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"SALVAGE OPPORTUNITIES AGAINST PUBLIC ACCOUNTANTS AFTER PAYMENT UNDER A FIDELITY POLICY"

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INTRODUCTION

Fidelity companies have traditionally sought to obtain salvage after they have paid losses on fidelity policies in two ways. The first way is through traditional subrogation rights acquired from the insured against the principal. The second way is pursuing actions against third parties. Fidelity companies have recovered losses in actions against third parties involved in perpetrating the thefts and third parties involved in fraudulent conveyances. Fidelity companies have recovered salvage by pursuing banks for various negligent actions such as conversion, forgery, and improper deposits. In addition to the salvage actions discussed above, Certified Public Accountants also represent a possible source of recovery for fidelity losses. Actions against CPAs by fidelity insurance companies are the focus of this paper.

There are generally two types of malpractice suits filed against CPAs. Malpractice suits are either filed (1) by a client as a direct result of the accountant's negligence; or (2) filed by third parties such as lenders, trade creditors, suppliers, customers, and potential investors who rely on the accountant's audit opinion. A client who has suffered damages as a direct result of his accountant's failure to exercise reasonable care generally has a cause of action against the accounting firm. The likelihood of success in pursuing a malpractice action against an accounting firm varies based on the facts, whether the action is by the client, or by a third party, and the law in the jurisdiction in which the suit is pursued.

Until 1997, a CPA's requirement to detect fraud was governed by SAS #53. SAS #82 replaces SAS #53 for financial statements issued after December 15, 1997. This paper will discuss the duties of the CPA to detect fraud even if the thefts are not material to the financial statements.

COMPILATION, REVIEW, AUDIT?

A compilation prepared by the accounting firm reflects the financial statements prepared by the client. The accountant does not perform any testing or any substantive work in connection with a compilation, and accordingly, malpractice actions based on compilations are very rare. A review by an accounting firm involves a few substantive tests and also rarely gives rise to an accounting malpractice suit. An audit is required to be performed in accordance with Generally Accepted Auditing Standards ("GAAS") and the financial statements must be issued in compliance with Generally Accepted Accounting Principles ("GAAP"). Most accounting malpractice suits arise out of audits. A fidelity insurance company will generally not want to invest a lot of time and expense in pursuing an accounting malpractice action based upon a compilation or review. For discussion purposes under this paper, it is assumed that the insured had audited financial statements.

SUBROGATION RIGHTS

Fidelity insurance companies can pursue actions against accountants through subrogation rights acquired from the insured. In these situations, the insured has relied on the audit opinion to its detriment resulting in a fidelity loss to the insured. In most cases, the auditor has not detected some type of fraud by an employee or by management of the Insured, and the auditor has issued a "clean" audit opinion. Fraud and/or embezzlement is later discovered. The fidelity company, after determining coverage, will pay the loss and obtain a release and assignment of salvage rights against possible third parties such as the accountant who audited the financial statements. Under its subrogation rights the fidelity company steps into the shoes of the Insured and can pursue any and all actions the Insured would have against the accountant.

The first question the fidelity company must determine prior to pursuing a claim against the accountant is did the accountant comply with GAAS and GAAP. This includes determining whether the audit was designed and executed to provide reasonable assurance of detecting material irregularities, and if the financial statements were misstated, were the statements materially misstated. A more in depth discussion of the auditor's duties are set out later in this paper.

DEFENSES OF THE ACCOUNTANT IN SUBROGATION ACTIONS

Subrogation rights can be both a blessing and a curse in pursuing an accounting malpractice action. The subrogation rights of a fidelity insurance company are acquired from its insured, and accordingly, all defenses which the accounting firm would have against the insured would also be assertable against the fidelity insurance company.

Many employee thefts are due either to the lack of internal controls or the insured's failure to control and implement the existing internal controls. Invariably, after any employee theft, changes are made to the insured's internal controls.

Even if the CPA did not comply with GAAS and GAAP, the CPA may still be able to avoid liability in a subrogation action by proving that the insured was negligent. The insured's failure to comply with its own internal controls, especially if the insured has been advised of material weaknesses concerning the internal controls by the CPA, is a strong defense in states which recognize comparative fault, modified comparative fault, and contributory negligence as defenses.

