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Exposure to Professional Liability

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THE EXTENT to which certified public accountants are exposed today to the consequences of professional legal liability should be a matter of personal concern to every practitioner. It is a form of liability that is alive and ever present, and it is assuming a proportion that finds its roots in the past, but is only now taking full shape. For these reasons, there is greater need than ever before for accountants to know where they stand —or are likely to stand in the near future.

In order to focus the problem on day-to-day activities, it seems appropriate at the outset to distinguish between the accountant's professional responsibilities and his legal responsibilities.

Kohler's *A Dictionary for Accountants* defines "accountant's responsibility" as: "The moral obligation assumed by a public accountant, as a member of a profession, in certifying to a financial statement from which information may be sought by management, creditors, and investors." Although it is well known that an accountant renders many services other than that of certifying financial statements, Kohler's definition should serve for purposes of this analysis.

The American Institute of Certified Public Accountants and many states have established minimum standards for the accountant in his professional practice. Usually, the penalties for violating such standards are limited to the possible temporary or permanent revocation of the accountant's license to practice in his state or to loss of membership in the national organization. In addition, of course, he faces the loss of his practice and other personal embarrassments.

Legal liability, on the other hand, as distinguished from moral responsibility, is enforceable under statutory and common law, and exposes the accountant not only to the penalties described above but to possible substantial monetary loss to those alleging that they were damaged as a result of his actions. He is confronted also with the possibility of revocation of his right to represent others before state and federal governmental agencies, such as the Securities and Exchange Commission. Among the statutory laws that pertain to the accountant in his relations to clients and third parties are those found in the Securities Act of 1933 (Section 11) and the Securities Exchange Act of 1934 (Section 10).

Common law as it affects the accountant is set forth in many court cases, the *Ultramares* case probably being the most significant; certainly, the law recently established in the *BarChris Construction Corporation* and *Continental Vending Company* cases has given members of the profession a clear indication of their exposure to liability. In a recent article in *The Accountant,* a publication of the Institute of Chartered Accountants in England and Wales, its author, in commenting on the BarChris and Continental Vending cases, makes this very interesting statement:

> The legal liability of auditors in the United States is undergoing a painful process of reshaping in the courts, and there's no telling how it may end.

While change has always been a part of the human tradition, it is having its effect on the accounting profession today more than in any period of the past.

Recently, one of our prominent congressmen said in an interview: "Nothing is so powerful as an idea whose time has come." While this paraphrases an expression attributed to Victor Hugo many years ago, today it is clear that court action against accountants is an idea whose time has come.

This discussion has three purposes: (a) to show the full dimensions of the problem, (b) to suggest ways for maintaining a day-to-day awareness of it, and (c) to suggest what can be done to minimize it.

DIMENSIONS OF THE PROBLEM

The accountant holds himself out to the public as a professional having exceptional skills. As such, he assumes, under common law, the same responsibilities for negligence as are shared by other skilled professionals. Some of the responsibilities confronted by the accountant, however, expose him to liability problems that are not faced by other professions, and this places the accountant in a unique position.

The lawyer and the physician are usually concerned with specific questions or special problems, and their opinions are usually designed only for their clients or patients; and no one else. Others who might be affected by their actions are relatively limited. The lawyer's participation in Securities Act engagements might be the outstanding exception to this.

By contrast, the accountant is responsible not only to his client but also to third parties, who are not clients, such as investors, creditors, bonding companies, and the like. This primary responsibility to clients as well as to the public serves to intensify the problems of an accountant practicing in this complex economy. It could be said that in terms of liability, perhaps only the engineer and the architect come close to the accountant's position.

It is important to recognize at the outset that professional liability arises out of every service rendered by the accountant—audit, tax, management advisory, and any other special service—and that it concerns itself not only with the quality of execution of the work but with the manner in which the results are reported.

