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COMMENTS

AUDITORS' THIRD PARTY LIABILITY: AN ILL-CONSIDERED EXTENSION OF THE LAW

INTRODUCTION

In recent years numerous legal commentators have advocated an expansion of auditors' liability to users of financial statements,¹ and the courts have begun to find liability in situations where it would have been unthinkable in earlier decades.²

This expanded liability has had two express aims: improved disclosure of financial information to investors,³ and restitution to investors who are injured by misleading financial statements⁴ and who cannot obtain restitution from the corporation itself.⁵ The advocates of increased

1. See, e.g., Bradley, *Auditor's Liability and the Need for Accounting Uniformity*, 30 LAW & CONTEMP. PROB. 898 (1965); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 DE PAUL L. REV. 56 (1968); Wyatt, *Auditors' Responsibilities*, 12 ST. LOUIS L.J. 331 (1968); Comment, *Accountants' Liabilities to Third Parties Under Common Law and Federal Securities Law*, 9 B.C. IND. & COM. L. REV. 137 (1967); Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967); Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for Users of Financial Statements*, 44 WASH. L. REV. 139 (1968); 41 ST. JOHN'S L. REV. 588 (1967); 23 U. MIAMI L. REV. 256 (1968); 23 VAND. L. REV. 809 (1970). Although the ideas of these articles are not novel to the late 60's, earlier articles were certainly less frequent. See, e.g., 36 IOWA L. REV. 319 (1951). Moreover, not all of the articles on the subject of auditors' liability unquestionably accepted its expansion as desirable. See Note, *Accountants' Liability for Nondisclosure of After-Acquired Information: Strict Liability Under Rule 10b-5?* 22 RUTGERS L. REV. 554 (1968), dealing with the Yale Express case (*Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967)), where the author passed no judgement on the potential expansion of liability; Katsoris, *Accountants' Third Party Liability—How Far Do We Go?* 36 FORDHAM L. REV. 191 (1967), who even went so far as to question the wisdom of expanded liability. At one place in his article, Professor Katsoris indicates that the idea of such liability is debatable: "this controversy leaves the accountant in a state of turmoil as to the practical economics of practicing his profession." *Id.* at 219-20. Even these hold-outs, however, seem to accept the increased liability as an inevitable and workable alternative.

2. See notes 6-19 and accompanying text, *infra*.

3. See authorities in note 1, *supra*. All of the commentators listed there subscribed to this view to some extent.

4. See, e.g., Note, 67 COLUM. L. REV., *supra* note 1, at 1468 (1967).

5. To date, the major cases brought under the Securities Acts have been brought after the demise of the businesses in question. See note 13 *infra*. Thus, the enterprises whose auditors have been challenged have themselves lacked sufficient resources to compensate injured investors. Moreover, the liabilities have uniformly been beyond the ability of the corporate officers and directors to meet from their personal resources.

In at least one of the major current suits involving auditors, however, there are

liability and the courts, however, have not carefully considered all of the major obstacles to the achievement of either of these goals, or all the potential effects of the liability on the accounting profession and the securities markets. This comment analyzes these goals and potential effects, and concludes not only that the obstacles appear to be insurmountable, but that expanded liability will probably result in injury to the auditing profession, the issuers of corporate securities and the investors in those securities.

I. HISTORICAL DEVELOPMENT

The liability of auditors to users of financial information has only recently become one of the "expanding areas of the law." For thirty years, most courts followed the decision in *Ultramares Corp. v. Touche, Niven & Co.*,⁶ where the New York Court of Appeals held that an accountant would be liable for negligence only to those with whom he was in privity of contract. This doctrine remained viable even though other areas of liability that were governed by the same principles were undergoing drastic reevaluation and change.⁷ While auditors could be held liable to third parties in cases of actual fraud,⁸ the infrequency⁹

indications that the officers and directors of the company, as well as the auditors, were insured against this liability. At least at the present time, such insurance seems permitted by the SEC, despite the bar to indemnification agreements included in Note to Rule 460 of the Securities Act of 1933, 17 CFR § 230.460 (Note (a)) (1971). SEC, GUIDES FOR PREPARATION AND FILING OF REGISTRATION STATEMENTS, SEC Securities Act Release No. 4936 (1968), at ¶ 46(c). Although this release was concerned only with Registration Statements under the Securities Act of 1933, it seems reasonable to assume that the same policy would be applied to the Securities Exchange Act of 1934.

At least one commentator, however, raises serious questions as to the continued availability of insurance for officers and directors against liability under the securities acts, and argues that if the SEC does not prohibit such insurance, the courts should refuse to enforce it as contrary to public policy. Comment, *Insuring Corporate Executives Against Liability Under Rule 10b-5: First Principles and Second Thoughts*, 63 Nw. U.L. REV. 544 (1968).

6. 255 N.Y. 170, 174 N.E. 441 (1931).

7. See, e.g., Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791 (1966). See also note 51, *infra*.

8. The opinion in *Ultramares* stated:

[O]ur holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud.

225 N.Y. 170, 188, 174 N.E. 441, 448 (1931). See also *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir.), *cert. denied*, 302 U.S. 758 (1937).

9. S. LEVY, ACCOUNTANTS' LEGAL RESPONSIBILITY 44 (1954). One author suggests that the dearth of suits against auditors was due to the virtual elimination of actual fraud. Bentson, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*

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and difficulty in proving actual fraud¹⁰ made suits against accountants a rarity.¹¹

In the 1960's, however, many legal commentators presented strong arguments for holding auditors liable for securities transactions losses by third party users of financial statements who were not in privity of contract with the auditors.¹² Numerous court actions then were instituted, based primarily upon the federal securities acts, and attempting to hold auditing firms liable for such losses.¹³

56-58, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 23 (H. Manne ed. 1969) [hereinafter cited as Manne].

10. The general requirements for a fraud action in the business sphere are stated in *RESTATEMENT OF TORTS* §§ 525, 526 (1938). For examples of the application of those requirements to auditors, see *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938); *Fidelity & Deposit Co. v. Atherton*, 47 N.M. 443, 144 P.2d 157 (1943); *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir), *cert. denied*, 302 U.S. 758 (1937). In the latter case, in considering the omission of contingent liabilities from the financial statements, the court stated that "such an abuse was not fraud unless accompanied by an intent to conceal." *Id.* at 56.

11. For a brief discussion of all major cases decided between *Ultramares* and the advent of the current cases, see Solomon, *Appendix A, supra* note 1, at 90 (1968).

12. See note 1, *supra*.

13. Three major cases have received a great deal of publicity. These are:

Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). The purchasers of 5½% convertible subordinated debentures brought suit under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1964), based on errors in the earnings per share figure and current ratio in the registration statement for those debentures. The auditors, as well as the other defendants, were found liable.

United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). Two partners and a manager of the auditing firm which performed the Continental Vending Machine audits were convicted of violations of 18 U.S.C. §§ 1001 and 1341, and § 32 of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1964), for knowingly filing and mailing false financial statements. The charges were based upon misleading footnotes regarding loans from Continental Vending to an affiliate, Valley Commercial Corporation.

Although this was a criminal case, David B. Isbell of Covington and Burling, Legal Counsel for the AICPA, who prepared the amicus curiae briefs for the AICPA in *Simon*, stated:

There is nothing . . . in any of these respects which turns on the fact that the case was criminal rather than civil.

This is to say that the specific implications of the case apply just as much to civil litigation, the risk of civil responsibility, as to the risk of criminal liability.

D. Isbell, *An Assessment of the Implications of the Continental Vending Case*, paper presented to the Spring Meeting of the Council of the AICPA, May 5, 1970.

Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967). This action was brought under § 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a) (1964), and Rule 10b-5 of that Act, 17 CFR § 240.10b-5 (1970), for failure to disclose information discovered subsequent to the close of the Yale Express audit during a management services engagement. While this case has not yet gone to trial, the opinion denying a motion to dismiss for failure to state a claim upon which relief could be granted expressly left open the possibility that there was a cause of action under Rule 10b-5.

Some other major actions are still awaiting trial, such as *Carpenter v. Hall*, Complaint, C.A. No. 68-H-738 (S.D. Tex., filed Aug. 23, 1968), where the trustee of Westec Corporation seeks to hold the auditors liable under both the security acts and common

The auditing profession responded to this threat of liability by accelerating its efforts to improve its standards and techniques,¹⁴ and by searching for other devices to evade the liability.¹⁵ The auditors' concern appears to have been well-founded, and it now appears that the courts have at least tentatively accepted the proposition that auditors can be liable under the securities acts for damages suffered by third-party users of financial statements.¹⁶ Moreover, the reported decisions applied the normal liability standard of the applicable section of the securities laws. Under some sections this means a negligence standard, similar to that for malpractice in other professions,¹⁷ but for other sections the statutory standard is the fairness of disclosure, with liability arising from material misleading statements or omissions¹⁸ in the financial statements.¹⁹

law negligence theories on the basis of alleged misstatements of sales and improper application of the pooling of interests technique. Other major actions have recently been at least tentatively settled, such as the Mill Factors action, a suit brought charging errors in computation of that firm's 1968 income, which has been tentatively settled for nearly \$6 million, with the auditors paying the lion's share. See Wall Street J., September 24, 1970, at 8, col. 3.

Excellent summaries of the first four cases can be found in Reiling & Taussig, *Recent Liability Cases—Implications for Accountants*, J. ACCOUNTANCY, Sept. 1970, at 39.

14. The public accounting profession has erected an extensive procedure for the creation, examination, reconsideration, alteration, and abandonment of accounting principles. See generally AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS [AICPA], ACCOUNTING PRINCIPLES BOARD ACCOUNTING PRINCIPLES (1969) [hereinafter cited as APB ACCOUNTING PRINCIPLES]. Activity in this area has been prolific in recent years, see AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTANT'S INDEX (1921), with its biennial supplements, and *Index*, J. ACCOUNTANCY, published semi-annually in the June and December issues, under "Accounting principles."

15. Examples of the suggested devices include practice as professional corporations and changes in the auditor's report. See notes 50 and 51 and accompanying text, *infra*.

16. See note 13, *supra*.

17. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). In evaluating the requisite standard of care to establish a due diligence defense under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1964), Judge McLean stated: "Accountants should not be held to a standard higher than that recognized in their profession." 283 F. Supp. at 703. The auditors were found liable in that case, but the court determined that they had not completed all of the steps in their own audit program.

18. No liability attaches under the securities acts solely for a misleading statement; the statement must be "material." It is not clear exactly what will be deemed a "material" misstatement, however, and it appears that the standards will differ under different sections of the securities acts. Nevertheless, even under Rule 10b-5, thought to be the least restrictive of the securities acts devices, a misstatement, to be material, must directly bear on the intrinsic value of the security, or at least be such that a reasonable man would attach significance to it in evaluating a possible purchase or sale. See *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Thus, not all of the misleading implications of financial statements will be potential sources of liability. If the subject matter or amount is important, however, it would seem that the misstatements will satisfy the requirement of materiality.

19. In the district court decision in *United States v. Simon*, an action under the

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II. OBJECTIVES OF EXPANDED LIABILITY

The probable reason for the continued viability of the privity defense in the area of accountants' liability, even after the enactment and subsequent judicial extension of the federal securities acts,²⁰ was the strength of the practical arguments supporting the *Ultramares* decision.²¹ In that decision, Judge Cardozo noted:²²

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 indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

For three decades these difficulties seemed to cool the fervor of those who were dissatisfied with the rule, but recently commentators have argued for an expanded auditors' liability in an attempt to improve disclosure to investors and to compensate investors injured by misleading financial statements.²³ Even if the economic desirability of

Securities Exchange Act of 1934, Judge Mansfield stated:

[T]he Court adheres to its view . . . that the jury was entitled, in determining whether or not a defendant knowingly concealed a material fact, to consider and weigh proof as to generally accepted auditing standards and accounting principles in effect at the time of their actions . . . but that proof of such standards and principles is not conclusive on the issue of fraud.

