**CHAPTER 24-ACCOUNTANTS' LIABILITY**

**TRUE/FALSE**

1. One of the accountant's most important roles is to serve as an independent evaluator of the financial statements issued by management to investors and creditors.

2. To verify transactions, accountants use two mirror-image processes: vouching and tracing. Tracing is a process where the accountant begins with an item of original data and checks out all the activity that has occurred from beginning to end to make sure it has been properly recorded throughout the bookkeeping process.

3. Generally accepted accounting principles are the rules for preparing financial statements.

4. Manuel, in conducting an audit, must rely most heavily on rules found in generally accepted accounting principles (GAAP).

5. The accounting firm of Griggs, Macon, and Fiurre audits the financial records of Chasse Co. The Sarbanes-Oxley Act prohibits the accounting firm from providing consulting services to Chasse on human resource matters.

6. Accountants must follow GAAP but not GAAS.

7. Teresa is suing her accountant for fraud. To win, Teresa must show that she justifiably relied on the accountant’s fraudulent statement.

8. Under the amended Securities Exchange Act of 1934, accountants are liable jointly and severally whether or not they knew they were violating the law.

9. BGH Accounting firm audited the financial statements that were included in E-prise's registration statement. The financial statements overstated sales by 2000%. In conducting the audit, BGH did not comply with generally accepted auditing standards (GAAS). Under Section 11 of the 1933 Act, BGH is liable for any material misstatement in the financial statements.

10. An auditor for Ralco Accounting firm was auditing the financial statements of E-prise. The auditor suspected that E-prise was engaged in conduct that violated FCPA, a federal law. Under Section 10A of the 1934 Act, the auditor is required to notify E-prise's board of directors of the suspicions.

11. Ralco was preparing Heidi's tax return. In confidence, Heidi revealed some information to Ralco. Under the federal accountant-client privilege, the information Heidi disclosed is protected from disclosure in a criminal action by the U.S. government.

12. After completing an audit, the most unfavorable opinion an auditor can issue is a disclaimer of opinion.

13. Auditors cannot protect themselves from liability to third parties by issuing a qualified or an adverse opinion.

14. Halbeck, LLC was negligent in its audit of E-treme, Inc. Unbeknownst to Halbeck, E-treme used the financial statements to secure a loan from Great State Bank. Under the *Ultramares* doctrine, Halbeck will be liable to Great State Bank for its losses on the loan.

15. Halbeck, LLC was negligent in its audit of E-treme, Inc. Unbeknownst to Halbeck, E-treme used the financial statements to secure a loan from Great State Bank. Under the foreseeable doctrine, Halbeck will be liable to Great State Bank for its losses on the loan.

**MULTIPLE CHOICE**

1. Which of the following opinions indicates that the company's financial statements fairly present its financial condition according to GAAP?

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| a. | Qualified opinion. |
| b. | Adverse opinion. |
| c. | Disclaimer of opinion. |
| d. | Unqualified opinion. |

2. An accountant is liable for fraud to:

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| a. | only her client. |
| b. | only her client and any known user of her information. |
| c. | any foreseeable user of her work product who justifiably relied on it. |
| d. | any third party who used the information contained in her work product. |

3. Clint is auditing MegaCorp. In reviewing the sales ledger, Clint saw that MegaCorp had sold 3,000 disk drives to CompSales, Inc. Clint reviewed the original invoice of this sale to ensure that the date, price, quantity, and customer's name all match. He then verified each step along the paper trail until the disk drives left the warehouse. This illustrates:

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| a. | tracing. |
| b. | vouching. |
| c. | following. |
| d. | monitoring. |

4. John is auditing MegaCorp. He finds an accounts payable for 1,000 reams of photocopy paper. He checks to make sure the paper actually arrived and that the receiving department had signed and dated the invoice. He also checks the original purchase order to make sure the purchase was properly authorized. This illustrates:

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| a. | tracing. |
| b. | vouching. |
| c. | following. |
| d. | monitoring. |

5. In *Ellis v Grant Thornton*:

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| a. | the lead partner issues an adverse opinion. |
| b. | held Grant Thornton liable for the back wages of the Keystone bank’s president. |
| c. | held that Grant Thornton did not know an employee would rely on the report and therefor it was not liable. |
| d. | The lead partner was found guilty of fraud. |

