

December 1936

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Recommended Citation

William R. MacMillan, *Sources and Extent of Liability of a Public Accountant*, 15 Chi.-Kent L. Rev. 1 (1936).

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CHICAGO-KENT REVIEW

VOL. XV

DECEMBER, 1936

No. 1

SOURCES AND EXTENT OF LIABILITY OF A PUBLIC ACCOUNTANT

WILLIAM R. MACMILLAN*

TO what extent a public accountant is liable for failure to portray through the audit report the true financial position of the subject is not definitely established. The reported cases in this country bearing directly on the subject are few in number. That the public accountant is a member of a skilled profession is now generally accepted. In *Smith v. London Assurance Corporation*,¹ the Supreme Court of New York said, “. . . public accountants now constitute a skilled professional class, and are subject generally to the same rules for liability for negligence in the practice of their profession as are the members of other skilled professions. And such is doubtless the law.”

Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment and, if his pretensions are unfounded, he

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¹ 96 N. Y. S. 820 (1905).

commits a specie of fraud upon every man that employs him in reliance on his public profession.²

Public accountants hold themselves out to be skilled and competent to perform the duties and services which they undertake to perform as accountants, and are bound by law to perform such services in a skillful manner. When accountants are employed for the purpose of auditing the books and accounts they occupy a position of trust and confidence to their employer based on their superior knowledge of the business of accounting possessed by accountants.³ An accountant, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the subject's affairs; he does not even guarantee that the balance sheet is accurate according to the books of the company. If he did he would be responsible for error on his part even if he were himself deceived without any want of reasonable care.⁴ He undertakes for good faith and integrity and is liable to his employer for negligence, bad faith, or dishonesty.

For the purpose of the analysis of the liability with which the public accountant may be charged, it may be well to consider separately the cases wherein the gist of the action is negligence and the cases predicated upon fraud. Since the negligence and the contractual theories are inter-related they will be treated together.

In order for the accountant to be liable on the theory of negligence he must owe a duty to the party who seeks to hold him liable. If he owes no duty he cannot be required to respond in damages no matter how negligent he may have been and no matter what damage the other

² 3 Cooley on Torts (4th ed.) 335, sec. 472.

³ Dantzer Lumber & Export Co. v. Columbia Casualty Co., 115 Fla. 541, 156 So. 116, 95 A. L. R. 258 (1934).

⁴ Leeds Estate, Building and Investment Co. v. Shepherd, 36 Ch. Div. 787 (1887).

party may have sustained.⁵ The contract of employment ordinarily supplies the duty necessary to form a basis for the action.

Negligence may be defined as the failure to observe for the protection of the interests of another person that degree of skill, care, and caution which the circumstances justly demand, whereby such other person suffers injury. In every case involving actionable negligence there are necessarily three basic elements essential to its existence:

1. The existence of a duty on the part of the defendant to protect the plaintiff from the injury.
2. The failure of the defendant to perform that duty.
3. An injury to the plaintiff from such failure of the defendant.⁶

Where the duty arises out of contract, the injured party has alternative remedies, one for the breach of the contract and the other in tort for negligence. Accompanying every contract is a common law duty to perform the thing agreed to be done with reasonable care, skill, and caution, and a negligence failure to observe these conditions is a tort as well as a breach of the contract. If the transaction complained of had its origin in contract which placed the parties in such a relation that in attempting to perform the promised service the tort was committed, then the breach of the contract is not necessarily the gravamen of the suit. The contract in such case may be considered merely as creating the state of things which furnishes the occasion for the tort. For injuries resulting from unskillful or otherwise negligent performance of a thing agreed by a valid contract to be done, an action *ex delicto* will lie notwithstanding the act

⁵ Landell v. Lybrand, 264 Pa. 406, 107 A. 783, 8 A. L. R. 461 (1919); Ultra Mares Corp. v. Touche, 255 N. Y. 170, 174 N. E. 441, 74 A. L. R. 1139 (1931).

⁶ Tampa Electric Co. v. Bazemore, 85 Fla. 164, 96 So. 297 (1923).

complained of would also be ground for an action *ex contractu*.⁷

The skill that he must use in the performance of an audit must be that which he purported to have by holding himself out as a public accountant. By making the contract of employment he impliedly warrants that he has the degree of skill that is generally possessed by others in the same calling. What is reasonable care and caution must necessarily depend on the facts and circumstances of each case. The Circuit Court of Appeals for the Second Circuit in *George N. Pierce Company v. Wells Fargo & Company*, commenting on the care a common carrier is bound to exercise, said: "Greater care is called for in transporting eggs than in transporting pig iron."⁸