Petitioner's Brief for Certiorari, Appendix B—Opinion of Mansfield, J., at 4b, *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970). The court of appeals decision in that case was to the same effect. Judge Friendly expressly approved the trial court charge to the jury which stated that proof of compliance with generally accepted standards was

evidence which may be very persuasive but not necessarily conclusive that he acted in good faith, and that the facts as certified were not materially false or misleading. *United States v. Simon*, 425 F.2d 796, 805-06 (2d Cir. 1969).

20. See, e.g., §§ 11 and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77q(a) (1964), and § 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a) (1934), which expressly authorize private rights of action. The implied private right of action under § 10(b) of the latter Act, 15 U.S.C. § 78j(b) (1964), and its supporting Rule 10b-5, 17 C.F.R. § 240.10b-5 (1970), was established as early as 1947, in *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

21. See, e.g., *Katsoris*, *supra* note 1, at 196. It should be noted that Judge Cardozo, who wrote the decision in *Ultramares* establishing the privity defense for auditors, had previously authored the opinion in *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916), which first rejected the privity defense as applied to manufacturers.

22. *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

23. See notes 3 & 4 and accompanying text, *supra*.

these objectives could be shown,²⁴ the following analysis suggests that those commentators may have been too quick to reject Cardozo's reasoning, and that expanded liability will probably not achieve either of its stated ends.

A. Compensation of Injured Investors

1. Scope of the Liability

The potential liability of the auditors is as immense today as it was when the *Ultramares* decision was written; for example, one of the "big eight" public accounting firms²⁵ recently reached tentative settlement of a liability suit for \$4,950,000.²⁶ Even this settlement amount

24. The argument for improved disclosure presupposes that the marginal value of additional disclosure is greater than that of the assets sacrificed to pay its costs. Some economists, however, suggest that investors are not using the disclosure they now have, Benton, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements*, in Manne, *supra* note 9, at 23. Other economists, while not questioning the use of information per se, conclude that any available information is almost immediately discounted by the securities markets, so that at least disclosure which is made after some persons are aware of its contents, "stale" disclosure, is of no value. Meltzer, *On Efficiency and Regulation of the Securities Industry*, in Manne at 217; Rooney, *Discussion and Comments on Papers*, in Manne at 106; See generally H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). Since the release of audited financial statements is often delayed for months, the financial statements represent such "stale" disclosure, and under either of the above analyses the utility and hence the marginal value of the improvement in the statements would be relatively low. Some economists reject the above analysis, and suggest that the value of new information is discounted over an extended period of time, W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 44-46 (1965). However, even under this analysis, it appears that the imposition of stricter requirements upon the auditor would simply cause a greater delay before issuance of the financial statements, thereby reducing whatever informational value those statements might otherwise retain.

For a listing of additional possible detriments to investors from a policy of increased disclosure, see Benton, *supra*, at 25.

The goal of restitution of stock market losses might also be questioned. Investors are presumed to recognize that there are certain risks inherent in securities transactions, and they are presumed to have been adequately compensated for those risks by higher returns. See generally Lintner, *A Model of a Perfectly Functioning Securities Market*, in Manne, *supra*, at 143. It may be that the investors are the most appropriate parties to bear that risk, simply because they can exact this compensation.

There are, of course, arguments favoring both objectives. See, e.g., Friend, *The SEC and the Economic Performance of Securities Markets*, in Manne at 185; H. ROSE, *DISCLOSURE IN COMPANY ACCOUNTS* (2d ed. 1965). The requisite economic data has apparently not yet been accumulated for a final evaluation, *Introduction* in Manne at vii, but it appears today that the legal analysts are more certain of the merits of their objectives than are the economists.

25. The so-called "big eight" public accounting firms perform the audits for about 80% of the publicly held companies in the United States. Louis, *The Accountants Are Changing the Rules*, *FORTUNE*, June 15, 1968, at 177, 178. These firms are: Peat, Marwick, Mitchell & Co.; Arthur Andersen & Co.; Ernst & Ernst; Price Waterhouse & Co.; Haskins & Sells; Lybrand, Ross Bros. & Montgomery; Touche, Ross, Bailey & Smart [now Touche, Ross & Co.]; and Arthur Young & Co.

26. Wall Street J., September 24, 1970, at 8, col. 3. An additional \$1 million will be

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is small, however, compared to possible future actions based upon a stock market where major stocks can decline 97% in value over a two-year period,²⁷ and a single man's holdings can be reduced in value by \$444 million in two days.²⁸

Further, the auditors have become no wealthier, and as service businesses whose primary assets are adding machines, personnel, and goodwill, the auditing firms can hardly be expected to pay judgments of any size from their bank accounts.²⁹ It does not appear, however, that *Ultramares* has been forgotten,³⁰ instead, the commentators and plaintiffs' attorneys believe that insurance is the answer to Cardozo's dilemma.

paid by the officers and directors of Mill Factors under the terms of that settlement. In November, 1967, Lybrand settled the civil suit arising out of the Continental Vending Company audits for \$1,960,936. Reiling & Taussig, *supra* note 13, at 49. Both of these settlement amounts were substantially higher than any judgments in any other malpractice area to date; the largest medical malpractice judgment to date is only \$1.5 million. Averbach, *Rx for Malpractice*, 1970 *Ins. L.J.* 69 (1970).

27. Babson, *The Stock Market's Collapse and Constructive Aftermath*, *The Commercial & Financial Chronicle*, June 4, 1970, at 4, 5.

28. The market value of H. Ross Perot's 81% holdings of Electronic Data Systems Corp. decreased over \$400 million during the April 22 and 23rd trading sessions. *Seattle Post-Intelligencer*, April 24, 1970, at A, col. 5. As one practitioner has noted, "The facts of life are that if you have a \$50 million registration statement, the limit of the liability for the CPA is \$50 million, the gross offering price." *CORPORATE FINANCIAL REPORTING, CONFLICTS AND CHALLENGES* 74 (J. Burton ed. 1969). (Burton reproduces the presentations and comments of a symposium conducted in November, 1968, by the AICPA, the Financial Analysts Federation, the Financial Executives Institute and the Robert Morris Associates, the national association of bank loan officers and credit men.)

29. Not all of the commentators agree with this position. Professor Edwin J. Bradley adopted the position that "in the light of the economic maturation of the independent accounting profession, further dependence on . . . judicial solicitude seems ill-advised." Bradley, *supra* note 1, at 921. Bradley also noted that five years earlier *Fortune* had estimated that the "big eight," while employing only 15% of the nation's CPA's, grossed over \$200 million. See also Wise, *The Auditors Have Arrived*, pt. I, *FORTUNE*, Nov. 1960, at 151.

Bradley's argument that the profession is hardly an economic pauper is certainly true, and more recent articles have indicated that the growth hasn't stopped. In 1966, it was estimated that the gross revenues of the "big eight" had increased by 250% over their 1960 levels. Louis, *The Accountants Are Changing the Rules*, *FORTUNE*, June 15, 1968, at 178. A 1970 editorial in that magazine indicated that public accounting revenues have reached \$2 billion per year. Editorial, *FORTUNE*, Aug. 29, 1970, at 98. Nevertheless, public accounting does not generate the amount of income necessary to pay judgments of the scope that Bradley or the other commentators are considering, and as another commentator has pointed out, "it is not socially desirable to have reputable accounting firms ruined financially because of one negligent audit." 41 *ST. JOHN'S L. REV.* 588, 597 (1967).

30. Quoting from an editorial in the *Journal of Accountancy*, one analyst acknowledged that "accounting firms are at a peculiar disadvantage in that the number of people who might rely on an auditor's opinion, and the amount involved, are virtually unlimited. This is not generally true of other professions." 41 *ST. JOHN'S L. REV.* 588, 597 (1967).

2. Insurance

Some commentators were suggesting insurance as the panacea to the threat of large judgments against accountants as early as 1951,³¹ and the more recent analysts seem uniformly satisfied that this really is a satisfactory answer.³² Unfortunately, accountant's liability insurance is not as complete an answer as the commentators have envisioned.

(a) Extent of Insurance Coverage

Normally, errors and omissions insurance provides no insurance against loss on account of any dishonest, fraudulent or criminal act.³³ The exact meaning of "fraudulent" in the context of statements prepared in conjunction with securities transactions is not completely clear,³⁴ but it seems almost certain that some element of affirmative dishonesty or actual intent to deceive would be required to bring the exception into play.³⁵ Even with the restriction upon insurance coverage so limited, however, the civil plaintiffs in the most serious cases, where criminal as well as civil action would be appropriate, will be denied any effective recovery.³⁶

31. 36 IOWA L. REV. 319, 327-28 (1951).

32. See, e.g., Solomon, *supra* note 1, at 86-89; 41 ST. JOHN'S L. REV. 588, 597 (1967).

33. R. RIEGEL & J. MILLER, *INSURANCE PRINCIPLES AND PRACTICES* 709 (5th Ed. 1966). In discussing the accountants' liability policy, the authors state that "[n]o insurance is provided, however, against loss on account of any dishonest, fraudulent, or criminal act." See also Parish, *Professional Liability Insurance*, in *PROPERTY AND LIABILITY INSURANCE HANDBOOK* 478, 488 (D. Gregg & J. Long eds. 1965).

34. For example, despite the express use of the terms "fraud" and "defraud" in Rule 10b-5 of the Securities Exchange Act of 1934, 17 CFR § 240.10b-5 (1970), even as basic a requirement of actual fraud as intent, *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir.), *cert. denied*, 302 U.S. 758 (1937), is being treated as non-essential for an action under that Rule. See *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965). See generally Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969).

Moreover, some states appear to have adopted the federal securities acts' concept of "fraud" in interpreting their own securities acts. See, e.g., *Shermer v. Baker*, 2 Wn. App. 845, 472 P.2d 589 (1970). A judge in such a jurisdiction might have difficulty framing an opinion which simultaneously found "fraud" for purposes of establishing an auditor's liability and rejected "fraud" for purposes of establishing the insurer's liability.

35. This is the case with the policies designed for corporate management in the same situations. 63 Nw. U.L. Rev., *supra* note 5, at 544 n.4 (1968), and the sales brochures prepared by the present administrators of the AICPA-negotiated coverage, see note 43, *infra*, state that they "provide coverage . . . where claims for damages are based on: . . . dishonesty, misrepresentation or fraud, except if made or committed . . . with affirmative dishonesty or actual intent to deceive or defraud." Sales Brochure from Washington Society of Certified Public Accountants to Joseph P. Dawson, February, 1971, on file at *Washington Law Review*.

36. The auditors are aware of this weakness in their insurance coverage. In the civil suit arising out of the Continental Vending Company audits, for example, the auditors

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(b) Price and Availability of Insurance Coverage

Even the limited compensation to injured investors currently available from auditors' liability insurance will probably be short-lived if that liability is significantly expanded. In 1966, the *Wall Street Journal* noted that auditors' malpractice insurance rates had recently risen by 30% or more, and that many companies were refusing to write these policies. More specifically, the article stated:³⁷

[O]f 15 insurers that wrote such coverage relatively freely a year ago, six now handle it only as an "accommodation" for big accounts or "in a limited manner," according to a recent issue of one insurance trade journal. Insurance Company of North America, Philadelphia, now has only one such policy in force in its New York office compared with about 100 five years ago. Many insurers have raised their rates by a third in order to make coverage profitable.

