Journal of Accountancy

Volume 52 | Issue 1 Article 1

7-1931

Editorial

A. P. Richardson

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Richardson, A. P. (1931) "Editorial," *Journal of Accountancy*: Vol. 52 : Iss. 1 , Article 1.
Available at: https://egrove.olemiss.edu/jofa/vol52/iss1/1

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

A. P. RICHARDSON, *Editor*

[*Opinions expressed in* THE JOURNAL OF ACCOUNTANCY *are not necessarily endorsed by the publishers or by the American Institute of Accountants. Articles are chosen for their general interest, but beliefs and conclusions are often merely those of individual authors.*]

VOL. 52 JULY, 1931 No. 1

EDITORIAL

The Ultramares Case Considered

One of the most important judgments ever rendered in the United States upon a question involving the duties and obligations of an accountant was the suit *Ultramares Corporation* v. *Touche et al.* In the February issue of THE JOURNAL OF ACCOUNTANCY there was somewhat extensive comment upon that section of the decision which disposed of the question of liability of the accountant to persons without privity of contract. At that time we expressed the opinion, which has subsequently been indorsed by competent authority, that the American Institute of Accountants, appearing as friend of the court and opposing the attempt to extend liability to the wide world, had accomplished complete success. The judgment was definite and apparently left no room for doubt as to the limitations which surround the legal liability of any professional man, even where gross negligence is supposed to have existed. There has been a great deal of correspondence on the subject of the judgment, and some people without knowledge, but with a readiness to impute iniquity, have jumped to the conclusion that the Institute condones negligence. If these statements are not malicious they are too silly to merit notice and, indeed, they do not deserve much consideration whatever be their motive. The fact is that the Institute appeared in the case as amicus curiæ and presented a brief which was largely adopted by the court of appeals in the state of New York. The Institute argued that there can be no liability where there is no privity of interest. What the accountant's individual liability to his individual client may be is not the subject of

present discussion, but it may be said in passing that it would be an excellent thing if there could be a legal determination of the extent of the accountant's liability to his client. Nobody knows what a court may assess as damages for failure to perform accounting work as it should be performed. The cases which have been before the courts are not sufficiently representative to be valuable as precedents, and even in those cases the differences of judgments are so great that all dependence upon them is futile. There seems to be no precedent which indicates the probable extent of financial liability for professional services of any kind.

The Question of "Constructive Fraud"

In our earlier discussion of the Ultramares case we carefully refrained from comment upon the second part of the finding, because that part sent back to the trial court another question which was not covered by the decision dealing with liability for negligence. The second half of the judgment stated that the lower court should submit to a jury the question whether or not the facts of the case involved fraud—in other words the question whether or not the audit had been so grossly negligent as to justify a finding that the accountants had no genuine belief in its adequacy. For, so the court said, that is fraud, while if less than that is proved the ensuing liability is one for negligence and is bounded by the contract. This threw the matter back into the courts and it became, so far as the question of fraud was involved, a matter sub judice and therefore not debatable. We have waited for the determination of the case before venturing to express any opinion on this second cause of action. Now it appears that the case has been settled out of court. It is therefore withdrawn from the docket and comment is permissible. In order to make clear the arguments which seem pertinent the following extracts are published:

"The second cause of action is yet to be considered.

"The defendants certified as a fact, true to their own knowledge, that the balance-sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true. We think the triers of the facts might hold it to be false. . . .

"In this connection we are to bear in mind the principle already stated in the course of this opinion that negligence or blindness, even when not equivalent to fraud, is none the less evidence to

sustain an inference of fraud. At least this is so if the negligence is gross. Not a little confusion has at times resulted from an undiscriminating quotation of statements in *Kountze* v. *Kennedy*, *supra*, statements proper enough in their setting, but capable of misleading when extracted and considered by themselves. 'Misjudgment, however gross,' it was there observed, 'or want of caution, however marked, is not fraud.' This was said in a case where the trier of the facts had held the defendants guiltless. The judgment of this court amounted merely to a holding that a finding of fraud did not follow as an inference of law. There is no holding that the evidence would have required a reversal of the judgment if the finding as to guilt had been the other way. Even *Derry* v. *Peek*, as we have seen, asserts the probative effect of negligence as an evidentiary fact. . . .

