BANK OF GREEN VALLEY

Wednesday, April 13, 2005, 9:48 a.m.:

“Congratulations are in order! You remember that I told you last year that we would be submitting your opinion about ZonTech’s financial statements to a bank to get some financing for our planned addition of a production facility. Don’t you? Well, the Bank of Green Valley just notified me that the loan committee approved our three million dollars loan after analyzing this year’s audited financial statements. The committee was really impressed that while everyone else in our industry operated at a loss or just broke even, we showed a substantial profit this period,” crowed Roger Shaw, CFO of ZonTech, in a telephone call to Michael Free, an auditing manager at Victor Hines, LLP. Michael headed the audit team that issued an unqualified opinion on ZonTech’s financial statements for each of the last four years.

“That’s great!” Michael responded. “The loan means that you’ll be able to complete that new circuit board production facility that you told me about, doesn’t it? That circuit board is the product your budget shows is going to increase sales revenue and cash flow next year. It’s a good thing you were able to generate a profit and get the loan. Without the new product, things looked pretty bleak.”

ZonTech designs and manufactures circuit boards for low-tech applications, such as those used in major household appliances. Sales in the appliance circuit board industry had declined or been flat in the past 18 months because of people’s reluctance to buy new appliances in a poor economy. ZonTech’s new circuit board was for washers and dryers that compete with Maytag’s Neptune series. ZonTech’s customer (a major competitor of Maytag) was launching a new washer/dryer with characteristics similar to the Neptune series, but they expected the price to be about 25% below that charged by Maytag. ZonTech had developed a circuit board to meet the engineering specifications of the new product, but could only land the business if they had new production facilities.

Lily Meza, an auditing staff member assigned to one of Michael’s jobs, overheard the conversation between Michael and Roger on the speakerphone while sitting in Michael’s office.

“Michael, I didn’t know that the company operated at a profit this year!” exclaimed Lily. “During my fieldwork, I analyzed the monthly income statements through November, and they showed that the company operated at a loss almost every month! How did they report a substantial profit at year-end?”

Michael replied, “Several years ago they made an investment in the stock of a closely held company that they thought might be a good strategic alliance. Unfortunately, that opportunity didn’t work out. Until December 2004, ZonTech had been holding the investment and hadn’t been receiving any dividends. The CFO of ZonTech actively searched for a company to buy the stock, and in December 2004, located a strategic buyer who took it off their hands at a substantial gain!” Michael continued. “ Since ZonTech frequently buys and sells stock investments, the gain is a part of their income from continuing operations.”

“Oh, that’s clever!” Lily responded. “But if it were such a large transaction, why didn’t they just use the cash flow from the stock sale to finance the new manufacturing facility?”

“Well,” Michael explained, “the company that ZonTech sold the stock to, GreenSel, is having their own cash flow problems right now. They couldn’t afford to give ZonTech cash, so ZonTech accepted a non-interest bearing note due in 5 years. Although ZonTech won’t see the cash for five years, since the title to the stock has passed to the new owners, it can record the gain on the sale.”

Lily pondered this information for a few minutes, and then queried, “Why a non-interest bearing note? Most companies with a credit rating like GreenSel are paying about 15% on loans for transactions like this one.”

"ZonTech didn't have any loans against the investment, so they aren't incurring any interest cost on the stock or the new note. They figured that there isn't any need to hurt GreenSel's cash flow when ZonTech doesn't have any interest cost on the investment," Michael responded.

"Michael, you sure know a lot about this transaction," teased Lily. "You'd think that you had found the buyer and negotiated the deal."

"Well, I am pretty excited," Michael responded. " I worked with the CFO on the transaction, reviewing the entry in the general journal and its reporting in ZonTech's income statement. I may not have arranged the deal, but I was instrumental in getting out the audited statements just in time. As you know, ZonTech really needed some serious cash infusion as soon as possible from some lender to complete a production facility for that new circuit board."

> "Since I missed all the excitement while I was working on a different client, why don't you share the details of the transaction?" demanded Lily.

"Well, ZonTech was carrying the investment at $5,100,000 and sold it to GreenSel for $8,000,000. So they booked a $2,900,000 gain on the transaction," Michael confidentially replied.