Further, it must be recognized that in addition to reports relating to financial statements and special services, and income tax returns, every document in the files or records of the accountant is related to professional liability: the engagement memorandum (in effect, the contract setting forth the services to be rendered) ; the audit, income tax and other working papers; file memoranda; correspondence; employment records; individual ratings of staff members; time records; training materials; publications; internal technical materials and procedural programs; and, in general, any material that is subject to subpoena and scrutiny by outsiders. Moreover, the non-existence of certain documentation may be pertinent, particularly of file memoranda or training materials.

As a practical matter, however, it is his formal, written reports or communications that expose the accountant most directly to liability problems. These include reports on audited financial statements, whether printed for wide distribution or otherwise reproduced for limited distribution; reports that are filed with the Securities and Exchange Commission and other regulatory bodies; unaudited financial statements with which the name of the accountant is associated; reports to underwriters and prospective purchasers of businesses, including those known as "comfort" letters; income tax returns; and special tax opinion reports.

In short, it could be said that any written material, regardless of its nature or form, that bears the signature of the accountant, or is associated with him or his firm, must be considered to affect his exposure to professional liability.

Moreover, the size of a client has no bearing on the problem. In fact, some of the most troublesome and costly liability situations have developed from services rendered to relatively small businesses.

At the present time, an increasingly greater number of complaints against accountants tend to be concerned with matters related to financial statements, rather than to employee defalcations, as was more common in the past. These complaints cover such matters as improper or inadequate disclosure of important financial data or transactions, overstated assets, understated liabilities, the application of inadequate or faulty audit procedures, and, in general, the exercise of poor judgment or the absence of due care.

As an expert in his field, the accountant can arrive at sound judgments only after considering the effect on a business, or an individual, of currently existing and proposed accounting principles (many of which, unfortunately, are subject to alternative applications), tax laws, securities laws, and corporation laws, at all levels—federal, state, and local. He must independently decide upon the materiality of any important matter and determine when disclosure is required, and he must stay abreast of precedent-setting court decisions, such as those previously referred to, that affect his status and professional activities. In the light of these responsibilities it is reasonable to expect that the accountant will face an ever increasing amount of litigation, in cases alleging malpractice in some degree. Current indications are that the profession is faced not only with a greater number of cases than ever before, but with awards and settlements that will be much larger than in the past. In addition, the legal and other expenses of defense against lawsuits are already high and bound to grow.

DAY-TO-DAY AWARENESS OF THE PROBLEM

Effects of Mergers

The importance of financial statements has been greatly heightened in recent years by a substantially increased number of mergers and other types of business combinations. Those who attempt to weigh the merits of such combinations are vitally concerned with the character and authenticity of the assets reported by their prospective partners, by the extent of the liabilities to be assumed, and by the trends shown in earnings and earnings per share. More specifically, they have a very keen interest in the quality and valuation of the inventory, the collectibility of the receivables, the nature and full extent of contingent as well as actual liabilities, the quality and consistency of the earnings, and any indications of unfavorable trends of the business or its products that are not apparent in the financial statements themselves.

But accountants, in examining and evaluating financial statements, are traditionally guided by the concept of the "going concern"; they seek to determine whether a "fair presentation" has been made on that basis. Possible adjustments or matters for possible disclosure that are not considered to be significant for a fair presentation on a going-concern basis (and thus are not comprehended or referred to in the financial statements) could have a much different interest to prospective purchasers of the business. Unfortunately, in most instances, a merger is either not in prospect at the time the accountant's work is performed or is not known to him. When a merger develops, the financial statements on which the accountant has previously expressed an opinion become important elements in the closing documents.

Purchasers of a business are invariably disturbed when they find that matters to which they attach great importance were regarded by the accountant as being not material, and perhaps rightfully so, on the going-concern basis. Thus, the conditions arise for possible litigation, and the accentuated prominence of financial statements in mergers places an additional responsibility on the accountant.

Materiality, under any given circumstance, assumes a much different significance when a delicate distinction must be made between what is material from the viewpoint of the purchaser as compared with that of the investor.