Five days later, the *New York Times* noted that Lloyd's of London, which insures many of the leading companies in the accounting field, had also raised its rates and that various members of the AICPA's Accounting Principles Board had projected that increased liability would raise fees to a prohibitive level for audits.³⁸ Within a short while other writers were reporting that even the continued existence of errors and omissions policies for auditors was in doubt.³⁹

agreed to a settlement, even though the securities acts require actual damages, *see, e.g.*, Securities Act of 1933 §§ 11(e) and 12, 15 U.S.C. §§ 77k, 77l (1964), and Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r (1964), and the financial statement's certification was withdrawn before any actual damages occurred. Isbell, *The Continental Vending Case: Lessons for the Profession*, J. ACCOUNTANCY, Aug. 1970, at 33.

It should also be noted that there are strong policy arguments against extending insurance coverage to criminal actions. Note, *Public Policy and Directors' Liability Insurance*, 67 COLUM. L. REV. 716 (1967), and that some would extend the prohibition to any liability arising under the Securities Acts, Comment, 63 Nw. U.L. REV. *supra* note 5, at 555.

37. *Wall Street J.*, Nov. 15, 1966, at 1, col. 6.

38. *N.Y. Times*, Nov. 20, 1966, Sec. 3, at 1, col. 1. While it might be questionable to accept the opinion of partisans without further question, it appears that there is something to the accountants' fears. A commentator discussing insurance for directors and officers of corporations against the same risks facing the auditors suggested that the cost of such insurance was so high as to be burdensome even to some of the largest corporations. Anderson, *Directors and Officers Liability Insurance*, 47 CHI. B. REC. 31 (1965). If anything, the scope of the risks is greater today, and even the largest auditing firms are not in the same league as the largest corporations, even though they bear the same risks.

39. Even the largest accounting firms, some of which carry liability insurance over \$10 million, were not sure that they would continue to be eligible by 1968. Louis, *The Accountants Are Changing the Rules*, *FORTUNE*, June 15, 1968, at 177. This was in a period of

Advocates of increased liability acknowledged these difficulties, but, in their view, there was little danger of insurance costs becoming absolutely prohibitive.⁴⁰ They argued that since all public accounting firms would be obligated to pay the insurance rates, the increased expense could be spread over the entire business community by an increase in the standard auditing fee.⁴¹ Any suggestion that such an increase might be more than the traffic could bear, or that the policies might not be available at any price,⁴² was apparently rejected.⁴³

It may be too early to tell with absolute certainty which analysts were correct in their prognostications,⁴⁴ but it is not difficult to deter-

unprecedented prosperity. The current situation, which has induced predictions of bankruptcies of major companies by knowledgeable senior executives, Wall Street J., July 3, 1970, at 16, col. 1, and has already seen one major company, the Pennsylvania Central Railroad, go under, presents a much bleaker picture. For additional commentary on the Penn Central case and its repercussions affecting the accounting profession, see Loving, *The Penn Central Bankruptcy Express*, FORTUNE, Aug. 1970, at 104; Wall Street J., Aug. 10, 1970, at 5, col. 1; Letter from Walter E. Hanson, managing Partner of Peat, Marwick, Mitchell & Co., to Louis Banks, Managing Editor of *Fortune*, Aug. 6, 1970, reproduced in FORTUNE, Sept. 1970, at 87-88, with the *Fortune* editorial reply.

40. See, e.g., Katsonis, *supra* note 1, at 232; Note, 22 RUTGERS L. REV., *supra* note 1, at 588; 41 ST. JOHN'S L. REV. 588, 597-98 (1967).

41. See, e.g., 41 ST. JOHN'S L. REV. at 598.

42. One comment suggested that the current data was inconclusive, and

Any existing reluctance to issue such auditors' liability insurance is likely caused by the presently unsettled legal situation, which makes it difficult for insurers to establish a rate structure which will predictably maintain a favorable loss ratio. Comment, 44 WASH. L. REV., *supra* note 1, at 181 n.228. This commentator is undoubtedly correct, but he might be somewhat optimistic in believing that the difficulties will disappear during the foreseeable future. Even if the legal situation were to stabilize, the accumulation of data upon which to base a rate structure, with the magnitude of potential judgments considered, could be an expensive interlude for insurers.

43. Why the senior partners of major public accounting firms and other members of the Accounting Principles Board who expressed worries as to the cost and availability of insurance should be thought unaware of the available alternatives is unclear. One commentator, for example, suggested the employment of risk-pooling techniques, such as experience-rated group policies. Comment, 44 WASH. L. REV., *supra* note 1, at 181 n.228. This device, as far as possible, has been in use by accounting firms since at least the early 1940's, Benson, *Member's Insurance, Fulfillment of a Need*. CALIFORNIA CPA Q., June, 1964, at 22, but in some states it is prohibited. For example, WASH. REV. CODE chs. 48.21, 24 (1969), which permit certain forms of group insurance in Washington, are deemed exclusive; no other forms of group insurance are permitted in Washington. Interview with Russell A. Davis, Executive Director of the Washington Society of Certified Public Accountants, in Seattle, Washington, June 24, 1970.

As a practical matter, there has proved to be no magic in numbers for the auditors, despite the theories. A negotiated policy endorsed by the state societies of over 20 states was summarily terminated just over three years ago, although the liability insurance of essentially all of the public accounting firms of over 20 states is a substantial block of insurance. Davis interview, *supra*. Although the AICPA was eventually able to negotiate a replacement policy, it does not appear overly secure, since the original administrators of that program have already been replaced. THE CPA, July-Aug. 1970, at 9.

44. Part of the difficulty in this area arises from the fact that, while data on the rates, self-insurance amounts, and coverage offered to smaller accounting firms is generally

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mine the present trend. A July, 1970 article by a partner in the Executive Office of Haskins & Sells noted:⁴⁵

In some instances premium costs have tripled over the past several years, while self-insurance, or the deductible portion under the policies, has grown over 50 times.

The 1971 figures reflect a continuation of these geometric trends.⁴⁶ Moreover, a May, 1970 article noted that the number of major casualty insurers in the United States still writing professional liability insurance for public accountants was down to two.⁴⁷ It seems, therefore, that despite overwhelming increases in premium and deductible amounts, insurers are abandoning the market.⁴⁸

Consequently, while errors and omissions insurance provides a "deep pocket" for the payment of some judgments today, insurance is not as complete an answer as previous analysts assumed, and the present trends indicate that even the current limited coverage may not remain available much longer. It is likely that auditors will not be able to satisfy judgments in favor of third parties for any appreciable length of time.

B. Improvement of Disclosure

The legal commentators who advocated an expanded liability of auditors to users of financial statements assumed that the threat of liability would force the auditors to eliminate misleading financial disclosures.⁴⁹ Those writers were probably correct at least in assuming

available to members of the sponsoring professional societies, see sales Brochure, *supra* note 35, information on the individually-negotiated policies of the larger accounting firms is not readily available.

45. Weyrich, *Exposure to Professional Liability*, 1970 NEW YORK CERTIFIED PUBLIC ACCOUNTANT 556, 561 (July, 1970).

46. One analyst states that insurance premiums for 1971 have again tripled over the 1970 levels for some firms among the top twenty in size, and that deductible amounts have increased as much as 900% between the two years. Interview with W. Thomas Porter, Associate Professor of Accounting and Director of Executive Development Programs at the University of Washington, in Seattle, Washington, Nov. 26, 1970.

47. Bakay, *A Review of Selected Claims Against CPA's*, J. ACCOUNTANCY, May 1970, at 54. See note 37 and accompanying text, *supra*.

48. See Weyrich, *supra* note 45, at 561, where the author asserts:

This enormous insurance cost, despite the increasing amount of self-insurance risk being assumed by the accountants, clearly reflects the insurance underwriters' evaluation of the problem. Moreover, it is becoming apparent that insurance underwriters are losing interest in this type of coverage—at any price.

49. See, e.g., Note, 22 RUTGERS L. REV., *supra* note 1, at 588; Comment, 44 WASH. L. REV., *supra* note 1, at 177.

that there would be no alternative means open to the auditors for avoiding the liability; such devices as practice in corporate form⁵⁰ and changes in the auditors' opinion⁵¹ apparently will be ineffective

50. In December, 1969, AICPA members approved an amendment to the Code of Professional Ethics to permit practice in incorporated form. J. ACCOUNTANCY, Feb. 1970, at 7. Although an article dealing with the legal profession indicated that professional incorporation had been legalized in 49 states as of mid-1970, Wall Street J., July 29, 1970, at 1, col. 5, it appears that despite what some auditors believe, *see, e.g.*, CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES 74 (J. Burton ed. 1969), professional corporation status will not normally shield auditors from complete liability for losses due to negligent or wrongful acts or misconduct in the performance of professional services. 45 WASH. L. REV. 827, 830 (1969). Incorporation is not a malpractice buffer under the usual state statute. *See, e.g.*, WASH. REV. CODE § 18.100.070 (Supp. 1970).

It is arguable that the California professional corporation laws, CAL. BUS. & PROF. CODE §§ 5157, 13400-10 (West 1962), permit limited malpractice liability for professional corporations which maintain adequate malpractice insurance coverage. Even if the argument were accepted, however, it would be of little solace to auditors, since it is the potential unavailability of such insurance which prompts the search for alternatives. For a discussion of the possible application of the California statute to the public accounting profession, written prior to the adoption of CAL. BUS. & PROF. CODE § 5157, *see* Neider & Tims, *CPA Incorporation—Why Not?*, 10 SANTA CLARA LAWYER 64 (1969).

51. *See, e.g.*, Editorial, *The Specter of Auditors' Liability*, J. ACCOUNTANCY, Sept. 1965, at 33. This proposal suffers from numerous practical problems. There are technical objections to the general-purpose use of a longer, "clearer" opinion, such as the possibility that exceptions taken by the auditors will tend to be buried, rather than spotlighted. *See* H. STETTLER, AUDITING PRINCIPLES 622-29 (2d ed. 1961). There are substantial pressures from users of financial statements, (*Accountant's Legal Liability*, J. ACCOUNTANCY, July 1968, at 58. (excerpts from an address by Walter J. Coakley of Sullivan & Cromwell before the Ohio Society of CPA's in Cleveland, Ohio, Oct. 19, 1967); *see generally* CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES (J. Burton ed. (1969)) and from auditors themselves, (*See, e.g.*, Wyatt, *supra* note 1, at 357 (1968)) against any changes which appear to reduce the extent of the auditor's responsibility. Recent SEC pronouncements, such as Accounting Series Release No. 90, March 1, 1962, and Accounting Series Release No. 115, Feb. 19, 1970, suggest that attempts to hedge through rewording of the opinion will bring the auditors into violation of SEC Reg. S-X, 17 C.F.R. § 210 (1971), even though the requirements of that resolution are not expressly exclusive, with all of the resulting calamitous effects for both auditor and client. *See* note 127, *infra*.

More importantly, it is unlikely that changes in the opinion, short of an express disclaimer of the specific liability in question, would be legally effective to shield the auditors from liability. The opinion currently used by auditors already makes it clear that there is no attempt to guarantee the accuracy of statements, COMMITTEE ON AUDITING PROCEDURE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS [AICPA], AUDITING STANDARDS AND PROCEDURES 57 (Statements on Auditing Procedures No. 33, 1963) [hereinafter cited as S.A.P. No. 33], but this has been ineffective in preventing users of financial statements from developing the impression of "an accountant's report as something like an insurance policy," *Accountants' Legal Liability, supra*, at 58, or in preventing liability in the recent cases, *see* note 13 and accompanying text, *supra*. The suggestion that nothing short of an express disclaimer will be effective arises from the very close analogy between the auditor's position and that of manufacturers, and the judicial trend toward requiring such express disclaimers, *see, e.g.*, Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960), if in fact any disclaimer at all is to be effective. *See* Ulmer v. Ford Motor Co., 75 Wn. 2d 522, 452 P.2d 729 (1969), for a case adopting the notion of strict liability of manufacturers which effectively allows no disclaimer in some situations. Although the courts will probably be satisfied with nothing less than express disclaimers, however, there are strong doubts that such disclaimers could be given effect if they were

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to shield the auditors from the expanded liability. Unfortunately, the commentators seem to have seriously underestimated some of the roadblocks to the improvement of disclosure.