Lily looked troubled and finally confided to Michael, "I'm enrolled in a CPA review course, and last week we studied long-term receivables and payables. I learned that generally accepted accounting principles (GAAP) require notes receivable due in more than one year to be carried at their present value. Wouldn't that affect the profit you reported?" Michael looked at Lily like she was trying to put him on the spot and icily replied, "I explained that ZonTech didn't incur any interest on this investment before the sale, so present value calculations aren't necessary! And, yes, the income statement we audited is consistent with GAAP."

ZonTech

Income Statements

For the four years ended December 31, 2004

(in 000's except per share amounts)

	2004	2003	2002	2001
Net Revenues and Gains	**$27,500**	**$26,300**	**$25,100**	**$20,900**
Expenses and Losses				
Cost of Sales	15,200	12,150	9,845	9,200
Operating Expenses	3,160	3,075	2,890	2,300
Other	4,570	3,966	3,146	2,214
Taxes	1,690	2,671	3,318	2,515
Net Income	**$2,880**	**$4,438**	**$5,901**	**$4,671**
Common Shares Outstanding	**3,000**	**3,000**	**3,000**	**3,000**

Memo

To: Rosie Cruz, Loan Delinquency Department, Bank of Green Valley.

From: Harold Ricardo, Senior Lending Officer, Bank of Green Valley

Date: January 17, 2008

Re: Default on ZonTech's loan

As I mentioned to you earlier today, I am forwarding to you the ZonTech's file. It is now in default on the three million dollar loan we extended on April 12, 2005. The total amount currently outstanding is $2,390,000. We were just informed yesterday that ZonTech has commenced bankruptcy protection under Chapter 7 of the Bankruptcy Code. As such, the prospects of a full recovery are minimal.

In addition to the loan documents, I am attaching copies of all the financial statements that we obtained from ZonTech as part of the loan application, including the one for the year 2004, which we received from ZonTech's CFO on February 2, 2005.

In looking back at the financial statements that we had in our file, I was stunned by ZonTech's dramatic and sudden collapse. When we approved the loan, the loan committee gave a lot of weight not only to the financial statements from 2004 but also to the ones from the prior three years; we were keenly impressed by the firm's pattern of income stability during those four calendar years.

I am also attaching a copy of an article I had placed in my file a number of years back. Ever since reading the article, I have had a lingering suspicion that the story in the article is about ZonTech.

VALLEY TIMES

December 15, 2005

Glen Oak, Green. In a surprise move yesterday, twelve staff accountants at Victor Hines, LLP left the firm and joined a competitor, Pillsbury & Skadden. In an interview with one of the twelve former auditors, it was learned that the departure followed alleged auditing irregularities practiced by senior partners at Victor Hines, LLP. "I have been really disillusioned with the level of scrutiny the senior managers and partners have been employing with regard to a number of audit engagements. In one case that I have worked on while I was an intern, my former manager signed off on an unqualified audit opinion where the client, a designer and manufacturer of home appliance circuit boards, had substantially overstated income and assets in contravention with General Accepted Accounting Principles. It is really too bad. I am really looking forward to joining this new firm. I believe it has a lot of potential," said one of the twelve departing accountants who wished to remain

Required:

Assume that you are Ms. Cruz, an associate in the Loan Delinquency Department at the Bank of Green Valley. Your supervisor would like to find out from you whether the Bank of Green Valley has a claim of negligence against the accounting firm of Victor Hines, LLP.

You have gathered additional information from the bankruptcy courts and know about the 2004 sale of stock to GreenSel and its accounting treatment in the income statement. Read the legal cases collected by the legal assistant and attached in the Library. Assume that the applicable precedent is from the fictional jurisdiction of the state of Green provided to you in the attached library. Assume that the financial statements audited by Victor Hines for the calendar years of 2003, 2002 and 2001 were accurate.

Prepare a report (see guidelines on the class website) for your supervisor.

You may want to review section 53.01 of the AICPA Code of Professional Ethics (you can review the section in the case library.) In preparing your answers, you may also wish to review the following Lower Division Core concepts, described in the Lower Division Core section of the BUS 302L website: financial accounting concepts 4, 7, and 9, and business law concept 2.

