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Discussant's Response to "'Under the Spreading Chestnut Tree' Accountants' Legal Liability— A Historical Perspective"

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Paul has done an excellent job of developing the history of accountants' legal liability. The message of the paper is enhanced by his introduction of some of the cast of characters who have helped shape the development of the subject—from the likes of George May of Price Waterhouse to Philip Musica, alias Frank Donald Coster, of McKesson & Robbin's.

My discussion of the content of Paul's paper will not address the factual settings which underlie the "landmark" cases presented nor will it address the general description of the all too well known tightening of accountants' liability. Rather, my comments will be restricted to expanding some topics discussed by Paul and possibly taking issue with respect to a few.

Whose Duty to Whom?—Some General Observations

The author presents the expansion of the role and responsibilities of the public auditor as one resisted and fought aggressively by auditors. Furthermore, he notes that "changes were frequently the result of litigation losses and/or government intervention."

One might respond that the first of these observations is accurate but a realistic occurrance due in part to a rather young profession trying to find its way to maturity while at the same time attempting to avoid the risks that might abate the maturation process. The second comment about change resulting from litigation could apply to many disciplines. Practicing professionals do not allocate resources to develop procedures to prevent problems unless significant problems exist or critical problems are perceived as imminent. Some might criticize this rather sympathetic response by stating that the accounting profession has done too little too late. The Moss-Metcalf and Dingell committees might be among those critics.

Professionalism

I believe the examination of the legal liability of accountants cannot be viewed as a single issue but must be couched in terms of the degree or extent to which we view accounting as a profession. The degree of professionalization of any occupation depends on how many of the following characteristics, and how much of each, it possesses:

a) General, systematic knowledge.
b) Authority over clients.
c) Community rather than self-interest; symbolic rather than monetary rewards.
d) Self-control.
e) Recognition by the public and law of professional status.
f) A distinctive culture.

Eliot Friedson, on the other hand, contends that the sole defining characteristic of a profession is its convincing of the public and the state of its right to self-control over work-related matters (Ritzer, 1972). Students of accounting history would have no problem seeing the relationship between all or part of these two definitions of a profession and their own accounting profession.

A State of Change

A seesawing relationship does exist between the development by CPAs of professional auditing standards and the liabilities of CPAs as public auditors to their clients and the public. This seesawing seems quite appropriate given the dynamic nature of both the accounting profession and our society's social-economic structure. Organizations and institutions, including professions, are expected to be responsive to the changing needs of the society in which they operate. Unobservant, rigid, and less responsive organizations and professions go the way of the dinosaur.

Our mission should be to carry on a continuing dialogue with the users of our products and services in a positive, nonadversarial way. Unfortunately, much of our profession's highly publicized communication with users has been through their representatives, Moss-Metcalf and more recently Dignell, and the judicial system. More has been written on the users' lack of understanding of accountants' products and service than has been written to address and overcome the problem.

Sharing the Blame

The author raises two issues about the responsibility of employers for the acts of employees. The first relates to adverse interest analysis. The second relates to the double standard held by the courts; CPA firms appear to be held to a higher standard of supervision for their employees than do clients in supervising their employees.

Fraud or Poor Quality Control

Originally, the employer was responsible for the acts of his employee (agency theory—respondeat supervisor) when the latter acted beyond the scope of employment (adverse to the interest of the employer) *if* the employer was "contributorily negligent" because of failure to avoid the loss by not exercising reasonable care in supervising employee(s). This standard was diluted by the "modified contributory negligence test" which narrowed the employer's exposure to liability. The employer now must somehow contribute to the auditor's inability to detect the employee's fraud.

I would like to make two comments in response to what Paul has said about adverse interest analysis. First, as much attention as employees' fraud receives and as devastating as it is on employers (clients), the CPA firms, and the shareholders, fraudulent activities by employees account for only a small percentage of the accountants' liability problems. St. Pierre and Anderson undertook a study which showed that of 334 errors found in 129 law cases examined, only 13 percent related to client (employee) fraud while 33 percent and 15 percent related to problems interpreting accounting principles and auditing standards, respectively (St. Pierre and Anderson, 1984).