Where the scope of the audit has been limited by contract, it cannot be supposed the auditors will take the same precautions to uncover irregularities as they would in the case of a detailed audit. In *International Laboratories, Ltd. v. Dewar*,⁹ the defendants, chartered accountants, had been employed to make a balance sheet audit. A more complete audit had been dispensed with to save money. The action was to recover for the losses which resulted to the plaintiff company through the alleged negligence of the auditors in failing to discover and report the defalcations of the office manager. The principal point in issue was whether or not the auditors were liable for negligence in view of the fact that the plaintiff, by contract with them, had so limited the scope of their audit that it was practically impossible for the auditors to uncover the defalcations. The court held that the auditors were not negligent in performing their work

⁷ 26 R. C. L. 758; *Barrett v. New Eng. Tel. & Tel. Co.*, 80 N. H. 354, 117 A. 264, 23 A. L. R. 947 (1922).

⁸ 189 F. 561 (1911).

⁹ 41 Manitoba L. R. 329 (1933).

because the measure of responsibility depended on the terms of their employment.¹⁰

An auditor is not bound to be a detective, or approach his work with suspicion, or with a foregone conclusion that there is something wrong. In *In re Kingston Cotton Mill Company (No. 2)*,¹¹ Lopes, L. J., said:

He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.

Unless the contract of employment so provides, he is not required to take inventory. Where there is nothing to excite his suspicion he is justified in assuming that the one taken by the agents of the employer is fair and made without fraud. It was held, therefore, in *In re Kingston Cotton Mill Company (No. 2)* that the auditors were not negligent in using in the preparation of their statements the inventory furnished them by their employer even though it subsequently turned out that it was grossly misstated.

The accountants were held not negligent in the performance of their audit in *Blue Band Navigation Company v. Price Waterhouse*¹² where they omitted to investigate an amount owing to the plaintiff company by a third party syndicate, relying instead on the personal guaranty of the managing director. The defendant auditors, when auditing the company's books, questioned him concerning the amount owing to the company by the syndicate. He refused to disclose its personnel or the nature of its business except that it was engaged in

¹⁰ The dissenting opinion was based not on the principle involved, but on what the parties understood the extent of the audit should be.

¹¹ [1896] 2 Ch. Div. 279, 65 L. J. Ch. 673, 74 L. T. R. 568.

¹² [1934] 3 D. L. R. 404, 48 Brit. Col. R. 325, 15 Can. Bankr. Rep. 434.

speculative ventures in the stock market, but he gave a personal written guaranty of the amount to the company. The auditors, who knew the managing director at the time to be very wealthy, accepted the guaranty as sufficient security for the purpose of the audit. Although they set the guaranty out in full in their report to the company, the details relating to its being given were not mentioned.

The accountants were held to be negligent in *Fox & Son v. Moorish Grant & Company*,¹³ where, over a number of years, they audited the books of the plaintiff company and stated the amount of cash in the bank as it appeared in the books without examining the bank pass book, or obtaining any statement with reference thereto from the bank, or informing the firm that they had not done so. The entries in the books of account were in fact falsely made by a dishonest clerk of the plaintiff whose defalcations would have been discovered if the entries had been checked with reference to the pass book.

Proof of negligence on the part of the accountant and an injury to the employer does not in itself establish a cause of action. There must be a causal connection between the negligent act or omission and the injury sought to be redressed. To make one liable on the theory of negligence, therefore, the plaintiff must not only allege and prove negligence on the part of the defendant, but must also allege and prove that the negligence of the defendant was the cause of the injury complained of. It is not sufficient to show that the negligence of the defendant and the injury to the plaintiff concurred.¹⁴ No matter how obvious the causal relation may be, it will not be presumed.¹⁵ The plaintiff municipal corporation in *County of Renfrew v. Lockhart*¹⁶ sought to recover from

¹³ 35 T. L. R. 126, 36 Sol. Jo. 193 (1918).

¹⁴ *Sowles v. Moore et al.*, 65 Vt. 322, 26 A. 629 (1893).

¹⁵ *Aiken v. City of Columbus*, 167 Ind. 139, 78 N. E. 657 (1906).

¹⁶ [1933] Ont. Week. N. 627.

the defendant auditors \$117,902 embezzled by one Biggs while acting as county treasurer from 1925 to 1931. During that time the defendants, who had been employed to audit the books of the treasurer's office failed to detect and report any irregularity. The accountants did not compare the cash book with the entries in the bank book as carefully as they might have done. Instead they took the balance in the cash book at the end of the year and compared it with the balance shown in the bank book and found these were in general correspondence. The plaintiff did not allege, nor prove that the injury resulted to it through any act or omission of the auditors. In affirming the decision of the trial court, the reviewing court said, "Here, there is no evidence of actual damage to the plaintiff, the corporation, flowing from the failure of the defendant to discover and report the defalcations on the part of Biggs. Were they guilty of breach of duty? That is not sufficient. There must be damages flowing from the breach, and there is nothing to show any damage was sustained by the plaintiff owing to the failure of the defendants to report the defalcations."