BANK OF GREEN VALLEY LIBRARY©

1. APB Opinion 21
2. AICPA Code of Professional Conduct, Section 53 - Article II: The Public Interest
3. Bily v. Peat Young & Company
4. Manhattan Federal v. Coopers Gibson

APB Opinion 21, (portions bolded to direct reader)

12. Note exchanged for property, goods, or service. When a note is exchanged for property, goods, or service in a bargained transaction entered into at arm's length, there should be a general presumption that the rate of interest stipulated by the parties to the transaction represents fair and adequate compensation to the supplier for the use of the related funds. That presumption, however, must not permit the form of the transaction to prevail over its economic substance and thus would not apply if (1) interest is not stated, or (2) the stated interest rate is unreasonable (paragraphs 13 and 14) or (3) the stated face amount of the note is materially different from the current cash sales price for the same or similar items or from the market value of the note at the date of the transaction. In these circumstances, the note, the sales price, and the cost of the property, goods, or service exchanged for the note should be recorded at the fair value of the property, goods, or services or at an amount that reasonably approximates the market value of the note, whichever is the more clearly determinable. That amount may or may not be the same as its face amount, and any resulting discount or premium should be accounted for as an element of interest over the life of the note (paragraph 15**). In the absence of established exchange prices for the related property, goods, or service or evidence of the market value of the note (paragraph 9), the present value of a note that stipulates either no interest or a rate of interest that is clearly unreasonable should be determined by discounting all future payments on the notes using an imputed rate of interest as described in paragraphs 13 and 14.** This determination should be made at the time the note is issued, assumed, or acquired; any subsequent changes in prevailing interest rates should be ignored.

13. *Determining an appropriate interest rate.* The variety of transactions encountered precludes any specific interest rate from being applicable in all circumstances. However, some general guides may be stated. The choice of a rate may be affected by the credit standing of the issuer, restrictive covenants, the collateral, payment and other terms pertaining to the debt, and, if appropriate, the tax consequences to the buyer and seller. **The prevailing rates for similar instruments of issuers with similar credit ratings will normally help determine the appropriate interest rate for determining the present value of a specific note at its date of issuance**. In any event, the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction. The objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity.

14. The selection of a rate may be affected by many considerations. For instance, where applicable, the choice of a rate may be influenced by (a) an approximation of the prevailing market rates for the source of credit that would provide a market for sale or assignment of the note; (b) the prime or higher rate for notes which are discounted with banks, giving due weight to the credit standing of the maker; (c) published market rates for similar quality bonds; (d) current rates for debentures with substantially identical terms and risks that are traded in open markets; and (e) the current rate charged by investors for first or second mortgage loans on similar property.[i]7

[1]APB21, Footnote 7--**A theory has been advanced which states that no imputation of interest is necessary if the stated interest rate on a note receivable exceeds the interest cost on the borrowed funds used to finance such notes. The Board considers this theory unacceptable for reasons discussed in this Opinion.**

AICPA Code of Professional Conduct

Section 53 - Article II: The Public Interest

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

.01 A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.

.02 In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.

.03 Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

.04 All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, members should seek continually to demonstrate their dedication to professional excellence.

CURTIS W. BILY, et al Plaintiffs and Respondents, v. PEAT YOUNG & COMPANY, Defendant and Appellant.

No. YU56823

SUPREME COURT OF GREEN

August 27, 1991, Decided

COUNSEL:

Marie L. Fiala, for Defendant and Appellant. Thomas G. Redmon & Matthew W. Powell on behalf of Defendant and Appellant.

OPINIONBY: WOODS, C. J.

OPINION:

I. *Summary of Facts*

This litigation emanates from the meteoric rise and equally rapid demise of Norne Computer Corporation (the “Company”). Founded in 1980 by entrepreneur Adam Osborne, the Company manufactured the first portable personal computer for the mass market. Shipments began in 1981. By fall 1982, sales of the Company's sole product, the Osborne I computer, had reached $ 10 million per month, making the Company one of the fastest growing enterprises in the history of American business.

In late 1982, the Company began planning for an early 1983 initial public offering of its stock, engaging three investment banking firms as underwriters. At the suggestion of the underwriters, the offering was postponed for several months, in part because of uncertainties caused by the Company's employment of a new chief executive officer and its plans to introduce a new computer to replace the Osborne I. In order to obtain "bridge" financing needed to meet the Company's capital requirements until the offering, the Company issued warrants to Investors in exchange for direct loans or letters of credit to secure bank loans to the Company (the “warrant transaction”). The warrants entitled their holders to purchase blocks of the Company's stock at favorable prices that were expected to yield a sizable profit if and when the public offering took place.

Plaintiffs, in this case, were investors in the Company. They include individuals as well as pension and venture capital investment funds. Several plaintiffs purchased warrants from the Company as part of the warrant transaction. Others purchased the common stock of the Company during early 1983.