In connection with a large fidelity loss, I reviewed an accounting firm's workpapers for internal control weaknesses. The accountant's workpapers, although not perfect, reflected discussions with the insured's management and board of directors concerning the internal control weaknesses and specifically addressed internal control weaknesses involving the employee who ultimately committed the thefts. The insured confirmed that the internal control weaknesses had been pointed out to the insured, but because of lack of money, additional people were not hired to segregate duties and to implement the other internal control changes which were suggested. Under Tennessee law, if the accounting firm can show that the insured is 50 percent or more at fault, then the insured could not maintain a cause of action against the accounting firm. If the accounting firm pursues the insured's subrogation rights against the accountant, then it can also be barred from recovery by the insured's negligence.

Accounting firms are not reinsurers. An accounting firm is required to comply with GAAS and issue its opinion on the financial statement in conformance with GAAP. If the accounting firm complies with GAAS and GAAP, no malpractice action can be maintained against the accounting firm. In many cases, the employee thefts are not material to the financial statements. If, for example, the employee has falsified the accounts receivable as part of the employee theft but has been able to reconcile the thefts and the thefts would not be detected through normal testing during the audit, the accounting firm is generally not liable. You will note that the key word is "generally" not liable. The accounting firm is required to comply with SAS #82 concerning the detection of fraud. SAS #82 is very important as it sets out the standard by which the accounting firm should check to determine whether there is fraud and how to handle any irregularities that it may detect during its audit engagement. Even if the losses are not material to the financial statements, if the auditors fail to comply with SAS #82, the auditors may be held liable to the insured and to the fidelity insurance company. A discussion of SAS #82 is set out separately within this paper.

DEFENSES OF THE ACCOUNTANT IN THIRD-PARTY ACTIONS

In a third-party action, the accounting firm has many of the same defenses that it would have in the event that the fidelity insurance company pursues an action through the insured's subrogation rights. Those defenses include compliance with GAAS and GAAP. In addition, if the financial statements are not materially misstated, absent the failure to comply with SAS #82, the accounting firm probably has no liability.

The first thing a fidelity insurance carrier must prove is whether the fidelity carrier can maintain the cause of action as a plaintiff in that particular jurisdiction. The three standards governing third party actions which have been adopted by the various jurisdictions are the Strict Privity Rule, the Restatement Test, and the Reasonably Foreseeable Rule. These three standards are discussed in more detail later in this paper. In Strict Privity jurisdictions such as New York (which has adopted the Credit Alliance Decision) the fidelity carrier can probably not maintain a third-party action against the accounting firm. In most cases where jurisdictions use the Restatement Test, a fidelity company would not qualify as an "intended beneficiary." Sureties, however, are generally intended beneficiaries and can maintain an action against the accountant. Sureties are extending lines of credit and evaluating the principal's ability to handle a volume of work and to repay the surety in the event of loss. A fidelity underwriter evaluates the risk of loss, not the ability of the insured to repay the loss. In jurisdictions that have a Reasonably Foreseeable rule, the fidelity insurance company could likely maintain a lawsuit against the accounting firm since nearly anybody can qualify as a plaintiff in those jurisdictions.

Even if the fidelity carrier can qualify as a plaintiff either under the Reasonably Foreseeable test or as an intended beneficiary, the fidelity carrier must still prove that it relied upon the financial statements to its detriment. In the typical surety underwriting file, there are worksheets evaluating the financial statements, such as working capital, etc. Most surety underwriting files reflect significant reliance upon the financial statements. If the financial statements are late, the underwriters are usually inquiring as to when the financial statements will be received.

The fidelity underwriters do not heavily rely upon the financial statements. In many cases, fidelity underwriters do not rely upon the financial statements at all. In a large number of cases, audited financial statements are not even required of the insured. I have seen numerous underwriting files that do not contain all the financial statements or the coverage was written and/or renewed prior to the financial statements being received.

The accounting firm can also assert the defenses of comparative fault, modified comparative fault and contributory negligence by the underwriter. If the underwriter should not have underwritten the account for other reasons, irrespective of whether the financial statements were materially misstated, this could represent a complete defense to the accounting firm.

REVIEW OF UNDERWRITING FILE

Prior to bringing any accounting malpractice suit, the fidelity carrier should have counsel review the entire underwriting file to determine whether the underwriters are negligent and have damaging documentation in the underwriting file which can be used against the fidelity company as a defense to an accounting malpractice suit. In the case of subrogation actions, fidelity carriers should also check to see whether there are defenses which can be maintained against the insured. Properly evaluating whether to pursue a case prior to filing suit can save the fidelity carrier thousands of dollars in attorneys' fees and in experts' fees and can prevent the fidelity company from pursuing a case which it is likely to lose.

