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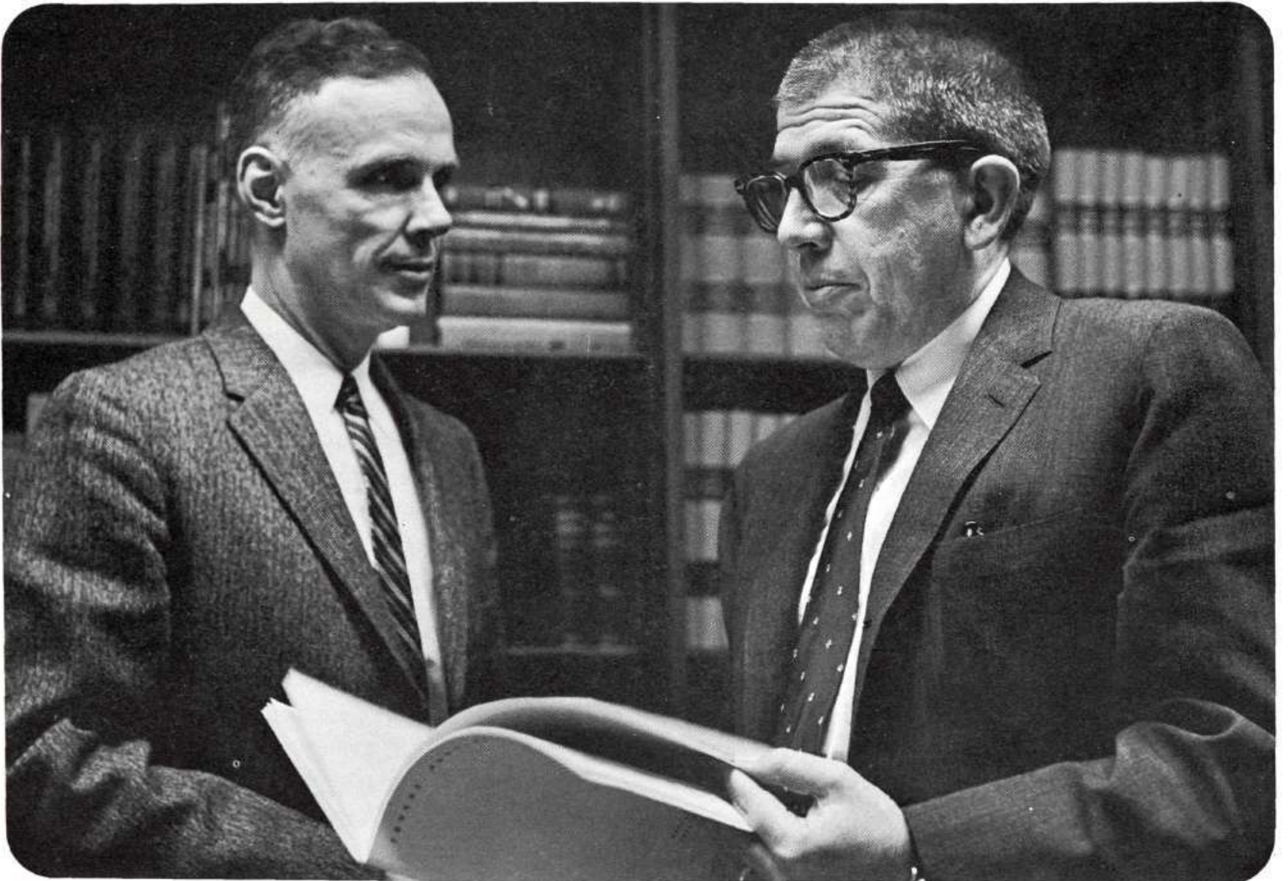
A current summary discussed non-technically for the information of practicing accountants

Liability of Professional Accountants to Clients and Others

R. James Gormley and Robert M. Trueblood



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Robert M. Trueblood, chairman of the TRB&S Policy Group and our National Director of Accounting and Auditing, is currently serving as president of the American Institute of Certified Public Accountants.

