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LEGAL LIABILITY OF THE PUBLIC ACCOUNTANT

BY COLVIN P. ROUSE*

The last decade and a half has witnessed a number of new customs in the business world which have intimately affected the work of the public accountant. The urgent and immediate needs of financing the World War, with the resulting tax upon incomes, brought about an increased demand for professional services of this kind. In order to determine the amount of this tax, it is necessary to determine the tax base the income upon which it is paid. The nationalization of business with its attendant deluge of consolidations, sales, and mergers of various business units has increased the demand for the services of the accountant as a consultant. Whereas formerly a great part of the time of the principals of an accounting firm was occupied out of the office, in the performance of the details of an audit, that is no longer the case. Instead that work has now been largely delegated by the principals, and their whole attention given to consultation and office practice. The tax work above mentioned has as an incident the prosecution of bases before the Treasury Department[1] and the United States Board of Tax Appeals. Here again the work of the lawyer and the accountant

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[1] "In business reorganizations and in tax matters the business man more and more relies upon the accountant as his counselor." Lawyers must be specifically admitted to the United States Treasury Bar. This admission is extended to the accountants as freely as to lawyers. *Robert H. Jordan, N. Y. State Bar Association Bulletin, February, 1931.*

has developed an interdependence between the two professions.[2] Finally the recognition by bankers, and business men, of the value of financial statements for credit purposes has greatly augmented the demand for the accountant's services.[3]

The organization of the individual office within the profession has proceeded upon lines that will carry into effect the rendition of the services above outlined. The functions might be divided into five classes: (a) general office routine; (b) general accounting and audit work; (c) installation of cost systems and efficiency work; (d) consultation and investigation; (e) income tax work. In the large firms there will perhaps be a partner directing the activities of each of these departments.[4] They delegate their duties in a large measure to subordinates. The classification of the personnel performing the accounting work varies with the size of the firms and also within a class it will vary from firm to firm. In addition to the partners, however, there might be managers, seniors, semi-seniors, juniors, and in the language of the profession, "temps". All above the class of semi-seniors will likely have been examined by govermental authority and certified as public accountants. Some within that group might also have achieved this status. The so-called "temps" are those that are only temporarily employed, usually upon a three months engagement, for the seasonal peak of the accounting work.

The changes that have demanded such a variation in the accounting practice, have stressed the need of selecting the highest type of personnel for the profession. This fact along with the seasonal nature of the work has placed the principals in a rather baffling dilemma. Their reputation for thorough and accurate work, perhaps gained painfully and slowly, is naturally at stake when much important work must be delegated in its performance. The exigencies of the intensive engagements, in

[2] The lack of training upon the part of the legal profession in the theory and practice of accounting is often stressed. Some of the large law schools are attempting to meet this need by offering lecture courses in accounting. Some doubt the adequacy of a training in the theory of accounting that omits the actual solution of practice problems. Even though lawyers are not going to be bookkeepers, that practice is considered by some essential for a mastery of the subject. A pre-legal training in the subject should meet the need.

[3] See the discussion by George S. Olive, in *"Conduct of An Accounting Practice,"* a bulletin of *"The Amercian Institute of Accountants."*

[4] See Kester, Vol. III, c. 12, p. 423.

which a vast amount of work is to be performed in a very short period of time, involving long hours and perhaps inconvenient living conditions, call for the highest *esprit de corp* upon the part of the staff. It is desirable to develop a leadership upon the part of the seniors that will enable the younger members to feel that they are working *with* them rather than *for* them in the interest of the client. Such leadership and such a spirit is very difficult to maintain in the cases of the large firms employing a large force for a limited engagement. Indeed it has been said that it is impossible to obtain the right calibre of men for the accounting profession as long as it is the custom to engage assistants for a temporary period. The very fact that they are open to engagement upon these terms is offered as evidence that they are not of the proper ability.[5] This is not necessarily true. There are undoubtedly many within the ranks of those temporarily employed who are so thoroughly obsessed with the desire to "find a place" within the accounting profession that they are willing to endure the bad fortune of seasonal employment rather than fill some other position. However, regardless of the reason for their existence, the conditions demanding seasonal employment are a just cause for concern by the members of the profession.

And indeed the members of the profession have given it serious thought and have taken steps to eliminate seasonal employment. By inducing some of their clients, when the business permits, to adopt a "natural business year" for a fiscal period, many audits can be made at a time other than the end of the calendar year. The mid-winter peak is thus alleviated to an extent. Arrangements for current audits throughout the year may also be used by the smaller firms for the same purpose. A third factor lessening the seasonal character of the work is the fact that the government authorities have no special time of the year for raising objections and filing complaints in tax matters. These complaints often call for an investigation and possibly for a defense, and they are in no wise controlled either by a fiscal period or a calendar year.

Some of those who desire the elimination of the temporarily employed from the ranks of the accounting profession also doubt the necessity for the employment of "juniors" by the moderate

[5] *Supra*, note (3).

and smaller offices. It is argued that much of the detailed work customarily performed by that class is unnecessary in an audit, provided the one making it has experience and uses discretion. Under these circumstances the quality of the work would be better because all parts of it would be performed by men well qualified by experience and training. For the performance of the audit, there should be one in charge to supervise it to its completion. This supervision is not necessarily left entirely to his judgment. There would be a number of matters which should be submitted to one of the principals of the firm. This, with modern means of communication, is not a difficult task. After the audit is completed and a report is written, it, with the working papers, should be submitted to one of the principals in charge for examination and approval. Each step of this routine is considered important by members of the profession as a protection against criticism and as a precaution to insure accuracy. The engagements of the average size firm do not require so many men but that each will receive a wide range of experience in handling the accounts of many different kinds of businesses. The audits will naturally include industrial, mercantile, financial, and public utility organizations, as well as the quasi-public, eleemosynary institutions. While thus receiving a wide general experience, opportunities for specialization are also offered, both of which are conducive to efficiency in the work.

The audit working papers are among the most important instruments used by the accountant in making an audit. It is from these records that the reports which he makes are written. They also constitute the source of his chief defense in case of criticism of the way the audit has been conducted. Aside from this, they often prove a valuable source of information in making future audits. For these reasons, it is desirable, and it is the practice, to bind and store the working papers of the important audits when the circumstances will permit. They should include a full record of the questions raised in the audit and the manner of their disposal. They belong exclusively to the auditor, and their contents should not be disclosed by members of the staff save upon the consent of one of the principals. If the information contained therein is disclosed to one other than the client, it is the practice to gain his consent before doing so. And indeed, this literary property in the audit working papers

may be asserted by the auditor against the client. In the case of *Ipswich Mills* v. *William Dillon, et al.*,[6] the defendants had been retained for a number of years by the plaintiff to make an annual audit, make tax returns, and perform other services in the matter of bookkeeping, cost accounting, and the preparation of statements for banks. Upon one occasion they conducted a tax case for plaintiff before the Bureau of Internal Revenue. At a later date a Federal Revenue agent was making an examination of plaintiff's income tax returns for that year. The plaintiff sent the agent to the defendant's office to secure the audit working papers used in the tax case. Upon the defendant's refusal to deliver the papers, the plaintiff tried, unsuccessfully, to obtain them by legal process.

The content of the working papers will depend in a large degree upon the nature of the audit that is made. If the purpose of the audit is to detect embezzlement, a thorough and detailed investigation will likely be made. On the other hand, if the purpose is to effect a reorganization; or for the purchase or sale of a business; or for the issue of new securities, it is likely that a "Balance Sheet" audit will be made.[7] The courts have recognized that an auditor should be fully instructed upon the purpose of an audit as the procedure is controlled thereby. In *Teacher* v. *Calder*[7a] the plaintiff lent the defendant thirty-five thousand pounds, under an agreement that the plaintiff was to receive interest and a right to share in the profits. The agreement also provided that the finding of profits by a certain firm of auditors should be considered final. The member of the firm of auditors who received the instructions died, and the junior accountant who performed the audit testified that the memorandum of instruction had been misplaced, and that had he known the real purpose of the audit his course of investigation would have been changed. Upon this testimony the court directed that the finding of profit shown by the audit should be set aside and another accounting rendered.

The maintenance of a permanent staff of report writers is also necessary for the performance of the work of public accountants. If in the estimation of inventories decimals are

[6] 157 N. E. (Mass.) 604 (1927).

[7] Audit Working Papers, J. Hugh Jackson. See also the studies of Palmer and Bell.

[7a] (1899) A. C. 451.

used, the consequence of the omission by a typist of the decimal point is readily perceived. For instance, the quantity of a bulky article like coal might be estimated by a surveyor, reduced to cubic feet, and calculated in terms of tons. It is quite possible that some estimate as 20,200.2 tons would be reached. If there were many such estimates carried into the final statement, and reduced to a pecuniary value, one may readily appreciate the necessity for having well trained and accurate reporting typists and proof readers. Instances have been cited of errors of this kind amounting to millions of dollars.[8] Perhaps the better practice is to omit the decimal in the estimates. It is safer to omit, and its use is of doubtful value. To summarize, the organization of the personnel, its selection, the proper planning of work so as to avoid the seasonal rush, the proper use and content of working papers, and the proper reporting of audits after they are made, are important.

(1) THE RIGHT TO ENGAGE IN THE PROFESSION OF PUBLIC ACCOUNTANT.

In the accounting profession there are no legal requirements to be complied with before entering the practice, as in the case of law or medicine. This is true both in England and in America. Though anyone has the privilege of engaging in the practice, there are organizations whose purposes are the establishment and maintenance of the standards of professional efficiency. In England there are two groups, and their members are known as "chartered" accountants and "incorporated" accountants. The former are members of the "Institute of Chartered Accountants in England and Wales." This society was incorporated by Royal Charter in 1880. The second class mentioned, are members of a society incorporated under the Companies Act of 1862.[9]

In America the state governments have enacted certain measures designed to improve the standards of the profession, Upon complying with the requirements of the State Boards, organized under these measures, a member of the profession may receive a degree of "Certified Public Accountant". This is a coveted distinction in the profession, and the state may prohibit

[8] See the discussion of John Flint, *supra*, note (3).
[9] *Bevin on Negligence*, Vol. II, p. 1326 (4th ed., 1928).

anyone from holding himself out as a "C. P. A." unless he has received a certificate from the State Board of Examiners.[10] Of course the state cannot exercise this regulation beyond its jurisdiction. In *State ex rel. of Atty. General* v. *Scott*[11] the State Board of Examiners for North Carolina attempted to give an examination in the District of Columbia. It seemed that the questions that were going to be used in this examination were duplicates of those used in the North Carolina examination the week before, and that they were available to the applicants in the Washington examination. The Board asserted its right to do so because the statute provided that examinations might be held by the Board as often as necessary, "at such times and places as it might designate". The court quite properly construed this by inserting the words "within the State" and issued the restraining order that was asked.

Not only does the State Board have the right to grant the privilege of holding oneself out as a "C. P. A.", but it may revoke that privilege if the statute which created it so provides. In denying a bill to restrain the defendant Board of Examiners from hearing charges preferred against plaintiff by other members of the profession, *Lehmann* v. *State Board of Public Accountancy*,[12] pointed out that the revocation of a certificate did not prevent one from engaging in the practice, but only deprived him of the recommendation of public authority.

The state cannot prohibit one, who fails to meet the requirements prescribed for the certified public accountant, from engaging in the practice of accountancy. A *quo warranto* proceeding was instituted in *State ex rel. Short* v. *Riddell, et al.*,[13] to oust the defendants from the exercise of the right of practicing accountancy without first obtaining a certificate from the state. The statute prohibited the performance of audits or other services of public accountants unless such a certificate were obtained. The defendants were not accountants for the state or any of its subdivisions, but served private business. Neither did they profess to be certified by the state. In holding this statute unconstitutional, the court found that it was a deprivation of private property; that it "infringed upon matters of contract of purely

[10] *State v. DeVerges*, 95 So. (La.) 805 (1923).
[11] 182 N. C. 865, 109 S. E. 789 (1921).
[12] 208 Ala. 185, 94 So. 94 (1922).
[13] 109 Okla. 35, 233 Pac. 684 (1924).

private concern bearing no perceptible relation to the general or public welfare";[14] and that it tended to create a monopoly amoung certified public accountants. Unfortunately, this condition can exist independently of statute as a consequence of arbitrary action by the Boards of Examiners.

In New York the power to confer the certificate of "C. P. A." is vested in the Board of Regents of the University of the State of New York.[15] This body not only has the power of prescribing the qualifications for applicants for the certificate, but the power to interpret those rules is vested with them. *Davis* v. *Sexton*[16] deals with a rule made by the Board of Regents, to the effect that an applicant for the examination must have been in the employ of a certified public accountant for two years prior to taking the examination. The applicant in this case had worked for two years under the supervision of two certified accountants, who were his fellow employees, for a firm of auditors, none of whom were certified public accountants. The refusal of the application by the Board was upheld.

The fact that one holds a certificate from another jurisdiction does not afford him the right to use the title "Certified Public Accountant" within a given state. In *People* v. *Marlowe*[17] the defendant held a certificate granted by the National Association of Certified Public Accountants, an organization of the District of Columbia. The use of the title, "C. P. A., National Association", in New York was held to be an infraction of the statute[18] and a misdemeanor. The rule has been followed in other states.[19]

The examining boards may grant certificates in some instances to holders in other states without the requirement of an examination. This practice exists as a matter of reciprocity between the states. In the absence of meeting that requirement, the courts are not prone to compel an examining board to grant a certificate. In *Goldsmith* v. *Clabaugh*,[20] the plaintiff, a certified public accountant in the State of New York, instituted

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[14] See *infra*, note (236).

[15] See 80 of General Business Law, L. of 1909, Ch. 25 as amended by L. 1913, Ch. 443.

[16] 211 App. Div. 233, 207 N. Y. S. 377 (1925).

[17] 40 N. Y. Criminal Rep. 448, 203 N. Y. S. 474 (1923).

[18] *Supra*, note (15).

[19] *Henry* v. *State*, 97 Tex. Criminal Rep. 67, 260 S. W. 190 (1924); *Crow* v. *State*, 97 Tex. Criminal Rep. 98, 260 S. W. 573 (1924).

[20] 55 App. D. C. 346, 6 F. (2d) 94 (1925).

mandamus proceedings against the Board of the District of Columbia to compel it to grant a certificate. The statute of the District of Columbia provided that the Board could grant the certificate to qualified certificate holders of other states which granted the same privilege to certificate holders from the District of Columbia. The statute[21] of New York extends this privilege to qualified certificate holders of other states, provided the applicant has practiced in that jurisdiction for three years. Inasmuch as the statute of the District of Columbia contained no prerequisite of practice by the foreign certificate holder, "the same privilege" was not extended by New York and mandamus was refused.

The right of the Board of Regents of the University of the State of New York to confer the certificate has been held to be an exclusive right.[22] The National Association of Certified Public Accountants was therefore restrained from giving an examination in New York.[23]

II. LIABILITY TO CLIENT

(1) THE SKILL REQUIRED IN THE PRACTICE OF THE PROFESSION.

(a) *In General.*

Aside from the many generalizations by the court in considering the liability of public accountants, one court[24] directly held that they were members of a learned profession. The defendant, a Canadian Bank, opened a branch in New York. It entered into a contract with an accountant whereby he was to serve as an assistant in the branch. This action was instituted under a statute[25] prohibiting the importation of contract labor. The statute contained, among other exemptions, members of a

[21] *Supra,* notes (18), (15).

[22] The General Business Law, Sec. 80, *supra* notes (21), (18), (15) gives them the right to grant the privilege of using the title: "Certified Public Accountant," and Sec. 66 of educational law gives them the right to determine what educational institutions can issue diplomas, degrees, and certificates.

[23] *People* v. *National Association,* 204 App. Div. 288, 197 N. Y. S. 775 (1923).

[24] *United States* v. *Union Bank of Canada,* 262 Fed. 91, 8 A. L. R. 1438 (1919).

[25] Compiled St., Sec. 4248, 3 Fed. St. Anno. (2d ed.), p. 264.

learned profession. A verdict for the defendant was entered under this section.

