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Watching the Watchdog: An Argument for Auditor Liability to Third Parties

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WATCHING THE WATCHDOG: AN ARGUMENT FOR AUDITOR LIABILITY TO THIRD PARTIES

*Kenneth Edward Shore**

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I. INTRODUCTION

THE independent auditing profession serves an essential role in our market economy by certifying that financial statements fairly present a company's financial condition and results of operations. Financial statements provide useful information to people making business and economic decisions. Trade creditors, financial institutions, and investors rely on audited financial statements in determining whether to transact with a given company. Accounting firms audit financial statements to give these users some assurance that the statements do not contain material errors.

Auditor liability arises when independent auditors fail to discover material misstatements or fraud contained in financial statements that they should have discovered if they had performed the audit according to the auditing profession's standards. There are two key issues with respect to auditor liability: (1) whether auditor liability should sound in tort or in contract law, and (2) if tort doctrine applies, precisely what should be the scope of liability to third parties. Jurisdictions differ significantly with respect to these two issues. A significant number of jurisdictions have determined that contract law should apply, while other jurisdictions have applied a variety of different negligence standards. When courts apply tort law, they use a variety of different legal concepts to artificially limit auditor liability to third parties. These concepts highlight judges' lack of understanding of the auditor's role in the economy and the purpose of an audit report.

This Comment examines the incentives and restraints facing auditors and investors and concludes that auditor liability to third-party users of financial statements should sound in tort, rather than contract law. Furthermore, the standard for auditor liability should be a professional negli-

gence standard, and auditors should be liable for their negligence to any investor who has been harmed by his reasonable reliance on the audit report. While the Comment recognizes that audits provide only limited surety against misstated financial statements, the purpose of an audit is to ensure that management fairly presents financial information. Auditors owe a duty to the users of financial statements to perform all tests required by the standards of the auditing profession to ensure that financial statements are fairly presented.

Part II of this Comment will briefly examine the business purpose behind audits and the unique public role of the auditing profession. Part III examines the evolution of the common law of auditor liability by examining leading cases representing each of the three major third-party liability standards. Part IV examines the various policy determinants that underlie the differing theories regarding the role of the auditor and suggests a scope of liability that is most consistent with these policies.

II. BACKGROUND: THE AUDITING PROCESS AND THE UNIQUE PUBLIC ROLE OF THE AUDITING PROFESSION

A. THE AUDITING PROCESS

Certified public accountants (“CPAs”) perform audits, under contract with their clients, to give an opinion on whether the client’s financial statements fairly present its financial position in conformity with Generally Accepted Accounting Principles (“GAAP”). Management produces the financial statements and the underlying accounting records. Therefore, the auditor must agree that management’s choice of accounting principles is appropriate and that any estimates are reasonable.

In order to conduct an audit, the auditor designs and performs a series of tests and procedures to determine whether the financial statements conform to GAAP. The auditor should perform these procedures in conformance with Generally Accepted Auditing Standards (“GAAS”),¹

1. Generally Accepted Auditing Standards are divided into three groups: general standards, standards of field work, and standards of reporting. See CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 150.02 (Am. Inst. of Certified Pub. Accountants 1999) [hereinafter AICPA Auditing Standards]. Lawsuits against auditors usually arise over alleged violations of either the general standards or the standards of field work. These standards are as follows:

General Standards

1. The [examination] is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the [examination] and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned, and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control [structure] is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

which are ten broad standards promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA"). These, along with the Statements on Auditing Standards ("SAS"), which were also promulgated by the Auditing Standards Board to elaborate on the general standards, define the standard of care in the auditing profession.² Unlike GAAS, the SAS can be quite detailed.

GAAP determines the correct method or methods to account for a given transaction. This is distinguished from GAAS, which involves the accepted means to test that a given accounting transaction is in conformance with GAAP. Because of the inherent judgmental nature of financial reporting, in certain circumstances GAAP allows firms considerable discretion regarding the correct method to record certain types of transactions in the financial statements. For this reason, there may be a dynamic tension between management, which understandably wants to present the financial statements by interpreting GAAP in a favorable light, and the auditor, who may wish to take a more conservative approach.

One of the first goals of the audit is to ensure that the client understands the purpose and limitations of an audit. Non-CPAs often believe that an audit should amount to a guarantee that there is no accounting fraud within the firm. In reality, this is not the case. A standard financial statement audit is not designed to detect many types of fraud, particularly systematic fraud involving the collusion of management. The AICPA Codification of Statements on Auditing Standards explains:

A presumption of management dishonesty . . . [would indicate that the auditor would] . . . potentially need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.³

Audits seek persuasive, not conclusive, evidence that a client's financial

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under [examination].

Id.

2. Under Rule 202 of the Code of Professional Conduct, every member of the AICPA must comply with all applicable SAS. See PROFESSIONAL CODE OF CONDUCT, ET 202 (Am. Inst. of Certified Pub. Accountants 1999) [hereinafter Code of Professional Conduct]. Virtually all courts allow these standards to be introduced at trial as evidence of the standard of care. See GEORGE SPELLMIRE ET AL., ACCOUNTING, AUDITING, AND FINANCIAL MALPRACTICE § 3.05, at 43 (1998). Some courts have held that the standard of care for accountants is defined by the principles set forth in GAAP, GAAS, and the SAS. See, e.g., *SEC v. Arthur Young*, 590 F.2d 785, 788 (9th Cir. 1979); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1108 (7th Cir. 1974); *Hawaii Corp. v. Crossley*, 567 F. Supp. 609, 617 (D. Haw. 1983); *Seafirst Corp. v. Jenkins*, 644 F. Supp. 1152, 1153-54 (W.D. Wash. 1986). Other courts have held that AICPA standards are merely evidentiary and not controlling as to the standard of care. See *Mishkin v. Peat, Marwick, Mitchell & Co.*, 744 F. Supp. 531, 538 (S.D.N.Y. 1990); see also *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, 779 P.2d 1083, 1086 (Or. Ct. App. 1989).

3. AICPA Auditing Standards, *supra* note 1, AU § 316.16.

information is reasonably accurate.⁴ It is critical that those who commission and rely upon an audit understand its limitations. Their occasional failure to do so is often referred to by CPAs as the “expectation gap.”⁵

A properly performed audit's ability to prevent outright fraud is limited. Audits do not provide complete surety against systematic fraud. Instead, they provide only a certain degree of assurance that management's financial statements are not materially misleading. Under GAAS, the auditor adopts an attitude of professional skepticism in planning and conducting an audit. Audits involve a rebuttable presumption, tested within certain limits,⁶ that management is honest and that the client is not engaged in systematic collusion to deceive the auditor and to misstate its financial statements. The auditor does not assume that management is trying to commit fraud and therefore turn over every leaf trying to find it. But properly planned and executed audits will uncover material errors in the financial statements, including certain types of accounting fraud. And indeed, despite the contentions of some commentators and the big accounting firms, this is exactly an audit's purpose.

B. EVALUATION OF AUDIT RISK

Audit risk is defined as “the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated.”⁷ Material errors may be the result of errors or irregularities or both. Irregularities may involve management misappropriation or misrepresentation.⁸ SAS 47 and 82 assign the independent auditor the responsibility for designing the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.⁹

1. Components of Audit Risk

a. Inherent Risk

Inherent risk relates to the susceptibility of an account balance or class of transactions to error that could be material assuming that there were no related internal controls.¹⁰ Inherent risk can be increased by the unique characteristics of the industry. Some industries have characteristics that make the capture of transactions by the accounting system more difficult. Such characteristics include, for example, a large amount of small cash transactions. Such characteristics also include complex transactions with difficult accounting estimates and calculations, such as those

4. See *id.*, *supra* note 1, AU §§ 312.02, 316.10.

5. James W. Zisa, *Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information*, 11 CAMPBELL L. REV. 123, 166 (1989).

6. See AICPA Auditing Standards, *supra* note 1, AU §§ 316.16, 316.08.

7. *Id.* at AU § 312.02.

8. See LARRY F. KONRATH, *AUDITING CONCEPTS AND APPLICATIONS: A RISK-ANALYSIS APPROACH* 153 (1993).

9. See AICPA Auditing Standards, *supra* note 1, AU § 312.20.

10. See *id.*, AU § 312.27(a).

in the insurance and oil and gas industries.¹¹ These characteristics increase the complexity and uncertainty inherent in an audit.

b. Control Risk

Control risk is the risk that material errors or irregularities are not prevented or detected by the company's internal accounting control structure and procedures.¹² Auditors must assess the internal controls of a company in order to determine the amount of control risk.¹³ Control weaknesses that auditors should look for include (1) failure to adequately review transactions; (2) inadequate documentation; (3) unlimited access to negotiable instruments, cash, and inventories; and (4) a lack of perpetual inventory records.¹⁴ The training and proficiency of client employees and the integrity of management are also key factors in assessing control risk.¹⁵ These are just a few examples of control weaknesses that can lead to material errors in the financial statements. Together, inherent risk and control risk determine the probability that the financial statements will contain material errors.

c. Detection Risk

Detection risk is the risk that the errors or irregularities that are not prevented or detected by the control structure are not detected by the independent auditor.¹⁶ This is the only area of risk over which the auditor has direct control. By increasing the amount of substantive audit procedures performed, the auditor can reduce detection risk.

2. Audit Risk Analysis

Audit risk analysis seeks to identify "areas presenting the highest probability of material errors or irregularities, and those areas of the greatest audit complexity."¹⁷ Audit risk can be viewed as a joint probability of inherent risk, control risk, and detection risk. The following equation expresses audit risk:

$$AR = IR \times CR \times DR$$

Where

AR = overall audit risk

IR = inherent risk

CR = control risk

11. See KONRATH, *supra* note 8, at 154.

12. See AICPA Auditing Standards, *supra* note 1, AU § 312.27(b).

13. See *id.*, AU § 150.02 (Second standard of field work). Furthermore, SAS 55, as amended by SAS 78, requires that an auditor obtain an understanding of a client's internal control as a basis for planning the audit engagement. See *id.* AU § 319.

