit. Which of the following is Dexter's best defense?
**A.** That the audit was performed in accordance with GAAS.
B. Dexter had no knowledge of the embezzlement.
C. The financial statements were presented in conformity with GAAP.
D. The treasurer was Bart's agent and as such had designed the controls which facilitated the embezzlement.

42. Under common law, when performing an audit, a CPA:
**A.** Must exercise the level of care, skill, and judgment expected of a reasonably prudent CPA under the circumstances.
B. Must strictly adhere to generally accepted accounting principles.
C. Is strictly liable for failures to discover client fraud.
D. Is not liable unless the CPA commits gross negligence or intentionally disregards generally accepted auditing standards.

43. A CPA's duty of due care to a client most likely will be breached when a CPA:
A. Gives a client an oral report instead of a written report.
B. Gives a client incorrect advice based on an honest error of judgment.
C. Fails to give tax advice that saves the client money.
**D.** Fails to follow generally accepted auditing standards.

44. Under common law, which of the following statements most accurately reflects the liability of a CPA who fraudulently gives an opinion on an audit of a client's financial statements?
A. The CPA is liable only to third parties in privity of contract with the CPA.
B. The CPA is liable only to known users of the financial statements.
**C.** The CPA probably is liable to any person who suffered a loss as a result of the fraud.
D. The CPA probably is liable to the client even if the client was aware of the fraud and did not rely on the opinion.

45. In a common law action against an accountant, lack of privity is a viable defense if the plaintiff:
**A.** Is the client's creditor who sues the accountant for negligence.
B. Can prove the presence of gross negligence that amounts to a reckless disregard for the truth.
C. Is the accountant's client.
D. Bases the action upon fraud.

46. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who are unknown to the CPA based on:
A. Ordinary negligence.
**B.** Gross negligence.
C. Strict liability.
D. Criminal deceit.

47. Hark, CPA, negligently failed to follow generally accepted auditing standards in auditing Long Corporation's financial statements. Long's president told Hark that the audited financial statements would be submitted to several, at this point undetermined, banks to obtain financing. Relying on the statements, Third Bank gave Long a loan. Long defaulted on the loan. In jurisdiction applying the Ultramares decision, if Third sues Hark, Hark will:
**A.** Win because there was no privity of contract between Hark and Third.
B. Lose because Hark knew that a bank would be relaying the financial statements.
C. Win because Third was contributory negligent in granting the loan.
D. Lose because Hark was negligent in performing the audit.

48. Under the Ultramares rule, to which of the following parties will an accountant be liable for ordinary negligence?
  
A. Option A
**B.** Option B
C. Option C
D. Option D

49. Quincy bought Teal Corp. common stock in an offering registered under the Securities Act of 1933. Worth & Co., CPAs, gave an unqualified opinion on Teal's financial statements that were included in the registration statement filed with the SEC. Quincy sued Worth under the provisions of the 1933 Act that deal with omission of facts required to be in the registration statement. Quincy must prove that:
A. There was fraudulent activity by Worth.
**B.** There was a material misstatement in the financial statements.
C. Quincy relied on Worth's opinion.
D. Quincy was in privity with Worth.

50. Bran, CPA, audited Frank Corporation. The shareholders sued both Frank and Bran for securities fraud under the Federal Securities Exchange Act of 1934. The court determined that there was securities fraud and that Frank was 80% at fault and Bran was 20% at fault due to her negligence in the audit. Both Frank and Bran are solvent and the damages were determined to be $1 million. What is the maximum liability of Bran?
A. $0
**B.** $200,000
C. $500,000
D. $1,000,000

51. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who are unknown to the CPA based on
A. Negligence.
**B.** Gross negligence.
C. Strict liability.
D. Criminal deceit.

52. The Public Company Accounting Oversight Board may conduct investigations and disciplinary proceedings of:
  
**A.** Option A
B. Option B
C. Option C
D. Option D

**Essay Questions**

53. Auditors may be held liable to both their clients and third parties under common law.
a. What must a client prove to recover its losses from the auditors under common law?
b. In a court that adheres to the precedent set by the Ultramares v. Touche case what must an ordinary third party prove to recover losses from the auditors under common law?

a. To recover losses under common law, a client must prove:
• Losses,
• Reliance on the auditors' representations,
• That reliance was proximate cause of the losses, and
• Negligence on the part of the auditors.
b. To recover losses under common law, ordinary third parties must prove:
•Losses,
• Reliance on the auditors' report,
• That reliance was proximate cause of the losses, and
• Gross negligence on the part of the auditors.

54. A CPA firm has audited the financial statements included in a Form S-1 filed with the SEC under the Securities Act of 1933. Shortly thereafter, the company went bankrupt and a class action lawsuit was filed by the initial investors against the CPA firm.
a. What should the plaintiff investors attempt to prove?
b. Must the plaintiffs prove that they relied on the financial statements included in the Form S-1?
c. What must the CPA firm prove in order to be successful with respect to the firm's defense?

a. The plaintiff investors should attempt to prove:
• That they sustained losses, and
• That the financial statements were misleading.
b. No. The investors need not prove reliance.
c. The auditors must prove:
• "Due diligence" that is, that they had reasonable grounds to believe and did believe that the financial statements were not misleading as of the effective date,
• The plaintiffs' losses were not caused by misstated statements, or
• The plaintiffs knew of the financial statement misstatement when the securities were purchased.

55. A plaintiff may elect to bring a lawsuit against auditors under applicable statutes--including the Securities Act of 1933 and the Securities Exchange Act of 1934--and under common law. For each circumstance, indicate the most likely source of CPA liability by placing the appropriate letter in the third column.
a. The Securities Act of 1933
b. The Securities Exchange Act of 1934
c. Common Law
 

 

56. Section 11 of the Securities Act of 1933, and Section 10 of the Securities Exchange Act of 1934 make a CPA potentially liable to a purchaser of registered securities. For items a through f, place a checkmark (√) under the column if the must prove its existence:
  

 