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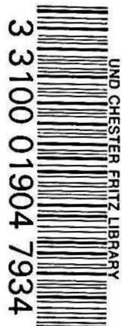
THE INDEPENDENT PUBLIC ACCOUNTANT'S LEGAL LIABILITY TO THIRD PARTIES WHEN ATTESTING TO FINANCIAL STATEMENTS



BY

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INTRODUCTION

This country has undergone a dramatic change in its social and economic philosophy in recent years. With increasing frequency, the American public is demanding that persons be held accountable for their conduct regardless of the reasons that motivated such conduct. This demand is not one to be taken lightly. Society has demonstrated that it has the desire, the power, and the determination to satisfy this demand. Two striking examples of this are: a relentless and piercing investigation of the White House and into the Oval Office itself, culminating in the resignation of the President and the jailing of several of his aides for overstepping their authority;[1] and a lawsuit which has resulted in a multimillion dollar action against the nation's largest automaker for substituting engines in a line of its cars.[2] These two instances underscore the

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[1]President Richard M. Nixon resigned as President of the United States in August of 1974 after several months of investigation into the break-in at the Watergate Building, the Democratic Party's national campaign headquarters in 1972. Several Nixon aides were subsequently convicted and sentenced to prison for their roles in the break-in and subsequent White House cover-up. All have since been released.

[2]General Motors(GM) substituted Chevrolet engines in a line of its Oldsmobile autos for the 1977 model year. Attorney generals from several states consolidated their suits into one large class action suit against GM. GM has recently received court approval for a plan to determine if approximately 67,000 customers who unknowingly purchased autos with the switched engines would accept a $200 cash settlement and an extended warranty in lieu of continuing the suit. Minneapolis Star, 6 July 1979, sec. A, p. 3.

public's commitment to a new philosophy, sometimes labeled "consumerism."[3] Society believed that a wrong had been committed and demanded that the offenders be held accountable for their actions.

One of the prime targets of the public's efforts has been the professional sector of society. During recent years there has been a significant increase in the amount of litigation brought against professional persons. Few professions have escaped unscathed from encounters with determined social sentinals. The public accounting profession has been no exception. The independent public accountant has been subjected to lawsuits from persons having both real and fancied grievances against him. The accountant has often been sued whenever some self-appointed critic perceived that the accountant had committed an act of misconduct. Whether deserved or not, this has often resulted in great hardship to the independent public accountant both financially and professionally.

Litigation has been the steadily increasingly action taken in an attempt to amend both actual and perceived wrongs. This approach has emerged as a significant social force with repercussions so strong that they threaten the existence of the accounting profession as it is known today. One explanation for the plethora of litigation against the independent public accountant was identified by a survey of CPAs which suggested that the primary reason for increased litigation was the direct

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[3]Carl D. Liggio, "The Expectation Gap: The Accountant's Legal Waterloo?" CPA Journal 45 (July 1975): 23.

result of our litigious times. This was supplemented by the fact that some attorneys encourage suits with doubtful merits because of these times.[4] Thus, it becomes essential to identify the sources posing the greatest threat for legal liability against the independent public accountant.

The accountant's greatest threat for the imposition of liability comes from third parties, someone other than his client, when the accountant attests to financial statements. In the early part of this century, an accountant's liability to third parties was limited to fraud[5] and gross negligence.[6] The Securities Acts of 1933 and 1934 added ordinary negligence[7]

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[4]James P. Bedingfield, "The Effect of Recent Litigation on Audit Practice," Journal of Accountancy 137 (May 1974): 61-2.

[5]"At common law, fraud consists of a combination of three elements: (1) false representation, (2) either knowledge of falsity or insufficient basis of information(scienter), and (3) intent or expectation of inducing reliance. The defendant's motive is not relevant and fraud may be proved without regard to the defendant's intent to obtain any personal benefit, or inflict injury on the plaintiff. In order to recover, the plaintiff is also required to show that he relied upon the misrepresentation and his reliance caused him damage." W. Prosser, Law of Torts, 4th ed., pp. 685-6 quoted in Denzil Y. Causey, Jr., Duties and Liabilities of the CPA (University of Texas at Austin: Bureau of Business Research, 1976), p. 130.

[6]Gross negligence can be defined as an extreme, flagrant, or reckless departure from standards of due care and competence in performing upon professional engagements. There is no dependable distinction from the oversight, inattention, or error of judgment or perception which amounts only to ordinary negligence. Accountants' Legal Liability (New York: Haskins & Sells, 1976), p. 2.

[7]Negligence is the omission to do something which a reasonable man would do, or doing something that a prudent and reasonable man would not do. For the independent public accountant, the "reasonable man" criterion refers to the due care expected of a professional accountant. Jack C. Robertson, Auditing (Dallas: Business Publications, Inc., 1976), p. 120.

and increased the number of possible plaintiffs. Nevertheless, the accounting profession was still relatively free of litigation and most accountants seldom had to deal with any significant problems because of their exposure to legal liability. However, during the last fifteen years, much of that has changed. The independent public accountant's exposure to legal liability and his approach to it have undergone material changes. Emerging case law has greatly expanded the accountant's legal liability to third parties. Investors and creditors who never before have had legal standing to sue the accountant are now finding that judges and juries are becoming increasingly supportive of their efforts in third party liability suits. This has resulted in the awarding of millions of dollars in damages by juries to the "wronged" plaintiffs. And with 20/20 hindsight, judges are striking down certain accounting and auditing procedures as inadequate and replacing them with their own. The accounting profession has been forced to adopt new standards and procedures in order to prevent another trip into the courtroom for repeating a similar "offense."

A by-product of this increase in litigation has been aggressive and extensive coverage by the news and financial media of the multimillion dollar trials. This has resulted in increased public outcry against the accounting profession and demands for correction. The response to this has been significant. Congress has formed two investigative subcommittees to examine the profession's effectiveness at self-regulation[8]

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[8]In 1976 a subcommittee of the Senate was convened and

and the Securities and Exchange Commission has promulgated numerous Accounting Series Releases which have reprimanded accountants and their firms as well as delineated new areas of responsibility.

Although independent public accountants have been subjected to an unprecedented amount of litigation and public criticism, not all of it is undeserved. A review of the cases brought against accountants indicates that many of the plaintiffs had legitimate complaints against the accountants involved. However, there are also other cases where the charges appear to be unfairly leveled against the accountant. In spite of this, investors and creditors have been awarded damages from accountants on the basis of decisions rendered by sympathetic juries. Some of the primary reasons for this include the failure of the jury to understand the accountant's function and the desire of jurors to aid injured parties from the only remaining

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began an inquiry into the accounting profession. Chaired by the late Senator Lee Metcalf, a preliminary study by the subcommittee concluded that the accounting profession's efforts at self-regulation were inadequate and that the federal government should take a more active role in the establishment of accounting and auditing standards as well as other regulatory measures. After the death of Metcalf in December of 1977, the subcommittee's responsibilities were reassigned to Senator Thomas Eagleton. This subcommittee is now taking testimony on the progress of the accounting profession's efforts at self-regulation.

In the House of Representatives, Congressman John Moss chairs a subcommittee which is also investigating the accounting profession's efforts at self-regulation. Congressman Moss has considered the possibility of establishing an association of accounting firms similar to the National Association of Securities Dealers and placing it under the jurisdiction of the Securities and Exchange Commission. Michael N. Chetkovich, The Accounting Profession Responds to the Challenges by the Government (New York: Deloitte Haskins & Sells, 1978), pp. 5-6, 8-9.

solvent party connected with the financial statements.[9] With these factors working against the accountant, it is no surprise that the accountant is at a disadvantage once he is summoned into court.

The area of legal liability that requires the accountant's greatest attention is in reducing his exposure to litigation and the financial and professional losses that it brings. The accountant must also take adequate measures that will minimize or eliminate his financial losses if he is called into court and a monetary judgment is assessed against him.

This paper will examine the independent public accountant's exposure to legal liability to third parties when attesting to financial statements. Following a discussion of landmark cases affecting the accountant's legal liability to third parties under common law, the accountant's liability under statutory law will be analyzed. This paper will also consider the independent public accountant's defenses to third party laibility as well as practices and procedures to minimize such liability.

As was noted earlier, the independent public accountant has not always had to live with the apprehension that he may be sued by some dissatisfied third party. Before World War I, the accountant had very little exposure to legal liability. The only source of liability came from a limited group of persons who possessed the legal standing to sue. The prevailing law in the United States was based on English law which almost totally denied liability to injured third parties. Chapter one

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[9]Bedingfield, p. 61.

will review the evolution of American law from English law and discuss the generally broadening scope of the independent public accountant's legal liability to third parties under common law when attesting to financial statements.

CHAPTER ONE

BASIS OF LIABILITY TO THIRD PARTIES UNDER COMMON LAW

It is the belief of the accounting profession that financial statements are ". . . to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors . . ."[1] But, this was not always the prevalent thought of the accounting profession or the law. The earliest court cases involving accountants and legal liability allowed only parties in privity with the accountant to sue for alleged damages, i.e., the plaintiff had to be a party to the contract with the auditor in order to sue. There was no protection for those who were not in privity with the auditor. Thus, injured third parties could not recover damages resulting from an accountant's misconduct. But as time went by, society became more consumer-oriented and worked towards providing remedies to third parties injured by an accountant's misconduct. Through the courts and then through Congress, remedies became available to persons who were not in privity with the accountant and suffered monetary damages because of an accountant's improper behavior.

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[1]Statement of the Accounting Principles Board No. 4, AICPA Professional Standards, Section 1024.01 (July 1979).

English Law

Early Cases

The English first took up the question of third party liability in 1833 in Price v. Easton.[2] The court ruled that although the plaintiff-third-party was entitled to damages from the defendant, the plaintiff could not sue because he was not in privity with the defendant. In 1842, a similar conclusion was reached in Winterbottom v. Wright[3] where a passenger who was not a party to a contract to maintain a stagecoach was injured. In the words of Lord Abinger:

> There is no privity of contract between these parties; and if the plaintiff can sue, every passenger, or even any person passing along the road who was injured by the upsetting of the coach, might bring a similar action. Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue.[4]

The case was interpretated to mean there could be no suit in tort[5] by such an injured party.

Derry

A landmark English case which applied more directly to

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[2]Price v. Easton, 4 Barn. & Adol. 433 (1833).

[3]Winterbottom v. Wright, 10M. & W. 109, 152 Eng. Rep. 402 (Ex. 1842).

[4]Ibid., at 114, 152 Eng. Rep. at 405 quoted in Causey, p. 173, note 6.