14. See KONRATH, *supra* note 8, at 154.

15. See *id.*

16. See AICPA Auditing Standards, *supra* note 1, AU § 312.27(c).

17. KONRATH, *supra* note 8, at 155.

$DR = \text{detection risk}^{18}$

Overall audit risk should be reduced to the point at which the cost of increasing the amount of audit procedures outweighs the expected benefit. "Conservatism [suggests] that inherent risk should be set initially at 100%."¹⁹ Control risk is assessed based upon the auditor's evaluation of the client's internal controls. The weaker the internal control structure, the higher the control risk. Detection risk is the part of the equation that is controllable by the auditor. Detection risk is reduced by increasing the amount of substantive testing the auditor performs. The auditor makes the most efficient use of substantive testing therefore, by identifying the most risky areas for misstatements and irregularities. These areas are either accounts or transactions with a higher inherent risk or areas where the client has weak internal controls. The auditor obtains the optimal amount of audit risk by identifying higher risk areas and performing substantive audit procedures to the point where the marginal benefit of the additional procedures is outweighed by the marginal cost.

Highly leveraged companies, start-ups, and companies under financial reporting pressures of various types are generally considered to represent greater audit risk than firms in less volatile circumstances. The SAS includes the following as factors that may be relevant in assessing audit risk (this list is not exhaustive):

A single individual dominates management, operating, and financial decisions

- An aggressive attitude with respect to financial reporting
- A high turnover rate, particularly for senior accounting management
- Undue emphasis on achieving earnings projections
- Poor reputation of management in the business community
- Profitability is highly sensitive to economic factors
- A high failure rate in the industry.²⁰

Auditors should consider these and other factors in determining a client's audit risk. GAAS requires the auditor to design the audit procedures to account for this risk.²¹ In order to conform to GAAS in cases involving high audit risk, more elaborate audit procedures are required than in a situation involving a lesser degree of audit risk.²²

In certain cases, the third parties to whom management is required to submit audited financial statements will often strongly influence the auditor's evaluation of the degree of audit risk. These cases typically involve creditors and certain loan covenants. For example, a highly leveraged firm may have debt covenant agreements with its lenders that require it to report that interest expense has not exceeded specified limits. In such

18. *Id.*

19. *Id.*

20. See AICPA Auditing Standards, *supra* note 1, AU § 316.17.

21. See *id.*, AU § 316.12.

22. See *United States v. Simon*, 425 F.2d 796, 806-07 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

a case, the auditor would take note of the heightened importance of this account type and the fact that the firm's lending institutions will rely upon the audited figures for interest expense in the financial statements. This might indicate that additional audit procedures to test interest expense are appropriate, relative to a similar situation in which there are no debt covenants. The additional audit procedures would probably be deemed appropriate due to the heightened audit risk for this account type.²³

Judgments such as the auditor's evaluation of audit risk illustrate that, although GAAS contain numerous specific requirements, it also contains a very significant judgmental component. For this reason, at trial, the question as to whether an audit firm has adhered to GAAS and met the required standard of professional care is a question of fact for the trier of fact to decide based on outside expert testimony and the other evidence presented.²⁴

As noted by the SAS, an auditor may change the evaluation of audit risk once the audit has commenced.²⁵ This uncertainty simply demonstrates that public accounting, like every other business, has built-in risks that participants must factor into their pricing. While auditors now perform most audits for a fixed fee, auditors are free to contract with their clients for fee adjustments based on their good faith discovery of the need for a more comprehensive audit. Clients may agree to bear an uncertainty component in their audit fees to account for the occasional discovery of unexpected audit risk, which requires additional substantive audit procedures. Auditors generally have diversified client portfolios and are in a position to absorb and spread this risk. Additionally, most audits are multi-year engagements, and auditors should be able to adjust their fees with increasing accuracy to reflect the appropriate degree of audit risk as they gain greater experience with a client.

C. AUDIT REPORTS

When an audit is completed, the audit firm will issue copies of the financial statements with the auditor's opinion attached directly to the client's financial statements. The auditor's opinion states, usually in the form recommended by the AICPA, that in the auditor's opinion, the financial statements fairly present the company's financial position in accordance with GAAP, assuming such is the case.²⁶ This is commonly

23. See AICPA Auditing Standards, *supra* note 1, AU §§ 316.14, 316.26, 312.17.

24. See *Seaward Int'l v. Price Waterhouse*, 391 S.E.2d 283, 287 (Va. 1990) ("The definition of 'generally accepted auditing standards,' and the application of that definition to the facts of a particular case, are matters beyond the common knowledge of laymen.").

25. See AICPA Auditing Standards, *supra* note 1, AU § 316.25.

26. See *id.*, AU § 508.08. The opinion, as recommended by the AICPA, reads: We have audited the accompanying balance sheet of X Company as of [date] and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

known as an “unqualified” opinion.

When either circumstances did not permit a GAAS audit, or when the auditor has other reasons for believing that the financial statements are not in accordance with GAAP, the audit opinion may reflect such reservations in what is termed a “qualified opinion.”²⁷ In practice, this is rarely done except in cases where the auditor’s reservations are technical in nature. The auditor and the client usually will work together to resolve whatever issues stand in the way of an unqualified audit opinion.

D. WHY AUDITING IS DIFFERENT FROM OTHER PROFESSIONAL SERVICES

Professionals such as physicians and attorneys generally owe their duty of care exclusively to their clients. But the public accounting profession insists that its members remain independent from their clients. The value of the audit opinion rests upon the auditor’s objective and disinterested viewpoint, independent of the client’s concerns.²⁸ Unlike the work product of other professionals, third parties are often directly dependent upon the auditor’s work product.

In the modern economy, the public accounting profession primarily functions to protect creditors and investors by helping to ensure that such third parties have access to accurate financial information about the firms with which they transact. The United States Supreme Court has acknowledged the CPA’s quasi-public role, stating:

By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public.²⁹

The public role of the independent accounting profession is central to the controversy regarding the legal duty that auditors owe to third parties. The fact that many different classes of economic actors, with whom

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [date], and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Id.

27. See generally AICPA Auditing Standards, *supra* note 1, at AU §§ 508.35-60.

28. See KONRATH, *supra* note 8, at 10.

29. United States v. Arthur Young & Co., 465 U.S. 805, 817-18 (1984).

the auditor lacks privity, systematically rely upon audit opinions, coupled with the characteristic of independence from the client, distinguishes the auditing profession from most other professions. How to translate the auditor's special role in the modern economy into a proper standard of legal duty is the topic of this Comment.

E. AUDITOR INCENTIVES

Audit work provides tremendous revenue for the "Big Five" accounting firms.³⁰ Each of the Big Five firms has revenue in the billions of dollars. The Securities and Exchange Commission ("SEC") requires publicly traded companies to issue audited financial statements. Only the large audit firms have the manpower to conduct many of these audits and the name recognition to assure investors that the financial statements are fairly presented. Therefore, the Big Five have a virtual monopoly on the audit business for large, publicly-traded companies.

To maximize their profits, the big accounting firms staff even the biggest and most complicated audits with very young staff members. The senior auditors, who manage the day-to-day work on an audit, are rarely more than twenty-five or twenty-six years old. The staff members are often twenty-two or twenty-three years old and not certified public accountants. Auditors with less than three years experience do more than 50% of the work done on an audit. These junior accountants do the substantive audit work, review actual documents, and make certain judgments as to the risk areas where more detailed work needs to be done. While more experienced auditors are more likely to uncover errors and material misstatements, the advantage of such staffing is higher profits for the accounting firms, but at the expense of an increase in the probability of serious problems with audits.

The audit industry has become very competitive despite being an oligopoly. Corporations often put their audit work out for bids. The accounting firms bid on these jobs for a predetermined fee. Auditors rarely charge clients by the hour. With a fixed fee, the audit firms have incentives to get the audits done with as few expenses as possible in terms of staff time. Furthermore, firms often offer audits as a loss leader. Accounting firms are willing to cut their audit fees to keep a foot in the chief financial officer's door. Audits are used as a base to market the firms' more lucrative consulting services.

When the young senior auditor or the manager hoping to become a partner sees a problem, he may not be in a position to confront the client with questions about the authenticity of the client's financial statements. Causing client disenchantment or losing a client not only costs the firm future audit fees, but also future consulting fees, which are substantially

30. The "Big Five" accounting firms include Pricewaterhouse Coopers, Arthur Andersen & Co., Deloitte & Touche, KPMG Peat Marwick, and Ernst & Young.

more lucrative. This market dynamic does not encourage auditors to act independently.

But public accountants do have some incentive to maintain their reputations as auditors. It is readily apparent that audit firms have an interest in avoiding the scandal that attaches to audit failure.³¹ Investors will discount the securities of companies that are audited by less reputable audit firms.³² For example, the risk component of a loan will be higher for a company that presents its creditors with financial statements audited by a less reputable accounting firm. Accordingly, those creditors will penalize these firms by increasing the cost of debt. Thus, an auditing firm will be able to attract more clients at higher rates if it has a good professional reputation.

A rational audit firm should be reluctant to create undue risk to its reputation for the benefit of one client, since this might endanger the firm's ability to retain and charge premium rates to its entire portfolio of clients.³³ Most accounting firms (and all of the Big Five firms) possess diversified client portfolios. Therefore, the benefit derived by an auditor for providing a misleading audit for one client may be slight compared to the effect that a reputation for negligence will impose on the fees that it can charge the rest of its clients.³⁴ This is a key difference between audit firms and the management of the companies being audited. A company's managers may not be deterred by reputational forces due to their relatively undiversified risk portfolios. On the other hand, a typical audit firm has a much stronger incentive to preserve its reputation within the financial community.

A company's management may attempt to shop the market for an auditor with an acceptable reputation, but who is nevertheless willing to tolerate an excessive degree of risk that the financial statements will contain material departures from GAAP. Such a strategy may be effective, since third parties cannot always sort out the good auditors from the bad ones, and information costs to determine the reputation of the audit firm, the particular office, and the particular partner in charge are high.³⁵ While the fact that most large companies are audited by one of only five auditing firms may suggest that information costs, at least for larger firms, are lower, that may not be the case. Offices within these large international firms may vary in terms of quality and ethics, making it more difficult to rely on a firm's reputation.

Additionally, as a CPA firm branch office's or a particular partner's relationship with a client grows over time, it may become more willing to tolerate questionable accounting because of its reluctance to endanger its

31. See Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 63 (1986).

32. See *id.* at 96-97.

33. See *id.* at 71.

34. See *id.*

35. See *id.* at 96-97.

relationship with a lucrative client.³⁶ This is especially true when the accounting firm is also providing extensive consulting services to the client. A local office of a big firm may tolerate questionable reporting practices by a key client, despite the possibility that over time this might degrade the overall reputation of the firm.