REVIEW OF ACCOUNTANT'S WORKPAPERS

Prior to bringing any accounting malpractice suit, it is advisable to review the accountant's workpapers to determine whether the accounting firm complied with GAAS and GAAP. The workpapers may also prove helpful in evaluating internal control issues and compliance with SAS #82 relating to the detection of fraud. Under most state's laws, the accountant's workpapers belong to the accountant. The accountant's workpapers are also protected by the accountant/client privilege. If the insured (or principal in the surety context) does not waive the accountant/client privilege, in many jurisdictions, the accountant's workpapers cannot be subpoenaed or discovered either before bringing suit or even after bringing suit.

Accordingly, it is critical that when negotiating the release with the insured, that the insured execute a separate waiver of the accountant/client privilege authorizing the fidelity company to review the accountant's workpapers. The Tennessee Supreme Court, in a case handled by our firm confirmed that the accountant/client privilege belongs to the client and can be waived by the client. Federal Insurance Company v. Arthur Andersen & Co., 816 S.W.2d 328 (Tenn. 1991)(copy attached). The Supreme Court also noted during oral arguments that if I had not obtained a waiver of the accountant/client privilege that I would have been barred from securing the accountant's workpapers.

Accountant's workpapers can provide a road map to successfully pursuing a malpractice action against an accountant. Likewise, good workpapers can be used to successfully defend most accounting malpractice suits. It is, therefore, advisable to review the accounting workpapers prior to bringing suit to determine whether you are wasting time and money or have a good cause of action.

In many cases, once you have obtained the waiver of the accountant/client privilege, the accounting firms will agree to let you review the workpapers, especially in the event that the workpapers reflect a good work product. If you find an accounting firm vigorously trying to prevent your review of the accountant's workpapers, in many cases, it can mean that the accountant did not properly perform the audit and the workpapers provide a road map for the fidelity carrier's attorneys and experts in pursuing a malpractice action.

EXPERT WITNESS

It is important for the fidelity insurance company to retain a qualified accounting expert. The accounting expert can be extremely helpful in reviewing the accounting firm's workpapers to determine whether an accounting malpractice suit is likely to be successful. A good accounting

expert should help evaluate the case and point out both the strengths and weaknesses. It is also difficult for plaintiffs to obtain good accounting experts since CPAs are reluctant to testify against each other; just as attorneys and physicians are also reluctant to testify against their peers. The "Big 6" accounting firms have an unwritten policy which prevents them from serving as experts and testifying against the other Big 6 firms.

PRIVITY; THE TRADITIONAL VIEW

The landmark case dealing with an accountant's duty to non-client third parties arose in the case of Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931) in the state of New York. In Ultramares, the New York court held that accountants are not liable to non-clients for professional negligence because of a lack of contractual relationship known as "privity" between them. Although the court recognized that Touche had been negligent in the conduct of its audit, it held that an accountant only has a duty of care to those with whom he has a direct contractual relationship. The Court stated:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes these consequences. Id. at 44.

The privity requirements set forth in Ultramares has been followed by several states including Colorado, Nebraska and Florida.

In Credit Alliance Corp. v. Arthur Andersen & Company, 483 N.E.2d 110 (N.Y. 1995), the New York court retreated slightly from the Ultramares decision. The court in Credit Alliance employed a three-prong test which must be met before accountants may be held liable in negligence to non-contractual third parties. The test provides that:

(1) the accountant must have been aware that the financial reports were to be used for a particular purpose;

(2) the accountant must have known that a certain party or parties was intending to rely on the financial reports; and

(3) there must have been some conduct on the part of the accountants linking them to that party which evidences the accountant's understanding of that party or the parties reliance.

Id. at 118. This is a very narrow exception to Ultramares. One situation where the test may be met is where the client specifically notifies the CPA before or during the audit that the final audit opinion will be supplied to a specific third party in contemplation of a sale of the client's business. Indiana and Idaho, in addition to New York, have adopted this test.

THE RESTATEMENT TEST - "INTENDED BENEFICIARY"

A majority of jurisdictions have adopted the Restatement Test which represents an extension of an accountant's liability to third parties over the Near Privity rule set forth in Credit Alliance. Under the Restatement rule it is not necessary for the non-client plaintiff to know that the accountant had a specific knowledge of the particular purpose for which the particular third party would rely on the financial statements. The non-client plaintiff need only show that he falls within the limited class of persons that the accountant knew would be receiving the financial information.

