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Current Problems of Accountants' Responsibilities to Third Parties

T. J. Fiftis*

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* Professor of Law, University of Colorado School of Law. B.S. 1954, Northwestern University; LL.B. 1957, Harvard University School of Law.

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In 1967, the statement was made correctly that "[s]uits against accountants by persons other than their clients have been almost uniformly unsuccessful."¹ Since the assertion of too much independence from clients could result in the accountant's dismissal,² his choice was clear; he knew the hand that fed him was also the only one which could beat him. It therefore is not surprising

1. Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967).

2. Sterling, *Accounting Power*, 136 J. OF ACCOUNTANCY, Jan. 1973, at 61, 63 and Johnson, *Management and Accounting Principles*, 30 LAW & CONTEMP. PROB. 690, 700 (1965) suggest that it is not uncommon for some companies to shop for agreeable auditors.

that "creative accounting"³ should thrive in such an environment.

The unchecked excesses of some managements in financial reporting, however, resulted in the rude jolts of the Westec, Yale Express, and Continental Vending scandals, causing prosecution and plaintiffs' lawyers to develop a small bit of creativity of their own. This resulted in the unprecedented imposition of professional liability in the seminal decisions in *Fischer v. Kletz*⁴ (Yale Express), *Escott v. BarChris Construction Corp.*⁵ and *United States v. Simon*⁶ (Continental Vending) in the late 1960's. This trickle of cases has swollen to hundreds of pending suits against accountants.⁷ Because the reaction has now set in, and legislation aimed at countering the

3. "Creative accounting" is the corruption of accepted accounting principles to present an overall misleading impression as well as the structuring and implementation of transactions primarily for the sake of presenting an attractive financial picture with little or no regard for business goals. See, e.g., STAFF OF SECURITIES AND EXCHANGE COMMISSION, REPORT TO SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY, 92d Cong., 2d Sess. 33-83 (1972); A. BRILOFF, UNACCOUNTABLE ACCOUNTING (1972).

4. 266 F. Supp. 180 (S.D.N.Y. 1967) (accountant may be liable for failure to disclose after-acquired information to correct prior audited statements).

5. 283 F. Supp. 643 (S.D.N.Y. 1968) (accountant has duty to exercise high degree of diligence).

6. 425 F.2d 796 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970) (conformity with GAAP principles no defense to criminal prosecution if financial statements do not "fairly present" condition of corporation). The extent of litigation in the Westec case, also referred to, is described in *Schneider v. Sears*, 265 F. Supp. 257, 259-61 (S.D.N.Y. 1967).

7. Arthur Andersen & Co. 1973 Ann. Rep. 4 estimated 500 suits or claims in progress involving auditors in March 1973; Liggio, *Expanding Concepts of Accountant's Liability*, CALIF. CPA Q. 18, 19 (Sept. 1974) estimated 500 to 1,000 pending actions and over 200 decisions. In this process, the struggle to harness corporate abuses has recently taken a new turn as the SEC and the courts have begun to look to corporate advisors to assume new responsibilities. Commissioner Sommer has listed the reasons why the Commission has focused especially on lawyers and accountants:

- (1) They are in a strategic position to influence management because without their active cooperation, many harmful transactions will not be feasible;
- (2) They have high standards of ethics both personally and institutionally made meaningful through Codes of Ethics and state and federal licensing;
- (3) They generally are independent of the economic fate of the client;
- (4) Society has accorded pre-eminence to both professions and the public's expectations should be met. Unpublished Address by Commissioner A. A. Sommer, American Bar Association, National Institute, Advisors to Management, Responsibilities and Liabilities of Lawyers and Accountants, in New York City, Oct. 3-5, 1974.

This approach, drafting accountants and lawyers into the public service, in preference to client interest, is not too great a change of the publicly stated role of accountants although it is a great shift for lawyers. But even for accountants, there is some difference between the claim that they represent investors and the new vision of the SEC and the courts.

For expressions of this policy, see *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973); *In re Emanuel Fields*, S.E.C. Rel. 33-5404 (6-18-73) in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,407, at 83,172; Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974); Sonde, *The Responsibilities of Professionals Under the Federal Securities Laws—Some Observations*, 68 Nw. U.L. REV. 1 (1973).

judicial onslaught can be expected,⁸ it is timely to review the recent developments in the area of accountants' responsibilities with a view to providing suggestions to federal and state legislatures and courts.

A first step is to understand the activities of accountants and the standards that guide them. Next, three as yet unresolved but fundamental difficulties of accounting that perhaps are the root causes of much of the current litigation will be considered. Lastly, some of the significant current problems of accountants' liability will be reviewed.

I. ACCOUNTANTS' FUNCTIONS

What is it that accountants do?

Their most common activities may be listed as:

- (1) The audit function and other activity involving published and unpublished financial data ranging down to "write up" work.⁹
- (2) Tax services.
- (3) Management advisory services of all types, such as developing data systems or recruiting executives.

