AUDITOR'S LIABILITY AND THE NEED FOR INCREASED ACCOUNTING UNIFORMITY

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For the most part this paper argues that accountants should worry less about possible legal liabilities under a system of increased uniformity in financial reporting and more about the possibility that some financial statements prepared under accepted current practices are so deceptive as to give rise to a legal cause of action. In other words, I am suggesting that financial reports as currently prepared may be open to legal attack because the accounting principles and methods of presentation used in their preparation are too many, too muddled, and too malleable.

The legal obstacles to broadening accountants' liability are more substantial than the foregoing conclusion indicates, but they are not such that courts strongly influenced by considerations of policy could not overcome them. This paper does not purport to investigate in detail the many doctrinal problems and problems of proof confronting plaintiffs in this area, but endeavors only to suggest the directions the law may take and to identify the propelling forces. There appears to me to be a substantial likelihood of a judicial response to increasingly felt necessities in the form of decisions imposing on accountants a greater duty to prevent deceptiveness in financial statements and to live up to the implications of their opinions. The impetus for such judicial action would, of course, proceed from the current situation with respect to "generally accepted accounting principles," which is the subject of this symposium.

I

THE UNIFORMITY MOVEMENT

A. The Current State of "Generally Accepted Accounting Principles"

The sources of so-called "generally accepted accounting principles"¹ appear currently to be many and various. They include at least the following: (1) procedures in fact followed by business entities with some acceptance by independent public accountants; (2) Accounting Research Bulletins issued by the former Com-

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¹ The importance of the concept of "generally accepted accounting principles" lies in the requirement that "the [auditor's] report shall state whether the financial statements are presented in accordance with general accepted principles of accounting." COMMITTEE ON AUDITING PROCEDURE, AICPA, AUDITING STANDARDS AND PROCEDURES 40 (Statement on Auditing Procedure No. 33, 1963). AICPA, CODE OF PROFESSIONAL ETHICS § 2.02 defines as an act discreditable to the profession the failure to direct attention to a material departure from "generally accepted accounting principles."

mittee on Accounting Procedure of the American Institute of Certified Public Accountants (AICPA), the national professional organization; (3) opinions of the AICPA's Accounting Principles Board, the successor to the Committee on Accounting Procedure; (4) state corporation statutes; (5) government agencies, such as the SEC, ICC, FPC, and state regulatory bodies; (6) standards of the American Accounting Association; (7) stock exchange listing requirements; (8) court decisions; (9) income tax requirements; and (10) treatises, texts, and periodicals. A similar list appears in Paul Grady's recent *Inventory of Generally Accepted Accounting Principles for Business Enterprises*,² which has itself become authoritative evidence of the general acceptance of the principles listed therein.

The multiplicity of sources of accounting principles has resulted in proliferation of accounting methods and widespread doubt about the adequacy of present-day financial accounting to the needs of the business and investment communities. A former Commissioner of the Securities and Exchange Commission has put well the state of affairs regarding the auditor's ostensible yardstick:

A reliance upon "generally accepted accounting principles," as developed by the accounting profession, has left a great deal of room for variation in the accounting practices and principles observed by companies I do not suggest that unvarying application of uniform accounting principles is a desirable end in itself. . . . I simply mean to suggest that a lay reader can read perfectly clear English and an orderly presentation of financial data and end up without a comprehension of the message sought to be conveyed.³

The major areas in which alternative accounting methods are available were summarized in Paul Grady's *Inventory*, and this summary is set forth in Appendix D to this symposium. The most important such areas include the following: (1) valuation of inventories; (2) depreciation methods; (3) income tax allocation; (4) pension costs; (5) research and development costs; (6) realization of income; (7) all-inclusive versus current-operating-performance income statements; (8) price-level changes; (9) long-term leases; and (10) use of the tax credit for prior loss years.

Various factors, such as the diversity of accounting principles for alternative application, the wide degree of flexibility in the form of presentation, and managerial discretion to disclose or not, may have made accounting the art of the illusionist rather than that of the meaningful communicator. In the welter of alternative and ingenious presentations of financial data, the auditor's unqualified opinion, with its assurance of the statements' conformity with "generally accepted accounting principles," may have become a trap for the unwary. The standard to which reference is made may have lost most of its inhibitory effect on man-

² PAUL GRADY, *INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES* 52-53 (AICPA Accounting Research Study No. 7, 1965).

³ Address by Jack M. Whitney II before the Washington, D. C., Society of Investment Analysts, Feb. 5, 1963, quoted in *J. Accountancy*, March 1963, p. 9.

agerial whim because it lacks fixed definitional contours. Interested parties (shareholders, investors, creditors, and so forth) may be drawn into a belief, despite frequent disclaimers, that the auditors have exercised an independent and neutral scrutiny of management's financial presentations, in the light of professional and reasonably definite criteria, when no such process has taken place at all.

B. The Debate Over "Uniformity"

The accounting profession has been waging a thirty-year, intramural debate over the need for greater uniformity of accounting principles used by companies, especially those of the same industry, in the preparation of financial reports. Some accountants loudly advocate a program of professional renewal. This proposed program would involve reformulation of basic accounting criteria, from which, in conjunction with the collected practical wisdom of the membership, might be derived a set of sound and fair accounting principles. Uniformity in application would be accorded a high place in the hierarchy of basic accounting values so that upon authoritative promulgation of these uniform principles adherence to them whenever feasible would be made a matter of professional responsibility, sternly enforced. This approach would eliminate, as far as practicable, choices between alternative principles each enjoying "general acceptance." Auditors' opinions would be withheld or qualified in the light of these uniform principles. The consequence of an effective program of this kind, this faction contends, would be a much higher degree of reliability and comparability of financial reports than now exists.

The opposing view generally supports the status quo but concedes the importance of a continuing search for sound accounting principles. For proponents of this position, diversity in accounting treatment is no scandal, but its excesses are to be avoided. The proliferation of alternative, equally acceptable accounting principles is regarded as the inevitable by-product of the transcendence of managerial business judgment and discretion. Alternative accounting principles and variations in the manner of presentation are deemed as natural as the factual differences in the transactions they reflect and in the companies and industries involved. The art of accounting must, it is argued, accommodate flexibility, experimentation, individual imagination, and empirical evolution; uniformity would stifle these progressive forces and cause the art to atrophy.

C. The Triumph of the Standards of Existing Practice

The developments leading up to Paul Grady's *Inventory*, which was prepared and published under the auspices of the AICPA, are instructive as to the way the trend of battle is going.

The AICPA Research Program was inaugurated in 1958, and the first director, Maurice Moonitz, was from an academic background. The research program's first published product, Moonitz's *The Basic Postulates of Accounting*, stated,

We are driven to the conclusion, then, that relatively heavy reliance must be placed on deductive reasoning in the development of accounting postulates and principles. We must first recognize and define the problems to be solved, then move to their solution by careful attention to what "ought" to be the case, not what "is" the case.⁴

This trail-blazing effort was followed in 1963 by another study similarly breaking new ground, *A Tentative Set of Broad Accounting Principles for Business Enterprises*.⁵ However, the Accounting Principles Board never officially accepted and promulgated either of these studies. They were held to involve too radical a departure from present accounting practice.⁶

Paul Grady, whose *Inventory* was Accounting Research Study No. 7, reportedly accepted the research position after a career as a CPA only on the condition that he be allowed to undertake a study of the kind that ultimately resulted, namely, a distillation of principles from existing practices.⁷ The *Inventory* sets forth, as one of ten "concepts" that underlie accounting principles, the concept of "diversity among independent entities." The late Weldon Powell, a former chairman of the Accounting Principles Board, the agency given the task of, among other things, reducing alternatives to a minimum, applauded Grady's resort to what is being done in practice and enthusiastically ratified diversity as a basic concept.⁸ He quoted from the *Inventory* with approval:

"Recognition of the concept of diversity in accounting among independent entities, as a fact of business life, in no way imperils the objective of the Accounting Principles Board to 'narrow the areas of difference in accounting' and to promote continuous improvement and greater comparability in financial statements. It does, however, place the objective within realistic limits which fall considerably short of uniformity."⁹

The *Inventory* itself, he opined, is a source of authoritative support for accounting practice.