The Company retained defendant Peat Young & Company (“Peat Young”), one of the then-"Big Eight" public accounting firms, to perform audits and issue audit reports on its 1981 and 1982 financial statements. In its role as auditor, Peat Young's responsibility was to review the annual financial statements prepared by the Company's in-house accounting department, examine the books and records of the Company, and issue an audit opinion on the financial statements.

Peat Young issued unqualified or "clean" audit opinions on the Company's 1981 and 1982 financial statements.

Each opinion appeared on Peat Young's letterhead, was addressed to the Company, and stated in essence: (1) Peat Young had performed an examination of the accompanying financial statements in accordance with the accounting profession's "Generally Accepted Auditing Standards" (GAAS); (2) the statements had been prepared in accordance with "Generally Accepted Accounting Principles" (GAAP); and (3) the statements "present[ed] fairly" the Company's financial position. The 1981 financial statement showed a net operating loss of approximately $1 million on sales of $6 million. The 1982 financial statements included a " Consolidated Statement of Operations" which revealed a modest net operating profit of $69,000 on sales of more than $68 million.

Peat Young's audit opinion on the 1982 financial statements was issued on February 11, 1983. The Peat Young partner in charge of the audit personally delivered 100 sets of the professionally printed opinion to the Company. Plaintiffs testified that their investments were made in reliance on Peat Young's unqualified audit opinion on the Company's 1982 financial statements.

As the warrant transaction closed on April 8, 1983, the Company's financial performance began to falter. Sales declined sharply because of manufacturing problems with the Company's new "Executive" model computer. When the

Executive appeared on the market, sales of the Osborne I naturally decreased, but were not being replaced because Executive units could not be produced fast enough. In June 1983, the IBM personal computer and IBM- compatible software became major factors in the small computer market, further damaging the Company's sales. The public offering never materialized. The Company filed for bankruptcy on September 13, 1983. Plaintiffs ultimately lost their investments.

Plaintiffs brought separate lawsuits against Peat Young in the Santa Rosie County Superior Court. The focus of plaintiffs' claims was Peat Young's audit and audit opinion of the Company's 1982 financial statements. The theory of liability pursued was negligence.

Plaintiffs' principal expert witness, William J. Baedecker, reviewed the 1982 audit and offered a critique identifying more than 40 deficiencies in Peat Young's performance amounting, in Baedecker's view, to gross professional negligence. In his opinion, Peat Young did not perform its examination in accordance with GAAS. He found the liabilities on the Company's financial statements to have been understated by approximately $3 million. As a result, the Company's supposed $69,000 operating profit was, in his view, a loss of more than $3 million. He also determined that Peat Young had discovered material weaknesses in the Company's accounting controls, but failed to report its discovery to management.

Although most of Baedecker's criticisms involved matters of oversight or nonfeasance, e.g., failures to detect weaknesses in the Company's accounting procedures and systems, he also charged that Peat Young had actually discovered deviations from GAAP, but failed to disclose them as qualifications or corrections to its audit report. For example, by January 1983, a senior auditor with Peat Young identified $1.3 million in unrecorded liabilities including failures to account for customer rebates, returns of products, etc. Although the auditor recommended that a letter be sent to the Company's board of directors disclosing material weaknesses in the Company's internal accounting controls, his superiors at Peat Young did not adopt the recommendation; no weaknesses were disclosed. Peat Young rendered its unqualified opinion on the 1982 statements a month later.

The case was tried to a jury for 13 weeks. At the close of the evidence and arguments, the jury returned a verdict in the plaintiffs' favor based on professional negligence. No comparative negligence on the plaintiffs' part was found. The jury awarded compensatory damages of approximately $4.3 million, representing approximately 75 percent of each investment made by plaintiffs. The Court of Appeal affirmed the resulting judgment in plaintiffs' favor with respect to all matters relevant to the issue now before us.

II. *The Audit Function in Public Accounting*

Although certified public accountants (CPA's) perform a variety of services for their clients, their primary function, which is the one that most frequently generates lawsuits against them by third persons, is financial auditing. "An audit is a verification of the financial statements of an entity through an examination of the underlying accounting records and supporting evidence." (Hagen, supra, 13 J. Contemp. Law at p. 66.) "In an audit engagement, an accountant reviews financial statements prepared by a client and issues an opinion stating whether such statements fairly represent the financial status of the audited entity." (Siliciano, supra, 86 Mich.L.Rev. at p. 1931.)