The liability of the accountant is even more complex because the profession itself is divided in its opinion on proper methods for dealing with a number of important, controversial questions, such as these: What are acceptable—and alternative—principles of accounting? When does a situation require extraordinary presentation? When does a change require retroactive, as opposed to prospective, application in the financial statements? What should be the treatment of "poolings of interests"? When is a development so significant, or an amount so material, that it must be set out separately in the financial statements, or in explanatory notes, or in the accountant's opinion? And, basically, what are the measurements of materiality?

Landmark Court Cases

The increased degree of responsibility being imposed upon accountants is highlighted by recent court decisions that have attracted international attention, four of which are worthy of attention:

The *BarChris Construction* case was a civil action brought by the company's bondholders. Here the court found that the officers, directors, lawyers, underwriters, and the independent public accountants were all negligent in that financial information in a BarChris registration statement was false and misleading.

In the *Yale Express* case, the independent accountants were charged with fraud and conspiracy for their part in certifying the financial statements.

In the *Westec* case, the independent accountants were charged with negligence and fraud on the grounds that they did not have sufficient information on the financial statements they certified.

The *Continental Vending Machine* case involved a civil as well as a criminal action against the independent auditors. It is well worth while to read the November 12, 1969 decision of the United States Court of Appeals in which three individuals of the accounting firm concerned were found guilty of fraud and conspiracy for their part in the firm's certification of the financial statements.

Some of the words of the court in the *BarChris Construction* case are certainly very significant:

> Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. However, the accountant's review did not come up to that standard. He did not take some of the steps which the firm's written programs prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries. . . . There were enough danger signals in the materials which he did examine to require further investigation on his part. Generally accepted accounting standards required much further investigation under these circumstances. It is not always sufficient merely to ask questions and accept answers. The burden of proof is on the accounting firm. I find that the burden has not been satisfied. I conclude that the firm has not established its due diligence defence.

Now listen to the words of the judge who wrote the unanimous decision of the Court of Appeals in the government's criminal case in the Continental Vending matter:

> Defendants (in the lower court) asked for two instructions which, in substance, would have told the jury that a defendant could be found guilty only if, according to generally accepted accounting principles, the financial statements as a whole did not fairly present the financial condition of Continental, and then only if his departure from accepted standards was due to willful disregard of those standards with knowledge of the falsity of the statements and an intent to deceive. The judge (of the lower court) declined to give these instructions. Dealing with the subject in the course of his charge, he said that the "critical test" was whether the financial statements as a whole "fairly presented the financial position of Continental, and whether it accurately reported the operations." If they did not, the basic issue became whether defendants acted in good faith. 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."
>
> The jury could reasonably have wondered how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts.

It is obvious that the thrust of these four court cases is on the extent of the independent accountant's liability to third parties. But there are other major issues. First, will the standards imposed on independent accountants be those recognized by the profession, or will they be standards established by the courts in applying federal securities law? Also, what constitutes "due diligence" for an expert such as a certified public accountant in the performance of his duties? Another question concerns the disclosure of information that comes to the attention of the accountant subsequent to his certification of financial statements. (We have tried to close this gap in the recent Statement No. 41.) Another is the question of whether our responsibility for financial reporting in a registration statement can be extended to financial reporting in the company's annual report to its owners.

There have been many other court cases in which it was alleged that the accountants condoned the use by their clients of improper accounting methods or methods that produced misleading results. In other cases, the accountants are charged with failing to carry out proper, or adequate, audit procedures with the resulting dissemination of information that was misleading or inadequate. Such allegations must be viewed in the light of what has previously been referred to here as the existing controversial and unresolved questions within the profession relating to generally accepted accounting principles and financial reporting.

It appears wise to warn the professional accountant that he is obliged to be continually on the alert, assessing the validity not only of the practices he follows but of those followed by his clients. Practices and procedures can no longer be accepted today simply because they were followed and were acceptable yesterday. Our current problems relating to proper accounting for sales of franchises is a good example of changing circumstances and procedures.