Although our concern here will be only with accountants' liabilities involving published financial data, it is necessary to know a little more of the nature of the other services listed in order to place in perspective some of the later discussion.

A. *Functions Other Than Audits*

Large and small businesses retain accountants to prepare tax returns and to plan for local, state, national and international tax matters in business transactions. In this area, the accountant's function frequently substantially overlaps with that of legal counsel, even extending to representation of clients in dealings with governmental agencies and in adversary proceedings before them, such as in the United States Tax Court.¹⁰ The resulting disputes between

8. The American Law Institute is currently engaged in the drafting of a proposed Federal Securities Code with Professor Louis Loss of the Harvard Law School as reporter. See ALI, FEDERAL SECURITIES CODE Tent. Draft No. 1 (1972); Tent. Draft No. 2 (1973); Tent. Draft No. 3 (1974); Reporter's Revision of Text of Tent. Drafts Nos. 1-3 (1974).

Generally, the civil liability provisions contained for the most part in Tentative Draft No. 2 would diminish exposure of accountants substantially below the present level. See *id.* at §§ 1402-06 especially. The most obvious such change is the limitation of damage liability in § 1403. But the Code's other provisions would reverse numerous existing decisions. The analysis of the Code provisions will be the subject of another paper and will not be of central concern here.

9. See note 13 *infra* and accompanying text for a brief description of "write up" work.

10. Under the Internal Revenue Code, accountants may be licensed to practice before the Tax Court. 26 U.S.C. § 7452 (1970).

the two professions are based on considerations ranging from economic self-interest to the adequacy of service to the client and have been the subject of a discrete history that need not be reviewed here.¹¹

Frequently, perhaps because the parties feel the tax considerations are the *only* considerations, accountants negotiate business transactions and draft documents without legal advice. Some accountants, who also hold law degrees, purport to be able to function in both capacities simultaneously. These activities are not condoned by either profession, and most knowledgeable practitioners in each field recognize the need for symbiosis of two professionals in these matters.¹²

Many large and small accounting firms act as marriage brokers in corporate acquisitions. Their activities include finding, evaluating and recommending suitable merger candidates to prospective acquiring companies. Some promote tax shelter opportunities for their clients' employees as a part of compensation planning. Other advisory functions are performed by many firms as a substantial part of their business; management consulting services range from advising on record-keeping and data processing systems analysis through actuarial services, budgeting, forecasting, employee efficiency studies, production planning and marketing. Some firms even provide executive recruiting services—evaluating and recommending employment of top officers.¹³

Many small firms perform "write up" work, which is a very substantial segment of their practices. Write up work ranges from complete record-keeping services to making adjusting entries and drafting statements.

Nevertheless, the primary reason for the existence of the accounting profession and the accountant's predominant activity is the audit function and its related activities.¹⁴ What is an audit?

B. *The Audit Function—A Thumbnail Sketch*

In essence, like most communication tasks, an audit consists of:

11. See 2 J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION*, ch. 9 (1970).

12. See, e.g., Loeh & Leete, *The Dual Practitioner: CPA, Lawyer, or Both?*, 135 J. OF ACCOUNTANCY, Aug. 1973, at 57.

13. See generally A. BRILOFF, *THE EFFECTIVENESS OF ACCOUNTING COMMUNICATION*, ch. 6 (1967); 2 J. CAREY, *supra* note 11, at 191-203; MONTGOMERY'S AUDITING 535 (8th ed. N. Lenhart & P. Defliese 1957) [hereinafter cited as MONTGOMERY'S AUDITING]-.

14. Arthur Andersen & Co. in 1973 received revenues from its various activities in the following proportions:

Accounting and Auditing	69%
Tax Practice	18%
Management Advisory Services	13%

Arthur Andersen & Co. 1973 Ann. Rep. at 32.

- (a) Investigation and collection of data;
- (b) Drawing of inferences from the findings; and
- (c) Presentation of conclusions.¹⁵

Many variations of an "audit" are possible, ranging from a complete, transaction by transaction reconstruction and investigation of everything done by the client's recordkeepers and other employees, to the opposite extreme of merely reading a statement of accounts receivable.¹⁶ Of necessity, practical limitations and the purpose of the examination will dictate the scope of the audit. And, because the environment changes with time and other conditions, including the general state of the economy, existing technology, habits of thought, the particular company and industry, and even morals, no two audits are identical. Because of the many variations possible, good practice calls for a written agreement defining the scope of the engagement.¹⁷

For large accounting firms, the hierarchy of auditing personnel, in descending order, comprises "partners," "managers" (or "supervisors" or "principals"), "seniors," "semi-seniors" and "juniors." The partner is usually in charge of several simultaneous audits and may or may not participate in the field work at the client's premises. The manager will participate in the field work although he too has

15. Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 803 (1959). The following textual description of the audit process is taken largely from MONTGOMERY'S AUDITING ch. 4.