As American business grows larger, the potential losses from business failure become greater for both creditors and investors. This economic circumstance is being experienced in a social environment characterized by an increasing tendency of enterprises and individuals to attempt to recoup losses of all kinds in the courts. And courts, generally, are seeming to become more liberal in granting redress for losses of all kinds.

Financial distress and failure in business are increasingly accompanied by searches for scapegoats. Naturally enough, the auditors have become favorite candidates. The rise in the amount of litigation against accountants and its possible effect on the profession are discussed in "The Specter of Auditors' Liability," in *The Journal of Accountancy* for September, 1965.

It is natural for an accountant to be incredulous at the thought that he could be guilty of fraud in the absence of intentional dishonesty on his part. Accordingly, the purpose of this article is to describe briefly to practicing accountants the extent of the legal liability of an accountant to his client and to others in connection with his professional services. The nature of due care, negligence, and fraud in the practice of accounting will be discussed, and the legal consequences which may follow them will be described. Since the article has been written for laymen and since a serious attempt has been made to avoid technical analysis, all legal citations and other references have been omitted.

Definitions

Basic definitions of several legal terms are set forth below, since these words and phrases and variations of them are used repeatedly in the discussion which follows. Actually, these few terms recapitulate much of the subject matter of the article.

> *Due care and competence* is that degree of care and competence which is reasonably expected of accountants, as members of a learned and skilled profession, in performing and reporting on professional engagements.

> *Negligence (or ordinary negligence)* is the failure of an accountant to perform or report on a professional engagement with the due care and competence reasonably expected of members of his profession.

> *Gross negligence* is an extreme, flagrant, or reckless departure from standards of due care and competence in performing or reporting on professional engagements—as contrasted with the thoughtless slip, honest blunder, or error of judgment which amounts to ordinary negligence.

> ~~The~~ *Fraud* ~~of deceit~~ is an intentional false representation of a material fact or opinion made to induce a person's reliance, and under circumstances in which the person justifiably does rely upon the false representation to his injury. The courts have said that an auditor commits ~~the~~ fraud ~~of deceit~~ in issuing an audit opinion if his audit has been so negligent as to justify the jury or a judge in concluding that the auditor could have had no genuine belief in the truth of his opinion. Evidence of negligence, and especially of gross negligence, on the part of the auditor may be considered by the trier-of-fact in deciding whether the facts support or do not support an inference that the auditor committed deceit. Evidence of heedlessness and reckless disregard of consequences may be considered in deciding whether or not the necessary element of intention was present to warrant a finding of fraud.

Liability to client

Accountants are members of a learned and skilled profession. Their professional status imposes an obligation to exercise the care and competence reasonably expected of persons in their profession, and to adhere to accepted professional standards. A similar responsibility applies to all professional experts, and has been described by the American Law Institute as follows:

> . . . If the matter is one which requires investigation, the supplier of the information must exercise reasonable care and competence to ascertain the facts on which his statement is based. He must exercise the competence reasonably expected of one in his business or professional position in drawing inferences . . . He must exercise reasonable care and competence in communicating the information so that it may be understood by the recipient . . .

If an accountant fails to exercise care and competence in performing and reporting on his auditing, accounting, tax, or management service engagements—he commits ordinary negligence. And he may be held liable for the damages resulting to his client.

The American Institute of Certified Public Accountants has formally defined professional standards of qualification such as education, experience, proficiency, judgment, and independence. The profession has also specified certain standards and some procedures to be used in the performance of and reporting upon audits. These professional statements of generally accepted auditing standards and

procedures will be given great, and perhaps decisive, weight in court in adjudicating liability.

The duties and responsibilities of an auditor are also governed, and may properly be limited, by the contractual terms of his engagement and the representations in his audit report. The scope of most audit engagements is defined in the standard auditor's report, which consists of his representations—primarily of fact in the first paragraph, and of opinion in the second. The representations in the short form opinion incorporate the profession's auditing standards and procedures and accounting principles, which are found in part in authoritative professional statements; in part in individual statements of respected writers; and in important part, in practical applications which are considered by an appreciable segment of the profession to be acceptable. If the scope of the auditor's assignment and duties is limited by the contract of his employment, any such limitation must be clearly described in his report.