[5]A tort liability is the liability created when social policy creates a duty that fails to get carried out by one of the parties to a contract. This can be contrasted with a breach of contract liability which is the liability created when a duty created by mutual assent of the contracting parties fails to get carried out. Causey, p. 125.

accountants occurred in 1889 in Derry v. Peek.[6] In a case brought for deceit,[7] it was held that a false statement carelessly made without reasonable ground for believing it to be true can be construed as evidence of fraud. But, as in the instant case, if such a statement was made in the honest belief that it was true, it is not fraudulent and cannot render the defendant liable in deceit to a third party. In delivering the court's opinion, Lord Herschell stated:

> First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved where it is shewn that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false . . . Thirdly, if fraud be proved, the motive of the person guilty is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made.[8]

However, these restrictions applied only in cases involving pecuniary loss. In cases of loss of life, limb, or health, liability to third parties could be established. Such was the law of England until 1963. American courts have subscribed somewhat to this theory, although, in the opinion of some, interpreting the requirements more loosely than the English.[9]

Candler

In 1951 a case finally arose involving accountants and

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[6]Derry v. Peek, 14 A.C. 337 (1889).

[7]Deceit is a fraudulent and cheating misrepresentation used by one party to deceive and trick another who is ignorant of the facts to the damage of the deceived party. Robertson, p. 120.

[8]Derry v. Peek quoted in Causey, p. 174.

[9]Prosser quoted in Causey, p. 174.

third party liability. In Candler v. Crane, Christmas & Co.[10] (Candler), it was held that a firm of accountants was not liable to third parties for negligence even though the accountants presented the financial statements directly to a third party user who intended to rely upon them. Despite the fact that the statements were grossly inaccurate, the court ruled that the plaintiff could not recover from the accountants because there was no fraud since the accountants honestly believed the statements to be correct. However, the ruling was not unanimous. The dissenting opinion of Lord Denning, although in direct contrast to the prevailing opinion, was soon to form the foundation of English law:

> I think that the law would fail to serve the best interests of the community if it should hold that accountants and auditors owe a duty to no one but their client . . . If such be the law, I think it is to be regretted, for it means that the accountant's certificate, which should be a safeguard, becomes a snare for those who rely on it. I do not myself think that is the law. In my opinion accountants owe a duty of care not only to their own clients, but also to all those whom they know will rely on their accounts in the transactions for which those accounts are prepared.[11]

Hedley Byrne

In 1963 English law underwent a dramatic change. The House of Lords, following the spirit of Lord Denning's dissent, overruled the decision of Candler and held in Hedley Byrne & Co. Ltd. v. Heller & Partners, Ltd.[12] that a party giving advice to another is liable for negligence to third parties who

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[10] Candler v. Crane, Christmas & Co., (1951) 2 K.B. 164.

[11] Candler quoted in Causey, p. 175.

[12] Hedley Byrne & Co. Ltd. v. Heller & Partners, Ltd., 1964 A.C. 465 (1963).

foreseeably may rely upon it. Although the decision in Candler was overruled, the Hedley Byrne holding only served to limit the Derry decision. According to Causey, in cases where reliance by third parties is not foreseen, Derry still prevails.[13]

Since Hedley Byrne did not pertain specifically to accountants, the Institute of Chartered Accountants in England and Wales requested legal counsel's advice as to accountants' liability to third parties in light of the Hedley Byrne decision. Counsel's opinion was that third parties may recover from negligent accountants:

> . . . in circumstances where the accountants knew or ought to have known that reports, accounts or financial statements in question were being prepared for the specific purpose or transaction which gave rise to the loss and that they would be shown to be relied on by third parties in that particular connection.[14]

American Law

Early Cases

Early American courts followed the English decision in Derry and limited liability for deceit to intentional misrepresentation and denied liability to third parties for merely negligent misrepresentations. In the area of tort liability, Judge Benjamin Cardozo departed from the 1842 English decision of Winterbottom and extended third party liability to manufacturers of articles that would be dangerous to life, limb, and health if negligently made. His 1916 decision in MacPherson

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[13]Causey, p. 175.

[14]Ibid., p. 176.

v. Buick Motor Co.[15] stated that if the element of danger was present, ". . . irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully."[16] The English courts reached a similar conclusion in 1932.

The first American case dealing with a CPA's liability to a third party occurred in 1919 in Landell v. Lybrand.[17] In a claim for damages resulting from a negligently prepared auditor's report, the Court, following Derry, denied the plaintiff's claim against the defendant CPAs because there was no intent to deceive, and since there was no contract, the CPAs could not be liable to the plaintiff for negligence.

Ultramares

In 1931 the New York Court of Appeals decided Ultramares v. Touche, Niven & Co.[18](Ultramares), a landmark American case which reaffirmed many of the predominate principles of English law as well as breaking new legal ground.

Facts

Fred Stern & Co., Inc., an importer of rubber, required extensive credit and borrowed large amounts of money from banks and factors to finance its operations. One of the factors was the plaintiff, Ultramares Corporation, a lender on receivables.

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[15]MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916).

[16]MacPherson quoted in Causey, p. 176.

[17]Landell v. Lybrand, 264 Pa. 406, 107 Atl. 783 (1919).

[18]Ultramares Corporation v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931).

The defendant, Touche, Niven & Co., was engaged by Fred Stern & Co., Inc. to audit its books and certify a balance sheet as of December 31, 1923. This audited balance sheet was to be exhibited to banks and factors when credit was to be extended. The defendants knew that certified balance sheets were routinely exhibited to credit-grantors, stockholders, purchasers, and other third parties in the normal course of business. But, they were not aware that the reason for their engagement was to prepare a certified balance for the use of the plaintiff in evaluating the Stern loan application. At the time of the audit, Ultramares had never advanced any money to Fred Stern & Co., Inc. and was not otherwise identified to the auditors. On the basis of the certified balance sheet, the plaintiff advanced money to the company.

Shortly thereafter, Fred Stern & Co., Inc. went bankrupt. Evidence presented in court revealed that the management of the company had falsified the accounting records by penciling in fictitious sales and accounts receivable at the bottom of the final month's sales journal. Since Touche had failed to investigate the significance of these penciled-in, year-end figures, Ultramares brought suit against them for negligence claiming damages suffered for the loans to Stern that could not be collected.

Holding

Liability to third parties for fraud

Judge Benjamin Cardozo ruled that an accountant can be held liable for deceit if he certifies a balance sheet without

possessing information leading to a sincere or genuine conclusion. In doing so he overruled Derry which held that deceit could not be sustained if the defendant honestly believed his representation to be true, even though the belief had no reasonable basis.[19] According to Judge Cardozo:

> No such charity of construction exonerates accountants, who by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries.[20]

Although the Ultramares suit was for damages due to negligence, Cardozo held that a jury could find the defendants had certified a statement as true to their own knowledge when, in fact, they had no knowledge on the subject,[21] i.e., the defendants could have been held liable to Ultramares Corporation in a suit for deceit. This was the first American case to establish the auditor's liability to third parties for deceit.

Primary benefit rule

However, Judge Cardozo held that the plaintiff could not sue the auditor for negligence since the auditor's report:

> . . . was primarily for the benefit of the (client) . . . for use in the development of the business, and only incedently or collaterally for the use of those to whom (the client) and his associates might exhibit it thereafter.[22]

This holding is called the primary benefit rule. In so deciding, Cardozo distinguished Ultramares from an earlier case where a plaintiff-third-party recovered from the defendant for

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[19]Causey, p. 178. [20]Ibid. [21]Ibid.

[22]R. James Gormley, "Accountants' Professional Liability--A Ten-Year Review," Business Lawyer 29 (July 1974): 1207.

negligence.[23] In that case a seller ordered a public weigher to weigh beans for a buyer who was to pay the seller according to the weight. Here the defendant(weigher) knew of both the transaction and the plaintiff-third-party(buyer) which, according to Cardozo, created a bond ". . . so close as to approach that of privity."[24] The plaintiff was in fact the primary beneficiary of the defendant's actions. It was the lack of this proximity and foreseeability that led Judge Cardozo to hold in Ultramares:

> 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.[25]

If Touche had known that the audit report was to be exhibited specifically to Ultramares by Stern, the Court might well have held them liable to Ultramares for negligence.[26]

Liability to third parties for gross negligence

Ultramares did not completely exonerate auditors from negligence. If the negligence is so gross, it may be construed as constructive fraud.[27] Judge Cardozo acknowledged

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[23]Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922).

[24]Causey, p. 179.

[25]Ultramares quoted in Causey, p. 178.

[26]Causey, p. 178.

[27]Constructive fraud is a deceit which involves a false representation of a material fact, with lack of reasonable ground for belief, to induce reliance by another, relied upon by the other, and causing damage to him. Actual fraud differs from constructive fraud in knowledge of the falsity of a

this when he said:

> Our holding does not emancipate accountants from this inference of fraud. It does not relieve them if their audit had been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. . . . 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.[28]

The holdings of Ultramares may be summarized that absent a showing of privity of contract, there is no liability to third parties for ordinary negligence; however, there may be liability for fraud or gross negligence.[29]

State Street Trust Co.

The 1938 case of State Street Trust Co. v. Ernst & Ernst[30] (State Street Trust Co.) upheld the findings of Ultramares and extended it by making gross negligence a surrogate basis of third party liability.

Facts

In this case the client was engaged in the factoring of receivables. A substantial portion of the client's funds was

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representation, rather than a lack of reasonable ground for belief in its truth. Constructive fraud may be inferred from evidence of gross negligence (see infra, State Street Trust Co.) although gross negligence is not necessarily constructive fraud in and of itself. Gormley, p. 1207.

[28]Marc Levine, "Legal Liability and the Auditing Profession," Michigan CPA (May/June 1977): 34.

[29]Murphy, "Notes and Comments--Accounts and Accounting: The Responsibilities of CPAs: Imposed by Law and the American Institute of Certified Public Accountants," 26 Oklahoma Law Review 386 (1973).

[30]State Street Trust Co. v. Ernst & Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938).

borrowed from a group of banks. Following an audit of the client firm by Ernst & Ernst, the firm sent copies of its audited statements, including a short-form audit report, to the creditor banks. Although the auditors examined the accounts receivable, they apparently failed to see an obvious point--most of the accounts were uncollectible. About one month later, Ernst & Ernst sent a long-form report with a cover letter to the client which stated that the reserve for doubtful accounts was grossly inadequate and as a result, the company had a negative equity balance. This was contradictory to the short-form report the client had sent to the bank which reflected that the client had a surplus in stockholders' equity. On the basis of the short-form report, one of the banks advanced the client firm $300,000 which became uncollectible. Inasmuch as the auditors had certified a false report of the client firm, the injured third-party-bank brought suit against the auditors.