6. An engagement letter is a written contract:

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| a. | between an accountant and client. |
| b. | in anticipation of marriage. |
| c. | between a corporation and the AICPA. |
| d. | intended to create a fiduciary duty of an accountant to his client. |

7. An auditor can be held liable to a third party for:

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| a. | Breach of the Accountant Client privilege. |
| b. | Negligence |
| c. | Fraud |
| d. | b & c are correct |

8. The Securities and Exchange Commission (SEC) has proposed a set of rules that would

ultimately require U.S. companies to use international financial reporting standards. Why?

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| a. | With global business there is a need for consistency |
| b. | More than 100 countries already use it. |
| c. | foreign companies would be more willing to invest in the United States if they could use international accounting rules. |
| d. | All of these answers are true |

9. To prevail under Section 11 of the 1933 Securities Act, the plaintiff must prove:

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| a. | the registration statement contained a material misstatement or omission; and the plaintiff lost money. |
| b. | the registration statement contained a material misstatement or omission; the auditor acted knowingly or recklessly; and the plaintiff lost money. |
| c. | the registration statement contained a material misstatement or omission; the auditor intended to deceive; and the plaintiff lost money. |
| d. | the registration statement contained a material misstatement or omission; the auditor acted with scienter; and the plaintiff lost money. |

10. If a plaintiff is successful in proving that an auditor has violated Section 10(b) of the 1934 Act, the auditor has:

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| a. | primary liability. |
| b. | secondary liability. |
| c. | contingent liability. |
| d. | rebuttable liability. |

11. What is the downside of using IFRS?

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| a. | IFRS rules generally offer greater flexibility,. |
| b. | cross-company comparisons might be more difficult |
| c. | It could cause multiple reports to be prepared. |
| d. | All of the above. |

12. Adam claimed that N & A, its accounting firm, negligently prepared an audit. To hold the accounting firm liable, which of the following elements must be established?

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| a. | Scienter or guilty knowledge. |
| b. | A fiduciary relationship. |
| c. | Failure to exercise due care. |
| d. | An executed engagement letter. |

13. An auditor who determines a company is materially misstating certain items on its financial statements should issue:

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| a. | an unqualified opinion. |
| b. | a qualified opinion. |
| c. | an adverse opinion. |
| d. | a disclaimer of opinion. |

14. Great State Bank claimed that Wiles Accounting committed fraud in the preparation of an audit. To hold the accounting firm liable, which of the following elements must be established?

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| a. | Knowledge or reckless disregard of the truth. |
| b. | A fiduciary relationship. |
| c. | Failure to exercise due care. |
| d. | An executed engagement letter. |

15. Who owns and controls an accountant's working papers?

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| a. | The client, in theory. |
| b. | The IRS. |
| c. | The accountant, in theory and practice. |
| d. | The AICPA. |

16. GBH, an accounting firm, was hired to prepare financial statements for E-treme. GBH:

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| a. | cannot show the working papers to E-treme unless there is a valid court order. |
| b. | cannot show the working papers to E-treme unless it obtains permission from the AICPA. |
| c. | can show the working papers to anyone that asks, since the accountant owns them. |
| d. | must allow E-treme access to the working papers. |

17. GBH, an accounting firm, was hired to prepare financial statements for E-treme. Great State Bank has asked to see GBH's working papers. Great State Bank is thinking about extending a $4 million line of credit to E-treme. GBH:

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| a. | can show the bank the working papers because Great State Bank has a proper purpose. |
| b. | can show the bank the working papers because Great State Bank is a known third party. |
| c. | cannot show the bank the working papers under any circumstances as they are not finalized. |
| d. | cannot show the bank the working papers unless E-treme gives permission. |

18. Criminal liability for accountants:

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| a. | is not an option under securities law; there is only civil liability. |
| b. | is possible under the Securities Act of 1933, the 1934 Act, state securities laws, and the Internal Revenue Code. |
| c. | may result in fines but not imprisonment from violation of the federal securities laws. |
| d. | will result from violation of the accountant-client privilege under federal law. |

19. The IRS files criminal charges against Rich for evasion of federal taxes. Rich's accountant, Sonya, is summoned to appear in court to testify against Rich. The state where the incident occurred recognizes an accountant-client privilege. Does Sonya have to testify in federal court against her client?