If an auditor has performed his audit with care and in accordance with professional standards, he should not be held liable for an inaccuracy in financial statements which would not necessarily be detected in an examination of the type and scope of his engagement. A court recently said: "Those who hire [public accountants] are not justified in expecting infallibility, but can expect only reasonable care and competence. They purchase service, not insurance . . . " For example, an auditor should not ordinarily be held responsible for the breakdown of an apparently satisfactory system of internal control because of collusive fraud among several persons at the top of a client organization, since groups of people at high levels have both the authority and the opportunity to contravene any system of internal control—no matter how well designed.

Even if the auditor has been negligent in his audit performance, he should not be held liable to the client unless the client can prove that he suffered loss; that his loss was the result of the auditor's negligence; and that the loss did not result in part from the client's own negligence in administering its business and supervising its employees. If, for example, an auditor recommends the installation of improved procedures for the protection of inventory and his client ignores the advice, it is difficult to conceive that the client would have redress against the auditor for failing to detect subsequent inventory losses which were concealed or obscured by inadequate inventory controls.

Before an accountant takes much comfort in the generality that he is not an insurer, he should, however, reflect that these rules are easier to state in the abstract than they are to apply to a set of facts with a confident prediction of the outcome in court.

The crucial issues in accountant's liability lawsuits are usually questions of fact as to whether the accountants deviated from standards of due care and competence in the engagement, and if so, whether their deviation amounted to negligence, gross negligence, or fraud. These questions must be decided by a trier-of-fact (judge or jury) by applying the appropriate rules of law to the evidence adduced at the trial. In so doing, the trier-of-fact may often be guided to a sound decision by expert accounting testimony and reference to the professional literature. Like all humans, however, triers-of-fact will be influenced to some extent by their own values, backgrounds, and experience. Some triers-of-fact may begin the fact-finding process with ignorance, or even a serious misconception of the whole professional issue. For example, some members of the public and, therefore, some members of a jury might wrongly assume that *any* error in an audited financial statement is a fault of the auditor.

Moreover, a trier-of-fact has no objective means of detecting what specific acts of human behavior will transform due care into negligence, negligence into gross negligence, or gross negligence into fraud. There are no clear lines of demarcation between the categories. This means that in any close question (and most of those which are litigated to a conclusion are somewhat close), some triers-of-fact might reach one conclusion (e.g., due care) and some another (e.g., negligence). In any given case, the facts and the rules of law are the same. The determination of the trier-of-fact is, however, decisive. The outcome of each case depends upon the judge's or the jury's reaction to and interpretation of the evidence presented, and their understanding and evaluation of the rules of law to be applied to the facts as they find them.

This confronts the auditor with some hard questions. Does *every* mistake, *every* oversight, constitute negligence? Does *every* rough edge, *every* loose end, *every* management explanation accepted in full, *every* benefit of a doubt in favor of the client — expose the auditor to damages and loss of reputation? The answer should be no — if the standard of duty is due care and competence, and if the auditor is not an insurer. However, the answer may not be that easy if there have been losses, in view of the judicial fact-finding process.

Liability to others under the common law — negligence

In the United States, and until recently in England, the courts have generally held negligent accountants to be liable only to their clents—not to third parties.

First, the courts have concluded on pragmatic grounds that the hazards of public accounting practice would be too extreme if the commission of ordinary negligence (such as a thoughtless slip or blunder) were to ". . . expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." (By contrast, however, some other professionals whose exposure to third persons is limited in numbers and in amount have been held liable to third persons for negligence.)

Second, the courts have said that auditors should not be liable for negligence to creditors and investors if their report ". . . was primarily for the benefit of the [client] . . . for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the client] and his associates might exhibit it thereafter." This is the *primary benefit* rule. It is based on the thought that a company ordinarily needs audited financial statements for many purposes — for management guidance, taxes, debt and equity investors, lenders, suppliers, customers — no single purpose alone being a decisive reason for obtaining audited statements.