The Accounting Principles Board (APB) was established in 1959 and consists of twenty-one members from the public accounting, academic, and institutional fields. The Board was to spearhead a continuing effort to narrow the areas of difference and inconsistency in accounting practice and was to emphasize research, employing accounting theory to develop basic postulates and principles. It appears that the purpose was to de-emphasize the importance of current practice and heighten the

⁴ MAURICE MOONITZ, *THE BASIC POSTULATES OF ACCOUNTING 6* (AICPA Accounting Research Study No. 1, 1961).

⁵ ROBERT T. SPROUSE & MAURICE MOONITZ, *A TENTATIVE SET OF BROAD ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES* (AICPA Accounting Research Study No. 3, 1963).

⁶ See statement of Accounting Principles Board quoted in *News Report*, J. Accountancy, May 1962, pp. 9-10.

⁷ See Powell, "Inventory of Generally Accepted Accounting Principles," J. Accountancy, March 1965, p. 29, at 30.

⁸ *Id.* at 32.

⁹ *Ibid.*, quoting GRADY, *op. cit. supra* note 2, at 35.

importance of accounting theory in the interest of achieving greater uniformity.¹⁰ To date the Board has issued six opinions on controverted accounting questions. However, in March 1965, it was written of the Board, with seeming justification, that it "has almost invariably assumed only a passive role Indeed, there is grave concern that the Board is not exercising its leadership function in developing accounting principles"¹¹

D. Status of APB Opinions

One token step towards uniformity has recently been taken by the Council of the AICPA, perhaps spurred by SEC Accounting Series Release No. 96, issued January 10, 1963, in which the Commission undercut the APB by accepting two alternative methods of accounting for the investment credit, one of which the Board had expressly disapproved in an opinion that was subsequently disregarded by a major segment of the profession.¹² The 1963 meeting of the membership of the AICPA rejected a resolution that APB opinions on a particular subject be regarded as the only "generally accepted accounting principle" on the matter. But in October 1964 the Council of the AICPA adopted a resolution calling for the disclosure of departures from the opinions of the Accounting Principles Board as well as from Accounting Research Bulletins not modified or rescinded.¹³ The financial effects of the departure must now be noted, but no professional ethical obligation is currently imposed.¹⁴

According to the Council resolution, generally accepted accounting principles are those having substantial authoritative support, and opinions of the APB and Accounting Research Bulletins are not the sole source for substantial authoritative support for accounting principles. An adverse or qualified opinion or disclaimer must be forthcoming only if an accounting principle or practice lacking substantial authoritative support is employed. But if substantial authoritative support can be found, an unqualified opinion may be given and the departure disclosed in a separate paragraph of the report, or the auditor must see to it that there is footnote disclosure of the departure and its effects.

¹⁰ See AICPA, ORGANIZATION AND OPERATION OF THE ACCOUNTING RESEARCH PROGRAM AND RELATED ACTIVITIES (1959) (unpublished). With only slight modification, the substance of this basic organizational document follows SPECIAL COMM. ON RESEARCH PROGRAM, AICPA, REPORT TO COUNCIL (1958), reprinted in J. Accountancy, Dec. 1958, p. 62.

¹¹ Graham & Langenderfer, *Reporting of Leases: Comment on APB Opinion No. 5*, J. Accountancy, March 1965, p. 57, at 62. See also Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, *supra*, pp. 706-26.

¹² See Sprouse & Vagts, *supra* note 11, at 714-16.

¹³ AICPA, DISCLOSURE OF DEPARTURES FROM OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD (Special Bull. 1964). See Ingalls, *Developing and Implementing Higher Professional Standards in Accounting*, *supra*, pp. 874-97, at 888-93. For the conclusion that neither the accounting profession nor business are yet ready for more than simple disclosure of departures from APB opinions, see Jennings, *Opinions of the Accounting Principles Board*, J. Accountancy, Aug. 1964, p. 27, at 30.

¹⁴ It has been authoritatively recommended that the Code of Professional Ethics should not be amended to implement these requirements until 1968, thus allowing a period of adjustment. SPECIAL COMM. ON OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD, AICPA, REPORT TO COUNCIL 31 (1965).

The Chairman of the Accounting Principles Board, in August 1964, wrote of this measure, when it was still in the proposal stage, that it would merely give Board opinions "a somewhat higher status than it gives to 'other substantial authoritative support.'"¹⁵ He described the resolution as ruling out "capricious disregard of the official position of the Institute"¹⁶ and expressed the opinion that the Board cannot insist on a monopoly for the formulation of "generally accepted accounting principles" because they are to some extent in the "public domain."¹⁷

E. Implications for the Future and the Auditor's Liability

From the foregoing, it would seem to be entirely appropriate to probe the future of accountants' liability on the hypothesis that no large advance in the direction of uniformity will soon be made. The accounting profession does not appear to be in the process of dramatically changing the conditions under which it practices its art. The evidence preponderates in favor of the conclusion that the profession will not embrace any drastic change. As a result, the predominant theoretical point of view will continue to stress the naturalness and inevitability of diversity of practice; indeed, diversity may have emerged with a new dignity and status as a fundamental principle. There will also be continuing stress on the primacy of managerial responsibility and discretion. A variety of "sound" and apparently respectable accounting principles applicable to quite similar facts will continue to be available for the selection of the company with the approbation of its auditor.

How can all of this affect the legal liability of auditors? Against this background this paper will speculate about the future of auditors' legal liability. The long-smoldering dispute over uniformity invites attention to this question from two vantage points. First of all, in deciding which course to take, the profession might naturally wonder about the effect in terms of potential legal liability of a system of substantial uniformity. Would a program involving the formulation and promulgation of, and the enforcement of adherence to, a set of uniform principles pose a new threat to independent public accountants? On this point, the estimate ventured in this paper is that no real risk of greater liability would attend such a program.

Another question stimulated by the uniformity debate is whether the accounting profession is now headed for a sharp increase in the incidence of legal liability based on alleged misrepresentation. On this point, this paper suggests, as indicated above, that the status quo presents a real risk of a wider scope for auditor's liability arising out of financial reports found to be misleading and accompanied by an unqualified auditor's opinion. The conditions surrounding the practice of the accounting art to which attention is drawn by both sides in the uniformity debate support the be-

¹⁵ Jennings, *supra* note 13, at 29.

¹⁶ *Ibid.*

¹⁷ *Id.* at 30.

lief that the possible consequences of uniformity in terms of legal liability are far less menacing than the possibilities for greater liability inherent in the existing situation. Finally, it should be pointed out that, in addition to facing a possible increase in the incidence of liability for fraud and misrepresentation, the accounting profession also stands in danger of having imposed a rigid administrative regulation of their work. This prospect may be even more distasteful than that of new risks of legal liability.

The points raised in the preceding two paragraphs are discussed in inverse order below.