"We conclude, to sum up the situation, that in certifying to the correspondence between balance-sheet and accounts the defendants made a statement as true to their own knowledge when they had, as a jury might find, no knowledge on the subject. If that is so, they may also be found to have acted without information leading to a sincere or genuine belief when they certified to an opinion that the balance-sheet faithfully reflected the condition of the business.

"Whatever wrong was committed by the defendants was not their personal act or omission, but that of their subordinates. This does not relieve them, however, of liability to answer in damages for the consequences of the wrong, if wrong there shall be found to be. It is not a question of constructive notice, as where facts are brought home to the knowledge of subordinates whose interests are adverse to those of the employer (*Henry* v. *Allen*, 151 N. Y. 1; see, however, Am. L. Inst., *Restatement of the Law of Agency*, Sec. 506, subd. 2a). These subordinates, so far as the record shows, had no interests adverse to the defendants, nor any thought in what they did to be unfaithful to their trust. The question is merely this, whether the defendants, having delegated the performance of this work to agents of their own selection, are responsible for the manner in which the business of the agency was done. As to that the answer is not doubtful. . . .

"Upon the plaintiff's appeal as to the second cause of action, the judgment of the appellate division and that of the trial term should be reversed, and a new trial granted, with costs to abide the event."

Fraud in Law Difficult to Define

It will be noted that Justice Cardozo, who rendered the judgment in the court of appeals, clearly relieves the defendants from any imputation of intentional wrong-doing. This does not relieve them, however, according to the learned judge, of liability to answer in damages for the consequence of wrong "if

wrong there shall be found to be." Even the subordinates, who were directly responsible for whatever neglect occurred, are not accused of unfaithfulness. The whole question of fraud is rendered obscure and difficult because of the evident difference which exists between the ordinary acceptation of the word and its legal significance. An eminent lawyer writes us, "Fraud in the legal sense is a somewhat elusive concept. Civil action for fraud involves what in reality under the old distinction of forms of action was the action of deceit. A consideration of the evidence which may bear upon the question of deceit involves a very careful and exact understanding of gross negligence and of silence in relation to statements which may be alleged to involve deceit. All this has a definite bearing upon what a certificate of an accountant may import to persons who act upon the faith of it. Deceit does not grow out of contract and no limitation upon liability for it exists so as to make an accountant responsible in such action only to the person with whom he has contracted." In other words a statement made in a professional capacity by any practitioner, if it is made without reasonable assurance of its accuracy, may be made the basis of an action for fraud by anyone who believes himself to be injured by reliance upon that statement. That is a broad extension of liability. Let us hope that the court in a given case would prevent injustice by pointing out that the evidence must show that there could have been no genuine belief in the sufficiency of the audit before the auditors could be found guilty of deceit or fraud. Probably nearly everyone will admit that fraud in the ordinary meaning of the word should make the perpetrator liable for whatever effect may follow his fraudulent act, but that applies only in the case of intentional fraud. It is noteworthy that in the case of *Derry* v. *Peek*, quoted in the judgment, Lord Herschell said, "In my opinion making a false statement through want of care falls short of and is a very different thing from fraud. I think mischief is likely to result from blurring the distinction between carelessness and fraud and equally holding a man fraudulent whether his acts can or can not be justly so designated." The importance of that section of Lord Herschell's opinion is indicated by the fact (to which attention is drawn by *The Accountant*, of London) that the head-note of the report reads, "In an action of deceit the plaintiff must prove actual fraud. Fraud is proved when it is shown that a false representation has been made knowingly or without belief in its truth or

recklessly without caring whether it be true or false. A false statement made through carelessness and without reasonable ground for believing it to be true may be evidence of fraud but does not necessarily amount to fraud. Such a statement, if made in the honest belief that it is true, is not fraudulent and does not render the person making it liable to an action of deceit."

An Attempt to Interpret the Decision

If we interpret this decision as the language seems to justify and if we may attempt to put it into ordinary straightforward statement, it seems that the sum of the whole matter is this: Gross negligence may be regarded as evidence that fraud may have existed. That is to say, where a misstatement, due to gross negligence, is made there is justification for going further into the case to find out whether there was intentional wrong-doing or not. If it be found that the error was innocently although negligently made there is neither fraud nor deceit. To put the matter in another way, it seems to us that the court says that there was reason to investigate further and ascertain the existence of fraud if any did exist. The court, however, explicitly stated that there was nothing to indicate intentional wrong-doing by defendants or their subordinates. It is therefore regrettable that the case was not carried through the process of adjudication without external settlement. As the matter stands at present there is grave doubt in the minds of a great many people as to what the court of appeals really meant. If our interpretation is correct the court of appeals was evidently trying to encourage a course of action which would bring about a definite adjudication on the question of fraud to supplement the decision which had been rendered on the question of liability to third parties even in case of gross negligence. However, the withdrawal of litigation prevented the accomplishment of that purpose, and in the meantime every professional man is left in suspense lest by some perfectly innocent error of judgment he be made the object of an action for fraud.