During the trial it was revealed that there was sufficient evidence of unusual and suspicious entries in the accounting records which should have indicated a need for a more thorough examination. Furthermore, the auditors knew of several facts which adversely affected the financial position of the company, but were not disclosed in the short-form report they issued.

Holding

The trial court found the defendant auditors guilty of gross negligence and therefore liable to the plaintiff third party. In upholding the trial court, the near-unanimous

Apellate Court said:

> Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless statement, or an opinion based upon grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention.
> In Ultramares v. Touche (255 N.Y. 170) we said with no uncertainty that negligence, if gross, or blindness, even though not equivalent to fraud, was sufficient to sustain an inference of fraud.[31]

It was also the opinion of the court that preparing a balance sheet which correctly reflects the books is not enough; it must also correctly reflect the true financial picture of the company. This is determined, not only by examination of the books, but also by independent inquiry.[32]

Duro Sportswear

The decision of State Street Trust Co. was upheld in 1955 in Duro Sportswear, Inc. v. Cogen[33](Duro Sportswear). In this case the auditor ignored bills which were outstanding but unrecorded at the audit date although he knew through years of experience that such bookkeeping delays were customary. The court held the auditor as grossly negligent because he failed

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[31]State Street Trust Co. quoted in Causey, p. 180.

[32]Arthur Harris Adelberg, "A Review of Major Cases on Accountants' Legal Liability," Georgia CPA 16 (Fall 1974): 15 quoting Edward J. Daus.

[33]Duro Sportswear, Inc. v. Cogen, 131 N.Y.S.2d 20 (Sup. Ct. 1954), aff'd mem., 285 App. Div. 864, 137 N.Y.S.2d 829 (1955).

to investigate subsequent events which resulted in a failure to qualify the auditor's opinion on the client firm's financial statements. The court said that an accountant has a duty to review events subsequent to the audit date to be sure that there are no omissions which would render the financial statements inaccurate or misleading. As a result of his gross negligence, the auditor was liable to the third party.[34] Duro Sportswear appears to interpret State Street Trust Co. to mean that gross negligence <u>does</u> constitute fraud as opposed to Judge Cardozo's holding that gross negligence <u>may</u> infer fraud or <u>may</u> be evidence of fraud (italics mine).[35]

The difference between the duty to third parties asserted by Cardozo and the duty to use due care so as to be free of ordinary negligence is a very narrow one. It is also difficult to distinguish ordinary negligence from "a refusal to see the obvious, a failure to investigate the doubtful" (State Street Trust Co.) and gross negligence (Duro Sportswear). Apparently auditors can look, ascertain the obvious, and still be guilty of ordinary negligence rendering themselves liable to clients but not to third parties.[36]

Ultramares Extended

In Ultramares, Judge Cardozo held that unless there is privity of contract, there can be no liability to third parties for ordinary negligence, but there may be liability for fraud

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[34]Rifkin, "Accountants Financial Disclosure and Investor Remedies," 18 <u>New York Law Forum</u> 686-7 (1973).

[35]Causey, p. 180. [36]Ibid.

or gross negligence.[37] In Rusch Factors, Inc. v. Levin[38] (Rusch Factors), the reasoning of Ultramares was rejected and the authority of its holding modified.

The plaintiffs, Rusch Factors, Inc., requested audited financial statements of a corporation who was seeking a loan. The corporation engaged the defendant accountants who provided audited statements which showed the corporation solvent when in fact it was insolvent. The corporation then submitted the statements to the plaintiff who, in reliance on such statements, granted a loan to the corporation. The corporation subsequently went bankrupt and the plaintiff lender filed suit against the accountants for damages which resulted from its reliance on the misrepresented financial statements. The defendant auditors moved for dismissal on the grounds of absence of privity of contract. Rather than citing Ultramares and granting the defendants' motion, the court denied the motion:

> The wisdom of the decision of Ultramares has been doubted . . . and this court shares that doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this court that the decision in Ultramares constitutes an unwarranted inroad upon the principle that "the risk reasonably to be perceived defines the duty to be obeyed . . ."[39]

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[37] Murphy, p. 386.

[38] Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (1968).

[39] Rusch Factors quoted in Levine, p. 35.

The court's holding went on further to state that an auditor's liability to third parties for ordinary negligence should be extended when the class of user and the type of transaction is foreseen:

> With respect then to the plaintiff's negligence theory, this court holds that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons. According to the plaintiff's complaint in the instant case, the defendant knew what his certification was to be used for, and had as its very aim and purpose, the reliance of potential financiers of the Rhode Island corporation. The defendant's motion is, therefore, denied.[40]

Rhode Island Hospital Trust

In Rhode Island Hospital Trust National Bank v. Swartz[41] (Rhode Island Hospital Trust), the defendant auditor was held liable to a third party for ordinary negligence notwithstanding the fact that the auditor had issued a disclaimer of opinion. The reason for the auditor's disclaimer was that certain capital improvements to his client's leased shipping facilities could not be valued due to the fact that practically all of this work was done with company employees and materials and fully complete and detailed cost records were not kept. In reliance upon representations made by the auditor's client concerning these additions to fixed assets in the financial statements, the plaintiff bank extended credit to the company.

During the trial it was determined that no cost records were kept and the improvements were never made. The charges

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[40]Rusch Factors quoted in Causey, p. 184.

[41]Rhode Island Hospital Trust National Bank v. Swartz, 455 F.2d 847 (4th Cir. 1972).

to fixed assets were actually operating expenses which resulted in the income statement showing a $9,000 profit instead of a significant loss. Since the disclaimer referred only to a valuation problem and did not question the existence of the additions, the court held that the auditor was negligent for failing to ". . . give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations"[42] as required by AICPA Statement on Auditing Procedure No. 33 at chapter 10, paragraphs 1 and 9.[43] The judge noted that the decision might have gone the other way if the language in the disclaimer had been more explicit as required by generally accepted auditing standards. The court ruled ". . . while industry standards may not always be the maximum test of liability, certainly they should be deemed the minimum standard by which liability should be determined."[44]

Restatement of the Law Second: Torts

The previous two cases illustrate, and were partially adjudicated on the basis of, Section 522, Tentative Draft No. 12 of Restatement of the Law Second: Torts[45] which states what some believe the law should be:

> (1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the

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[42]Rhode Island Hospital Trust quoted in Causey, p. 185.

[43]Causey, p. 185.

[44]Rhode Island Hospital Trust quoted in Levine, p. 35.

[45]Restatement of the Law Second: Torts: Tentative Draft No. 12, 14 (1966).

> guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered
>
> (a) by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
>
> (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.[46]

The independent public accountant's liability to third parties under common law went through considerable change during the 1960s and 70s. From a time when only those in privity with an accountant could sue for fraud, the accountant's exposure to legal liability expanded to damages caused by his ordinary negligence. But this was not the only source of the independent public accountant's increasing legal dilemma. The securities laws were also becoming a force to be reckoned with as several class action suits against accountants were to prove.

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[46]Restatement of the Law Second quoted in Causey, p. 183.

CHAPTER TWO

LIABILITY TO THIRD PARTIES UNDER STATUTORY LAW

An accountant's liability to third parties under statutory law is derived most significantly from two federal laws--the Securities Act of 1933 and the Securities Exchange Act of 1934. Although many states had blue-sky laws regulating securities by the early 1930s, these were not adequate to sufficiently protect the investor dealing in interstate transactions, the primary investing market. Following the stock market crash of 1929 and much discussion in the financial press about investor protection, Congress passed the Securities Act of 1933 which regulated the initial offering and sale of securities that use the mail for offers or distribution. This law was followed by the Securities Exchange Act of 1934 which regulated the trading of securities after their initial distribution. The 1934 Act also established the Securities and Exchange Commission.

Securities Act of 1933

The accountant's exposure to liability to third parties under the Securities Act of 1933(Securities Act) arises from Section 11 of the Act. This section provides a federal right of action to any person acquiring a security for which a registration statement has been issued and which contains misleading material information or statements or omits material information

which makes the statements misleading.[1] The effect of this section on the independent public accountant may be summed up as follows:

(1) Any person acquiring securities described in the Registration Statement may sue the accountant, regardless of the fact that he is not the client of the accountant.
(2) His claim may be based upon an alleged false statement or misleading omission in the financial statements, which constitutes his _prima facie_ case. The plaintiff does not have the further burden of proving that the accountant was negligent or fraudulent in certifying to the financial statements involved.
(3) The plaintiff does not have to prove that he relied upon the statement or that the loss which he suffered was the proximate result of the falsity or misleading character of the financial statement.
(4) The accountant has thrust upon him, the burden of establishing his freedom from negligence and fraud by proving that he had, after reasonable investigation, reasonable ground to believe and did believe that the financial statements which he certified were true not only as of the date of the financial statements, but beyond that, as of the time when the Registration Statement became effective.
(5) The accountant has the burden of establishing by way of defense or in reduction of alleged damages, that the loss of the plaintiff resulted in whole or in part from causes other than the false statements or the misleading omissions in the financial statements. Under the common law it would have been part of the plaintiff's affirmative case to prove that the damages which he claims he sustained were proximately caused by the negligence or fraud of the accountant.[2]

Passage of the Securities Act resulted in three marked changes with regards to civil actions against the independent public accountant: it significantly expanded the number of potential plaintiffs who could bring suit against the accountant; it significantly reduced the burden of proof to be borne

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[1]Michael M. Kennedy, "Accountants' Liability Overview," _Pennsylvania CPA Spokesman_ 46 (November 1975): 5.

[2]Saul Levy, _Accountants' Legal Liability_ quoted in Levine, p. 36.

by the plaintiff in such a suit;[3] and it deprived the accountant of some of his most important common law protections in suits filed by third parties.[4] The foremost judicial interpretation of Section 11 of the Securities Act was issued in 1968 in the BarChris case.[5]

BarChris

BarChris Construction Corporation was engaged in the business of constructing and installing bowling alleys. According to the prospectus, net sales had increased from approximately $800,000 in 1956 to over $9,000,000 in 1960. In constant need of cash to finance its expanding operations, BarChris filed a registration statement for debentures in 1961. On May 24 of that year the financing was complete and BarChris received the net proceeds. During 1961-62, the fortunes of the bowling industry declined, primarily as a result of overexpansion. On October 29, 1962, BarChris filed a petition under Chapter XI of the Bankruptcy Act.