Want of due care on the part of the party injured may also preclude recovery for the negligent acts of the defendant. The defendant's wrong is not considered the proximate cause of the injury where the plaintiff has been guilty of some fault concurrent with, or subsequent to that of the defendant, without which the injury would not have happened.¹⁷ In *Craig v. Anyon*¹⁸ it was held that the plaintiffs, stock and commodity brokers, could not recover for the negligence of the defendant auditors in failing to discover and report the defalcations of one Moore, an employee of the plaintiffs, as it was found that the loss resulted also from the negligent manner in which the brokers conducted their business. Moore had been

¹⁷ *Lea v. Southern Public Utilities*, 176 N. C. 511, 97 S. E. 492 (1918); *Louisville & N. R. Co. v. Davis*, 75 F. (2d) 849 (1935).

¹⁸ 208 N. Y. S. 259 (1925).

given full charge of the commodities department and had a free hand in making the entries in the books of account and in the handling of contracts. Although the defendants cautioned the brokers about providing a system of internal check, the brokers failed to do so. From 1913 to 1917 Moore embezzled \$1,250,000 of the company's funds. Every three months during that time the defendants audited the books of the plaintiff company and their reports, without making reference to any irregularity, assured the plaintiffs that the books were properly kept. The accountants, as well as the plaintiffs relied on the honesty of the defaulting employee. The court said, "There is no doubt in this case that the plaintiff could have prevented loss by the exercise of reasonable care and they should not have relied exclusively on the accountants." This conclusion was reached even though the defendants could have performed the work independently of the information furnished by the employee. Not all negligent acts of the plaintiff, however, will bar a recovery. In order to defeat recovery, the negligence of the plaintiff must be of a character that the injury complained of would not have occurred but for such act or omission. An act or omission that merely increases or adds to the extent of the loss or injury does not preclude the plaintiff's right to recover, although it may affect the amount of damages to be recovered in a given case.¹⁹

It is a general rule that one who asserts that another party is negligent has the burden of proving it when such negligence is in issue.²⁰ There is some authority for the view that proof of a contract or undertaking and damage resulting from a breach make out a prima facie case.²¹ Following the latter line of thought, Astbury, J., speaking for the court in *In re Republic of Bolivia Exploration Syndicate (No. 2)*²² said, "I think when it is shown that

¹⁹ *Smithwick v. Hall & Upson Co.*, 59 Conn. 261, 21 A. 924 (1890).

²⁰ *Chicago Union Traction Co. v. Giese*, 229 Ill. 260, 82 N. E. 232 (1907).

²¹ 1 *Shearman & Redfield on Negligence* (6th ed.) 122, 134, secs. 57 and 60.

²² 83 L. J. Ch. 235 (1913).

audited balance sheets do not shew the true condition of the company, and damage has resulted, the onus is on the auditors to shew that it was not the result of any breach of duty on their part.”

Where a case of negligence is made out against the accountant, he must respond for all damages that flow proximately from the breach of duty.²³ He is not liable for all irregularities, but he is responsible for losses that result to his client through his failure to report such irregularities as would be discovered by the exercise of reasonable care and skill. Thus in *Fox & Son v. Moorish Grant & Company*,²⁴ the accountants, who had negligently failed to detect and report the defalcations of an employee extending over a period of years, were required to reimburse their client for the losses that could have been averted had they performed their duty with care and skill. When the accountant reports the irregularities, the employer is enabled to take proper steps to avoid a repetition. If, as a natural consequence of the auditor's breach of duty, payments are made which are a misapplication of the company's funds, the auditors are responsible.²⁵ To come within the sphere of recovery, however, the loss must be the natural consequence of the breach of duty, or could have been foreseen as the probable result of it as distinguished from remote and speculative damages.²⁶

*Hadley v. Baxendale*²⁷ is the leading case pertaining to damages that result from the breach of contract and the rule laid down therein is generally followed in this country.²⁸ The court in that case said:

²³ *Smith v. London Assurance Co.*, 96 N. Y. S. 820 (1905).

²⁴ 35 T. L. R. 126, 36 Sol. Jo. 193 (1918).

²⁵ *Leeds Estate Building & Investment Co. v. Shepherd*, 36 Ch. Div. 787 (1887).

²⁶ *City of East Grand Forks v. Steele*, 121 Minn. 296, 141 N. W. 181, 45 L. R. A. (N. S.) 205 (1913).

²⁷ 9 Exch. 341, 23 L. J. Exch. 179, 156 Eng. Rep. 145 (1854).