Auditor liability helps prevent audit firms and their clients from externalizing the costs of material misstatements and negligent audits. Although some auditors will not compromise, or unduly risk their reputations for integrity regardless of the financial incentives involved, across an entire market we must assume that auditors will tend to react in an economically rational manner to cost-benefit incentives.³⁷ Accordingly, auditors may be expected to weigh the financial benefits of tolerating or risking material misstatements in the financial statements against the expected costs of doing so.

Auditor liability to third parties raises the expected cost of conducting a negligent audit. The reasons civil liability directed at firms or their management are ineffective as a means of deterring financial fraud do not apply to audit firms. Unlike managers, audit firms do not typically face insolvency if a single client becomes bankrupt. An audit firm has an incentive to avoid a civil liability judgment that might result from an audit failure, since the auditor, unlike its client, will expect to be around afterward to pay it.

Auditor liability can thus provide a strong disincentive to negligence by forcing audit firms to bear the costs of their own negligence, rather than forcing third-party users of financial statements to bear these costs (i.e., third parties believe that a firm performed a GAAS audit when it has, in fact, performed a negligent audit). Auditor liability can force both auditors and their clients to internalize the costs of material misstatements in the financial statements by motivating auditors to use due care in performing the audit. These necessary steps include closely adhering to the general standards and the standards of field work.³⁸ Under these standards, the auditor is required to gain a thorough understanding of the client's internal accounting system and do the necessary substantive procedures to lower overall audit risk to an acceptable level. These necessary steps require the clients to pay larger audit fees. These fees internalize the costs of possible material misstatements in the financial statements to the auditor's clients. Clients can, in turn, increase the level of internal control and thus reduce the control risk assessment by the auditors. Reducing control risk lowers the amount of substantive testing required, which lowers audit fees. Thus, auditor liability not only ensures that the auditors conduct the audit properly, but also encourages audit clients to set up accurate and well-controlled financial reporting systems to avoid higher audit fees.

36. *See id.* at 63.

37. *See id.* at 67-68.

38. *See* AICPA Auditing Standards, *supra* note 1, AU § 150.02.

These business realities are part of the reason that it is important to have a vigorous civil remedy for bad audit work. Lawsuits over bad audits are not a sign that something is wrong with the civil justice system, but a sign that there are problems with the audit industry that the big accounting firms have not fully addressed.

Despite these strong arguments in favor of a vigorous civil remedy for bad audits, the courts have consistently sought ways to limit auditor liability. These attempts, as will be seen in the discussion in the next section, have no sound theoretical basis. The following cases demonstrate the extent to which judges fail to understand the role of auditors in the modern economy and the purpose and procedures of an audit.

III. THE EVOLUTION OF THE COMMON LAW DOCTRINES OF AUDITOR LIABILITY

A. INTRODUCTION

As noted above, the controversy regarding auditor liability is complicated because the plaintiff is generally a party or parties who foreseeably relied upon the audited financial statements, but did not contract with the auditor to do the audit. Such plaintiffs might be trade creditors or bankers who routinely require a firm to submit audited financial statements as a prerequisite to receiving short- or long-term credit. Other potential plaintiffs include investors, who also typically rely upon audited financial statements to make the decision whether to invest.

In the usual case, a third party will request and receive an audited financial report directly from the client firm's management and use it in deciding whether to transact with the firm. The firm later encounters financial difficulties, perhaps resulting in insolvency, causing it to default on its obligations to the third party. The audited financial statements, which had seemed to indicate that the firm was on a sound financial footing, will prove to be incorrect or fraudulent, and the auditor will have failed to detect the errors. With the client now insolvent, the third party will seek to recover damages from the audit firm, which it perceives to possess the financial capacity to compensate it for damages, since the audit firm, unlike its client, is still solvent and perhaps insured.

The plaintiff will allege that all the elements for a tort action against the auditor are present. It will contend that the auditor owed a duty to typical third-party users of financial statements to perform its audit with due care. The plaintiff will contend the auditor breached this duty of care since the auditor failed to uncover material errors in the financial statements. The plaintiff will allege that it materially and detrimentally relied upon the audited financial statements in making its decision to transact with the auditor's client. Often the auditor will respond with a motion for summary judgment, citing the third party's lack of privity with the auditor and contending that the auditor owed a legal duty of care only to his or her client, and not to third parties.

Such cases raise several issues. The primary issue is whether the auditor has a duty to third-party users of the financial statements that it has audited, or whether they owe this duty only to their clients. This issue is essentially whether the dispute sounds in tort or contract law. Secondly, there is the issue of whether the failure of an audit to detect fraudulent accounting by management actually represents a breach of the professional duty of care. Third, there is an issue as to what extent did the breach of professional care by the auditor actually contribute to the damages of the third party. The third party's decision to transact with the defunct client that resulted in the damages may have been caused by a multitude of factors in addition to the auditor's negligent unqualified opinion.

For nearly fifty years the issue of auditor liability to third parties has been dominated by the issue of what should be the scope of the auditor's liability to third parties and whether tort or contract law should govern. Under contract law, third parties must establish that they were the intended, rather than incidental, beneficiaries of the contract between the auditor and the client firm at the time the parties contracted.³⁹ Classic negligence tort doctrine, on the other hand, does not require privity between tortfeasor and plaintiff. Whether courts find auditor liability to lie in contract or tort law is therefore critical, since if contract law governs, only those parties who meet the strict criteria as third-party beneficiaries will have standing to sue.

For decades, auditor liability to third parties lay within the realm of contract law, with its strict requirements of privity and third-party beneficiary criteria. Some jurisdictions have abandoned a contract-based theory of liability in favor of a negligence standard with an expanded scope of auditor liability to third parties. But the question of precisely which third parties are owed a duty of care by a firm's independent auditor in cases involving audit failure remains contentious.

B. THE PRIVITY AND PRIMARY BENEFIT STANDARD

1. *Ultramares: The Establishment of the Privity Standard*

The seminal case regarding the liability of auditors to third-party users of audited financial statements is the famous case of *Ultramares Corp. v. Touche*.⁴⁰ In this case, the New York Court of Appeals, in an opinion written by Justice Cardozo, established the "privity" standard for auditor liability.⁴¹ This standard limits the liability of the independent auditor to those with whom the auditor has privity of contract, and to third-party beneficiaries.⁴²

39. See generally JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 17-2 (3d. ed. 1987).

40. 174 N.E. 441, 448 (N.Y. 1931).

41. See *id.*

42. See *id.*

In *Ultramares*, the independent auditing firm, Touche, Niven & Co. ("Touche"), rendered an unqualified audit opinion of the balance sheet of Fred Stern Company ("Stern").⁴³ The management of Stern had recorded certain material fraudulent accounting transactions that caused the financial statements to paint a rosy financial picture when, in reality, the firm was on the verge of insolvency. Touche failed to detect the management fraud because the Touche auditors fell short of an adequate level of professional care while conducting the audit.⁴⁴ Touche did not perform such fundamental auditing procedures as verifying the worth of accounts receivables or the existence and value of inventories. The trier of fact determined that Touche was fully aware of Stern's plans to submit the audit report to creditors to obtain working capital, and in fact had printed serial-numbered copies of the report to Stern apparently to control the distribution of the financial statements for this purpose.

After the audit, Stern filed for bankruptcy. Ultramares, a creditor of Stern, claimed that when it made its decision to extend credit to Stern, it relied upon the Touche audit report and was now faced with having to write-off its loan balance to Stern. It sued Touche alleging tort liability under negligence theory.

Despite concluding that Touche performed its audit negligently,⁴⁵ and despite the fact that the court concluded that it was reasonably foreseeable that Stern would submit the audit report to trade creditors such as Ultramares who would rely upon it,⁴⁶ the court held that Touche was not liable to Ultramares for damages. Applying contract law, the court held that auditors owed a legal duty of professional care only to those with whom they contracted, or to those users of the financial statements that auditor and client specifically agreed, at the time of the audit, would receive the financial statements as third-party beneficiaries to the audit engagement.⁴⁷ The court further justified this narrow scope of liability on the theory that a broader scope would impose potentially crushing liability upon the auditing profession and would "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁴⁸

The court distinguished between cases involving negligence and those involving outright or "constructive" fraud on the part of the auditor. In the case of fraud, the court held that third parties could bring suit in tort.⁴⁹ This therefore left the door open for tort suits against audit firms in situations in which their failure to exercise due care is sufficiently reckless as to constitute "constructive fraud."

43. *See id.* at 442-43.

44. *See id.* at 444.

45. *See id.* at 443.

46. *See id.*, at 442.

47. *See id.* at 444-49.

48. *Id.* at 444.

49. *See id.* at 448.

2. *Credit Alliance: The Primary Benefit Standard*

In New York, the *Ultramares* privity scope of liability for auditors remains essentially unchanged to this day. A number of other jurisdictions have followed *Ultramares*, which was the dominant American doctrine regarding the scope of auditor liability for many decades.⁵⁰ It was upheld and refined by a 1985 New York decision, *Credit Alliance Corp. v. Arthur Andersen & Co.*⁵¹ This opinion actually involved two separate actions, consolidated into a single opinion, in which accountants were being sued by third-party users who had detrimentally relied on audited financial statements containing material misstatements of financial condition.⁵²

The court's differential treatment of the two cases is instructive. The facts of the first case closely resembled those in *Ultramares*. L.B. Smith, Inc. ("Smith"), a capital intensive enterprise that regularly required working capital financing, hired Arthur Andersen & Co. ("Andersen"), a "Big Eight"⁵³ accounting firm, to audit Smith's consolidated financial statements. Plaintiffs required audited financial statements from Smith each year as a precondition to continued financing. For the years 1977 to 1979, Andersen issued an unqualified audit report on Smith's financial statements. The trier of fact found that plaintiffs relied on these audited financial statements in deciding to extend significant amounts of working capital financing.⁵⁴

Despite a string of unqualified opinions issued by Andersen, the jury found that the financial statements materially overstated the value of Smith's assets, net worth, and financial condition. In 1980, Smith filed for bankruptcy, having defaulted on several millions of dollars in obligations to the plaintiffs. Plaintiffs brought suit claiming both professional negligence and fraud by Andersen in the conduct of its audit and the preparation of its reports. Plaintiffs established that because of Smith's capital-intensive nature, it had been completely foreseeable by Andersen that creditors, such as plaintiffs, would rely on the financial statements as third-party users.⁵⁵

The second case in the opinion, *European American Bank & Trust Co. v. Strauhs & Kaye*,⁵⁶ involved facts similar to the first, but with a critical difference. European American Bank & Trust ("EAB") had extended credit to Majestic Electro Industries and certain of its subsidiaries from

50. See *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 118-19 (N.Y. 1985).

51. 483 N.E.2d 110 (N.Y. 1985).