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| a. | Yes. |
| b. | Yes, but only if she is granted immunity by her state. |
| c. | No, the federal court must recognize her state's accountant-client privilege. |
| d. | No, the federal accountant-client privilege will protect her from testifying. |

20. In which of the following cases will the federal accountant-client privilege protect the information from being disclosed?

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| a. | A criminal case. |
| b. | A case involving the SEC. |
| c. | A case concerning the preparation of tax returns. |
| d. | A civil fraud case involving the IRS. |

21. Why did Congress pass the Sarbanes Oxley Act?

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| a. | Accounting rules were too restrictive and complicated to follow. |
| b. | Because the Big 4 were spending too much money on litigation |
| c. | In response to Enron |
| d. | To combine consulting service and auditing services into one streamlined service package. |

22. The accounting firm of Gray & Co. did accounting work for both Regional Bank and Carter Electronics. Without Carter’s knowledge or approval, Gray & Co. discussed Carter’s financial problems with Regional Bank. Gray & Co.:

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| a. | breached a legal obligation to keep all client information confidential. |
| b. | breached a moral, but not a legal, obligation of confidentiality. |
| c. | did not breach any obligations to its clients. |
| d. | acted properly because it was protecting its client, Regional Bank, from possibly making an unwise loan to Carter Electronics. |

23. Larry is a certified public accountant in a firm which audits public companies. Larry is accused of unethical conduct. Is Larry required to abide by the ethical standards of the Public Company Accounting Oversight Board?

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| a. | Yes. |
| b. | He can be held liable only if he had actual knowledge of the particular guideline he is accused of violating. |
| c. | No, the PCAOB establishes audit rules, not ethical guidelines. |
| d. | No, the PCAOB has no authority over Larry. |

24. A CPA's duty of care to a client most likely will be breached when the CPA:

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| a. | gives a client an oral report instead of a written report. |
| b. | gives a client incorrect advice based on an honest error in judgment. |
| c. | fails to give tax advice that would save the client money. |
| d. | fails to follow generally accepted auditing standards (GAAS). |

25. Which of the following is not a provision of the Sarbanes-Oxley Act of 2002?

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| --- | --- |
| a. | Congress established the Public Company Accounting Oversight Board, which has the authority to regulate public accounting firms, establishing audit rules and ethics guidelines. |
| b. | After five years with a client, the lead audit partner must rotate off the account for at least five years. |
| c. | Congress established the American Institute of Certified Public Accountants to develop ethical guidelines in a Code of Professional Conduct. |
| d. | Auditors must communicate regularly and completely with audit committees of their clients and must describe options the firm considers in preparing financial statements. |

**ESSAY**

1. Discuss how SEC rules affect the legal and the ethical relationship between accountants and the companies they audit.

2. Discuss the advantages and disadvantages of using IFRS.

3. Fast Auditors prepared audited financial statements for Mega Company's registration statement in compliance with the 1933 Securities Act. John bought stock in Mega Company. It was discovered that the financial statements prepared for the registration statement contained some important omissions. John sued Fast Auditors to recover his investment when Mega Company turned out to be a bad investment. What must John prove to recover from Fast Auditors?

4. An auditor suspects its client is committing illegal acts that will have a material impact on its financial statements. What is the auditor legally required to do and under what circumstances would the auditor directly notify the SEC?

5. Ron is an accountant who was contacted by Zebra Toy Company to prepare financial statements. Zebra Toy Company told Ron that it wished to present these documents to Lion Wholesalers, Inc., a large supplier of toys. If Lion is convinced that Zebra Toy Company is financially solid, it will issue Zebra a large line of credit.

After Ron prepares the financial documents, Zebra presents the information to Lion Wholesalers and also to Tiger Toy Company, another wholesaler of toys. Zebra wishes to obtain a line of credit from Tiger as well as from Lion. If Ron committed a serious error by overstating Zebra Toy Company's financial soundness and the two creditors, Lion and Tiger, are damaged as a result, can these third parties recover damages from Ron? Explain.