²⁸ *Illinois Central R. R. v. Cobb Christy Co.*, 64 Ill. 128 (1872); *Eckington & Soldiers' Home Railway Co. v. McDevitt*, 191 U. S. 103, 48 L. Ed. 112

Now we think the proper rule . . . is this: Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect to such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they reasonably contemplate would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

The rule in *Hadley v. Baxendale* was followed by the Supreme Court of Minnesota in *City of East Grand Forks v. Steele*.²⁹ The plaintiff city had hired the defendants, public accountants, for two years to make an audit of the books of the city clerk. During both years the clerk embezzled several thousand dollars of the city's funds. The evidence showed that the defendants failed to discover the defalcations because of incompetence and negligence. Had the defendants discovered the defalcations in the first audit, recovery could have been had from the surety on the clerk's fidelity bond and the losses could have been averted the second year, had the facts been known, by removing the clerk for misconduct in office. During his second year in office, the surety company became insolvent. The city declared both in contract and in tort for negligence, but the court held that

(1903); *Chapman v. Fargo*, 223 N. Y. 32, 119 N. E. 76 (1918); *Altschuler v. Atchison, T. & S. F. Ry. Co.*, 155 Wis. 146, 144 N. W. 294 (1913); *Miholevich v. Mid-West Mut. Auto Ins. Co.*, 261 Mich. 495, 246 N. W. 202, 86 A. L. R. 633 (1933); *Shopper Pub. Co. v. Skat Co.*, 90 Conn. 317, 97 A. 317 (1916); *Dondis v. Borden*, 230 Mass. 73, 119 N. E. 184 (1918); *De Honey v. Gjarde*, 134 Wash. 647, 236 P. 290 (1925); *Alabama Water Service Co. v. Wakefield*, 231 Ala. 112, 163 So. 626 (1935).

²⁹ 121 Minn. 296, 141 N. W. 181, 45 L. R. A. (N. S.) 205 (1913).

the plaintiff had stated but one cause of action and that was on the contract. The damages prayed for were the sums embezzled each of the two years and the fees that were paid the defendants for their services. Recovery was not permitted for the defalcations because it was not shown that these were in the contemplation of the parties at the time of making the contract, or that the losses may reasonably have been expected from the breach. The city was allowed to recover on the theory of a breach of warranty for the fees that were paid to the defendants. On this point the court said, "In accepting employment as expert accountants, they undertook, and the plaintiff had the right to expect, that in the performance of their duties they would exercise the average ability and skill of those engaged in that branch of skilled labor." Had it been shown that it was within the contemplation of the parties that losses might ensue from future embezzlements if the accountants failed to detect them, or had the accountants been apprised that the purpose of the audit was to guard against such loss, the language of the court would indicate that the accountants would have been liable for the losses that could have been averted by properly performing their contract.

As far as the extent of recovery is concerned in a suit between the parties to the contract, it makes no difference whether the action be in tort for negligence, or whether it be founded on the breach of contract.³⁰ The underlying principles governing an award of damages are the same whether the action is in contract or in tort arising from contract.³¹ In all civil actions the law gives, or endeavors to give, a just indemnity for the wrong that has been done to the plaintiff, and whether the act was of the kind designated as a tort or one consisting of breach of con-

³⁰ *Thompson v. Clemens*, 96 Md. 196, 53 A. 919, 60 L. R. A. 580 (1903).

³¹ 17 C. J. 717, and cases there cited.

tract, is, on the question of damages, an irrelevant inquiry.³²

A third theory on which an accountant may be charged with liability is fraud and deceit. Accountants in making an audit, owe to their employer a duty imposed by law to make their audit without fraud.³³ Fraud or deceit is the false representation or concealment of a material fact, made with knowledge that it is false, or recklessly made without regard to its truth, intended to be relied upon by another, and which is in fact reasonably relied upon by that other to his damage.³⁴

The accountants were found to be guilty of fraud in *Canadian Woodmen of the World v. Hooper*.³⁵ An employee of the plaintiff company had been provided with funds and instructed by the board of directors to buy Grand Trunk Railway bonds, but instead of buying the bonds, he purchased a mortgage on a skating rink. The employee not only failed to report to the directorate what he had done, but concealed the fact from them by false entries in the company's books by showing that the investment in railway bonds had been made. The transaction was carried on the company's books without any discovery of the true state of affairs except by the defendants, public accountants. They found out what had taken place and yet they made no report to the directorate, nor to any official of the plaintiff company other than the defaulting employee who had promised to have the matter put right. The auditors' report for 1927, 1928, and 1929 showed the railway bonds as an investment and each report was accompanied with the certificate: "The bonds, debentures, and mortgages have been

³² Hetzel v. Baltimore & Ohio R. R. Co., 169 U. S. 26, 42 L. Ed. 648 (1898).