52. See *id.* at 111-14.

53. A series of mergers have reduced the "Big Eight" to the "Big Five." Two megamergers occurred in 1989 when Ernst & Whinney merged with Arthur Young to form Ernst & Young and Touche Ross merged with Deloitte, Haskins & Sells to form Deloitte & Touche. For eight years this group was known as the "Big Six." Then in 1997, Price Waterhouse and Coopers & Lybrand merged to form Pricewaterhouse Coopers - reducing the number to five.

54. See *Credit Alliance Corp.*, 483 N.E.2d at 111.

55. See *id.* at 111-12.

56. 102 A.D.2d 776, *aff'd sub nom. Credit Alliance Corp.*, 483 N.E. at 112-13.

1979 through 1982, relying upon unqualified audit opinions rendered by Strauhs & Kaye (“S&K”), an auditing firm. In late 1982, Majestic defaulted on its loans, causing significant losses to EAB.⁵⁷ EAB subsequently sued S&K, alleging that the S&K-audited financial statements materially misstated Majestic’s inventories and accounts receivables, painted an overall false picture of its financial health, and failed to disclose significant inadequacies in Majestic’s internal accounting controls.⁵⁸ But unlike the situation involving Credit Alliance, the audit firm was aware that its client would use the audit report primarily to obtain credit. Furthermore, S&K had frequent direct meetings and other communications with EAB regarding EAB’s reliance on the S&K audits.⁵⁹

In each case, the intermediate appellate court concluded that the plaintiffs were members of a limited class—suppliers of working capital credit—whose reliance upon the financial statements should have been specifically foreseen by the auditors, and as such, the plaintiffs fell within an exception to the general rule requiring privity to bring suit against an auditor for negligence.⁶⁰

The New York Court of Appeals, however, distinguished the Andersen litigation from that involving S&K by noting that S&K had direct knowledge of, as well as communications with, the third-party user of its audit report, whereas Andersen had never directly communicated with Credit Alliance. Upholding *Ultramares*, the court enumerated a three-part test to determine whether a court may hold accountants liable in tort to parties with whom they had not contracted. This test distinguishes situations such as *Ultramares*, in which the auditor has had no direct communication with the third party bringing suit, from situations in which communication between the auditor and the plaintiff has occurred.

The opinion explained that to hold accountants liable in negligence to non-contractual parties who rely to their detriment on inaccurate financial reports, certain circumstances must be present:

- (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and
- (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which indicates the accountant’s understanding of that party or parties’ reliance.⁶¹

A key feature of the privity doctrine, as enumerated in *Ultramares* and *Credit Alliance*, is the crucial distinction it draws between third-party users that are specifically known to the auditor, and members of a foreseeable class of users who are, nevertheless, not specifically known in advance.

57. See *Credit Alliance Corp.*, 483 N.E.2d at 113.

58. See *id.*

59. See *id.*

60. See *id.* at 120.

61. *Id.* at 118.

Making a critical distinction between foreseeable but unidentified firms on the one hand, and firms whose reliance happens to be known specifically to the auditor on the other, is overly legalistic. Furthermore, it demonstrates the New York Court of Appeal's basic misunderstanding of what auditing is and how audits are conducted. As discussed above in Part I, who relies on the audited financial statement has little or nothing to do with how the auditor conducts the audit. Audit tests are driven by the types of transactions the client conducts, the client's internal accounting system, and the integrity of the management.⁶² These are the factors auditors take into account when determining audit risk. The auditor's assessment of inherent risk and control risk, in turn, determines what substantive tests are performed and the extent of those tests. While certain types of transactions, such as short-term working capital financing like in *Credit Alliance* and *European American*, may indicate one type of user (finance companies), the auditor's duty and standard of care does not change because the auditor knows the name of the person who is relying on his or her work.

Certain jurisdictions have declined to attach great importance to this illogical distinction and have abandoned the *Ultramares* standard in favor of a foreseeability standard. Criticism of the rigid privity standard was also a factor in the adoption of section 552 of the Restatement (Second) of Torts, which adopted an intermediate position between a true negligence regime, and the contract law approach of *Ultramares*.⁶³ A number of jurisdictions have adopted the Restatement position. The remainder of this section examines leading cases for each liability standard.

C. THE FORESEEABILITY STANDARD

Some states hold accountants liable to all reasonably foreseeable users of financial statements.⁶⁴ But even under this standard with the broadest scope of liability to third parties, courts sometimes erect artificial limits on auditors' liability to some third parties that common sense tells us are "foreseeable."

1. *H. Rosenblum, Inc. v. Adler*

In *H. Rosenblum, Inc. v. Adler*,⁶⁵ the Supreme Court of New Jersey considered a common law negligence suit brought against a company's independent auditors by third parties who allegedly relied upon the com-

62. See AICPA Auditing Standards, *supra* note 1, at AU § 342.10.

63. See generally *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 145 (N.J. 1983) (explaining that widespread criticism of the privity standard in *Ultramares* resulted in the enumeration of broader scope of liability in the Restatement (Second) of Torts).

64. See, e.g., *Wirtz v. Switzer*, 586 So. 2d 775, 780 (Miss. 1991) (holding that an accountant will be liable for any loss suffered by reasonably foreseeable users if the loss was proximately caused by the accountant's negligence); see also *H. Rosenblum, Inc. v. Adler*, 444 A.2d 66, 67 (N.J. Super. Ct. App. Div. 1982), *aff'd in part, rev'd in part*, 461 A.2d 138 (N.J. 1983).

65. 461 A.2d 138 (N.J. 1983).

pany's audited financial statements in carrying out a merger transaction. Touche Ross & Co. ("Touche") issued unqualified audit reports for the years 1969 through 1972 for Giant Stores Corporation ("Giant"). In 1971, the plaintiffs, Rosenblum Inc. and Summit Promotions, Inc., consummated a merger agreement with Giant, whereby plaintiffs would receive an amount of Giant stock to be determined by a formula based upon Giant's net income in the fiscal year subsequent to the completion of the merger. Accordingly, plaintiffs allegedly relied upon both the historical and the 1972 audited financial statements in order to determine the value of the Giant stock in the merger transaction. One of the Touche partners was present during portions of the merger negotiations, although apparently not as a negotiator. Giant stock was publicly traded on the American Stock Exchange.

After the completion of the merger, the plaintiff discovered that Giant's management fraudulently distorted the company's financial records. Specifically, management recorded nonexistent assets and materially understated accounts payable liabilities. Therefore, the 1971 and 1972 financial statements, upon which Touche had rendered unqualified audit opinions, concealed the fact that Giant was on the verge of insolvency. Trading in Giant stock was suspended and never resumed. The stock became worthless, and Touche withdrew its 1972 audit report. Giant subsequently filed for bankruptcy, and litigation ensued. Plaintiffs brought suit against Touche for fraudulent misrepresentation, gross negligence, negligence, and breach of warranty. Touche moved for summary judgment based upon the *Ultramares* privity doctrine.⁶⁶

The *Rosenblum* court declined to follow *Ultramares* and rejected that court's policy rationale of crushing liability. Citing public policy rationales of deterrence, allocative efficiency, and superior ability to insure, the *Rosenblum* court determined that auditors should be liable in tort to foreseeable third-party users of the financial statements.⁶⁷ The opinion stated:

Certified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. In those circumstances accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day.⁶⁸

The court noted that the role of the auditor, unlike other professionals, inherently involves a duty to others besides the client with whom he or she has privity, and in fact requires the auditor to remain independent from the affairs of the client.⁶⁹ The opinion rejected the concern expressed by the New York Court of Appeals in *Ultramares* that a foresee-

66. *See id.*

67. *See id.* at 152.

68. *Id.* at 153.

69. *See id.*

ability standard would lead to "extreme" liability for auditors.⁷⁰ To the contrary, the *Rosenblum* court concluded that accounting firms were in the better position, relative to foreseeable third-party users of audit reports, to spread or insure against the costs of auditor malpractice.⁷¹ The court further noted the deterrent effect of a negligence standard. The court stated that such a liability standard encourages higher professional standards within the auditing profession and possibly reduces the incidence of accountant malpractice litigation:

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 costs 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.⁷²

This foreseeability standard requires plaintiffs to fully satisfy the elements of a negligence claim: (1) duty, which is established by the foreseeable reliance of the third party; (2) a breach of the auditor's duty of professional care; (3) causation; and (4) damages, which would be limited to actual losses due to the reliance on the misstatement.⁷³ The court also mentioned ways in which the auditor could proactively limit liability, such as limiting the applicability of the opinion in the actual audit report or indemnification of the auditor by the client.⁷⁴

The opinion placed negligent misrepresentation by accountants in the same realm as products liability for manufacturers, concluding that the policy rationales supporting liability are essentially the same for both.⁷⁵ The opinion stated that "[i]t is clear that an action for negligence with respect to an injury arising out of a defective product may be maintained without privity. The negligence involved may be that ascribable to negligent misrepresentation."⁷⁶

Unfortunately, the opinion does not seem to totally abandon contract law for tort principles. With respect to the scope of third parties to whom the auditor owes a duty of care, the opinion actually states that "[t]he plaintiffs would have to establish that they received the audited statements from the company pursuant to a proper company purpose, [and] that they, in accordance with that purpose, relied on the statements"⁷⁷ On its face, this language appears somewhat more restrictive than a pure foreseeability standard that would hold the auditor liable to any third party that relied upon the audited financial report, regardless of how he or she had obtained it. The "proper company purpose" stipu-

70. *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931).

71. See *Rosenblum*, 461 A.2d at 152.

72. *Id.*

73. See *id.*

74. See *id.*

75. See *id.* at 145-46.

76. *Id.* at 146.

77. *Id.* at 152.

lation, along with the court's suggestion that the auditor could limit liability by expressly stating use limitations in the body of the opinion, has been cited as an indication that the court intended to stop short of a pure foreseeability standard of liability.⁷⁸ This is further suggested by this statement in the court's opinion:

Thus, for example, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle. Nor would stockholders who purchased the stock after a negligent audit be covered in the absence of demonstrating the necessary conditions precedent. Those and similar cases beyond the stated rule are not before us and we express no opinion with respect to such situations.⁷⁹

So there is still a question of what is a "proper company purpose." Clearly this applies to bank creditors who receive the audited financial statements from the client. It also clearly applies to parties who are negotiating a merger or similar transaction with the client. It seems from the opinion, however, that investors who buy stock or bonds in a company in the secondary market or in an initial public offering from an underwriter are not covered. One "proper company purpose" is certainly to promote active trading and liquidity in a company's securities. Without liquidity, the value of the securities declines substantially. Audited financial statements provide the reliable information necessary to have an active secondary market. Therefore, it seems an arbitrary cut-off for the New Jersey Supreme Court to allow bank creditors to sue auditors for negligence but not other "unforeseen" investors.