Over sixty purchasers of the debentures brought suit against (1) persons who signed the registration statement, (2) the underwriters (led by Drexel & Co.), and (3) BarChris's auditors, Peat, Marwick, Mitchell & Co.(Peat Marwick), under Section 11 of the Securities Act. The plaintiffs charged that the registration statement contained material misstatements

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[3]Kennedy, p. 6.

[4]Gormsley, p. 1216.

[5]Escott v. BarChris Construction Corporation, 283 F. Supp. 643 (S.D.N.Y. 1968).

and material omissions. Peat Marwick used due diligence for an expert as a defense.

Peat Marwick audited BarChris's financial statements for 1958, 1959, and 1960 as well as undertaking an S-1 review in connection with the registration. The purpose of the S-1 review was to determine if any material changes had occurred subsequent to the date of the certified balance sheet which would cause the balance sheet figures to be misleading. The court, in deciding against Peat Marwick, ruled that the auditors had not performed a diligent and reasonable investigation and that the S-1 review was useless. The holding stated that the accountants should not be held to a standard higher than that recognized in their profession. But it was the court's decision that the auditors did not meet that standard. However, the auditors' liability was based on ordinary negligence alone. Under common law, there would have been no liability because there was no evidence of fraud, intentional concealment, or gross negligence.[6]

An important aspect of the case is the court's interpretation of then-current generally accepted accounting principles. In 1960, BarChris was involved in a sale and leaseback transaction in which considerable profit was recognized. The court ruled that the sale and leaseback was not in fact a sale because the property never left the company's control and, as a result, sales and gross profits were overstated.[7] Generally accepted accounting principles in effect at the time required only that

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[6]Levine, p. 36. [7]Ibid.

there should be disclosure of the principal details of the transaction. This view was not modified until Accounting Principles Board Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee," was issued by the American Institute of Certified Public Accountants in 1964. Thus, the court struck down generally accepted accounting principles and promulgated its own accounting principles and the way in which they should be applied.[8] According to Causey, this occurred because the applicable accounting principles were not up to the level that the "average prudent investor" had a right to expect. Causey wrote:

> When generally accepted accounting principles, as approved by auditors following generally accepted auditing standards, fall below the reasonable expectations of the "average prudent investor," liability will be imposed where proximity of the parties is such that a duty should be recognized.[9]

Securities Exchange Act of 1934

As noted previously, the Securities Exchange Act of 1934 (Exchange Act) regulates the trading of securities after their initial distribution. There are several sections in the Exchange Act under which accountants can be brought to trial for liability to third parties. The two primary sections which affect accountants most directly are Section 18(a) and Section 10(b) along with attendant SEC Rule 10(b)-5.

Section 18(a)

Section 18(a) provides:

Any person who shall make or cause to be made any statement

[8]Adelberg, p. 17. [9]Causey, p. 212.

> in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder or any undertaking contained in a regulation statement . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.[10]

Rule 10(b)-5

Rule 10(b)-5, promulgated by the Securities and Exchange Commission pursuant to Section 10(b) of the Exchange Act, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made . . . not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[11]

Although the rule contains no express provisions for any civil liability, the provisions have been construed by federal courts as establishing civil remedies for any violation. Liability has been established for (1) insiders, (2) broker-dealers, (3) corporations whose stock is purchased and sold by plaintiffs, and (4) those who aid or abet someone in the first three categories.[12]

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[10] 15 U.S.C. Section 78r (1971) quoted in Murphy, p. 390.

[11] Ibid., p. 391.

[12] Causey, p. 214.

Court Cases

There have been several actions brought by dissatisfied third parties against independent public accountants under the Exchange Act. These cases have resulted in modifications and/or extensions of the independent public accountant's liability to third parties.

Yale Express

The court's 1967 ruling in Fisher v. Kletz,[13] more commonly known as the Yale Express case, resulted in auditors being liable for disclosure of information affecting either audited or unaudited financial statements even after the statements have been filed with the SEC or disseminated to the public.

Facts

During 1964, Peat, Marwick, Mitchell & Co.(Peat Marwick) entered into a management advisory services engagement with Yale Express System, Inc. for the purpose of conducting special studies of Yale's past and current income and expense. During the course of the engagement, Peat Marwick learned that the figures in the 1963 annual report audited by Peat Marwick were substantially false and misleading. The misstatements were not corrected or publicly disclosed until May of 1965 when the report of the special studies was released. The stockholders and debenture holders brought suit against the auditors for failure to disclose the misleading nature of the financial statements as soon as the misstatements were discovered.

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[13]Fisher v. Kletz, 266 F. Supp. 180 (1967).

The plaintiffs' suit alleged common law deceit and violations of Section 18, Section 10(b)-5, and Rule 10(b)-5 of the Exchange Act. The plaintiffs contended that the misstatements were known to the auditors prior to June 1964 when Yale Express filed its 10-K report with the SEC. The auditors denied it, stating that such knowledge was acquired after the filing. The significance of this case comes not from a decision finding the defendant auditors guilty, but rather from the court's denial of the defendants' motion to dismiss the suit. The suit itself was later settled out of court.

Request for dismissal under
common law rejected

In arguing for dismissal, the defendants contended that the duty to disclose a prior representation as false and misleading did not apply to auditors. Although such a duty is imposed on a party to a business transaction, auditors could not be considered a party to a business transaction because they have no opportunity for personal gain by virtue of nondisclosure.[14] But the court rejected this argument:

> . . . the act of certification . . . is similar in its effect to a representation made in a business transaction: both supply information which is naturally and justifiably relied upon by individuals for decisional purposes. Viewed in this context of the impact of nondisclosure on the injured party, it is difficult to conceive that a distinction between accountants and parties to a business transaction is warranted. The elements of "good faith and common honesty" which govern the businessman presumably should also apply to the statutory "independent public accountant."[15]

Thus, the motion to dismiss under common law deceit was denied.

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[14] Causey, p. 190. [15] Ibid.

Request for dismissal under
Section 18 rejected

Since there was a dispute as to the facts of the case (i.e., as to when Peat Marwick actually discovered that the 1963 statements were false and misleading), the court refused to dismiss the claim under Section 18. This was apparently in concurring with the plaintiffs' contention that if Peat Marwick did discover the misstatement prior to the filing of the 10-K with the SEC, then liability under Section 18 would be established for causing a false certificate to be filed.[16]

Signigicance of Yale Express

The precedents established by this case were: (1) the independent public accountant's duty does not terminate with the issuance of the certified financial statements and (2) the public accountant has a duty to the public apart from any duty that he may owe to his client. The duty to disclose to the public information which is material, regardless of when it is discovered, is greater than the duty to the client not to disclose, even with respect to privileged information.[17]

The American Institute of Certified Public Accountants has since set a standard for the requirements of disclosure of information discovered subsequent to the issuance of financial statements.[18] Failure to adhere to this standard would now be

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[16]Causey, p. 224.

[17]Adelberg, p. 19.

[18]The rules are incorporated in Statements on Auditing Standards No. 1 (New York: American Institute of Certified Public Accountants, 1972).

Continental engaged Lybrand to audit its 1962 financial statements. At about the time the auditors were preparing to release the audit report, Roth informed them that Valley would not be able to repay Continental because Roth was unable to repay Valley. In order to secure his receivable with Valley, Roth agreed to post collateral valued in excess of the net amount that Valley owed Continental. This collateral consisted of about 80% of stock and debentures of Continental. However, in the footnotes to the financial statements of Continental, neither the fact that Roth was the actual recipient of the money creating the Valley receivable or that 80% of the collateral consisted of securities issued by Continental was disclosed.

When the annual report was released, it showed that Continental was in a deteriorating financial position after suffering a large loss in fiscal 1962. Continental's stock prices fell resulting in a withdrawal of the auditors' opinion on the financial statements because the value of the collateral was now reduced far below the amount of the net Valley receivable. When one of Continental's checks to the Internal Revenue Service bounced, an immediate investigation was made which resulted in the closing of the Continental plants and the initiation of bankruptcy proceedings.

Accountants face criminal charges

Criminal charges were brought against the Lybrand accountants under the Securities Exchange Act of 1934 for knowingly drawing up and certifying false and misleading financial

statements. Charges were also brought under the Federal Mail Fraud Statute for use of the mails to distribute the statements in violation of the statute.

In its case, the government contended that the footnote disclosure in Continental's financial statements was misleading because:

(1) it did not disclose that Roth had received the money that Valley borrowed from Continental;
(2) the footnote did not disclose that a material portion of the collateral consisted of securities issued by Continental;
(3) the fact that the $3.5 million receivable had increased to $3.9 million from the balance sheet date to the opinion date had not been disclosed; and
(4) the footnote represented that the Valley receivable could be netted against the liability to Valley when, in fact, the receivable was from Valley and the liability was to the bank which had discounted Continental's notes.[21]

Compliance with generally accepted accounting principles not an ironclad defense

Except for the netting of the two accounts, which the defendant auditors admitted was an erroneous accounting treatment, eight expert witnesses testified on behalf of the Lybrand auditors that none of the items required disclosure under generally accepted accounting principles or generally accepted auditing standards. On this basis, the defendants requested that the judge instruct the jury that if they found that Lybrand complied with generally accepted accounting principles, they could not be found guilty. But, the trial judge rejected this argument and instead instructed the jury: "Proof of

[21]Causey, p. 245.

compliance with generally accepted standards is evidence which may be very persuasive but not necessarily conclusive that he acted in good faith, and the facts certified were not materially false or misleading."[22]

Initially it would appear that the judge had struck down all defenses using compliance with generally accepted accounting principles. But it is the opinion of some that this is the case only when there is no specific accounting principle addressing the question in point. If there is an official pronouncement of a governing body such as an APB opinion or FASB statement which is directly in point, a different result would be reached.[23]

Disclosure of improper client activities

The court's opinion also established the precedent that the auditor must disclose improper activities of the client or officers of the client when the auditor knows that such activities may reasonably affect the financial statements. Although the court's opinion does not set explicit guidelines for what conduct should be considered improper, it charges the auditor to decide what actions should be deemed not in the best interest of the stockholders:

> It 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

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[22]Kenneth I. Solomon, Charles Chazen, and Barry S. Augenbraun, "Who Judges the Auditor, and How?" Journal of Accountancy 142 (August 1976): 70.

[23]Liggio, p. 26.

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[22]Kenneth I. Solomon, Charles Chazen, and Barry S. Augenbraun, "Who Judges the Auditor, and How?" Journal of Accountancy 142 (August 1976): 70.

