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"Under the Spreading Chestnut Tree" Accountants' Legal Liability—A Historical Perspective

Paul J. Ostling*
Arthur Young & Co.

I. Introduction

It is difficult these days to read a week's worth of newspaper financial sections and business magazines without finding an article, sometimes lurid, discussing the role and liabilities of the public auditor. Those within the profession often view this attention as an undeserved, new development. Certainly the frequency, scope, and magnitude of civil suits against auditors have grown. There has, however, always been a close connection between the legal liabilities imposed upon auditors and the standards adopted by the profession—as well as its perceived scope and responsibilities of practice.

This paper describes some present and recent legal challenges facing the profession, their historical perspective, and predictions as to possible future developments. Taken in perspective, current attacks on the profession may be no more than a maturation and reevaluation of the auditor's standards and role. As the investor community becomes more sophisticated in its appreciation of the limitations in the auditor's role pursuant to generally accepted auditing standards (GAAS), and better understands the "gray areas" where generally accepted accounting principles (GAAP) permit more than one treatment of certain financial transactions, a credibility gap looms. To reduce the gap, the courts and legislators are attempting to regulate the profession and impose more "watchdog" responsibilities. Because of the gap, insurance companies and bright young graduates, fearful, respectively, of large legal judgments and less rewarding career opportunities may avoid the accounting profession.

Counter-productive activities of the professionals themselves and their representative associations may be complicating this trend. Nearly predatory competition drives the price of audit services downward at the very same time that the attendant risks are skyrocketing. Legislative "overseers" lambast the profession, often inaccurately and unjustifiably, but the associations often seem timid by comparison in their response. Public auditors must act quickly and affirmatively to resolve these conflicts in order to assure the future growth and profitability of the profession.

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* The views expressed herein are those of the author individually.

II. Development of Standards and Liabilities

It is now settled that the role and responsibilities of the public auditor include the supply of accurate financial information to facilitate the function of the free markets, including the securities markets. This was not always accepted by the profession as such. Indeed, our predecessors in practice initially viewed their audience as including only their direct, paying clients. Auditors vociferously resisted the expansion of their role and responsibilities, and changes were frequently the result of litigation losses and/or government intervention.

A. Our United Kingdom Roots

While there are reports of "auditors" having counting responsibilities during biblical times, the analysis of the evolution of accountants' legal liabilities must commence in the United Kingdom. It comes as no great surprise to even the less scholarly students of the profession that the modern auditing profession as we know it evolved in England and Scotland.

Laws permitting the formation of corporate entities (whose ownership was represented by and transferable through stock) and the concept of "limited liability" (that a shareholder is liable to the extent of his capital invested in purchasing stock, but is not "personally liable") were passed there during the 1840's and 1850's. The Joint Stock Companies Act of 1844[1] required that a "full and fair" balance sheet be sent to shareholders before their meetings and filed with the Registrar of Companies. Auditors (who were to be non-office-holding stock-holders) were required to be appointed to report on the balance sheet. There were no meaningful legal requirements or standards as to the form or content of the balance sheets or the manner of the conduct of the auditors' reviews. There were no enforcement provisions relating to the content or the filing of the balance sheet with the Registrar of Companies. The 1844 Act should not be thought of as anything approaching our own federal or state securities laws.

Because the balance sheets were standardless and the "audits" were a perfunctory checking of support for disbursements there was little faith by third parties in either the fullness or fairness of the balance sheets.[2] The balance sheet requirement was dropped in 1856,[3] and the matter of accounting and auditing was left up to the corporations themselves. It was not until 1900 that all registrants under the Companies Act were again required to have annual audits conducted. In 1907, they were again required to file their balance sheets.[4]

In the fifty-year interim, however, certain industry-specific requirements were enacted. During the late 1860's railroad companies were required to publish their accounts; during the 1870's banks were required to audit their accounts and gas companies to publish theirs; and in the early 1880's electrical companies were to publish their accounts. These industries were regarded as special because of the public trust in their operations, or the speculative nature of their early operations. In the meantime, the accounting profession was beginning to organize and establish standards. In Scotland, the Society of Accountants in Edinburgh was granted a royal charter in 1854. In England, a charter was granted to The Institute of Chartered Accountants in England and

Wales in 1880. Two other associations were formed in Scotland, and in England the Society of Incorporated Accountants and Auditors was formed in 1885. In both Scotland and England these groups agreed upon uniform examinations for new members (designated chartered accountant or C.A.) as well as apprenticeship programs.[5]

The British audit during the 1880's evolved as having the primary goal of uncovering fraud. Detailed bookkeeping-type examinations reviewed the numbers in the books of account. Courses in study evolved in auditing, and a textbook was prepared. Customs developed for the preparation of the auditors' "certification". The Scots and English auditors had acquired some status and had established some commonly accepted auditing and accounting "standards" by 1900, when all registered companies were required to have audits conducted. For example, the use of the term "certificate" to describe the report, and the representation that financial statements "present fairly" were English customs. This is not to say, however, that auditors' "legal liabilities" had been yet fully examined.

For the most part the manner of report and the procedures applied were determined by the corporation's articles of incorporation and the engagement contract between the auditor and the client. In most cases the company's articles required that the balance sheet be "full and fair" and prepared to display the "true and correct" picture of the company's "state of affairs." This requirement was based upon the model articles of incorporation appended to the 1856 Companies Act.[6] The earliest reported losing cases involving auditors arose in England prior to 1900, and focused upon whether the auditor's certificate had adequately communicated the "state of affairs" of the company.[7]

In the case of *Leeds Estate,* the auditor's certificate for seven years, 1874 through 1880, said:

> I certify that I have examined the above accounts and find them to be a true copy of those [shown] in the books of the company.

While escaping damages because that statute of limitations had run, the auditor was found guilty of negligence to its client for failing to actually go behind the numbers presented by management to ascertain their accuracy.

In *In re London* the auditor's 1892 certificate said:

> We have examined the . . . balance-sheet and compared it with the books of the company; and we certify that it is a correct summary of the accounts therein recorded. The value of the assets as [shown] on the balance-sheet is dependent upon their realization.

Again the auditor was found liable for negligence in breaching its duty to its clients—the shareholders—because the Court felt the words "subject to realization" was not a qualification which adequately communicated the company's true state of affairs.

Thus, by 1900, some rudimentary legal reporting requirements had been imposed upon their clients, and the court had just begun to impose a legal duty

upon auditors to carry out an audit in accordance with their engagement contracts. The duty was a narrow one by today's standards, but the auditors gave those clients some level of comfort with regard to detecting fraud which was on the clients' books. To be sure, the primary purposes and benefits from the audit were to assist the client's management in monitoring its financial matters, ward off defalcations, and secure financial support from bankers.

B. Migration to America

In 1776, America was essentially an agrarian society. While the revolution removed the yoke of British governmental rule, the financial connections which had already been formed by British financiers provided much of the capital for the American industrial revolution. American states passed laws permitting the formation of corporations. The industrial revolution, corporate growth, and British investment all led to the birth of the accounting profession in America—but as a child of the United Kingdom practice.