Generally every man, in whatever calling, who offers his services to another, assumes the duty of exercising reasonable care and skill in the performance of the work. If he offers his services in a calling that requires peculiar skill, he is understood as possessing the degree of skill that is common in that particular calling. If he fails to possess that skill, some[26] have said that he commits a specie of fraud upon any member of the public who relies upon his public profession and is damaged. This rule was followed in *Smith* v. *London Assurance Corporation.*[27] In an action for the recovery of fees for services rendered as an auditor, the court permitted a recovery upon a counterclaim for negligence. Others[28] have stated the same liability in terms of warranty. That is, a person engaging in a profession that requires technical skill, impliedly warrants the possession of such a degree of skill as is necessary for its competent performance.

Many cases have applied the rule to the various professions. In *Lamphier* v. *Phipos,*[29] the client of a surgeon was permitted to recover for negligent treatment, the result of which was the loss of use of an arm.[30] *Hart* v. *Frame*[31] permits recovery against an attorney; and to the same effect is *Fletcher* v. *Jubb.*[32] In the latter, an attorney was instructed to sue a corporation. He overlooked the expiration of time within which an action could be brought before it was barred by the Statute of Limitations.

The rule is more difficult in application than it is in stating.

[26] *Cooley on Torts*, Sec. 472 (4th ed., 1932), p. 335.

[27] 109 App. Div. 882, 96 N. Y. S. 820.

[28] *Bevin, Negligence in Law* (4th ed.), Vol. 2, p. 1321.

[29] (1838), 8 C. and P. 475.

[30] Tindal, C. J., at p. 479: "Every person who enters a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill. He does not undertake if he is an attorney, that at all events he will gain your case, nor does a surgeon undertake that he will perform a cure, nor does he undertake that he will use the highest possible degree of skill. There may be persons who have a higher education and greater advantages than he has, but he undertakes to bring a fair, reasonable, and competent degree of skill."

[31] 6 Cl. and F. 193 (1838). The plaintiff, a master, employed the defendant to take proceedings against apprentices for misconduct. The defendant negligently instituted the proceedings under the wrong section of the statute. It was quashed, and the apprentices recovered from the plaintiff in a cross action.

[32] 122 L. T. R. 258 (1920), 1 K. B. 275.

What is the skill "common" in the calling? Is it the skill of a certified public accountant in America? In England, is it the skill of a "chartered" or "incorporated" accountant? It has been said[33] that the duties of an accountant and the skill required in their performance are a matter for legal evidence and not one for judicial notice. The skill "common" in the profession might not differ from that required to qualify as a certified public accountant, a "chartered" or an "incorporated" accountant. That would be true if the number within these groups would represent such a proportion of practicing accountants that their skill would represent the average of practitioners at large.[34] This test would apply merely to the skill in the work of accountancy. The general educational qualifications which are required by some of the societies are irrelevant. *Leeds Estate, Building and Investment Co., Ltd.* v. *Shepherd*,[35] presents an instance in which the skill exercised was less than the average. The defendant auditor in this case was a bank clerk at the time of his appointment. He received only a nominal fee for the service, and the audit consisted of a most perfunctory formality,[36] which was not sufficient.

Some courts[37] have said that the duty of an auditor is to make a reasonable and proper investigation. If, from the accounts and stock sheets, a reasonably prudent man ought to conclude something is wrong, it is the duty of the auditor to call it to the attention of his employer.[38] Others[39] have stated that it is the duty of the auditors to examine the books and ascertain that they are "right", and to prepare a balance sheet showing the

[33] L. T. 171; 453, May, 1931.

[34] *Bevin, Negligence in Law* (4th ed.), Vol. II, p. 1326.

[35] 36 Ch. Div. 787 (1887).

[36] The certificates and correspondence with the management are evidence of the auditor's inexperience and incompetence. "I certify that I have examined the above accounts and find them to be a true copy of those shown in the books of the company." According to this certificate the auditor was apparently satisfied by a mere mathematical accuracy and correspondence between the balance sheet and the books of the company. In a letter to the directors, the auditor suggested that it would have been better if profits had been accumulated before distribution of dividends, but acquiesced by saying, "a dividend is no doubt a necessity."

[37] *Squire Cash Chemists, Ltd.* v. *Ball, Baker and Co.*, 106 L. T. 197, 28 T. L. R. 81 (1912).

[38] *Lord Alverstone*, in 27 T. L. R. 269.

[39] *Re the Kingston Cotton Mills Co., Ltd.*, 74 L. T. R. 568; *Re London and General Bank* (1895), 2 Ch. 673.

"true financial position" of the company at the time to which the balance sheet refers. Auditors are not always accountants. At least a person does not have to be skilled in the art of book-keeping to qualify as an auditor under the many companies acts of England.[40] An auditor serving under these circumstances may employ an accountant to assist him. This he may do without the consent of his co-auditor.[41]

The rule that one must exercise average skill, or that which is "common" in the profession does not apply in all circumstances. Upon employment the accountant might disclaim any peculiar skill in the matter, or he might be retained because of a feeling of friendship upon the part of the client.[42] In both of these instances, the skill that would be required would likely be less than the average. So too, might it be more. If an accountant holds himself out as an expert, or if he is generally known as such in some particular practice, as bankruptcy or in tax matters, a greater degree of skill will be required then the average. One is bound to use that skill and experience which he in fact possesses. And even in the field of specialists there might be some variation.[43] If the skill of the "certified", the "chartered" and the "incorporated" accountants should not be considered[44] as the average, but greater than the average, we should find this latter reasoning to apply. They would then be considered as "experts" as distinguished from the members of the profession generally, and within their ranks might be varying degrees of responsibility according to their specialization in

[40] In a rather exceptional case parliament provided that at least one of the auditors of Building Societies should be "a person who carries on the business of an accountant." 57-8, Vict., C. 47, Sec. 3 (1894). Also it has been assumed that the auditors would not be accountants, by providing that the auditors could employ accountants to assist them. 8 and 9 Vict., C. 16, Sec. 108.

[41] Recovery allowed for part of the fees paid out. *Steele* v. *Sutton Gas Co.*, 12 Q. B. 68; 49 L. T. 682.

[42] If this be true, "the rule of skill loses its relation to the general standard of the art and is determined by regard to the particular person." *Supra*, note (34).

[43] *Supra*, note (34) at p. 1355: In the medical profession the specialist might be expected to exercise greater skill than the general practitioner. And there is variation in the field of specialists. "A heart specialist would be expected to know more about heart matters than a general consultant." 171 L. T. 453, citing Bowstead's Agency (1924), Art. 45, p. 123 (7th ed.).

[44] *Supra*, note (34).

the practice. The liability might vary further by reason of statutory or contractual terms under which they are appointed.

Honesty and integrity are fundamental keynotes in judicial observations upon the responsibility of auditors and accountants. In *Re London and General Bank No. 2*[45] the auditors were cognizant of the worthless character of the receivables (one of the chief assets of the Bank). They prepared a statement for the board of directors which recited: "we cannot conclude without expressing our opinion unhesitatingly that no dividend should be paid this year". Upon the insistent solicitation of the managing director this statement was altered before placing it before the board meeting. In the statement presented to the shareholders, the defendant auditor's also acquiesced in the request of the manager to temper their language.[46] Lindley, L. J., in his opinion expressed the belief that this amounted to a failure to maintain the standard of honesty owing by the auditors to the shareholders.[47] It thus seems that it is necessary for the auditor to assume a positive, aggressive attitude in protecting the interests of the shareholders.

(b) *Is the Failure to Detect Fraud Negligence?*

Should an auditor be suspicious? We have said[48] that it is his duty to make a reasonable and proper investigation. A proper investigation depends upon the circumstances of the case. An auditor does not insure absolutely against error in his work. When there are no circumstances to excite suspicion, less care would be reasonable than in the case where suspicion is or ought to have been aroused.[49] To use the metaphors of Lopes, L. J.:[50] "An auditor is not bound to be a detective or to

[45] (1895) 2 Ch. 673.

[46] The financial statement was merely qualified: "The value of the assets shown upon the balance sheet is dependent upon realization." The report as originally drawn contained this phrase: "and on this point we have reported specifically to the Board." This last phrase was only stricken from the report upon the promise of the manager to call the stockholders' attention thereto in the general meeting.

[47] "The main duty of the auditor is that he be honest." And further, "he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

[48] *Supra*, note (37).

[49] *In Re London and General Bank No. 2* (1895), 2 Ch. 673.

[50] *Re the Kingston Cotton Mills Co., Ltd.*, 74 L. T. R. 568, at p. 571.

approach his work with the foregone conclusion that something is wrong. He is a watchdog but not a bloodhound.''[51]

Closely allied with the necessity of an auditor approaching his work with a suspicious attitude, or "a foregone conclusion that something is wrong," is the duty of an auditor to detect fraud. Generally speaking it is necessary to state the true financial position of a company by examining the books of account. Care should be exercised also in ascertaining that this basic data from which the auditor's report is made is correct. It is difficult to state the point at which this verification is sufficient. It is a question of fact to be determined by evidence of what a reasonable man, e. g., an auditor, would have done under the circumstances. The courts have had occasion to prescribe boundaries upon the question from both sides, which fade away into the indeterminate realm of factual inquiry. On the one hand we have seen that an investigation that stops with the ascertainment of the mathematical accuracy and correspondence of books and balance sheet is not sufficient.[52] At the other extreme are the cases which deny the auditor's liability for failure to detect fraud. Under the circumstances of these cases, to impose liability would make the auditor an insurer of his reports in the absolute sense. This the courts have refused to do. Though it is the auditor's duty to ascertain that the books and financial statement present the true position of the company, he does not *guarantee* this result. Indeed, he does not guarantee that his statement is accurate according to the books of the company. An auditor would not be liable in case he himself had been deceived and had exercised reasonable care. Both of these circumstances might occur and still the statement might be inaccurate, due to the wrongful and fraudulent concealment of books from him.[53]

Indeed, where the scheme and mechanism for the execution of the fraud are elaborate and intricate, the courts have declared

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[51] *Lord Alverstone in Mead* v. *Ball*, 106 L. T. 197 (1912), emphasized the necessity of the auditor's conduct being determined by the circumstances. In commenting upon the language of Lopes, L. J., he said: "He might have to be a detective in some cases if there are circumstances to arouse his suspicions as a reasonable man."

[52] *Leed's Estate, Building and Investment Co., Ltd.* v. *Shepherd*, *supra*, note (35).

[53] *In Re London and General Bank No. 2* (1895), 2 Ch. 673.

there is no duty of discovery. The "window dressing" practiced in *Re City Equitable Fire Ins. Co.*[54] is an example. There the parties responsible for the defalcations purchased Treasury Bills to the extent of two hundred thousand pounds, upon margin, at every accounting period. The presence of this large, liquid, and safe investment in the portfolios made the loans to the brokers (which were understated and which led to insolvency) seem relatively smaller. There is no duty to discover all fraud.[55] Yet if the means of effecting it are so simple that a reasonable investigation would reveal the fraudulent transaction, the auditor is liable for failing to detect it. This is even true when, by the contract, the scope of the audit is limited.[56] In view of this limitation upon the auditor's liability for failing to discover fraud, it seems that the fears expressed by the court about extending liability to third parties, who are damaged by relying upon an audit, were not well founded.[57]

(2) DUTY TO KNOW LAW AND TO GIVE ADVICE UPON LEGAL MATTERS.

(a) *In Tax Matters.*

Is an accountant under a legal duty to inform his client of ways and means of effecting tax exemptions? Need he tell an unmarried man that if he marries he will enjoy an exemption in his income tax? Or tell a married man that if he has children he will be entitled to further exemptions? Most accountants do tell and are expected to tell their clients how a tax may be saved. Aside from the practice, the question of legal duty was recently raised in the case of *Dimmock and Cowtan* v. *Bayley, Wood, Cave and Co.*[58] The plaintiffs were stockbrokers and the defendants were chartered accountants. The year of 1928 was a very profitable one upon the stock exchange, and the following one, 1929, was equally unprofitable as a consequence of the world-wide finan-

[54] 94 L. J. Ch. 445 (1925), Ch. 407, 133 L. T. 520, 40 T. L. R. 853.

[55] *Re The Kingston Cotton Mills Co., Ltd.*, 74 L. T. R. 568.

[56] *Fox and Son* v. *Morrish, Grant and Co.*, 35 L. T. R. 126 (1918). Lawrence, J., expressed sympathy for the defendant: "He was young at the time and he went on believing that people were honest in a perfectly natural way; but he took a risk and the duty which he undertook did not entitle him to take that risk."

[57] *Uultramares* v. *Touche*, 255 N. Y. 170, 174 N. E.. 441 (1931).

[58] The Law Times, 171: 453, May, 1931. Heard at Manchester Assizes by Commissioner, Mr. H. du Parcq, sitting without a jury.

cial strain and credit retraction. A member of the plaintiff firm had luncheon, while in London, with a friend who was a chartered accountant. The latter informed the plaintiff that by changing the articles of co-partnership and admitting a new member, a vast saving could be effected under the Finance Act of 1926; that by such arrangement the firm would be considered a new business and the tax would be considerably less. Upon his return to Manchester, the plaintiff called one of the defendants, who had charge of plaintiff's tax matters, and asked him if the saving could be effected. The defendant replied that he did not think "there was anything to it," but promised that he would investigate the matter further upon going to London. This was in October, 1929. In May, 1930, the plaintiff again saw the chartered accountant of London, who had given him the information. Plaintiff again mentioned the matter to him, and upon this occasion he was informed that it was too late; that the last date for effecting the change was the early part of April, 1930. Upon verification this information proved correct. The plaintiffs thereupon brought their action under two counts: (a) contract, failure to obey the instructions of 1929; (b) tort, negligently failing to be acquainted with the relevant section of the Finance Act of 1926, and to advise accordingly. Counsel[59] for the plaintiff argued that an accountant who had passed an examination on the law of income tax should be familiar with the Act of 1926. Counsel[60] for the defendant answered that a chartered accountant is not a lawyer; his duties are those of "pure accountancy."[61] It is not the duty of an accountant to inform his client how a tax might be saved unless he is asked.[62] It was the duty of the defendant to make out the returns of the firm as it then existed, not of a new firm.[63] During the course of the

[59] Mr. Cyril Atkinson, K. C.

[60] Sir Leslie Scott, K. C. M. P.

[61] The Commissioner: "What is 'pure accounting'?"

[62] The Commissioner thought that a physician might have to tell a patient of a discovery in a disease for which the doctor was treating the patient.

[63] This last argument might well be criticised because the gist of the action here was the failure to give advice for saving a tax; not for failure in making out the returns. In other words, there was no claim of mathematical or bookkeeping inaccuracy.

closing arguments the parties compromised by awarding the plaintiff one-half of the amount claimed.[64]

In special subjects[65] of the law the accountant should and probably does have a wider range of information than the average lawyer. Of course he is not expected to be acquainted with the whole body of the law and all the cases upon the subject. Within the domains of his special practice, however, he should be able to find the law applicable to a given question, or incur liability for failing to secure legal advice from competent sources.[66] It has been said that the duty to vounteer advice as to tax matters depends upon the preliminary contract between client and accountant and whether the client is taking additional advice concerning the accounts.[67]

(b) *In Corporate Finance.*

Do auditors and accountants profess to be experts in corporate finance? If so, is it necessary that they make themselves acquainted with the general features of the law and regulation governing corporate activity? If the answer should be in the affirmative, it is clear that they would incur liability for failure to take cognizance of illegal and *ultra vires* transactions by the corporation. If the answer should be in the negative, their duty in the performance of an audit would be fulfilled provided they set forth, truthfully, the results of the transactions of the corporation, regardless of whether they were illegal or *ultra vires.*

In *Re Republic of Bolivia Exploration Syndicate*[68] presented the question.[69] The cause of the complaint was the irreg-

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[64] The case therefore does not present a legal precedent in the strict sense, but it will undoubtedly have its influence as a practical matter. A like disposition was made of the issue of fraud in the case of *Ultamares* v. *Touche, supra,* note (57).

[65] Cases interpreting statutes governing bankruptcy and income tax are examples.

[66] "The obligation of a person professing skill is to be conversant with the general principles of the law applicable to his profession and with the methods of practice of most ordinary occurrence, even though knowledge outside the general scope of his profession is involved. A professional acquaintance of the requirements of the subject are not required, however." *Bevin on Negligence,* p. 1322.