[23]Liggio, p. 26.

> president. Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then, . . . he must extend his procedures to determine whether or not such suspicions are justified. If, as a result of such an extension or, as here, without it, he finds his suspicions to be confirmed, full disclosure must be the rule ... .[24]

In its opinion, the court noted that the lack of full disclosure may have been the result of something more than an oversight, i.e., the defendant auditors may not have been acting in good faith:

> When we add the delay in getting at the critical matter of the Valley receivable, the failure to follow up Roth's offer of a mortgage on his house and furniture, and the last minute changes in the balance sheet, we find it impossible to say that a reasonable jury could not be convinced beyond a reasonable doubt that the striking difference between what Note 2 said and what it needed to say in order to reveal the truth resulted not from mere carelessness but from design.[25]

The criminal conviction of the Lybrand auditors resulted in the settlement of a companion civil suit in the amount of $2.1 million.[26]

Conclusions

The court's findings have been summarized as follows:

(1) Compliance with generally accepted accounting principles and generally accepted auditing standards is not a complete defense to a criminal prosecution under federal statutes;
(2) In order for generally accepted accounting principles and generally accepted auditing standards to be of evidential weight, they must be (a) specifically stated in relation to the situation involved in the case, and

[24]Levine, p. 37.

[25]United States v. Simon as reprinted in Causey, p. 399.

[26]Rifkin, p. 708.

(b) compliance with these standards must result in a fair presentation of financial standing; and

(3) The general test in an action against accountants on criminal charges is (a) did the financial statements present the financial position of the company fairly? (b) if they did not, did the accountants act in good faith?[27]

David Isbell, counsel of the AICPA as *amicus curiae* in the Continental Vending case, argued that:

> It is fundamentally unfair to require a man to conform to an uncertain standard of conduct that is established by a jury after the fact, and that differs from and may well conflict with the standards of his profession. Must professional men conform to standards established in retrospect by a lay jury rather than standards of their own profession?[28]

The crux of the matter appears to be entrenched in whether or not the auditor's report fairly presents the true financial position and is not materially false or misleading. As to disclosure:

> In case of doubt the legal balance is weighed heavily on the side of disclosures, in a manner and detail in which the facts of material importance are sufficiently intelligible to be understandable to an ordinary person notwithstanding the formalities of the accounting conventions.[29]

<u>Herzfeld</u>

The implication of Continental Vending was painfully obvious: the judiciary was willing to go to extreme measures to compel the independent public accountant to make full and adequate disclosure on financial statements. Some questions on the minds of many were: How far were the courts willing to go?

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[27]Murphy, p. 392.

[28]Ibid., p. 393.

[29]Gormsley, p. 1223.

Were the standards of Continental Vending the limit or could the courts go even further? As might be expected during a period of increasing litigation, the answer was that the limits could go further. The court's decision in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath[30] (Herzfeld) resulted in accountants being held civilly liable to a third-party-investor because their opinion, even though qualified, did not provide a fair representation of an unusual transaction.

Facts

In mid-November 1969 the client, The Firestone Group, Ltd.(FGL), engaged Laventhol, Krekstein, Horwath & Horwath (Laventhol) to perform an audit for the eleven-month period ending November 30, 1969. On November 22, FGL entered into an agreement to purchase a group of California nursing homes on a nonrecourse basis for approximately $13 million. Four days later the client entered into another agreement to sell the same group of nursing homes for $15 million, again on a nonrecourse basis. The terms of FGL's purchase were $5,000 payable on execution of the contract, $25,000 four weeks later, and $4 million by January 30, 1970. The balance of the purchase price was payable by FGL by assuming liabilities and issuing its own 25-year purchase money notes.

The terms of the sale by FGL were similar to its own purchase: payment of $25,000 to FGL on execution of the sales contract, $25,000 five weeks later, and $5 million on or before

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[30] Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, CCH Fed. Sec. L. Rep. Section 94,574 (S.D.N.Y. 1974).

January 30, 1970. The buyer's remaining balance of the purchase price was payable to FGL by assuming liabilities and issuing purchase money notes. Thus, approximately half of the $2 million profit on the deal would be realized by FGL by January 30, 1970, representing the excess of the cash received over the cash paid out.

The buyer company of the nursing homes from FGL was controlled by an experienced and highly regarded syndicator. However, the company had a net worth of only $100,000, less than 1% of the total price tag on the transaction. Laventhol made extensive inquiries into the background of the buyer in trying to determine the probability of the collectibility of the receivable held by FGL. Nothing negative was learned about the transaction or the buyer's ability to perform.

FGL wanted Laventhol to recognize the entire $2 million gain on the deal as current income for 1969. But due to the small down payment (only $25,000 had been paid by the buyer to FGL) and FGL's small equity in the property (FGL had paid only $5,000 at the balance sheet date), Laventhol permitted only $235,000 to be recognized as current year income. This amount represented the $25,000 payment already received, plus the next $25,000 payment, plus $185,000 of liquidated damages provided for in the sales contract. The balance of the gain, some $1.8 million, was recorded as a deferred income item, supplemented by a footnote.

But Laventhol, although approving the accounting treatment of the transactions, was reluctant to issue an unqualified

opinion due to the materiality of the amounts involved and persisting uncertainty as to the collectibility of the receivable. Thus, they issued a qualified opinion which stated that it was "subject to the collectibility of the balance due on the contract for sale" and referenced the same footnote previously discussed.

Shortly thereafter, FGL made a private placement of securities in the amount of $750,000. The nursing home deal eventually fell through with no more money being exchanged. In 1971 the company was reorganized under Chapter XI of the federal bankruptcy law. An investor who had purchased FGL stock and notes in the private placement brought suit against the accountants under Rule 10(b)-5, New York Blue Law, and common law fraud. The plaintiff's only requirement was to show misrepresentation and reliance thereon.

Holding

In finding the defendant auditors liable to the plaintiff-investor, the court did not consider whether the report was prepared in accordance with generally accepted accounting principles but rather, whether the report presented fairly the true financial position of the company ". . . to the untutored eye of an ordinary investor."[31]

Specifically, the court ruled that the auditors failed to effectively communicate to investors (1) the uncertainty of collectibility which was indicated by the purchaser's limited

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[31]Herzfeld quoted in Causey, p. 19.

net worth, (2) that the principal shareholder of the buyer, upon whose reputation Laventhol heavily relied, had no personal liability, and (3) that it was the custom of the buyer to resell property without ever taking title.[32] In bypassing the question of whether or not generally accepted accounting principles had been properly applied, the court held:

> The policy underlying the securities laws of providing investors with all the facts needed to make intelligent decisions can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company. In those cases where application of generally accepted accounting principles fulfill the duty of full and fair disclosure, the accountant need go no further. But if application of accounting principles alone will not adequately inform investors, accountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.[33]

Although Laventhol followed generally accepted accounting principles in qualifying its opinion, the court nevertheless found fault with the auditors' methods of disclosure:

> We agree that the qualification throws some doubt on whether the transaction would be culminated, but we think more was required of Laventhol as an independent auditor.[34]

The lesson of Herzfeld appears to be that when accountants must qualify their opinions, they should take a layman's point of view as to the extent and prominence of the qualification necessary to disclose the question in point in light of its materiality to the financial statements.[35]

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[32]Causey, p. 21.

[33]Herzfeld quoted in Causey, p. 21.

[34]John J. Slain, "Recent Herzfeld Decision Extends Accountants' Liability Even Further," Practical Accountant 8 (September/October 1975): 73.

[35]Ibid., p. 71.

Federal Rules of Civil Procedure

It was noted earlier that although federal securities laws had been existence for years, little litigation was actually initiated. Much of the reason for this was that a particular investor's loss on a purchase or sale of securities was relatively small in comparison to the cost of litigation. Thus, court action was not a realistic alternative. However, this situation changed significantly in the mid-sixties when the Supreme Court adopted Rule 23 of the Federal Rules of Civil Procedure which became effective July 1, 1966.

Rule 23 liberalized the conditions under which purchasers, sellers, or holders of securities could institute a collective lawsuit on behalf of themselves and as representatives of the class of persons similarly situated, without the necessity for each member of the class to formally join the lawsuit as a plaintiff. The primary restriction is that the questions of law or fact common to the class must predominate over questions affecting the individual members.

Class actions are particularly applicable to suits under Section 11 of the Securities Act. This is because any misrepresentation in the registration statement and prospectus will be a question of fact to all members of the class. No reliance is required under Section 11 for plaintiffs who purchase prior to the issuance of a report on earnings for the twelve months following registration. BarChris was a class action suit.[36]

[36]Causey, p. 226.

Securities and Exchange Commission

Purpose

The Securities and Exchange Commission(SEC) was created under the authority of the Securities Exchange Act of 1934 and charged with the duty to protect investors from fraud and deception and to ensure the integrity of the securities market.[37] Under Section 19(a) of the Securities Act and Section 13(b) of the Exchange Act, respectively, the SEC is empowered to:

> (1) determine such rules and regulations as may be necessary to carry out the provisions of this title, including . . . defining accounting . . . terms and among other things . . . the methods to be followed in the preparation of accounts and
> (2) prescribe the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in the preparation of reports . . . .[38]

These provisions appear to infer that the SEC has the power to make and enforce both accounting and auditing standards.[39]

Accounting Series Releases

One of the ways that the SEC discharges the foregoing responsibilities is through the promulgation of Accounting Series Releases(ASRs). The primary purpose of these releases is to explain and clarify accounting procedures and practices requiring special treatment.[40] Beginning with Accounting Series

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[37]A. A. Sommer, Jr., "Accountants: A Flexible Standard," Journal of Accountancy 138 (December 1974): 77.

[38]Causey, p. 77, note 32.

[39]Ibid., p. 77.

[40]K. Fred Skousen, An Introduction to the SEC (Cincinnati: South-Western Publishing Co., 1976), p. 89.

Release No. 1,[41] where the Commission announced a program of publication ". . . of opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions," the SEC has continually promulgated rules for the presentation of publicly-held companies' financial statements.

The Commission requires all financial statements filed with it to comply with generally accepted accounting principles. Statements with qualified "except for" or adverse opinions will not be accepted. Corrections must be made to bring the statements into compliance with generally accepted accounting principles. The Commission's posture with regards to accounting principles is that considerable weight will be given to principles and practices adopted by the accounting profession, but that it reserves for itself the right to make the final determination so as to protect the public interest.[42] ASR No. 4[43] outlines the relationship between generally accepted accounting principles adopted by the accounting profession and how they are viewed by the SEC. Jack Robertson summarized it as follows:

> (1) When financial statements filed with the Commission are prepared according to principles that have no authoritative support, they will be presumed to be misleading. Other disclosures or footnotes will not cure this presumption.