Thus far the primary benefit rule has been an important protection to auditors from liability to persons other than their clients for ordinary negligence. Audits have been held to be for the primary benefit of the client even in cases in which the auditor knew that his report would be furnished by the client, or was to be furnished by the auditor at the request of the client, to a third person. The primary benefit rule has also been invoked when it was known that the audit report would be used by the client to induce action by a third person (such as a creditor or an investor), and might be relied upon by that person in taking action. Of course, a third-party plaintiff may always attempt to prove that as a matter of fact the particular audit in his case was for the primary benefit of the plaintiff, rather than for the primary benefit of the client. In reported decisions, however, the triers-of-fact (both judge and jury) have ruled for the auditors on the fact question in such circumstances.

Nonetheless, the existing decisions do not mean that there can be no such thing as an audit or a report for the primary benefit of someone other than the client — especially if the report is of a specialized nature which is likely to be of interest or is delivered only to a single person or category of persons (such as a lender), rather than to all of the persons interested in the financial affairs of the client. Consider these examples: an opinion of an accountant, delivered directly or indirectly to a lender, to the effect that in his annual audit he observed no breaches in the restrictions of a loan agreement; or the accountant's comfort letter addressed both to the client and underwriters of its securities and delivered in fulfillment of a condition precedent to the obligation of the underwriters to purchase the securities; or special receivables audits required by lenders on collateralized debt. It remains to be established whether any of these or other special audits or reports are considered to be for the primary benefit of persons other than the client.

Recently the primary benefit rule has been under attack in courts and in the literature, and there may be some danger of partial erosion of this protection to auditors. The rule was upheld and applied by the English court of appeal in 1951, but in the face of a strong dissent which argued that: (a) the duty of avoiding negligence extends ". . . also . . . to any [specific] third person to whom [the auditors] themselves show the accounts, or to whom they know their employer is going to show the accounts so as to induce him to invest money or take some other action on them"; (b) an auditor might possibly be liable also ". . . if he prepared his accounts for the guidance of a specific class of persons in a specific class of transactions"; (c) the auditors' duty should not, however, apply to strangers of whom they have heard nothing and to whom the client may show their accounts without their knowledge or consent.

Auditors cannot help but foresee that their reports on financial statements of a client will in fact be relied upon by existing and prospective lenders, creditors, investors, and other persons dealing with the client. In some cases the numbers of such persons may be large and their aggregate commitments in the client may be great. The language of the dissenting opinion could raise a question as to whether at least some of those groups are "a specific class of persons in a specific class of transactions" to whom the dissenting judge would have thought that auditors should be liable for negligence.

In 1963, the dissent in the 1951 case was cited with approval in the *Hedley Byrne* case, which was ruled on by the highest court of England. That case did not involve a report of auditors, but rather an accommodation credit report by a bank, innocently given but negligently worded, on which a third person relied to his damage. In their opinions the justices spoke variously of "special," "particu-

lar," "direct," and "proximate" relationships between defendant and plaintiff, but the justices were unable to formulate a general guide as to the circumstances which do or do not create such a *"special relationship."*

It remains to be seen whether the "special relationship" concept of the *Hedley Byrne* decision will affect the primary benefit rule in the United States. English decisions sometimes, but not always, influence United States courts — and vice versa. No departures from the primary benefit rule have been found in reported United States decisions involving accountants. However, a committee of the well-regarded American Law Institute has recently suggested, with reference to *Hedley Byrne* and other recent decisions, that the correct interpretation of the law would now apply a duty of care, not necessarily ". . . to the very large class of persons whom almost any negligently given information may foreseeably reach and influence," but at least ". . . to the comparatively small group (not necessarily identified by individuals) whom the defendant expects and intends to influence."