Individuals, such as Arthur Young, came to America in growing numbers during the 1880's and 1890's to look after the interests of English investors, and then began their own practices here—evolving into firms of accountants. English firms, such as Price Waterhouse & Co., sent agents of the firm to the United States to conduct examinations on behalf of English investors. By 1900, Price Waterhouse's activities were significant enough here that Arthur Lowes Dickenson came to manage them. A young English auditor on his staff at the time, George O. May, succeeded Dickenson as senior partner in America in 1911, remained in the post until 1940, and had an incredible influence upon the manner of practice and the development of standards in America. An American of the day, Colonel Robert Montgomery, was also an early leader in establishing the American practice. He was a CPA, a lawyer, a military figure, a Columbia University professor, and president of the associations which eventually became the AICPA. In 1905, he edited the first American textbook on auditing (called, simply *Auditing*) which was, naturally, an adaptation of the leading English text of the day.

In 1896, New York was the first state to pass a law designating the professional title of Certified Public Accountant. Other states quickly followed. Likewise, uniform tests for CPAs were developed early in this century. Through this period, however, the American practice, in terms of procedures and process, was little more than an extension of the Scots and English methodologies. Indeed, most of the leading U.S. firms were led by Scots and Englishmen until the early 1960's. For at least the first quarter of the century, the bulk of audit "staffmen" were imported from the United Kingdom. Thus, as in England, the focus in America was initially upon auditing as a report *to* management rather than as a review of management's report to investors and lenders of its own stewardship. Much of the development of the auditor's legal liabilities over the past 53 years has focused on this change in the audit's emphasis to a review of the managment's financial report to third-party users of financial information.

C. Early Development of Standards in America

Pressure for a change in emphasis in the purpose of financial reporting and auditing began early in this century. Before the great stock market crash of 1929, ownership of stocks and bonds became more than a game for the wealthy. Many small, individual purchasers—relatively unsophisticated and in large measure financing their purchases with borrowed money—entered the stock market. Investors wanted more and more accurate financial information, and critics wanted more standardization of accounting and reporting practices. The new investing audience was more interested "in the income statement and less in the balance sheet."[8] Despite this need for more standardization, practices varied substantially on subjects such as depreciation and reporting of income statements. Critics of the profession complained of the lack of standardization, the inadequacy of financial information, and the manipulative practices which abounded.[9]

Three developments between 1916 and 1934 went far in the United States to formulate standards and define the duties and liabilities of auditors. In 1916 the Secretary of Commerce (William Redfield), the Federal Trade Commission (FTC) and the Federal Reserve Board (FRB) requested the American Institute of Accountants (AIA) to prepare a memorandum on balance sheet audits. Since many of the audits conducted had been balance sheet audits done without actual observation of inventories and assets, they were concerned about the integrity of financial information of the day.

The AIA committee, which included George May and Robert Montgomery, adopted a Price Waterhouse internal memorandum entitled *Memorandum on Balance Sheet Audits*. This memorandum was approved and accepted by the FTC and the FRB and published initially in 1917 in the Federal Reserve Bulletin. It was revised and republished several times before 1930. The AIA itself revised the memorandum and published it in 1936 as *Examination of Financial Statements by Independent Public Accountants*. While this effort resulted in some standardization and definition of the auditor's role, it still did not require observation or testing of inventories or the confirmation of receivables. It would be left to a major scandal for that to occur.

The second major occurrence in the development of standards began from a 1927 AIA initiative, when it approached, but was turned down by the New York Stock Exchange (NYSE), to jointly develop financial reporting requirements for NYSE registrants. After the 1929 crash, the NYSE reversed itself and asked for the AIA's help in developing accounting principles. George May was called into service yet again to chair two separate committees to cooperate with exchanges and develop accounting principles.

May's committees did not support the adoption of a set of specific directives of accounting treatment, but suggested in 1932 "very broad limits [of accounting treatments within which reporting companies would make] disclosure of the methods employed and consistency in their application from year to year."[10] In 1933 the NYSE required all new registrants to have audited annual financial reports, but made no requirements for disclosure of accounting methods. May's committees published a pamphlet in 1934 called "Audits of Corporate Accounts" and recommended a new form of audit report which used the words: "fairly present, in accordance with accepted principles of account-

ing consistently maintained." In 1940 the reference to "accepted principles of accounting" became "generally accepted accounting principles." From 1934 on, the profession recommended that companies choose accounting methods "within very broad limits" and identify them in the financial statements. Thus the concept of GAAP was born—with the built-in flexibilities upon which many of today's critics harp.

The third major occurrence in the period was the enactment of the Securities Act of 1933[11] and the Securities Exchange Act of 1934.[12] Before these enactments, no laws in the U.S. required audited financial statements for "public companies." When initially passed, the Securities Act was enforced by the FTC, which quickly published regulations for the determination of independence of auditors and uniform accounting rules. The Securities Act requires registration of new securities via a registration "statement" including financial statements certified by an independent accountant. The 1933 Act imposes significant legal liabilities upon experts identified in the registration statements for false statements in the portions of the report as to which they are experts. It also prohibits fraud in connection with the sale of new securities.

The 1934 Act is an overlay beyond the 1933 Act which created the SEC to enforce both Acts. It prohibits false statements in connection with the sale of securities, and was particularly significant in its impact upon public auditors in the context of private securities fraud suits. The 1933 and 1934 Acts and the regulations promulgated thereunder clearly established concrete standards, roles, and liabilities for American auditors.

D. The Agony of Defeat

The late 1930's marked the beginning of litigation in the United States which had direct impact upon the duties and liabilities of auditors. This paper cannot relate *all* cases which have historical significance, but several have had "landmark" results upon the profession.

1. Testing Inventories and Assets

The *McKesson & Robbins* case is the most significant "early" auditing case in America. Philip Musica, alias Frank Donald Coster, was a con man. His first scrape with American justice in 1909 resulted in conviction and a prison sentence for bribing customs officials and preparing fraudulent invoices and customs documents. Within three years of leaving prison, he was caught for bilking twenty-two banks on loans obtained with collateral he did not own. He spent three years in prison and was placed on probation.

In 1920, Musica claimed to be in the drug business but was actually a prohibition bootlegger. In 1923, he became the sole owner of Girard & Company, a manufacturer of drugs. Despite being sole owner, he hired Price Waterhouse to conduct audits. He studied auditing procedures and noted that auditors did not observe physical inventories unless requested to do so. In 1926, with financial support from bankers, he purchased McKesson & Robbins which was merged with his company.

In December 1938, Musica was confronted by his treasurer and director who had uncovered fraud, waste, mismanagement and inclusion of fictitious inventories and assets exceeding $10 million. A receiver was appointed by a

federal judge, and that same day the ever present George May of Price Waterhouse met with the company's executives and assured them that, as far as he knew, the books were in order. Eleven days later Musica committed suicide. Investigation revealed that on stated assets of over $87 million, $10 million in inventory and $9 million of receivables were fictitious.

Price Waterhouse settled the trustee's claim by refunding $522,402.29 representing five years' audit fees. The SEC commenced an investigation which exposed the lack of agreement among auditors as to what the appropriate audit procedures were with regard to inventories and receivables. In the wake of the scandal, but before the SEC could issue its final report, the AIA established a committee in January 1939, to examine audit procedures. In October 1939, the AIA issued its Committee on Auditing Procedures' *Statement on Auditing Procedure No. 1: Extensions of Auditing Procedure,* which required observation and testing of physical inventory and confirmation of receivables.