[67] *Supra,* note (58).

[68] 110 L. T. Rep. 141 (1914), 1 Ch. 139.

[69] The case dealt solely with the liability of the auditors though the directors and solicitor were named in the summons. One director confessed judgment; another was dismissed upon plea of privilege under diplomatic service; the solicitor died.

ularities of the dealing between the directors, the solicitor, and the corporation. Under the law, the company had no power to deal with the directors. Notwithstanding, the company entered into an agreement with one of the directors whereby he was empowered to go to Bolivia and take up certain mining properties. By the terms of the contract no vouchers of the expenses of the trip were required. The company promotors also allowed the solicitor a profit for legal services for the organization. At the time of the organization, the solicitor was not a director but was subsequently elected. He continued to serve as counsel after becoming a director and received remuneration for his services. The contract with the director for the Bolivia expedition was confirmed at the same board meeting at which the defendants were appointed. The report of the defendant auditors revealed fully the nature of the above transactions. However, they did not call to the attention of the shareholders their illegal character nor the right of the shareholders to contest them. The court, though mentioning the question of the auditor's duty to know the law,[70] gave a decision for the defendant upon the ground that the omission was not the proximate cause of the injury.

It is submitted that accountants should take cognizance of the articles of incorporation and the general law of corporations, so that their reports would correspond with "the reality in law"[71] of the company's financial position.

(3) PROCEDURE IN MAKING AN AUDIT.

The actual procedure to be followed in making an audit is a troublesome problem to those who make the audit and the parties for whom it is made. In 1917 the Federal Trade Commission requested the American Institute of Accountants to prepare a memorandum upon procedure. After the preparation of the memorandum approved by the council of the American Institute and the Federal Trade Commission. The Federal Reserve Board also gave it tentative indorsement and submitted

[70] "Now there are some legal matters which an auditor must obviously know, as there are others which it is equally obvious he could not be held responsible for not knowing, and it may not always be easy to say in what category any particular case falls." Atsbury, J., p. 171.

[71] *Supra*, note (68), in the brief for plaintiff.

it to bankers and banking associations throughout the country. While the procedure is more elaborate than that followed in the making of a "balance sheet" audit, it has been said that it is no more than is required for the preparation of statements of persons and companies seeking credit or loans of cash.[72] Of course the extent of the verification must lie within the discretion of the auditor making the audit. That discretion cannot be abused, however. The degree of division of duties and the internal check afforded by the particular bookkeeping system are factors for the auditor to consider in determining the verification that is necessary.

In all events, it is desirable to prepare after closing trial balances, both at the beginning and the end of the period. These should be prepared from the general ledger and stated in comparative form. All items appearing thereon should be traced to the balance sheet to insure that no "contra" asset or liability, appearing in the accounts have been omitted from the statement. By omitting a portion of the value reflected in accounts such as inventory and accounts payable, the books will still "balance". The omission is of fundamental importance to a prospective creditor, however. Though the so-called "current ratio" does not reflect a more favorable position for the extension of credit by reason of the omission, the result produced by the "acid test" would. This is true because under the latter consideration the inventory account is of no importance, while accounts payable are of great significance.

Newton v. *Birmingham Small Arms Co. Ltd.*,[73] though by no means a direct authority, recognizes the necessity of stating all of the assets and liabilities. In this case the Board of Directors passed a resolution for the creation of a secret reserve fund. The resolution provided that it would be disclosed to the auditors but the latter were under a duty not to disclose it to the share holders.[74] Though the articles[75] of the company

[72] "Verification of Financial Statements," submitted by the Federal Reserve Board, U. S. Government Printing Office, 1929.

[73] (1906) 2 Ch. 378.

[74] The resolution also provided that the directors could invest the fund as they saw fit, and that they were not to have any personal liability as long as it was for the best interest of the company.

[75] Among other things, they provided: (1) that the directors had the right to determine the maximum dividend that could be passed;

gave some color of authority to the directors to pass such a resolution, the court granted an injunction restraining action upon it. The evils of such a practice are readily discernible. The investments might be of such a character as to involve the company in loss, or even if they were of such character that the company's position was shown to be less favorable than it was in fact, there is still likelihood of harm. The minority holders might be misled to their detriment. Unfortunately, the court qualified its opinion to the extent of saying that a secret reserve was all right unless the auditors thought their statutory duty required them to reveal it[76] It was led to do so apparently because secrecy in investments is necessary due to the trials and exactions of competition. An auditor who presents a *partial* statement of a company's affairs certainly is running the risk of incurring liability for failure to state the "true position" of the company.

(a) *Cash.*

Suppose that an agent of a business, the subject of an audit, fraudulently pledges accounts receivables, or securities for the purpose of showing a false cash balance, should the auditor detect the transaction? Or again, suppose that after the auditor verified the cash balance on hand, a sum was withdrawn and placed in the cash fund of the business so as to falsify the total balance of cash, what is the duty of discovery by the auditor?

Good accounting practice demands that the cash on hand should be counted after banking hours on the last day of the period under audit. It with the amount on deposit in the bank should be reconciled with the cash records. This verification should be made upon the same day as a verification is made of other liquid assets such as investments and accounts receivables. This precaution will preclude the possible substitution of funds received upon a temporary loan to make up a false balance. Ad-

(2) for the creation of a Reserve Fund; (3) the shareholders were only to have the right of inspection conferred by statute and authorized by the directors.

[76] "It is, I think, competent for the majority of the shareholders to say that as to particular items of their business it is of interest to the corporation that there shall be secrecy, and that the auditors who must for the purpose of the audit know all such details shall not, unless their duty under the statute requires it, disclose such details to the members."

vances to employees should be scrutinized. It is very doubtful if they should be considered as a part of cash. If the currency and the check transactions are kept together in one record, and the cash is not counted until after the close of the period, the bank balance of the date of the count should be obtained as well as of the date of closing. Deposits for a short time prior to closing should be examined to see that they are *bona fide* deposits. The records of the bank should disclose that they were charged to the account of the drawee. Comparison should be made between the deposit slips furnished by banks with debits of the cash book. This will verify whether or not deposits are made promptly.

The liquidity of cash, which makes it easy to manipulate and a temptation for defalcations, justifies this apparently meticulous procedure. The courts have recognized this. *Re The Kingston Cotton Mills, Ltd.,*[77] distinguished between the care that was necessary in verification of cash from that which should be used in the case of inventories.[78] *Fox and Son* v. *Morrish, Grant and Co.*[79] illustrates further the strictness with which the courts have viewed the auditor's duty in this respect. In this case, the plaintiffs were the owner of two businesses: linen manufacturers at Leeds and warehousemen in London. The defendants were retained by the plaintiffs to verify their books and to present half yearly balance sheets. The retainer was arranged by oral conversation some fifteen years previous to the time of this litigation. The statements showed a balance of cash on hand at the London Bank and an overdraft at the Leeds Bank. The books also revealed that large sums had been drawn upon the London business in favor of the Leeds business. In fact these sums were never deposited in favor of the Leeds business. If the pass-book of the Leeds bank had been examined, or a certificate requested from any official of the Leeds Bank the defalcations would have been revealed. The defendant claimed that his only duty was to examine the "postings" of the books and to prepare a balance sheet. The court held that

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[77] 74 L. T. R. 568.

[78] Lindley, L. J., at p. 570: "His position" (employee in charge of stock) "was not similar to a cashier who has to account for the cash which he receives, and whose own account of his receipts and payments could not be reasonably taken by an auditor."

[79] 35 T. L. R. 126 (1918).

notwithstanding the arrangement for a limited audit, the defendant was liable for his failure to verify cash. It seems that the only way that an auditor can be relieved of this duty is by an express agreement to that effect; or a statement in the balance sheet that a verification of cash has not been made.

Not only does the proper verification of cash require proof that all cash receipts and disbursements are made for the use of the business, but that it has been used in the *right way* by the business. For illustration we might take this simple example:

Account	Dr.	Cr.
Cash	$100	
Interest Income		$100

This would be clearly erroneous if $75 represented principal of the loan and $25 as interest income. *Leeds Estate Building and Investment Co., Ltd.* v. *Shepherd*[80] presents the case where the auditor failed to distinguish between income and capital, with the consequence of dividends being paid when no profits were made.[81] The cash receipts record made no analysis between income and assets. The loans made by the company were of long duration, and it was necessary to amortize the principal in order to obtain the correct allocation between capital and income.[82] The court held that the auditors and directors were guilty of a breach of duty.

(b) *Receivables.*

What consideration must an auditor give to the receivables, in the form of promisory notes and book accounts of the trade customers? Suppose that the par value of the notes was accepted notwithstanding there were many renewal notes and others in the hands of attorneys for collection. Would this amount to a breach of duty? Should receivables of affiliated companies and officers be segregated upon the statement? A failure to do so might lead to various interpretations. Some, ignorant of the true situation, might interpret the statement as

[80] 36 Ch. Div. 787 (1887).

[81] The articles provided for a commission for the directors and a bonus for the manager in all years in which the income exceeded 5%. Only in one year did the company make a profit and this was less than 5%. In all others it operated at a loss. Notwithstanding, the company paid dividends every year amounting to 5% or 10% of capital.

[82] The directors claimed that this was a computation involving actuarial skill and for that reason they should not be liable.

showing an exceedingly strong current ratio. Others might suppose that it indicated weakness by comparing the ratio between notes receivables and accounts receivables. How should an auditor guard against fictitious notes? And so with the accounts receivables, suppose that a large percentage of the "control" account represents fictitious items. Is the auditor bound to verify the balances by the subsidiary ledger and supporting memoranda?

Good accounting practice requires that a schedule of notes receivables should be made. It should include detailed information of the principal, the interest rate, date of execution, and the maturity dates. If discounted, verification should be obtained from banks discounting. The probable value of renewal notes and notes in the hands of attorneys for collection should be considered. Installment sales notes and others maturing later than one year should be segregated upon the balance sheet. Likewise, notes of officers and employees and notes arising out of any transaction other than regular business should be stated separately. Notes made by affiliated companies, even though arising out of the course of the business, should be segregated. If the affiliated company has a good current ratio they might be stated as current assets, however. The probable negative factor of notes discounted should be noted. It is desirable to have a personal acknowledgment by the maker, communicated directly to the auditor.

Balances of the accounts receivables should be classified according to the age of the accounts. A comparison should be made with individual customers' accounts appearing in the subsidiary ledgers. The composition of the accounts should be examined for disputed claims even though they are active, paying accounts. An estimate should be made of the value of the claim in dispute. As in the case of notes receivables the accounts maturing later than one year, and those of employees, and officers, should be segregated. An appraisal of the reserve for bad debts should be made. It is necessary to indicate an assignment of accounts receivables.

In many respects we find that the law is in accord with the requirements set forth as the proper accounting practice in the verification of receivables. The duty of the auditor to take notice of the *value* of receivables has been recognized. This was

the chief deficiency of the report made in *Re London and General Bank, No. 2*[83] Though this case was a statutory proceeding, charging the auditors with misfeasance under the statute,[84] the test of duty does not differ materially from that which would prevail in an action on the case for negligence.[85] The real difference between the two proceedings is one of form rather than substantive law. The practical value of the statutory proceeding is that it is not barred by the Statute of Limitations.[86] The Bank's chief business in this case was the loaning of money to about four development companies. Their greatest asset therefore consisted of receivables. The loans were valueless and the auditors were held liable for failing to bring this to the attention of stockholders in understandable terms. By stating the nominal rather than the real value of the receivables the balance sheet showed a profit when in fact there was none. *Leeds Estate, Building and Investment Co.* v. *Shepherd*[86a] also recognized the duty of an auditor to consider the value of receivables. In reviewing the deficiencies of the system there under consideration, the court pointed out there was no allowance for bad debts, losses, or contingencies. Of course, this duty to consider the value of receivables, does not mean that auditors are under a duty to volunteer advice to the management as to the expediency of certain policies. They are not interested in the mat-

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[83] (1895), 2 Ch. 673.

[84] 42 and 43 Vict. C. 76, Sec. 7; 53 and 54 Vict. C. 63, Sec. 10.

[85] See opinion of *Stirling*, J., in *Western Counties Steam Bakeries and Milling Co. (In Re Parsons' and Robjent's Case)*, 66 L. J. Ch. 354; (1897) 1 Ch. 617, 76 L. T. 239, at p. 622. (The case was reversed upon the question of substantive law.) *Lopes*, L. J., in *Re The Kingston Cotton Mills, Ltd.*, 74 L. T. R. 568, seemed to think that the statutory duty, the breach of which would justify a charge of misfeasance, was more limited than the legal duty to use ordinary care. Thus at p. 570 he states: "The learned judge in the court below held that misfeasance covered any misconduct by an officer of the company as such, for which such officer might have been sued apart from the section. In my judgment *this is too wide; it would cover any act of negligence*, any actionable wrong by an officer of the company which did not involve the misapplication of assets of the company." (Italics are those of the writer.) *Kay*, L. J., however, in the same case spoke of the statutory duty in the terms of negligence. At p. 572 he said: "If it was the duty of the auditor to test the statements of the manager in the manner suggested, or indeed in any manner, *they were certainly guilty of negligence*, for they made no attempt whatever to test them. The question is, was it their duty?" (Italics are those of writer.)

[86] See the opinion of Stirling, J., *supra*, note (85).

[86A] 36 Ch. Div. 787 (1887).

ters of policy save to the extent that those matters directly affect the existing financial position of the company.[87]

The duty to segregate, upon the financial statements, receivables from officers, employees and affiliated companies, has incurred more serious obstacles in judicial recognition. The first cause of complaint in *Re City Equitable Fire Ins. Co.*[88] was the description, by the auditors, of the debts of the company's manager and brokers as "Loans at call or short notice". This point the court thought was immaterial, since the directors would not have investigated the company's status anyway. This conclusion was reached, however, after the court had considered, what was thought to be the only other alternative description: "Loans".[89] The observation therefore is probably true as far as it goes. That does not mean that the item should not have been set forth as "Loans to Officers" or "Loans to Stock-brokers". This, it is submitted, would have put the directors upon notice. The court also seemed to erroneously apply the limitation of duty to volunteer advice upon expediency of policy,[90] which should have no application in this case. Following the literal language of the opinion of *Re London General Bank No. 2*[91] rather than the substance seemed to have facilitated this result. Since this decision was rendered the duty to segregate receivables from affiliated companies. has been asserted by the statutory enactment.[92] The same rule should be applied in the case of officers and employees.

Auditors and public accountants are under a legal duty to exercise care in preventing inflation of receivables by including fictitious items. In the case of *Ultramares* v. *Touche,*

[87] *In Re London and General Bank No. 2, supra,* note (83): "An auditor has nothing to do with the prudence or imprudence of making loans without security. It is nothing to him whether a business is being conducted prudently or imprudently, profitably or unprofitably.—His business is to ascertain and state the true financial position of the company at the time of the audit."

[88] *Supra,* note (54).

[89] Romer, J., at p. 482.

[90] *Supra,* note (87).

[91] *Supra,* note (83).

[92] 19 and 20 Geo. V. C. 23, Sec. 125: "When any of the assets of a company consist of shares in or accounts owing (whether on account of loan or otherwise) from a subsidiary company—the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the balance sheet of the first mentioned company separately from all its other assets."

etc,[93] this was the basis of falsification. In this business at the time the audit was made there had been no posting of the general ledger for a long period. A junior accountant was assigned the task. Upon its completion the amount of accounts receivables was $644,758.17. Following that total an employee of the corporation inserted the amount of $706,843. This was supposed to represent additional accounts receivables growing out of sales for the month in which the audit was made.[94] Opposite this last entry there was a posting index. In fact there was no entry in the journal from which the item had been posted.[95] There were sales invoices which supported the amount. They were in fact fictitious and had the auditor examined them their character would have been revealed.[96] The court did not hesitate to say that his procedure would justify a finding of negligence.