II

POSSIBLE LIABILITY FOR MISREPRESENTATION UNDER CURRENT PRACTICES

Any assertion that the work of independent public accountants is riddled with intentional or negligent misrepresentation would be unwarranted and extremely unfair. And there is no basis for a prophecy that accountants are about to be inundated by a flood of actions for misrepresentation arising out of their performance of their auditing function. But the increasing importance of financial statements to more and more people will necessarily cause expectations with respect to the work of accountants to rise. There is already some evidence of a growing impatience in the market place with what is thought to be slipshod or management-biased work.¹⁸ Although the question of negligence in the course of the auditing procedures is not within the scope of this paper, a recent upsurge in litigation in this area demonstrates that those who rely on financial statements are looking more and more to the auditors in fixing responsibility for the insufficiencies of corporate reports.¹⁹

An example of the kind of action that might well become more prevalent because of the confused state of affairs regarding "generally accepted accounting principles" is *Teich v. Arthur Andersen & Co.*²⁰ This was an action in the New York courts by a shareholder who alleged that his investment was not worth what it was represented to be worth because of the fraudulent omission from the corporation's financial statements of data connected with an alleged material change in the company's pension plan. The trial court's favorable ruling on the defendant's motion for summary judgment, based upon the absence of pecuniary damages at the time of the filing of the complaint, was recently reversed and the case remanded for trial. The case raises various interesting issues relevant to this discussion: for example, the obligation to conform to Accounting Research Bulletin No. 47, which deals with pension plans;²¹ the materiality of the estimated future charge to be

¹⁸ E.g., N.Y. Times, Feb. 2, 1966, p. 43, col. 2 (city ed.).

¹⁹ See Editorial, *The Specter of Auditors' Liability*, J. Accountancy, Sept. 1965, p. 33, lamenting an alleged alarming increase in the number of lawsuits filed against public accountants.

²⁰ 40 Misc. 2d 519, 243 N.Y.S.2d 368 (Sup. Ct. 1963), *rev'd per curiam*, — App. Div. 2d —, 263 N.Y.S.2d 932 (1965).

²¹ COMMITTEE ON ACCOUNTING PROCEDURE, AICPA, ACCOUNTING FOR COSTS OF PENSION PLANS (Accounting Research Bull. No. 47, 1956).

made annually for funding the increased cost of past service pension benefits; the sufficiency of the asserted disclosure of the matter in the president's letter in the annual report; and the curative effect of disclosure to the Securities and Exchange Commission.²² To some, the plaintiff in this case may appear to be litigious, but this is the stuff out of which adverse law can be, and often is, made. If the courts are moved to the belief that social and economic conditions and the circumstances surrounding the practice of the accounting art require strict treatment of the work of the auditor, they have at their disposal an abundance of doctrines, principles, and rules for use in upholding actions against accountants based on misleading financial reports.

It would not tax the ingenuity of counsel or the courts to locate the elements of an action for deceit in cases involving deficient financial reports. If this proved awkward in a given case, the great body of negligence law could be pressed into service in validating recoveries against auditors for their role in the issuance of false or misleading financial reports.

A. The Deceit Theory

1. *The Auditor's Opinion*

The independent public accountant's audit report in unqualified form states that "in our opinion, the [financial statements] present fairly the financial position of X Corporation at [date] and the results of operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."²³ The threat of an increase in the incidence of auditors' legal liability for misrepresentation is believed to arise out of accountants' excessive generosity in furnishing such an unqualified opinion. The willingness of the auditor to give a "clean" opinion so long as the accounting principles used can be justified on the basis of some use and acceptance by some accountants may easily implicate the auditor in fraud. The financial statement to which this professional approval is given may be found to be misleading and to have been made that way intentionally by management with the willing assistance of the auditor. The effectiveness of the statements for accomplishing deception is, of course, enhanced by the attachment of the auditor's imprimatur.

The danger facing the auditor is, of course, that the courts may be receptive to the argument that a particular statement is more misleading than meaningful, more deceptive than disclosing. Management's choice to disclose or not—where that is discretionary under the present system—its structuring of the data, and its choice of alternative principles may be found in a concrete case to have been motivated by

²² The damages point involved in the reversal of the *Teich* case turned on the choice between allowing recovery of "out-of-pocket" losses and the "benefit of the bargain." See RESTATEMENT (SECOND), TORTS § 549 (Tent. Draft. No. 11, 1965), which adopts the latter measure.

²³ See generally COMMITTEE ON AUDITING PROCEDURE, AICPA, AUDITING STANDARDS AND PROCEDURES chs. 7-11 (Statement on Auditing Procedure No. 33, 1963).

the desire to create a false picture of the earnings or to maintain the appearance of a favorable upward trend. A court's finding of the auditor's connivance in this deception of investors, based on his knowledge that the reports do not portray an altogether honest picture of the company's operations and prospects, will involve him in the fraud.

At least one court has been totally unimpressed with the argument that the modern version of the auditor's "opinion" is not a warranty of the financial condition of the company.²⁴ AICPA publications make clear that the auditor's responsibility for the statements is confined to an expression of his opinion of them and that the financial reports remain the representation of management.²⁵ On the other hand, the AICPA's standards of reporting also require that the auditor's report state whether the financial statements are presented in accordance with generally accepted accounting principles,²⁶ and a CPA is prohibited from rendering an unqualified opinion on statements that he believes are false and misleading as a whole or in any significant respect unless he requires adjustment or adequate disclosure.²⁷

The wording of the report may effectively dispel any notion that the auditor is taking responsibility for the conformance of the financial statements to the books of accounts on a warranty-like basis. That certainly is one of the intentions of the modern wording ever since the celebrated *Ultramares* case,²⁸ where the plaintiff contended that the auditor's "certificate," as it was then called, assumed responsibility for the truth of the balance-sheet items and reported earnings and the conformity of the reports to the books of account. The certificate said, "We . . . certify that . . . [the balance sheet], in our opinion, presents a true and correct view of the financial condition of" the audited firm.²⁹

The auditor should not have to take responsibility on an absolute basis for the truth of the financial data³⁰ and should not be taken as asserting the truth of that data as if it were presented on the basis of his personal knowledge. (The question whether the auditing procedures were adequate and carefully performed is not of concern here.) But the status of the unqualified opinion as a representation that the financial reports present the financial condition as it appears to the auditor without deception or distortion is indisputable. If in fact the earnings are distorted or some other financial fact such as working capital position is misrepresented,

²⁴ *Mutual Ventures Inc. v. Barondess*, 17 Misc. 2d 483, 186 N.Y.S.2d 308 (Sup. Ct. 1959).

²⁵ COMMITTEE ON AUDITING PROCEDURE, *op. cit. supra* note 23, at 10.

²⁶ *Id.* at 9.

²⁷ *Id.* at 56-63.

²⁸ *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

²⁹ *Id.* at 174, 174 N.E. at 442.

³⁰ In *Teich v. Arthur Andersen & Co.*, 40 Misc. 2d 519, 243 N.Y.S.2d 368 (Sup. Ct. 1963), *rev'd per curiam*, — App. Div. 2d —, 263 N.Y.S.2d 932 (1965), discussed in text accompanying notes 20-22 *supra*, the plaintiff contended that the auditor's opinion is a "warranty." It might be productive of mischief to characterize the auditor's opinion in this way for it might lead to an insurer's liability for the fraud of the management. For a discussion of the historical differences between warranty and misrepresentation, see WILLIAM L. PROSSER, *TORTS* 700 (3d ed. 1964).

through omissions,³¹ half truths, or misleading presentation³² or through the unfair or unsound use of generally accepted accounting principles,³³ the auditor is vulnerable to a charge of participating in a deliberate fraud. The evidence in a particular case may show that the auditor was sensitive about the matter and confronted management with it only to bow in the face of management insistence on nondisclosure or on disclosure in a way that the auditor considers relatively unsound or unfair. Or it may merely be a case of habitually going along with management whenever support of any kind can be found for what is proposed. The widespread use and critical importance of the financial reports could well provide a basis for a finding that the auditor who is indiscriminate with the unqualified opinion in this way has become implicated in a deliberate deception.