The Financial Hazard

The financial penalties to which the accountant is exposed can truly be staggering, and some observers have said that the potential financial threat could be so great that smaller accounting firms might be forced to merge with others, for that reason alone.

The seriousness of this threat can be appreciated when it is viewed from the standpoint of even one prominent insurance underwriting firm, which in 1968 had 77 cases pending against accountants. This number had grown steadily from 33 cases four years earlier, and 18 were in the $1 million category. On September 1, 1969, about one year later, there were 83 open liability cases pending against accountants, an increase of six, and 24 were for amounts in excess of $1 million, also an increase of six. Thirty-four of these 83 cases were for claimed damages in excess of $100,000. Fifty-one were against the eight largest accounting firms. To repeat, these statistics are those of only one underwriting firm.

In the case of still another insurance underwriter, during the 18 months ended November 1969, 28 new liability cases arose, of which 15 pertained to annual reports, five to registration statements, five to special services, two to tax work, and one to refusal to certify after work was done. Plaintiffs in these suits were: shareholders, eight (29%); buyers, seven (25%); clients, five (17%); lending institutions, three; and various others, five. Five of the 28 cases involved fraud of top management in some degree.

The number of cases will surely continue to grow, and with more frequency, and the awards and settlements will become even larger. What effect does this trend have on professional liability insurance? A very dramatic one, indeed. 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. 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.

WHAT CAN BE DONE

While the situation calls for a program of constructive action, it should nonetheless be recognized that the accountant can never hope to avoid liability situations completely. No matter how conscientiously he works, the danger of having to defend himself against unscrupulous persons seeking to victimize him will always potentially be present. Furthermore, human as he is, it is in the nature of things for unintentional short-comings to creep into his work. The basic problem is how he can minimize his risks.

Fundamentally, there are several defenses against professional liability suits. First, an accountant should be aware of the specific contract he has with his client (the engagement memorandum) and be sure that he possesses all the technical skills needed to perform under it. Then he should prepare thoughtful, well-designed audit work programs, and well-organized and informative audit working papers (this being the evidential material that can give documentary proof of the quality and extent of work performed and the conclusions reached on all matters of importance). Evidence that a competent, adequately supervised staff was assigned to the work is also essential, and the financial statements and notes must be informative, carefully assembled, and clearly worded.

Watchwords that provide the framework for a constructive approach to achieving those objectives are: *Alert Thinking* and *Foresight.*

The characteristics of alert thinking are well presented by John R. Raben, a partner in the law firm of Sullivan & Cromwell, in a recent paper:

> Partners and other personnel have the training and experience required by the standards. They will satisfy them, however, if, and only to the extent that each person on the engagement thinks.
>
> When you think: you reject performances by routine; you reject blind adherence to the activities of the prior periods; you reject the handling of a transaction in a particular fashion solely because it is somewhat similar to one or more prior transactions; you reject unsatisfactory answers by the client and you independently verify; you reject "gimmickry" that has no economic purpose other than to increase

earnings per share; and you reject the treatment of a transaction in a fashion contrary to its economic reality.

Who Must Be Alert?

It is obvious that each individual, at whatever level of the practice, must be alert at all times, but one can never over-stress the essential importance of alertness at the levels of junior and senior accountants. While these accountants may think their assigned work is routine, the actual fact is that they are working in some of the most critical areas of the audit program, particularly from the viewpoint of professional liability. They have the first opportunity—and sometimes the only one—to examine the pulse of an enterprise at first-hand, to see what has gone in and out of the business during the period under study. The accountants at the junior and senior levels who are attentive, wide-awake, keen, and observant are in an excellent position to uncover problems that might otherwise never come to the attention of those higher up on the ladder of responsibility. Oddly enough, many of these problems could not possibly be anticipated in the audit work program or otherwise provided for in advance.