(c) *Investments.*

Good accounting practice recognizes various circumstances in the treatment of securities. They may or may not be current assets. If funds are temporarily invested, they can be so classified. If, however, a material equity of another concern is represented thereby, the interest is fixed and not current. The interest is to gain and maintain control rather than to receive dividends or market accretions. If the securities are not readily marketable they should be stated separately. The auditor should compile a detailed schedule of those owned. If it appears that some of the securities have no market value, the balance sheet of the issuing corporation should be consulted, with particular attention given to the existence of a surplus or deficit. Securities in the hands of a transfer agent should be certified as properly belonging to the subject of the audit. If the total market value is less than the total book value, a reserve for possible loss should be established.

As already pointed out, the segregation of securities owned

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[93] 255 N. Y. 170, 174 N. E. 441 (1931).

[94] This is a tremendous sum, relatively, and *prima facie* suspicious.

[95] The index reference: "12-29" was not supported by any entry. Had the auditor examined the subsidiary ledger his suspicion would, if a careful man, prompted further inquiry.

[96] The sales invoices if examined would have confirmed suspicion because they contained no shipping number or customer's order number.

in other affiliated companies has become mandatory by statute in England.[97] The right of the auditors to rely upon the certificates of agents holding the company's securities presents a more troublesome question. It will depend upon various considerations. Was the party with whom the securities were left a "proper depository"? Was a personal inspection by the auditor impracticable? The court in *Re City Equitable Fire Ins. Co.*[98] had occasion to treat of this custom. Upon the winding up of this insurance company there appeared a shortage of one million two hundred thousand pounds in the funds of the company. The shortage was due in part to the depreciation of the securities owned, and in part to the fraudulent conduct of the managing director. The scheme of the fraud was most elaborate and as stated above[99] the court held that the auditors were not liable for failing to discover it from the books of the company. Romer, J.,[100] said that but for the exemptions[101] contained in the company's articles, the defendant auditors would have been liable, however. This dictum was based upon the fact that the securities were left with the company's brokers, and it was represented that they held securities which they did not. The auditors accepted the certificate of the brokers. The court stated that except for the brief time in which it was necessary to leave securities with brokers, the latter were not to be considered proper depositories. This was true notwithstanding their reputation for honesty and integrity. If practicable, a personal inspection of securities, left with one other than a proper depository, is necessary.[102]

(b) *Inventories.*

The positive factor in the consideration of credit, the goods of the trader, affords the auditor difficulties in its examination. It is of vital importance also. By its misstatement a loss is readily converted into a gain; a deficit into an adequate equity of ownership. Strangers to the business, and indeed oftentimes

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[97] *Supra*, note (92).

[98] *Supra*, note (54).

[99] *Supra*, note (54).

[100] *Ibid.*, at p. 498.

[101] The articles of the company exempted the directors and auditors for losses except those which were the result of willful neglect.

[102] Romer, J., *supra*, note (100).

the owners themselves, have no accurate means of ascertaining the valuation of large inventories save from the accounting records. It therefore behooves the auditor to ascertain if those records present a true story. An examination should have a three-fold purpose: (a) The ascertainment of quantity. Attention should be given to the clerical accuracy of the footings, computations, and the recapitulations. Final inventory sheets should be compared with original memoranda. The amounts should be certified by those who made the computations and the auditor should satisfy himself of the competency of those making the computations. Care should be used to exclude from "work-in-process" records, items that have been sold and billed out. Post dated invoices and goods in transit should be ascertained in order to give special treatment thereto. Goods received on consignment should be excluded. Those consigned to others should be valued at a price that will make allowance for possible damage or expense of return. Perhaps the better method would be to value at cost or market, in the usual fashion, and establish a reserve to meet these contingencies. (b) The basis of valuation should be given adequate consideration. The conservative policy, cost or market, whichever is lower, is the proper one. Though cost should not be written up to market, attention might be called to the difference in a footnote. An examination should be made of the cost system to ascertain the prices at which "work-in-progress" is included in the inventory. Selling expenses, interest charges, or administrative expenses should not be included in factory overhead, so as to reflect in the value of work-in-process. Duties and transit charges may properly be added to cost. Machinery and materials that have been charged to property or plant should not be included, however. (c) Of equal importance to an accurate statement of inventory value is the consideration of quality and condition of the goods. Lists of inactive stock should be compiled from supplies, work-in-process, finished products and purchased stock in trade. If the company has discontinued the manufacture of any of its products during the year, the inventory should be scrutinized, and if unsalable, the net amount should be deducted. If the turnover is below the normal rate that fact may be due to a poor stock of goods. This condition often arises from an unwillingness to dispose of old and unsalable goods at

a sacrifice. In general, the accuracy of inventory estimates can be ascertained by the "gross profits" test. If gross profits have been fairly constant, and a failure to maintain that constancy cannot be explained by a rise or a fall in the selling price, the error is likely due to false stock taking.

The possibilities of abuse afforded by the inventory account is illustrated by *Leeds Estate, Building and Investment Co.* v. *Shepherd.*[103] The so-called "stock account" was in reality a "Loans" account of a bank. Its manipulation in this instance was characteristic of that which is made with inventories due to their difficulty of verification. The manager admitted upon trial of the case that it had been his practice to state all the assets represented in the business except those of this account, and all of the liabilities and proprietorship items. After ascertaining these amounts, he inserted in the "stock account" an amount that would be sufficient to show whatever profit that was desired for the year.

Though it is not the duty of an auditor to "take stock",[104] he may call for explanations[105] of particular items in the stock-sheets. The reluctance which the courts have felt in holding auditors liable for errors arising out of false statements of inventories is illustrated by *Squire Cash Chemist, Ltd.*, v. *Ball, Baker and Co.*[106] For years the plaintiff had been a mortgagee creditor of a chemist operating a wholesale house and a chain of nine retail shops. The proprietor stated that he had a flourishing business, but that it needed more capital. He suggested that a limited company be formed and that the plaintiff become a shareholder. The plaintiff had to decide whether he would collect his loan or invest other money. For the purpose of making this decision he employed the defendants, independent auditors, to make an examination of the firm. The plaintiff invested more money in the company. After a few years it failed, the debenture holders receiving a nominal amount and the shareholders and open creditors nothing. Among the claims of negligence was the failure to verify the stock-sheets. The court denied the claim, however, because in fact the defendants had "test checked" the accuracy of stock-sheets with invoices of

[103] 36 Ch. Div. 787 (1887).
[104] *Re The Kingston Cotton Mills Co., Ltd.*, 74 L. T. R. 568.
[105] Coznes-Hardy, M. R., infra, note (106).
[106] 106 L. T. 197, 28 T. L. R. 81 (1912).

purchases. The plaintiff claimed that upon their face the stock-sheets contained items[107] that indicated that the auditors should have taken notice of this fact. The court commented upon the absence of evidence which would establish this contention. It did not feel at liberty to take judicial notice of a matter of such a technical character.[108] In making an audit an accountant has a right to rely upon certificates presented by servants of the company unless he has reason to believe that they are dishonest.[109] The manager of the company, in *Re Kingston Cotton Mills Co., Ltd.,*[110] had falsely stated the inventories of the company for a number of years in order to show a profit from operations. This was during the late "eighties" and early "nineties" in a time of a business depression. The misstatement was made in order to make the company appear in a better condition than it was and not for the selfish interest of the wrong-doer. The auditor accepted the statement of the manager.[111] The business here was the spinning of cotton into yarn. The amount of the inventory might have been ascertained from the books of the company. To do so it was necessary to apply this formula:

$$\text{I. In.} + \text{P} - (\text{S} + \text{W}) = \text{F. In.}$$[112]

Notwithstanding this verification would have revealed the falsification, the failure to make it was not held to be a breach of duty. The only justification that the decision has, apparently, is the fact that inventory was stated to be the estimate of the manager. The discovery of a gross inflation of inventory should be such a warning as to put an auditor on guard and

[107] The labels of the wholesale shop were carried at four hundred and seventy-five (475) pounds and of the retail shop at two hundred and fifty (250) pounds.

[108] The court comments upon the difficulty of verifying the stock of a chemist because there are so many small detail items of various values. Their apparatus is equally difficult to verify both from standpoint of quantity and value.

[109] Lord Alverstone in 27 T. L. R. 269.

[110] 74 L. T. R. 568 (1896).

[111] The auditor qualified his statement by inserting after inventory item, "as per the certificate of the manager."

[112] The following substitutions should be made: I. In.—Initial Inventory, composed of both cotton and yarn; P.—Purchases of Cotton; S.—Sales of finished product; W.—Waste or shrinkage, estimated at 25% of the raw material processed; F. In.—Final Inventory or the desired unknown.

require the exercise of a higher degree of care than would have to be exercised otherwise.[113]

(e) *Fixed Property and Deferred Charges.*

Though fixed property is of little value for short term credit purposes, it must be examined. In order to present its present status the auditor must know its original status and the subsequent changes. The balance at the beginning of the period, additions to and deductions from will present the proper value at a given time. When the authorization fails to specify whether the expenditure is an addition, repair, or a replacement, the physical properties should be examined to ascertain the proper classification. Additions can only be considered as such when the object of the expenditure is to increase the productive capacity of the plant. Payroll, store, and supply charges to jobs must be verified from original memoranda. Construction work in progress and materials for construction work are properly shown as fixed assets and not as inventory items. The purchase of real estate should be verified by an examination of the title deeds and the vouchers for payment. Recordation should be verified. If the company occupies leasehold properties, the leases should be examined and their terms noted so that improvements on such properties may be written off during the lease. The difference in the amount recoverable for insurance upon property prematurely put out of use and its recorded value should be written off. The adequacy of depreciation reserves should be considered.

There are other incidental favorable factors to the extension of credit that should be considered. While the so-called deferred charges to operation might be considered as of minor importance from the standpoint of a credit inquiry, their estimate and statement are necessary for an accurate presentation of the financial status of the subject of inquiry. Unexpired insurance, bond discounts applicable to a future period, and experimental charges are examples of the factors falling within this category. Aside from the greater accuracy afforded by the statement of these factors, their consideration affords collateral information of value. To properly state the item of prepaid

[113] In *Ultramares* v. *Touche*, *supra*, note (57), the inventory as given to the auditors was $347,219.08. The defendants discovered errors in the sum of $303,863.20, which were corrected.

royalties, the royalty agreement must be examined. That instrument, interpreted in connection with royalty vouchers will disclose the productivity of properties leased by the company. Experimental charges will afford collateral information as to the productive policies of the company. Insurance policies may disclose the existence of mortgages and liens upon the property so covered. Unprotected properties should be noted.

(f) *Negative Factors.*

As the reporter of the credit agency must ascertain the negative factors that[113a] militate against an affirmative credit judgment, so too must the auditor verify those factors. A schedule of notes payable and bills accepted should be prepared. The date of execution, maturity date, the name of the payee, collateral hypothecated, other indorsers, the amount of accrued interest payable and notations of renewal are informative details which that schedule should include. A comparison should be made between this schedule and the special ledgers and the account of the general ledger that records this data. Statements of all loans or drafts sold or discounted should be obtained from the bankers with whom the concern transacts business. Notes that have been paid should be discharged. A confirmation of securities hypothecated should be obtained from the pledges.

The suppression of negative factors might just as easily be an instrument of fraud as the inflation of a positive factor. In *Squire Cash Chemist, Ltd.* v. *Ball, Baker and Co.*[114] the failure to discover the suppression of liabilities was one of the causes for complaint. It was not allowed by the court because the act of suppression amounted to an act of fraud, the failure of discovery of which did not amount to negligence. Of course the decision was directed to the facts before the court and it does not mean that the failure to discover all fraudulent suppression of liabilities would be immune to a charge of negligence. Paradoxical as it may sound, the inflation of negative factors might also be the means of defrauding the client of the auditor. This is likely to happen only in the case of collusion between some agent of the company and a third party who is

[113A] From the standpoint of making a decision upon the extension of credit, the financial characteristics of a business might be classified as affirmative and negative.

[114] *Supra*, note (106).

apparently a creditor of the company. In *Craig* v. *Anyon*[115] an employee of a firm of brokers was dealing in behalf of one of its customers. By paying out large sums of money to this customer when his account showed a balance in favor of the brokers, the firm was defrauded of a tremendous sum.[116] Though the court said the failure to discover this defalcation by the auditor constituted negligence, a verdict for the plaintiff was set aside for other reasons which will be discussed later.

In *Ultramares* v. *Touche, Etc.*[117] the auditors made inquiry of creditors to ascertain if any securities had been pledged. The inquiry revealed that the same accounts receivables had been pledged to two, three, and four banks at the same time. This, the court said, did not render the assets less valuable but it should raise doubts as to the solvency of a business that would indulge in the practice. For this reason the failure to verify the additional accounts receivables[118] was all the more reprehensible.

Reasons for disputed claims payable should be ascertained. It is probably the better practice to show liability for goods in transit in accounts payable with an opposite entry to inventories. In this case the positive factor is less liquid than the negative factor. This difference of liquidity makes it of significant importance. Care should be exercised to prevent an abuse of the voucher system. Bills on hand but not vouchered nor entered in the accounts should be examined. A study of the minutes of the company might reveal additional liabilities. If the contract prices are higher than the market price, and the purchase is not protected by sales, future commitments should be protected by a reserve for the possible loss. The detection of liability for goods received and sold upon consignment is often difficult. Such transactions might be recorded by memoranda only. Certificates that all liabilities have been disclosed should be obtained from the proper officers of the firm. With regard to legal claims inquiry should be made of the president. He is usually the proper party upon whom to serve process and for this reason perhaps the only one apprised of the information.

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[115] 212 App. Div. 55, 208 N. Y. S. 259, aff'd without opinion, 242 N. Y. 569, 152 N. E. 431 (1926).

[116] Plaintiffs offered evidence that with one customer alone they had been defrauded of more than one and one-half million dollars during the five years in which the defendants performed audits.

[117] *Supra*, note (57).

[118] *Supra*, notes (93), (94).

In England auditors who are regularly appointed in fulfillment of statutory requirements, have the right of access to the books at all times. This provision is intended to protect the auditors in the obligations that they assume. In an opinion given[119] to the Institute of Chartered Accountants several years ago "the books of the company" was construed to mean all of the books of the company and not merely the books of account. This would surely include the minutes of the controlling boards and officers.[120] *Cuff* v. *London County Land and Building Co.*[121] seemed to qualify the right of the auditors to the books of the company when they were desired not for the purpose of making an audit, but to defeat a threatened suit for negligence. The directors of the company charged that the company had suffered severe losses by reason of the negligence of the plaintiff auditors, and were threatening them with suit. In dismissing a suit to recover the books of account the court distinguished between the statutory right of access to the books and the right of a mandatory decree to enforce the statute. In the absence of an absolute legal right of access to the books the auditor has the practical protection of withdrawing from the engagement in the event his requests are not complied with.

(g) *Certificates of Audits.*

It is impossible to say the exact form which the certification of an audit should take. It is fairly clear, however, that auditors and public accountants cannot legally, and should not desire practically, to relieve themselves of responsibility by using vague and indefinite language. The use of equivocal language gains the auditor no immunity. Neither is it sufficient to use an expression which might be understood by those who are experts in finance as qualifying a statement, but which to the laymen is meaningless. The report and audit should use such language as will render it capable of understanding by those to whom it is addressed. The statement in *Re London*

[119] Opinion was given by Haldane, Q. C. M. P., and Eady, Q. C.

[120] 45 Solicitor's Journal, 167 (1901).

[121] 81 L. J. Ch. 426 (1912), 1 Ch. 440, 106 L. T. 285, 28 T. L. R. 218. The manager had defrauded the company by embezzling its cash and showing the amount taken as an accrued asset, e. g., rentals in arrears.

and General Bank No. 2[122] contained this qualification: "The value of the assets shown upon the Balance Sheet is dependent upon realization." This the court said amounted to duplicity upon the part of the auditors. Their duty to the shareholders was not satisfied by the mere statement of a half truth.[123] Of course the objection can quite intelligently be made that the public circulation of doubtful reports might needlessly bring ruin upon the company. It is not necessary to give wide publicity to such a report, however. A confidential report might be addressed to the interested parties, which informs them where the full information can be obtained.[124] If the language used in the report clearly indicates that the information is gained from an unverified source, the auditors are not responsible for its falsity.[125]

We thus see that it is the duty of the auditor to: (1) Ascertain that all of the positive factors, shown by the books of account actually existed; (2) Establish that no positive factor that should be considered was omitted from the book records; (3) Establish that all negative factors were in fact shown; (4) Establish that all apparent negative factors were the result of properly authorized transactions.[125a] With respect to the last consideration, a similar observation might be made in connection with the positive factors that are the obligations of other corporations.