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[41]Securities and Exchange Commission, SEC Accounting Series Release No. 1, "Treatment of Losses Resulting from Revaluation of Assets," (1937).

[42]Causey, p. 78.

[43]Securities and Exchange Commission, SEC Accounting Series Release No. 4, "Administrative Policy on Financial Statements," (1938).

(2) When financial statements involve a principle on which the Commission disagrees but has promulgated no explicit rules or regulations, and the principle has substantial authoritative support, then supplementary disclosures will be accepted in lieu of correction of the statements.

(3) When financial statements involve a principle that (1) has authoritative support in general, but (2) the Commission has ruled against its use, then the statements will be presumed misleading. Supplementary disclosures will not cure this presumption.[44]

Consequently, an auditor's knowledge must not only comprehend generally accepted accounting principles, but also the principles and practices that the Commission has ruled against.[45]

Rule 2(e)

In addition to the authority discussed above, the SEC also has the power to discipline accountants and other persons who practice before it. Rule 2(e) provides for the imposition of sanctions against any person found:

(1) not to possess the requisite qualifications to represent others, or
(2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or
(3) to have willfully violated any provision of the federal securities laws or their rules and regulations.[46]

In cases where the Commission finds inadequate professional conduct, the offender may be privately reprimanded or have remedial sanctions placed against him which are announced publicly. Such public disclosures are usually communicated by issuing an Accounting Series Release under the name of the offender. The Commission's specific remedy is determined by the nature of the offense.[47] The most the SEC can do is bar a practitioner from

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[44]Robertson, p. 124. [45]Ibid., p. 125.

[46]Ibid., pp. 123-24. [47]Causey, p. 80.

practicing before it,[48] which for a firm with numerous SEC clients would be a costly penalty to pay.

The securities laws and actions of the SEC have been a significant force in shaping an accountant's liability to third parties. There have also been other, more narrowly defined, laws and regulations which have contributed to this process. With the trend towards more liberal views on third party liability and the public's increased access to courtrooms, it would appear that the independent public accountant's struggle to protect himself from third party liability is on a runaway train towards liability to any and all third parties. But as the following discussion will show, the independent public accountant is not defenseless and is beginning to make some headway along the course of defining his boundaries with respect to third party liability.

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[48]Sommer, p. 77.

CHAPTER THREE

THE INDEPENDENT PUBLIC ACCOUNTANT'S DEFENSES TO THIRD PARTY LIABILITY UNDER COMMON LAW

The independent public accountant's exposure to third party liability has undergone a dramatic change in recent years. The accountant's defenses have been eroding as they have been assailed from several sources: common law, federal securities laws, and the SEC. Prior to the mid-seventies, the accountant had lost nearly every major test of third party liability. It appeared that it might be only a matter of time before an accountant would be held liable to some previously unidentified third party for an act of ordinary negligence, heretofore an impenetrable defense for accountants. But in 1975, the prevailing tide against accountants was curbed with the Supreme Court's decision in Ernst & Ernst v. Hochfelder[1](Hochfelder). Since that time, there have been other cases, albeit less significant ones, which have given the accounting profession, indeed all professions, hope that, at long last, the limit on third party liability has been defined.

Hochfelder

Facts

Ernst & Ernst had been retained from 1946 to 1967 to

[1]Ernst & Ernst v. Hochfelder, cert. granted, 43 LW 3345

perform the audit of First Securities Company of Chicago, a small brokerage firm registered with the SEC and a member of the Midwest Stock Exchange. The company was operated by its president, Leston B. Nay, a 92% shareholder. In a period spanning several years from the forties through the sixties, Nay persuaded several of his brokerage clients to invest in an "escrow" account which would yield a high rate of return. From time to time, he paid some interest on his client's investments which made the investments appear legitimate. In 1968, Nay committed suicide and left a note which described First Securities as bankrupt and the escrow accounts as "spurious." In actuality there were no escrow accounts. The money Nay had received for the investments had been diverted for his own use. None of the transactions had ever been recorded. The customers either wrote the checks to Nay or to a bank account designated by Nay.

The duped investors charged that Nay's scheme violated Section 10(b) of the Exchange Act and SEC Rule 10(b)-5. The plaintiffs sued Ernst & Ernst as aiders and abettors under Rule 10(b)-5 on the basis of the auditors' "inexcusable negligence" for not discovering the fraud perpetrated by a material weakness in internal control: Nay had imposed a mail rule which prohibited anyone but himself from opening mail addressed to him. In his absence, the mail was placed on his desk to be opened upon his return regardless of the length of time that

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(April 14, 1975). See Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

he was gone. The plaintiffs contended that Ernst & Ernst's failure to detect this practice aided and abetted Nay's violation of the federal securities laws. In charging the auditors with negligence, the plaintiffs specifically disclaimed the existence of fraud or intentional misconduct on the part of Ernst & Ernst.

Holding

Lower court rulings

When the case went to trial, the district court granted Ernst & Ernst's motion for summary judgment and dismissed the case. The plaintiffs appealed to the U.S. Court of Appeals for the Seventh Circuit. The Appeals Court noted that the auditors had no duty under common law to exercise due care for the benefit of the plaintiffs since ". . . at no time did Ernst & Ernst specifically foresee that the plaintiffs' limited class might suffer from the consequences of a negligent audit on its part."[2] The court ruled that since the plaintiffs did not rely on audit reports prepared by Ernst & Ernst, there could be no common law action.

But the Seventh Circuit Court did find that the auditors had a statutory duty to inquire under Section 17(a) of the Exchange Act and that failure to do so would result in a breach of duty toward the plaintiffs. As a result, the court held that the auditors' negligence aided and abetted a Section 10(b) violation. Thus, the Appeals Court reversed the district court's

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[2]Causey, p. 221.

dismissal. Ernst & Ernst appealed the decision to the U.S. Supreme Court.

Supreme Court decision

In reversing the Seventh Circuit, the Supreme Court held:

> The (SEC) . . . reasons that . . . the effect upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional (and that) Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-orientated approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning . . . The argument simply ignores the use of the words "manipulative," "device," and "contrivance," terms that make unmistakeable a congressional intent to proscribe a type of conduct quite different from negligence. Use of the word "manipulative" is especially significant. It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.[3]

The result of the holding is that the independent public accountant cannot be held liable to third parties for ordinary negligence under Section 10(b) of the Exchange Act or Rule 10(b)-5. It would appear that an auditor's liability under Rule 10(b)-5 must be based to some extent on the auditor's knowledge of the fraud or some form of participation in it.[4]

What Hochfelder Does Not Do

Although Hochfelder was a welcome change in the accountant's

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[3]Hochfelder quoted in Michael Schlesinger, "The Hochfelder Decision: How it Will Effect Future Malpractice Suits Against Accountants," Practical Accountant 9 (September/October 1976): 77-8.

[4]J. Jay Hampson, "Accountants' Liability--the Significance of Hochfelder," Journal of Accountancy 142 (December 1976): 73.

increasing liability to third parties, it did not completely resolve the question of whether an accountant would be liable for gross negligence or recklessness under Section 10(b) and Rule 10(b)-5. In its opinion the Court stated that liability could not be imposed under Section 10(b) or Rule 10(b)-5 ". . . in the absence of any allegation of 'scienter'--intent to deceive, manipulate, or defraud . . ."[5] But the Court stopped short of stating that scienter must be present for liability to be imposed. In a footnote to its opinion, the Court stated:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10(b)-5.[6]

Thus, the Hochfelder decision removed liability under the 1934 Act for acts of ordinary negligence, but left the door open for third party liability with respect to gross negligence and recklessness under Section 10(b) and Rule 10(b)-5. Emerging legal principle appears to find liability when the auditor evidences recklessness or a willful disregard of the facts that he should have known through the normal exercise of his function.[7]

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[5]Allen Kramer, "The Significance of the Hochfelder Decision," <u>CPA Journal</u> 46 (August 1976): 12.

[6]Hochfelder as reprinted in Causey, p. 383.

[7]See McLean v. Alexander, 420 F. Supp. 1057, August 13, 1976, where an auditor was held liable under Rule 10(b)-5 and under common law fraud to a third party for conduct which amounted to reckless and/or knowing misbehavior that was characterized as "far more than mere negligence" but falling "short of a preconceived actual intent to defraud." John S. Stoppelman,

It should be noted that Hochfelder applies primarily to actions brought under Section 10(b) of the Exchange Act. The independent public accountant may still be liable to third parties for ordinary negligence under sections of the 1933 and 1934 Acts other than Section 10(b).[8]

Other Cases

Since Hochfelder there have been other cases whose decisions have indicated that some limits are being set on the independent public accountant's liability to third parties.

Four Seasons

The acquittal of the accountants of Arthur Andersen & Company(Andersen) in U.S. v. Jack Clark, et al.,[9](Four Seasons) was the result when the court accepted the accountants' argument that in situations not covered by specific generally accepted

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"Accountants and Rule 10(b)-5: After Hochfelder," Journal of Accountancy 144 (August 1977): 50.
Since this is only a district court decision, it remains to be seen whether this will be the prevailing thought in other jurisdictions or with the U.S. Supreme Court. In the opinion of Stoppelman, the Supreme Court, when presented with an appropriate case, will rule that reckless conduct will render the accountant liable under Rule 10(b)-5. Ibid., p. 54.

[8]Schlesinger, p. 80.

[9]U.S. v. Jack Clark, et al., No recorded case opinion. All information obtained from: Arthur Andersen & Co., In the Matter of Four Seasons Nursing Centers of America, Inc. Submission to U.S. Attorney with Respect to Arthur Andersen and Certain of its Personnel, at 1-39. (Aug. 29, 1972), before the Securities and Exchange Commission, In the Matter of Four Seasons Nursing Centers of America, Inc. File No. FW-1439, at 1-58 (Aug. 18, 1971) as cited in Terry L. Lantry, "What is the Role of Generally Accepted Accounting Principles," National Public Accountant 20 (June 1975): 25.

accounting principles, it is acceptable to apply "rational accounting principles."

Four Seasons Nursing Homes of America engaged Andersen to perform an audit for its 1969 fiscal year. During the course of the audit, Andersen tested Four Seasons's estimate of physical percentage-of-completion of its construction jobs in process based on incurred costs. The test resulted in a writedown of profit from that which would have been reported under the physical percentage-of-completion certified to by licensed architects. Offsite construction costs, represented by executory contracts, were then included in a second test of the percentage-of-completion of construction contracts. After the second test, sales figures for 1969 were 250% in excess of those for 1968 and net income increased by 225% over the same period.

