

The Fine Line Between an Auditor's Recklessness and Intent to Deceive

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A recent decision out of the Southern District of New York explores the delicate issue of just how egregious an accounting firm's failure to comply with generally accepted auditing standards ("GAAS") and generally accepted accounting principles ("GAAP") must be to subject that firm to a fraud claim arising out of its audit of a client's financials. *Jacobs v. Coopers & Lybrand, LLP*, 97 Civ. 3374 (RPP) (S.D.N.Y., March 1, 1999). The issue is a critical one because while a failure to adhere to one or more of these principles may give rise to a negligence claim (a troublesome enough predicament), a more extensive failure to comply with these industry standards can reflect such a reckless disregard for the accuracy of a client's financial representations as to satisfy the scienter element of a fraud claim against the auditor itself. Where that line is drawn can have grave consequences for accounting firms understandably eager not to end up on the receiving end of a fraud claim that, even if totally unfounded, can have a devastating impact on their stock in trade—*i.e.*, their professional reputation.

District Judge Robert P. Patterson, Jr. addressed this issue in *Jacobs v. Coopers & Lybrand, LLP*. *Id.* *Jacobs* involved a federal securities class action in which the plaintiffs alleged that Happiness Express, Inc. ("Happiness" or the "Company"), a publicly traded marketer of products based on children's entertainment characters, fraudulently overstated its 1995 financial performance in filings with the Securities and Exchange Commission. *Id.* at 2-3. Coopers & Lybrand ("Coopers") was sued in connection with its role as auditor of the Company's financials. *Id.* at 3. Coopers gave its unqualified approval to the Happiness financials. *Id.* at 4. Plaintiffs alleged that Coopers failed to properly audit the Company's accounts receivable from two of its suppliers. *Id.* at 3. As a result, plaintiffs alleged, the Company's 1995 public filings reflected almost \$6.3 million in bogus sales. *Id.* Plaintiffs alleged:

Coopers turned a blind eye to "red flags" in an extreme departure from the standards of ordinary care. Coopers' workpapers indicate that it examined certain of the suspicious documents and consciously disregarded their suspicious nature. Indeed, Coopers did not plan and perform its audit of Happiness' [sic] fiscal 1995 financial statements with an attitude of professional skepticism as required by GAAS. This conduct, coupled with auditing procedures that were so deficient that they grossly violated GAAS, allowed Happiness to disseminate materially false and misleading "audited" financial statements and financial results to the market. *Id.* at 4-5.

Coopers moved to dismiss the complaint for failure to state a claim. Judge Patterson observed that plaintiffs' claim under Section 10(b) of the Securities and Exchange Act of 1934 would survive the motion "unless it appears beyond doubt that the plaintiffs can prove no set of facts in support of their claims that would entitle them to relief." *Id.* at 17. Judge Patterson noted that a Section 10(b) claim must plead facts demonstrating that, in connection with the offering or sale of a security, the defendant (1) made a false material representation, and (2) did so with scienter—*i.e.*, "a mental state embracing intent to deceive, manipulate, or defraud" which the plaintiff must demonstrate either by alleging facts showing that the defendant had both the motive and opportunity to commit fraud or by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* at 17-18. To adequately plead a Section 10(b) violation, the court stated, "a plaintiff must plead sufficient facts amounting to recklessness such that recklessness approximates intent" to deceive. *Id.* at 18. The court noted that although an auditor may be found liable for a Section 10(b) violation, "an auditing firm's failure to follow GAAP, without more, does not constitute a Section 10(b) violation." *Id.* at 17.

Coopers argued that the Section 10(b) claim should be dismissed because the complaint alleged no facts which, even if accepted as true, could support an inference of scienter. Coopers contended that because, as alleged, it did adhere to GAAS in several instances, there could be no inference of scienter as a matter of law. Judge Patterson flatly rejected Cooper's position. *Id.* at 19. He denied the accounting firm's motion, observing that "Coopers does not offer any authority for this proposition⁴." *Id.* To the contrary, the court noted, the complaint "details several examples of alleged departures from GAAS which amount to more than 'nitpicking attacks' as Coopers has characterized them." *Id.*

Judge Patterson then set forth a litany of alleged transgressions under GAAS which, when viewed collectively and accepted as true, he found sufficient to constitute a degree of recklessness so extensive as to be tantamount to a fraudulent intent to deceive. "Indeed," the court wrote, "the Plaintiffs more than just allege that the [sic] Coopers failed to adhere to GAAS in its audit of Happiness's 1995 finances. They put this failure in a broader context with allegations that, taken together, paint a portrait of an audit so reckless that a jury could infer intent to defraud." *Id.* at 23.