(4) DEFENSES.

(a) *Proximate Cause.*

The test of what is the proximate cause of an event is not easy to state. In case of negligence of an accountant or an auditor the question might well be asked: Does the misconduct, undisturbed by any independent cause, produce the injury? Some jurisdictions have held that proximate cause is deter-

[122] *Supra*, note (45).

[123] "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." The qualification here used might incite inquiry among the accounting profession but to the layman it was nothing more than a meaningless truism.

[124] *Supra*, notes (122), (45).

[125] *Supra*, note (111).

[125A] "Auditing Theory and Practice," Montgomery.

mined by whether or not the injury complained of could have been reasonably foreseen as a probable consequence of the act of negligence.[126] But the same jurisdictions have declared that negligence is the proximate cause of an injury that follows in an unbroken sequence from the act, though the specific result would seem improbable at the time of doing the act.[127]

Would a balance sheet, faultily prepared by auditors, and presented by them to directors be a direct cause of injury to a company if the directors recommended the payment of a dividend and this recommendation was acted upon by shareholders? Here it might be plausible to argue that there was an intervening agency; the recommendation of the directors. This was the argument presented in *Re London and General Bank, No. 2.*[128] It is not hard to sustain the court's denial[129] of the contention. Applying the rule of foreseeability, the only purpose of the audit was to ascertain whether the position of the company warranted the declaration of a dividend. The declaration of the dividend, as a consequence of the erroneous balance sheet, therefore, could hardly be designated an unexpected event. The same result might be reached under the test of the directness of the sequence of the events,[130] by looking upon the balance sheet as a continuing representation.[131] In *Re Republic of Bolivia Exploration Syndicate*[132] presents a case in which the negligence of the auditors was not the proximate cause of the injury. The cause of the complaint here was the failure to instruct the shareholders that certain promotion

[126] Cooley on Torts (4th ed.), Sec. 53 (1932), citing *South-Side Passenger Ry. Co.* v. *Trich*, 117 Pa. St. 390, 11 Atl. 627, 2 Am. St. Rep. 672.

[127] *Ibid.*, citing *Bunting* v. *Hogset*, 139 Pa. St. 363, 21 Atl. 31, 12 L. R. A. 268, 23 Am. St. Rep. 192, in which the impact of two locomotives opened the steam valve of the one driven by the negligent engineer, and caused it to complete the circle of a switch, causing a second collision and injury to plaintiff. See also Bohlen, "Studies in the Law of Torts," C. 1.

[128] *Supra*, note (45).

[129] "The balance sheet and the account certified by the auditors, showing a profit available for a dividend, were in my judgment, not the remote, but the real operating cause of the resolution for the payment of the dividend, which the directors improperly recommended."

[130] *Supra*, note (127).

[131] Rigby, L. J., at p. 697: "The report of the auditors was a continuing representation made indeed before, but in law and in good sense to be treated as repeated after the recommendation of the directors."

[132] 110 L. T. Rep. 141 (1914), 1 Ch. 139.

charges were improper. At the stockholders' meeting, some of the shareholders challenged the payment of some of these items. The defendant auditor told them that they could approve the charges or not, as they saw fit. Thereupon the meeting adjourned for the purpose of discussing and considering the question. Upon reconvening the charges were approved. *Squire Cash Chemist, Ltd.* v. *Ball, Baker and Co.*[133] seems harder to justify upon this ground. The plaintiff was not satisfied with the statement presented by the company's auditors in this case and therefore employed the defendants to make an audit. Following that audit he made further investments instead of collecting an existing loan. In spite of these facts, the court of appeal was not willing to say that the negligent audit was the proximate cause of the injury.[134]

(b) *Contributory Negligence.*

If we recognize fault as a test of right, in the law, the defense of contributory negligence follows as a logical consequence. By this criterion a man should not be permitted to base a right of recovery upon his own fault.[135] Practically, however, it is a difficult defense to establish upon behalf of auditors because of the matter of proof. The great majority of people who rely upon the work of an accountant do so almost in blind faith. The work is so foreign to their understanding that they are not in a position to say whether it has been done properly or not.[136] Some have expressed doubts as to whether courts have recognized that imposing liability for negligent statements was not the extension of the law of intentional wrongdoing but of negligent conduct.[137] If they failed to realize

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[133] *Supra*, note (106).

[134] Cozen-Hardy, M. R.: Is it a necessary implication that if the defendant had done their duty as accountants, the plaintiff would not have invested his money? I am unable to draw that inference." The court questioned the sufficiency of the proof as the matter was properly alleged. It is difficult to understand what proof would have satisfied the court as the facts we have stated appeared in the testimony of the plaintiff.

[135] *Rathburn and West* v. *Payne*, 19 Wend. (N. Y.) 399.

[136] Taylor, C. at p. 209 of 45 L. R. A. (N. S.): "The work of an expert accountant is of such a technical character and requires such peculiar skill, that the ordinary person cannot be expected to know whether he performs his duties properly or otherwise, but must rely upon his report as to the thoroughness and accuracy of his work."

[137] "Misrepresentation as Deceit, Negligence, or Warranty," Bohlen, 42 Harvard Law Review, 733, at p. 737, Part I.

that distinction, it is quite probable in those jurisdictions that contributory negligence would not be available as a defense. It is the modern tendency to deny contributory negligence as a defense in an action for fraud.[138] Though it has been said[139] that no case intimated that contributory negligence would be a defense for a purely negligent misrepresentation, it is submitted that New York[140] has applied the doctrine[141] in the case of *Craig* v. *Anyon*[142] It is true that the negligence of plaintiff in this case did not consist in the failure to examine the statements presented. From the facts it appearad that the plaintiffs were stockbrokers and that they had retained the defendants to make an audit and submit a report periodically. There had been defalcations[143] extending over a five-year period. This action was based upon the negligent performance of the audit. It was found by the jury, and the appellate division on review concurred, that had the auditors performed their work properly the error would have been discovered.[144] The court took the unusual position that inasmuch as the plaintiffs had permitted the defaulting employee to carry out his scheme uninterrupted and unsupervised that they were guilty of contributory negligence and therefore the special verdict for plaintiff should be set aside.[145] In doing so it cited and quoted in *Re Kingston*

[138] *Crompton* v. *Beedle*, 83 Vt. 287, 75 Atl. 331, 30 L. R. A. (N. S.) 748.

[139] *Supra*, note (137): "While the question has not been definitely presented for judicial decision, it is strange that no case contains any intimation to the effect that where the misstatement is merely negligent the plaintiff may be barred from recovery by a failure to utilize obvious means of checking up its accuracy, although his failure to do so would not bar his recovery were the misstatement intentionally and consciously misleading." At p. 740.

[140] This is one of the few jurisdictions that recognize negligent misstatements as such. *Supra*, note (137), p. 737(n).

[141] There was nothing in the case that would contrast fraud and negligence and the non-applicability of defense of contributory negligence to the former, however.

[142] 212 App. Div. 55, 208 N. Y. S. 259; aff'd 242 N. Y. 569, 152 N. E. 431 (1926).

[143] *Supra*, note (116)

[144] Two questions were submitted to a jury for a special verdict. They were: (1) "Were the defendants guilty in the performance of their agreement with Craig and Co.?" (2) "If so what damages resulted directly and proximately from such negligence?" The jury answered the first, "Yes," and the second, "$1,177,805.26."

[145] The court did permit the recovery of two thousand dollars, the amount of compensation paid for defendants' services. See, *infra*, the discussion of damages.

Cotton Mills, Ltd.[146] which stated that an auditor had a right to rely upon the summaries and certificates of employees of the business under audit. This result has been criticised[147] upon two grounds. The first was the distinction between *Craig* v. *Anyon*[148] and in *Re Kingston Cotton Mills*.[149] The distinction was said to be that in the latter there was no means of an independent verification, whereas in the former there was such an opportunity.[150] This distinction apparently does not exist.[151] The second basis of the criticism seems well founded. In permitting the defense of contributory negligence upon the facts in this case the court is certainly going contrary to the realities of modern business. It is a matter of common knowledge that the only way in which our modern business can be carried on is through the legal device of agency. Modern business is so complex, covers so many detailed transactions and extends over such a wide area of space that it would be impossible to accomplish satisfactory results save by permitting the entrepreneur to extend his personality and multiply his activity through agents. It is equally clear that it is impossible for the entrepreneur to verify the fidelity of these agents. For this reason the accounting profession has come into existence. It therefore seems absurd to say that unless the business man performs the function which he employs the accountant to perform, he cannot recover from the accountant for misfeasance. If the rule in this case were logically carried out, there would remain little utility in the services of the public accountant.

Some have argued that, logically, the rule of contributory negligence has no place in an action for injury resulting from the malpractice of a professional service. The treatment of the case as sounding in tort for negligent injury is a survival of the ancient action of misfeasance.[152] If the action were founded upon a breach of contract, the doctrine of contributory negligence would not prevail. The only obligation of the client in

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[146] *Supra*, note (110).

[147] "The Legal Responsibility of Public Accountants," 35 Yale Law Journal 76.

[148] *Supra*, notes (142), (115).

[149] *Supra*, note (110).

[150] *Supra*, note (147), p. 82, note (20).

[151] *Supra*, note (112).

[152] *Supra*, note (147) citing Ames, Lectures on Legal History, p. 129, et. seq.

this instance would be to mitigate damages after notice of breach.[153] It is hard to see in the light of many cases why the duty of the accountant to the client should not rest either upon contract or a tort arising out of the faulty performance of the contract. Though it has been said[154] that the modern tendency of the law does not favor the extension of the doctrine of contributory negligence, there is a field within which it does and should apply. *If the circumstances warrant it* the defense may well be applied to actions against public accountants. It is believed, however, that those occasions will be very rare.[155]

(5) MEASURE OF DAMAGES.

Finding that an accountant has conducted an audit in an improper fashion and that no legal defense could be asserted thereto, what principles should determine the assessment of damages for the wrong? Should the element of damages be confined to the natural consequences of the act complained of? The answer to the question should depend upon whether the cause of the injury is considered as a breach of contract or a tort for negligence. In the latter, for the purpose of determining whether there is a *cause of action* the injury complained of must be *both* the natural and proximate result of the wrongful act. For the purpose of determining damages once the cause of action has been established, the proximate result of the tort is the test, regardless of whether it is the natural result. But in the case of contract, in ascertaining the elements of damage, the injury must be the natural consequences of the breach, or it must be within the actual or potential contemplation of the parties at the time the obligation was assumed.[156]

East Grand Forks v. *Steele*,[157] treated of the question of the measurement of damages for the negligent performance of an audit. The defendants were employed to audit the books of a city clerk. He was charged, in addition to his regular duties, with the collection of money due the city for electric lights, water, sewer assessments and license fees. For the honest per-

[153] *Supra*, note (147), p. 80.
[154] "Misrepresentation as Deceit, Negligence, or Warranty," Bohlen, *supra*, note (137).
[155] *Supra*, note (136).
[156] *Sedgwick on Damages*, Section 142.
[157] 121 Minn. 296, 141 N. W. 181, 45 L. R. A. (N. S.) 205 (1913).

formance of these duties he had given bond. The defendants audited the books for two successive years and upon both occasions reported that the accounts were accurate. In fact, the clerk was in default upon both occasions.[158] The audit was negligently made.[159] At the time of the first audit the clerk's surety was solvent and had the defalcation been discovered the city would have been saved, harmless. The city sued to recover: (1) the amount of the defalcation; (2) the fees paid the accountants. A demurrer was sustained as to the first count and overruled as to the second. The court, in applying the rule of *Hadley* v. *Baxendale*,[160] stated that in the absence of special circumstances known to the accountants from which they ought to have inferred that such losses were likely to result, the subsequent defalcation of the city clerk and insolvency of his surety could be considered as neither the natural or proximate consequence of the negligent audit. *Craig* v. *Anyon*[161] follows this rule as to the measure of damages.[162] It therefore presents the unusual situation of permitting the defense of contributory negligence upon the theory that the action sounded in tort and at the same time following a case that was based upon breach of contract for the purpose of measuring damages. There is no reason why auditors should not be liable for the amount of the defalcations that follow as a consequence of their negligence. Their duty in many cases has been stated in terms of tort.[163] As stated above,[164] under that theory they should be liable for

[158] At the end of the first year the accounts were deficient in the amount of $1,984.26 and at the end of the second year in the amount of $5,339.

[159] A conclusion of the court based upon the allegations of the complaint, to which a demurrer was filed, that the defalcations were readily discovered by the state examiners.

[160] 9 Ex. 341, 23 L. J. Ex. 179. This is the leading case upon the measurement of damages for breach of contract. Plaintiffs were owners of a steam mill. The shaft in the mill was broken and they gave it to the defendants, a carrier, to take to an engineer. The latter was to use it for a model. The defendant delayed in the delivery and the plaintiff attempted to recover loss of profits from the cessation of the operation of the mill. As the defendant did not know the absence of the shaft was the sole cause of the cessation of operation, plaintiff could not recover for loss of profits.

[161] *Supra*, note (142).

[162] *Supra*, note (145).

[163] *Fox and Son* v. *Morrish, Grant and Co.*, 35 T. L. R. 126 (1918); *Smith* v. *London Assurance Corporation*, 109 App. Div. 882, 96 N. Y. S. 820 (1905).

[164] *Supra*, note (156).

all injuries that are the proximate result of their misfeasance. *Smith* v. *London Assurance Corporation*[165] did permit recovery of the amount of the embezzlement that resulted subsequent to their faulty audit. They should not be held liable for losses which were occasioned by defalcations prior to their employment, however.

Accepting the theory of the case of *East Grand Forks* v. *Steele*,[166] there is apparently no reason why the auditors might not in the proper case be held liable for the amount which the client has lost by reason of their failure to perform their duty. The suggestion[167] that parties at the time of making a contract do not anticipate its breach, seems a rational one. The test of whether a particular injury falls within that contemplated by the parties should not be limited to their actual contemplation but to the possible, natural or normal contemplation in view of all the circumstances attending the making of the agreement. The prevention of future losses by the discovery of any existing defalcation is certainly within the possible contemplation of auditor and client at the time that relationship is assumed. It is quite properly a question of fact. It is hard to see how a court could properly set aside a finding to that effect in the absence of evidence that the purpose of the audit was only to ascertain the then existing financial condition of the business.

III. LIABILITY TO THIRD PARTIES.

What is the liability of the public accountant to the business man with whom he has no relation? Is he liable to him for the negligent performance of an audit? If so, does liability extend in all cases or only in the case in which the courts find that there is a "duty" owing by the accountant? If the latter is necessary, what is sufficient to raise that "duty"? Are there any other theories under which an accountant might be made liable? These and many other questions must be answered in dealing with this troublesome problem. It is a novel question in the majority of jurisdictions. Those that have treated of it have done so with a lack of unanimity of opinion.[168]

[165] *Supra*, note (163).
[166] *Supra*, note (157).
[167] *Wilson* v. *Newport Dock Co.*, L. R. 1 Ex. 177.
[168] In *Ultramares* v. *Touche*, *supra*, note (93), there were two counts: the first for the negligent misrepresentation and the second

(1) NEGLIGENCE.

In the field of torts legal liability may be stated in terms of misrepresentations. The character of the conduct that produces a misrepresentation will determine the legal liability of the actor. It may be physical conduct, or spoken language; intentional, dishonest, or careless and unintentional. Depending upon these attributes we are accustomed to think of it in terms of negligence, deceit, and fraud. Misrepresentations that lead a party into unsuccessful economic ventures and result in a diminution of one's financial estate customarily give rise to a legal cause of action for deceit. On the other hand, those that result in physical injury and which are brought about by physical conduct rather than language may give rise to a legal action for negligence. In this latter instance the law is more liberal in according redress for the injury that has been caused.[169]

Does, and should, the law give redress for a negligent misrepresentation by language which results merely in the diminution of one's financial estate? The great case of *Derry* v. *Peek*[170] raised the query by way of dictum. The Court of Appeals[171] answered it in the affirmative; the House of Lords in the negative.[172] This is essentially the problem raised when an accountant issues a negligently prepared statement to a client

for the fraudulent misrepresentation. The trial judge dismissed the cause for fraud and submitted the issue for negligence. The jury found for the plaintiff, and the trial court then granted the reserved motion to dismiss. The appellate division affirmed the dismissal upon the issue of fraud, but reversed the dismissal for negligence. The Court of Appeals reversed the Appellate Division upon both issues, holding that the issue of fraud should be submitted and that of negligence dismissed. We thus find the cause argued before three tribunals, all of which were of a different opinion upon the law of the case.