³³ Ultra Mares Corp. v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931).

³⁴ Pain v. Kiel, 288 F. 527 (1923); Billstrom v. Tripple Tread Tire Co., 220 Ill. App. 550 (1921).

³⁵ 41 Ont. Week. N. 328 (1932), [1933] 1 D. L. R. 168.

examined by us and are according to the list annexed hereto." The auditors did not disclose the true facts to the plaintiff until March 3, 1931. The court in speaking of the accountants said, "Their liability depends on a positive act amounting to misconduct in the office of auditor. Upon discovery of the so-called irregularity, it was the auditors' duty to report at once the true facts to the company." Although they were not responsible for the conduct of the defaulting employee, they were found to be liable for any loss which resulted from their failure to report the true facts to the plaintiff at the time they acquired the information.

To be actionable fraud, the statement need not be made with the intent to deceive. Where a party represents a material fact to be true of his own personal knowledge, as distinguished from belief or opinion, when he does not know whether it is true or not, and it is actually untrue, he is guilty of falsehood even though he believed it to be true. If the statement is made with the intention that it should be relied upon by another who does so act upon it to his injury, the result is actionable fraud.³⁶ If fraud is proved, the motive of the person guilty is immaterial.³⁷

Although it was not shown in *Ultra Mares Corporation v. Touche*³⁸ that the accountants intended to deceive anyone, they were, nevertheless, found guilty of fraud. They certified as a fact, true of their own knowledge, that the balance sheet was in accordance with the books of account.³⁹ The balance sheet may be summarized as follows:

³⁶ *Owens v. Waterhouse*, 233 N. Y. S. 535 (1929); *Bystrom v. Villard*, 162 N. Y. S. 100 (1916).

³⁷ *Derry v. Peek*, 14 App. Cas. 337 (1889).

³⁸ 255 N. Y. 170, 174 N. E. 441, 74 A. L. R. 1139 (1931).

³⁹ To the balance sheet was appended the following certificates: "We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923."

Assets	\$2,550,671.88	Liabilities	\$1,479,956.62
		Net Worth	1,070,715.26
	<hr/>		<hr/>
	\$2,550,671.88		\$2,550,671.88

In reality, the capital and surplus accounts had been wiped out and the corporation was insolvent. The books had been falsified by those in charge of the business so as to set forth accounts receivable and other assets which turned out to be fictitious. Inquiries of creditors gave notice to the accountants that some of the assets had been pledged at as many as four different banks at the same time. An item amounting to more than \$700,000 which represented the sales for the month of December was taken as true, where there were not supporting entries, without examining the invoices. If there was not an intentional misrepresentation, it amounted to what is sometimes called reckless indifference. It amounts to knowledge of the falsity, because it excludes any possibility of real belief in the truth of the fact stated.⁴⁰ To prevent a false statement from being fraudulent, there must always be an honest belief in the truth.⁴¹ If there has been neither reckless misstatement, nor insincere profession of an opinion, but only an honest blunder, the ensuing liability is for negligence.⁴²

One is not relieved of liability for fraud because his statements were ambiguous and in a sense true, if they were calculated to mislead. Speaking of an equivocal prospectus, which was condemned as fraudulent by the House of Lords in *Aaron's Reefs, Ltd. v. Twiss*,⁴³ Lord Halsbury called the language ambidexterous. In the case it was argued that no specific allegation of fact was proved to be false. The Lord Chancellor protested against this being the true test, and declared the question was

⁴⁰ *Owens v. Waterhouse*, 233 N. Y. S. 535 (1929).

⁴¹ *Derry v. Peek*, 14 App. Cas. 337 (1889).

⁴² *Ultra Mares Corp. v. Touche*, 255 N. Y. 170, 174 N. E. 441 (1931).

⁴³ [1896] A. C. 273.

whether taking the whole thing together, there was a false representation.

I do not care by what means it is conveyed—by what trick or device or ambiguous language: all those are expedients by which fraudulent people seem to think they can escape the real substance of the transaction. If by a number of statements you intentionally give a false impression and induce a person to act upon it, it is not the less false although if one takes each statement by itself there may be difficulty in showing that any specific statement is untrue.