2. *Truth and Falsity in Financial Reporting*

The traditional accounting position is that it is impossible except in palpable cases to say that reported earnings are "false" or that financial position is misrepresented unless there is blatant disregard of a rather well-accepted fundamental principle without a semblance of factual justification. For, it may be argued, what is "truth" where financial position and periodic results of operations are concerned? It is commonly acknowledged that the best that accounting can yield is an imperfect approximation of the financial condition of a company, and the accounting language and symbols are able to convey only a most limited view of how profitably the company has been operated.

In Justice Jackson's dissenting opinion in *FPC v. Hope Natural Gas Co.*, we read:

Even as a recording of current transactions, bookkeeping is hardly an exact science. As a representation of the condition and trend of a business, it uses symbols of certainty to express values that actually are in constant flux. . . . If one cannot rely on accountancy accurately to disclose past or current conditions of a business, the fallacy of using it as a sole guide to future price policy ought to be apparent. However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive.³⁴

³¹ *E.g.*, *Teich v. Arthur Andersen & Co.*, *supra* note 30, where the plaintiff alleged fraudulent omission from the financial reports of an alleged material increase in the future annual charge to fund the cost of past service pension benefits.

³² For a thorough analysis of what constitutes falsity in a misrepresentation, see WILLIAM L. PROSSER, *TORTS* § 101 (3d ed. 1964).

³³ Misleading use of a particular alternative way of reporting the gain from the sale of a capital asset could give rise to a finding of fraud in a given case. The sale of the assets of a profitable subsidiary, which cuts off for the future the source of an important portion of the reported earnings, without adequate analysis of the fact and the final net income figure, is confusing and misleading and may be found to be fraudulent. The tax credit arising from operating losses may also be used in a misleading way. For further illustrations, see Greer, *How to Succeed in Confusing People Without Really Trying*, J. Accountancy, March 1963, p. 61. Management often does have legitimate business reasons for accounting decisions, but the risk is growing that accounting practice is so plastic that the asserted reasons may be found to be only a facade for fraud.

³⁴ 320 U.S. 591, 643-44 n.40 (1944).

This is a powerful argument that will require many concessions to be made, but it is not believed that it will present an invincible obstacle to judicial action in this area. By way of concession, it must be recognized that the accounting art cannot be expected to shoulder a responsibility for the inability to do what is inherently impossible—that is, produce a system of data and symbols that can tell us the absolute truth about asset valuation, flow of costs, contingent liabilities, and the like. And the accountant cannot be made the scapegoat for every losing investment or loan. The concept of a false financial report cannot be carried too far, and auditors should not be subjected to a requirement of having to accompany financial reports and their unqualified opinions with an investment analysis that surveys the impact of the data presented in the light of the condition of the economy or the particular industry or the state of the President's health. Close control must be retained by the courts over the question of falsity, materiality, causation, damages, and reasonable reliance. On this latter score, for example, the accountant should perhaps not be blamed for the investor's uncritical use of the earnings-per-share figure in isolation.

The case of *Teich v. Arthur Andersen & Co.*, noted above,³⁵ raises the question of the materiality of the increase in the estimated annual charge for the purpose of funding past service pension benefits arising out of an amendment to a pension plan. The auditor took the position that the charge was not material because the amount involved was not large enough. It is noteworthy that the auditor was sufficiently concerned about the point to have brought it to the attention of management, but the ultimate decision was to disclose it in the annual report.³⁶ The plaintiff denies the disclosure and disputes its adequacy.³⁷ Upon the trial of the case, a jury could well be asked to resolve the various questions. Obviously the auditor is not in the strongest tactical position when he has himself raised the question of disclosure only to submit to a management suggestion that there be no treatment or something other than candid treatment of the matter in the financial reports themselves. This is not to prejudge the *Teich* case, but merely to point out the perils of anything less than the stoutest independence, about which more will be said.

The decided cases on auditor's liability have not in fact frequently raised subtle questions of what is to be regarded as fraud through the selective use of alternative accounting principles or by the cunning use of methods of presentation; most of the cases involving liability of accountants have dealt with negligence in auditing, that is, in mechanical or verification procedures. In the *Teich* case, the plaintiff alleged that the auditor's unqualified opinion was fraudulent with respect to its recital of conformity of the financial statements to generally accepted accounting principles. The plaintiff argued that Accounting Research Bulletin No. 47 required

³⁵ See notes 30 and 31 *supra* and text accompanying notes 20-22 *supra*.

³⁶ Brief for Respondent, p. 5, *Teich v. Arthur Andersen & Co.*, — App. Div. 2d —, 263 N.Y.S.2d 932 (1965).

³⁷ Reply Brief for Appellant, pp. 3-4, *Teich v. Arthur Andersen & Co.*, *supra* note 36.

disclosure of the data with respect to the estimated future annual charge for funding the past service pension benefits. The trial court, in holding for the defendant on the damages question, uttered the dictum that the case appeared to involve not a deliberate concealment but only an accounting irregularity. Whether this dictum will become significant as the case unfolds remains to be seen.

Accountants should not take too much comfort in the fact that they have so far escaped liability for their approval of misleading financial statements. Attitudes change, and judges can be educated. In an increasingly complex society and economy and with the spread of shareholding, dependence upon financial reports is acute. Sophisticated issues of fraud in the presentation of accounting data are inevitable. The standard of reasonable care relating to the performance of auditing procedures—the verification of assets, for example—has been raised considerably since *McKesson & Robbins*.³⁸ Similarly, the courts are likely to, and should, adopt a criterion of truthfulness consistent with modern needs and the expectations of interested parties.

3. *The Conditions Conducive to Legal Change*

The critical importance of the financial reports and the work of auditors provides strong motivation for courts to become much more demanding of the accounting profession than they have been. The financial and economic crisis of the 1930s gave the impetus to disclosure requirements. Many companies at that time did not release income statements although the balance sheet did yield some information about the company's earnings. The New York Stock Exchange, the SEC, and the AICPA cooperated in efforts that brought about the improvement of accounting practices. The standard of "generally accepted accounting principles consistently applied" provided a most useful focal point for this improvement, but it has apparently outlived its capacity for inciting to progress. The disclosure philosophy requires fuller realization. An example of the recognition of this and the imminence of steps to bring about that fuller realization of disclosure for the nation's almost twenty million investors can be found in the recommendations in the *Report of the Special Study of the Securities Markets*:

A still broader point is that wider dissemination or at least wider availability of filed information ought to be generally fostered. Today's advanced techniques for speedy and inexpensive communication and duplication of the printed word make quite obsolete and inadequate the present system—essentially unchanged for a generation—of requiring "public" filing in but one or two locations and providing copies only with considerable delay and at substantial cost. . . . It should even be possible to standardize the physical presentation of reports sufficiently so that up-to-date information about an issuer could be made available in some kind of looseleaf form in the manner of present privately published services. The possibilities would seem to be numerous and varied and at least some of them

³⁸ *McKesson & Robbins, Inc.*, SEC Accounting Ser. Release No. 19, Dec. 5, 1940.

should prove, now or in the foreseeable future, well within the bounds of practicality. . . .