1. *Communication Difficulties*

The auditor's communication of the status of a business entity is limited to the financial statements, with their footnotes, and his opinion on them. It is extremely difficult, however, to communicate the status of a business entity and the results of its operations over a period of time through financial statements and footnotes. At least two major factors contribute to this difficulty, and it may be that both are insurmountable.

First, the language and symbolism employed in financial statements is different and more complex than the language employed in everyday communication. There are numerous terms of art which carry meanings different from those normally attached to the same terms by laymen,⁵² and sometimes even different from the normally envisioned technical meanings of the words.⁵³ Like other technical languages, it is a type

used. The auditors' expanded liability is based upon a statutory standard, *see* notes 16-19 and accompanying text, *supra*, and it may be that there is no effective way to disclaim a liability which arises out of violation of the federal securities acts. *See* James, *Statutory Standards and Negligence in Accident Cases*, 11 LA. L.R. 95 (1950); *see also* Gregory, *Breach of Criminal Licensing Statutes in Civil Litigation*, 36 CORNELL L.Q. 622 (1951). The federal securities acts are essentially criminal regulatory acts. *See* Securities Act of 1933 § 24, 15 U.S.C. § 77x (1964), Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff (1964). The express terms of § 14 of the Securities Act of 1933, 15 U.S.C. § 77n (1964) and § 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(a) (1964), making "any condition, stipulation, or provision binding any person to waive compliance with any provision of the acts themselves or any rules or regulations thereunder" void, coupled with the attitude of the SEC towards even attempts at indemnification agreements reflected in Note to Rule 460 of the Securities Act of 1933, 17 C.F.R. § 230.460 (1971), indicate that the legislative intent to allow a defense through express disclaimers of liability could not be found by the courts.

In any event, there is no question as to the SEC's position on express disclaimers by auditors. SEC Accounting Series Release No. 7 (1938) lists a "disclaimer of responsibility on the part of the certifying accountants with respect to matters clearly within their province" among deficiencies encountered in filed financial statements, and deficiencies mean ineffective reports and registration statements. *See* note 127, *infra*. A disclaimer will guarantee a client financial calamity.

52. An example is the term "credit." *See* note 122 and accompanying text, *infra*, for a discussion utilizing a common interpretation of the term "credit." Whatever that term connotes to readers, it is almost certainly not the amounts representing the liabilities and equity of a business enterprise, which is the meaning of the term in the context of financial statements. As an additional sidelight, it is probably fair to predict that no one other than those trained in preparing financial statements, and perhaps not all of them, would equate the term "deferred credit" with received-but-uneared revenue.

53. An example is the term "reserve." While the normal connotation of the term is an

of shorthand, employing single terms to represent entire concepts which are clear to the preparer of the statements but vague to the users.⁵⁴

Like all technical languages or vocabularies, the language of accountants has come under harsh fire at times,⁵⁵ both from within and without the accounting profession.⁵⁶ The normal rebuttal to attacks on technical languages is that the terminology expedites activity among those familiar with the language, as is the case, for example, with medical jargon. That rebuttal is valid only when those who are unfamiliar with the language have no need to understand the attempted communications. Since the statements are intended for use and understanding by the general populace,⁵⁷ the convenience of preparers and auditors is not a sufficient answer.

Unlike a general statement which can ordinarily be made in clear, simple terms, however, a specific financial statement, covering every technicality and carrying exactly the specific message intended, can more often than not be made only in technical terms, carrying explicit

accumulation held for some specific purpose, the technical usage of that phrase until recently denoted simply an amount treated as an expense and representing a decrease in value of an asset account or an estimated liability. In the case of the "reserve for depreciation," for example, the term was intended to denote a systematic reduction in value to apportion the cost of an asset, but not to indicate the accumulation of an equivalent amount for replacement of the asset. The inherent confusion in this usage became obvious to preparers of financial statements, and modern statements replace this term with other terms, such as "allowance for depreciation" or "accumulated depreciation." See W. MEIGS, C. JOHNSON & T. KELLER, *INTERMEDIATE ACCOUNTING* 130 (1963). Elimination of the problems inherent in a technical language is apparently not a simple task.

54. See generally AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS [AICPA], *ACCOUNTING TERMINOLOGY BULLETINS* Nos. 1-4, in 2 A.P.B. *ACCOUNTING PRINCIPLES*, *supra* note 14, at ¶ 9501.

55. This criticism seems justified. See Lehnberry, *THE U.S. ARMY AUDIT AGENCY BULL.*, Dec. 1963, at 34-40; Garbutt, *Students' Understanding of Accountancy Terms*, *ACCOUNTANCY*, Mar. 1964, at 203-08. In fact, even the *Wall Street Journal* has difficulty deciphering some financial statements. Stabler, *The Conglomerates: Even the Accountants Find Some Financial Reports of Combines Baffling*, *Wall Street J.*, Aug. 5, 1968, at 1, col. 6.

56. A former Commissioner of the SEC stated, "I simply mean to suggest that a lay reader can read perfectly clear English and an orderly presentation of financial data and end up without a comprehension of the message sought to be conveyed." Address by Jack M. Whitney II before the Washington, D.C. Society of Investment Analysts, Feb. 5, 1963, *quoted in* *J. ACCOUNTANCY*, March 1963, at 9. See also Watson, *Do Financial Statements Communicate?* *J. ACCOUNTANCY*, April 1969, at 59; AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *ACCOUNTING TERMINOLOGY BULLETINS*, Introduction, in 2 A.P.B. *ACCOUNTING PRINCIPLES*, *supra* note 14, at ¶ 9504.

57. See H. STETTLER, *AUDITING PRINCIPLES* 627 (2d ed. 1961) for a discussion of the use of technical jargon by accountants. See also M. CHARNLEY, *REPORTING* 181 (1959), for comments on the use of technical jargon in an analogous field, newswriting.

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denotations. Legislative and other legal drafters find themselves confronted by this dilemma which often results in "incomprehensible" legal documents and legislation;⁵⁸ preparers of financial information and their auditors face the same problem. No one yet has proposed a real solution to this problem,⁵⁹ and so long as it remains it will be a barrier to full disclosure.

The second major difficulty in communicating through financial statements and footnotes comes from the necessity for summarization.⁶⁰ In part, this problem is an extension of the difficulties inherent in the use of accounting language; the use of any language indicates a summarization of the available information,⁶¹ and the language of accounting is still further limited in that it makes no attempt to describe all of the characteristics of a business entity or business events, but instead attempts to communicate only the monetary magnitude of business events.⁶² Even beyond the limitations inherent in the language, however, is the absolute limit upon the data which can be communicated in the statements themselves; they must be relatively short to be useable at all.⁶³ Financial statements and their footnotes

58. See generally D. MELLINKOFF, *THE LANGUAGE OF THE LAW* (1963).

59. Some commentators have suggested that the solution to the difficulties in communicating through accounting language, if a solution exists, will be achieved by narrowing still further the denotations of the technical terms. In effect, they are arguing that the language is not technical enough. See, e.g., Garbutt, *Problems in Accounting Terminology*, *THE COST ACCOUNTANT*, April 1964, at 119-24; Watson, *Do Financial Statements Communicate?* *J. ACCOUNTANCY*, April 1969, at 59.

There may be some validity to the suggested proposals; the language may not be, in fact, as technical as the most sophisticated users would like. Narrowing the definition of terms and creating a still more technical language, however, would do little to help the average users of financial statements; their only apparent benefit from such a proposal would hinge upon a massive program of education of users in the technical language, and such a program is beyond the unilateral capability of the public accounting profession, if it is feasible at all.

The auditors are caught in the middle; making the language more technical will only compound the problems of most users, but using a less technical language will cripple their ability to communicate with any accuracy through the medium of financial statements. *But see* Address by Jack M. Whitney II before the Washington D.C. Society of Investment Analysts, Feb. 5, 1963, *quoted in* *J. ACCOUNTANCY*, March 1966, at 9.

60. Some of the difficulties in selecting and phrasing material for disclosure, under today's interpretations of Rule 10b-5, 17 C.F.R. § 240.10b-5 (1971), are considered in Judge Moore's dissent to *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). The dilemma which Judge Moore saw that decision as placing upon management is in many respects repeated in the preparation of financial statements.

61. See, e.g., D. BERLO, *THE PROCESS OF COMMUNICATION* 26 (1960); S. CHASE, *POWER OF WORDS* 139-40 (1953).

62. Li, *Semantics of Communication Theory and Accountancy*, *J. ACCOUNTING RESEARCH*, Spring, 1963, at 102.

63. SECURITIES AND EXCHANGE COMMISSION, *DISCLOSURE TO INVESTORS—A RE-*

necessarily only summarize the relevant data, and it seems impossible that such a summary, or any of the data within it, could be other than misleading to some degree.⁶⁴

2. *Control of Financial Statement Content*

Even if "improvements" in the quality of audits and reports provided some protection against the expanding liability of auditors, utilization of that protection would require that the contents of financial statements be under the auditors' control. They are not; the financial statements are management's responsibility.⁶⁵ These statements are the report of management on its stewardship of the financial entity, and management has made it clear that they desire greater latitude, not less latitude, in the preparation of these reports.⁶⁶

Arguments have been advanced that management's performance in this area renders it, by and large, unfit to continue to perform the function of reporting.⁶⁷ Possibly there is some justification for this view,⁶⁸ but there are equally strong arguments for management's position. Management is the only one who *can* prepare financial statements. A report on financial position and operations requires the development and operation of a system within the organization to accumulate and organize the information for the report. Only management can develop and operate this system; certainly an auditor could not do so and remain independent.⁶⁹ In addition, the summary form is obviously neces-

APPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (THE WHEAT REPORT) 41-43 (1969).

64. See note 18, *supra*.

65. This includes the footnotes to the financial statements. Bullock, *Footnotes in Financial Statement Preparation*, J. ACCOUNTANCY, July 1956, at 39.

66. See generally CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES (J. Burton ed. 1969).

67. See, e.g., Kripke, *Conglomerates and the Moment of Truth in Accounting*, CONGLOMERATE MERGERS AND ACQUISITIONS: OPINION & ANALYSIS, 44 ST. JOHN'S L. REV. 791 (Special Ed. 1970); Loving and other authorities cited in note 39, *supra*.

68. Without exception, the cases where auditors have been made parties to suits alleging misstatements in the financial statements (see note 9, *supra*) present situations where management's performance of its stewardship and reporting functions have appeared inadequate, and these cases hardly represent an exhaustive listing of that phenomenon.

But see CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES 4 (J. Burton ed. 1969). The users, as well as the preparers, of financial statements agreed that there was not as acute a problem with people taking advantage of differing principles in preparing those statements as many outsiders believed.

69. See, e.g., Appendix to Address by Donald C. Cook, Vice-Chairman of the Securities and Exchange Commission, before the AICPA, Oct. 3, 1950, reproduced at 4 CCH FED.

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sary for the report, and a report which is to be a summary requires decisions on the inclusion or exclusion of information. Only management has the knowledge required to make those decisions. Moreover, the SEC, which has the final word in the dispute, has made it clear that it regards the statements as management's responsibility.⁷⁰

3. *Suggested Solutions to the Disclosure Problems*

Most analysts have argued that the difficulties outlined above can be overcome by the application of "better accounting principles,"⁷¹ using the phrase broadly to mean improved accounting principles *and* improved auditing and reporting standards.⁷² Neither, however, appears to provide a practical solution to the problem of misleading disclosure.