In *In re London and General Bank (No. 2)*,⁴⁴ a suit by the liquidator of an insolvent corporation, the auditors were held liable for two semi-annual dividends paid while the corporation was insolvent, because they had failed to discharge the duty imposed by statute⁴⁵ to report to both the directors and stockholders the financial position of the company. As the stockholders were required to concur in the declaring of a dividend, it was necessary that they be apprised of the company's condition. The most important asset on the balance sheet was "Loans to customers and other securities" £346,975. The evidence showed that the defendant auditors were aware of the precarious condition of the investments and that the company was in fact insolvent. The report to the directors as originally drawn concluded with the observation, "We cannot conclude without expressing our opinion unhesitatingly that no dividend should be paid this year." The auditors, however, were persuaded by the chairman of the company to strike the sentence from their report. The certificate signed by the auditors and laid before the shareholders at their annual meeting was as follows: "We have examined the above balance-sheet and compared it with the books of the company; and we certify that it is a correct summary of the accounts therein recorded. The value of the assets as shewn on the balance sheet is

⁴⁴ [1895] 2 Ch. Div. 673.

⁴⁵ Companies Act (Eng.) 1877, sec. 7.

dependent upon realization." It was contended by the auditors that they were only required to certify that the balance sheet was correctly drawn from the books of the company. They further maintained that they did in fact warn the stockholders of the necessity of inquiring into the sufficiency of the securities by appending a note to their report to the effect that the value of the securities depended on realization. The court held the defendants' contentions to be untenable and that it is the duty of the accountant, by examining the books of the company, to ascertain and state its true financial position at the time of the audit. In commenting further the court said, . . . he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves shew the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be an idle farce. . . . A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more.

One who has been wronged by the fraud and deceit of another is entitled to reparation for the injuries that have been occasioned thereby. Usually the defendant is compelled to respond in such damages as will place the plaintiff where he would have been if the wrong had never been committed.⁴⁶ As fraud is considered an intentional wrong, the liability of the perpetrator is absolute. When a case of fraud is made out against the defendant, he is liable for the consequences and it does not matter whether or not the injury complained of was within the contemplation of the parties at the time of the occurrence of the transaction; or if it could have been foreseen by the defendant; or if the injury was the natural and probable result of the fraudulent misrepresentation; or if the plaintiff was himself negligent.

It has been previously pointed out that the accountant

⁴⁶ Bauer on Damages, pp. 388-9, sec. 225.

must owe a duty to the party who seeks to hold him liable for negligence in order that he be liable on that ground. As the duty to use care and skill in the performance of the audit grows out of the contractual relationship, it follows that he would not be required to account on that basis to a stranger to the contract. This, undoubtedly, is the general rule. It has been frequently laid down as a principle of law that no cause of action for negligence can arise out of the breach of a duty existing by virtue of a contract unless there be a privity of contract between the parties.⁴⁷ In the absence of fraud or collusion, a person making a certificate is liable, ordinarily, only to his employer for negligent errors or omissions therein.⁴⁸

In *Landell v. Lybrand*⁴⁹ the plaintiff, third party stranger to the contract, in reliance on the defendants' audit report, invested in shares of stock of the subject company. The report was erroneous and he thereby suffered a loss which he sought to recover from the accountants. The averment in the statement of claim was that the defendants were negligent in making their report. It was held that even though they were careless in the performance of the audit, the plaintiff failed to state a

⁴⁷ 20 R. C. L. 49, note 7.

⁴⁸ An engineering firm, whose business was to test building materials, inspected a quantity of steel rails for the owner and rendered a report thereon concerning their quality. The report was erroneous. It was held that the plaintiff, who purchased the rails in reliance on the report, had no cause of action against the engineers who made the false report. *National Iron & Steel v. Hunt*, 312 Ill. 245, 143 N. E. 833, 34 A. L. R. 63 (1924).

An expert grain inspector certified to a mill that certain wheat was grade No. 1 red winter wheat, when in fact it was inferior grade. The mill sold the wheat to the plaintiff, and he, relying on the certificate of inspection paid for the wheat without examining it. It was held that the plaintiff could not recover damages from the inspector for the reason that the latter owed him no legal duty. *Gordon v. Livingston*, 12 Mo. App. 267 (1882).

An attorney, employed to draw a will, was held not liable to a person, who through the attorney's neglect, or ignorance, in the discharge of his professional duties, had been deprived of a portion of the estate the testator instructed should be given by his will. The basis of the decision was that there was no privity between the attorney and the disappointed beneficiary. *Buckley v. Gray*, 110 Cal. 339, 42 P. 900 (1895). As to the third parties who relied on certificates of title to real property, see *National Savings Bank v. Ward*, 100 U. S. 195, 25 L. Ed. 621 (1880) and *Thomas v. Guaranty Title & Trust*, 81 Ohio St. 432, 91 N. E. 183 (1910).

⁴⁹ 264 Pa. 406, 107 A. 783, 8 A. L. R. 461 (1919).

cause of action because he had not shown that the accountants owed him a duty. It was similarly held in *Ultra Mares Corporation v. Touche* that the plaintiff, which had advanced credit in reliance on a certified balance sheet, stated no cause of action for negligence.