16. MONTGOMERY'S AUDITING *supra* note 13, at 9-10 states:

Classification of Audits.—The work of the independent public accountant in examining financial statements has long been referred to as an audit. Since the word "audit" is a general expression, there have been many attempts to classify the various activities of public accountants by more descriptive terms, such as "detailed audit," "complete audit," "continuous audit," "test audit," "protective audit," "balance sheet audit," and others. None of these expressions has proved satisfactory, and they are more and more falling into disuse.

It is logical to classify audits into two general divisions: (a) examinations of financial statements for the purpose of expressing a professional opinion whether they present fairly the financial position of a business at a given date and the results of its operations for a stated period, in conformity with generally accepted accounting principles consistently applied, and (b) examinations for various purposes, as a result of which it is not expected that the public accountant will state his opinion regarding the financial statements as a whole. The former examination is often referred to simply as an 'examination of financial statements.'

17. MONTGOMERY'S AUDITING, *supra* note 13, at 36; see 1136 Tenants' Corp. v. Max Rothenburg & Co., 27 App. Div. 2d 830, 277 N.Y.S.2d 996 (1967), *aff'd*, 21 N.Y.2d 995, 290 N.Y.S.2d 919 (1968) (evidence raised issue of fact as to nature of engagement), 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971) (affirming trial court's finding of engagement to audit), *aff'd*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972), in which a failure to follow this practice resulted in a dispute as to whether a full audit was agreed to (although the court held that under the circumstances, liability existed regardless of the scope of the engagement).

multiple engagements at most times. As part of the engagement, each individual supervises, guides, and then reviews the work of his subordinates.¹⁸

(i) The preliminary survey of facts.

The first stage undertaken is planning the audit in conformity with the scope of the engagement. When an accountant is employed for a full audit of a client for the first time, usually the partner in charge will make a preliminary survey of the business, gleaning information about the nature of the business, sales trends, manufacturing and marketing techniques, sources of raw materials, conditions in the industry, major customers, products, personnel, budgeting and accounting systems, characteristics of management, affiliations and the like. In this process, he will collect and review both oral and written data such as organizational charts, annual reports, prior tax returns and financials, accounting manuals, and marketing literature. Either at this point or later, an on-site inspection of major plant and facilities also will be made.

At this stage he should make an intensive analysis of the prior financial statements, studying ratios and trends to determine unusual variations, sluggish turnover of inventory, manipulations, etc. Also, the basic accounting policies being followed by the client will be ascertained. These policies may be contained in company manuals and minutes or no consistent policies may be followed. The auditor also now must become familiar with the company's accounting procedures—including charts of names of accounts, journals and ledgers used, and the like.

The reason for this preliminary survey is clear: sound planning of the audit dictates that the auditor understand the nature of the client's business, its operations and organization.

(ii) Planning the "audit program."

After this preliminary survey, the next step in the planning stage is development of the "audit program," the guide to the audit describing the "audit procedures:" the what, how and when to do certain things in checking the client's accounting. This task may

18. Given the distaste of accountants for audit field work, it usually falls to the youngest and newest employees to perform this task. As a result, the supervising and reviewing functions are extremely important, since it is fair to say that bewilderment far outweighs understanding in most initiates. Sometimes the more experienced find the complexities beyond their ken. *See, e.g.*, the comments on the work of the senior accountant in *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697-703 (S.D.N.Y. 1968). The SEC in *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 715-16 (1939) placed great emphasis on the review function.

rest primarily on the senior, who will report to and consult with the manager or partner on some questions.

"Auditing procedures" are designed to establish the reliability and integrity of the client's system of "internal controls" over its activities. "Internal control" means the client's *record-keeping* system and its system of *checking* the operations of the business, for example, the subsystem of matching reports of the receiving department for goods received with vendors' invoices.¹⁹ Audit procedures further include independent checking, such as confirmation of accounts receivable with customers or of bank balances with banks.

The auditor probably will develop a skeleton audit program based on an opening trial balance of all the ledger accounts, the preliminary survey data including a reading of the documents obtained, and audit procedures common to most audits, such as the confirmation of bank balances, just mentioned. Although he is not an insurer against fraud on the client, he must always give consideration to "the possibility [that] fraud may exist."²⁰ Moreover, an even higher awareness must be had of the possibility of deliberate misrepresentation by management to investors. The discovery of such misrepresentations "is usually more closely associated with the objective of the ordinary examination,"²¹ than is the discovery of fraud on the company.