In Bethlehem Steel Corp. v Ernst & Whinney, 822 S.W.2d 592(Tenn. 1991) (copy attached), the Tennessee Supreme Court adopted the Restatement Rule stating even though specific knowledge is not required in order to hold an accountant liable, liability is limited to those persons or class of persons, as determined by current business practices and the particular factual situation, whom the accountant at the time the report is published should reasonably expect to receive and rely on the information. Id. at 596. The Restatement Rule stops well short of opening the courthouse to all non-client claimants. For example, if the accountant is not informed of any specific purpose for the financial statements, but nevertheless understands the statements are customarily used in a wide variety of transactions and may be relied upon by a wide variety of people, the accountant is nonetheless not liable to those parties who may rely to their detriment on the negligently prepared reports. Tennessee, Georgia, North Carolina, Kentucky and many other states have adopted this rule.

REASONABLY FORESEEABLE RULE

A small minority of states have completely abandoned the notion that an accountant's exposure to a non-client third party should be in any way limited. The courts in those states have held that CPAs are liable to those parties that are reasonably foreseeable users of the accountant's work. The only test a non-client must meet is that he was a reasonably foreseeable user of the financial statements for some proper business purpose. The states adopting this minority position include New Jersey, California and Mississippi.

While the distinctions between these tests are sometimes hard to determine, all indicate an increasing exposure for the practicing CPA. Because of this, the accounting profession has attempted to more clearly define the accountant/auditor's responsibilities.

STATUTE OF LIMITATIONS

In most states, the state accounting organizations have lobbied to secure for accountants the same statute of limitations period enjoyed by attorneys (which is generally one year). Accordingly, a fidelity carrier should act quickly in preserving its rights to pursue an accounting malpractice action as well as any actions against other third parties. If the insured's claim is being investigated, or even if it has been settled and the accounting firm needs time to review the workpapers, in many instances, the accounting firms will agree to a tolling of the statute of limitations rather than forcing the insured and/or the insurance carrier to bring a premature malpractice action.

It should also be noted in subrogation situations, that the statute of limitations begins to run at the time the insured obtained knowledge of the loss, not when the fidelity carrier obtained knowledge.

SAS #53 AND SAS #82 - THE AUDITOR'S DUTY TO DETECT FRAUD

Determining exactly when an accountant has been negligent in detecting fraud can be difficult. In 1988 the American Institute of CPAs issued a statement on auditing standards ("SAS") that upgraded the auditor's responsibility for uncovering fraud concealed in financial statements, SAS #53, entitled "The Auditor's Responsibility to Detect and Report Errors and Irregularities." SAS #53 required the auditor to provide reasonable assurance of detecting errors and irregularities that were material to the financial statements. SAS #53 stated the auditor's responsibility in terms of exercising due care and the proper degree of professional skepticism. The auditor was required to be sensitive to the possibility of material irregularities in every audit and carefully consider and evaluate the risk that financial statements may be materially misstated because of intentional misconduct of officers or employees. The auditor needed to recognize the importance of management integrity by conducting an effective client investigation before starting the audit and by paying close attention to warning signs, or red flags, that might arise during the planning and performance of the audit.

With the increased litigation against CPAs, a new auditing standard, SAS #82, was issued in February of 1997 which will supersede SAS #53. It will be effective for financial statements for periods ending on or after December 15, 1997. The stated purpose of SAS #82 "is to provide expanded operational guidance on the consideration of fraud in conducting a financial statement audit." The real purpose of SAS #82 is to make sure the CPA and the intended beneficiaries of the audit understand the CPA's obligation to test for and detect fraud.

The new SAS #82 establishes the auditor's responsibility to "obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." In addition, it states that the auditor is only able to obtain reasonable assurance that material misstatements are detected "because of the nature of audit evidence and the characteristics of fraud." This new statement addresses the concept of reasonable assurance and should heighten the auditor's awareness of the need for professional skepticism throughout the conduct of the audit. It also reaffirms that professional skepticism is a critical component of due professional care. The purposes of the new standard are to:

- provide expanded operation guidance on the consideration of fraud and conducting of financial statement audit;

- clarify the auditor's present responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud; and,

- provide added guidance on the standard of due professional care including the need to exercise professional skepticism in the conduct of reasonable assurance.