Although the question does not seem to have arisen in any reported case involving the liability of an accountant, analogous cases would lead one to believe that where the audit is made at the instance of the subject company for the benefit of a third party, and it can be shown that the auditor knew the purpose for which it was intended, there is a duty owing to that third party for the breach of which the auditor must respond in damages. If one, who is in the business of preparing abstracts of title to real estate, is employed by a proprietor to prepare an abstract for another's benefit, and if he knows the person to whom it will be delivered and knows that he will act on it in making a purchase or trade, he is liable to such person for want of care or skill in its preparation.⁵⁰ The same principle was involved in *Glanzer v. Shepard*,⁵¹ where the defendants, public weighers, were requested by the seller to weigh a quantity of beans and make duplicate return thereon, one copy to the seller and the other to the buyer. The plaintiff-buyer, who, in reliance on the report which turned out to be erroneous, overpaid the seller, was allowed to recover the loss occasioned through the negligence of the defendants.

The doctrine of *Lawrence v. Fox*,⁵² the principle which permits a third person to maintain an action on a contract made between other persons for his benefit, has been

⁵⁰ *Anderson v. Priestersbach*, 69 Wash. 393, 125 P. 166 (1912); *Denton v. Nashville Title Co.*, 112 Tenn. 320, 79 S. W. 799 (1904); *Western Loan & Savings Co. v. Silver Bow Abstract Co.*, 31 Mont. 448, 78 P. 774 (1904); *Economy Bldg. & Loan Ass'n v. West Jersey Title & Guar. Co.*, 64 N. J. L. 27, 44 A. 854 (1899).

⁵¹ 233 N. Y. 236, 135 N. E. 275 (1922).

⁵² 20 N. Y. 268 (1859).

gradually expanding until today the beneficiary of a promise, clearly designated as such is seldom without a remedy.⁵³ In order to maintain an action as a third party beneficiary for the breach of an agreement, the plaintiff should show that the agreement was intended for his direct benefit.⁵⁴ Ordinarily something more must appear than that the promise shall redound to the benefit of the public or that of a class of indefinite extension.⁵⁵ In a few jurisdictions it is held that if a third party, even though unknown at the time of making the contract, is necessarily to be benefited by the performance of the contract, he has a remedy for its breach if he thereby suffers injury.⁵⁶ It appears, however, that in cases where a third party has been permitted to recover for the breach of a duty in making a certificate, he has been required to show that the agreement was made for his special benefit.

In any instance where a third person may maintain a tort action for negligence for the breach of a duty arising out of a contractual relationship, he may also, on the doctrine of *Lawrence v. Fox* have a recovery for his injury in an action based on the contract itself.⁵⁷

Where the theory of the cause of action is fraud and deceit, it is neither necessary to show a privity of contract, nor that the contract was made for the plaintiff's benefit. All that is essential is that it was intended that the injured party should rely on the false statement and that he did rely on it to his damage. The fraudulent representations which form the basis of the action may be

⁵³ *Seaver v. Ransom*, 224 N. Y. 233, 120 N. E. 639, 2 A. L. R. 1187 (1918). See also 81 A. L. R. 1271, note.

⁵⁴ *Chicago, R. I. & P. Ry. Co. v. Maryland Casualty Co.*, 75 F. (2d) 596 (1935); *Kenfield Pub. Co. v. Baumgartner*, 189 Ill. App. 413 (1914).

⁵⁵ *H. R. Moch Co. v. Rensselaer Water Co.*, 247 N. Y. 160, 159 N. E. 896, 62 A. L. R. 1199 (1928).

⁵⁶ *Ohio Casualty Ins. Co. v. Beckwith*, 74 F. (2d) 75 (1934); *Binswanger v. Employers' Liability Assurance Corp.*, 224 Mo. App. 1025, 28 S. W. (2d) 448 (1930); *Gorell v. Greensboro Water-Supply Co.*, 124 N. C. 328, 32 S. E. 720 (1899).