In other respects, too, the general goal of fostering public awareness and use of disclosed data in making investment decisions should be a continuing and active concern of the regulatory authorities, so that maximum benefit may be derived from the disclosure which it is the basic purpose of the Federal securities laws to provide. For example, continuous educational measures of various kinds, to advise the public of what prospectuses are designed for and what they contain, what kinds of reports of issuers are publicly available, and why their contents or particular portions need be read and heeded, would seem to be an appropriate or even necessary function of the Commission.³⁹

Financial accounting has taken on an immense importance in today's economy. Shareholders and the public must have a fair basis for measurement of the performance of business management if the capital markets are to function efficiently. The backbone of the information to be used in arriving at investment decisions is the operating results and financial position of the corporation reflected in its financial statements. Financial statements filed with the SEC represent an important source of information, which is disseminated by investment advisory services and other intermediaries.⁴⁰ The recent increase in SEC reporting requirements promises to improve the flow of information.

In all of this the public accountant holds a position of the highest strategic importance as reviewer of management financial reporting. But, under conditions as they exist, the auditor must provide an unqualified opinion so long as management's reports are in keeping with a universe of accounting principles that at times seems limitless. The auditor's professional performance is wedded to a public standard that does not offer a sufficient check on what management has done and that does not permit the auditor to voice personal disapproval of those financial statements in accordance with his professional standards independently arrived at.

The reported earnings per share of a company has become a widely used datum for investment judgments and future projections. Management invites this perhaps

³⁹ SEC, *Report of Special Study of Securities Markets*, H.R. Doc. No. 95, pt. 3, 88th Cong., 1st Sess. 59-60 (1963).

⁴⁰ See *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964), in which plaintiff shareholders, in an action against the corporation and its management, alleged their reliance on false information appearing in an investment advisory service compiled from data submitted by defendants to the SEC. The court upheld the cause of action based on common-law deceit, relying in large part on RESTATEMENT, TORTS § 536 (1938), which reads as follows:

"§ 536. *Information Required by Statute.*

If a statute requires a report showing the maker's financial position and business activities

(a) to be published by the maker, or

(b) to be made to a public official who is required or permitted to publish it or to hold it open to public inspection while in his custody,

one who makes a fraudulent representation in such a report is subject to liability to those for whose information the report is required for harm suffered because of reliance on the representation in a transaction for guidance in which the report is required to be made available."

Financial data filed with the SEC clearly falls within the scope of this doctrine. The implication of the accountant in the deceit, of course, poses some additional problems.

exaggerated reliance on earnings per share, often itself resorting to it to lay claim to a successful running of the business. Annual reports dwell upon earnings per share on a comparative basis, and future increases are projected by management for the edification of security analysts.

With this set of conditions prevailing and, indeed, intensifying, it is possible to build theories of liability for fraud and misrepresentation. For, with the knowledge that judgments and projections are going to be made about future prospects, do not the company and the auditor fraudulently lead the reader into error when the facts presented to him for his analysis can be fully expected, and indeed are designed, to convey an impression that is inadequate and unreliable and when the true significance is impossible to capture without painstaking explanation? Even conservative courts may soon be persuaded that management and auditor ought to be held accountable where this characterization of their conduct proves apt.

4. *Illustrative Case Law*

One famous court decision and a series of SEC decisions involving accounting questions suggest the manner in which particular methods of accounting may be found to be deceptive. As indicated above, a finding of deception may lead easily to the accountant's liability in a suit by an investor who can show causation and damages.

In *Kaiser-Frazer Corp. v. Otis & Co.*,⁴¹ the underwriting contract for breach of which Kaiser-Frazer sued its underwriter, Otis, contained the promise of Kaiser-Frazer, as the issuing corporation, to furnish to the underwriter, as a condition precedent to the underwriter's obligation to close, an opinion of counsel to the effect that the registration statement contained no untrue statement of a material fact. One of the underwriter's grounds of defense was that the registration statement contained false and misleading statements. In passing upon this issue, the court emphasized the importance of the reported earnings for the last quarter of 1947 and any significant trend manifested thereby. The success of the stock issue depended on whether investors believed Kaiser-Frazer had been successful in its effort to become an effective competitor in the automobile industry. The prospectus contained a summary of earnings prepared by the company and for the most part unaudited. This table disclosed net profits for the two months ended November 30, 1947, of \$9.4 million. The table did not contain a direct statement of earnings for December 1947 but did represent that the earnings for the quarter ended December 31, 1947, were \$13.4 million. This invited the investor to make the subtraction and derive December earnings of \$4 million. The actual earnings from operations in December were \$600,000, and the difference between that figure and the \$4 million figure was traceable to year-end inventory adjustments. But these

⁴¹ 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952).

inventory adjustments would decrease cost of goods sold for the entire year and not merely for December. The reader concluding that there were earnings of \$4 million in December could compare that to a loss of \$19 million in the prior year, 1946, and a loss of \$2.2 million for the first six months of 1947. This apparent dramatic upturn in K-F's earnings might have indicated the company's firm implantation in the auto industry and its movement out of the formative, developmental stage to a period of profitable operation.

The district court had found that the earnings summary was computed in accordance with "accepted accounting procedures" and that it was not misleading.⁴² The court of appeals, in reversing, stated that "regardless of whether its accounting system was a sound one, Kaiser-Frazer stated its earnings in such a way as to represent that it had made a profit of about \$4,000,000 in December 1947."⁴³ And the court said the appended footnote calling attention to the fact that an inventory adjustment had occurred and other matters did not sufficiently dispel the impression. The high standard of presentation and disclosure imposed in this case could easily be carried over to cases involving auditor's liability.

Courts may well follow the example of the Securities and Exchange Commission, which has repeatedly rejected literal compliance with "generally accepted accounting principles" as decisive of the question of adequate and fair disclosure. In a celebrated case, in which disciplinary action was taken against an accounting firm, the Commission wrote the following:

In support of their position on this [accounting] question, as well as on the other allegations in the order for proceedings, respondents introduced the evidence of three members of other firms of certified public accountants who testified as experts. Respondents lay great emphasis on this testimony and point out that no expert testimony to the contrary was introduced by the Office of the Chief Accountant. However, as we have previously stated, while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice. We have given careful consideration to the testimony of the experts as well as to all the other evidence in arriving at our conclusions herein. We have not deemed it necessary to discuss their testimony since the views they expressed were substantially the same as those of the respondent.⁴⁴

The Commission wrote on another occasion:

The basic deficiency of the financial statements was that they did not portray realistically the financial affairs of Seaboard. . . . It seems clear that the efforts of the Seaboard management were directed to the objective of concealing and minimizing the true unfavorable condition of the company and that respondents

⁴² See 195 F.2d at 843.

⁴³ *Id.* at 843.

⁴⁴ Haskins & Sells, SEC Accounting Ser. Release No. 73, Oct. 30, 1952. (Footnote omitted.) The accounting firm had sanctioned the entering of certain assets at a value equal to the par value of the stock with which they had been acquired.

were swayed by the wishes of the management and their certificate did not prevent the accomplishment of the management's purpose.⁴⁵

These expressions accord with the Commission's consistent view that its own views on the soundness of the accounting employed must prevail over general acceptance of a particular practice in the profession.⁴⁶ Courts might rely more heavily on expert testimony but, like the Commission, need not consider themselves bound by the frequency of a practice deemed misleading under the circumstances.

Qualified opinions or footnote disclosures and disclaimers offer a possible way out for the auditor. But these devices should be *effective* in erasing the misimpressions implanted by the financial reports if they are to immunize the auditors from responsibility for deception. Some of the negligent audit cases involve this point, and accountants have avoided liability on occasion by the use of footnote disclaimers as to the scope of their examination.⁴⁷ Footnote disclaimers as to the use of accounting principles would seem to raise more difficult questions, however, since they may be so technical as to fail to dispel the impact of the reported earnings figures on the average reader. Thus, footnote explanations are not likely to prove to be effective escape hatches for the auditor in every case. Courts may well come to believe that the duty to withhold an unqualified opinion unless there is a complete change in the company's accounting presentation and not merely a gesture toward disclosure in a footnote is not an unfair burden on the auditor.