The SEC's report, which was issued in 1940[13] contained the following:

- Price Waterhouse was found to be derelict in failing to follow procedures which a diligent auditor would have used in the circumstances, and which were called for in the authoritative works on auditing (*e.g.*, Montgomery, *Auditing Theory and Practice* (1934), p. 157 and 182).
- While auditors claimed not to be insurers of financial health, "discovery of gross overstatement in the accounts is a major purpose of an audit. . . ."
- Management's activities are within the scope of an audit, so auditors should be elected by shareholders.
- The profession did well to publish SAP No. 1, but it should also distinguish between auditing "standards" and "procedures."
- Regulation S-X was amended so that the auditor's report states whether the audit was made in accordance with appropriate GAAS.

The profession responded by having the AIA Committee on Auditing Procedure prepare a statement defining audit standards. In 1947, the AIA published a brochure incorporating the Committee's memorandum "Tentative Statement of Auditing Standards—Their Generally Accepted Significance and Scope." We now know this as *Statement on Auditing Standards No. 1.* The statement distinguished between standards (which deal with "quality of performance and objectives to be attained") and procedures (which "relate to acts to be performed"). While over the years the interpretations have been amended from time to time, the three original auditing standards ("General Standards," "Standards of Field Work" and "Standards of Reporting") remain the same.

The *McKesson & Robbins* case is a graphic illustration of how scandal and litigation can result directly in long-term advances in the definition of a profession's role, standards, and legal liabilities. Since this case resulted directly in SAP NO. 1 and SAS No. 1, it is difficult to find a more seminal example.

2. Go Directly to Jail, Do Not Pass "Go"

Perhaps the most image-shattering cases for the profession have been those which resulted in criminal convictions for independent auditors. Recently, in connection with a federal investigation and indictments relating to a major financial scandal, a picture of a Big Eight partner being led to his arraignment in handcuffs appeared on page 1 of the *New York Times* Business Section. More recently, a managing partner of a Florida practice office of a major accounting firm pleaded guilty to several counts of fraud and criminal securities conduct, including taking a payment from ESM Securities and giving a clean opinion in the face of fictitious collateral securing millions of dollars of ESM's securities transactions. In the same case, the company's lawyer (the son-in-law of ESM's major benefactor) committed suicide. The lurid headlines created by these criminal financial scandals have a far-reaching impact upon the public's perception of and respect (or lack thereof) for the profession.

Three such criminal cases have had far-reaching impact upon the profession's self-image and its view of the attendant duties and liabilities. In 1968, a senior partner, a junior partner, and a senior associate of Lybrand, Ross Bros. & Montgomery were convicted (after a jury trial) of mail fraud and securities fraud for certifying the 1962 financial statements of Continental Vending Corporation. The main defense was that the financial statements were in compliance with GAAP. The trial court held, and the United States Court of Appeals for the Second Circuit affirmed[14] that compliance with GAAP was not a complete defense against a charge of criminally certifying a false and misleading financial statement, and that auditors must report major management misconduct.

The Second Circuit took its task of passing on criminal liability of professionals quite seriously:

> While every criminal conviction is important to the defendant, there is a special poignancy and a corresponding responsibility on reviewing judges when, as here, the defendants have been men of blameless lives and respected members of a learned profession. . . .

In a widely quoted passage, the court enunciated an accountant's legal responsibility to investigate management dishonesty:

> [I]t simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. For a court to say that all this is immaterial as a matter of law if only such loans are thought to be collectible would be to say that independent accountants have no responsibility to reveal known dishonesty by a high corporate officer. If certification does not at least imply that the corporation has not been looted by insiders so far as the accountants know, or, if it has been, that the diversion has been made good beyond peradventure (or adequately reserved against) and effective steps taken to prevent a recurrence, it would mean nothing, and the reliance placed on it by the public would be a snare and a dilution. . . .

The defendants were fined and placed on probation. In 1972, President Nixon pardoned them.

In 1974, a partner and an audit supervisor were convicted after a jury trial for criminal violations of the securities law by making false statements in a 1969 proxy statement for National Student Marketing (NSM). On appeal, the conviction of the partner was affirmed, while the supervisor's was reversed.[15] The partner was sentenced to imprisonment for one year and fined $10,000. The jail sentence was suspended to 60 days.

The charges centered upon NSM's policy of recognizing revenue which was selected by the partner and based upon the percentage-of-completion method. NSM was recognizing revenue when it allegedly received "commitments" on fixed-fee contracts to participate in marketing programs developed by NSM which were aimed at the "youth market." NSM's utilization of the method, and its decisions as to when it had "commitments" (*i.e.* recognizing revenue on "unbilled accounts receivable") resulted in overstating "net sales" by approximately $1 million and reporting "net earnings" of $702,270 in its 1968 Annual Report when there were in fact no earnings at all. NSM experienced an incredible stock price rise (from $6 to $80 in less than two years) and used the stock to make a series of acquisitions.

After selecting the percentage-of-completion method for NSM's 1968 financial statements, the partner instructed the supervisor to check on the commitments. The supervisor did so, but in a haphazard manner by telephone. No written verifications were sought or received. The partner permitted NSM to include $1.7 million of such commitments as unbilled receivables for 1968 and this in turn permitted NSM to show a profit instead of a loss. The footnotes to the annual report's financial statements did not disclose the "flimsy" nature of the commitments.

Within five months of the publication of the 1968 financial statements, NSM had to write off $1 million of the $1.7 million of commitments. When the auditors learned of the circumstances of the write-off and the periods they related to, they netted the reduced earnings against a favorable extraordinary tax item instead of reducing earnings and sales for the prior period. Thus, the auditors helped to conceal the actual write-off of profits. NSM then published the Proxy Statement for the nine months following 1968 without disclosing the problems with the earlier period.

The Second Circuit noted that the partner's action in allowing bookings on commitments for 1968 "was contrary to sound accounting practice,"[16] and after discovering the bogus nature of them "[h]onesty should have impelled [him] to disclose" the problems in the updated footnotes in the Proxy Statement. The Second Circuit then enunciated what is now called the "suspicious inquiry doctrine."

Shortly after the *Natelli* conviction, three independent auditors were convicted in the aftermath of the Equity Funding Corporation of America securities scandal. The three were the partner in charge and two audit managers of Wolfson, Weiner, Ratloff & Lapin which had been merged into Seidman and Seidman in 1972. After a jury trial, the three were convicted of multiple counts of securities fraud and filing false SEC documents. The conviction was upheld on appeal.[17] The Equity Funding scandal, which involved widespread use of computers to perpetrate a massive fraud and the spectacle

of issuing new insurance policies to dead people to make Equity Funding's growth track look continuous, was perhaps the most publicized securities scandal of the 1960's and 1970's. Books have been written about the case. Careers of attorneys were made while careers of investment advisors and accountants were destroyed.

These cases, and cases like them, should stand as a beacon for the profession signifying a line beyond which one cannot go for one's client. Moreover, they clearly demonstrate that auditors are not exempt from criminal liability.

3. Expanding Liability to Clients—The "Adverse Interest" Analysis

Even as criticism of the accounting profession by governmental representatives, investors, customers of failed banks and financial services institutions, and the courts grows, the profession's own clients are expanding the auditor's responsibilities and liabilities. The financial statements of a company are, legally and under the accounting literature, management's reports of the company's financial transactions. It often comes as a rude awakening then, when, after the client's officers and directors have set accounting policy, prepared the financial statements, and represented them to be true and accurate to the auditor, the corporate *client* disclaims responsibility for the active fraud of its own officers and directors, and sues the auditor for negligence in failing to discover and/or disclose that fraud. There was a time when clients were unable to make these suits stick, but those days are gone.