(a) *Improved Accounting Principles*

When accountants speak of generally accepted accounting principles, they are speaking of the various acceptable assumptions, procedures, and techniques⁷³ for the preparation of financial statements.⁷⁴ They are speaking of the ways of stating financial data within the limitations established to prevent reporters from accidentally or intentionally straying too far in their portraits of a business entity. The position of

SEC. L. REP. ¶ 68,51541, .62-64 (1970). Accountants who had set up and operated accounting systems for clients were deemed not independent for purposes of audits under the securities acts.

70. SEC Accounting Series Release No. 62 (1947) states:

Financial statements filed for the registrant and its subsidiaries have been recognized by this Commission and by public accountants generally as representations of management upon whom rests the primary responsibility for their propriety and accuracy.

71. See, e.g., Bradley, *supra* note 1, at 898; Wyatt, *supra* note 1, at 331; 23 VAND. L. REV. *supra* note 1, at 813-14.

In discussing the difficulties inherent in defining the term accounting principles, one writer notes that there are at least twenty common words in use with the same meaning as "principles"; the problem, of course, is that the connotations of each of these words is significantly different. They may all mean "principles," but they are not synonyms. McMonnies, *The Importance of Being English*, THE ACCOUNTANT'S MAGAZINE, Feb. 1967, at 74. See also AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TERMINOLOGY BULLETIN No. 1, in 2 A.P.B. ACCOUNTING PRINCIPLES, *supra* note 14 at ¶ 9505.

72. S.A.P. No. 33, *supra* note 51, at 15-17 states these standards.

73. For a comprehensive listing of alternative techniques included among generally acceptable accounting principles, see P. GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 373-79 (Accounting Research Study No. 7 1965).

74. S.A.P. No. 33, *supra* note 51, at 40.

the commentators who actually attack "accounting principles" is normally that the range of these permissible alternatives, either as a whole or within particular industries, should be narrowed.⁷⁵

This approach is unlikely to contribute much to the elimination of misleading statements in financial statements, however. Even if it were possible to narrow the spectrum of generally accepted accounting principles, the solution may be self-defeating. Every business entity reflects a different economic reality, and the imposition of narrower limits upon financial reporters in a search for a less misleading financial statement is just as likely to produce a more misleading financial statement.⁷⁶ Furthermore, there is no general agreement as to which generally accepted accounting principles are undesirable. Since both opponents and proponents of any given principle can present factual patterns showing either the accuracy or complete misstatement possible under that particular principle, they have made little progress.⁷⁷

75. See, e.g., Bradley, *supra* note 1, at 898. Many accountants have also expressed this position. See note 14, *supra*.

76. While a narrowing of the range of alternative methods available for reflecting economic reality may prevent extreme misstatements, it may also prevent extremely accurate statements. Carried anywhere near its logical extreme, the narrowing of generally accepted accounting principles would so limit reporters that no financial statements would properly reflect the status of the described entity. CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES 4 (J. Burton ed. 1969). Surprisingly, the users as well as preparers of financial statements who were involved in the symposium indicated that they felt abuse in this area to be relatively infrequent.

77. One example is recorded in R. AMORY & C. HARDEE, MATERIALS ON ACCOUNTING 9-16 (1968 Supp. D. Herwitz). General Motors and Standard Oil of New Jersey each sold their one-half interests in the Ethyl Corporation, with net profits totalling nearly \$130 million. GM included its share of the gain in 1962 net income, while Standard Oil of New Jersey credited its gain directly to surplus. Since then, the Accounting Principles Board has designed a system for reporting such gains which is intended to eliminate the problem. See ACCOUNTING PRINCIPLES BOARD, AICPA, OPINION No. 9 (1966). Unfortunately, because both sides had logical arguments supporting their position, the APB was able to do no more than say that both a figure including the gain and a figure excluding the gain should be shown. That solution really does not solve the problem.

A more recent example is the debate over "pooling of interests" in merger cases. Favoring the retention of "pooling" as an acceptable technique, see Lauer, *The Case for Poolings*, 41 ACCOUNTING REV. 65 (1966); Schrader, Malcolm & Willingham, *In Support of Poolings*, FINANCIAL EXECUTIVE, Dec. 1969, at 54; Snavely, "Pooling" is Good Accounting, FINANCIAL ANALYSTS J., Nov.-Dec. 1968, at 85. Opposing that principle see Brillhof, *Distortions Arising from Pooling-of-Interests Accounting*, FINANCIAL ANALYSTS J., March-April 1968, at 71; Gormley, *The Pooling of Interests Principle of Accounting: A Lawyer's View*, 24 BUS. LAW. 407 (1968). With this background, it is hardly surprising that when the Accounting Principles Board attacked the problem at the end of 1969 there was little prospect held out for major action; even the SEC was reported backing off from the problem, Wall Street J., Dec. 3, 1969, at 40, col. 1. Perhaps it is amazing that the Board took even the action that it did. See Wall Street J., Aug. 3, 1970, at 4, col. 3; ACCOUNTING PRINCIPLES BOARD, AICPA, OPINION No. 16 (1970).

(b) *Improved Auditing and Disclosure Standards*

Some commentators have recognized the futility of attacking misleading disclosure by attacking accounting principles, recognizing that it is not the principle itself, but the application of the principle to a particular business entity, which determines whether the resulting statement will be misleading.⁷⁸

These analysts argue that the problems of communication and control can be overcome through the improvement of what the accountants term "auditing standards,"⁷⁹ including the standards of disclosure.⁸⁰ The gist of this argument is a demand for auditing and reporting techniques which will create more certainty from the audit, more accuracy in the reported figures, and an explanation in the report which will leave no material data uncommunicated.

Taken literally, this argument is circular; in effect, the analysts are saying that the problems inherent in improving disclosure can be solved by requiring better disclosure. All of the previously suggested constraints work against the performance of the necessary work and preparation of the desired statements.⁸¹ The auditors maintain that additional accuracy, certainty, and explanation are not possible within the present scope of their audits.⁸² They maintain that they can't work magic.⁸³

78. See, e.g., Comment, 44 WASH. L. REV., *supra* note 1, at 146. This approach appears to coincide with that of the SEC, or at least of one commissioner. Woodside, *A Review of the Commission's Administrative Policies Relating to Financial Reporting Under the Securities Acts*, J. ACCOUNTANCY, Feb. 1966, at 49, 52.

79. See note 72, *supra*.

80. See, e.g., Comment, 44 WASH. L. REV., *supra* note 1, at 148-51, which argues for improved disclosure standards.

81. See notes 52-70 and accompanying text, *supra*.

82. Of course, this is not literally true. Some techniques have been proposed, attempted, and apparently proved sound, but not uniformly adopted throughout the profession. One notable example is the use of statistical sampling and Bayesian probability analysis in auditing. See, e.g., AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AN AUDITOR'S APPROACH TO STATISTICAL SAMPLING (1967-1969); Tracy, *Bayesian Statistical Confidence Intervals for Auditors*, J. ACCOUNTANCY, July 1969, at 41; Trentin, *Sampling in Auditing—A Case Study*, J. ACCOUNTANCY, March 1968, at 39. One article considering expanded auditor's liability suggested that universal use of these techniques would contribute to the elimination of misleading statements, and that conclusion is probably correct. Reiling & Taussig, *supra* note 13, at 39. It must be recognized, however, that the use of statistical techniques is hardly a complete answer. Many of the accounts analyzed in an audit do not readily lend themselves to statistical sampling, either because the absolute value of each item is too great or because the total population is too small to permit a meaningful and significant statistical sample to be drawn and analyzed. Furthermore, confidence limits in Bayesian analysis include a factor which is arrived at through educated guesses. Misleading statements, with their resulting liability, arise in

An alternative interpretation of the analysts' position avoids the necessity for prestidigitation, however. Greater accuracy, certainty, and explanation could all be achieved by the relatively simple expedient of drastically expanding the scope of the audit, and there are no theoretical barriers to doing more work. Probably this is the course which previous commentators had in mind. Unfortunately, this approach faces a practical problem. Although the accounting profession has frequently indicated a desire to expand its attest function,⁸⁴ it can't realistically do so. The public accounting profession has a manpower shortage.

John L. Carey, the past AICPA Executive Director, has pointed out:⁸⁵

[C]ountless CPA's in large and small firms have said that their greatest problem is getting enough qualified people to do the work that needs to be done.

The 1969 president of the AICPA headed his list of problems facing the profession that year with the increasing shortage of college graduates coming into the profession.⁸⁶

The exact scope of the manpower shortage in public accounting has never been made completely clear.⁸⁷ The best estimates indicate, how-

situations where those educated guesses were incorrect, and statistical techniques will make those guesses no more accurate. *See generally* H. BIEMAN, C. BONINI, L. FOURAKER & R. JAEDICKE, *QUANTITATIVE ANALYSIS FOR BUSINESS DECISIONS* (Rev. Ed. 1965).

83. The accounting literature has continually pointed out that the auditing procedures are limited tests of a system and its results, and that the scope of these tests is inadequate to permit any conclusion beyond that of the fairness of the statements as a whole. *See, e.g.*, NATIONAL CONFERENCE OF BANKERS AND CERTIFIED PUBLIC ACCOUNTANTS, *THE AUDITOR'S REPORT—ITS MEANING AND SIGNIFICANCE* (1967).

84. *See, e.g.*, Imke, *The Future of the Attest Function*, *J. ACCOUNTANCY*, April 1967, at 51, where the author stated that 89% of the accountants surveyed believed that the attest function should be expanded.

85. Carey, *How to Attract Young People*, *CPA*, March 1964, at 4. *See also* Wall Street J., February 4, 1969, at 1, col. 5.

86. Kent, *The Accounting Profession and Our Firm: Past, Present and Future*, *THE ARTHUR YOUNG J.*, 75th Anniv. Ed., Spring-Summer 1969, 4, at 10. The significance of the statement is heightened when it is noted that the "big eight" accounting firms, and apparently most others in public accounting, are hiring only college graduates. *N.Y. Times*, Nov. 20, 1966, at 14, col. 7. There is little question that the bare undergraduate degree is the minimum educational requirement today, as the complexity and scope of the economy and of the auditor's role within it has undergone tremendous expansion in recent years. In fact, by mid-1968, 29 states had made a college degree a prerequisite for the CPA certificate. *J. ACCOUNTANCY*, Aug. 1968, at 10.

87. One survey on the requirements for accountants in a current year is being performed currently by Mr. Leo Herbert of the U.S. General Accounting Office, and another is planned this year by the AICPA. Letter from Maria J. Salvemini, Staff Assistant in the Examinations Division of the AICPA, to Joseph P. Dawson, July 8, 1970.

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ever, that the demand⁸⁸ for accounting-trained personnel in the public accounting firms alone will equal approximately 80% of the total available supply⁸⁹ of such people in any current year,⁹⁰ that only about 60% of the total number of accounting-trained people have the minimum qualifications for the practice of public accounting,⁹¹ and that, after allowing for the competition of business and government for the available people, the public accounting profession cannot anticipate obtaining more than 50 percent of the available new personnel,⁹² or,

88. One of the "big eight" public accounting firms projected a demand just among public accounting firms across the country for 15,000 new people in 1969. Schornack, *The Arthur Young People*, THE ARTHUR YOUNG J., 75th Anniv. Ed., Spring-Summer 1969, 64, at 69. Guy Trump's independent estimates were 14,000 in 1969, 15,000 in 1970, and 20,000 in 1975. Letter from Guy W. Trump, Director of Education of the AICPA, to Joseph P. Dawson, June 5, 1970 [hereinafter cited as Trump Letter].

89. In 1968, 18,075 undergraduate degrees in accounting were earned in the United States. U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 131 (1970). While the equivalent figures in every preceding year were over 2,000 lower, and reflected no major increments, and while the AICPA Director of Education estimated that there would be only 16,000 trained people available to meet the 1970 personnel requirements in accounting, Trump Letter, *supra* note 88, the higher, more conservative figure of 18,000 is used in this analysis as the annual available supply.