The skeleton audit program will be re-examined after the auditor reviews and tests the client's internal control system. The better the internal control system the more reliable will be the testing and sampling by the auditor and hence less detailed checking will be required. The internal control system includes not only matters of relevance to the audit, but also administration of all aspects of the business; the auditor need consider only those controls that relate to the safeguarding of assets from loss and the reliability of the financial records. He will make a detailed examination of them in order to determine when he may rely on the client's system and when he must reinforce that system with his own procedures. He will also test the client's system by tracing sample transactions from start to finish to assure that it in fact operates as represented.

Based on the results of his review and testing of the client's

19. For cases illustrating the inadequacy of an internal control system, see *Bates v. Dresser*, 251 U.S. 524 (1920); *Maryland Cas. Co. v. Cook*, 35 F. Supp. 160 (E.D. Mich. 1940); *National Sur. Corp. v. Lybrand*, 256 App. Div. 226, 9 N.Y.S.2d 554 (1939); *Dantzer Lumber & Export Co. v. Columbia Cas.Co.*, 115 Fla. 541, 156 So. 116 (1934); *Fox & Son v. Moorrish, Grant & Co.*, 35 T.L.R. 126 (K.B. 1918).

20. AICPA, *Statement on Auditing Standards No. 1*, in 1 CCH AICPA PROF. STANDS. AU § 110.05 (1974) [hereinafter cited as SAS].

21. *Id.*

internal control system as well as the results of the study of the preliminary survey, he will prepare a revised audit program, which will consist of specific procedures to test the reliability of the financial statements including, for example, such matters as testing and sampling the books of account for accuracy, reading corporate minutes, contracts and leases (internal evidence), and confirming bank accounts with the bank and receivables with the client's debtors (external evidence).

This generally is the bulk of the work. The audit program is always regarded as merely tentative and to be modified as facts unfold in the process of carrying out the procedures. For example, the necessity of probing suspicious circumstances may require additional procedures.

(iii) Implementation and adjustment of the audit program.

The planning stage is completed at this point and the audit program is ready for implementation. In this stage of the process, the auditor must continue his healthy skepticism, for example, scrutinizing documents closely for suspicious deletions or interlineations, backdating, lack of dating, forgeries and the like. In every case, materiality and the probabilities of the situation will call for more or less attention. "It is fundamental that there should be stronger grounds to sustain the auditor's opinion of relatively important items in the financial statements and those with possibilities of relatively material error than are required to sustain his opinion of items without these characteristics."²² Financial insecurity of the business also has a significant influence on how far the auditor's procedures must go.

When the auditor begins the audit program, he will record in "working papers" his work and findings. Each page will be dated and initialed by all persons who dealt with it. The papers should be indexed and bound and retained for some years. They should also be comprehensible as they are intended for use by others as well as for later use.

A trial balance is usually the first working paper. Other standard working papers are data from the corporate charter, by-laws, and minutes and analyses of accounts, prescribed by the audit program. One of the last working papers will be the management's "letter of representation" executed by the top officers, stating that no relevant post-balance-sheet-date events or other matters make the financial statements misleading, that disclosure of all known

22. MONTGOMERY'S AUDITING, *supra* note 13, at 49.

shortages has been made, that complete and correct corporate minutes have been supplied, and other matters of like import.

The working papers not only form the basis for integration of the audit findings with the financial statements but also are the facts that a partner or other reviewer of the field work will check. The SEC has stated that the working papers must support in detail any unusual items as well as all others.²³ They also should establish the adequacy of the audit procedures.

(iv) The auditor's report.

After completion of the field work and discussions with management of questions raised as to the form of the financial statements, the auditor will "report" on whether he conducted his examination in accordance with generally accepted auditing standards (GAAS) and whether the statements are presented in accordance with generally accepted accounting principles (GAAP) consistently observed in relation to the prior period. The distinction between accounting principles on the one hand and auditing standards and procedures on the other must be kept in mind for much misunderstanding has occurred in judicial opinions and other lawyers' work because of a lack of discrimination between them, even among sophisticated corporate lawyers. This may be because in some cases the two overlap. Nevertheless, by and large they are separate domains.

"Auditing standards" address the objectives to be attained by the audit and fix the standard of quality of performance of the audit procedures. GAAS, as established by the AICPA, require the auditor to exercise skill, independence and care, compel adequate planning and supervision of the audit including evaluation of the client's internal controls and independent confirmations, and require the report of compliance with GAAP.²⁴

23. *Interstate Hosiery Mills, Inc.*, 4 S.E.C. 706, 715-16 (1939).

24. The "generally accepted auditing standards" as established by the AICPA have been briefly stated:

General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. There is to be a proper study and evaluation of the existing internal control as a basis

“Accounting principles,” distinguishable from both auditing standards and auditing procedures, generally deal with such facts or conclusions as the existence of a deposit in the sum of \$1,000 to the First National Bank which is still outstanding, and provide for certain accounting treatment of that fact; *e.g.*, that the bank deposit will be designated “Cash” in the accounts, instead of, for example, “Accounts Receivable—First National Bank.”