The early cases concerning the allocation of blame for financial dishonesty between the client and the auditor often arose where employees made defalcations of the client's assets. The issue was generally addressed from the perspective of whether the client should bear responsibility for failure to properly supervise its employee, or whether the auditor should bear the loss for negligence in not detecting the employee's dishonesty. Under ancient common law theories of "agency" or *respondeat superior* the principal/employer is responsible for the negligent or wrongful acts committed in the course of the agent/employee's employment. When the employee actually steals *from* his employer, the courts have ruled the illegal deed to be outside the "scope of employment" (*i.e.*, it is "adverse" to the "interests" of the employer), and held the agency/*respondeat superior* doctrines inapplicable to place the blame on the employer. Rather, in these cases the courts generally adopted the old contributory negligence standard. Under this approach, even if the auditor were negligent in detecting the fraud, there would be no liability for the loss where the client was "contributorially negligent" and thus could have avoided the loss by the exercise of reasonable care in supervising its own employee.[18] Even in these cases, auditors were sometimes found in "breach of contract" and had to return their fees to the client.

This standard, which was the most favorable for auditors, began to be reduced when courts overlaid a requirement that the auditor would not avoid liability unless the client's contributing negligence somehow contributed to the auditor's inability to detect the employee's fraud.[19] In such cases, the courts acknowledged a belief that part of the function of the audit *was* "detecting

defalcations which the [company's] negligence ha[d] made possible. . . ." Thus, there was no automatic defense for the auditor just because the client's negligence in supervising the errant employee permitted the *loss* to occur, but there was a defense when the client's negligence permitted the *auditor's* negligence or somehow undercut the *auditor's* ability to perform its job.

The tightening of the noose around auditors began in a series of cases which adopted a variant of the "adverse interest" analysis. First, in *Shapiro v. Glekel,*[20] the court utilizing the modified negligence test described above refused to dismiss a case against the auditors of Beck Industries. Beck had become a conglomerate by acquiring numerous companies in the 1960's. The president and chairman of Beck's executive board had fraudulently prepared financial statements which overstated assets and revenues. These inflated statements helped keep Beck's stock price high, and the stock and fraudulent statements were used in the acquisitions. Beck went bankrupt. The trustee for the estate sued the auditors on behalf of Beck arguing that the "outside" directors would never have authorized the aggressive acquisition program had they known Beck's true financial condition.

The court found that however negligent or unlawful the conduct of Beck's officers had been, it had not prevented the auditors from performing their audit. In analyzing the case it is difficult to see how the actions of the president and his cohorts were not on behalf of Beck and in the scope of employment. They did not steal *from* Beck *per se,* rather they launched a scheme which aggrandized the company and allowed *it* to acquire new assets (although surely their own stock holdings and positions were benefited as well). If the auditors were able to utilize the *respondeat superior* argument, they would certainly have been able to avoid or significantly cushion liability.

To date the courts have refused to permit auditors to use such arguments. A prime example is *In re Investors Funding Corp.*,[21] where the company's officers' attempted bribes led directly to the company's failure. In suing the auditors after the company failed, the trustee claimed that the officers' fraud and mismanagement would not have continued "but for" the auditor's actions. The auditor staked its defense on the claim that it was a *victim* of the officers' fraud, and not *responsible* for it. The court referred to the principles of *respondeat superior* and observed that the adverse interest test (which lets the employer *off* the hook when the employee's acts are "adverse" to the employer") does not apply when the employee is acting at least partly for the employer's benefit "even though the agent's primary interest is inimical to that of the principal."

Nevertheless, the court refused to dismiss the trustee's case and found that the officers' scheme to keep the company afloat was not even partly for the benefit of the company. It accepted the trustee's allegations that the officers' false financial statements prolonged the company's "artificial solvency," and this was "predominantly antagonistic" to the company's interests. The court held that this benefited *only* the officers and not the company.

Auditors have had a bright moment in the interim, such as in a case where the court found a company's officers had turned the company into "an engine of theft against outsiders" and refused to permit recovery on behalf of the company against its auditors.[22] But for the most part, the courts have refused to follow such logic, and refuse to saddle a client with the fraudulent or even

criminal acts of its own officers and directors, and do permit recovery against auditors.[23]

An interesting irony has developed with regard to the auditor's legal liabilities as opposed to those of the officers and directors of America's larger public companies. The former have come to be regarded as having a higher standard of diligence and care—they are the "watchdogs"[24]—than the officers and directors of their clients who have the underlying duty to honestly and faithfully account to the public for their stewardship. Auditors have not been permitted to avoid the acts of their own employees who have been found to have had fraudulent intent (even where no partners have such intent) again, because the special duties of auditors require them to be even more vigilant in monitoring their employees.[25]

In essence, the courts have permitted corporations whose downfall is attributable to their own leaders to disclaim responsibility because the leaders' acts were so wrongful as to be *"ultra vires"*—even though the corporation may have been aggrandized, incurred increased assets, and grown in share price as a result of those acts before the acts were discovered. The very shareholders and creditors of the corporations have then been permitted to collect millions of dollars in damages from auditors and their insurers to pay for the ensuing drop in share price, the debts, and the shortfalls created by the wrongdoers. On the contrary, the courts have not permitted auditing firms to escape liability where the acts of partners or junior auditors are clearly and undeniably contrary to the audit firms' overall interests and their own published policies and procedures.[26] Has the pendulum swung too far? Should corporations, their shareholders and creditors (who frequently have significant corporate governance power through debt covenants and agreements) share in the responsibility for ensuring that their corporate leaders prepare and release accurate financial statements?

III. Expansion of the "Protected" Class

The subject of the expansion of class of those who will be permitted to bring suit against the auditor always begins with a discussion of *Ultramares Corp. v. Touche,*[27] even though *Ultramares* was not the first case to restrict the class of those entitled to sue an auditor.[28] In *Ultramares,* Touche, Niven & Co. was retained to prepare and report on the balance sheet of Fred Stern & Co. as of December 31, 1923, as they had done for three prior years. Fred Stern financed his company through extensive borrowings, and Touche knew how Stern financed the company. Touche was aware that Stern would show its certified balance sheet to creditors. Touche supplied Stern with 32 copies of the balance sheet, each as a counterpart original. There was, however, no specific agreement with Touche as to who would see the balance sheets or how many times they might be used. There was no identification of Ultramares, no communication between Touche and Ultramares, and Ultramares had not been a Stern creditor in earlier years. The subject of who would look at the balance sheet was left indefinite.

The audit was finished and a net worth of more than $1 million was indicated in the balance sheet. Touche issued a clean opinion. The books had been falsified, and Stern was actually insolvent. Ultramares saw the balance sheet and extended substantial credit to Stern before discovery of the insolvency. It

sued Touche claiming the audit was negligent or fraudulent. There was no indication of fraudulent intent ("scienter") and the trial judge dismissed the fraud claim, but the jury found Touche negligent. The judge granted Touche a dismissal judgment notwithstanding the verdict. The Appellate Division reversed the judge's holding and held Touche negligent.