90. This percentage is based upon an assumption of a supply of 18,000 people and a demand among public accounting firms for 15,000 people annually. See notes 88-89, *supra*.

91. Trump Letter, *supra* note 88. Mr. Trump indicated that of the 16,000 accounting-trained people available to meet the personnel requirements of accounting in 1970, only 10,000 might be reasonably well-qualified for the accounting profession. He qualified this estimate, however, by noting that the evaluation of the qualifications of prospective public accounting personnel is extremely difficult.

92. A 1961 survey of Drake University accounting graduates since 1921 found only 25 percent of those graduates working in public accounting. THE ACCOUNTING REV., Jan. 1961, at 121. A 1964 survey in Louisiana suggested that the accounting profession could anticipate obtaining 60 percent of the available accounting-trained personnel. Tracker, *A Study of the Successful CPA Candidates in Louisiana, 5 Sittings*, LA. CPA, May 1964, as cited in Burnam, *Obtaining and Keeping Personnel*, LA. CPA, July 1964, at 32. More recently Carpenter & Strawser, in *Job Selection Preferences of Accounting Students*, J. ACCOUNTANCY, June 1970, at 84, 85, arrived at the following table of Job Preferences of undergraduate accounting majors by academic average:

Grade-Point Average*	Number of Respondents	National CPA Firms	Local CPA Firms
3.50 or above	9	5	4
3.00 to 3.49	26	19	7
2.50 to 2.99	49	32	17
Below 2.50	35	28	7
Totals	119	84	35

*(A-4.00; B-3.00; C-2.00)

The difficulty with the later figures, as pointed out by the preceding table, is that no correction has been made in recognition of the quality standards of the accounting profession. Arbitrarily assuming a cut-off above the lowest level in the preceding table as an appropriate correction produces a figure of roughly 50 percent.

in other words, hardly more than 60 percent of the new people required simply to maintain today's level of services.⁹³ Moreover, there seems no reason to anticipate any major shift in the number of accountants entering public accounting in the near future.⁹⁴

The public accounting profession has been actively attempting to alleviate its unique manpower and recruiting problems for several years.⁹⁵ The profession requires top-caliber practitioners, but is not well-known⁹⁶ and is an element of the business field, which is becoming

93. See note 88, *supra*. The percentages do not completely take into account the trend in the public accounting profession toward hiring and training people with advanced degrees. One of the "big eight" hired 40 percent of its new personnel in a recent year from among graduate students, N.Y. Times, Nov. 20, 1966, at 14, col. 7, and a recent study indicated that public accounting led the field in career choices of holders of M.B.A. degrees from the "Big Eight" graduate business schools, with 10.8 percent of those graduates electing public accounting as their career choices. MBA ENTERPRISES, INC., MBA RECRUITMENT, Table 24 (1968), cited in Schornack, *supra* note 88, at 70-71. Unfortunately, this trend is of little solace to those looking at the plight of auditing, as these people are generally being employed in the management services departments of the accounting firms, rather than in auditing. They do not provide, on the whole, a manpower pool from which to draw auditors.

94. Professor Howard Stettler recently predicted that the increased use of the computer for clerical tasks by industry would result in nearly all accountants being employed in public accounting by the year 2000. CPAs/Auditing/2000 ±, J. ACCOUNTANCY, May 1968, at 55. Other prognosticators, on the other hand, predict an even greater industrial demand for people with training in accounting and finance. J. ACCOUNTANCY, June 1970, at 24.

Perhaps the most efficient way in which to predict the probable trend in the need for public accountants is an examination of the possible direction of the national economy for, as Ralph Kent suggested, the growth of the public accounting profession, subject only to the availability of the necessary personnel, can be expected at least to follow the growth of the economy. Kent, *The Accounting Profession and Our Firm: Past, Present and Future*, THE ARTHUR YOUNG J., 75th Anniv. Ed., Spring—Summer 1969, at 9.

95. Numerous recruiting programs have been suggested, evaluated, and implemented at all levels. A number of these are discussed in *Attraction of Personnel to Public Accounting Firms*, J. ACCOUNTANCY, June 1969, at 57. Numerous other programs have been publicized in various professional publications. See, e.g., THE WASHINGTON CPA, Nov., 1970, at 3. See generally AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTANT'S INDEX (1921), and the ACCOUNTANT'S INDEX SUPPLEMENT(S) through 1968. Reports of success in these programs is less frequent, however. For discussion of one relatively successful program at the post-graduate level, see Nw. U. BUS. REP., Spring, 1969 at 26. As a result, some of the most recent programs go quite far afield. The AICPA has even reached the point of developing a one-minute television spot intended as a public-service advertisement of the profession. For complete details, see Letter from Martin Rosenberg, AICPA Staff Assistant, State Society Relations, to state society directors, June 1970, on file with the Washington Society of Certified Public Accountants.

96. John L. Carey summed up the problem which the profession faces in this area when he stated:

Few outstanding high school students who are preparing for college are attracted to accounting as a career at age sixteen or seventeen—partly because their teachers and guidance counselors don't know how accounting functions in modern society nor what opportunities it offers for able young people. Carey, *How to Attract Young People*, CPA, March 1964, at 4. See also Commission VI—

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increasingly unpopular among students.⁹⁷ Students who are trained in accounting are frequently unwilling to undergo the traditional "apprenticeship" as junior accountants,⁹⁸ and many people who do enter public accounting do so because they regard it as a springboard to other positions.⁹⁹ Finally there is an extremely large personnel turnover in public accounting,¹⁰⁰ and the competition for selected students between auditors and corporate personnel specialists is frequently a terribly unbalanced contest.¹⁰¹

The public accounting profession today faces an increasing shortage of adequately trained personnel to accomplish the current volume of work.¹⁰² A major 1970 study predicts that no change can be anticipated.¹⁰³ An expanded attest function is therefore a practical impos-

Placement, American College Personnel Association Study Commission, *What ARE the Attitudes of Students toward Occupations*, J. COLLEGE PLACEMENT, Dec. 1966, Jan. 1967, at 27.

97. The overall enrollment in business courses is not increasing rapidly enough to meet the demand for graduates. Arnett, *The Recruitment Problem: A Proposed Solution*, THE MICHIGAN CPA, Nov-Dec. 1966, at 20. Carey, *How to Attract Young People*, CPA, March 1964, at 4. The problem is not only quantitative, however. John Ashworth of the AICPA's Education Division has noted:

Only accounting, among the four major professions, must recruit from a relatively mediocre manpower pool because most intelligent high school boys are ignorant about the opportunities in our business-directed society. Ashworth, *Who Wants to Be a CPA? Not Enough of the Right Students*, U.S. Study Finds, CPA, Nov. 1964, at 2.

98. See, e.g., Letter to the Journal, J. ACCOUNTANCY, July 1968, at 22.

99. A survey of U.C.L.A. graduates found that the most important single factor in selecting accounting as a collegiate major was the knowledge that the accounting profession would open doors to opportunities in business and government. H. Simons, *Education for Accountancy 27* (1960), cited in Master, *Recruiting: A Growing Problem*, THE FLORIDA CERTIFIED PUBLIC ACCOUNTANT, May 1965, at 12.

100. The exact scope of the turnover problem is currently unknown, although a study of the problem is being conducted, THE CPA, July-Aug. 1970, at 7. A Seattle partner in one of the "big eight" public accounting firms indicated that he anticipated a 15 to 20 percent turnover in the first year alone. Interview with Roger W. Nyquist, partner in Price, Waterhouse & Co., in Seattle, Washington, April 20, 1970.

101. See J. CAREY, THE CPA PLANS FOR THE FUTURE 293-94 (1965).

102. The current economic situation has had some effect on the demand for accountants. A mid-1970 article in the Seattle Times, June 7, 1970, sec. A, at 1, col. 3, however, indicated that even in Seattle, one of the areas hardest hit by the economic slump, accountants still stood "almost alone on the 'most wanted' list." On the national level, the *Wall Street Journal* reported in the summer of 1970 that "graduates in accounting experienced only a 7% drop in job offers this spring [1970] compared with a year ago, while the volume in 10 engineering and science fields plunged 40% Offers for all Bachelor's degree holders skidded 34%" *Wall Street J.*, July 21, 1970, at 1, col. 5.

103. The study concluded:

Accounting beginning salaries have increased and so has the number of accounting graduates. So also, apparently, has the need for accountants. There is no indication that new graduate production figures can begin to meet the demand, however.

. . . .
A review of . . . accounting—indicates that rapidly increasing salaries have not generally resulted in an increasing supply. Demand is great; salaries are high and

sibility, and while it appears that everyone desires improved disclosure, such improvement is completely beyond the auditors' capability.

III. EFFECTS OF EXPANDED LIABILITY

It appears highly probable that expanded auditors' liability will not result in either of its stated objectives. A brief examination of the current economic situation in the auditing market and the changes which are likely to result from expanded auditors' liability, however, indicate that the probable failure of expanded liability to accomplish its stated objectives will be a secondary evil when compared to the new problems which it will generate.

A. *Effects upon the Auditing Profession*

There is an oligopoly among the accounting firms which audit companies involved in the securities markets.¹⁰⁴ The oligopoly, however, is not complete; firms other than the big eight perform the audits for 20 percent of the publicly-held companies,¹⁰⁵ and probably prepare an even greater percentage of the registration statements for firms making an initial public offering.¹⁰⁶ Furthermore, the oligopoly would probably not become substantially more complete in the foreseeable future without the addition of an expanded auditors' liability, because the smaller firms have a protective weapon in the Code of Professional Ethics,¹⁰⁷ which impedes the "big eight's" use of their powerful market

apparently going higher; the supply of technically prepared college graduates is not responding.

Harkness, *Beginning Salaries and Reality*, J. COLLEGE PLACEMENT, Feb.-March 1970, at 48, 52.

104. A 1968 study, for example, determined that the "big eight" public accounting firms performed the audits for 468 of the largest 500 corporations in the United States. Louis, *The Accountants Are Changing the Rules*, FORTUNE, June 15, 1968, at 177, 178.

105. *Id.* at 178-79. This study noted that other auditing firms performed the audits for four companies even among the top 100 in size. As the size of the client decreases, a larger proportion of the audits is performed by auditing firms other than the "big eight"; analysis of the June, 1970 Fortune Survey of the Second 500 Largest U.S. Industrial Companies shows 70 of these 500 corporations audited by regional or local firms.

106. This seems a reasonable inference from the trend suggested by note 105, *supra*, and accompanying text, since firms making initial public offerings are normally relatively small in comparison to existing publicly-held corporations. A study by Charles Carpenter and Robert Strawser on the displacement of auditors because of public offerings, scheduled for publication in the June, 1971 *J. Accountancy*, will likely contain empirical data on this proposition.

107. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL ETHICS AND INTERPRETIVE OPINIONS (1970).

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positions to pirate clients from smaller competitors.¹⁰⁸ Because the giant firms' control is not complete, today's auditing market does not suffer from either price-fixing or discrimination in services,¹⁰⁹ the abuses which are frequently feared from oligopolies.¹¹⁰

However, we can anticipate a radically changed situation in the structure of the accounting industry and in the price and availability of auditing services as a result of the expansion of auditors' liability. Expanded auditors' liability is likely to result in complete control of the audits of large publicly-held corporations by the "big eight," since even the firms immediately below the "big eight" in size have, under pressure from expanding liability, considered redirecting their efforts away from the public sector. A consultant involved in designing a marketing strategy for one of these firms, for example, has indicated that the costs¹¹¹ and exposure¹¹² of the potential liability accom-

108. See note 107, *supra*. The oligopoly is partially a function of the structure of the clients' markets, and some necessary functions are difficult for any but the largest auditing firms to perform for some clients. See, e.g., S.A.P. No. 33, *supra* note 51, at 38, dealing with observation of inventories. Still, it appears that a substantial portion of the growth of the oligopolists has come about through merger. See, e.g., Rea, *The Purchase, Sale & Merger of Small Practices*, 1966 N.Y. CERTIFIED PUBLIC ACCOUNTANT 579; Farrow, *Mergers by Accountants and Accounting Firms*, J. ACCOUNTANCY, May 1967, at 37. With the apparent movement toward practice in corporate form, see note 50, *supra*, the merger movement may run up against section 7 of the Clayton Antitrust Act, 15 U.S.C. § 19 (1964), and become a substantially less significant factor.