Second, the GAO recently issued a report stating that CPAs did not satisfactorily comply with standards on 34 percent of the governmental audits they performed, and more than half of the unsatisfactory audits had severe violations of standards. Two prominent problems identified were insufficient audit work in testing compliance with governmental laws and regulations and the evaluation of internal accounting controls. Smaller CPA firms had greater problems in complying with standards (GAO, 1986). One might conclude from the above discussion that CPAs have a problem with the professional characteristic of "self-control" as mentioned earlier in my remarks.

Spotlight on Management and the Board

Let's assume that material employee fraud, regardless of the small frequency cited above, induces a state of trauma for the client, the public auditor, investors and creditors. Are we, as accountants, to accept the courts' shifting of burden to accountants with the formulation of the modified contributory negligence test? I think not! Clearly, the courts and users have fallen into the expectation gap, the area where perceived levels of responsibility for such things as fraud detection and compilation and review services exceed the auditors' actual responsibility as expressed in professional standards and determined by reasonable cost-benefit considerations. We must educate all user groups including primary users such as investors and creditors, as well as the secondary user groups composed of individuals in the judicial and legislative branches of government.

I do agree with the author that the courts have gone too far in holding auditors more responsible than the client's management and board for an employee's action that is clearly beyond the scope of legal and reasonable business practice. Of the four most commonly identified management functions of planning, organizing, directing, and **controlling,** the courts seem to be overlooking the last of the four functions. Broadly stated, controlling is the process by which managers determine whether organizational objectives are achieved and whether actual operations are consistent with plans.

The four management functions are interrelated and should not be viewed as separate or discrete. All management functions may be viewed within the context of control systems with the following objectives (IIA, 1978):

1. reliability and integrity of information;
2. compliance with policies, plans, procedures, laws and regulations;
3. safeguarding of assets;
4. economical and efficient use of resources; and

5. accomplishment of established objectives and goals for operations and programs.

One might assume that the more effectively these control objectives are achieved, the better the firm's managment.

Our socio-economic structure often permits an inbalance, for a certain period of time, before adjustments are subsequently induced to return to what society views as an equilibrium. Forces have been at work for more than ten years to induce changes to check the undesirable behavior of corporate managements and boards. These changes include:

1. passage of the Foreign Corrupt Practices Act of 1977;
2. adoption of audit committees by many corporate boards;
3. introduction and/or enhancement of the internal audit function in corporations; and
4. the collapse of the "good old boys" boardroom environment.

Collectively, these four changes have had, and will continue to have, a dramatic influence on improving corporate accountability. An additional potential influence, but one that has yet to produce benefits because its work is not completed, is the National Commission on Fraudulent Financial Reporting. Recently, the Commission's chairman, James C. Treadway suggested a mandatory expanded role for internal auditors in some circumstances (IAA, 1986).

The items in the two previous paragraphs have heightened the independence and, in a general professional sense, the authority of the public auditor over the client. As a result, CPAs now have a stronger degree of professionalism.

Supervision of Staff

Turning to Paul's comment on the double standard of the court, i.e., CPA firms appear to be held to a higher standard of supervision for their employees than do clients in supervising their employees. My response is: why not? Professionals should be held to a higher level of care than non-professionals.

Firms that are members of the AICPA Division of CPA Firms are obligated to adhere to quality control standards promulgated by the institute. Quality control standards, among other things, call for establishing policies and procedures for supervising the work of firm personnel. Seven of the nine elements of quality control relate directly to firm personnel (AICPA, 1986). The fact that the profession has taken such a step attests to the fact that the profession has attempted to meet its responsibility to society. Unfortunately, membership in the division is not mandatory for all firms.

A Matter of Perspective

Any discussion about expanding the classes of plaintiffs who should be permitted to be successful in their suit against the auditor is always explosive. Discussants generally have a hard time balancing their own economic interests with the general social good.

The courts, social commentators, and critics have had a hard time applying existing responsibility models to the accounting profession. What other profession gets paid by the party with whom they contracted while the benefits of that relationship flow, in many cases, to their parties, aptly coined by Judge Cardoza, "an indeterminate class"? The courts have had difficulty reconciling the amount of the public auditor's responsibility with the amount of loss suffered by potentially great numbers of people the public auditor himself admittedly intends the product of his attest function to serve. At the extreme, a judge, unfamiliar with all of the variables in play, might, after reading Statement of Financial Accounting Concepts No. 1 (FASB, 1978) think that public policy dictates that liability for ordinary negligence be imposed on accountants for foreseeable injuries resulting from their negligent acts.