On appeal, New York's highest court reversed and found for Touche. In an eloquent opinion the famous Judge Cardozo rejected "the assault on the citadel of privity." "Privity" is the close relationship which exists between parties to a contract. Cardozo was concerned to prevent the expansion of liability for "negligent words" from growing to duplicate an action in fraud in the absence of the "indispensable element" of *scienter.* In this sense he was four decades ahead of the United States Supreme Court's decision in *Ernst & Ernst v. Hochfelder.*[29]

Dispensing with the issue of fraud since there was none, Cardozo turned to negligence. He held that auditors cannot be liable for negligence to third parties where the auditor could only foresee the third-party plaintiff in a general way. This was the case where plaintiff's loans to the audit client were within a "wide range of transactions in which a certificate of audit might be expected to play a part." Cardozo refused to unnecessarily enlarge the class of third parties which might sue auditors:

> 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.

Judge Cardozo made it clear that he had no intention of "emancipating" auditors from liability. He simply would not extend it to an "indefinite" group of third parties in the absence of more than mere negligence. Much of what has happened in the auditor's legal liability during the last fifty years can be viewed as ebbs and flows in the application of the privity doctrine.

A. Privity and Unaudited Financial Statements

Conflicting opinions as to the range of accountants' liability have led courts to issue confusing decisions where unaudited statements are involved. In a number of cases, auditors have been found liable to their *client* for non-audit work,[30] and to the *public* in actions by the SEC or criminal authorities.[31] In *Natelli, supra,* the court adopted what has come to be referred to as the "suspicious inquiry" standard in connection with accountants involved in preparing unaudited financial statements. The auditor has a duty to investigate figures known by him to be suspicious, and to insist upon corrections in published reports, even though no audit is conducted.

In cases involving nonaudited statements, the courts frequently frame the critical issue as the question of extending accountants' liability to third parties who are not in privity. One line of case law continues to accept the *Ultramares* approach, while other courts take issue with *Ultramares* and generally rely on the *Restatement (Second) of Torts* (Restatement) standard in assessing the

extent of the accountants' liability. Section 552 of the Restatement rejects *Ultramares* to the extent that privity is the sole definitional criterion of duty. The Restatement standard for negligent misrepresentation seems to be "knowing reliance" rather than "reasonable foreseeability," the latter being the hallmark of the negligence determination in other areas of tort law. Courts using this analysis to find liability focus on whether the accountant knew the third party would rely upon the financial statement.

In *Bonhiver v. Graff,*[32] the Minnesota Supreme Court found an accountant liable to a third party, a receiver of an insurance company, for failing to discover an embezzlement during a write-up engagement that was never completed. The court based its decision on the fact that the accountant had audited the firm in a prior year and was aware of its poor financial condition. When the accountant personally showed his workpapers and figures to state examiners who relied on such data, such knowledge on the defendants' part "rendered them liable for their negligence" in the preparation of those workpapers. For authority, the court analogized to the *Natelli* case. For additional authority Restatement § 552 was applied.

A classic example of the Restatement reasoning is in *Ryan v. Kanne.*[33] There, the Iowa Supreme Court dealt a blow to the concept of privity, increasing considerably the accountant's potential liability to third parties. Kanne owned and operated certain businesses, including lumber companies, which had incurred considerable indebtedness. He sought the services of an accountant at the insistence of the officers of a creditor. The accountants were to determine the true amount of the accounts payable. The accountant submitted financal statements clearly marked "unaudited," but an accompanying letter described certain confirmation procedures which the accountants had undertaken to verify the accuracy of their figures. When Kanne Lumber and Supply, Inc. was incorporated and took over the assets and liabilities of Kanne's lumber business, it discovered that the accounts payable were incorrect.

The *Ryan* court looked to *Rusch Factors, Inc. v. Levin,*[34] as establishing the guiding principle to be followed for determining auditor responsibility in this context. In *Rusch Factors,* which involved a *certified* financial statement, the federal district court expressed considerable doubt about the wisdom of *Ultramares*:

> Why should an innocent party be forced to carry the weighty burden of an accountants' professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by impositing [sic] it on the accounting profession, which can pass the cost of insuring against the risk on to its customers, who can in turn pass the costs on to the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?

The *Ryan* court concluded that "the test to be adopted is whether the third party to whom the accountant owes a duty of care is actually foreseen and a member of a limited class of persons contemplated." Recovery for negligence is limited "to persons for whose benefit and guidance the accountant knows the information is intended." The court approved the more liberal Restatement position but declined to say whether liability should extend to all foreseeable third parties.

Despite the fact that the statements were clearly labeled "unaudited," the court was unwilling to accept the accounting profession's concept of unaudited services, a rejection which was probably attributable to the court's perception of the public expectation of accountant responsibility in both audit and nonaudit engagements.

Recently in *Seedkem, Inc. v. Safranek,*[35] an Indiana corporate creditor brought a diversity action against a CPA who was a resident of Nebraska. The plaintiff claimed that financial documents prepared for the debtor were "recklessly and wantonly prepared" and the accountant knew that the unaudited, inaccurate statements failed to conform with generally accepted accounting principles. The court rejected the accountant's motion for summary judgment on strict *Ultramares* privity grounds because the case at hand was "qualitatively distinguishable," and because "in light of the overwhelming and subsequent erosion of the viability of the *Ultramares* decision, it is not so readily apparent that the state courts . . . of Indiana and Nebraska would cling to the outmoded and restrictive doctrine of privity as a precondition to a finding of accountant's liability."

The court quoted *Ryan* and noted that the state courts of Indiana and Nebraska might choose to follow § 552 of the Restatement as both have followed the Restatement's positions in other areas.

A second case which relied on the *Ryan* rationale was *Spherex, Inc. v. Alexander Grant & CO.*[36] General Home Products (GHP) engaged Alexander Grant to prepare an ***unaudited*** financial statement for a twelve-month period based on financial information provided by GHP. Copies of this statement were submitted by GHP to Spherex to obtain credit. When Spherex subsequently sustained a financial loss in its dealing with GHP and sued Alexander Grant, the latter contended that its liability did not extend to a third party creditor not in privity.

The court began its analysis by noting that it had previously expressed disfavor of the privity doctrine in personal injury cases: "Our reluctance to apply the privity rule has extended to allowing a proper plaintiff to recover for mere financial loss resulting from the negligent performance of services." Furthermore, the court noted a resemblance of this case to cases involving contract law in that the duty owed by Alexander Grant to Spherex was "not entirely dissimilar to the duty we have held a promisor owes to an intended third-party beneficiary." Next, the court analyzed the evolution of the *Ultramares* holding and its privity requirement. According to the New Hampshire court's observation, "judges have not hesitated to permit recovery where the plaintiff's identity was specifically known to the negligent defendant." The reason for this, the court stated, was that judges are seeking to link the privity doctrine with Cardozo's "social utility" rationale of protecting professions from the specter of unlimited liability to a virtually limitless class of plaintiffs. The real question, said the court, is whether the defendant has some special reason to anticipate the reliance of the plaintiff.

According to the *Spherex* court, the second reason for distinguishing the *Ultramares* opinion is that it is "a relic of a bygone economic era." Both the sophistication of modern accounting procedures and the accountant's central role in the financing and investment industry are a far cry from the fledgling profession in need of judicial protection that existed at the time of *Ultramares*.