In a suit against Andersen, the government contended that the auditors had created millions of dollars of false, fictitious, and nonexistent construction costs for the purpose of materially overstating Four Seasons's earnings for 1969. Andersen responded that it had applied rational accounting criteria in a situation not covered by generally accepted accounting principles.

In presenting its case, Andersen argued that the law recognizes the economic substance of executory contracts. Although such recognition conflicted with accounting custom, there was a logical (and legal) basis for treating such costs as assets. It was the defendants' position that the economic reality of the circumstances required them to include these

In Hochfelder the Supreme Court held that liability could not be imposed under Section 10(b) or Rule 10(b)-5 for ordinary negligence. However, the Court was silent on whether Ernst & Ernst was actually negligent in its audit procedures. In the opinion of Wendell, Ernst & Ernst followed generally accepted auditing standards, and on the basis of the GeoTek decision, they should have been absolved of negligence. The decision in GeoTek recognized that generally accepted auditing standards are a proper basis for the independent public accountant's audit.[14] (As in McLean v. Alexander, see supra note 7 in this chapter, this is only a district court ruling and it remains to be seen whether this will be the prevailing thought in other jurisdictions in similar circumstances).

Although the accountant has now made inroads into avoiding third party liability in the courtroom, litigation is the last course of action that an accountant wants to take in order to avoid liability to third parties. It is far better for the accountant to avoid liability at the earliest possible opportunity. This can be done by adopting practices and procedures which will prevent many troublesome situations from occurring and requiring resolution through litigation.

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[14]Ibid., p. 2.

CHAPTER FOUR

PRACTICES AND PROCEDURES FOR THE ACCOUNTANT TO MINIMIZE EXPOSURE TO THIRD PARTY LIABILITY

Preventative Practices and Procedures

The threat of legal liability is of considerable concern to every practicing independent public accountant. The holdings of many of the above-discussed cases have resulted in accountants adopting new practices and procedures in order to prevent a recurrence of what has been judged to be an act of misconduct. Adherence to these newly adopted practices, as well as previously adopted procedures designed for safe practice, will work towards reducing the accountant's exposure to legal liability to an acceptable minimum. Some of the most common practices and procedures which should be a part of every firm's operating policies are:

(1) Exercise care and discretion in accepting new clients --Although nearly every accounting firm would like to take on new clients, a new client should not be accepted until the firm has thoroughly checked out the background of the potential new client and assured itself that the ethical standards of the prospective client are satisfactory. Such an investigation should include inquiries of the predecessor auditor as to management's integrity and the existence of substantial

differences between the client and predecessor,[1] discussions with members of the business community who have had dealings with the potential new client,[2] and any indications that the prospective client has recently changed legal counsel which could be a warning that legal problems exist.[3] According to Statement on Auditing Standards No. 4:

> Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity. Suggesting that there should be procedures for this purpose does not imply that an auditor vouches for the integrity or reliability of a client, nor does it imply that an auditor has a duty to anyone but himself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that an auditor be selective in determining his professional relationships.[4]

(2) Review desirability of maintaining present clients --A corollary of the first practice, these first two practices are perhaps the most important policies for an accounting firm to follow. In the opinion of one author, a common factor in many lawsuits against the independent public accountant arises from services performed for marginal entities, i.e., those that are very risk-orientated. The accountant should be wary about

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[1]Richard L. Miller, Jr., "Cases on Accountants' Liability --Some Rules of Safe Practice," Pennsylvania CPA Spokesman 46 (November 1975): 9.

[2]Bedingfield, p. 56.

[3]Miller, p. 9.

[4]Statement on Auditing Standards No. 4, AICPA Professional Standards, Section 160.19 (July 1977).

accepting and retaining such clients.[5]

(3) Each engagement should be adequately staffed and supervised--In accordance with the first standard of field work which states that: "The work is to be adequately planned and assistants, if any, are to be properly supervised,"[6] this practice is often overlooked until the accountant faces a lawsuit (e.g., BarChris audit was senior accountant's first in-charge assignment as well as his first exposure to the bowling industry). The provisions of SAS No. 4 also direct accountants to establish policies and procedures for the assignment and supervision of the professional staff.

Related to the topic of adequate staffing and supervision is auditor rotation. Partners, managers, and staff should be rotated every few years to avoid becoming overfamiliar with the engagement and, thus, less alert for potential problem areas.[7]

(4) Audit staff should have adequate knowledge and training--It almost goes without saying that each member of the audit staff should be thoroughly familiar with both generally accepted auditing standards(GAAS) and generally accepted accounting principles(GAAP).[8] While knowledge and application of GAAS and/or GAAP

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[5]Stephen A. Moscove, "Accountants' Legal Liability," Management Accounting 58 (May 1977): 26.

[6]SAS No. 1, Section 150.02.

[7]Moscove, p. 30. [8]Miller, pp. 10-11.

will not guarantee protection from third party liability(see supra, Herzfeld), failure to know and practice them will certainly result in the imposition of liability to third parties. In addition to knowledge of GAAS and GAAP, the independent public accountant should also be well acquainted with characteristics of any specialized industry in which he has audit clients (e.g., banking industry or health-care industry).[9]

Continuing professional education is a must for every independent public accountant.[10] This may include instruction during performance of an engagement, training seminars conducted by the firm, university, AICPA, or a state CPA society, and reading literature about current developments in accounting and auditing.[11]

The independent public accountant should not hesitate to consult with personnel within the firm on auditing or accounting matters or to seek professional advice from outsiders.[12] According to SAS No. 1:

> Policies and procedures for consultation should be established to provide reasonable assurance that auditors will seek assistance on accounting and auditing questions, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority.[13]

This includes a two-way flow of information between

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[9]Moscove, p. 26. [10]Ibid.

[11]SAS No. 1, Section 160.16.

[12]Miller, p. 10.

[13]SAS No. 1, Section 160.09.

staff accountants and their supervisors. Staff accountants generally spend more time in the field than anyone else and often have the greatest opportunity for discovering the unknown.[14]

(5) Audit testing--Appropriate audit tests should be designed for each engagement and then reassessed and updated as required.[15] Statistical sampling should be employed whenever possible and practicable. In the opinion of Moscove, statistical sampling techniques, when properly utilized, serve as far more convincing evidence in the courtroom than do block judgments.[16] And in situations where the accountant is faced with a situation not specifically covered by generally accepted accounting principles, the accountant should employ "rational accounting principles" (see supra, Four Seasons) in order to insulate himself from third party liability as much as possible.

(6) Working papers--It is essential that working papers be complete, reviewed, and retained since working papers are the auditor's only evidence of the work he has performed. Being complete means that tests and conclusions must be well documented with particular attention paid to the resolution of vulnerable problem areas. All working papers should be reviewed in order to ascertain that all relevant testing was performed and that the

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[14]Miller, p. 10.

[15]Moscove, p. 26. [16]Ibid.

testing performed supports the conclusions reached.[17] In addition, working papers should be retained for a period of time sufficient to meet the needs of the accountant's practice. This is particularly important for lawsuits based on charges of negligence or other violations which occurred years earlier.[18]

(7) Disclosure--The importance of full and adequate disclosure cannot be overemphasized. Decisions against accountants in the Rhode Island Hospital Trust, Herzfeld, and Continental Vending cases were the result of what the courts determined were inadequate disclosures. Reasons for qualifying or disclaiming an opinion or rendering an adverse opinion on a client's financial statements should be stated fully and clearly and in a language which will be understood by the least sophisticated user of the financial statements. When in doubt, the accountant should consult legal counsel who can offer independent judgment not only from the viewpoint of a layman, but also from the perspective which courts and juries might adopt.[19]

Practices and Procedures for Minimizing Losses During Litigation

There are times when the accountant, in spite of all the precautions he has taken, will still be sued for damages by a third party accuser. When this occurs, the accountant must

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[17] Ibid. [18] Miller, p. 12. [19] Ibid., p. 13.

analyze his situation to determine what steps he should take to minimize his professional and/or financial losses:

(1) Successfully argue a defense--If the plaintiff's charges are based on common law violations, then the accountant must review case law to determine what defenses are available to him (see supra, Chapter Three). If the plaintiff's charges are based on securities laws violations, then the accountant must determine if he has a statutory defense available to him:

Defenses Under the Securities Act

In order to avoid third party liability under Section 11 of the Securities Act, the accountant must successfully prove one of the following:

(a) the statements are true and are not misleading;
(b) the misstatement was immaterial;
(c) the plaintiffs purchased after the issuance of an earnings statement covering twelve months following the effective date of the registration statement and did not rely on it;
(d) the accountant exercised due diligence;
(e) the damage does not relate to the misstatement by the accountant;
(f) the plaintiff had prior knowledge of the falsity of the misrepresentations; or
(g) the statute of limitations has run.[20]

Defenses Under the Exchange Act

The primary defenses under Section 10(b) of the Exchange Act are:

(a) the auditor is not an insurer and his conduct was not sufficiently culpable to justify his bearing the loss. Since this is a value judgment, the language used to express the required standard of conduct may have little effect on the final decision;

[20]Causey, p. 208.

(b) the auditor's conduct did not cause the plaintiff's loss (i.e., there is a lack of reliance or materiality);
(c) the statute of limitations has run; and
(d) other parties should indemnify the auditor or, at least, contribute to the loss.[21]

(2) Purchase and maintain adequate liability insurance --As in any business which provides services to the public, liability insurance is a must. Nearly all engagements entail potential liability which far exceeds the amount of the audit fee. Insurance not only provides dollar liability in the coverage purchased, it also protects the existence and future growth of the independent public accountant's practice.[22] The accountant should be cognizant of what his policy allows and what it does not allow. In selecting the appropriate policy, it is prudent to enlist the aid of the accountant's legal counsel.[23] Selection of the proper policy is essential so that financial destruction may be reduced or eliminated in the event that a judgment is eventually entered against the accountant.

These are not the only practices and procedures that the accountant should adopt. However, adoption of these will do much in reducing the independent public accountant's exposure to third party liability.

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[21]Causey, p. 222.

[22]Richard S. Helstein, "Guidelines for Professional Liability Insurance Coverage," CPA Journal 43 (October 1973): 853.

[23]Miller, p. 13.