[169] Misrepresentations as Deceit, Negligence, or Warranty, Francis Bohlen, 42 Harvard Law Review 733 (1929).

[170] 37 Ch. D. 541 (1885), 14 A. C. 337 (1889). The defendants stated in a prospectus that a tramway to be constructed had a franchise to use steam power. The act granting the right made the permission of the Board of Trade a condiiton precedent to the right to use steam power. The prospectus was issued by the defendants, believing that there would be no difficulty in securing the permission. They failed to secure the right and upon the failure of the company, the plaintiff brought an action for deceit.

[171] The Court of Appeals reasoned that if the statements made were false, known to be such, or *without reasonable grounds to believe that they were true*, then the plaintiff could recover. (Italics are those of the writer.)

[172] The House of Lords reasoned that in order to maintain deceit

and a stranger is injured by relying upon it. There have been but two cases in which the question was raised. The first was that of *Landell* v. *Lybrand.*[173] The plaintiff purchased stock in a corporation upon the faith of a certificate shown him by a third party. The stock was worthless. He brought an action against the accountants for negligently auditing the books of the company. In a brief opinion the court awarded a judgment for the defendants. In effect it reached the conclusion that there was no "duty" owing to the plaintiff inasmuch as he and the party who presented the certificate to him were strangers to the defendant. The issue of negligence was dismissed for a similar reason in *Ultramares* v. *Touche.*[174] The latter should be distinguished from *Landell* v. *Lybrand,*[175] however. There the defendants made an audit and prepared thirty-two duplicate copies of their report and balance sheet. They knew that the client would use these copies as an instrumentality for receiving credit. The balance sheet showed a net worth of over a million dollars, when in fact the corporation was insolvent. The plaintiff, before extending credit, demanded a financial statement. That which had been prepared by the defendant was presented. The plaintiff relied upon it to his detriment. The court reasoned that the plaintiff could not be considered as a party to the contract between the client and the auditor. In this decision it made tort "duty" coterminous with the "privity" of that contract. The clear logic of the opinion certainly is not open to criticism. Reading the opinion as a whole, however, one cannot but believe that the court was more troubled with the practical consequences of imposing liability than with the logical difficulties of precedent.[176] The fears expressed upon the practical consequences of such a holding would not result from the mere imposition of liability for negligence.[177] In order to reach the

it was necessary to show fraud. A statement honestly made was not fraudulent even though there was no reasonable grounds for making it.

[173] 264 Pa. 406, 107 Atl. 783 (1919).

[174] *Supra,* notes (93), (168).

[175] *Supra,* note (173).

[176] "If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminant amount, for an indeterminant time, to an indeterminant class." Cardozo, J., at p. 444 of 174 N. E. 441.

[177] See II (b). *"Is the Failure to Detect Fraud Negligence?" Supra,* note (57).

results anticipated by the court, liability for negligence would have to be extended into liability as an insurer.

(a) *What Relationship is Necessary to Justify the Conclusion that There is Privity Between the Parties?*

The foregoing cases cannot be accepted as holding that accountants are not liable to strangers for negligence under any circumstances. If tort duty is accepted as coterminous with contractual privity, it is interesting to note that many times a party other than those that perfect the bargain may enforce rights that accrue under it. A promise made for the benefit of a creditor of the promisee,[178] or for the benefit of the wife,[179] or the child,[180] of the promisee is enforceable. The same is true of some promises made for the benefit of citizens of a municipality.[181] So too, if at the request of a party to a contract, the promise runs directly to the beneficiary, the latter may recover although he does not furnish the consideration.[182] Though objection might be raised to the foregoing cases because they sounded in contract rather than tort,[183] there have been cases in New York that approach very nearly the situation here discussed. In *Glazner* v. *Shephard*[184] liability was predicated upon tort liability for negligently issuing a weigher's certificate. The defendant was a public weigher and was engaged and paid by the seller. He knew that the purpose of the weighing was to ascertain the amount which the plaintiff, the purchaser, should pay. By reason of the defendant's negligence, the plaintiff paid an excessive amount for the goods. He was permitted to recover

[178] *Lawrence v. Fox*, 20 N. Y. 268.

[179] *Buchanan* v. *Tilden*, 158 N. Y. 109, 52 N. E. 724, 44 L R. A. 170, 70 Am. St. Rep. 454.

[180] *Todd* v. *Weber*, 95 N. Y. 181.

[181] Restatement of the Law of Contracts, Sec. 145 (b). A contract with a city that streets will be kept in repair is enforceable by a member of public because the city is under a duty to the public to keep them in repair.

[182] In *Seaver* v. *Ransom*, 224 N. Y. 233, 120 N. E. 639 (1918), a testatrix in extremis, signed a will upon the promise of her husband to make provision for a favorite niece. The husband died without having made provision for the niece and she was permitted to recover against the estate of the promisor.

[183] As previously stated in the text at note (175), et seq., the liability is co-extensive, however.

[184] 233 N. Y. 236, 135 N. E. 275 (1922).

back the amount of the overpayment. The court emphasized that here the defendant was made liable not merely for careless words but for the careless performance of a physical act.[185] This is not a persuasive distinction from *Ultramares* v. *Touche*[186] however. In the latter it might well be pointed out that the accountants were guilty of the negligent omission of a physical act, e. g., the series of physical acts that would be necessary for an examination of the subsidiary ledgers and supporting memoranda.[187] The real distinction seems to be that in the Glanzer case the certificate was addressed to the purchaser. The requirements of privity within the meaning of third party beneficiary contracts[188] is thus present, whereas in the Ultramares case it is not. This would seem to justify the conclusion that the Glanzer case is still law. It also seems more helpful and of more substance than that founded upon "primary" and "incidental" beneficiaries of the contract for the performance of the audit.[189] In other words the facts that justify the conclusion as to whether a particular party is an incidental or primary beneficiary are more important than the conclusion itself.

International Products Co. v. *Erie Ry. Co.*[190] also presents facts which bring it within the rule of the Glanzer case. The gist of the action here was the negligent designation of a place of storage of goods imported by the plaintiff. The plaintiff relied upon that designation and gave it in the description of the goods for purpose of effecting insurance. Upon the destruction of the goods and the failure of the insurance to attach, recovery was permitted against the carrier. The court expressly

[185] It has been said that the recovery in *Glanzer* v. *Shephard* should not be justified solely upon the negligent physical omission of the weigher. "But recovery should not be denied simply because the physical act is missing and there is substituted a mental service or act negligently performed which similarly finds culmination in the words of a certificate or prospectus." The result of *Glanzer* v. *Shephard* was here approved. 36 Harvard Law Review 114.

[186] *Supra*, notes (168), (93).

[187] *Supra*, notes (95), (96).

[188] *Supra*, note (182).

[189] Cardozo in distinguishing *Glanzer* v. *Shephard*, said: "Here was a case where the transmission of the certificate to another was not merely one possibility among many but the end and aim of the transaction, as certain and deliberately willed as if a husband were to order a gown to be delivered to his wife. . . ."

[190] 244 N. Y. 331, 155 N. E. 662 (1927).

placed the decision upon the ground of negligence. In doing so it recognized that the English law had denied a right of recovery under these circumstances.[191]

Boyle v. *Chatham Phenix National Bank*,[192] both upon the facts and the language used in the opinion, presents a more difficult case to distinguish from *Ultramares* v. *Touche*.[193] The defendants here were held liable for negligently certifying that collateral had been deposited to secure a bond issue. The issue was actually a swindle. All of the collateral was worthless. The following elements were said to be necessary to render one liable for negligent language:[194] (1) The author of the statement must have knowledge that it is required for a serious purpose; (2) he must have knowledge that those for whom it is made intend to act and rely upon it; (3) he must know that if it is false they may be damaged; and (4) the relationship of the parties arising out of contract or otherwise, must be such that there is a duty to give the information with care. It is true that the plaintiff here belonged to a determined class—prospective purchasers of bonds. There was also created by the act of purchase a fiduciary relationship. But at the time of the certification there was no more relationship between the trustee and *cestui* than there was between the accountant and the creditor in the Ultramares case.

Jaillet v. *Cashman*,[195] and *Courteen Seed Co.* v. *Banking Corporation*[196] present restrictions upon the doctrine of negligent misstatements. The former was an action for the negligent transmission of information by a ticker service. A customer of the broker, acting in response thereto, was damaged. He sought recovery against the service. It was denied. The case may be distinguished from the usual negligent language action upon the nature of the service rendered. Like a newspaper, the speed with which the information is dis-

[191] Citing Pollock on Torts (12 ed.), p. 565; a dictum of *Derry* v. *Peek*, L. R. 14 A. C. 337: "No cause of action is maintainable for a mere statement although untrue, and although acted upon to the damage of the person to whom the statement is made unless the statement be false to the knowledge of the party making it."

[192] 253 N. Y. 369, 171 N. E. 574.

[193] *Supra*, notes (186), (168), (93).

[194] Citing Andrews, J., in *International Products Co.* v. *Erie Ry. Co.*, *Supra*, note (190).

[195] 235 N. Y. 511, 139 N. E. 714.

[196] 245 N. Y. 377, 157 N. E. 272, 56 A. L. R. 1186.

seminated is its chief utility. Probable error in its accuracy then should be contemplated. The latter may also be distinguished upon the ground that the plaintiff was guilty of contributory negligence.[197]

In England, at one time, it was held that there was liability for negligent statements in the absence of contractual duty. In *Cann* v. *Wilson*[198] a mortgagor applied to the defendant, an expert valuer, for an appraisal upon property that was to be mortgaged. The defendant sent the valuation directly to the solicitors of the mortgagee. Upon default, the property was not sufficient to cover the amount of the loan. From the evidence it appeared that the defendant knew the intended use of the valuation. The plaintiff was permitted to reecover. This case was overruled[199] by *Le Lievre* v. *Gould*.[200] The attempt to extend liability for financial injury resulting from negligence, in the absence of privity between the parties, failed.[201] *Robertson* v. *Fleming*[202] presented some rather fine distinctions upon the obligation of a lawyer to parties who were not his clients. They were dependent upon the doctrine of privity as the term is understood in the interpretation of "third-party beneficiary" contracts.[203]

If contractual duty is established the rule founded upon the dictum of *Derry* v. *Peek*[204] does not apply. In *Pritty* v. *Child*[205] the plaintiff employed the defendant, a professional water finder, to locate a well. A spot was designated upon which it was said that water might be found at a depth of thirty

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[197] 16 Cornell Law Quarterly 419, at p. 422.

[198] 57 L. J. Ch. 1034, 39 Ch. D. 39, 59 L. T. 723.

[199] "No doubt if *Cann* v. *Wilson*," *supra*, note (198), "stood as good law, it would cover the present case. But I do not hesitate to say that *Cann* v. *Wilson* is not now law. Chitty, J., in deciding that case acted upon an erroneous proposition of law which has since been overruled by *Derry* v. *Peek*." *Supra*, note (170), per Lord Esher.

[200] 62 L. J. Q. B. 353 (1893), 1 Q. B. 491.

[201] See 40 Yale Law Journal 128.

[202] 4 Macq. H. L. 167, 1 Paterson 1053 (1861).

[203] The obligor of leasehold properties undertook to indemnify his sureties thereunder by an assignment of certain leasehold properties. The obligor employed the defendant to perfect the transaction. By reason of the failure to notify the landlord the security was lost. The court intimated that the lawyer would be liable to the sureties as he knew he was the only lawyer employed in the case. By way of dictum the court denied, however, that a disappointed legatee would have any right against a solicitor who had drawn a defective will.

[204] *Supra*, note (191).

[205] 71 L. J. K. B. 512, 18 T. L. R. 460 (1902).

feet. The plaintiff drilled beyond that depth and failed to reach water. Recovery was permitted.[206] Sometimes the same result is reached by estoppel.[207]

This doctrine upon which the decision of *Ultramares* v. *Touche*[208] was based has been applied in a great many cases involving the negligent issue of certificates. *Saving Bank* v. *Ward*[209] is the leading case upon title abstracter's liability. In this case the borrower of money employed the defendant to examine his title to property. The latter certified that the former's title was "good and unencumbered". The plaintiff, upon the faith of the certificate, accepted a mortgage of the lot. At the time the defendant issued the certificate the mortgagor had conveyed the property in fee. This conveyance was also a matter of record.[210] *Thomas* v. *Guarantee Title and Trust Co.*[211] followed *Savings Bank* v. *Ward*.[212] In this opinion we find the doctrine of *caveat emptor* applying with its fullest vigor. Like the application of the doctrine of contributory negligence[213] between accountant and client, this rule overlooks the necessity of division of labor under capitalistic production.

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[206] Lord Alverstone hinted that if the trial judge had not found that the statement was one of fact, he would be induced to dismiss the petition because the statement was an expression of an opinion. Query: May one not rely upon the expression of opinion under some circumstances? One who is not an expert may rely upon expert opinion. "Liability for Non-Defamatory Statements," 47 South African Law Journal 359, citing *Edwards* v. *Lamb*, 67 N. H. 597, 45 Atl. 480 (1899). In this case a physician was held liable for negligently expressing an opinion that plaintiff could dress an infection without danger.

[207] In *Compania Naviera Vasconzoda* v. *Churchill and Sin* (1906), 1 K. B. 237, the plaintiffs relied upon statements in the bill of lading that the goods were in good condition when shipped. In fact they were damaged when they were received by the carrier. The plaintiff paid for them upon receiving the shipping documents.

[208] *Supra, notes* (186), (168), (93).

[209] 100 U. S. 195 (1879).

[210] Mr. Chief Justice Waite, Swayne and Bradley, J. J., concurring dissented: The defendant had carelessly issued a certificate which he might reasonably know would be relied upon by some third party in some business transaction. He should be responsible for that loss. This is probably the foundation of the rule that liability in this situation is dependent upon knowledge of intended reliance of a particular plaintiff. See Columbia Law Review, 858 at p. 861 (n), (15).

[211] 81 Ohio St. 432, 91 N. E. 183 (1910).

[212] *Supra*, note (209).

[213] See discussion in the text of the second criticism, *supra*, note (147), of *Craig* v. *Anyon*, *supra*, note (142).

The case of *Gordon* v. *Livingston* is often cited[214] as an application of the doctrine for the negligent issue of a grain inspector's certificate. The language of the opinion does speak of an absence of tort duty unless contractual privity can be found. The facts of the case, however, would lead one to believe that the petition was, or might have been, dismissed because there was no evidence of negligence upon the part of the defendant.[215] The same treatment[216] has been given to *Kahl* v. *Love*.[217] It might likewise be distinguished upon its facts. Here the owner of real property in Jersey City paid a tax and received a receipt from the tax collector. This receipt was subsequently exhibited to the plaintiff who purchased the property upon the representation that the tax had been paid. The check given in payment was dishonored and the city enforced the taxes against the plaintiff. He then sought to recover against the defendant collector for the negligent issue of the tax certificate. In denying recovery the court stressed the fact that the defendant was neither required nor authorized by statute to issue a certificate. The receipt was to be considered, then, in the same light as the ordinary business receipt. These are ordinarily issued upon the presentation of a check and before the check has been honored. Though the opinion did not advance the reason, it seems that the case might have been decided for the defendant upon the ground of contributory negligence. The doctrine of the co-extensiveness of tort duty and contractual privity is fairly supported by *National Iron and Steel Co.* v. *Hunt*,[218] and *Love* v. *Mack*.[219] *Humphrey* v. *Brown*[220] presents

[214] 31 Columbia Law Review 858, at p. 862, note (22); 40 Yale Law Journal 128.