The SEC has not always accepted footnote explanations where the statements were misleading on their face. In one decision the SEC took the position that the financial statements filed as part of a registration statement overstated assets and minimized information that would have fairly disclosed the true nature of the assets.⁴⁸ The Commission stated that

It is not enough to say that here perhaps much (but by no means all) of the factual background forming the basis of the original patent and patent application account was given in footnote data. Significant data were not provided; but even if these had been given there is an obligation to present the material in a way in which it will be useful to the informed but less sophisticated readers.⁴⁹

⁴⁵ Touche, Niven, Bailey & Smart, SEC Accounting Ser. Release No. 78, March 25, 1957. (Footnotes omitted.)

⁴⁶ E.g., SEC Accounting Ser. Release No. 4, April 25, 1938.

⁴⁷ In *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N.E. 808 (1934), the auditor's certificate made clear that the audit was based solely on the statements of foreign constituent companies and not on an examination and audit of their books. And, in *C.I.T. Financial Corp. v. Glover*, 224 F.2d 44 (2d Cir. 1955), there was an effective disclaimer as to the valuation of a key current asset, loans receivable, heavily relied on by the plaintiff-lender.

⁴⁸ *Thomascolor, Inc.*, 27 S.E.C. 151 (1947). This case grew out of the same facts as the decision quoted in the text accompanying note 44 *supra*.

⁴⁹ *Id.* at 170 n.17. Cf. *Associated Gas & Elec. Co.*, 11 S.E.C. 975, 1058-59 (1942):

"We should have hesitated to criticize the accountants on individual items had we not been unequivocally satisfied that the financial statements, looked at as a whole, were not truthfully informative and should never have been certified.

"We think, moreover, that too much attention to the question whether the financial statements

The emphasis on utility to "informed but less sophisticated readers" is noteworthy. The courts might adopt a similar standard in appraising the deceptiveness of financial statements for purposes of imposing auditor's liability.

B. Other Possible Theories of Liability

1. Section 11 of the Securities Act of 1933

As to financial statements contained in registration statements filed with the SEC under the Securities Act, a potentially important statutory remedy is provided by section 11. As an "expert," the certifying accountant is held to be liable to "any person acquiring such security" for any "untrue statement of a material fact" made on his authority or for an omission "to state a material fact required to be stated [in the registration statement] . . . or necessary to make the statements therein not misleading"⁵⁰ Only one reported case arising under this provision has concerned accountants,⁵¹ but the potentiality for such actions exists. The claim may be one for negligence or for deliberate misrepresentation, although seemingly the complaint need allege only the misstatement or omission, the accountant's consent to the use of his name, reliance, and damages. The privity requirement of the *Ultramares* case, which is discussed more fully below,⁵² is not applicable to the statutory cause of action.⁵³

It would seem that a disgruntled investor might encounter fewer legal hazards and problems of proof in proceeding under section 11 than under any of the other theories discussed in this paper. However, the one court decision concerning accountants' liability under the section imposed such a low standard of duty on the accountant and raised so many other artificial obstacles to recovery that prospective plaintiffs may be discouraged.⁵⁴ Nevertheless, the precedential value of this 1939 decision is doubtful. Of course, the statutory remedy is applicable only where a 1933 act registration statement can be relied on, and the ultimate question of when accounting data can fairly be characterized as "untrue" still remains.

formally complied with principles, practices and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements performed the function of enlightenment, which is their only reason for existence."

⁵⁰ Securities Act of 1933, § 11(a), 48 Stat. 86, as amended, 15 U.S.C. § 77k(a) (1964).

⁵¹ *Shonts v. Hirliman*, 28 F. Supp. 478 (S.D. Cal. 1939).

⁵² See text accompanying notes 66-68 *infra*.

⁵³ See 3 LOUIS LOSS, *SECURITIES REGULATION* 1731-32 (2d ed. 1961).

⁵⁴ *Shonts v. Hirliman*, 28 F. Supp. 478 (S.D. Cal. 1939), which, however, involved events occurring in large part after the date of the auditors' certificate. Discussing this case, Loss says:

"If the suprisingly low accounting standards which seemed to satisfy the court in this case are followed as the norm required by § 11, that section will turn out not to have advanced far beyond the 'gross negligence' standard The fact is that the District Court set a standard of care far below that which is customary for the profession and necessary for the detection of possible contingent liabilities to be listed in the registration statement."

3 LOUIS LOSS, *SECURITIES REGULATION* 1733 (2d ed. 1961).

2. Section 10(b) of the Securities Exchange Act of 1934

Plaintiffs may also be well advised on occasion to rely on section 10(b) of the Securities Exchange Act of 1934⁵⁵ and SEC Rule 10b-5 thereunder⁵⁶ in an action against an accountant for damages incurred in reliance on misleading financial statements bearing the accountant's imprimatur. This statute and rule, under which civil actions have been held to lie,⁵⁷ prohibit the use of the mails, any instrumentality of interstate commerce, or facilities of a securities exchange "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or . . . 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."⁵⁸

One action against an auditor charged with knowingly preparing false financial statements has been upheld under section 10(b).⁵⁹ The suit was brought by a corporation that exchanged its stock in a merger for stock of the audited company, and the complaint alleged that the auditor was a participant in a conspiracy to defraud. This case indicates that the auditor may be charged directly under section 10(b) even though technically his role is merely one of expressing an opinion on the financial statements. Privity does not appear to be an essential ingredient of the cause of action,⁶⁰ and it has been persuasively argued that scienter (roughly, intent to deceive, normally a requirement in fraud cases) need not be established to sustain an action under the statute and the rule.⁶¹

Section 10(b) and Rule 10b-5 have been remarkably productive of causes of action in other contexts in the recent past, giving rise, in fact, to a whole new body of law sometimes referred to as "federal corporation law."⁶² In the area of auditor's liability, as in other areas, plaintiffs may find section 10(b) and Rule 10b-5 a useful substitute for common-law theories based on fraud and misrepresentation. The broad language of the statute and the rule are fully compatible with findings of violations based on incomplete, inaccurate, or disingenuous financial presentation.

⁵⁵ 48 Stat. 891, 15 U.S.C. § 78j(b) (1964).

⁵⁶ 17 C.F.R. § 240.10b-5 (1964).

⁵⁷ E.g., *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

⁵⁸ Rule 10b-5, 17 C.F.R. § 240.10b-5 (1964).

⁵⁹ *H. L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960).

⁶⁰ See these discussions of this difficult issue: 3 LOUIS LOSS, *SECURITIES REGULATION* 167-71 (2d ed. 1961); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185, 196-206 (1964); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 671-77 (1963); Note, 43 N.C.L. REV. 637 (1965); Comment, 74 YALE L.J. 658 (1965).

⁶¹ Comment, 74 YALE L.J. 658, 682-89 (1965). But see 3 LOUIS LOSS, *SECURITIES REGULATION* 1766 (2d ed. 1961).

⁶² E.g., *Cady, Roberts & Co.*, 40 S.E.C. 907, 910 (1961) (referring to a "wholly new and far-reaching body of Federal corporation law"). See generally Joseph, *Civil Liability Under Rule 10b-5—A Reply*, 59 NW. U.L. REV. 171 (1964); articles by Ruder, *supra* note 60; Note, 43 N.C.L. REV. 637 (1965); Comment, 74 YALE L. J. 658 (1965).