CHAPTER FIVE

SUMMARY AND CONCLUSIONS

During this age of consumerism, investors with real and fancied grievances have increasingly resorted to legal action in an attempt to recover investment losses. Frequently, the target of this mounting litigation is the independent public accountant. And as accountants are subjected to lawsuit after lawsuit, the financial and popular press have been there to record and dramatize the plight of the injured investors thereby creating additional adverse publicity for the accountant. There are several reasons which contribute to the accountant's quandry. One of the primary reasons is what is referred to as the expectation gap, i.e., the difference between the level of performance the public expects the accountant to achieve and the level of performance the accountant expects to achieve.[1] The decisions of several cases have demonstrated that although the accounting profession believed that a certain level of performance was satisfactory (see supra, Herzfeld and Rhode Island Hospital Trust), society believed it to be unsatisfactory. As a result, the accountant could no longer rely on adherence to generally accepted accounting principles or generally accepted auditing standards as an ironclad defense.

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[1] Liggio, p. 23.

What should determine the performance level that the independent public accountant should achieve? What should govern the amount of disclosure required in financial statements and/or their footnotes? According to Causey, the prevailing schools of thought which have been argued in the courtroom are:

<u>AICPA Views</u>

(1) The standard of communication required is measured by specific GAAP and GAAS and in absence of specific rules or customs by the views of experts (professional certified public accountants).
(2) The jury (or court in case of trial without a jury) is never authorized to question the wisdom of the professional standard.

<u>SEC Views</u>

(1) The auditor has an obligation that goes beyond specific GAAP and GAAS or professional custom to effectively communicate material information.
(2) If GAAP or GAAS are found lacking, the SEC will not hesitate to invoke its authority to establish meaningful standards of performance regardless of expert testimony as to professional standards.

<u>Judicial Views</u>

(1) Where the profession has established specific GAAS for reasonably dealing with a perceived problem, the professional duty will be limited to conformance with the standard if resulting financial statements fairly and meaningfully inform the investor. Even if the auditor fails to follow professional standards, liability is imposed only when the resulting financials actually cause damage to plaintiffs. Exemplary (punitive) damages are awarded only where defendant's conduct is willful, fraudulent, or wanton and reckless. However, when misleading financials cause losses, the courts will not hesitate to penalize the auditor despite strong evidence of conformity with GAAP or GAAS. Courts are especially apt to reject GAAP when the misleading results are of overwhelming materiality.
(2) Where application of auditing standards requires expertise in (a) evaluating and testing internal controls, (b) statistical sampling of transactions, and (c) obtaining competent evidential matter, expert testimony will be conclusive. However, where communication of

> findings is involved, expert testimony as to compliance with GAAP will be persuasive but not conclusive.[2]

Thus, accountants argue that GAAP and GAAS are satisfactory standards by which the independent public accountant should be judged, but the SEC and the courts have no qualms about going beyond GAAP and GAAS and applying 20/20 hindsight to a situation in determining what the standard should have been.

As a result of increasing public criticism against the accountant, Congress has been actively examining the role it should have in the regulation of the accounting profession. The Federal Trade Commission is investigating the profession in such areas as licensing, competition, and advertising. In response to threatened federal regulation of the accounting profession, the AICPA has instituted several new reforms:

(1) Established two Sections within the AICPA: one for firms who audit clients registered with the SEC and the other for firms who audit privately-owned clients. A firm may join either or both Sections. To qualify for membership in the SEC Practice Section, a firm must meet several requirements which are designed to safeguard independence and audit quality;
(2) Established an independent Public Oversight Board to help assure the public that the SEC Practice Section is meeting its responsibilities. All Board members are nonaccountants. The Board has its own staff and conducts its own inquiries, reporting to the public as it sees fit;
(3) Amended its by-laws to allow advertising and solicitation by accountants and to add three nonaccountants to the Institute's Board of Directors; and
(4) Opened meetings of the AICPA Council and senior committees to the public for the first time as well as increased the representation of smaller firms on these committees.[3]

But it is apparent that the accounting profession must do

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[2]Causey, pp. 13-18.

[3]Chetkovich, pp. 6-8.

more. Although the SEC has thus far concurred with the profession's activities in self-regulation, Congress is not yet satisfied. If the profession fails to satisfy Congress, there is little doubt that government regulation of accountants will become a reality.

The expectation gap must be narrowed. The public must become better informed about what the independent public accountant's role is when he renders his opinion. The investor must realize that financial statements are not precise measurements of a company's financial position, but only a representation of the condition of the company's financial position. In his article, Liggio quotes an editorial that appeared in the May 1974 issue of The CPA:

> . . . financial statements should not boil down to "buy," "sell," or "hold" decisions. It is ridiculous to assert that preparers of financial statements are accountable for poor investment decisions of users because the preparers of the financials did not anticipate all the events and circumstances attendant to the investor's loss. I do not suggest that improprieties be overlooked; I am concerned that crystal ball brownout has led to unjust public criticism of the public accounting profession. Hindsight may be useful for evaluating the logic of a given standard, but using hindsight to challenge the information produced by the proper application of a standard which was logical at the time is futile. New and improved standards should flow from logical objectives and not from the perfection of hindsight.
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> Preparers of financial statements and independent accountants have a primary responsibility to the public. The Objectives Report asserts, however, that the public has some responsibility to understand the limitations of financial reporting: "Financial statements should not be presented to imply a misleading degree of precision or reliability." Even though accountants no longer blush about dividing a nebulous net earnings figure into perhaps 14 seemingly precise earnings-per-share figures, we must educate users --perhaps directly in the financial statements-- that imprecision exists and should be recognized.
>
> Another harsh truth that often escapes both the professional and the user is that "financial statements are

not suited to the communication of all information that may have an impact on economic decisions."[4]

The profession itself must also do its part in narrowing the expectation gap. By realizing that society does not fully understand the accountant's function, the accounting profession must raise its own level of performance so that it is closer to the level expected by society. Education, on both sides, is the key. The narrowing process must be a joint effort.[5]

However, even if the expectation gap is bridged, lawsuits against accountants will not be eliminated. Therefore, accountants must make an attempt to change the way in which litigation is decided. In the past, sympathetic and uninformed juries have awarded millions to investors who have brought suits against accountants. Judges have used 20/20 hindsight and struck down GAAP and GAAS as inadequate and substituted their own accounting and auditing standards. Expert testimony has been virtually ignored in some cases (see supra, Herzfeld). One group of authors has suggested several remedial alternatives:

(1) Use of an arbitration panel, rather than a civilian jury, to decide the facts in civil malpractice actions. This remedy has served with some measure of success in the medical and legal professions. With some structural modifications, it could also accomodate auditor liability litigation.
(2) Institution of a referee panel of experts to provide technical assistance in court cases. While the panel's judgment would not be binding, it could help the court to understand the issues better. Use of this alternative would compare similarly to the submission of an <u>amicus</u> brief before, rather than after, a court's ruling.
(3) A revision in the judicial system so that a defendant auditor has the right to waive trial by jury in criminal cases.[6]

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[4]Liggio, pp. 28-29. [5]Ibid., p. 29.

[6]Solomon, Chazen, and Augenbraun, p. 74.

Whether the accounting profession can effect the necessary changes remains to be seen. If it does not, the cost will be high: further costly lawsuits and/or strict government regulation. But if such changes can be made through bold action and a willingness to make adjustments to social changes, the accounting profession will emerge from this period stronger and more responsive to the needs of society.

APPENDIX

EVOLUTION OF AUDITORS' LIABILITY TO THIRD PARTIES

Year	Event	Result
1833	Price v. Easton--English	No standing to sue unless in privity with the accountant.
1842	Winterbottom v. Wright--English	Affirmed decision of Price v. Easton.
1889	Derry v. Peek--English	A false statement made without reasonable ground for believing it to be true can be construed as evidence of fraud.
1916	MacPherson v. Buick Motor Co.[1]	Liability for ordinary negligence if the element of danger is present.
1919	Landell v. Lybrand	American case affirming the English decision in Derry v. Peek.
1931	Ultramares v. Touche, Niven & Co.	Without privity of contract, there can be no liability for ordinary negligence; however, liability <u>may</u> be established for fraud or gross negligence.
1933	Securities Act of 1933	Liability for a material misstatement or omission in a registration statement, even if such an act constitutes ordinary negligence.

[1]Unless otherwise indicated, all court cases and laws pertain to the United States.

Year	Event	Result
1934	Securities Exchange Act of 1934	Liability for failure to truthfully disclose special knowledge of the issuer; created Securities and Exchange Commission.
1938	State Street Trust Co. v. Ernst & Ernst	Liability can be established for fraud or gross negligence.
1951	Candler v. Crane, Christmas & Co.--English	Affirmed the decision of Derry v. Peek.
1955	Duro Sportswear, Inc. v. Cogen	Affirmed the decision of State Street Trust Co. v. Ernst & Ernst.
1963	Hedley Byrne & Co. Ltd. v. Heller & Partners, Ltd.	Liability for ordinary negligence when both the class of financial statement user and the type of transaction are specifically foreseen. Reversed the Candler decision and partially reversed the Derry decision.
1966	Federal Rules of Civil Procedure	Allowed the use of class action suits when suing under federal securities laws.
1967	Fisher v. Kletz	Auditors responsible for disclosure of information even after the statements have been disseminated to the public.
1968	Rusch Factors, Inc. v. Levin	Liability for ordinary negligence when both the class of financial statement user and the type of transaction are specifically foreseen. (Same as Hedley Byrne decision). Partially reversed Ultramares.
1968	Escott v. BarChris Construction Corporation	Violation of generally accepted accounting principles constitutes ordinary negligence and renders accountants liable to third parties.

Year	Event	Result
1969	United States v. Simon	Compliance with generally accepted accounting principles does not constitute an ironclad defense under the Exchange Act.
1972	Rhode Island Hospital Trust National Bank v. Swartz	Affirmed the decision in Rusch Factors, Inc. v. Levin.
1974	Herzfeld v. Laventhol, Krekstein, Horwath & Horwath	Regardless of adherence to generally accepted accounting principles, liability can still be established where the report does not present fairly the true financial picture of the company to the untutored eye of an ordinary investor.
1975	Ernst & Ernst v. Hochfelder	No liability for ordinary negligence under Section 10(b) of the Exchange Act.
1976	McLean v. Alexander	Liability for recklessness or gross negligence under Section 10(b) of the Exchange Act.
1976	U.S. v. Jack Clark, et al.	No liability when the accountant employs rational accounting principles in situations not specifically covered by generally accepted accounting principles.
1976	SEC v. GeoTek, et al.	Generally accepted accounting principles are a proper basis for the accountant's audit when they are followed in good-faith.

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