In order for accounting principles to be considered GAAP they should have substantial authoritative support. The sources for determining whether a particular principle has substantial authoritative support are the following: practices commonly used in business that have proven dependable; the views of stock exchanges, commercial and investment bankers, and regulatory agencies, especially the SEC; affirmative opinions of practicing and academic accountants in oral or written opinions, expert testimony, textbooks and articles; and published opinions of the AICPA and the academic accountants’ organization, the American Accounting Association.²⁵ Thus, accountants define GAAP as going beyond custom; the words, “generally accepted,” are given a meaning contrary to their normal meaning since customary practices are only one type of GAAP.

The auditor’s report may be:

(a) “Unqualified”—indicating that the statements are presented fairly, that his opinion was formed on the basis of an examination made in accordance with GAAS, and that the statements conform with GAAP consistently applied, and include all disclosures necessary to make the statements not misleading. This is the

for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor’s examination, if any, and the degree of responsibility he is taking.

SAS No. 1, *supra* note 20, at AU § 150.02.

25. P. GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES, AICPA ACCOUNTING RESEARCH STUDY No. 7, 52-53 (1965).

standard accountant's report found affixed to most audited financial statements.²⁶

(b) "Qualified"—same as above with certain qualifications and clearly explained reasons and descriptions of the effect on the statements.²⁷

(c) "Adverse"—stating that the statements are not fairly presented in conformity with GAAP, or

(d) A "Disclaimer of Opinion"—stating that the auditor is unable to express an opinion because of a serious limitation on the scope of the examination.²⁸

This completes the audit.

Keeping this broad outline of the audit process in mind will facilitate an understanding of the following discussion of some of the problems of accountants' responsibilities.

II. THREE FUNDAMENTAL PROBLEMS OF ACCOUNTING

Accountants, starting with the highest aspirations to provide fair and unbiased reports, have learned that it is one thing to have noble ambitions and another to achieve them. Doubtless they seek to do a good job, but some unsolved problems of accounting remain, which frustrate full realization of this goal. These are the problems of the modular, artificial nature of financial reporting, the independence of individual auditors, and the impartiality of the profession.

A. *Accounting As A Model of the Real World, and the Pygmalion Syndrome.*

Pygmalion's statue may have been given life by Venus, but

26. Typically, it reads:

Auditors' Report

To the Shareholders of X Corporation: We have examined the consolidated balance sheet of X Corporation (a Delaware corporation) and subsidiaries as of December 31, 19___, and the related statements of consolidated earnings retained for requirements of the business and consolidated application of funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements described above present fairly the financial position of X Corporation and subsidiaries as of December 31, 19___, and the results of their operations and application of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Chicago, Illinois, March 19, 19___

/s/Readem & Weep

27. SAS No. 2, ¶ 32-34, in 138 J. OF ACCOUNTANCY, Dec. 1974, at 87, 91-92, now requires the report to contain a separate explanatory paragraph.

28. See SAS No. 1, *supra* note 20, at AU §§ 510-14, repealed and replaced for statements dated after December 31, 1974 by SAS No. 2, note 27 *supra*.

such miracles do not often occur; models stay models and although they bear some similarities to the real world, in many ways they are quite misleading. While a realistic marble statue may accurately portray a human being as having four limbs, a head and torso, standing erect and having certain other features, a visitor from another planet, not knowing the qualifications on the statute, could be deceived into believing that earthlings are rigid, hard to the touch, unthinking and monochromatic.

Thus, one viewing any model constantly must bear in mind that, unlike Pygmalion's virgin, it is not the real world. Despite the simplicity of this caveat, many otherwise sophisticated businessmen and even accountants display the Pygmalion Syndrome,²⁹ and many, perhaps most, laymen fall into the same error, believing that the facts, rather than a modular abstraction of the facts, are contained in financial statements. They are not.

Homer Kripke has dealt with the concept in different terms, pointing out the qualifications on what he said some people call accounting "facts," noting:

(a) They represent probabilities, not absolutes (*e.g.*, accounts receivable are reduced by a statistically derived estimate of probable bad debts);

(b) Conservatism in communicating these probabilities from a securities seller's viewpoint (*e.g.*, non-inclusion of a probable ore discovery) in a registration statement is non-conservatism when a buyer does the same thing (*e.g.*, on an insider purchase), and the SEC's conservatism for sellers' statements has worked perversely for buyers' statements;

(c) Alternative accounting choices yield different "facts" for the same event (*e.g.*, inventory valued on a FIFO basis may be carried at a much higher figure with resulting higher profit than when the same inventory is valued on a LIFO basis);

(d) Accounting principles change with time and hence accounting "facts" change; and

(e) Accounting "facts" are sometimes arbitrary determinations because some GAAP are merely rules of the road selected from among equally suitable alternatives.³⁰

Kripke finally concludes that the qualifications on the model are so many and so technical that financial disclosure rules should be based on communicating only with sophisticated users of financial statements, because the real world differences from the model can never be understood fully by the layman, and, in any event, the intelligent investor acts by getting at least part of his information from professionals.³¹

29. The term is not mine. See J.L. SYNGE, TALKING ABOUT RELATIVITY 18 (1970).

30. Kripke, *Rule 10b-5 Liability and "Material" "Facts"*, 46 N.Y.U.L. REV. 1061, 1070-75 (1971).

31. Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1165-68 (1970). The question was raised in A. BRILOFF, THE EFFECTIVENESS OF ACCOUNTING COMMUNICATION 225-26 (1967) without resolution.