3. *Negligence*

If proof is absent that the auditor knowingly sanctioned financial statements that are misleading and calculated to defraud, liability might well be put upon grounds of negligence.⁶³ The usual test for professional negligence is a comparison of the care and skill exercised in the case with the prevailing standards of reasonable care and skill in the profession.⁶⁴ However, courts have it within their power to vary this formula somewhat, and may be inclined to do so in the belief that no profession is deserving of the protection of a legal standard of its own devising unless the profession displays a sufficient regard for the safety of those who depend upon the practitioner's exercise of a high degree of skill and competence.⁶⁵ As we have noted above, there are some grounds for considering that the accounting profession has not measured up to the legitimate expectations. Accounting may be an art, but the law need not accord the accountant an untrammelled poetic license.

Another substantial barrier to adoption of a negligence theory is the survival of notions of privity since the famous *Ultramares* case of 1931.⁶⁶ That case, it will be recalled, refused to "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁶⁷ Although the policy objections to making the auditor's duty of care and skill run to all of the investing public are manifest, some broadening of the extent of the auditor's duty might easily occur.⁶⁸

C. The Future

What has been said above does not represent a conclusion as to which side is right in the uniformity debate. Nor is it a suggestion that accountants should give

⁶³ This might be unnecessary in a case where courts were willing to presume the accountant's knowledge of the effect of the accounting method used. The differences between deceit and negligent misrepresentation are spelled out in WILLIAM L. PROSSER, *TORTS* § 102 (3d ed. 1964).

⁶⁴ 1 FOWLER V. HARPER & FLEMING JAMES, JR., *TORTS* § 7.6 (1956); WILLIAM L. PROSSER, *TORTS* 164-68 (3d ed. 1964).

⁶⁵ An analogy perhaps is apparent in the following:

"[W]hen the jury are considered competent to do so, they are permitted to find that a practice generally followed by the medical profession is negligent. This has frequently been done in the cases of sponges left in the patient's abdomen after an operation, where the task of keeping track of them has been delegated by the surgeon to a nurse. Although this was, and perhaps still is, universal practice, it has still been found to be negligent."

WILLIAM L. PROSSER, *TORTS* 168 (3d ed. 1964). (Footnote omitted.) Similarly, on the relevance of custom in establishing a standard of care, Prosser states, "Even an entire industry, by adopting such careless methods to save time, effort, or money, cannot be permitted to set its own uncontrolled standard." *Id.* at 170. (Footnote omitted.) The alleged negligent act must be relatively flagrant before these doctrines would come into play.

⁶⁶ *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

⁶⁷ *Id.* at 179, 174 N.E. at 444.

⁶⁸ The course of the law in this area remains uncertain. See Bradley, *Liability to Third Persons for a Negligent Audit*, — J. BUS. LAW — (forthcoming); *Duro Sportswear, Inc. v. Cogen*, 131 N.Y.S.2d 20 (Sup. Ct. 1954), *aff'd mem.*, 285 App. Div. 867, 137 N.Y.S.2d 829 (1955); Annot., 54 A.L.R.2d 324, 345 (1957); and the following cases involving professionals other than accountants: *Texas Tunneling Co. v. City of Chattanooga*, 204 F. Supp. 821 (E.D. Tenn. 1962), *rev'd*, 329 F.2d 402 (6th Cir. 1964); *M. Miller Co. v. Dames & Moore*, 198 Cal. App. 2d 305, 18 Cal. Rptr. 13 (1961); *Hedley Byrne & Co. v. Haller & Partners*, [1964] A.C. 465 (1963).

up their honestly held views on what is sound accounting, the proper role of the auditor, or the prerogatives of the business manager. The point is rather that the profession must face the fact that the standard of generally accepted accounting principles may be wide open to the charge of not matching the social and economic needs of the times and may therefore prove an ineffective shield against legal liability. The accounting profession need not plunge itself into a professional straitjacket because of this, but a change in stress would seem to be in order, a change in emphasis away from apologies for diversity as a fundamental principle and away from stout defenses of the managerial prerogative. The profession ought rather to emphasize its own vigorous and independent pursuit of accounting principles and practices and modes of disclosure and of presentation of data that contribute the most faithful and comparable picture of financial position and results of operations in the judgment of the *auditors*.

The search for absolute truth in terms of accounting data may indeed be a futile one. In addition, the accounting profession has needed and continues to need time to carry out a scientific study and appraisal of its own work. But the notion that the accountant need not fear legal liability merely because he has certified what is literally true—that is, that the financial reports conform to “generally accepted accounting principles”—is an unfortunate and dangerous one. Accountants run a real risk of nonpersuasion on the technical and complex question of whether the accounting presentation is “false.”

III

THE PROBABLE CONSEQUENCES OF ACHIEVING UNIFORMITY

A. Auditor's Liability

Now let us assume the development of a set of uniform accounting principles along with a detailed guide to their application, and let us further assume a professional obligation to conform to these principles unless a departure may be justified by the peculiar facts of a given case. What would be the legal consequences of a departure from these principles? Would such a departure be fraud or negligence *per se*?

For purposes of discussion, let us further assume that the auditor is required to adopt a new formulation in his opinion which refers to the authoritative uniform principles. And let us suppose a hypothetical departure that involves the application of an accounting principle that would have been within the embrace of the traditional generally accepted accounting principles.

If the auditor certifies that the financial reports conform to the uniform principles when in fact they do not, there is a palpable falsehood. If the accountant certifies merely to the adherence by the company in the preparation of the statements to “generally accepted accounting principles” and says nothing about the

uniform principles, his opinion would be inadequate. In either case, in the absence of disclosure of the departure from uniform principles, courts would be likely to sustain charges of fraud or negligent misrepresentation for the reason that expectations and analysis would be based on the uniform principles. Moreover, the standard of truthfulness and reasonable care in the profession would have become the system of uniform principles. Of course, in a particular case questions of materiality and the reasonableness of the reliance, if any, would remain open for litigation.

It seems perfectly clear that auditors may take it as certain that a departure, without adequate disclosure or qualification, from any uniform principles that may be developed would entail a serious risk of liability for misrepresentation. But no detailed examination of this problem in its many ramifications seems to be worthwhile because the danger of this legal liability in the advent of a uniform system should be of very little concern to accountants. For it means only the minor inconvenience and irritation of not being able to sanction a departure from the uniform principles and say nothing about it. This should surely not be cause for terror or alarm.

It is only superficially that uniformity invites greater liability. It may be thought that proof of a departure from a uniform rule is easy compared to an attempt to establish the lack of congeniality to an amorphous cluster of "generally accepted" principles. But the question is not that simple. As we have seen above, the protection against legal liability afforded by existing standards is in danger of breaking down. If the law begins to supply its own benchmark for truthfulness in accounting, there is the prospect of juries and judges passing on the adequacy of accounting data, and on the honesty of the auditor's certificate, without substantial deference to the prevailing standards of professional skill and competence as testified to by expert witnesses. This possibility ought to produce shudders among accountants, and perhaps also a preference for a more reliable set of accounting principles.

For these reasons, the AICPA should retain a firm control over the standards of reporting for auditors. A professional standard of competence and truthfulness related to a convincing and effective set of independently formulated accounting canons that command the respect of the courts must always be at hand. This would be far more useful in avoiding liability than pitiable diatribes against contingent-fee-seeking lawyers, disgruntled creditors greedily seeking a scapegoat, and traitorous accountants who testify in damage actions against other accountants.⁶⁹ The immediate establishment of a program wholeheartedly dedicated to the formulation of sound and fair uniform principles of accounting would be the step most likely to forestall a major breakthrough in the direction of increased liability.

⁶⁹ Editorial, *The Specter of Auditors' Liability*, J. Accountancy, Sept. 1965, p. 14.