As published in *The Journal of Accountancy* for October, 1965, it is reported to be the view of legal counsel to the Council of The Institute of Chartered Accountants in England and Wales that the *Hedley Byrne* principle will subject accountants to liability to third persons for loss resulting from negligence only "... in circumstances where the accountants knew or ought to have known that the reports, accounts, or financial statements in question were being prepared for the specific purpose or transaction which gave rise to the loss and that they would be shown to and relied upon by third parties in that particular connection." Such a view, if confirmed by the English courts, might tend to limit, though not necessarily eliminate altogether, the apparent disparity between the American primary benefit rule and the English special relationship rule.

To illustrate the possible difference between the primary benefit rule and the special relationship rule, consider the case of the auditor who performs a periodic audit and knows (as he is bound to) that his client is required by a loan or merger agreement to deliver financial statements reported on by independent accountants. One could predict with some confidence that the auditor would be protected by the primary benefit rule against liability to the other party to the agreement for ordinary negligence. But one of the justices in *Hedley Byrne* said that if an expert or informed person ". . . takes it upon himself to give information or advice to, or allows his information or advice to be passed on to, another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise."

So if the special relationship rule should wholly or partly supplant the primary benefit rule in the United States, auditors would become exposed to liability for negligence to some part of the "indeterminate" class from which they have heretofore been protected. Thus far the English courts have articulated their new rule only imperfectly. If the United States courts were to adopt the rule at all, the degree of increased exposure would remain uncertain until the rule was applied in litigation.

Liability to others under the common law — fraud

Even though an auditor may not be liable to persons other than his client for ordinary negligence, he will be exposed to liability to others if the deficiencies or lapses in his professional work are of such magnitude that the issuance of his report constitutes deceit, which is one of the categories of fraud.

Deceit is defined legally as the intentional misstatement or concealment of a material fact or opinion for the purpose of inducing another to act in reliance upon it.

An auditor who commits deceit may be held liable to the persons whom he should have reason to expect to act or refrain from acting in reliance upon his deceit — for loss suffered by them in any of the types of transactions in which he should expect their conduct to be influenced by his deceit. Such a liability could extend to those among the potentially large number of present and prospective security-holders, suppliers, customers, contractors, and others whom the auditor should have reason to expect to act or to forbear to act in reliance upon the auditor's report. It is a question of fact as to which of those persons the auditor would have a duty, varying according to the circumstances of different cases. One cannot predict confidently how any specified question of fact would be decided by various triers-of-fact, except that the decisions would undoubtedly not be consistent.

In any case, the exposure of the auditor to liability for fraud would not be limited to the relatively small group referred to in the preceding section who might be able to prove that the auditor issued his report for their "primary benefit," or (under the broader rule) that there was a "special relationship" between the group and the auditor. The scope of liability for deceit is broader than for negligence because a deception is considered more culpable than mere carelessness.

An allegation against an accountant for deceit would ordinarily arise in connection with his audit report. The

standard audit report carries the implicit representation that the issuer is a competent expert in auditing.

The first paragraph of the standard report contains representations which are largely, though not wholly, representations of fact. The auditor represents that he has examined the financial statements of a concern, in accordance with generally accepted auditing standards, and by such auditing procedures as in his reasonable opinion were necessary in the circumstances. If the evidence should reveal significant gaps or omissions in the audit program or serious incompetence or carelessness of staff work or supervision, such facts might support an allegation that the statements of what was done were deceptive misrepresentations and might justify a trier-of-fact in so deciding.

The second paragraph of the standard opinion contains representations of opinion that the financial statements present fairly the financial position and results of operation of the concern. If the evidence should suggest that the audit deficiencies or accounting lapses were so extensive that the auditor may have lacked reasonable ground for believing in the accuracy of his opinion, such circumstances might support an allegation that the auditor's opinion was a deceptive misrepresentation and might justify the trier-of-fact in so deciding.

As was stated in one decision:

> A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.

Whether or not an auditor has committed fraudulent misrepresentation is a factual question for the jury or judge, based on expert testimony and other evidence. Facts indicating either ordinary negligence (a blunder or error of judgment) or gross negligence (serious lapses in the coverage or review of the audit work) may be considered by the finder of fact in considering whether the accountant could reasonably have had a genuine belief in the accuracy of his report.