2. Citizens State Bank v. Timm, Schmidt & Co.

Almost immediately after the *Rosenblum* decision, the Wisconsin Supreme Court, in a question of first impression in that state, also placed auditor liability within the realm of negligence doctrine in *Citizens State Bank v. Timm, Schmidt & Co.*⁸⁰ In this case, Clintonville Fire Apparatus, Inc. ("CFA") had retained Timm, Schmidt & Co. ("Timm"), an independent auditing firm, to audit its financial statements for the years 1973 through 1976. Timm issued an unqualified audit opinion for the years 1974-76, but disclaimed from issuing an opinion for 1973 for reasons not completely clear from the record.⁸¹ After reviewing the financial information contained in the audited financial report, Citizens State Bank ("Citizens") loaned \$300,000 to CFA.

Subsequent to the issuance of the loan, during its 1976 audit, Timm discovered that the 1974 and 1975 financial statements contained a number of errors that materially overstated the company's financial health. Once these errors were corrected, Timm informed Citizens of the

78. See Thomas L. Gossman, *The Fallacy of Expanding Accountant's Liability*, 1988 COLUM. BUS. L. REV. 213, 224 (1988).

79. *Rosenblum*, 461 A.2d at 153.

80. 335 N.W.2d 361 (Wis. 1983).

81. See *id.* at 362.

errors. Citizens called its loans due, and as a result CFA became bankrupt. Citizens filed an action against Timm alleging liability in tort. Timm filed a motion to dismiss based upon the privity doctrine.⁸²

The Wisconsin Supreme Court reversed the lower court, which had found for Timm, and determined that "an accountant may be held liable to a third party not in privity for the negligent preparation of an audit report under the principles of Wisconsin negligence law"⁸³ and remanded for retrial on that basis. Citing *Rosenblum*, the court based its decision on the same public policy grounds of deterrence and the court's belief that auditing firms are in the superior position to spread and insure against the costs of audit malpractice.⁸⁴

Noting that the third-party use of audited financial statements is routine and foreseeable, the opinion placed the issue of liability to third parties firmly in the realm of negligence law, explaining that "[t]he fundamental principle of Wisconsin negligence law is that a tortfeasor is fully liable for all foreseeable consequences of his act except as those consequences are limited by policy factors."⁸⁵ The court rejected the middle ground of the Restatement (Second) of Torts, stating that "[t]he Restatement's statement of limiting liability to certain third parties is too restrictive a statement of policy factors for this Court to adopt."⁸⁶

D. THE RESTATEMENT (SECOND) OF TORTS STANDARD

The need to provide some relief to third-party users of audited financial statements, largely denied by the *Ultramares* doctrine of privity, was a factor in the formulation of section 552 of the Restatement (Second) of Torts, which is titled "Information Negligently Supplied for the Guidance of Others."⁸⁷ The Restatement is widely viewed as an intermediate standard of liability, establishing a duty of auditors to third parties that is narrower in scope than ordinary tort negligence doctrine, but broader in scope than the privity standard.⁸⁸ Various interpretations of the Restatement standard of liability have replaced the privity standard in a majority of U.S. jurisdictions.⁸⁹

The standard set forth in the Restatement provides:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused

82. See *id.* at 362-63.

83. *Id.* at 362.

84. See *id.* at 366.

85. *Id.*

86. *Id.*

87. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

88. See *Raritan River Steel Co. v. Cherry, Bekaert & Holland*, 367 S.E.2d 609, 617 (N.C. 1988) (stating that the Restatement (Second) of Torts § 552 "constitutes a middle ground between the restrictive *Ultramares* approach . . . and the expansive 'reasonably foreseeable' approach.").

89. See *Bily v. Arthur Young & Co.*, 834 P.2d 745, 752 (Cal. 1992).

to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

- (2) . . . [t]he liability stated in subsection (1) is limited to loss suffered
- (a) by 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 or in a substantially similar transaction.⁹⁰

This standard falls short of a complete negligence regime because it essentially limits liability to classes of third parties that the auditor has actually foreseen, rather than parties that are reasonably foreseeable. It has been interpreted in a variety of ways by jurisdictions that nominally adhere to it. It can be interpreted broadly or narrowly, depending on how the court defines "limited group of persons" or "substantially similar transaction."⁹¹ For example, in *Simpson v. Specialty Retail Concepts, Inc.*⁹² a North Carolina federal court found that public market investors can constitute a limited class. In doing so, the court noted that "the adjective 'limited' . . . pertains not to size, but to identifiability."⁹³ Under such a broad interpretation of the Restatement, the Restatement approach differs little from the foreseeability approach discussed above. But in most jurisdictions, the Restatement test is satisfied only in situations where the audit is used for a specific limited purpose, such as the sale of a corporation or an extension of credit.⁹⁴

90. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

91. The question of whether the plaintiff falls under a "limited group of persons" is a question of fact. See *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873, 879 (Tex. Civ. App.—Fort Worth 1971, writ ref'd n.r.e.) (adopting the Restatement approach); *Blue Bell, Inc. v. Peat, Marwick, Mitchell & Co.*, 715 S.W.2d 408, 412 (Tex. App.—Dallas 1986, writ ref'd n.r.e.) (rejecting a strict interpretation of the Restatement approach and holding that whether a person falls within the limited class of persons to whom a duty is owed is a fact issue).

92. 908 F. Supp. 323, 331-32 (M.D.N.C. 1995); see also *In re Sahlen & Assoc., Inc.*, 773 F. Supp. 342, 373-74 (S.D. Fla. 1991) (applying Florida law, the court held that institutional investors in a corporation could maintain a negligence action against the corporation's auditors under the Restatement because the institutional investors alleged that the accountants knew that they would be acting in reliance on the audit report, but holding that investors who had purchased shares of the corporation in the open market could not maintain a negligence action).

93. *Simpson*, 908 F. Supp. at 331 (explaining that the word "limited" in § 552 of the Restatement (Second) referred not to a group's size, but to identifiability); see also *Guenther v. Cooper Life Sciences, Inc.*, 759 F. Supp. 1437, 1443 (N.D. Cal. 1990) ("[W]here a group is identifiable, accountants and other information providers are not relieved of liability merely because the group of people whom they intend to influence with their information is too large.").

94. See *Nycal Corp. v. KPMG Peat Marwick LLP*, 688 N.E.2d 1368, 1373 (Mass. 1998) (interpreting § 552 to limit an accountant's potential liability to noncontractual third parties who can establish the accountant's actual knowledge of the limited group of third parties that will rely on the audited financial statements as well as actual knowledge of the particular financial transaction that the audit report will be used to influence).

1. Raritan River Steel: *The Restatement Approach*

In *Raritan River Steel Co. v. Cherry, Bekaert & Holland*,⁹⁵ the North Carolina Supreme Court considered which scope of liability to third parties to adopt in that state. In *Raritan*, creditors of Intercontinental Metals Corporation ("IMC") alleged that they had detrimentally relied upon an audit report that contained materially misstated financial data due to the auditor's negligent audit. The case is illustrative because, at the time it was considered, all three liability standards existed.⁹⁶ The opinion concluded that the Restatement (Second) approach represented the best approach to auditor liability to third parties because it took a "middle ground" between foreseeability and privity.

The court rejected the privity approach, stating that it did not adequately provide for the crucial role played by independent auditors in the financial world and the systematic reliance placed on audit reports by investors and lenders.⁹⁷ On the other hand, the court declined to adopt the foreseeability standard adopted in *Citizens State Bank and Rosenblum*, stating that the foreseeability approach results in "liability more expansive than an accountant should be expected to bear."⁹⁸

The opinion criticized the *Rosenblum* court's conclusion that public policy did not justify disparate treatment between accounting firms, on the one hand, and manufacturing firms that are subject to products liability on the other. The court reasoned, in language similar to the "indeterminate" language in *Ultramares*, that while manufacturers and designers can limit their potential liability by limiting the quantity of their product, auditors "have no control over the distribution of their reports, and hence lack control over their exposure to liability."⁹⁹ The court was apparently uncomfortable with abandoning contract law in favor of negligence. The opinion distinguished between manufacturers, who typically expect that their product will be used by a wide field of users unknown to them, and audit firms, who perform their services under contract to a single client.

The court held that the Restatement approach "prevents extension of liability in situations where the accountant 'merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements].'"¹⁰⁰ But the court appears to have interpreted the Restatement approach fairly broadly:

The Restatement's text does not demand that the accountant be informed by the client himself of the audit report's intended use. The text requires only that the auditor *know* that his client intends to supply information to another person or limited group of persons. Whether the auditor acquires this knowledge from his client or elsewhere should make no difference. If he knows at the time he

95. 367 S.E.2d 609 (N.C. 1988).

96. *See id.* at 614.

97. *See id.* at 615.

98. *Id.*

99. *Id.* at 616.

100. *Id.* at 617 (quoting RESTATEMENT (SECOND) OF TORTS § 552 cmt. h).

prepares his report that specific persons, or a limited group of persons, will rely on his work, and intends or knows that this client intends such reliance, his duty of care should extend to them.¹⁰¹

The court concluded that those creditors that had relied upon the actual audited financial statements were owed a duty by the audit firm because the audit firm knew: "(1) the statements would be used by IMC to represent its financial condition to creditors who would extend credit on the basis of the report, and (2) plaintiff and other creditors would rely upon the audit report."¹⁰²

This opinion appears to indicate that the court interpreted the Restatement scope of liability broadly enough to impose on auditors a duty of care to all trade creditors who can show reliance upon the audit report if the auditor is aware that the company will use the audit report in order to obtain credit. Thus, the court held that trade creditors represent a "foreseeable class" under the Restatement. Once again, the court's opinion with regard to trade creditors as a "foreseeable class" begs the question—are trade creditors any more foreseeable than other investors?