Auditors will be required to document the work performed to comply with SAS #82. CPAs will be required to consider the possibility of fraud and factors that contribute to fraud for every audit.

"Relevant fraudulent acts" are intentional acts that cause a material misstatement in financial statements. The type of acts of concern are fraudulent financial reporting usually done by management and misappropriation of assets, usually done by employees. The auditors are called upon to assess the risk of material misstatement of the financial statements due to fraud and consider that assessment in designing the audit procedures to be performed. The auditor should

consider whether fraud risk factors are present that can influence management or others within the company to commit fraud. The new SAS #82 sets forth examples of risk factors by type of fraud and source of risk which are attached to this paper. These risk factors are very important and attempt to quantify risks that auditors should consider for all audits.

The purpose of SAS #82 is to make the profession more aware of its responsibility for fraud and provide guidance to the auditor in meeting that responsibility.

CONCLUSION

Through SAS #82, the auditors are being asked to be more sensitive to the possibility of the existence of fraud. In addition, the auditor is being asked to consider the performance of additional audit procedures and to document that consideration and any procedures performed. SAS #82 is an attempt by the accounting profession to let the public know that an auditor can only provide reasonable assurance that financial statements are free of material misstatements. Fidelity companies are increasingly considering suits against accounting firms when the financial statements are incorrect and fraud goes undetected. The new SAS #82 should help clarify the auditor's responsibilities to detect fraud. An auditor's failure to comply <u>and document the compliance</u> in workpapers may be actionable by a fidelity insurance company.

FRAUD RISK FACTORS

Risk Factors Relating to Fraudulent Financial Reporting

Management Characteristics

- *A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process*
- *A significant portion of management's compensation which is contingent upon the entity achieving unduly targets for operating results or financial position*
- *An excessive interest in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices*
- *Nonfinancial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates*
- *A practice by management of committing to analysts, creditors and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts*
- *High turnover of senior management, counsel, or board members*
- *Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws*
- *Strained relationships between management and the current or predecessor auditor*

Industry Conditions

- *New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity*
- *High degree of competition or market saturation, accompanied by declining margins*
- *Declining industry with increasing business failures*
- *Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology or rapid product obsolescence*

Operating Characteristics and Financial Stability

- *Significant pressure to obtain additional capital*
- *Accounts based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity*
- *Significant related-party transactions not in the ordinary course of business or with related parties not audited or audited by another firm*
- *Significant, unusual or highly complex transactions close to year end that pose difficult "substance over form" questions*
- *Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification*
- *Overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose*
- *Difficulty in determining the organization or individual(s) that control(s) the entity*

- *Unusually rapid growth or profitability, especially compared with that of other companies in the same industry*
- *Especially high vulnerability to changes in interest rates*
- *Unusually high dependence on debt or marginal ability to meet debt repayment requirements; debt covenants that are difficult to maintain*
- *Unrealistically aggressive sales or profitability incentive programs*
- *Threat of imminent bankruptcy or foreclosure*
- *Adverse consequences on significant pending transactions*
- *Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity*
- *Inability to generate cash flows from operations while reporting earnings and earnings growth*

Risk Factors Relating to Misappropriation of Assets

Susceptibility of Assets to Misappropriation

- *Large amounts of cash on hand or processed*
- *Inventory characteristics, such as small size, high value or high demand*
- *Easily convertible assets, such as bearer bonds, diamonds or computer chips*
- *Fixed asset characteristics, such as small size, marketability or lack of ownership identification*

Employee Relationships

- *Anticipated future employee layoffs known to the work force*
- *Employees with access to assets susceptible to misappropriation who are known to be dissatisfied*
- *Unexplained unusual and observable changes in behavior of employees with access to assets susceptible to misappropriation*
- *Known and observable personal financial pressures affecting employees with access to assets susceptible to misappropriation*

Controls

- *Lack of appropriate management oversight*
- *Lack of job applicant screening procedures relating to employees with access to assets susceptible to misappropriation*
- *Accounting system in disarray*
- *Lack of appropriate segregation of duties or independent checks*
- *Lack of appropriate system of authorizations and approval of transactions*
- *Poor physical safeguards over cash, investments, inventory or fixed assets*
- *Lack of timely and appropriate documentation for transactions*
- *Lack of a mandatory vacation policy for employees performing key control functions*