The question is, are society's expectations realistic? Let's explore *H. Rosenblum, Inc. v. Adler,* one example that reflects society's expectations through the pen of the judge who wrote the opinion[1]. Although the author first discusses *Citizens State Bank v. Timm, Schmidt & Co., Rosenblum, Inc. v. Adler* is the initial case to hold accountants liable for ordinary negligence to foreseeable third parties. On the surface, the logic underlying the New Jersey Supreme Court decision appears sound. However, it is flawed. The author recounts the court's two-step process to determine the accountant's liability. I would like to use the same process but take a different approach than the author in responding to the court.

The court began "first, we shall consider whether, in the absence of privity, an action for negligent misrepresentation may be maintained for economic loss against the provider of a service." The court continued:

> If recovery for defective products may include economic loss, why should such loss not be compensable if caused by negligent misrepresentation? The maker of the product and the person making a written representation with intent that it be relied upon are, respectively, impliedly holding out that the product is reasonably fit, suitable and safe and that the representation is reasonably sufficient, suitable and accurate.

In response, I believe the differences found in the comparison made between a manufacturer's product and a public auditor's opinion appear to far outweight the similarities. The manufacturer controls, and is responsible for, the process by which the product is made as well as the product resulting from that process. Likewise, as pointed out earlier, the client controls, and is responsible for, the adequacy of the accounting process and its product. The public auditor, on the other hand, is charged to test management's assertions which are articulated in the financial statements. A similar position is also held by Gormley and Minnow (Gormley, 1984; Minnow, 1984).

The author then analyzes the court's second question—"what duty should the auditor . . . bear to best serve the public interest in light of the role of the auditor in today's economy?" The duty found to exist must be equated with what is fair; the analysis of fairness "involves a weighing of the relationship of the parties, the nature of the risks and the public interest in the proposed solution."

In response, the courts judging fairness in terms of the objectives of financial reporting mentioned earlier totally avoid addressing the broader issue which has given rise to the litigation explosion. It appears that the courts have rejected the idea that when professionals are working at the best of their ability, within the concept of the average prudent auditor, there are chance occurrences that may still befall the client. The rejection of this assumption leads the courts to accept the idea that all losses shall be borne by someone. This, in turn, leads to the notion that the deep pocket has no bottom; a fountain of funds for all those who, by mere chance, have suffered a loss. Courts in New Jersey, Wisconsin, and most recently California, in *International Mortgage Company v. John P. Butler Accounting Corporation,* view insurance as a readily available vehicle for making the plaintiff whole and have extended the accountant's liability to foreseeable parties. Resultant insurance premium increases, the courts believe, can be passed along to all consumers.

The insurance public policy argument has been successfully employed in many other segments of our society. So successful has been its use that the insurance piggy bank is nearly empty.

Between 1975 and 1984 product liability cases have increased 600 percent to approximately 10,500; suits against officers and directors have increased more than 200 percent during the same time period (Samuelson, 1986). This significant increase in liability cases is due primarily to the self serving interests of the members of the Association of Trial Lawyers, whose ranks tripled in the last 15 years to 60,000. This group has placed its own economic interests ahead of the "public interest," or so many believe. A wave of reforms are under consideration in state capitals and Washington. In Washington, the Kasten bill limits the amount of contingency-fee lawyers can earn, and also restricts joint and several liability (WSJ, 1986).

Summary and Conclusions

Survival of the profession has and will continue to be measured in terms of the ability of its members to adapt to changes in society. Change should be looked upon as an opportunity, an opportunity to serve, grow and mature.

The application of extending liability of accountants to reasonably foreseeable third parties will probably increase beyond the three states where it is now applied. The profession can meet this challenge by aggressively pursuing:

- A continuing dialogue with users of financial statements as to the role and responsibilities of the external auditor, corporate management, and boards in the financial reporting process.
- Mandatory membership in the AICPA Division for CPA Firms for all firms.
- A reasonable limitation, such as a multiple of the annual audit fee, on the amount of liability extended to CPA defendants and elimination of joint and several liability.

End Notes

1. 461 A 2d 138 (N.J. 1983)

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