Under this court's theory, if the choice is between the reliant third party and the CPA, the accountant should bear the burdens of legal responsibility. The court buttressed this reasoning by drawing an analogy between an accountant and a manufacturer under product liability law. Both are "in the best position to regulate the effects of [their] conduct by controlling the degree of care exercised during the performance of [their] professional duties." The court concluded that the Restatement harmonizes the accountant's contemporary role and his potential liability, and "represents a reasoned approach to the issue of professional liability for negligent misrepresentation."

B. Potential Widespread Liability to Third Parties

In *Citizens State Bank v. Timm, Schmidt & Co.*,[37] the issue was phrased as a broad question: "May an accountant be held liable for the negligent preparation of an audit report to a third party not in privity who relies on the report?" The court answered in the affirmative, based on the principles of Wisconsin negligence law. The defendant accountants in this case regularly prepared financial statements for their client CFA. In November 1975, Citizens Bank made a loan to CFA after reviewing the statements Timm had prepared. In early 1977, during the course of preparing CFA's financial statement for the previous year, Timm's employees discovered that the 1974 and 1975 statements contained a number of material errors totalling over $400,000. Once informed of these errors, the bank called its loan, resulting in CFA going into receivership and dissolving.

The court characterized the issue as one of first impression in the state of Wisconsin. For authority, the court turned to sources such as *Rusch Factors, Ryan,* and the Restatement § 552. The court also analogized to a Wisconsin state case involving an attorney who was held liable to a beneficiary not in privity for the attorney's negligence in supervising the execution of a will. The court observed that the imposition of liability would make attorneys and accountants more careful in the execution of their responsibilities:

> Unless liability is imposed, third parties who rely upon the accuracy of the financial statements will not be protected. Unless an accountant can be held liable to a relying third party, this negligence will go undeterred.

This "public policy" rationale was the main argument on which the court "hangs its hat." But there were "additional policy reasons to allow the imposition of liability." The court feared that if relying third parties, such as creditors, were not allowed to recover, the cost of credit to the general public would increase. Accountants, on the other hand, might spread the risk through the use of liability insurance. The court concluded that accountants' liability to third parties should be determined under (and limited by) the accepted principles of Wisconsin state negligence law:

> According to these principles, a finding of non-liability will be made only if there is a strong public policy requiring such a finding. . . . Liability will be imposed on these accountants for the foreseeable injuries resulting from their negligent acts unless, under the facts of this particular case, as a matter of policy to be decided by the court, recovery is denied on grounds of public policy.

In *Rosenblum, Inc. v. Adler,*[38] the New Jersey Supreme Court determined on appeal from a motion for partial summary judgment that public policy did not preclude the imposition of liablity on accountants to third parties not in privity. The plaintiff-shareholders acquired stock in Giant Store Corporation, allegedly relying on the correctness of the audits done by defendants Touche Ross. Unfortunately, Giant had manipulated its books by falsely recording assets it did not own and omitting substantial amounts of accounts payable so the financial information that Touche had certified in the 1971 and 1972 statements was incorrect.

While the New Jersey court obviously strained to be methodical and comprehensive, the reasoning of the opinion is tenuous at many points. The court engaged in a two-step process to determine the accountant's liability in this situation. "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 case law in New Jersey is split on this issue, according to the court. However, the court did note that the requirement of privity was long ago discarded in product liability cases based on negligence. After a review of the decisions demonstrating that negligent representations referring to products may be the basis of liability irrespective of privity, the court answered the question it had posed:

> Why should a claim of negligent misrepresentation be barred in the absence of privity when no such limit is imposed where the plaintiff's claim also sounds in tort, but is based on liability for defects in products arising out of a negligent misrepresentation? 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. The fundamental issue is whether there should be any duty to respond in damages for economic loss owed to a foreseeable user neither in privity with the declarant nor intended by the declarant to be the user of the statement or opinion.

The second question which the court framed was: "what duty [should] the auditor . . . bear to best serve the public interest in light of the role of the auditor in today's economy?" Whether a duty exists, asserted the court, is ultimately a question of fairness. The judicial analysis that must be made "involves a weighing of the relationship of the parties, the nature of the risk, and the public interest in the proposed solution."

The court appraised the fairness of imposing a duty by first reviewing the auditing function of an accountant, concentrating on how it has changed and developed over the years. For example: "It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes. . . ." And: "The auditor's function has expanded from that of a watch-dog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others." The court added that despite expanded liability, accountants have been able to

obtain insurance to cover these risks, leading them to believe that auditors should be able to "purchase malpractice insurance policies that cover their negligent acts leading to misstatements relied upon by persons who receive the audit from the company pursuant to a proper business purpose."

When the court tacked on to the previous discussion the ideas that the imposition of a duty to foreseeable users will "cause accounting firms to engage in more thorough reviews" and the extent of financial exposure already has certain "built-in limits" to protect auditors from too much liability, the fate of the defendant was sealed. The policy arguments made in *Rusch Factors Inc.*, that the accountant can more easily carry the burden of liability were repeated here, but the New Jersey court did add its own philosophy: "it is just and rational judicial policy that the same criteria govern the imposition of negligence liability, regardless of the context in which it arises." The court believed that the investor and the general public will benefit in the long run when the liability of the CPA for negligent misrepresentation is measured by the foreseeability standard.

In applying the above analysis to the facts at hand, the court looked *first* to see whether the entity for whom the audit was being made (Giant) used it for a "proper business purpose." Acccording to the opinion, the defendants should reasonably expect that their client would distribute the financial statements pursuant to matters relating to its business, particularly given that there was no limitation in the accountants' opinion. The second requirement for finding liability is justifiable reliance. "Having inserted the audit in that economic stream" the defendants should be responsible for "their careless misrepresentations to parties who justifiably relied upon their expert opinions."

Rosenblum is a frightening spectre for the profession. At the same time as auditors are unable to secure reasonable insurance coverage, courts assume the fact of that coverage and extend liability even further.[39]

C. The Ultramares Court Speaks Again

The New York Court of Appeals had an opportunity to revisit the privity issue a little less than a year ago in *Credit Alliance Corporation v. Arthur Andersen & Co.*,[40] which considered two different appeals by two different accounting firms. In the *Andersen* case, plaintiff Credit Alliance and others were major financial services companies which financed the purchase of capital equipment through installment sales or leasing agreements. They provided financing to L.B. Smith (Smith), a "capital intensive enterprise that regularly required financing." Plaintiff began to insist in 1978 that Smith provide audited financial statements as a pre-condition to further loans. Smith provided its consolidated financial statements for the years 1976 and 1977 examined and reported upon by Andersen. In reliance on the statements, plaintiff provided substantial loans to Smith. Plaintiff continued to receive, rely, and lend on Smith's financial statements in 1979. Smith petitioned for bankruptcy in 1980 while in default to plaintiff on several million dollars of debt.

Plaintiff sued Andersen alleging negligence and fraud, claiming Andersen knew or should have known that Smith was showing the statements to it for the purpose of obtaining loans. Andersen's motion to dismiss the negligence claim on privity grounds was denied in the lower court. The Appellate Division

affirmed, finding plaintiff fit into a narrow New York exception to the privity rule because the plaintiff was a member of the "limited class" entitled to rely on Andersen's report. The Court of Appeals reversed the decision in favor of Andersen.