In reaching this conclusion, Judge Patterson focused on, among others, the following allegations:

- Despite the fact that the Company's receivables from West Coast Liquidators ("West Coast") represented approximately thirteen percent of its total receivable balance at fiscal year-end, Coopers failed to independently confirm directly through West Coast the existence of such receivables;
- Coopers failed to sufficiently inquire into purported sales to West Coast and a second entity, Wow Wee International, Ltd. ("Wow Wee"). Sales to these entities purportedly amounted to 35 percent of the Company's fourth quarter sales and 34 percent of the fiscal year accounts receivable. Coopers failed to inquire into the Company's suspicious representation that nearly all of the purported Wow Wee sales were invoiced on the last day of the fiscal year, and all of the purported West Coast sales were invoiced within the last 36 days of the fiscal year;
- Notwithstanding its historical knowledge of the Company's operations and the fact that Wow Wee was a supplier to the Company, Coopers did not question why in fiscal year 1995 the Company showed millions of dollars in sales to Wow Wee;
- Coopers did not conduct its audit in such a way as to determine why in 1994 the breakdown of the Company's accounts receivable was 88 percent factored and 12 percent non-factored, when in 1995 the breakdown was 19 percent factored and 81 percent non-factored;
- Coopers failed to detect that Happiness had issued checks in excess of \$100,000 without supporting documentation, with these funds being used to cover the personal expenses of the Company's chief financial officer;
- Coopers did not question invoices which did not identify a shipping company, customer purchase order numbers and/or bills of lading although it knew that the Company's internal procedures required such information; and,
- In connection with its 1995 audit, Coopers improperly relied on information gathered during the course of its 1994 audit without independently assessing the relevant 1995 data. *Id.* at 4-13, 18-25.

The totality of the facts as alleged, the court concluded, compelled denial of the motion to dismiss. In doing so, Judge Patterson observed that the complaint:

[A]lleges a situation much more grave than one in which the auditor simply failed to make further inquiries, which alone amounts only to negligence. Failing to adhere to one or two Auditing Interpretations may be only negligence but Coopers is alleged to have disregarded many different Auditing Interpretations. Based on the facts as alleged, a finder of fact could find Cooper's [sic] audit so reckless that Coopers should have known of the underlying fraud... and acted in blind disregard that there was a strong likelihood that Happiness was engaged in the underlying fraud. *Id.* at 25. Alleging fraud, the court acknowledged, is one thing. Actually proving it at trial is an entirely different matter. However, at this early juncture in the litigation, Judge Patterson concluded that the plaintiffs "have alleged facts sufficient to support a finding of scienter on the part of Coopers...." *Id.*

Conclusion

All fraud cases, of course, are extremely fact-sensitive and each must be evaluated based on the unique set of facts and circumstances giving rise to the claim in question. Fraud claims arising out of an accounting firm's auditing practices are no exception to this rule. Nevertheless, we believe Judge Patterson's probing analysis of the allegations in *Jacobs* provides invaluable insight into where, as a general matter, the line falls between auditing practices which are merely sloppy and those which are sufficiently reckless as to provide a springboard for fraud claims against the auditor. *Jacobs* reaffirms the common sense notion that, while absolute perfection may prove elusive, rigorous adherence to GAAS nonetheless is absolutely critical not only to meeting an accounting firm's professional responsibilities but in guarding against potentially crippling fraud claims as well. Easier said than done, of course. Nevertheless, that approach holds true for accounting firms both small and large. If *Jacobs* offers one clear lesson it is that the courts will not be receptive to Coopers' apparent line of defense as Judge Patterson interpreted it in his decision: We could not have possessed the requisite fraudulent intent because, well, we adhered to *some* GAAS guidelines. Judge Patterson made short shrift of that contention. No doubt, most courts would find it similarly unpersuasive.