

In-Class LO 4-2, 3,
Team Case 4, 5



- 4-41. The following appeared in a brief article in a major business newspaper: A local court is in the process of ruling on whether the public accounting firm of James Willis and Co., CPAs, PC, should be required to pay all or part of \$16 million in damages relating to Geiger Co. for failing to detect a scheme to defraud the company, a former audit client.

Geiger Co., an SEC registrant, charges that Willis was negligent in failing to discover fraud committed by the company's controller and wants Willis to foot the bill for all \$16 million in claims by and against the company. The company claims that if it had known about the fraud, it could have stopped it and recovered financially. The bank involved claims that it granted the loan based on misstated financial statements. The shareholders involved claim that they purchased the stock on the American Stock Exchange at an inflated price due to the misstated financial statements. They acknowledged that while stock had been outstanding and traded for many years (10) prior to the fraud, they made their investment decisions relying upon the misstated financial statements.

Willis's general counsel said, "We anxiously await a decision that will show that CPAs are not guarantors for everything that goes on in the company." Geiger Co.'s lawyer said that she anxiously awaited a decision because it will "clearly show that CPAs are liable for finding fraud."

Assume that Willis performed that audit with ordinary negligence and this ordinary negligence is the reason that the defalcation was not discovered and recovered. Further, assume that the \$16,000,000 of loss is properly allocated as follows:

Company itself	\$8,000,000
Bank that gave a commercial loan	5,000,000
Shareholders	3,000,000

Reply from the perspective that the only issues involved here are whether the plaintiffs involved may recover from a CPA that has performed the engagement with this degree of negligence. Assume the situation described above, and assume that other elements of proof (e.g., loss, proximate cause) are not at issue.

Required:

- a. Assume that the case is brought under common law, and that the state in which Geiger Co. is headquartered follows the *known user* approach for third-party legal liability.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.
 4. Which of answers 1, 2, and 3 might change if the jurisdiction involved followed the *Restatement of Torts* approach? Explain.

- b. Assume that the case is brought under the Securities Act of 1933. Answer the following from the perspective of CPA liability under that act.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.
 4. Which, if any, of answers 1, 2, and 3 might change if the stock involved had been issued to the public for the first time and the financial statements involved had been included in a registration statement for the securities? Explain.

- c. Assume that the case is brought under the Securities Exchange Act of 1934. Answer the following from the perspective of CPA liability under that act.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.