⁵⁷ *Economy Bldg. & Loan Ass'n v. West Jersey Title & Guarantee Co.*, 64 N. J. L. 27, 44 A. 854 (1899).

made to an individual, or may be made to the public generally if the intent is that the ones to whom the information is communicated will rely on it.⁵⁸ To create a cause of action for fraud, it is not necessary that the deceit should have been practiced directly on the plaintiff, but it is sufficient if the initial fraud which was intended to injure the plaintiff caused him damage through intermediate agencies.⁵⁹

In *Ultra Mares Corporation v. Touche*, the subject company was engaged in the sale of rubber, and in financing its operations it required extensive credit and borrowed large sums of money from banks and other lenders. All this was known to the defendant accountants. They were also aware that in the usual course of business, the balance sheets, when certified, would be exhibited by the subject company to banks, creditors, stockholders, purchasers, or sellers, according to the needs of the occasion as a basis of financial dealings. Accordingly, when the balance sheet was made up, the defendants supplied the subject company with thirty-two copies, certified with serial numbers, as counterpart originals. Nothing was said as to whom these counterparts would be shown, or the extent or number of transactions in which they would be used. In particular, there was no mention of the plaintiff, which until then, had never extended credit to the subject company. The defendants were, nevertheless, liable for the loss sustained by the plaintiff on account of advances made in reliance on the false statement certified by the defendants and placed in its hands through the medium of the subject company.

The accountant may also be liable to one other than the employer on the theory of subrogation. That is the equity by which a person who is secondarily liable for

⁵⁸ *Ver Wys v. Vander Mey*, 206 Mich. 499, 173 N. W. 504 (1919); *Leonard v. Springer*, 197 Ill. 532, 64 N. E. 299 (1902).

⁵⁹ *Cooper v. Weissblatt*, 277 N. Y. S. 709 (1935).

a debt, and has paid it, is put in the place of the creditor so as to entitle him to make use of all the securities and remedies possessed by the creditor in order to enforce the right of exoneration against the principal debtor.⁶⁰ No new cause of action is created, nor additional rights afforded under this theory. It is merely a transfer to a third party of the right the employer had to maintain an action against the accountant for negligence or fraud in making the audit. In *Dantzler Lumber & Export Company v. Columbia Casualty Company*,⁶¹ the plaintiff was required to make good to the employer the losses it had sustained through the defalcations of a dishonest employee because it was surety on the defaulting employee's fidelity bond. In that action it was held that the plaintiff was entitled to be subrogated to the rights of the subject company to be indemnified for the injuries it had sustained as a result of the negligence and fraud of the auditors in making their audit and report. As the one subrogated stands in the position of the employer, the principles which apply are those relating to accountant and employer and not those of accountant and third persons.

It is possible that an accountant may be liable to his client for disclosing to another, or using for his own benefit confidential information he has acquired in the course of his employment. When accountants are employed for the purpose of auditing books and accounts, they occupy a position of trust and confidence.⁶² For a successful audit to be made, the accountant should have free access to the books of account, customer's lists, memoranda, and minutes of the meetings of the board of directors. In examining files and records in the performance of the audit, he is in position to acquire knowledge

⁶⁰ Black's Law Dictionary.

⁶¹ 115 Fla. 541, 156 So. 116, 95 A. L. R. 258 (1934).

⁶² *Dantzler Lumber & Export Co. v. Columbia Casualty Co.*, 115 Fla. 541, 156 So. 116 (1934).

of trade secrets and other information, which, if placed in the hands of a competitor, would be damaging to the client. To permit the accountant to use for his own benefit, or for the benefit of another in competition with his employer, information so acquired would destroy the freedom of communication that should exist. It is against public policy to allow persons occupying fiduciary relations to be placed in positions in which there will be constant danger of betrayal of trusts by selfish motives.⁶³

The accountant occupies a position similar to that of a confidential agent and it seems logical that the same duty of loyalty that an agent owes to his principal inheres in the relation between the accountant and his client. It is stated in the *Restatement of the Law of Agency*: "Thus, an agent who is told by the principal of his plans, or who secretly examines books or memoranda of the employer, is not privileged to use such information at his principal's expense."⁶⁴

One who has made wrongful use of confidential information acquired in the course of his employment may be forced to indemnify the party wronged by an action at law for the breach of an implied contract not to divulge, or may be required to account in a court of equity for profits derived from the wrongful use. The wrongdoer may be enjoined from committing threatened or continued disclosure of his employer's secrets. Justice Story in his work on equity jurisprudence,⁶⁵ said, "Courts of equity will restrain a party from making a disclosure of secrets communicated to him in the course of a confidential employment, and it matters not in such cases whether they are secrets of trade or secrets of title, or any other secrets important to his interests."

An attempt has been made here to point out the sources

⁶³ 25 C. J. 1120.

⁶⁴ Sec. 395, comment.

⁶⁵ 2 Story's Eq. Juris. (13th ed.), sec. 952.

and extent of liability of the public accountant in his relation with his client and with the public generally. As a large proportion of the cases involving the accountant's liability have arisen in the last decade, the subject appears to be one of growing importance. It should be borne in mind that the principles herein discussed are not new law, but are only applications of existing law to new sets of facts. When, in the future, questions of a similar nature are presented to the courts for consideration, they will, undoubtedly, in interpreting and applying the broad principles of the common law, be guided by the cases already decided on the subject.