What Is To Be Done?

What is the accountant to do? For one thing, it seems fairly clear that every accountant's report will be addressed to the client only and that any use of the report by the client will be without the express knowledge of the accountant. It also seems

probable that the accountant will divide his report into two sections, one dealing with fact and one with opinion. This will have an injurious effect upon the value of accountants' reports, because the client wants to know what the accountant thinks more than he wants to know what are the facts. The facts, perhaps, he could determine for himself, but he desires the opinions of a competent expert. It has been suggested that accountants might incorporate and thereby limit liability, but that is an unprofessional form of practice and would not prevent litigation. The accountant perhaps should abandon certificates and merely make reports without accepting any liability whatever. The word certificate, which has been used for many years, is quite inappropriate and should be abandoned, in any case, especially with reference to any opinion. It is absurd to speak of certifying an opinion. Perhaps the Ultramares case will be the means of bringing about a reform which will eliminate the words certify and certificate.

There Must Be Definition

The present uncertainty can not continue. Sooner or later there will be a case which will be carried through without settlement and we shall learn what the courts believe to be the correct definitions of fraud and liability. If the acts committed by the defendants in the Ultramares case were fraudulent in the true sense of the word the penalties should have been exacted. If they were not fraudulent the defendants should have been exonerated. Where negligence exists whatever penalty is just should be paid; where fraud exists the proper punishment should be inflicted—but in heaven's name let us have something definite. It is all well enough to talk grandiloquently about assuming the full burden of responsibility for every word uttered. Accountants must be careful and must tell the truth, but if they make a mistake honestly it seems to the layman, at least, preposterous to suggest that there has been fraud. We are not defending and do not care to defend the act of any accountant who is guilty of fraud, but we do desire to be known as opposing indefinite inference. Meanwhile pending the coming of the settlement of the question a great "racket" will follow the Ultramares judgment. Whenever, an accountant renders a professional service he will be liable to strike suits and goodness only knows what else in an effort to extort money from him. The decision of the Ultramares case was well

worth while, however, because it seems to have settled the question of liability for negligence to persons having no privity of interest, which was the great point upon which the American Institute argued and in doing so rendered a service to the entire country.

"The American Standard of Living"

A group of accountants in course of discussion of the existing conditions in business turned to the question of wages, particularly wages of the artisan class and those of unskilled labor. The discussion was stimulated by recent remarks by leaders of industry to the general effect that it was undesirable and would be undesirable to reduce the scale of compensation for labor, lest in the process the standard of living be lowered and the general conditions of the country be thereby adversely affected. The other side of the argument was represented by the writings of various economists and others, some of whom had expressed the opinion that, inasmuch as the cost of living had been substantially reduced, there could be and should be a proportionate decrease in the scale of wages without in any way affecting the so-called standard of living. There seemed to be a wide difference of opinion as to whether this reduction of wages, with certain exceptions, represented the sounder policy or not. It is undoubtedly true that there has been a great deal of nonsense spoken and written on the subject of the standard of living. It is certain the American workman lives in what would be regarded as affluence by the workmen of any other country. We have passed from the days of the humble wants of the toiler to what may be called "the two-car age." He is, indeed, a poor man who can not have two cars, one comparatively new and one still usable, in his garage. Most of the men who are thus doubly blessed can not really afford the luxury of two cars, but they are accustomed to having what they want and as they want two cars we have come into the two-car age, whether the grocer or the butcher be paid or not. It is ridiculous to speak of these purely unnecessary luxuries as part of the standard of living. They may be part of the standard of extravagance, but not of living. Then again there seems to be no absolute necessity for many of the enjoyments which are now regarded as part of the standard of living. In the old days it was an event of importance to attend a theatre or an entertainment of any sort. Now the entire family