Interestingly, the court discussed the inherent reliance by an auditor upon his or her client's records, assertions, and integrity as further evidence that audit firms have less control over their work product than do manufacturers, and therefore reasoned that auditors should have a more limited scope of liability than a negligence regime would provide.¹⁰³ As was discussed above in Part I, this is actually one of the reasons why auditors *should* be held to a negligence standard of liability. This argument is further developed in Part III.

2. *Bily v. Arthur Young & Co.*

In *Bily v. Arthur Young & Co.*,¹⁰⁴ the California Supreme Court retreated from its previous foreseeability standard in favor of a restrictive interpretation of the Restatement scope of liability. In the facts surrounding this well-known case, Osborne Computer Co. ("Osborne") had created a sensation by creating the world's first mass-produced portable microcomputer, which was also "bundled" with popular software applications. There was clearly a large and untapped market for portable computers, particularly among business travelers, and Osborne's sales skyrocketed. The company sought large amounts of bridge capital to enable it to continue expanding operations in advance of an initial public offering ("IPO"). Many individual investors bought stock from the company's founders. Others issued standby letters of credit in return for warrants that would permit them to purchase stock immediately after the IPO at a below-market price.¹⁰⁵ In advance of the IPO, Osborne hired

101. *Raritan River Steel Co.*, 367 S.E.2d at 618.

102. *Id.*

103. *See id.* at 616.

104. 834 P.2d 745 (Cal. 1992).

105. *See Bily v. Arthur Young & Co.*, 271 Cal. Rptr. 470, 490 (Cal. Ct. App. 1990), *rev'd*, 834 P.2d 745 (Cal. 1992).

the "Big Eight" CPA auditing firm of Arthur Young & Co. ("AY") to perform an audit of the company's 1981 and 1982 financial statements. The audited financial statements reported a net operating loss of approximately \$1,000,000 in 1981 on sales of \$6,000,000. Indicating a trend towards profitability, the income statement reported a modest \$69,000 operating profit in 1982 on skyrocketing sales of \$68,000,000.¹⁰⁶

It was subsequently discovered that Osborne had, in fact, incurred a substantial 1982 net operating loss in 1982 of approximately \$3,000,000. Osborne's market position subsequently deteriorated, and sales declined due to the failed introduction of a follow-up product and the entry of several new competitors, including IBM, into the microcomputer market. Consequently, the IPO never materialized and the company filed for bankruptcy. The stock and warrants were now worthless, and creditors faced a write-off of their loans.

A mass of litigation against AY ensued, brought by investors and creditors that had allegedly relied upon the AY-audited financial statements. Expert testimony identified over forty major deficiencies in AY's audit. These deficiencies appeared to constitute gross negligence. The plaintiff's evidence indicated that AY failed to follow GAAS during the audit and that the audit team failed to follow standard AY audit procedures.¹⁰⁷ This allegedly caused AY to fail to act upon various material errors in Osborne's accounting records and flaws in its accounting practices.

For example, members of the audit team had discovered significant deviations from proper accounting practices, as well as material defects in Osborne's internal accounting controls. These defects had allowed \$1,300,000 in liabilities to remain unrecorded in Osborne's financial records. These findings were not disclosed either as qualifications to the audit opinion or in the report to Osborne's board of directors. Based on such shortcomings in AY's conduct of the audit, plaintiffs alleged gross negligence, fraud, and negligent misrepresentation.¹⁰⁸

The lower California courts applied the foreseeability standard in accordance with a precedent set by a California appellate court in *International Mortgage Co. v. John P. Butler Accountancy Corp.*¹⁰⁹ This case had established a foreseeability standard for the scope of auditor duty to third parties.¹¹⁰ At trial, the jury had absolved AY of the charges of intentional fraud and negligent misrepresentation. But it found professional negligence on the part of AY, with no comparative negligence on the part of the plaintiffs. It awarded damages to plaintiffs equal to about seventy-five percent of their lost investment.¹¹¹

The California Supreme Court's majority opinion rejected the foreseeability scope of liability applied by the lower courts. Like the opinion in

106. See *id.* at 747-48.

107. See *id.* at 748.

108. See *id.* at 748-49.

109. 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).

110. See *Bily*, 834 P.2d at 757.

111. See *id.* at 749.

Ultramares, the court expressed concern that a negligence regime would result in potentially crushing liability to the independent auditing profession.¹¹² The opinion stated that “[i]n our judgment, a foreseeability rule applied in this context inevitably produces large numbers of expensive and complex lawsuits of questionable merit as scores of investors and lenders seek to recoup business losses.”¹¹³ The court also noted that only a comparatively few jurisdictions had adopted a foreseeability standard of liability for auditors.¹¹⁴ The *Bily* court determined that the allocative efficiency and deterrence criteria discussed in *Rosenblum* are adequately addressed by the Restatement’s more limited scope of liability.¹¹⁵

In adopting the Restatement rule, the court interpreted it as indicating that “an auditor’s liability for general negligence in the conduct of an audit of its client’s financial statements is confined to the client, i.e., the person who contracts for or engages the audit services. Other persons may not recover on a pure negligence theory.”¹¹⁶ The court explained that third-party users of financial statements could only bring an action based on either negligent misrepresentation or fraud.¹¹⁷

The court distinguished between negligent misrepresentation and ordinary negligence. The distinction has nothing to do with whether there are material misstatements in the financial statements. Instead, the distinction made by the California Supreme Court in *Bily* concerns the relationship of the tortfeasor to the plaintiff. While negligence would involve a plaintiff whose reliance was reasonably foreseeable, the tort of negligent misrepresentation requires a more formal relationship between tortfeasor and plaintiff, such that the plaintiff’s reliance on the audit report was substantially certain. The court suggested a jury instruction for the tort of negligent misrepresentation as follows:

The representation must have been made with the intent to induce plaintiff, or a particular class of persons to which plaintiff belongs, to act in reliance upon the representation in a *specific transaction, or a specific type of transaction*, that defendant intended to influence. Defendant is deemed to have intended to influence [its client’s] transaction with plaintiff whenever defendant knows with substantial certainty that plaintiff, or the particular class of persons to which plaintiff belongs, will rely on the representation in the course of the transaction. If others become aware of the representation and act upon it, there is no liability even though defendant should reasonably have foreseen such a possibility.¹¹⁸

This narrow-scope interpretation of the Restatement (Second) approach limits the scope of liability to specific parties whose reliance was

112. *See id.* at 761.

113. *Id.* at 767.

114. *See id.* at 757. The only states that have explicitly adopted the foreseeability standard are Mississippi, New Jersey, and Wisconsin. *See SPELLMIRE, supra* note 2, § 2.04.

115. *See Bily*, 834 P.2d at 758-59.

116. *Id.* at 767.

117. *See id.* at 767, 773.

118. *Id.* at 772-73 (emphasis added).

actually foreseen, rather than simply parties for whom such reliance is reasonably foreseeable, and is simply another example of a court arbitrarily choosing a limitation on auditor liability to third parties with no sound theoretical basis for its choice.¹¹⁹

E. FRAUD AND CONSTRUCTIVE FRAUD BY AUDITORS:
CONSISTENT LIABILITY

The Restatement and privity standards of auditor liability offer considerable protection to the auditor for negligence. But even in jurisdictions where courts have consistently allowed the protection offered by these standards, courts have found auditors liable for damages when they committed fraud or constructive fraud. Constructive fraud exists where the auditor's breach of care is sufficiently egregious as to support an inference of fraud.

There is a line of cases that has consistently supported recovery on the basis of actual and constructive fraud. In *State Street Trust Co. v. Ernst & Ernst*,¹²⁰ decided seven years after the *Ultramares* decision, the New York Court of Appeals remanded the case for trial on the basis of constructive fraud by an audit firm.

In *State Street Trust*, the Pelz-Greenstein Co. ("Pelz-Greenstein") sought a working capital loan and line of credit from the plaintiff, State Street Trust Co. The plaintiffs refused to complete the transaction until Pelz-Greenstein submitted an audited balance sheet, although they did extend a limited demand note based on the unaudited financial statements. Pelz-Greenstein engaged the audit firm of Ernst & Ernst ("Ernst"), which was aware that the purpose of the audit report was to enable Pelz-Greenstein to obtain credit. Ernst issued an unqualified audit opinion to Pelz-Greenstein's balance sheet, which indicated that the company had substantial net worth. Ernst submitted ten bound copies of the report directly to Pelz-Greenstein's management. Pelz-Greenstein in turn submitted the audit report to the plaintiffs, who then agreed to complete the loan transaction.¹²¹

Approximately seventeen days after Ernst issued the unqualified audit report to Pelz-Greenstein, Pelz-Greenstein filed for bankruptcy. About thirty days following the issuance of the audit report, Ernst sent Pelz-Greenstein a letter explaining that a material amount of the accounts receivables that were shown as fully collectible were, in fact, likely uncollectible. The letter further explained that Pelz-Greenstein had failed to record substantial allowances for these uncollectible accounts. These

119. Other courts have seized upon the "particular transaction" language in *Bily* to erect the same artificial limits on auditor liability. For example in *Machata v. Seidman & Seidman*, 644 So. 2d 114, 116 (Fla. Dist. Ct. App. 1994), the court held that the defendant accounting firm was not liable to the plaintiffs, who had relied upon the firm's audit report when the plaintiffs participated in certain stock transactions, because the audit firm did not know that the plaintiffs would be relying on the audit report for that specific transaction.

120. 15 N.E.2d 416 (N.Y. 1938).

121. *See id.* at 418.

reserves had the effect of showing that Pelz-Greenstein, contrary to the original audited financial statements, had a negative net worth, and was in fact insolvent. Despite the fact that Ernst had originally issued the audit report without qualification, the letter stated that “[t]his balance sheet is subject to the comments contained in the letter attached to and made a part of this report.”¹²²

The court concluded that deliberately circulating an audit report that the audit firm itself knew to be misleading “was itself gross negligence and an important piece of evidence raising an inference of fraud.”¹²³ The court refused to apply the privity rule (as the lower courts had done) and remanded for trial based on constructive fraud.

Thus the fraud exception to the normal rule of auditor liability has been consistently upheld, even in jurisdictions that otherwise hold that auditors owe no duty of care to third parties.

IV. A PROPER SCOPE OF LEGAL DUTY TO THIRD PARTIES

Auditors should be liable to all parties who actually relied upon the financial statements, regardless of whether they are trade creditors, bank creditors, debt security investors, or equity investors, and certainly regardless of whether the auditor had actually spoken with that particular investor. None of the justifications given by the courts or commentators for limiting liability have any sound theoretical basis.