In the second case, European American Bank (EAB) sued the firm of Strauhs & Kaye (S&K) because it made large loans to Majestic Electro (Majestic) beginning in 1979, allegedly in reliance upon interim and year-end financial statements reported upon by S&K. S&K allegedly overstated Majestic's inventory and accounts receivable and did not disclose Majestic's poor internal controls. Majestic went into bankruptcy in 1983 after defaulting on the loans to EAB. EAB sued S&K, alleging negligence in auditing and that S&K was familiar with the EAB-Majestic lending relationship and lending agreements, including the fact that EAB was receiving and relying upon the S&K audited financial statements. Indeed, there were allegations that S&K and EAB representatives had been in direct oral and written communication during the entire course of the lending relationship. On S&K's motion in the lower court, the complaint was dismissed for lack of privity. The Appellate Division reversed citing the direct communication between S&K and EAB—using a Restatement § 552 approach—and observing that S&K specifically knew EAB was relying on the financial statements. The Court of Appeals affirmed in S&K's case.

The Court of Appeals reviewed the *Ultramares* case and its rationale and reaffirmed it as expounded upon. The court observed that some relationships are "so close as to approach privity" and that would be a sufficient predicate for finding liability, thus the result in the EAB portion of the case. The Court of Appeals focused on the fact that in *Ultramares* the accountants only knew "generally" that third parties would see the report, and nothing had been said between auditor and client about who would see the reports "or the extent or number of transactions in which they would be used." The court distinguished this situation from one where the facts bespeak "an affirmative assumption of a duty of care to a specific party, for a specific purpose, regardless of whether there was a contractual relationship." It found the Andersen case to fit the *Ultramares* type of fact pattern, while the S&K case fit the latter situation.

The Court of Appeals set forth a test for guidance in determining whether auditors should be held liable to those not in privity:

> Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.

The court observed that different states had adopted different standards in addressing the privity issue. Some like New Jersey and Wisconsin had thrown it out and extended liability to any third party who could be foreseen to rely on the financial statements. Others, like Pennsylvania, Florida, Georgia, Colorado and Kansas follow a strict *Ultramares* privity test. Still others use the Restatement approach. The New York Court of Appeals explanation of what

Ultramares means and how liability may extend to third parties in appropriate factual circumstances is certainly a reasonable, well-thought-out and refreshing consideration of the issue. It is also another end of the historical thread linking the development of today's standards to the earlier precedents.

IV. Where We Are Headed

This paper has considered the historical development of several facets of auditor's responsibilities, standards and liabilities; the interplay between litigation, legislation and professional standards; the broadening of the auditor's responsibilities to its client even in the face of management's criminal activities; the overlay of potential criminal liability to those who close their eyes to suspicious developments and attempt blindly to follow GAAP; and, the incredible expansion of third parties who have been held entitled to rely on financial statements and to sue the auditor. It remains to consider what the future may hold. It would be impossible to consider all ramifications outside the context of a textbook or a novel.

In the ESM litigation referred to *supra,* Alexander Grant is being sued for millions of dollars in damages by numerous customers of ESM including various municipalities from around the country. The allegations of the suits incorporate the expected common law negligence and fraud claims, and securities law violations. They go further and allege violations of the Racketeer Influenced and Corrupt Organizations Act (RICO),[41] that Alexander Grant participated with others through a "pattern of racketeering activity" to use ESM as an enterprise to commit criminal acts. If successful in proving a RICO case, damages to which the plaintiffs would be entitled would be trebled and could theoretically approach $1 billion. While the allegations of ESM present a rather wide departure from appropriate auditing and accounting standards, the spectre of RICO liability for auditors in connection with "garden variety securities fraud" cases looms ahead.

RICO was originally drafted to stem the inroads by organized crime into legitimate businesses. It provides a civil suit remedy and has become a favorite of the plaintiffs' bar. Last summer accountants were hoping for relief when the Supreme Court decided *Sedima S.P.R.L. v. Imrex Co.*[42] Unfortunately, the Court refused to read RICO narrowly and ruled that its civil provisions could be applied to virtually all commercial disputes. Justice White acknowledged the problem, but observed that the cure "must lie with Congress." Congress, however, has shown no serious intention to amend RICO. Certainly, on the heels of the ESM scandal and the media attention given to the E.F. Hutton overdrafting system, the public has not indicated that it favors a narrowing of RICO's targets to accept "legitimate businessmen" such as auditors.

Even the foreign judicial systems and lending agencies have caught the fever. In an Australian case, *Cambridge Credit Corp. v. Hutcheson,* the auditors were found liable for a negligent audit and the plaintiff was awarded approximately $100 million (an amount exceeding the audit firm's assets as well as those of its individual partners). In recent lawsuits in New York a foreign government, England, and at least ninety other plaintiffs have sued Arthur Andersen in several federal actions as a result of the collapse of John DeLorean's automobile venture. The suits allege securities violations as well

as RICO causes of action, and request $270 million in damages to be trebled to nearly $800 million. The British government invested $120 million to finance DeLorean's Belfast, Ireland factory.

Andersen issued a clean opinion for DeLorean Motor Company. The plaintiffs allege that some of their money was diverted through a Swiss bank account of GPD Services, Inc. (a Panamanian company) to DeLorean's personal account. They claim as well that Andersen had ample knowledge of questionable transactions between GPD and DeLorean's company. The plaintiffs suggest that Andersen workpapers indicate an awareness of problems which should have brought the *Natelli* "suspicious inquiry doctrine" into play.[43]

Dramatic, albeit not quite as dramatic, mega-suits have evolved against auditors as a result of the Penn Square National Bank and Drysdale Government Securities scandals. The number of such lawsuits is not likely to decline in the near future, thus making it more difficult for auditors to obtain insurance.

At the same time as these suits appear, our legislators in Washington continue to examine the conflict-of-interest standards and other alleged deficiencies of the profession. Representative John Dingell (D. Mich.) is chairman of a House oversight subcommittee before which witnesses have criticized the peer review system, the SEC's laxity in overseeing the profession, and the fact that audit client's management hire, fire, and pay the auditor. The latter criticism allegedly makes auditors reluctant to report objectively on their client's financial statements and/or to blow the whistle where appropriate. In addition, certain accounting treatments which are justifiable under GAAP have been questioned. Dingell and some of his witnesses are unhappy with the flexibility afforded under GAAP for various methods of depreciation, costing of inventory, as well as for alleged inconsistency of disclosure for various accounting treatments. The subcommittee has been troubled by the issuance of clean opinions just prior to financial debacles which have made front page news.

The Dingell subcommittee required the Big Eight accounting firms to submit detailed disclosure reports relating to litigation losses as well as to internal matters. As of yet, Dingell shows no lack of continued interest in pursuing the oversight hearings. Not even Washington insiders are sure where the subcommittee will end up. The ultimate questions, of course, are: Will there be some form of more direct government regulation of the practice? Will auditors be permitted to continue to practice in the scope of practice which is currently enjoyed? Will more dramatic corporate governance mechanisms become the rule?