[215] The defendant in this case was a grain inspector and the plaintiff was a purchaser who paid for it relying upon his certificate that it was, "No. 1 Red Winter Wheat." In fact a part of the wheat was "No. 2" which was of lesser value. The plaintiff had to respond to its vendors for the inferior quality of wheat. The original seller had instructed the elevator officials to mix the wheat so that it would more nearly correspond to the new standard grade which had been adopted since his sale to the plainitff. They also instructed the elevator officials to keep this a secret from the defendant inspector. The failure to detect this fraudulent scheme hardly amounted to negligence upon the part of the defendant.

[216] *Supra*, note (214).

[217] 37 N. J. L. 5 (1874).

[218] 312 Ill. 245, 143 N. E. 833 (1924). The defendant inspected steel rails upon two occasions. Upon the first there was a favorable certificate. Upon the last, the certificate stated they were not "first-class

a more doubtful authority. This was an action brought by a ship owner because of the negligent survey of his yacht by one acting for the Society of Lloyd's Register. The ship was reported to be in good condition when in fact the main mast was decayed. Though the opinion was written in terms of "privity" and "duty", there was a stipulation by the Society exempting it from liability for negligence. The evidence of damage in the case was also doubtful.

(b) *Exceptions to the Rule that Tort Duty and Contractual Privity are Coterminous.*

(1) Liability of Those Engaged in a Public Calling.

It was early decided that those engaged in a calling which "was affected with a public interest were liable for negligence to third parties with whom they had no contractual relation. This was true in England where the restriction[221] upon tort duty was first established. In *Peppin* v. *Shephard*[222] an action was brought for negligently treating the wound of plaintiff. Recovery was permitted even though the defendant was employed by the plaintiff's husband. This relationship between the plaintiff and the party engaging the defendant weakens the authority of the case. It might well be said by virtue of that relationship a status of "privity" was established between the plaintiff and the defendant.[223] The court, however, placed the duty of defendant upon the necessity of protecting the public interest.[224] The decision might be explained upon the basis of the nature of the injury resulting from the negligence. Here the injury was physical injury rather than financial loss. That explanation loses its force, however, when considered with *Harriot* v. *Plemption.*[225] The defendant, as the result of a

relaying rails." The purchaser who relied upon the first certificate and was prevented from selling by the last inspection brought the action. A judgment for the defendant was entered because of a lack of duty.

[219] 93 L. T. 352 (1905).

[220] 45 T. L. R. 297.

[221] *Supra*, note (200).

[222] 11 Price 400, 147 Eng. Rep. 512 (1822).

[223] *Supra*, note (179).

[224] "It would be a most mischievous consequence if this declaration could not be sustained. In the practice of surgery, particularly the public are exposed to great risks from the number of ignorant persons professing a knowledge of the art without the least pretensions to the necessary qualifications."

[225] 166 Mass. 585 (1896).

negligent diagnosis of the plaintiff, uttered a defamatory statement. An action of slander was not maintainable because the statement was privileged. The court held that the petition stated a cause of action under the theory of negligence. The exception of the persons belonging to a public calling is further substantiated by the duty of a telegraph company to the addressee. Recovery is permitted by the recipient for the negligent transmission of a message even though it is paid for by the sender.[226] Some[227] have said, however, that this is not an exception, as the rule may be brought within the doctrine of contractual privity.

From the beginning it has been insisted that public accountants should be brought within this exception. A review[228] of *Landell* v. *Lybrand*[229] agreed that the reasons for the result of that case were in accord with established precedent, but questioned its consequences. It insisted that if the courts were not willing to impose liability, it should be done by legislative enactment. The decision of the Appellate Division[230] in *Ultramares* v. *Touche* was readily accepted[231] as being in accord with the rule urged[232] in *Landell* v. *Lybrand, supra.* Here it stated[233] that by "economic necessity" the profession of Public Accountant amounted to a public calling. Though the result of the decision was approved, regret was expressed that liability had not been imposed by legislative enactment. This it was thought would have permitted members of the profession an opportunity to make an adjustment in their fees and to perfect insurance against liability. The Court of Appeals,[234] however,

[226] *Western Union Telegraph Co.* v. *Dubois*, 128 Ill. 248, 21 N. E. 4 (1889).

[227] 3 Dakota Law Review 381, at p. 382, states that the basis for the decision is that the addressee is the express beneficiary of the contract, citing Shearman and Redfield, Law of Negligence, Vol. 2 (6th ed.—1913), Section 343.

[228] 29 Yale Law Journal 234.

[229] 264 Pa. 406, 107 Atl. 783 (1919).

[230] 243 N. Y. S. 179 (1930).

[231] 40 Yale Law Journal 128.

[232] *Supra*, note (228).

[233] *Supra*, note (231). For the test of the importance of the business to the public in determining whether it is a common calling see 75 University of Pennsylvania Law Review 411 (1927).

[234] 174 N. E. 441, at p. 448: "Public accountants are public only in the sense that their services are offered to anyone who choose to employ them. This is far from saying that those who do not employ them are in the same position as those who do."

denied that public accountants had the characteristic of a "public calling" which would subject them to liability. It has been suggested that the opposite result could have been reached had the court so desired.[235] The court did have *State ex Rel. Short* v. *Riedell*[236] for authority, though this case was apparently not called to its attention. This case might cast doubt upon the constitutionality of a statute imposing liability as recommended above.[237] It is true, however, that some businesses may be regulated in one respect and not in another.[238] Statutes of identical nature have been enacted applying to title abstracters.[239]

(2) The Maker of a Dangerous Instrumentality.

The rule that the maker of a dangerous instrumentality owes a duty imposed by law to persons with whom there is no contractual privity, grew out of a class of cases that established the contrary rule in the first instance. If we pause to observe the development of the law which first gave rise to the absence of duty; its abrogation by this exception; and finally its express reversal in the very class of cases that first denied duty; we cannot but question its tenacious maintenance in another class of cases, which at the best are only supported by way of analogy. *Winterbottom* v. *Wright*[240] apparently established the rule denying duty in the absence of contractual privity. This it will be remembered,[241] involved the negligent construction of a coach and the injury of one other than the vendee. Reasons of

[235] 16 Cornell Law Quarterly 419, at p. 426: "And might not the court, had it so desired, have considered that a public accountant is engaged in a public calling?"

[236] *Supra*, note (14).

[237] *Supra*, note (228).

[238] *Cap. F. Bourland Ice Co.* v. *Franklin Utilities Co.*, 180 Ark. 720, 22 S. W. (2) 993, 68 A. L. R. 1018 (1930). In this case the section of the statute fixing the price of ice was upheld; that requiring a certificate of public necessity and convenience was declared unconstitutional. See *New State Ice Co.* v. *Liebman*, 52 Fed. (2d) 349 (1931), affirmed 52 S. Ct. Rep. 371 (1932).

[239] See 31 Columbia Law Review 858, at p. 862 (n) (20).

[240] 1 M. and W. 109.

[241] The defendant contracted with the Postmaster-General to furnish a mail coach. The plaintiff's master contracted to furnish horses for the coach along the line. By reason of the defective construction, the plaintiff was injured.

substance supporting the decision are hard to find.[242] The court apparently hesitated to extend liability for fear of increasing the number of law suits and deterring prudent tradesmen from engaging in useful occupations.[243] The dissatisfaction with this rule may be evidenced by the case of *Thomas* v. *Winchester.*[244] The court quite readily seized upon the theory that an article imminently dangerous to human life should be an exception to the rule of absence of duty between the manufacturer and the consumer. The negligent mislabeling of a poisonous drug was therefore sufficient to raise a duty between the maker and the remote vendee. This opening wedge was a welcome device for the courts to emasculate the rule of *Winterbottom* v. *Wright.*[245] The decision that a scaffold,[246] a derrick rope,[247] an elevator,[248] a siphon bottle [249] and a coffee urn[250] were imminently dangerous to human life are evidence of the dissatisfaction with the rule that tort duty and contractual privity are co-extensive.

The invention and the almost universal use of the automobile emphasized the serious consequences of the results produced by the rule of *Winterbottom* v. *Wright.*[251] Here it should be noted that the situation is practically the same as in that case. Of course the substitution of mechanical power with increased speed and wider possibilities of accidents weigh heavily, in favor of the interest of the consumer and against the manufacturer. Judge Carroll in *Old Motor Works* v. *Shaffer*[252] was apparently impressed with this consideration. The decision for the plaintiff was placed upon this ground. Later *McPherson* v.

[242] The rule "seems to savour strongly of that scholasticism which so often has led the English courts to emphasize the shadow and ignore the substance of a judicial situation." *Negligence in Relation to Privity of Contract*, 16 *Law Quarterly Review*, 168, at p. 172.

[243] Doubt was expressed upon the ability of the lawyer to pass upon the operation of economic forces. *Supra*, note (242).

[244] 6 N. Y. 397 (1852).

[245] *Supra*, note (240).

[246] *Delvine* v. *Smith*, 89 N. Y. 470.

[247] *Davies* v. *Pelham Hod Elevator Co.*, 65 Hun. 573, 20 N. Y. S. 523.

[248] *Kohner* v. *Otis Elevator Co.*, 96 N. Y. App. Div. 169, 89 N. Y. S. 185.

[249] *Lorgesen* v. *Schultz*, 192 N. Y. 156, 84 N. E. 956.

[250] *Statler* v. *Ray Mfg. Co.*, 195 N. Y. 478, 88 N. E. 1063.

[251] *Supra*, notes (245), (240).

[252] 145 Ky. 616, 140 S. W. 1047 (1911). The plaintiff, a passenger in a car, was injured when the rumble seat, which was built upon a box, gave way while going up a steep grade.

Buick[253] also allowed recovery when the user of a car was injured in accident which resulted from a defective wheel. The negligent inspection by the manufacturer rendered him liable to the consumer. This case abandoned the overused fiction of a dangerous instrumentality, and substituted the probability of harm or the foreseeability of injury as the test of duty.[254] Since the cases, which established the rule that tort duty and contractual privity were coterminous, have by subsequent development practically refuted the doctrine;[255] it does not seem to be an insurmountable obstacle to imposing liability upon public accountants to third parties.

(3) Liability for Negligent Advertisements.

The exception that the manufacturer who negligently advertises his product is liable for injury to a member of the public is likewise a refutation of the doctrine of *Winterbottom* v. *Wright*,[256] which was followed in *Ultramares* v. *Touche*[257] and *Landell* v. *Lybrand*.[258] The rule is well illustrated by *Crist* v. *Art Metal Works*.[259] Here the plaintiff sued the manufacturer for the negligent advertisement of a toy pistol which resulted in the serious injury of a twelve year old boy. The toy was of such a character that it could not be said to be an inherently dangerous object. The theory of the complaint was that the defendant had advertised it as "perfectly harmless". While the child was playing with the toy during the Christmas holidays, the sparks discharged therefrom ignited the beard of a Santa Claus costume. The child was severely burned. The court held that the facts stated a cause of action. The basis of the decision was the negligent failure to disclose the dangerous potentialities of the toy. The pistol could not be said to be dangerous when used for any purpose. Neither was there any defect in its construction. *Miller* v. *Sears, Roebuck and Co.*[260]

[253] 217 N. Y. 382, 111 N. E. 1050, L. R. A. 1916 F. 697.

[254] The results and the reasons supporting it have been commended. 16 Columbia Law Review 428, 29 Harvard Law Review 866.

[255] Liability of Manufacturers to Persons Other Than Their Immediate Vendees, 45 Law Quarterly Review 343 (1929).

[256] *Supra*, notes (251), (245), (240).

[257] *Supra*, notes (193), (186), (168), (93).

[258] *Supra*, note (173).

[259] 230 App. Div. 114, 243 N. Y. S. 496, aff'd 175 N. E. 341.

[260] 250 Ill. App. Div. 340 (1929).

reached the opposite result from *Crist* v. *Art Metal Works*.[261] The two cases involved injuries suffered from the use of the identical toy. The injured child, in the latter, fired the pistol while drawing gasoline from a tank, and as a result he was severely burned. The cases are hard to distinguish though it has been said[262] that in the latter the contributory negligence of the plaintiff justified the court in directing a verdict for the defendant. *Henry* v. *Crook*[263] also permitted recovery for failing to give notice of the dangerous potentialities of the article advertised. The plaintiff's dress in this instance was ignited by a sparkler. Though there was a notice[264] of possible harm, it was held to be insufficient. *Rosenbach* v. *General Electric Co.*[265] held that an article that was dangerously packed[266] would give rise to a cause of action. In this case blocks of wood had been placed in an electrical transformer in order to hold the coils intact during shipment. The purchaser failed to remove them. When put to use, the blocks created a short circuit which caused an explosion. An employee of the purchaser was killed. The court held that notwithstanding the lack of privity between the plaintiff and the defendant, and the possible negligence of the purchaser, the defendant was liable.

Historically, the doctrine of *Winterbottom* v. *Wright*,[267] seems to be traceable to the old technicalities resulting from the niceties of the forms of action in common law pleading. Thus it was reasoned, that in no case of a tort arising out of a contract, could an action be maintained except in those instances in which an action upon the contract was maintainable. This rule, coupled with the elementary proposition that none save parties to contracts may sue thereon, produced the deduction that torts arising out of a contractual relationship were not actionable by strangers to the contract. This deduction has been

[261] *Supra*, note (259).

[262] 16 Cornell Law Quarterly 125, at p. 129. The facts showed that the child held the muzzle of the pistol about five inches from the flowing gasoline.

[263] 202 App. Div. 19, 195 N. Y. S. 642.

[264] The container had a warning "not to touch the wire."

[265] 236 N. Y. 227, 140 N. E. 571 (1923).

[266] Crane, J., said there was no distinction between a defective instrument and a perfect instrument defectively and dangerously packed.

[267] *Supra*, notes (256), (251), (245), (240).

challenged forcibly.[268] In all cases which we have examined upon this subject of tort liability in the absence of contractual privity, the trend seems to be away from the original holding denying liability. Especially is this true in those cases which result in physical injuries. Why, then, should the courts cling to the doctrine when the injury consists in the loss of property? Such an artificial distinction seems to overlook the very spirit of an action at law to recover damages. The purpose of that action is compensatory. It is more nearly realized when the cause of the complaint is a diminution of one's financial estate than in the case of physical injuries.

(2) OTHER THEORIES OF LIABILITY.

(a) *Fraud.*

The court in *Ultramares* v. *Touche*[269] stated that upon the facts presented the case should be submitted upon the issue of fraud. This is again the language of legal conclusions. and has raised the question of just what is meant by that descriptive phrase. Not only has the question been raised before the accounting profession,[270] but the courts in many jurisdictions have cited the case as sustaining various meanings of fraud.

Fraud usually consists of intentionally misleading another. This may result from stating as a fact that which one knows does not exist. Or if one states a thing as true while conscious of a lack of knowledge upon the matter, he is guilty of intentionally misleading the person to whom the statement is made. This does not mean that the party speaks maliciously in the actual sense. It does not mean that the statement is accompanied by a desire to inflict harm or injury. In fact, the speakers may actually hope that his audience will be benefited or that the future will prove his assertion to be true. Notwithstanding these laudable aims, if they are coupled with an intention to

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[268] "It is one thing to say that a party to a contract can recover, whatever his form of action, only when there has been a breach of contract. It is quite another to say that this implies the corollary that a stranger to the contract, being unable to sue upon it is unable to sue at all." *Negligence in Relation to Privity of Contract*, 16 Law Quarterly Review 168.

[269] *Supra*, notes (257), (193), (186), (168), (93).

[270] *The Liability of Public Accountants*, Roger Baldwin, 52 Journal of Accountancy 342.

mislead, the statement is properly considered as fraudulent.[271] This is apparently the meaning of the decision of the House of Lords[272] in *Derry* v. *Peek*.[273] Some courts in this country have followed the Court of Appeals'[274] decision in that case, however. Other states have adopted the Court of Appeals' view by statutory enactment.[275]

The view of the House of Lords upon this subject was apparently the rule in New York. In *Reno* v. *Bull*[276] an action was brought by a purchaser of stock in a corporation against the directors who had authorized and approved a banking circular, issued for the purpose of selling the stock. The judgment for the plaintiff was reversed because, under the instructions of the trial court, the plaintiff might have recovered upon conduct which at the most amounted to negligence. "Representation, falsity, scienter, deception and damage" were said by the court[277] to be necessary elements of the action. Following *Glanzer* v. *Shephard*[278] it was thought[279] that the results of *Reno* v. *Bull*[280] would have been otherwise, had the complaint sounded in negligence. The result of *Ultramares* v. *Touche*[281] probably alters the basis for this prophecy.