feels down-trodden if it can not be taken to the movies at least twice a week. The manner of clothing has become extravagant, and so have many other things, all of which the advocates of high wages endeavor to disguise as the American standard of living. But even supposing that it were true that these things were necessary, it is difficult to understand how in a time of falling prices the maintenance of high wages is necessary to the continuance of that standard of living. For example, if a man's wages are ten dollars a day and it costs him nine dollars to live and luxuriate, he is not as well off as he would be if his wages were six dollars a day and his costs four dollars. In the latter case his actual saving, if he saved, would be greater in number of dollars, and when the difference in the value of the dollar is considered his savings would be considerably more than doubled. All this is a theory of economy which has been reiterated time and again. The point which is of interest to accountants is the part which they may play in bringing about better understanding of the true conditions and in advocating the resumption of something like a parity between wage and value received for the wage. To speak of the maintenance of high wages in time of falling costs is to speak of an enormous increase in wages. Take, for example, our workman whose wages have been ten dollars a day—if costs of living were nine dollars and they are now reduced to four dollars, his margin of saving has increased from one to six dollars and he still has the same necessities and luxuries which he had before. Is there any justification for maintaining wages in a time of depression when the maintenance of wages means an increase in wages?

High Wages and Politics

The trouble is that so many business men who are employers of labor and practically all politicians who depend upon labor for their existence seem to feel that it is necessary to pamper the working man at the cost of the stability of the country. The workman is entitled to a fair wage if he does a day's work; indeed, it is safe to go further and say that he is entitled to the utmost that can be paid him without injury to the general conditions of the country, but that is not to say that he must have his income remain intact or even increase while the man who pays him that income has suffered losses which are almost destructive. It is probably idle to hope for honest fairplay in the political

arena. Whatever section of the community has the most votes will have the most influence, and the men elected to office are, as a rule, attentive only to the voices of their masters, the workingmen's organizations. We yield to no one in our desire for high wages, but it does seem that the time has come to adopt a spirit of common sense. In nearly every office the salaries of the "white collar workers" have been reduced or, if not reduced, the staff has been decimated and all new employees are engaged at much lower compensation. In a great many industries men have been compelled to limit their working days to two or three or four a week so that the scale of wages might be maintained and our blessed standard of living perpetuated. There are some workmen who seem to feel that if they work two days a week at ten dollars a day they are infinitely better off than they would be working six days a week at five dollars a day. The trouble with such men is that they need a knowledge of the results of the multiplication table.

Accountants Have Opportunity to Assist

Now accountants have an opportunity here for constructive service. Most business men who employ the service of professional accountants have confidence in their general sagacity as well as in their specific expertness. A word of advice or warning from the accountant does not go unheeded in most cases. Let us assume that there is a factory employing a thousand men and that the scarcity of orders has involved the reduction of working days to two a week, but the scale of wages remains unaltered at ten dollars a day. The result of this condition is that the thousand employees are receiving twenty thousand dollars a week. The plant is closed on five days. There is the loss of efficiency as well as the depreciation of physical assets inseparable from shut-down. The men spend their idle five days doing practically nothing and acquire habits of indolence. The market for the product of the factory is supplied by the two days of work, but there is no surplus, and we are told that reduction of surplus is one of the most urgently needed reforms to hasten the return of prosperity. It would be unwise to manufacture without a market, but sooner or later the market is going to increase and the demand for the product of the factory will return with surprising rapidity. When once the spectre of fear has been laid low it will be only a little time before buying begins in substantial volume.

What is our factory to do then? The answer seems simple enough. The men will be told that they can work three days a week, then four and so on until the earning capacity of the factory's men has increased to sixty thousand dollars a week. That sounds delightful, and it might be so if the price of the product of the factory were to remain as it was before the depression, but we all know that the prices of raw materials are now below the 1913 level—a consummation which the learned economists of many universities stoutly affirmed could never occur. Retail prices have not been reduced so far in proportion to the reduction of raw materials, but prices find their level like water, and it is absolutely sure that with low commodity prices there will follow low prices of manufactured articles. Consequently, we shall come to a point where our factory may have demand for enough product to engage the services of the men for a full week, but the prices which will be paid for the product will be out of line with the wage scale of the factory, and the consequence will be failure. Either wages must come down in the factory or prices must go up, and there is small chance of the latter contingency for many years to come. Now if there be an accountant engaged as consultant and advisor to the factory he has a splendid opportunity to render a genuine service. He may point out to his client the effect of the existing policy, and if he be a man of vision and personality he may do much in his intercourse with the employees to demonstrate to them the economic soundness of the theory of fewer dollars but equal wages.