A. THE ROLE OF THE AUDITOR: CONTRACT VERSUS TORT

As noted earlier in this Comment, and as illustrated by *Ultramares* and *Credit Alliance*, if contract law governs auditor liability, this is usually dispositive as to the outcome of the typical third-party claim against an audit firm. Therefore, the first step in determining the proper scope of legal duty is to determine whether liability should sound in contract law or tort. This question in turn should be driven by our concept of the role of the auditor in the modern economy.

Commentators have criticized the privity standard as providing special treatment to the auditing profession relative to other professionals, who are said to be subject to an ordinary negligence standard.¹²⁴ The issue is not whether auditors should be liable for negligent audits, but rather the scope of persons to whom the auditor owes the legal duty of professional care. Addressing this critical distinction within the context of the common law, Professor Thomas Grossman claims that no commentator has cited a single case in which a professional other than an auditor has been held to owe a duty of care in cases involving negligent misrepresentation and financial loss rather than physical harm to any party not meeting the

122. *Id.* at 420.

123. *Id.*

124. See John W. Bagby & John C. Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 GA. L. REV. 149, 180 (1987).

contract law requirements of privity.¹²⁵ Accordingly, the question is not whether auditors require special protection. Properly stated, the issue is whether auditors, because of their unique public role, should be subject to a broader scope of liability for their negligent professional conduct than other professionals, outside the restricted privity scope of contract law.

B. POLICY OBJECTIONS TO BROAD-SCOPE AUDITOR LIABILITY

The fact that most jurisdictions have been reluctant to adopt a foreseeability standard, and instead have opted for the intermediate approach taken by the authors of the Restatement (Second), reflects a perceived need to place limits upon auditor liability. This approach says that if liability is to sound in tort, the scope of this liability should be governed and, if appropriate, limited by public policy considerations.¹²⁶ Courts have expressed various objections to broad-scope auditor liability. The most persistent objection is the fear of crushing liability to the public accounting profession. Courts have argued that broad scope liability would result in excessive costs to audit firms because: (a) the primary purpose of auditing is to benefit the client, with third parties as secondary beneficiaries;¹²⁷ (b) auditing is primarily dependent upon client-controlled records and is, therefore, always subject to audit risk;¹²⁸ and (c) there is a potentially unlimited pool of potential plaintiffs, for indefinite duration, since the client, rather than the auditor, controls the distribution of the audit report.¹²⁹ These objections are without merit and based upon a misunderstanding of the audit's function and the planning of an audit.

1. *The Primary Purpose of an Audit is to Aid Investors and Creditors*

The *Ultramares* court justified its choice of contract law as the framework for auditor liability based upon its belief that the service performed by the auditor was primarily for the benefit of the client.¹³⁰ Originally the auditing function was primarily used by companies as a check upon, and supplement to, their internal accounting functions in order to assure management that it had accurate financial information to enable it to run the business. Seen in this context, it would be logical that contract law should govern an arrangement that is best understood as a promise by the auditor to validate the work of the client's accounting function. Consistent with the *Credit Alliance* decision, exceptions would be limited to third parties who are in "near-privity" with the audit firm.

But in the present day, the notion that an audit is primarily for the benefit of management is hopelessly outdated. Audited financial state-

125. See Grossman, *supra* note 78, at 228.

126. See *Citizens State Bank v. Timm, Schmidt & Co.*, 335 N.W.2d 361, 386 (Wis. 1983).

127. See, e.g., *Bily*, 834 P.2d at 761 (describing the "watchdog" role of the auditor as secondary).

128. See *id.* at 762.

129. See, e.g., *Raritan River Steel Co.*, 367 S.E.2d at 615-16.

130. See *Ultramares*, 174 N.E. at 446.

ments are the lifeblood of our modern economy. As commercial transactions and activities become more complex, audited financial statements become even more important. Investors, creditors, and shareholders rely on audited financial statements to become educated about a company and make well-informed decisions. Suppliers and vendors rely on audited financial statements to make certain they will get paid for their goods and services. Banks rely on audited financial statements to make lending decisions. Businesses large and small absolutely need to rely on audited financial statements. This necessary reliance is what gives the auditor a "public watchdog" function.

The accounting profession itself has long acknowledged the public duty performed by the auditor and the profession's unique requirement of independence from the client. The literature of the profession is unequivocal on this point.¹³¹ The United States Supreme Court has also recognized the auditing profession's public role.¹³²

Today, even relatively small firms have sophisticated in-house accounting functions that can reliably produce financial statements that are more or less in accordance with GAAP, and are quite adequate to supply management with the financial information it needs to make internal decisions. Nevertheless, in order to induce creditors to lend or investors to invest, management must be prepared to present audited financial statements to these third parties because third parties insist upon having the additional surety provided by the independent accountant's opinion.

Audited financial statements reduce transaction costs by giving the investors some assurance that the information on which they are relying is accurate. It would be extremely costly for investors to spend the time and resources to assure themselves that the actual financial condition of the companies in which they invest are in accordance to the assertions made by the companies' management in the companies' financial statements. Therefore, in situations involving auditor negligence, it is these third parties, rather than the client, who suffer harm. The auditing profession primarily exists not to help management verify its numbers, but rather to provide assurance to creditors and investors.

When evaluated in the context of modern commercial realities, the *Ultramares* contract-law framework for auditor liability lacks a sound doctrinal basis. Nevertheless, the privity doctrine is very much alive and kicking in nine states, including New York.¹³³ Additionally, other states, such as California, have made a narrow interpretation of the Restatement that approaches a privity standard, in that it excludes most foreseeable third parties from recovering damages against a negligent auditor.¹³⁴ But

131. See *Rosenblum*, 461 A.2d at 150.

132. See *Arthur Young & Co.*, 465 U.S. at 817-18.

133. See *Bily*, 834 P.2d at 752-55. The states that still follow the privity approach are Colorado, Connecticut, Idaho, Indiana, Montana, Nebraska, New York, Pennsylvania, and Virginia. See SPELLMIRE, *supra* note 2, § 2.04.

134. See generally *Bily*, 834 P.2d at 752-55.

the movement of most jurisdictions away from contract law reflects the acknowledgment by courts of the auditor's unique public role.

2. *Addressing Audit Risk is the Auditor's Professional Duty*

Audit risk is the risk that the financial statements will contain material misstatements. Every audit has a certain degree of audit risk. There is inherent risk in any accounting data because of the complexity of the transactions and the accounting estimates that are made in certain types of transactions. There is also the risk that the client's accounting system and controls did not record the transactions properly. The auditor's evaluation of management, the proficiency and integrity of the accounting function of the company, and the inherent risk in recording the types of transaction in which the company engages all guide the auditor with respect to how rigorous the audit must be (reducing detection risk) in order to meet the requirements of due care. Courts have reasoned that audit risk creates an inherently lesser degree of quality control in an auditor's work product relative to manufacturing. These courts reason that this risk in an auditor's work product justifies a narrower scope of liability to third parties.¹³⁵ This justification for limiting the scope of auditor negligence is misguided. The courts that have used this justification failed to see that assessing inherent risk and control risk, and thus adjusting the audit procedures performed, is simply part of an auditor's professional duty. Auditors are trained to analyze these types of risks. This ability to identify areas for potential misstatements is a basic skill of a professional auditor. Furthermore, this type of analysis may be appropriate in determining the standard of care, but not in determining to whom the auditor owes a professional duty.

3. *There is a Limited Number of Plaintiffs for a Limited Duration*

The courts that have limited auditor liability to so-called foreseeable users have cited the auditors inability to control the distribution of the audit report as justification for the limitation of liability.¹³⁶ This concern was expressed in *Ultramares*, where the opinion worried about the "indeterminate" number of users,¹³⁷ and was echoed sixty-one years later in the California Supreme Court's *Bily* opinion, where the court characterized the potential liability under a foreseeability regime as "'endless because [it], like light, travels indefinitely in a vacuum. . . . Although [foreseeability] may set tolerable limits for most types of physical harm, it provides virtually no limit on liability for nonphysical harm.'"¹³⁸

The *Bily* court's reasoning is flawed for two reasons. First, there is not an unlimited number of plaintiffs in such cases. Plaintiffs must have invested in the company that issued the materially misstated financial state-

135. *See id.* at 765-66.

136. *See Raritan River Steel Co.*, 367 S.E.2d at 615-16.

137. *See Ultramares*, 174 N.E. at 444.

138. *Bily*, 834 P.2d at 762.

ments. This is clearly a limited class. Second, the notion that audits persist indefinitely simply ignores the realities of the financial reporting process. Financial statements become stale within a year and are not a basis for reliance beyond that point. Addressing this issue, the dissenting opinion in *Bily* correctly recognized that "because audited financial statements become obsolete within a few years at most, the accountant's liability exposure has been finite and reasonably predictable in duration. Liability continues only so long as the audited financial statements reasonably influence business decisions."¹³⁹

C. ECONOMIC RATIONALES FOR AND AGAINST BROAD-SCOPE AUDITOR LIABILITY

1. *Cost Spreading*

Courts¹⁴⁰ and commentators¹⁴¹ have argued inconclusively about whether economic factors involving the ability to spread or insure against the cost of auditor malpractice supports a broad or narrow scope of liability. The courts' justifications, one way or the other, tend to be bald assertions regarding which party the court thinks can best absorb and spread these costs, without any rigorous analysis as to why. Professor Siliciano describes the courts' justifications regarding these economic determinants as "little more than ritualistic incantations of the concepts of deterrence and loss bearing, with little or no substance to their application."¹⁴²

The majority opinion in *Bily* when addressing this issue once again demonstrated its lack of understanding of the basic issues before the court. It reasoned that third-party lenders and investors are frequently sophisticated market participants with diversified portfolios and are in a superior position to absorb and spread the costs of a firm's collapse in the wake of audit failure.¹⁴³ Clearly audit firms are not liable to a client's investors for a client's business failure. That is not the issue. Institutional investors are in a good position to spread the cost of a company's collapse by diversifying their portfolios and assessing the business and financial risk of their investments. Auditors, on the other hand, are in a better position to absorb and spread the cost of *audit failures*.

Auditors should be liable for the losses that investors suffer when the auditor renders an unqualified opinion on financial statements that materially misrepresent a client's financial position, and the investors rely on

139. *Id.* at 780.

140. See *Rosenblum*, 461 A.2d at 152-53 (concluding that the auditing profession can best prevent and spread the cost of malpractice). But see *Bily*, 834 P.2d at 765-66 (concluding that third parties can best prevent and spread the cost of materially misstated financial statements).