Other manifestations exist of accounting's modular nature. Accountants, in discussing the problem of cost or value,³² in reality are raising the question of whether to develop a different model from the historical cost model because it may work better to solve some real world problems. Historical cost, like a flat map, has sophisticated uses, but fair value accounting, like a globe, may be better for other, perhaps less sophisticated, purposes. For example, the historical cost of an asset owned by a firm has been forcefully stated to be a "fact" useful to expert users, while the estimated current fair market value has been said not to be a fact.³³ Yet it is clear that an ordinary investor asked to sell his shares might be misled if the "fact" of historical cost was stated but the non-fact of a current value three times as much was not.³⁴ The use of the historical cost accounting model in this case is deceptive to one unfamiliar with its limitations.

Thus, the current accounting model is likely to mislead the layman, unaware of its qualifications, into believing it depicts the facts of the real world, and therefore is inappropriate for lay users.³⁵ The next logical question is whether we can develop a model that can be used by laymen.³⁶ In the meantime, the question of immediate interest for this paper is whether accountants should be held liable for the limitations of the current accounting model which mislead lay investors.

Before considering this particular question, two other unresolved difficulties of the accounting profession will be described.

32. See, e.g., G. MAY, FINANCIAL ACCOUNTING 86-88 (1943); H. ROSS, FINANCIAL STATEMENTS, A CRUSADE FOR CURRENT VALUES (1969).

33. Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 BUS. LAWYER 300, 308-09 (1961).

34. *Fogler v. Norcan Oils Ltd.*, 43 D.L.R.2d 508 (Alta. Sup. Ct. 1964), *rev'd on other grounds*, 46 D.L.R.2d 630 (Canada, 1964). *But see Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-94 (2d Cir. 1973); *Kobn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972); *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447, 450-51 (10th Cir. 1968); *Denison Mines Ltd. v. Fibreboard Corp.*, CCH FED. SEC. L. REP. ¶ 94,869, at 96,960 (D. Del. 1974).

35. Two very unconventional models eliminate financial statements as such in favor of a textual format. See *Wheelabrator-Frye Inc. 1973 Ann. Rep. for Young People at 14* (designed for children and using a pie chart distribution reading in this vein: "We mentioned earlier that Wheelabrator-Frye received \$256,000,000 from its sales to customers in 1973. . . . Now let's see who was paid how much—and for what: . . ."); *Arthur Andersen & Co. 1973 Ann. Rep.* (designed for Andersen's partners and audit clients and using a similar although less "pabulumatic" vocabulary). Is there a message in these reports serving the least and the most sophisticated in nearly identical fashion?

36. The central problem of accounting has been just this for over 30 years. See G. MAY, FINANCIAL ACCOUNTING 86-117 (1943). See T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS, ch. 7 (1971) describing the three prototype models now available: historical cost, price-level, and fair market value.

B. Independence of the Individual Auditor

In addition to the duties of skill and care common to most callings, a unique attribute required of accountants, independence, poses a second unresolved problem: GAAS establish a standard of "independence in mental attitude" for auditors.³⁷ Because public confidence in auditors' independence is essential, not only actual but also apparent independence is necessary. It is a question of fact in each case³⁸ and hence difficult to ascertain. Moreover, true inde-

37. SAS No. 1, *supra* note 20, at §§ 150.02, 220; 2 CCH AICPA PROF. STANDS. ET § 52 (1974).

38. The standard of the profession for independence is "whether reasonable men, having knowledge of all the facts and taking into consideration normal strength of character and normal behavior under the circumstances, would conclude that a specified relationship between a CPA and a client poses an unacceptable threat to the CPA's integrity or objectivity." Code of Professional Ethics, 2 CCH AICPA PROF. STANDS. ET § 52.09 (1974). The Rules of Conduct for Independence are Rules 101 and 102:

Rule 101—Independence. A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise. Independence will be considered to be impaired if, for example:

A. During the period of his professional engagement, or at the time of expressing his opinion, he or his firm

1. Had or was committed to acquire any direct or material indirect financial interest in the enterprise; or
2. Had any joint closely held business investment with the enterprise or any officer, director or principal stockholder thereof which was material in relation to his or his firm's net worth; or
3. Had any loan to or from the enterprise or any officer, director or principal stockholder thereof. This latter proscription does not apply to the following loans from a financial institution when made under normal lending procedures, terms and requirements:
 - (a) Loans obtained by a member of his firm which are not material in relation to the net worth of such borrower.
 - (b) Home mortgages.
 - (c) Other secured loans, except loans guaranteed by a member's firm which are otherwise unsecured.