B. Auditor's Independence

Another favorable effect of achieving increased uniformity would be the strengthening of the auditor's position of independence and professionalism by better enabling the auditor to resist the use of questionable practices. The strategic position of the accountant vis-à-vis management is clearly enhanced when the accountant is put under a professionally imposed ethical obligation to withhold an unqualified opinion, to disclose the discrepancies from the uniform system, and to provide a reconciliation of the financial result of the departure.⁷⁰ And it is further enhanced when all of the auditor's competitors are under a similar obligation. The auditor is then in a much better position to disassociate himself from the kind of financial report that might make him vulnerable to legal liability.

The use of disclaimers and other escape clauses by the auditor would be more convincing under a tighter and more disciplined system of maximum feasible uniformity. Disclaimers and disclosures of departures from the uniform principles, together with an explanation of the effects of the departure, offer effective insulators against liability. Under present circumstances, disclaimers and disclosures of this kind are possible but in terms of client relationships are vastly more difficult to impose than should be the case if the auditing standard were severely tightened and an ethical obligation attached. Conformity to an authoritative set of uniform principles could be assertively insisted upon by the auditor free of whatever competitive pressures to go along with management now exist. Candid and meaningful disclosure about departures would be far less embarrassing and much more easily defended.

There is something to be said for the general desirability of unqualified opinions and about the hampering effect of qualified opinions by auditors. But the feeling is inescapable that investors and shareholders would much prefer all of the facts, unadorned, conspicuously and lucidly presented, over the false comfort of an unqualified auditor's opinion. Of course, from management's point of view the unqualified opinion is a useful seal of good housekeeping. But pandering to the wishes of a management seeking such a seal while posing as an independent reviewer of management's reports is, as we have seen, dangerous living.

An accounting firm's economic survival apparently does not depend upon compromising its independence. In the twilight of a very successful career, George O. May was quoted as saying that "this policy of independence is richly rewarding in the long run. . . . We lost very little business by taking a firm stand, and we gained quite a lot."⁷¹ A prominent business manager has gone on record as agreeing with this:

⁷⁰ Two of these three conditions have fortunately been achieved, although the obligation to adhere to them has not yet been made a matter of professional ethics. See note 14 *supra* and accompanying text.

⁷¹ *A Talk With George O. May*, J. Accountancy, June 1955, p. 40, at 44-45.

Fundamentally, I think the cause of the trouble is a laxity in the professional standards and independence of accountants. I believe that business would readily conform to fair standards if principles were established on a sound basis and adhered to by all members of the profession.⁷²

On at least one occasion, the courts have taken note of the importance of the auditor's independence. In *Epstein v. Schenck*,⁷³ the shareholders attacked a profit sharing agreement for executives, and one of the issues was the correctness of the accounting methods used in making the computations under the plan. The court found some of the accounting to have been improper and discussed the charge that the auditors were complacent and surrendered to the company's suggestions. The court pointed out how sensitive is the relationship of certified public accountants to the public and stressed the indispensability of the profession's work, noting how this situation demands that nothing happen to shake public confidence in the soundness of financial reporting. The court's advice is eminently sound: "[When] independent accountants have an opinion of their own which differs from that of the inside auditors, they should assert their views, and not merely proceed along the line of least resistance."⁷⁴

Finally, let us note some areas where management prerogatives have often been regarded as inviolate. One area of current difference in accounting practice concerns research and development costs and the question whether they should be capitalized or charged to current operations. A common attitude among accountants is that such decisions are a matter of management discretion based on business judgment.⁷⁵ But a carefully justified professional standard can and should work a change in a system of accounting in a company despite the usual protest that what is being done is based on the unique facts in that particular company. The effective club is the threat of a qualified opinion. One writer has pointed out that Accounting Research Bulletin No. 44 (Revised)⁷⁶ had the effect of causing companies to change their method of computing depreciation on a declining balance basis.⁷⁷ The steadfastness of accountants and the possibility of a qualified opinion provided the immediate impetus for this change in an area where deference to management judgment is usually the rule.

⁷² Address by Willis Gale, former Chairman of the Board of Consolidated Edison, University of Chicago Business School, Dec. 4, 1963.

⁷³ 35 N.Y.S.2d 969 (Sup. Ct. 1939).

⁷⁴ *Id.* at 980.

⁷⁵ See, e.g., Fox, "Useful Comparability" in *Financial Reporting*, J. Accountancy, Dec. 1964, p. 44, at 45.

⁷⁶ COMMITTEE ON ACCOUNTING PROCEDURE, AICPA, DECLINING-BALANCE DEPRECIATION (Accounting Research Bull. No. 44 (revised), 1958).

⁷⁷ Catlett, *Controversy Over Uniformity of Accounting Principles*, J. Accountancy, Dec. 1964, p. 37, at 40.

IV

COMMENTS AND CONCLUSION

Accountants invite judicial disfavor and adverse case holdings when they worship the false idol of managerial privilege and when they prostitute their professional skills in applying a rubber stamp to whatever management chooses to do instead of performing as independent arbiters of the soundness and fairness of what management proposes. If financial statements are in some respects misleading, accountants should not be surprised if the courts lay a large part of the blame at their door.

In the past the courts have been remarkably solicitous for the accountant's legal fate. Chief among the reasons has been the fear of ruinous liability. This is best illustrated by the classic *Ultramares* case.⁷⁸ But in the light of the economic maturation of the independent accounting profession, further dependence on such judicial solicitude seems ill-advised. Five years ago, *Fortune* estimated that the top eight public accounting firms employed about fifteen per cent of the nation's approximately 77,000 CPAs.⁷⁹ Together, it was estimated, these accounting houses grossed annually over 200 million dollars. Furthermore, a typical firm was thought to carry about fifteen million dollars in insurance. While a substantial increase in the cost of professional insurance would certainly attend an increase in the incidence of auditor's liability, shareholders and the public would undoubtedly be willing to pay the price in return for the assurance of a ruggedly independent auditor.

The accounting profession's efforts to date in the direction of improvement of accounting principles have been less than startlingly impressive. Possibly one obstacle has been a sense that the standard of "generally accepted accounting principles," by providing many versions of the truth each of which is acceptable to the profession, supplies the best possible protection against legal claims. While this may be an accurate appraisal of the law as it has been, the conditions are ripe for legal change. This article, although it stops short of a flat prediction of immediate and precipitous change, has attempted to demonstrate the possibility of a movement in the direction of increased incidence of auditor's liability.

Ironically and unfortunately, the same professional self-criticism that is necessary to bring about an improvement in reporting standards also has the effect of calling attention to deficiencies that may be the basis for lawsuits and of catalyzing potential plaintiffs, legal commentators (such as the instant one), and judges. This is unavoidable in view of the alternative of silence and neglect of the highest of professional responsibilities, but it points up the necessity for haste in accomplishing far-reaching improvements in accounting standards before legal compulsion of one kind or another is employed.

⁷⁸ *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931). See text accompanying notes 28-29, 66-68 *supra*.

⁷⁹ Wise, *The Auditors Have Arrived*, pt. I, *Fortune*, Nov. 1960, p. 151.

The legal duties of the auditor undoubtedly ought to be co-extensive with his professional pretensions. Since he holds himself out as more than a rubber stamp for management, his legal duties should go beyond those appropriate to that status. The most desirable environment for auditor independence would be a state of affairs in which the maximum feasible uniformity grows out of a thoroughgoing, conscientious, and energetic professional effort to develop and apply sound and fair principles and practices and methods of presentation of financial data. The staunchest protection against legal liability for complicity in misrepresentation is the exercise of a high degree of independent, unbiased professionalism.