141. See Bagby & Ruhnka, *supra* note 124, at 185-87 (arguing in favor of broad scope of liability based on the auditing profession's ability to absorb, spread, and insure against the costs of malpractice). But see John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929, 1970-78 (1988) (questioning whether cost spreading is a sound rationale for imposing liability on the auditing profession).

142. Siliciano, *supra* note 141, at 1978.

143. See *Bily*, 834 P.2d at 766.

those financial statements in making their analysis of the business and financial risk of their investment. Audit firms may absorb and spread the costs of audit failure by purchasing professional liability insurance. The auditors, in turn, may pass this cost along to their clients through higher fees. The higher fees to the clients lower the profits of the clients, thus passing these costs on to the client's investors – the primary beneficiary of the audit.

The traditional cost absorption analysis falls short in that the commentators have failed to recognize that in an effort to reduce their audit fees, the clients will increase their own internal control procedures to reduce the amount of substantive testing the auditors must do to become comfortable with the numbers on the financial statements. When auditors are held liable for their negligence, they are less likely to succumb to pressure by a client to reduce fees unless the client increases his own internal control procedures. Thus auditor liability pressures both the audit firms and their clients to reduce the number of material errors in financial statements.

For example, assume the auditor assesses the client's internal controls as weak, and therefore determines that control risk is 80% – there is an 80% chance that the client's internal controls will miss a material misstatement.¹⁴⁴ Furthermore, assume that the inherent risk is set at 100%, and the auditor wants to set audit risk at 10%. The auditor must set detection risk at 12.5%. This number can be derived by the following formula:

$$DR = \frac{AR}{IR \times CR} = \frac{10\%}{100\% \times 80\%} = 12.5\%$$

When the detection risk the auditor must achieve to render an unqualified opinion in accordance with the auditor's professional standards is 12.5%, the auditor must complete enough substantive tests of the client's accounting transactions to ensure that there is only a 12.5% chance that the auditor will miss a material error in recording a particular transaction. This low level of detection risk is necessary to ensure that there is not a material error in the financial statements. To achieve such a low detection risk, the auditor must perform a substantial amount of substantive audit work, thus driving up the time and expense of the audit. In order to achieve lower audit fees, the company will take steps to improve its internal accounting controls and thus reduce the control risk assessed by the auditor. If the client can reduce the control risk assessment to 20%, the

144. The second standard of audit field work requires the auditor to obtain a sufficient understanding of a client's control structure to plan the audit and determine the nature, timing, and extent of tests to be performed. See AICPA Auditing Standards, *supra* note 1, AU § 319.16. This usually entails flowcharting the client's accounting system identifying all control points built into the system. Next, the auditor will test a sample of transactions to see whether those procedures were performed while recording those transactions. If the control procedures are inadequate or were not consistently applied, the auditor will increase its control risk assessment.

detection risk will rise to 50%.¹⁴⁵ Such a change in the required detection risk could have a substantial impact on the cost of the audit.

Unless auditors are forced to bear the full costs of performing negligent audits, they will not be deterred from committing a socially undesirable level of negligence, nor will their clients set the proper level of internal controls within their financial reporting function. The statements by some courts¹⁴⁶ that third parties should absorb and spread the risk of financial reporting error ignores the problem of motivating auditors to minimize their negligence to a socially desirable level.

2. Best Precaution Taker

Some courts have stated that third parties should be viewed as the best precaution-takers against financial reporting errors or fraud. For example, the California Supreme Court, in its majority opinion in *Bily*, stated that third parties are usually sophisticated lenders and investors who are well suited to evaluate the risk involved in a given transaction or alternatively to mitigate the risks of audit failure through diversification.¹⁴⁷

The financial risk of a given transaction and the risk that the investor is relying on materially misstated financial statements are two totally separate issues. Investors cannot independently verify that the financial statements are not materially misstated. If they did not have the assurance that the numbers on the financial statements were accurate, the risk in all transactions would increase substantially. The required rate of return for any given investment would increase significantly, thus squeezing out many deals that would otherwise be done in an environment where the numbers on the financial statements can be relied upon. Once again, the *Bily* court's analysis is dead wrong.

3. Liability to Third Parties Will Not Result in Fewer Audits

Some commentators argue that auditors may avoid certain types of firms such as start-ups or firms in new industries, which carry a high degree of audit risk, even where audits might be the most efficient way to control a portion of the risk of transacting with such firms.¹⁴⁸ Even if audit firms carry malpractice insurance, they may seek to lower their costs of insurance by avoiding risky clients.¹⁴⁹ These commentators contend that if the costs of audits become too high, due to audit firms having to pass the costs of excessive auditor liability in the form of higher audit fees to new or risky clients, some companies that do not absolutely re-

$$145. \quad \frac{10\%}{100\% \times 20\%} = 50\%$$

146. See e.g., *Bily*, 834 P.2d at 766.

147. See *id.*

148. See Kraakman, *supra* note 31, at 76.

149. See Siliciano, *supra* note 141, at 1959-60; see also Robert Mednick and Jeffrey J. Peck, *Proportionality: A Much-Needed Solution to the Accountants' Legal Liability Crisis*, 28 VAL. U. L. REV. 867 (1994).

quire audits in order to function may simply try to operate without audit opinions, paying a commensurately higher price for higher-risk capital.¹⁵⁰ This extra cost of capital would also be a hidden cost of excessive auditor liability, since it would be more efficient for these firms to control this excess risk by means of an audit.

On the most basic level, these arguments are totally unconvincing. Auditors do not assure investors that these new ventures will not fail. They assure investors that the financial statements of these new ventures are not materially misstated. These arguments also overlook that fact that imposing liability on the auditors does not increase the cost of ensuring that financial statements are accurate. Instead, it is merely a way to allocate these costs.

The audit procedures that the auditors perform during an audit of a new venture will be based upon the risk of material misstatement that the auditor assesses during the planning phase of the audit – not the risk that the venture will fail. One way for new ventures to reduce the costs of their audits is to take steps to reduce the risk that their financial statements are materially misstated – reduce control risk. These steps may include investing early on to develop a reliable financial reporting system, placing proper internal controls in the accounting system, and hiring experienced and competent financial officers and accounting personnel.

E. PROPORTIONATE LIABILITY

The law should recognize that a negligent audit report may be only one of numerous substantial factors that results in a third party's decision to transact with the auditor's client. The auditor should not be liable for the total amount of losses caused by a third party's decision to transact, but only for that portion resulting from reliance on a negligent audit report.¹⁵¹ This apportionment should be a matter to be determined by the trier of fact.

Accordingly, tort doctrine dictates that the auditor should only be liable for the portion of a third party's loss that was caused by reasonable reliance on the negligent audit report.¹⁵² Courts must recognize that in many cases of audit failure, factors besides a negligent audit report induced third parties to transact with a risky firm. The California Supreme Court's majority opinion in *Bily* made this point by the reference to the hype that had surrounded the Osborne Computer venture:

150. See Siliciano, *supra* note 141, at 1970-71.

151. See generally, Mednick & Peck, *supra* note 149; see also Jordan H. Leibman and Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle*, 30 AM. BUS. L.J. 345, 438 (1992) (concluding that "[i]n third-party claims against negligent auditors, the reasonably foreseeable plaintiff should have standing to sue, but the culpability of the auditor should be assessed by the fact finder and only that equitably apportioned share should be imposed on the auditor, whether or not potential joint defendants are insolvent or immune from suit").

152. See, e.g., *Rosenblum*, 461 A.2d at 152.

Although plaintiffs now profess reliance on Arthur Young's audit report as the *sine qua non* of their investments, the record reveals a more complicated decision-making process. As a group of corporate insiders and venture capitalists who were closely following the Cinderella-like transformation of the company, plaintiffs perceived an opportunity to make a large sum of money in a very short time by investing in a company that they believed would (literally within months) become the dominant force in the new personal computer market.

Although hindsight suggests they misjudged a number of major factors (including, at a minimum, the product, the market, the competition, and the company's manufacturing capacity), plaintiffs' litigation-focused attention is now exclusively on the auditor and its report. Plaintiffs would have us believe that, had the Arthur Young report disclosed deficiencies in accounting controls and the [losses], they would have ignored all the other positive factors that triggered their interest¹⁵³

The above excerpt makes the point that the law should not view third-party reliance upon an audit report, in terms of causation, to be the complete cause of a third party's misfortune in the wake of a firm's collapse in situations involving audit failure. Third parties base their decisions to transact upon many factors in addition to an audit report.

Proportionate liability addresses several other arguments against a broad scope of liability to third parties. Courts and legal commentators fear that a broad scope of liability will lead to excess litigation because the auditing profession is a natural "deep pocket" target for disappointed creditors and investors in the wake of a firm's collapse. But a strict standard of causation, governed by proportionate liability, would have the effect of discouraging meritless suits.

V. CONCLUSION

The controversy regarding the scope of common law liability of auditors to third-party users of financial statements continues. Courts have continually erected artificial limits on auditor liability based upon a general misunderstanding of the nature and purpose of audits. As a consequence, in the absence of the discipline of the tort system, the level of negligence is probably excessive, and the victims are being undercompensated.

Courts have failed to recognize that auditors are the most efficient controllers of risk within the limits of a GAAS audit and that a professional negligence standard of liability is necessary to prevent auditors from externalizing the costs of their negligence upon third parties. By allowing auditors to evade liability by means of the outmoded privity doctrine or restrictive interpretations of the Restatement (Second) standard, courts have ignored the critical public role played by the auditing profession in

153. *Bily*, 834 P.2d at 763-64.

our market economy and the need to deter auditor negligence and to compensate its victims. The courts have largely based their objections to broad-based liability on analytically invalid concerns, such as fears of indeterminate liability, perceived difficulties in determining due care, or apportioning causation.

The privity standard and the stricter interpretations of the Restatement approach (e.g., as in *Bily*) fail to either adequately deter negligent conduct or compensate the victims of such conduct. When an auditor has performed an audit in a negligent manner and third parties have foreseeably relied upon the auditor's professional opinion and suffered harm, notions of fairness, economic efficiency, and deterrence indicate that the negligent auditor should share the liability. When an auditor instead escapes all responsibility due to an artificial, and analytically unsound, limitation upon the scope of liability the tort system has not protected private rights from negligence. For this reason, this controversy will not disappear until the law recognizes that the auditing profession owes the public a legal duty of care within the limits of the assurance that it provides in its audit opinions.

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