

Briefly Stated

- *The AICPA issued an Exposure Draft* on April 10, 2009 proposing changes to the Statement on Auditing Standards. The Exposure Draft, among other things, expands the definitions of “subsequent events” and “subsequently discovered facts” consistent with the International Standards on Auditing, and includes additional requirements relating to the reissuance of an auditor’s report. Comments on the Exposure Draft are due by July 15, 2009.
- *CPA Leadership Institute “Webinar”*: Gary Barnes will be instructing three “webinar” programs for the CPA Leadership Institute. For more information, please go to www.cpaleadership.com/public/department197.cfm
- *CPA Mutual Insurance Company* offers a discount to policyholders who receive *in-house risk management training* from PPEC. Dates are now available for the Summer of 2009. Interested in in-house training at your firm? Contact Gary Barnes at 802-864-0880 for more information.
- *PPEC’s recent engagements* include representing an accountant subpoenaed to testify about his client’s financial statements; advising an accounting firm that properly audited an investment fund, but learned that one of the fund’s principal investments was in a “Ponzi” scheme; and advising an accounting firm whose employee benefit plan audit was rejected by the U.S. Department of Labor.

PPEC’s accountant liability team includes attorneys **Gary H. Barnes**, **Gary F. Karnedy**, **Jon R. Eggleston** and **Andrew K. Braley**. For a description of the services we provide to accounting firms, please visit our website at www.ppeclaw.com.

INVESTOR CLAIM AGAINST AUDITOR DISMISSED WHERE INVESTOR’S OWN CARELESSNESS CAUSED THE LOSS



By: Gary F. Karnedy

Does your firm obtain signed engagement letters tailored for each client engagement? Why is tailoring necessary? Read this case. It is another example of how a well-crafted engagement letter *tailored to the unique circumstances of the engagement* can be helpful in limiting an accountant’s exposure to liability.

On March 5, 2009, the Appellate Division of the Supreme Court of New York dismissed a claim against PriceWaterhouse Coopers (“PwC”), in *DDJ Management, LLC et al. v. Rhone Group, LLC and PriceWaterhouseCoopers, LLC*.

DDJ Management, LLC (“DDJ Management”) was a group of investors that loaned \$40 million to the now defunct American Remanufacturers Holdings, Inc. (“ARHI”). DDJ Management required as a condition of the loan that PwC perform an “unqualified” audit of ARHI’s 2003 financial statements. PwC audited the financial statements, but did not certify the audit as “unqualified” until 2005.

Before PwC issued the unqualified audit report, ARHI issued 2004 financial statements that were unaudited and unfootnoted, showing that earnings before interest, taxes, depreciation, and amortization (“EBITDA”) had dramatically improved from the 2003 financial statements. DDJ Management relied on this EBITDA in

making the loan. What DDJ Management didn't know was that the improved EBITDA resulted from a "bookkeeping device" that was not employed in the 2003 financial statements. Unlike in the earlier year when goods unsold after a year were reserved as obsolescent, ARHI in 2004 reserved as obsolescent only items which remained unsold for *two* years. Therefore, while the 2004 EBITA appeared to improve dramatically, it did not represent a true improvement in the business position, but only reflected a bookkeeping change.

PwC examined ARHI's unaudited and unfootnoted financial statements for 2004 before completing the unqualified audit of the 2003 financial statements. Significantly, PwC did not prepare a "subsequent events" footnote, or conduct a "going concern" analysis relating to the 2004 financial statements, nor did it require DDJ to refer to the bookkeeping change in any way in the 2003 financial statements and footnotes. Shortly after DDJ Management loaned the money to ARHI, the borrowers went bankrupt, and DDJ Management lost the entire \$40 million.

DDJ Management sued PwC for fraud, claiming PwC misrepresented that the audit was independent and complied with GAAS. DDJ Management alleged that GAAS required PwC to conduct a going concern analysis and to require that ARHI include a subsequent events note. They further claimed that GAAS required PwC to discover the falsity in the books and inform DDJ Management that ARHI was "on the verge of collapse."

The Court disagreed. The Court found that PwC's alleged misrepresentation must not only have induced DDJ Management to make the loan, but must also have been the "proximate cause" of the loss. The Court noted that by the time PwC issued its 2003 audit report, ARHI had continued as a going concern for more than a year, and that PwC had no obligation to make a going concern determination beyond one year under GAAS. The Court also found that PwC was not obligated to include a subsequent events note, discovering and revealing changes in ARHI's 2004 financial

statements, since that information had no effect on any part of the task they were hired to complete (*i.e.*, an unqualified audit of the 2003 financial statements).

The Court found that DDJ Management caused its own loss. It failed to conduct any due diligence regarding the 2004 financial statements, an express right it was afforded in the loan documents. DDJ Management could have insisted on looking at the 2004 books and records before making the loan. Since they failed to make an effort to assess the risk themselves, their claim of reasonable reliance on purported misrepresentations failed.

In the end, the claims against PwC were dismissed and PwC dodged a \$40 Million bullet. But what if the "task" PwC was retained to perform had not been clearly defined in advance? Any question over the scope of PwC's engagement would undoubtedly have prolonged the litigation and raised the stakes for PwC.

This case is a good example of how a clear, defined scope of engagement, and staying within that scope in your audit work, can stop a future third party lawsuit by a disgruntled investor when a client goes belly-up. The step toward avoiding liability and defending unnecessary lawsuits begins at the outset of the engagement with a well-crafted engagement letter.

Such a letter should define the scope of each engagement, educate the client about the limitations of the accountant's work and about the client's responsibilities, and limit any third party's use of the accountant's work. Some auditors have gone so far as to include in the bound audited financial statements a separate page that makes third party users subject to the terms of the engagement letter.

Reminders

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