109. It is still not within the ability of the oligopolists to conspire effectively to fix prices or discriminate in services because, while they have 80 percent of the publicly-held companies' business, see note 105, *supra*, there are numerous other firms which are desirous and capable of performing the audits now performed by the oligopolists. Any attempt by the larger firms to employ monopolistic techniques today would find numerous competitors waiting for the customers discriminated against.

110. See notes 117-118 and accompanying text, *infra*.

111. It was previously noted that insurance rates and deductible amounts are rising rapidly. See notes 37-48 and accompanying text, *supra*. One firm in the "big eight" noted that even four years ago the defense costs alone for auditors' liability suits were hundreds of thousands of dollars per year. Wall Street J., Nov. 15, 1966, at 13, col. 3. Because of the size of the deductible amounts, it is clear that large auditing firms are paying substantial portions of the defense costs out of their own pockets.

The exact amount of these deductible portions is not obtainable, but informed estimates of these amounts suggest that firms immediately below the big eight in size have deductible amounts as high as \$100,000 for 1971, with increases of up to 300 percent per year over the recent past. Interview with W. Thomas Porter, Associate Professor of Accounting and Director of Executive Development Programs at the University of Washington, in Seattle, Washington, Nov. 26, 1970. The deductible amounts for members of the big eight may be even higher. Interview with Frederick J. Wonsetler, Partner in Lybrand, Ross Bros. & Montgomery, in Seattle, Washington, June 24, 1970, and interview with Richard Y. Glidden, partner in Ernst & Ernst, in Seattle, Washington, June 23, 1970. See also Weyrich, *Exposure to Professional Liability*, 1970 N.Y. CERTIFIED PUBLIC ACCOUNTANT 556, 561, where the author, a partner in the Executive Office of Haskins & Sells, stated

panying major public audits is the major new factor in the practical economics of accounting practice.¹¹³ He suggests that a reasonable marketing strategy under today's conditions should include a de-emphasis of the public sector.¹¹⁴ If the larger regional and local firms do respond to the current market forces and abandon the public sector, the oligopolists' share of the market will probably become virtually complete.

The oligopolists' effective control in the evolving market will also be substantially greater. Until now, the professional Code of Ethics solicitation and advertising provisions have apparently slowed the trend toward oligopoly and preserved the position of the larger competitors of the "big eight" in the public market.¹¹⁵ If the competitors abandon the audits, however, the Code of Ethics will effectively entrench the members of the "big eight" beyond recall.

In addition, the audit of publicly-held companies calls for the maintenance of a large and specialized staff capacity which would otherwise be unnecessary. Those auditing firms which abandoned the public market would presumably also dismantle these staffs,¹¹⁶ and once disbanded, these staffs would be nearly impossible to reestablish. As a consequence, the competitors of the "big eight" will be effectively barred from reentry, and the oligopolists will no longer be restrained by potential competitors.

that "self-insurance, or the deductible portion under the policies, has grown over 50 times."

112. See notes 26-28 and accompanying text, *supra*.

113. Interview with W. Thomas Porter, Associate Professor of Accounting and Director of Executive Development Programs, Univ. of Washington, in Seattle, Washington, July 3, 1970.

The other factors supporting de-emphasis of the audit of publicly-held corporations are:

- 1) The overhead incurred by maintaining the staff specialization required to perform audits for major corporate clients;
- 2) The stiff competition from both the giant firms and the other major regional and local firms in this area.
- 3) The possibility that servicing problems would develop as the client enlarged, and that the client might be lost as it grew in any event.

Id.

All of these factors have existed for many years, but, by themselves, they were not enough to necessitate the abandonment of the public sector, at least among firms of substantial size.

114. *Id.*

115. See notes 107-108 and accompanying text, *supra*.

116. See note 113, *supra*. The high cost of maintaining this staff capability is one of the factors inducing the auditing firms to abandon the public sector.

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B. Effects on the Auditing Market

The effects of an unrestrained oligopoly are likely to be felt in the form of price-fixing and discrimination in service,¹¹⁷ and, ominously, expanded auditor's liability will also bring even more direct pressures to bear on both the price and availability of audits.

1. Price

Two separate forces, both due to expanded liability, will act to raise prices. First, a price rise will probably result from the self-elimination of the competitors of the "big eight" from the public sector. The pressures toward maintaining competitive prices will be replaced by strong temptations toward tight, monopoly-like pricing¹¹⁸ when the "big eight" find themselves without any substantial competition. In a market characterized by a shortage of auditors, such a pricing strategy will probably evolve rather quickly. Second, a further price increment will result from the fact that at least part of the costs of the expanded auditors' liability will be passed on in the form of higher auditing fees. Users of auditors' services will pay more because of the increased risk to the auditors even though no increased service seems probable.

2. Availability

A drastic change in the availability of audits can also be anticipated. Even among the firms which remain in the market for auditing of publicly-held companies, rational business judgment would sometimes call for a refusal to perform audits for those clients which are in danger of collapse or diminution in value.¹¹⁹ There is already evidence that

117. Price and "output," in this case, services, are the factors in maximizing profit: in an unrestrained oligopoly, both are within the control of the oligopolists. *See, e.g., L. REYNOLDS, ECONOMICS, A GENERAL INTRODUCTION 146-56 (1963); J. BAIN, INDUSTRIAL ORGANIZATION 266-98 (1959).*

118. Under monopolistic pricing, the concept of marginal revenue will result in quantity being limited to the amount where marginal revenue of an additional unit will not exceed its marginal cost, and the price for the service being based upon the demand level for that restricted quantity. This pricing technique enables a monopolist to achieve a higher level of prices and profits while providing less service. *See, e.g., L. REYNOLDS, ECONOMICS, A GENERAL INTRODUCTION 142-47 (1963), J. BAIN, INDUSTRIAL ORGANIZATION 266-98 (1959).*

119. A recent article in the *Journal of Accountancy* encouraged just such a policy. In a list of requirements which should be met before a CPA accepts a new client, the article includes a competent staff and good financial condition. Moore, *Selecting New Clients*, *J. ACCOUNTANCY*, March 1970, at 78. Moreover, it can be anticipated that insurers will amplify the pressures in this direction still further, as the scope of the risk appears to be directly proportional to the financial stability of the audited company. *See note 5, supra.*

some accounting firms, including members of the "big eight," are considering abandoning questionable clients out of self-protection,¹²⁰ and the shortage of auditors again suggests that the public accountants will not be loathe to sacrifice the business.

Even without the previously discussed reduction in the number of auditing firms, the trend toward abandonment of clients by some firms would represent a serious problem, but the problem is compounded by the prospect of a complete oligopoly in auditing. In a market with essentially only eight highly sophisticated firms, all having the same insurers, it seems reasonable to predict that the firms would use similar standards in making their choice among prospective clients, and that many firms would be denied an audit altogether.

C. *Additional Effects on the Economy*

The elimination of numerous auditing firms from the public sector, the imposition of unproductive increases in auditing costs, and the reduction in availability of audits would be serious enough if they occurred in a vacuum. Unfortunately, this is not the case, and the evolving market will probably have some further effects on the economy.¹²¹

120. Interview with Frederick J. Wonsetler, a Seattle partner in Lybrand, Ross Bros. & Montgomery, in Seattle, Washington, June 24, 1970. As the policy is now formulated the emphasis is on questioning the continued audits of firms involved in questionable as opposed to merely unprofitable business practices.

121. The analysis in this section presumes a relatively unfettered capitalistic economy, but the American economy is subject to regulation in numerous areas, and one set of regulations, the antitrust acts, see the Sherman Act, 15 U.S.C. §§ 1-7 (1964), and the Clayton Act, 15 U.S.C. §§ 12-27 (1964), was aimed particularly at discrimination in price and service. J. VAN CISE, *UNDERSTANDING THE ANTITRUST LAWS* 34 (1970). See generally S. MARCUS, *COMPETITION AND THE LAW* (1967).

Moreover, a professional code of ethics restricting competition, see *Associated Press v. United States*, 326 U.S. 1, 8 (1945), *United States v. National Ass'n of Real Estate Bds.*, 339 U.S. 485 (1950), J. VAN CISE, *supra*, at 222-23, or continuous intercourse among competitors, as through professional societies, J. VAN CISE, *supra*, at 155-58, are market characteristics which the antitrust acts have sometimes reached.

It appears, however, that the antitrust acts may not be applicable to the evolving auditing market. First, public accounting firms may not be subject to the antitrust acts. There are doubts that the antitrust acts are applicable to oligopolistic markets. KOTTKE, *ANTITRUST AND MONOPOLY SUBCOMM. OF THE SENATE JUDICIARY COMM. ADMINISTERED PRICES*, 88th Cong., 1st Sess. 182 (Comm. Print 1963); S. MARCUS, *supra* at 134-38. Moreover, the Securities Acts have been held to impliedly repeal the antitrust acts in some areas. *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963). *But cf. United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953). It is certainly not clear that the antitrust acts cannot apply to auditing firms, however. See *American Medical Ass'n v. United States*, 317 U.S. 519 (1943), *United States v. Oregon State Medical Soc'y*, 343 U.S. 326 (1952), *AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL ETHICS AND INTERPRETIVE OPINIONS* 5 n.* (1970).

Second, even if the antitrust acts were deemed applicable to the auditors, all of the statutory and judicially evolved defenses under those acts would have to be overcome. For

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1. *Effect on Capital Users and Resource Allocation*

The capitalistic economic system depends upon credit to allocate capital resources among competing potential investments.¹²² The corporation was developed to enable the accumulation of investment capital from diverse sources for a single user,¹²³ and the securities markets¹²⁴ are the main channel facilitating that accumulation.¹²⁵ All participation in the securities markets, unless one of the extremely limited exceptions under the securities acts is utilized,¹²⁶ requires audited financial statements.¹²⁷

example, price differentials are tolerated under the Clayton Antitrust Act to the extent of legitimate cost differentials in serving the customer, and the auditors would probably be able to satisfy even the present stringent requirements for segregation of costs in respect to insurance and hours, J. VANCISE, *supra*, at 151-52, thereby insulating their cost differentials from attack under that act.

Finally, even if the antitrust acts could be applied to auditors and the auditing market, their application to that market would be relatively ineffective; the increased risks of liability, with their increased costs and the shortage of personnel in auditing, are not antitrust problems, and even the traditional antitrust problem of lack of competition could not be solved through the remedies available under the antitrust acts. Removing impediments to competition such as the Code of Ethics or potential sources of restraints of trade or discrimination such as professional societies will not solve the overwhelming problem of the lack of willing competitors. Divestiture and orders to operate do not seem effective tools when the smaller organizations do not *want* to participate in the industry, even if the rather thorny problems of dividing up what are essentially partnership organizations could be solved. In sum, where legal doctrines and market forces rather than conscious action by competitors are the causative agents, the antitrust acts are not an effective corrective tool. *United States v. United Shoe Mach. Corp.*, 110 F. Supp. 295 (D. Mass. 1953), *aff'd*, 347 U.S. 521 (1954). *See also* 21 CONG. REC. 3152 (1890).