B. During the period covered by the financial statements, during the period of the professional engagement or at the time of expressing an opinion, he or his firm

1. Was connected with the enterprise as a promoter, underwriter or voting trustee, a director or officer or in any capacity equivalent to that of a member of management or of an employee; or
2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had a direct or material indirect financial interest in the enterprise; or was a trustee for any pension or profit-sharing trust of the enterprise.

The above examples are not intended to be all-inclusive.

2 CCH AICPA PROF. STANDS. ET § 101.01 (1974).

Rule 102—Integrity and Objectivity. A member shall not knowingly misrepresent facts, and when engaged in the practice of public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others.

pendence, or at least an appearance of true independence, arguably has never been achieved.

The profession recently has taken an important step in the quest by making it an ethical violation for an AICPA member to certify that financial statements are in conformity with GAAP if they depart from official pronouncements of the "body designated by Council" of the Institute.³⁹ This means that in those situations

In tax practice, a member may resolve doubt in favor of his client as long as there is reasonable support for his position.

Id. ET § 102.01.

These rules have been supplemented by Ethics Opinions and Interpretations of Rules of Conduct of the Institute's Ethics Division. *See also* SEC Accounting Series Release No. 47 (Jan. 25, 1944) CCH FED. SEC. L. REP. ¶ 72,065 (hereinafter the Commission's Accounting Series Releases will not be cited to CCH because they appear in consecutive order there).

39. Rule 203 of the Rules of Conduct of the AICPA Code of Professional Ethics (1973). The full text of the rule reads:

Rule 203—Accounting principles. A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

2 CCH AICPA PROF. STANDS. ET § 203.01 (1974).

"In the spring of 1973, the Council of the Institute designated FASB as the body to establish accounting principles pursuant to Rule 203. It also specified that Accounting Research Bulletins and Opinions of the Accounting Principles Board adopted by the APB by June 30, 1973, shall constitute accounting principles promulgated by a body designated by Council pursuant to Rule 203 until they are superseded by action of the FASB." Carmichael & Rosenfield, *The Transition to the FASB and Rule 203*, 136 J. OF ACCOUNTANCY, Sept. 1973, at 94. *See* Appendix B and Interpretations of Rules of Conduct 203-1 and 203-2, 2 CCH AICPA PROF. STANDS. ET §§ 203.01-.02 (1974). Rule 203 represents an extremely important milestone in establishing accounting principles although it falls short in two respects: (1) In the vast area of problems not covered by FASB or APB Opinions or ARB's it has no effect; (2) it works indirectly by imposing ethical obligations on members of the AICPA—thus not reaching issuers of statements or even auditors who are non-members of the AICPA. The history of the AICPA's efforts to provide sanctions for its pronouncements may be traced by reading: (a) Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies in Accounting Practice: An Interim Appraisal*, 30 LAW & CONTEMP. PROB. 706 (1965) (for history until mid-1965); (b) APB Op. No. 6, App. A, 2 CCH AICPA APB ACCOUNTING PRINCIPLES 6531 (1965); and (c) Carmichael & Rosenfield, *supra*. For a good history to November 1971, see Brief of Arthur Andersen & Co., Before the Study Group on Establishment of Accounting Principles of the AICPA, App. C (1971).

Kripke, prior to Rule 203, asserted that, "The ultimate sanction for the opinions of the [APB] presently comes not from the Ethics Committee of the AICPA—but from the fact that the SEC refuses to accept accounting statements that are not certified as being in accord with [GAAP], and thus the SEC has made the [APB] its unofficial legislative arm." Address by Homer Kripke, Conference on Institutional Issues Related to Formulating Reporting Standards, Northwestern Univ., Oct. 18-19, 1971, citing Kripke, *Is Fair Value Accounting the Solution?*, 26 BUS. LAWYER 289 (1970). *See also* SEC Accounting Series Release No. 150 (Dec. 20, 1973).