Liability to others under the federal securities acts

Section 11 of the Securities Act of 1933 deprives the accountant of some of his most important protections in suits by third persons. An accountant who certifies financial statements in a registration statement under the Securities Act of 1933 is subject to the liabilities of Section 11.

An investor in a security registered under the act who can prove that the certified financial statements contained an omission or misstatement of material importance may sue the certifying accountant for the amount of his loss, without being obliged to prove:

(1) negligence or fraud by the accountant in auditing the statements;

(2) reliance on the accountant's opinion (unless plaintiff acquired his securities after the issuer made generally available an earnings statement for a period of at least twelve months beginning after the effective date of the registration statement);

(3) a causal relationship between the omission or misstatement and his loss;

(4) a contractual relationship with the accountant, issuer, sellers, or underwriters. Thus, even a stranger purchasing the registered security in the open market is entitled to recover under the section.

The suit would be barred by the statute of limitations, unless the plaintiff shows that he sued within one year after he discovered, or in the exercise of reasonable diligence should have discovered, the alleged omission or misstatement—and in any case within three years after the security was offered to the public.

The accountant may escape liability if he is able to sustain the burden of proof that after making reasonable investigation, he had reasonable ground to believe that the financial statements certified by him contained no material omission or misstatement. In effect, the accountant will be held liable unless he can prove that he was not negligent. And that is indeed a rigorous standard.

The auditor may also undertake to prove, if he can, that there was no causal relationship between the omission or misstatement and plaintiff's loss, or that plaintiff knew of the omision or misstatement when he acquired the security.

Section 18 of the Securities Exchange Act of 1934 could subject accountants to liability for loss to persons who purchased or sold securities in reliance upon financial statements containing material misstatements or

omissions certified by the accountants and filed with the Securities and Exchange Commission under the act on such forms as 8-K and 10-K. Under this section, the plaintiff must prove reliance upon the omission or misstatement, and although privity (a contract relationship) is no requisite and plaintiff need not prove negligence or fraud by the accountant, the accountant is entitled to prove that he acted in good faith and had no knowledge that the statement was false or misleading. It therefore appears that under the 1934 Act the standards of liability are probably similar or equivalent to those of fraud under the common law (and, accordingly, are less stringent than under the 1933 Act). If so, the legal exposure of accountants to liability to third persons may not be significantly increased, as a practical matter, by this provision of the 1934 Act.

State Laws

No attempt was made for the purpose of this summary to search the securities and other statutes of 50 states for provisions imposing statutory liability on accountants. A brief check of secondary sources suggests that there may be very little in the way of state statutes which specifically impose liability on accountants for negligence, or of more general state statutes which have been applied to impose liability on accountants for negligence. Nonetheless, federal and state securities laws contain fraud provisions which are broad enough to apply to an accountant if his activities are such as to involve him as a participant in a fraudulent sale or purchase of securities. And, there is extensive state legislation on the licensing, regulating, and disciplining of accountants.

The above summary suggests that despite important defenses, practicing accountants have an extensive and probably increasing degree of exposure to clients and others arising from their accounting and auditing services. The damage to an accountant's purse can be severe. The damage to his reputation can be irreparable. The emotional cost of involvement can be deadly.

This article has been written primarily to describe the risk, rather than to prescribe for it. But there are two things which accountants should do, one of them comparatively minor and the other all-important.

Accountants should become more conscious of the degree of responsibility which they are assuming to persons other than their clients, for which they may be receiving no commensurate fee. When called upon to furnish special reports or other information to third persons, accountants should seriously consider insisting on a stipulation that such reports are furnished without responsibility to persons other than their client, or they should incorporate a disclaimer of responsibility to third persons in each such report.

More importantly, accountants must redouble their vigilance in the performance of their work. They must assure that the work performed by their professional staffs is of the highest quality at all levels. They must assure that the supervision and review of staff work is adequate to detect deficiencies, and that technical competence is complemented with mature business judgment. This is the surest and the most direct way to minimize the risk of liability to clients and others.

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