In a typical audit, a CPA firm may verify the existence of tangible assets, observe business activities, and confirm account balances and mathematical computations. It might also examine sample transactions or records to ascertain the accuracy of the client Company's financial and accounting systems. For example, auditors often select transactions recorded in the Company's books to determine whether the recorded entries are supported by underlying data (vouching). Or, approaching the problem from the opposite perspective, an auditor might choose particular items of data to trace through the client's accounting and bookkeeping process to determine whether the data have been properly recorded and accounted for (tracing). (Hagen, supra, 13 J. Contemp. Law at pp. 66-67).

For practical reasons of time and cost, an audit rarely, if ever, examines every accounting transaction in the records of a business. The end product of an audit is the audit report or opinion. The report is generally expressed in a letter addressed to the client. The body of the report refers to the specific client-prepared financial statements which are attached. In the case of the so-called "unqualified report" (of which Peat Young's report on the Company's 1982 financial statement is an example), two paragraphs are relatively standard.

In a scope paragraph, the CPA firm asserts that it has examined the accompanying financial statements in accordance with GAAS. GAAS are promulgated by the American Institute of Certified Public Accountants (AICPA), a national professional organization of CPA's, whose membership is open to persons holding certified public accountant certificates issued by state boards of accountancy. (Hagen, supra, 13 J. Contemp. Law at pp. 72-73.)

In an opinion paragraph, the audit report generally states the CPA firm's opinion that the audited financial statements, taken as a whole, are in conformity with GAAP and present fairly in all material respects the financial position, results of operations, and changes in the financial position of the client in the relevant periods.

The GAAP are an amalgam of statements issued by the AICPA through the successive groups it has established to promulgate accounting principles: the Committee on Accounting Procedure, the Accounting Principles Board, and the Financial Accounting Standards Board. Like GAAS, GAAP includes broad statements of accounting principles amounting to aspirational norms as well as more specific guidelines and illustrations.

Peat Young correctly observes that clients may commission audits for different purposes. Nonetheless, audits of financial statements and the resulting audit reports are very frequently (if not almost universally) used by businesses to establish the financial credibility of their enterprises in the perceptions of outside persons (e.g., existing and prospective investors, financial institutions, and others who extend credit to an enterprise or make risk-oriented decisions based on its economic viability). The unqualified audit report of a CPA firm, particularly one of the "Big Five," is often an admission ticket to venture capital markets--a necessary condition precedent to attracting the kind and level of outside funds essential to the client's financial growth and survival. As one commentator summarizes: "In the first instance, this unqualified opinion serves as an assurance to the client that its own perception of its financial health is valid and that its accounting systems are reliable. The audit, however, frequently plays a second major role: it assists the client in convincing third parties that it is safe to extend credit or invest in the client." (Siliciano, supra, at p. 1932.)

III. *Prima Facie Case for Negligence*

A. Negligence in general: "[N]egligence is conduct which falls below the standard established by law for the protection of others." (Rest.2d Torts, § 282.) "Every one is [*397] responsible, not only for the result of his willful acts, but also for an injury occasioned to another by his want of ordinary care or skill in the management of his property or person, except so far as the latter has, willfully or by want of ordinary care, brought the injury upon himself." (§ 1714, subd. (a).)

A. <u>Duty of care</u>: The threshold element of a cause of action for negligence is the existence of a duty to use due care toward an interest of another that enjoys legal protection against unintentional invasion. (Rest.2d Torts, § 281). "Courts, however, have invoked the concept of duty to limit generally 'the otherwise potentially infinite liability which would follow from every negligent act ....' " (Thompson v. County of Alameda (1980).

The complex nature of the audit function and its economic implications has resulted in different approaches to the question of whether CPA auditors owe a duty of care to third parties who read and rely on audit reports. Presently, there are three schools of thought on the matter. A number of jurisdictions follow the lead of Chief Judge Cardozo's 1931 opinion for the New York Court of Appeals in Ultramares, supra, at p. 441, by denying recovery to third parties for auditor negligence in the absence of privity. From the cases cited by the parties, it appears at least nine states purport to follow privity or near privity rules restricting the liability of auditors to parties with whom they have a contractual relationship. However, most jurisdictions have abandoned this restrictive standard because it does not impose upon accountants a duty commensurate with the significance of their role in current business and financial affairs.