Whatever the results of the trends, the pattern is a continuum of what has been happening in the profession for more than 80 years. The financial community's demand for accurate financial information has grown, not abated. Auditors created a business for themselves over the past 130 years of fulfilling the marketplace's financial information needs. Indeed, the CPA's license is a franchise to attest with respect to the market's financial statements. That marketplace, as well as the regulators responsible for oversight, had been allocating greater and greater responsibility—with attendant legal liability—to the profession. In many cases the expansion was based upon a now obsolete

premise that the auditor could, in turn, assess that liability broadly through fee structure and insurance coverage.

As the profession faces this challenge, several actions seem imperative. The profession must reflect upon standards which are unclear, ambiguous, or insufficient. The *wide* flexibility favored by George May is simply so out of favor in several critical areas that it needs to at least be reexamined. The profession must be even more vigilant in applying the suspicious inquiry doctrine. Several more major financial scandals where clean reports have been issued will only spur on the regulators and the plaintiffs' bar. The profession and its representatives must be media-conscious and take initiative to get its message to the public. It should perhaps explain the billions of dollars of financial transactions which are successfully audited year-in-and-year-out. It should lobby and communicate about the problems associated with RICO and the current use of the adverse interest analysis. But, the profession is far from fatally diseased. If history repeats itself, it will make the appropriate accommodations and move forward.

End Notes

1. 7 & 8 Vict., Chapter 110. This was the first comprehensive law allowing corporate development after the repeal in 1825 of the "Bubble Act," which itself was enacted in 1720, after the South Sea Company "Bubble Case" scandal broke, in an effort to restrict speculative investing in chartered companies.
2. A.C. Littleton, *Accounting Evolution to 1900* (1966). *See also,* H.C. Edey and P. Panitpakdi, "British Company Accounting and the Law 1844–1900," reprinted in *Studies in the History of Accounting,* ed. A.C. Littleton and B.S. Yamey (1956), pp. 356–61.
3. 19 & 20 Vict., Chapter 47.
4. 63 & 64 Vict., Chapter 48 § 23; and, Edw. VII, Chapter 50 § 19 (2)(b), respectively.
5. *See generally,* J.L. Carey, *The Rise of the Accounting Profession,* Vol. I (1969); N. Stacey, *English Accountancy 1800–1954* (1954); and *Contemporary Studies in the Evolution of Accounting Thought,* ed. M. Charfield (1968).
6. 19 & 20 Vict., Chapter 47, Table B, art. 84.
7. *In re London and General Bank,* 2 Ch. 673 (C.A. 1895); *Leeds Estate, Building and Investment Co. v. Shepherd,* 36 Ch. D. 787 (1887).
8. D. Causey, *Duties And Responsibilities of Certified Public Accountants* (1979), p. 15.
9. *E.g.*, A. Berle Jr. and G. Means, *The Modern Corporation and Private Property* (1933); W. Ripley, *Main Street and Wall Street* (1927).
10. G. May, *Twenty-five Years of Accounting Responsibility 1911-1936* (1936) pp. 112–144.
11. 15 U.S.C. §§ 77a–77aa.
12. 15 U.S.C. §§ 78a–78jj.
13. SEC Accounting Series Release No. 19, *In the Matter of McKesson & Robbins, Inc.* (1940).
14. *United States v. Simon,* 425 F.2d 796, 799 (2d Cir. 1969).
15. *United States v. Natelli,* 527 F.2d 311 (2d Cir. 1975) *cert. denied,* 96 S. Ct. 1663 (1976).
16. In fact the standards for utilizing the percentage-of-completion method versus the completed contract method for "long-term projects" was an area of great uncertainty in this period, and became more so during the 1970's. One of the collateral results of the NSM litigation had an impact much like *McKesson & Robbins*. As a part of its undertaking pursuant to its consent decree terminating the SEC's litigation against it, Peat, Marwick agreed to prepare a set of guidelines pertaining to accounting for long-term contracts and the percentage-of-completion method. In particular, the resulting Peat, Marwick paper called for tightening up of procedures in the area of recognizing revenues on claims and unbilled receivables. The Peat, Marwick paper was used as one of the starting points by the AICPA for what eventually was published in 1981 as *Audit and Accounting Guide—"Construction Contractors."* Thus, unsuccessful accountant's litigation again led to new standards for the profession.
17. *United States v. Weiner,* 578 F.2d 757 (9th Cir. 1978).

18. *See, e.g., Craig v. Anyon,* 212 App. Div. 55, 208 N.Y.S. 259 (1st Dept. 1925), *affirmed,* 242 N.Y. 569, 152 N.E. 431 (1926).

19. *See, e.g.,* National Surety Corp. v. Lybrand, 256 App. Div. 226, 9 N.Y.S.2d 554 (1st Dept. 1939).

20. 380 F. Supp. 1053 (S.D.N.Y. 1974).

21. 523 F. Supp. 533 (S.D.N.Y. 1980).

22. *Cenco Inc. v. Seidman & Seidman,* 686 F.2d 449 (7th Cir.), *cert. denied,* 459 U.S. 880 (1982).

23. *See, e.g., Schachtt v. Brown,* 711 F.2d 1343 (7th Cir.), *cert. denied,* 464 U.S. 1002 (1983); *Holland v. Arthur Andersen & Co.,* 469 N.E.2d 419 (Ill. Ct. App. 1984).

24. *United States v. Arthur Young & Co.,* 466 U.S. 936 (1984).

25. *Sharp v. Coopers & Lybrand,* 649 F.2d 175 (3d Cir. 1981); *cert. denied,* 455 U.S. 938 (1982).

26. As an aftermath of the ESM Securities scandal, Alexander Grant (now Grant Thornton) is seeking to avoid responsibility for the acts of its wayward general partner—who has pleaded guilty to accepting ESM money—under the *ultra vires* doctrine.

27. 255 N.Y. 170, 174 N.E. 441 (1931).

28. *See, e.g., Landell v. Lybrand.* 264 Pa. 406, 107 A. 783 (1919).

29. 425 U.S. 185 (1976).

30. *E.g., 1136 Tenants Corp. v. Max Rothenberg & Co.,* 36 A.D.2d 804, 319 N.Y.S.2d 1007 (1st. Dept. 1971); *affirmed,* 30 N.Y.2d 585, 281 N.E.2d 846 (1972) (auditor claimed it was engaged to do write-up work but jury agreed with client that there was to be an audit); *Stanley L. Bloch, Inc. v. Klein,* 45 Misc. 2d 1054, 258 N.Y.S.2d 501 (1965) (auditor held liable on preparation of interim unaudited financial statements).

31. *E.g., United States v. Natelli, supra,* 527 F.2d 311 (2d Cir. 1975). *See also Blakely v. Lisac,* 357 F. Supp. 255 (D.Or. 1972) (auditor liable on unaudited financial statements included in a prospectus even though he was performing an unaudited write-up); and *Escott v. BarChris Construction Corp.,* 283 F. Supp. 643 (S.D.N.Y. 1968) (liability *re* an S-1 review—which was treated by the court as a non-audit engagement).

32. 311 Minn. 111, 248 N.W.2d 291 (1976).

33. 170 N.W.2d 395 (Iowa 1969).

34. 284 F. Supp. 85 (D.R.I. 1968).

35. 466 F. Supp. 340 (D.Neb. 1979).

36. 122 N.H. 898, 451 A.2d 1308 (1982).

37. 113 Wis. 2d 376, 385 N.W.2d 361 (1983).

38. 93 N.J. 324 (1983).

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