The Role of Foresight

Naturally, accounting firms cannot rely completely on their junior staff personnel to raise such questions. For this reason, standard procedures should call for critical review, and independent concurring reviews, of the application of every part of the technical procedures employed in the work—a system of checks and balances that operates from the inception of the engagement to the final report or income tax return. But such a system can never take the place of alertness during the course of the work. Once the work is done and the report is rendered, the accountant does not have the luxury of hindsight, although his critics do. They can charge that they were damaged either because the accountant failed to do something in carrying out his responsibilities or because he did not do it soon enough.

The best defense against such use of hindsight is, and will always be, the use of foresight—the power to look ahead and visualize the way something said or done today will appear tomorrow. This is the ability to anticipate the way reports, working papers, and memoranda will look to someone on the outside—a judge or a jury—two years or more from now, and particularly to persons who do not understand the nature of financial reports or the extent of the accountant's responsibilities in connection with them.

Part of the role of foresight is to enable the accountant to identify, as he goes along, those situations that demand further thought and investigation. Cases in which the courts have sustained charges against accountants have resulted to a greater degree from the failure to identify such situations than from the application of faulty audit procedures.

Guidelines

In order to measure up to the watchwords of Alert Thinking and Foresight, for which there is no substitute, it should help to have certain guidelines for day-to-day activities. There are seven basic points that should be kept in mind:

Point One—Working Papers—Clear, well-organized working papers are the accountant's most valuable possession when liability problems arise. These papers should show not only what was done but also the points that were considered in reaching any conclusion. They have a very important function in court proceedings as support for the conclusions expressed by the accountant in his opinion; there is no substitute for their value; and nothing else can take their place. Since unfriendly parties will always search for damaging evidence to use against him, the accountant's working papers must serve to sustain his contention that a proper job was done, that questionable matters were followed to proper conclusions, and that the judgments made were clear-cut and were based on the conclusive resolution of any conflicting viewpoints that may have existed.

Point Two—Vulnerable Areas of the Business—The particular vulnerable areas of any business should be pinpointed. These may include: the methods or bases for valuing inventories; the methods for taking up income; the basis for recognizing real and contingent liabilities; the trends of the lines of products; the real and not the theoretical functioning of internal control. For example, in the finance business there might be three such sensitive areas on which to concentrate: the quality and valuation of receivables, the outstanding debt and lines of credit, and the method used for taking up revenues.

Point Three—Constant Reassessment—Audit procedures must be appropriate and adequate to meet present objectives. As a rule of thumb, it could be said that in today's fast-moving economy, any method or assumption that has been used for up to five years should be reassessed, simply because circumstances within the organization and the industry are bound to have changed.

Point Four—Knowledge of the Industry—Accountants must know their client's business, the people who run it, its products or services, its position in the industry, and the accounting principles that should apply to it. In many instances, liability problems stem from inadequate knowledge of the business. Only when the business is properly understood can effective services be performed; only then can management be offered the kind of constructive suggestions it needs.

Point Five—Independent Conclusions—Conclusions must be reached independently, objectively, and without bias. Whatever inquiry, study, and investigation is required in the circumstances must be carried out regardless of the amount of time it takes.

Point Six—Importance of Each Job—An accountant's personal reputation and future are at stake in every service he renders, regardless of its type or size. Situations that demand additional time and effort should never be ignored. A piece of substandard work, or evidence of poor judgment, reflects upon the standing of the accountant in the eyes of the business community and the public at large, and upon the profession itself.

Point Seven—Know Your Clients—Those clients that are not considered desirable for professional or other reasons should be terminated. Otherwise they will sooner or later cause trouble for the accountant in one way or another.

Awareness of the points discussed here should help a professional accountant to make a maximum contribution toward minimizing his exposure to professional liability. Recognizing that he will always be faced with threats of litigation, he can respond to them only by relying on sound audit procedures and techniques, an alert, well-trained professional staff, intimate knowledge of current developments in the business and professional fields, foresight at every stage of his work, and objective thinking on the broadest possible scale. It is not too much to say that the professional accountant can only be as strong as the weakest link in his auditing procedures and in his professional staff.