Workmen are Aware of Facts

Workmen are not fools and it is no uncommon experience in conversation with them to hear them express complete willingness to accept a reduction of wages commensurate with the cost of living. The workmen themselves are not the source of the difficulty. It is the leaders of the workmen, most of whom depend for existence upon agitation. They are the ones of whom the politicians stand in fear. If the matter were left to the workmen themselves it might be found that they would voluntarily accept lower wages for longer hours. That is the end devoutly to be desired. Idleness is not good for anyone, much as most of us love it, and it is particularly evil when it is applied to groups of people. The whole community is better if it works a reasonable length of time for a reasonable wage. And it must

not be forgotten that, whether we like it or not, there will be a reduction of wages, and if it is kept away too long the force behind will be dammed up and accumulated so that when it does burst it will come through in ruinous immensity. Then we may see wages reduced far below the actual needs of the workers. The experience may be something like that of the stock market, which kept piling up and piling up its inflated value until in spite of warning it reached such a height that it toppled over—and great was the fall of it. Wages may follow the same course if there be not wisdom and common sense applied to the solution of the present problem. If that disaster happens, which heaven forbid, the labor leaders will be hard put to it to explain the reason of it. All that some of them think of today is the maintenance of high wages so that we may not do any damage to that idol which we call the American standard of living. We need courage in our leaders of industry, in our leaders of labor, in the men who are supposed to lead in politics. Instead of followers we need real leaders with honesty and vision and knowledge. The difficulty is not insuperable. It will work out its own solution somehow, but it may be very painful in the process. If we treat it wisely and recognize truth as it appears we shall be able to avoid the worst and gradually come into a condition of peaceful prosperity and something approaching an equilibrium.

Australia Prescribes Ethical Procedure

The Accountant, of London, in its issue of April 11, 1931, reports that the council of the Institute of Chartered Accountants in Australia is enforcing a strict code of professional etiquette.

"It has resolved that the inclusion of the names of the members in the classified section of the telephone directory is a form of advertising, and that any references in publications should not contain any allusions to professional appointments, other than directorships of public companies, and that the insertion of such matter should on no consideration be paid for. With regard to certificates of estimated profits, it has been laid down that a member of the institute is not permitted to give or sign in his own or his firm's name a certificate of estimated future profits of any business, or contemplated business, for publication on the flotation, or contemplated flotation, of any company or corporation, public or private. References to members in any prospectus or document inviting the public to subscribe for shares or debentures in any company or proposed company shall be confined to the

professional designation of the member therein referred to. No laudatory references will be permitted, and no member shall permit his name to be used in any such document until the words proposed to be used therein in respect of such member shall have first been submitted to and approved by him. The council considers that the publishing of the name of a member on a prospectus, particularly one relating to potential profits, is unprofessional conduct, and likely to bring the institute into disrepute. A member is not permitted to allow his name to appear in any prospectus which contains an unsigned estimate of future profits. A rule has also been made that an associate not in practice shall not undertake accountancy or auditing work for remuneration outside of his duties to his employer or employers."

It will be noted that the word "etiquette" is used by our contemporary instead of the word "ethics," but it does not seem to us that the substitution is happy. There is a distinction between ethics and etiquette. For example it may not be unethical to eat with one's knife, but all the canons of etiquette would be outraged by such manners. The rules which are quoted are most interesting. They indicate that the ambition of the accountancy profession to maintain the highest standard of practice is spreading throughout the world. Some of the American accountants who profess to believe that advertising should be permitted will probably stand aghast at the thought that publication of names in a classified telephone directory constitutes a breach of ethics. It is undoubtedly true, however, that such publication is advertisement and it has always seemed to us that if advertisement is wrong in one form it is wrong in all forms. (This refers, of course, to the printed advertisement for which payment is made.) It is gratifying to see that the Australian authorities forbid the certification of estimated profits. That inhibition is in harmony with the decision of the American Institute of Accountants. Indeed the whole scheme of behavior which is indicated by the Australian council bears a striking resemblance to the rules of conduct prescribed by the American Institute. The accountants of Australia are to be congratulated on the courage of their regulations.