In contrast, a handful of jurisdictions, spurred by law review commentary, have recently allowed recovery based on auditor negligence to third parties whose reliance on the audit report was "foreseeable." Arguing that accountants should be subject to liability to third persons on the same basis as other tortfeasors, Justice Howard Wiener advocated rejection of the rule of Ultramares in a 1983 law review article. In its place, he proposed a rule-based on foreseeability of injury to third persons.

Criticizing what he called the "anachronistic protection" given to accountants by the traditional rules limiting third person liability, he concluded: "Accountant liability based on foreseeable injury would serve the dual functions of compensation for injury and deterrence of negligent conduct. Moreover, it is a just and rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which it arises. The accountant, the investor, and the general public will in the long run benefit when the liability of the of the certified public accountant for negligence is measured by the foreseeability standard." (at p. 260.) From a public policy standpoint, the courts that have adopted the foreseeability test have emphasized the potential deterrent effect of a liability-imposing rule on the conduct and cost of audits: "The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews. This might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue. Much of the additional cost incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers." (Rosenblum v. Adler, supra, at p. 152.) In the nearly 10 years since it was formally proposed, the foreseeability approach has not attracted a substantial following.

Most jurisdictions have steered a middle course based in varying degrees on Restatement Second of Torts section 552, which generally imposes liability on suppliers of commercial information to third persons who are intended beneficiaries of the information. Section 552 of the Restatement Second of Torts covers "Information Negligently Supplied for the Guidance of Others." It states a general principle that one who negligently supplies false information "for the guidance of others in their business transactions" is liable for economic loss suffered by the recipients in justifiable reliance on the information. (Id., subd. (1).) But the liability created by the general principle is expressly limited to loss suffered:

"(a) [B]y the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends." (Id., subd. (2).) To paraphrase, under the restatement view, the accountants retain control over their liability exposure. The restricted group includes third parties whom the accountants intend to influence or those whom the accountants know their clients intend to influence. Accordingly, liability is fixed by the accountants’ particular knowledge at the moment the audit is published, not by the foreseeable path of harm envisioned by jurists years following an unfortunate business decision. Accordingly, the Restatement adopts the cautious position that an accountant may be liable to a third party with whom the accountant is not in privity, but not every reasonably foreseeable consumer of financial information may recover.

For example, the auditor may be held liable to a third party lender if the auditor is informed by the client that the audit will be used to obtain a $50,000 loan, even if the specific lender remains unnamed or the client names one lender and then borrows from another. (Com. (h), illus. 6,7.) However, there is no liability where the auditor agrees to conduct the audit with the express understanding the report will be transmitted only to a specified bank and it is then transmitted to other lenders. (Com. (h), illus. 5.)

Under the Restatement rule, an auditor retained to conduct an annual audit and to furnish an opinion for no particular purpose generally undertakes no duty to third parties. Such an auditor is not informed "of any intended use of the financial statements; but ... knows that the financial statements, accompanied by an auditor's opinion, are customarily used in a wide variety of financial transactions by the [client] corporation and that they may be relied upon by lenders, investors, shareholders, creditors, purchasers and the like, in numerous possible kinds of transactions.

In attempting to ascertain the presence of an intent to benefit third parties from the facts of particular audit engagements and communications with auditors, the Restatement rule inevitably results in some degree of uncertainty.

Viewing the problem before us, we decline to permit all merely foreseeable third party users of audit reports to sue the auditor on a theory of negligence and we reject the privity relationship approach as it is too restrictive. Instead, we follow the majority rule use of the Restatement approach. Accordingly, we find that since Peat Young was told that the audited financial statements would be used to solicit funds from prospective investors as part of its public offering and since the plaintiffs here were exactly such investors, Peat Young owed them a duty of care.

B. <u>Breach of duty of care</u>: To prove professional negligence, a plaintiff is required to show not only that the accountant owed him a duty of care, but also that he had breached its duty of care to the plaintiff. In performing professional services for a client, the independent auditor, has the duty to have that degree of learning and skill ordinarily possessed by a reputable certified public accountant practicing in the same or a similar locality and under similar circumstances. In determining whether the accountant fulfilled its professional duties, one may consider among other evidence whether or not the accountant's work complied with ... GAAP and GAAS.