Did it likewise change the rule upon fraud by indicating that negligence would raise an inference of fraud? Did the court mean to imply that a statement, though honestly made, if made without reasonable grounds for believing it to be true, would be sufficient to sustain an action for fraud? Though subsequent cases[282] in New York have thrown little light upon the

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[271] *Misrepresentations as Deceit, Negligence or Warranty*, Bohlen, 42 Harvard Law Review 733.

[272] *Supra*, note (172).

[273] *Supra*, note (170).

[274] *Trimble* v. *Reid*, 97 Ky. 713, 31 S. W. 861 (1895); *Parette* v. *Ravenock*, 81 Mo. Ap. 494 (1899).

[275] California Civil Code (Deering), Section 1572; *supra*, note 270, at page 736

[276] 226 N. Y. 546, 124 N. E. 144 (1919).

[277] Citing *Derry* v. *Peek*, 14 A. C. 337 (1889).

[278] 233 N. Y. 236, 135 N. E. 275 (1922).

[279] 36 Harvard Law Review 114.

[280] *Supra*, note (276).

[281] *Supra*, notes (269), (257), (193), (186), (168), (93).

[282] *People* v. *Mancuso, et al.*, 255 N. Y. 463, 175 N. E. 177, at p. 184 (1931), repeated the proposition that negligence itself may raise an inference of fraud. *People* v. *Mangan, et al.*, 252 N. Y. S. 45 (1931), at p. 51, stated that fraud may include pretense of knowledge where there is no knowledge.

subject that is the view taken in some jurisdictions upon the decision.[283] The language of the Massachusetts court would certainly indicate that it believed the New York court had switched from the view of the House of Lords[284] to that of the Court of Appeals[285] in *Derry* v. *Peek*.[286] In citing *Ultramares* v. *Touche, supra,* McLearn Hill,[287] stated that words and conduct free from an intentional purpose to deceive may constitute fraud under appropriate circumstances. The same is true of the California court. This jurisdiction, we have said,[288] adopted the negligent theory of fraud by statute. *Washington Lumber and Millwork Co.* v. *McGuire,*[289] in construing that statute[290] cited *Ultramares* v. *Touche, supra,* for the proposition that actionable deceit may be based upon negligence as well as on willful misrepresentations.

Notwithstanding this apparent confusion, it is believed that the New York court did not intend to change its rule upon the elements of fraud. It has been one of the few jurisdictions[291] to properly distinguish between the actions for negligent language and fraudulent statements. To hold that *Ultramares* v. *Touche*[292] adopted the rule of fraud credited to it by the Massachusetts and California courts would make that opinion self-contradictory. If by that decision the rule was changed from its prior view[293] upon fraud, the court would be in the anomolous position of denying recovery for negligence and allowing it at the same time by calling it fraud. It is believed that the court had reference to statements grossly negligent. The rule that gross negligence will raise an inference of fraud, so that evidence to that effect must be submitted to a jury, is analogous to the rule in defamation, that evidence of negligence

[283] *Supra,* notes (281), (269), (257), (193), (186), (168), (93).
[284] *Supra,* notes (272), (172).
[285] *Supra,* note (171).
[286] *Supra,* notes (273), (170).
[287] 177 N. E. (Mass.) 617, at p. 621.
[288] *Supra,* note (275).
[289] 1 Pac. (2d) Cal. 437 (1931).
[290] Section 1710 of California Civil Code, Deering (1923), defines deceit: "The assertion of a fact of that which is not true by one who has no reasonable grounds for believing it to be true."
[291] *Misrepresentations as Deceit, Negligence or Warranty,* 42 Harvard Law Review 733.
[292] *Supra,* notes (283), (281), (269), (257), (193), (186), (168), (93).
[293] *Supra,* notes (276).

is admissible as an inference of malice which will defeat a conditional privilege.[294]

(b) *Warranty.*

Much of the uncertainty that has resulted from the court's decision[295] that the accountants were liable to third parties for fraud, and the meaning of that word, is due to the confusion of that theory of liability with liability for breach of warranty. Some[296] have stated that the important element of the Ultramares opinion is that which deals with fraud. In analyzing the meaning of the court upon that phase of the case, it was pointed out that *the absence of knowledge* and not *the absence of belief* was the important thing in finding a false financial statement fraudulent. And, indeed, there is language in the opinion[297] to justify this conclusion.

There are many cases which hold that if a person makes a statement of a fact, true to his own knowledge, then he is liable if that statement is false, even though he believed it to be true. In *Chatham Furnace Co.* v. *Moffatt*,[298] an action of deceit was brought against the vendor of a mineral lease for misrepresenting the quantity of ore. Though the vendor did not know that his statements were false, he knew that their accuracy depended upon a survey, one line of which had been assumed. The survey proved to be erroneous. In awarding judgment for the plaintiff, the court emphasized the falsity of the statement[299] rather than the intention to mislead. According to this view, if the statement is false, *scienter* is apparently presumed.[300] In

[294] Acknowledgment is made to Dean Young B. Smith, Law School of Columbia University. For the rule upon defamation, see 16 Harvard Law Review 71; for an explanation of the contrary view, see 57 University of Pennsylvania Law Review 243.

[295] *Ultramares* v. *Touche*, *supra*, notes (292), (283), (281), (269), (257), (193), (186), (168), (93).

[296] The Liability of the Public Accountant, Roger N. Baldwin, 52 Journal of Accountancy 342 (1931).

[297] "The defendants stated as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false they are not to be exonerated because they believe it to be true." Cardozo, J., 174 N. E. 441, at p. 448.

[298] 147 Mass. 403, 18 N. E. 168 (1888).

[299] "The fraud consists in stating that the party knows that the thing exists, when he does not know it to exist; and if he does not know it he must ordinarily be deemed to know that he does not."

[300] This case ascribed "to a person who makes the statement an introspective omniscience which, however common in New England,

Hadcock v. *Osmer*[301] a debtor of the defendant was informed that he would have to pay. In order to help the debtor raise funds with which to meet the obligation, the defendant wrote a letter[302] recommending their credit. The debtor was insolvent at the time. The court found that the defendant may have believed[303] their credit to be good, but he did not know whether it was good or not. In permitting the plaintiff to recover the Court of Appeals held that the instructions[304] of the trial court were not too favorable to the plaintiff. In so doing, the emphasis again was placed upon the falsity of the statement. Looking at the case for what it actually decided, it may be readily sustained. The sole question before the appellate court was the correctness of the instructions. They were correct in that the conduct condemned by them was the pretense of knowledge where there was none. This would amount to intentionally misleading another and fraud in its generally accepted sense. We should question the language of the opinion that a statement made of a fact, true to the knowledge of the speaker, is fraudulent if false, notwithstanding belief in its truth. Such a holding would, in effect, amount to a warranty that the statement was true. The facts do not disclose that the plainiff was a proper party to complain of a breach of warranty.

Courts are treading upon dangerous ground, when they treat a statement of fact true to the knowledge of the speaker, as fraudulent, if false. They are then passing from the realm of intentional wrong into the field of contract law. It amounts to a confusion of tort principles with those of contract.[305]

is rarely if ever encountered elsewhere." Francis Bohlen, *Misrepresentations as Deceit, Negligence or Warranty*, 42 Harvard Law Review 733, at p. 744.

[301] 153 N. Y. 604, 47 N. E. 923 (1897).

[302] "Mr. Hadcock: The Browns are good for what money you let them have."

[303] This finding of the court is difficult to sustain since the debtor informed the defendant that he could not pay when requested. Were it not for the matter of the instructions, the case might have well been based upon the intention of the defendant to mislead.

[304] The instructions were: "That if he made the statement that they were good as a fact, not as an opinion, without knowing whether it was true or not, then it was false in the sense that he made a statement of fact as though he knew it to be true, which he did not know to be true."

[305] *Supra*, note (300). *Wimple* v. *Patterson*, 117 S. W. (Tex. Civ. Ap.) 1034, is cited as being one of the few courts to recognize the true nature of this liability.

Most of the cases that assert this principle are dealing with misrepresentations between parties to contracts. As such, making a statement true to the personal knowledge of the speaker, may well be taken to amount to a warranty that the statement is true. It may also be applied as long as the contractual relationship exists. It is submitted that the rule[306] that certified public accountants are liable for the falsity of their statements, when stated as facts true to their personal knowledge, should not be extended to "third parties", with whom there is no contractual relationship. The cases cited[307] to sustain that proposition, present representations inducing the formation of contracts. There is justification for saying that the party making the representation in those cases, warranted their verity and should not be exonerated merely because he believed the statements to be true. The failure to distinguish this rule as an extension of the law of warranty, rather than defining the limits of fraudulent statements, would readily lead to its misapplication.

IV. SUMMARY.

The advent of new taxes and new business customs has increased the demand for the services of the accountant. Specialization and the delegation of duties have become necessary. Seasonal work has complicated the selection of the personnel of the accounting profession. The legal liability of members of the profession is a novel question of increasing importance. There are no legal requirements to be complied with before engaging in the profession. In the United States there have been created by the legislatures, examining boards. These exercise a selective process in determining the members of the profession who are proficient enough to be certified by the state as public accountants. Successful applicants in these tests may hold themselves out as Certified Public Accountants. Usually there are statutes prohibiting others from exercising this privilege. The power of the state to exercise this selective process will not be given extra-territorial effect. Each state may stipulate upon what terms reciprocity shall exist between it and other states.

[306] *Supra*, note (297).

[307] *Lehigh Zinc and Iron Co.* v. *Bamford*, 150 U. S. 665, 14 S. Ct. 219, 37 L. Ed. 1215; *Chatham Furnace Co.* v. *Moffat*, 147 Mass. 403, 18 N. E. 168, 9 Am. St. Rep. 727.

The courts have declared that public accountants are members of a learned profession. As such, they warrant the exercise of the degree of skill that is common in the profession. Average skill is a question of fact. Circumstances, statutes, and contracts may alter the degree of skill that is required to be exercised. Honesty and integrity in the performance of the work are fundamental requirements, universally observed. The failure to detect fraud may or may not be negligence. The nature of the fraudulent scheme, the verification that would be necessary to detect it, and the verification that was made are controlling. An auditor is not an insurer of the accuracy of his work. He should be liable for the failure to know the general principles of law of special significance to his practice.

The legal requirements for the verification of cash are stringent. The courts have not relaxed these requirements, even when the parties have limited the scope and purpose of the audit. In the verification of receivables the value must be taken into consideration, and the expression given thereto in terms understandable by the person to whom the statement is addressed. Though there have been cases which stated that there was no duty to segregate receivables from affiliates, later legislative enactment in that jurisdiction has made it mandatory. It seems that the legislative policy is preferable to the decision of the court upon this practice. Inflation of receivables should be detected by verification of supporting memoranda. It has been said by way of dictum that a verification of securities in the hands of a depository was necessary. The courts are apparently reluctant to impose liability for failing to detect errors in inventories. The problem is a difficult one, but it is quite futile to impose stringent requirements for the verification of some accounts such as cash, receivables and investments, and to relax those requirements with inventories. By the manipulation of this account fraud is easily perpetrated. The courts have often stated that it is not the auditor's duty to "take stock". Some have suggested, however, that explanations should be sought by them if the occasion demands it. The discovery of errors and discrepancies in inventories should exact greater care and caution in the performance of the audit. It is legally proper to accept certificates of officers and employees of the business under audit as to quantities and estimates of in-

ventories, unless the auditor has reason to believe they are dishonest. Good accounting practice requires that the auditor make inquiry to ascertain the competency of these officials before accepting their certificates.

Care should be exercised by the auditor to detect the suppression or inflation of liabilities. By the latter the entrepreneur, who is probably the client, will suffer injury; by the former a creditor is likely to suffer injury. In order to detect liabilities, the minutes of the company should be examined. The auditor's right to all records ought to be unlimited. If this right is not recognized, the person making the audit should exercise self-help by a refusal to continue the engagement. The certificates and reports of the auditors should be unequivocal and couched in language that is capable of understanding. The errors of making an audit may or may not be the proximate cause of injury. The usual rules should govern the application of this defense. Sometimes it is permitted. Other authorities deny that it has any application in an action against an accountant. Especially is this true when the action is instituted by the client. The action may well be based upon negligence, however, and it seems that contributory negligence might properly be asserted as a defense. As a practical matter it is, and should be, a difficult defense to prove. When the courts, as a matter of law, set aside a verdict for a plaintiff for this reason, they are overlooking the practical neecessities of division of labor under capitalistic production.

The measure of damages might be that which is usual for the breach of a contract or the commission of a tort. Two jurisdictions have refused to permit the recovery of the defalcations subsequent to the negligent audit. This was considered as the remote consequence of the breach and not within the contemplation of the parties when the agreement for the audit was made. In one of these, the defense of contributory negligence and the contract measure of damages were applied in the same case. Some cases have permitted the recovery of the subsequent embezzlements. If the complainant can properly state a cause of action in tort, there is no apparent reason why he should not recover for money embezzled as a consequence of, and subsequent to, the negligent audit.

Two jurisdictions have held that accountants are not liable

to parties other than those for whom they have agreed to make the audit. In so holding they made tort duty coterminous with contractual privity. The logic of the New York case is unassailable. One gathers, however, that the court was more troubled with the practical hardships of imposing liability than it was with legal precedent. There are authorities both allowing and denying liability for negligent language. The cases in which liability has been imposed present facts, which bring the party recovering within the class of persons who could recover upon the contract that was responsible for the utterance of the language. The doctrine that tort duty and contractual privity are coterminous has been applied in cases of the certificfiates of title abstracters, tax collectors and inspectors of grain and steel. There are many exceptions to the rule. Those that are engaged in a public calling are liable for negligence to others in the absence of a contractual relationship. This was the main basis for criticising the first case that denied liability of public accountants. The rule that tort duty and contractual privity are co-extensive was first limited, and later practically emasculated by the exception applying to makers of dangerous instrumentalities. The rule is rarely observed except when the injury consists of the diminution of one's financial estate. The absence of privity does not excuse the negligent advertiser. Historically, it has been ascribed to the rationalizations of the technicalities resulting from the various forms of action in common law pleading. The rule has been condemned as illogical when considered with the general fundamental principles of the law of negligence. There are other theories of liability to persons with whom public accountants have no contractual relationship. They are usually embraced with the troublesome "catch-all"—fraud. The liability of public accountants under this theory should be limited to the cases in which they intentionally mislead another. To say that public accountants make a statement of fact, true to their own knowledge, and that they are liable if it is false, regardless of honesty, is to impose liability for a breach of warranty. This liability should not be imposed in favor of third parties.

In conclusion, it is submitted that between auditor and client the legal requirements of skill in making an audit have not reached a satisfactory consistency. In certain phases of

the audit the legal requirements are very strict, and in other phases they are less than that which is considered good accounting practice. It is desirable to have legal duty and good practice conform. By this policy, accounting records and periodical audits will become a more perfect mechanism for business control. The lack of liability to third parties has been adversely criticised in the majority of intances.[308] The greatest inconvenience imposed by the Ultramares case will probably be the failure of the business community to understand its significance when considered with the Glanzer case, and the failure to conform business practice with the two. If we accept the rule in New York as the law upon the subject, it behooves the creditor or investor to procure financial statements addressed directly to him. All financial statements are not unreliable, in a legal sense, but only those that are issued in blank to the public generally.

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[308] 16 *Cornell Law Quarterly* 419; 31 Columbia Law Review 858; 19 *California Law Review* 454, while approving the logic of the opinion in *Ultramares* v. *Touche*, supra, question the results. 17 *Virginia Law Review* 701, upholds both the reasons and the result. This analysis is not very clear and seems contrary to the holding of the principal case. 3 *Dakota Law Review* 381 approves the reasons of the opinion, and makes no comment upon the result.