122. J. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT* 68-69 (1934).

Capital is intended to flow to those enterprises which can earn the highest rate of return, since theoretically they will be willing to pay the highest price for that capital. That rate of return reflects demand in the marketplace for the commodities produced by the enterprise.

123. T. COCHRAN, *BASIC HISTORY OF AMERICAN BUSINESS* 41 (1959).

124. This analysis applies to both the "primary" and "secondary" securities markets. The primary market refers to the channels which handle the initial sales of securities by issuers; the secondary market refers to the channels which facilitate later sales of securities between investors. The latter is of equal significance to the security issuer, as initial investments would be difficult to induce if the investor were locked in. *See generally* R. JOHNSON, *FINANCIAL MANAGEMENT* (2d ed. 1962); C. GERSTENBERG, *FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS* 213-81 (4th rev. ed. 1959); J. BOGEN, *FINANCIAL HANDBOOK*, 9-1 through 10-58 (4th ed. 1964). *See also* 1 SECURITIES & EXCHANGE COMMISSION, *REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS* 10 (1963) [hereinafter cited as 1 SEC MARKET STUDY]. The authors there point out that there is a tremendous public interest in the continued efficient operation of those markets.

125. The securities markets are not the only source of outside capital for corporations. Banks and related lending institutions also provide funds, usually for shorter periods than are involved in the securities markets, but these lenders, too, almost without exception require audits today for any major loans. *See generally* CORPORATE FINANCIAL REPORTING: CONFLICTS AND CHALLENGES (J. Burton ed. 1969). Moreover, in most respects the economic arguments made regarding the securities markets are also applicable to these capital sources.

126. A detailed analysis of these exceptions and exemptions is beyond the scope of this

As audits become more expensive and less universally available, therefore, the credit system will become less efficient in performing its functions. The cumulative effects of the evolving auditing market may significantly impede the allocation of capital resources within and between some sectors of the economy.

2. *Effects of Rising Prices*

For the majority of publicly-held corporations, a higher audit price without increased return will merely be wasteful.¹²⁸ For at least two types of corporations, however, the situation will be substantially more serious.

Auditing fees are not a strictly variable cost which increases proportionately with the size of the audited business entity. A larger number of auditing hours per dollar of assets is necessary for the audit of smaller firms, so those firms pay a larger relative amount for their audits than do larger firms.¹²⁹ As auditing fees increase, therefore, even if the increases are strictly pro-rata hourly rate increases, the difference in percentage of total expenses represented by the auditing bills of

paper; it is sufficient to note that they are limited and sometimes hazardous. *See generally* R. JENNINGS & H. MARSH, *SECURITIES REGULATIONS CASES AND MATERIALS* (2d ed. 1968).

127. SEC Reg. S-X, 17 C.F.R. § 210 (1950) states the requirements as to form and content of all financial statements, with some limited exceptions, filed under the federal securities acts. § 210.2 makes certification of financial statements by an independent auditor a requirement for all financial statements subject to the regulation, and under the terms of § 8 of the Securities Act of 1933, 15 U.S.C. § 77h (1933), and § 19 of the Securities Exchange Act of 1934, 15 U.S.C. § 78s (1934), the SEC has the power to prevent sale of a new issue of securities or to suspend trading in previously issued securities, if the regulations under those acts are not satisfied or if it appears that material facts are misstated. The actual practices of the Commission are somewhat more informal than the statutes would indicate, but if the registration statements required by the Securities Act of 1933 do not satisfy Regulation S-X, the SEC will refuse to accelerate the effective date of the registration statement, *see, e.g.*, *Wall Street J.*, June 19, 1968, at 4, col. 3, thereby effectively destroying the marketing of the new issue of securities because of the practical impossibility of pricing the issue 20 days in advance of initial sale, and if the reports required by the Securities Exchange Act of 1934 do not satisfy that regulation, and are not corrected to the SEC's satisfaction, that Commission will eventually stop trading in the securities of the company. Interview with Mac Nelson, a manager with Ernst & Ernst, in Seattle, Washington, September 18, 1970. For a case study of a suspension of trading, based upon financial statements, under the Securities Exchange Act of 1934, see Rappaport, *Accounting and the S.E.C.*, N.Y. CERTIFIED PUBLIC ACCOUNTANT, Jan. 1963, at 54-55.

128. This is not strictly true, as the overall return available from investments in corporate securities is a major determinant of the amount of resources which will flow into the capital market. If that return is reduced across the board, more resources will be employed in other areas, such as consumption. *See, e.g.*, A. ALCHIAN & W. ALLEN, *UNIVERSITY ECONOMICS* chs. 15, 29, 33 (1964).

129. SECURITIES & EXCHANGE COMMISSION, *COST OF FLOTATION, 1951-1955*, cited in Benston, in Manne, *supra* note 9, at 62.

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large and small firms will become even more disproportionate.¹³⁰ Expanded auditors' liability, however, will not create only pro-rata rate increases. Although everyone will pay substantially more for audits, the "high risk" firms will probably pay a disproportionate premium.¹³¹ Unfortunately, the "high risk" firms will also frequently be the smaller firms within a given industry,¹³² and in such cases both of the factors suggested in the paragraph will combine to inflict a competitive disadvantage, in the form of a higher cost of capital, upon those smaller firms.

Perhaps even more important than the effect upon competition within established industries, however, is the probable disproportionate rise in the cost of capital between different industries. On the whole, new business ventures and industries are smaller and riskier than older, established firms and industries,¹³³ but in many cases it is the newer, innovative concerns which are offering the products which are most demanded by the economy.¹³⁴ A larger rise in the cost of capital of the new, innovative concerns will cripple the ability of the credit market to allocate resources to more desired products.¹³⁵

130. *Id.* In the early 1950's the percentage of proceeds expended for auditing services for newly placed debt issues below \$1 million was 14½ times as great as the percentage for debt issues over \$20 million, and as auditing costs have increased substantially in the interim, the disproportion in percentages is probably substantially greater now. For an indication of the increase in auditing prices, compare Wheat & Blackstone, *Guideposts for a First Public Offering*, 15 BUS. LAWYER 539 (1960) and Blackstone, *Epilogue: Post-Effective Amendment to Guideposts for a First Public Offering*, in AMERICAN BAR ASSOCIATION, *SELECTED ARTICLES ON FEDERAL SECURITIES LAW 27* (1968). These articles indicate that the average absolute auditing cost for a small issue doubled in the early 1960's alone.

131. The commentators who argued for expanded liability of auditors to users of financial statements believed that the cost of adequate insurance coverage against auditors' liability could be spread evenly across the entire economy through increases in the standard auditing fee. See, e.g., 41 ST. JOHN'S L. REV., *supra* note 29, at 598. But there is no reason to believe that this will actually occur. Different firms will present different degrees of risk to auditors, and it is reasonable to presume that any identifiable overhead costs, such as increased insurance rates, which result from the audit of a particular client will be charged to that client, rather than pro-rated. If this approach were not adopted, another auditing firm with a "safer" mix of clients could charge a lower rate and theoretically accumulate all of the safer clients.

132. 1 SEC MARKET STUDY, *supra* note 124, at 504.

133. *Id.*

134. Apparently, these same firms are already taking a beating because of the securities acts policies. Concern over this situation, even without the additional impediment of astronomical auditing fees, has been reflected in the formation and operations of the Small Business Administration. Friend, *The SEC and the Economic Performance of Securities Markets*, in Manne, *supra* note 9, at 192 n.7.

135. It is currently impossible to predict the absolute amount of the increase in auditing costs or the extent of the disproportion in costs of capital among different firms.

3. *Effects of Restricted Availability*

While doubts might be raised as to the significance of the price-increase effects upon the economy, the effects of limited availability of audits are more certain. A firm deemed overly risky and denied an audit¹³⁶ will be denied access to the security markets.¹³⁷ Some of the firms denied this access to the securities markets might well have been poor investments.¹³⁸ This is not universally true, however, and the innovative concern with an untried management, an untried product and a shortage of capital would undoubtedly be hard hit.¹³⁹ The securities markets were developed to supply the capital needs of just such firms; in barring these firms from their credit channels, we would have effectively prevented exactly what the securities markets were developed to promote.

4. *Effects on Investors*

It is difficult to generalize about investors, but three observations seem appropriate. First, since it appears that the anticipated benefits to be derived from expanded auditors' liability will not materialize, any of the costs associated with that expanded liability which fall upon the users of financial statements will be a net loss to those investors.¹⁴⁰

Until now, auditing fees have been a relatively minor expense even for smaller firms, and it is possible that the effects of price increases, except in the more extreme cases, will not deal too severe a blow to the resource allocation capability of the economy. A very rough approximation of this expense as a percentage of proceeds for smaller public issues today would put the audit fees at approximately $\frac{2}{3}$'s of one percent. This figure is evolved by presuming the lowest suggested auditing fee for a new public offering in Blackstone, *supra* note 130, at 27, \$5,000., and applying that figure to an offering of \$750,000. If this figure were accurate, it would represent a doubling of the percentage of proceeds necessary for auditing on a small issue since the early 1950's. SECURITIES & EXCHANGE COMMISSION, COST OF FLOTATION, 1951-1955 (1957), *supra* note 129. It is apparent that the principal cost of such an issue is still the underwriting compensation. *Id.* See also 1 SEC MARKET STUDY, *supra* note 124, at 502.

136. The same is true of those firms whose auditors issue opinions unacceptable to the SEC purely because of an excess of caution by the auditor. Qualified opinions can have all of the effects suggested in note 127, *supra*. Interview with Mac Nelson, manager with Ernst & Ernst, in Seattle, Washington, September 18, 1970.

137. See note 127, *supra*.

138. Some states, such as California, would apparently take the position that extreme risk alone is sufficient to prevent the sale of the securities. R. JENNINGS & H. MARSH, *supra* note 126, at 526-28.

139. The problems would by no means be limited to such firms, however. Even the largest and best established firms can encounter difficulties where they require immediate access to large amounts of capital. See Wall Street J., July 3, 1970, at 16, col. 1. These firms, too, could find that the capital markets were closed to them at the moment they needed them the most, due to auditors' gunshyness.

140. See note 24, *supra*.

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Second, not all users of financial statements desire only limited risk investment; some investors prefer higher risk enterprises, with their commensurately higher rate of return.¹⁴¹ These investors will find, however, that the evolving auditing market will completely eliminate part of the high-risk investments through the denial of an audit, and will reduce the rate of return from the investments remaining at the riskier end of the spectrum through disproportionate auditing charges.

Finally, it is possible that in the short-run, as auditing firms abandon clients out of self-protection, or raise rates, less competent or less reputable auditors will pick up the clientele. While this seems relatively unlikely,¹⁴² if it did occur the users would find that expanded liability had resulted in poorer, rather than improved, disclosure, and reduced, rather than increased, assurance from the audit.

CONCLUSION

Legal analysts in recent years have advocated an expanded auditors' liability to users of financial statements, with the dual objectives of improved disclosure to all investors and compensation of those who are injured. Unfortunately, it appears that the liability will not achieve either of its stated objectives. Instead, the liability will probably cause severe damage to the users of capital, the suppliers of that capital, the auditing profession, and the resource-allocating ability of the economy. Consequently, an expanded auditors' liability should be rejected, and the legal standard which permitted the accounting profession to develop the audit to today's level of assurance to investors should be reaffirmed.

*Joseph P. Dawson**

141. For an economist's analysis of the effects of risk upon the securities markets, see Lintner, *A Model of a Perfectly Functioning Securities Market*, in Manne, *supra* note 9, at 143.

142. While regulations such as SEC Reg. S-X, 17 C.F.R. § 210 (1971) do not provide authority to evaluate the competence and honesty of auditors in advance of their giving opinions as to statements, it is probable that the SEC, the exchanges, or the underwriters would effectively minimize this risk through informal channels.

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