Here, the jury had ample evidence to conclude that Peat & Young breached its duty of care to the plaintiffs. According to some expert testimony provided during trial, Peat Young discovered deviations from GAAP, but failed to disclose them as qualifications to its audit report. For example, by January 1983, a senior auditor with Peat Young identified $1.3 million in unrecorded liabilities. However, the firm did not disclose the weaknesses and issued an unqualified opinion a month later.

C. <u>Causation</u>: Third, to prevail, a plaintiff must demonstrate that there is a causal connection between the negligent conduct and the resulting injury. To determine whether the defendant's negligence has caused plaintiff's injuries, the plaintiff must demonstrate that but for the defendant's negligence, the plaintiff would not have sustained the loss. Here, all plaintiffs have testified that they have read and relied on the 1982 audited financial statement of the Company before investing their money in it. Therefore, but for Peat Young's negligence in rendering the audit, the plaintiffs would not have invested in the firm. The plaintiffs would not have invested in the firm because a financial statement prepared according to GAAP would have disclosed the significant liabilities the firm had at the time. As the plaintiffs were investing in the firm based on negligently rendered financial statements that failed to disclose significant liabilities, they would not have sustained their investment losses but for the defendant's negligence.

D. <u>Damages</u>: Lastly, the plaintiff must demonstrate that she sustained actual loss or damage resulting from the professional negligence. Here, following the demise of the Company, the plaintiffs-investors have lost all of their investment in the Company arising out of the warrant transaction and hence they have all sustained damages.

The judgment is affirmed.

MANHATTAN FEDERAL BANK, Plaintiff and Appellant, v. COOPERS GIBSON & CO., Defendant and Respondent.

No. CE765445.

COURT OF APPEAL OF STARS, SECOND APPELLATE DISTRICT, DIVISION SEVEN.

July 17, 1995, Decided

COUNSEL:

Robert W. Brull for Plaintiffs and Appellants.

Janet B. Bennett for Defendant and Respondent.

OPINIONBY: MARTINEZ

OPINION:

Appellant, Manhattan Federal Bank, sued Spitzer Loan Ltd.'s former accounting firm, Coopers Gibson & Co. for professional negligence. The accounting firm (defendant and respondent) demurred, asserting the statute of limitations. (Code Civ. Proc., § 339, subd. (1).) The trial court sustained the demurrer without leave to amend. We affirm.

FACTUAL BACKGROUND

Spitzer Loan Ltd. ("Spitzer"), a partnership, was an "alternative lender" company which made loans to those "who might not qualify for loans made by most banks or savings and loan associations." The loans were "secured by junior interests in real property."

Spitzer engaged in the following practices: it made "uncollectable" loans; it had inadequate loan loss reserves, it made loans "unjustified by appropriate lending criteria"; it "rolled over" defaulted loans into new loans to related parties and reported defaulted interest and loan fees as income; it used interest reserves to make new loans; it made loans secured by property which they had appraised only by a "drive-by" without inspecting the interior and "based upon dissimilar and/or incomplete market analysis data."

Defendant audited the financial statements of the partnerships and companies annually from 1981-1988 but failed to disclose these practices in their audit reports and concluded that the subject "loan portfolio was adequately collateralized."

Spitzer obtained loan funds from the plaintiff, Manhattan Federal Bank who relied upon defendant's audit reports.

On March 28, 1989, the City of Los Angeles and others filed an action "to redress the practice ... of maintaining and operating slum buildings through a complex set of financial machinations." Defendants included not just slum building owners but those "who have financed them." The complaint alleged "[t]he lender defendants have been aware of the slum and substandard character of these buildings; have been aware of the lack of financial capability of the record owners; have written loans which would absorb all or virtually all of the rental flow from the buildings; have made huge sums from high interest and high 'points' on each loan; have assisted frequent property transfers, often only months apart and often timed such that the transfer undermined City Attorney prosecutions of the then existing record owners.... have effectively operated as the real beneficial owners of ... one or more of the buildings ...."

The lawsuit named 141 defendants including Spitzer Loan Ltd. Of the 11 slum properties identified in the City lawsuit Spitzer Loan Ltd financed all.

Immediately following the filing of the City's lawsuit, Manhattan Federal Bank refused to extend any further credit to Spitzer Loan Ltd. On November 24, 1989, Spitzer Loan Ltd. filed a petition under Chapter 11 of the United States Bankruptcy Code.

On October 15, 1993, appellant filed the instant action for professional negligence, breach of written contract, and negligent misrepresentation.

On February 17, 1994, respondent demurred to the complaint. On May 24, 1994, after a hearing and argument by counsel, the trial court dismissed the complaint without leave to amend, stating the two year statute of limitations barred the professional negligence cause of action because "[t]he City's suit provided sufficient notice to start the statute of limitations running."

On June 17, 1994, the trial court signed an order dismissing the lawsuit. This appeal followed.

DISCUSSION

"[I]n a malpractice action against an accountant the statute of limitations does not run until the negligent act is discovered, or with reasonable diligence could have been discovered." (Moonie v. Lynch (1967); Liberty Mut. Ins. Co. v. Harris, Kerr, Forster & Co. (1970) "The 'discovery rule' assumes that all conditions of accrual of the action—including harm--exist, but nevertheless postpones commencement of the limitation period until 'the plaintiff discovers or should have discovered all facts essential to his cause of action, which is to say when plaintiff either (1) actually discovered his injury and its negligent cause or (2) could have discovered injury and cause through the exercise of reasonable diligence. CAMSI IV v. Hunter Technology Corp. (1991)

Appellant contends that while it had possession and its officers have read the city's lawsuit in 1989, it could not with reasonable diligence have discovered respondent's negligence from the city's lawsuit for all of the following reasons: (1) that lawsuit involved only eleven of Spitzer Loan Ltd.'s properties out of a loan portfolio secured by hundreds of properties (2) "the City Lawsuit did not name [respondent], did not contain any reference to [respondent] or [respondent's] audits, or otherwise give notice that [respondent] failed to perform its audits in accordance with GAAP [Generally Accepted Accounting Principles] or committed any wrongdoing." (3) "nothing in the City Lawsuit suggested that the financial condition of Spitzer Loan Ltd. Was materially misstated in their financial statements" and (4) respondent issued an audit report after the City lawsuit filing which indicated "Spitzer Loan Ltd. had a substantial net worth, its accounting procedures wholly complied with GAAP and their loan loss reserves were adequate." The contention does not bear scrutiny.

The 134-page City lawsuit complaint described the subject slum properties. Those descriptions would have alerted any reasonable person, let alone a professional lender, to the almost worthlessness of the properties. For example: "These slum dwellings ... have rodent and vermin infestation, lack of hot water and heat, severe fire hazards, undisposed of garbage and other unsanitary conditions, broken windows and doors, leakage from plumbing and roof defects, [and] a serious lack of personal security and similar conditions."

As to appellants' eleven involved properties, the City lawsuit complaint stated among other things: the 2686 Idell Street property "has been in substandard condition since 1982 or earlier"; the 5634 North San Pedro property "has been a slum since 1981 ... and [s]ince 1979 ... has been cited 18 times for violations of the fire codes, health codes and building codes"; the 9632 Virginia Lane property "was cited for numerous housing code violations since at least 1981. The 7342 North Bonnie Brae Street property "has been a slum building, unfit for human habitation, since before 1981. The property has been the subject of six criminal prosecutions ... in the period 1981 to 1988 ....".

Finally, these City lawsuit allegations, irreconcilable with respondent's audits, should have led appellants to discover "all facts essential to [their] cause of action" against respondent back in 1989 (CAMSI IV v. Hunter Technology Corp., supra, at 1526): "Acting fraudulently, the lender defendants, with full knowledge of the slum character of these buildings have made loans for amounts exceeding the value of the slum buildings ...."; "The slum buildings ..., at material times ... have had no reasonable rental value"; "... the loans made by the lender defendants were unjustifiably high in that they were clearly unwarranted by the value of the slum building"; "... The loans were made ... without any or with completely inadequate appraisals of the property; lending without any or with completely inadequate credit checks of the borrowers"; "The lender defendants routinely and repeatedly made loans to record owners in amounts that were far in excess of the true value of the slum buildings.

In addition, lender defendants repeatedly inflated the alleged value of the slum buildings despite the steady deterioration of the properties."

DISPOSITION

The two-year statute of limitation has began running in 1989 when the appellant either had actual knowledge or should have discovered through the exercise of reasonable diligence the respondent's alleged negligence. Since the appellant waited until 1993 to file this action for professional negligence, it is time barred under the two-year statute of limitation. The judgment is affirmed. Costs on appeal are awarded to respondent.

Lillie, P. J., and Johnson, J., concurred.