Whether AICPA pronouncements establish standards for nonmembers of the AICPA is

covered by formal pronouncements, unlike those not so covered, management may not select the accounting principles to be followed and get unqualified auditor's opinions unless they comport with the formal statements. Prior to this rule, management could select from among alternative principles even when formal pronouncements were different, and the auditor had to approve if the principle had any support.⁴⁰

Another procedural technique aimed at reinforcing independence by way of providing additional incentive to auditors is the stepped-up effort in the area of peer reviews.⁴¹

In addition, recognizing the need for the force of law behind some aspects of the independence issue, Congress in the securities acts conferred power on the SEC to maximize independence and rules have been adopted by the Commission to further this end.⁴²

Recently the Commission has begun a new attack on the independence problem. The first salvo was an effort to diminish client pressures on accountants by requiring disclosure in SEC filings of a change in auditors and disagreements that could have or did require mention in the auditor's report.⁴³ In addition, as a matter of policy,

not clearly settled. But a few courts have in certain circumstances applied the AICPA standards as industry standards. *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972); *Stanley L. Bloch, Inc. v. Klein*, 45 Misc. 2d 1054, 258 N.Y.S.2d 501, 506 (Sup. Ct. 1965).

40. P. GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES, AICPA ACCOUNTING RESEARCH STUDY No. 7 at 47-54 (1965); cf. APB Op. No. 6, App. A, 2 CCH AICPA APB ACCOUNTING PRINCIPLES 6531 (1965). See also Miller, *Audited Statements—Are They Really Managements'?*, 118 J. OF ACCOUNTANCY, Oct. 1964, at 43.

41. Under 2 AICPA plans, one for local and the other for multiple office firms, a review by a panel of auditors from other firms may be arranged, at the expense of the subject firm. For descriptions see AICPA, SPECIAL COMMITTEE TO STUDY QUALITY REVIEW FOR MULTI-OFFICE FIRMS, PLAN FOR IMPLEMENTATION OF AICPA VOLUNTARY PROGRAM FOR REVIEWS OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS (April 1974); Bruschi, *The Institute's Local Firm Quality Review Program*, 137 J. OF ACCOUNTANCY, Mar. 1974, at 109.

The SEC by several consent orders has established peer review procedures. *In re Loux, Gose & Co.*, SEC Accounting Series Release No. 160 (Aug. 27, 1974); see *Touche Ross & Co.*, SEC Accounting Series Release No. 153 (Feb. 25, 1974).

42. The Commission has adopted disciplinary Rule 2e, 17 C.F.R. § 201.2(e), 4 CCH FED. SEC. L. REP. ¶ 66,102 (1971), imposing sanctions for unethical conduct, and Rule 2-01 of Reg. S-X, 17 C.F.R. § 210.2-01, 4 CCH FED. SEC. L. REP. ¶ 69,122 (1972), to implement this power. Rule 2-01 gives these examples of facts that spoil independence: direct financial interests or material indirect financial interests in the client or connection with the client as a promoter, underwriter, voting trustee, director, officer or employee. These examples have been fortified by releases specifying actual situations where independence was lacking. Several ASR's and administrative proceedings consider the issue of independence. For a partial list, see SEC Accounting Series Release No. 126 (July 5, 1972).

43. SEC Securities Act Release No. 9344 (Sept. 27, 1971); SEC Form 8-K, Item 12, 3 CCH FED. SEC. L. REP. ¶ 31,003 (1971). For a similar requirement for broker-dealers, see SEC Rule 17a-5, 17 C.F.R. § 240.17a-5 (1972). A sampling of some 300 8-K forms in late 1971 turned up 13 changes of auditors and no indications of any disagreements. Wall Street J.,

the Commission in conferences with clients generally has shored up auditors' positions with their clients. Moreover, it has several times recommended the use of audit committees of outside directors to facilitate communication with the disinterested segments of the board.⁴⁴ Most recently additional disclosures were required in form 8K's, proxy statements and financials, regarding termination of old auditors as well as engagement of new ones.⁴⁵

Despite these efforts to enhance independence, major structural characteristics of the practice of accounting remain a roadblock to full independence. The substantial write-up work of many small firms and the management and tax advisory services of larger ones have been attacked as threats to independence.⁴⁶ Both write-up work and management advising, it is said, place the auditor in a position of being part of management as well as having to assess the results of his own work, which imposes pressure for a biased report.

The economic self-interest of the accountant in preserving this business so far has prevented the profession from prohibiting it. Indeed, the AICPA Code of Ethics was painstakingly drafted to legitimize expressly these activities.⁴⁷ Yet, the divorce of auditing from management advisory services à la the Glass-Steagall Act of 1933⁴⁸ remains a live suggestion for the enhancement of independence.

Other steps also remain available but have not yet been taken. Apparently no one has suggested a return to anything like the original practice in England under which shareholders were designated as "auditors" and empowered to hire accountants at company expense to help in the audit.⁴⁹ Suggestions have been made for selec-

Feb. 7, 1972, at 9, col. 2. In one study, 250 auditor changes resulted in 14 reported disagreements. Bedingfield & Loeb, *Auditor Changes—An Examination*, 137 J. OF ACCOUNTANCY, Mar. 1974, at 66.

44. SEC Accounting Series Release No. 126 (July 5, 1972); *id.* No. 123 (Mar. 23, 1972).

45. SEC Accounting Series Release No. 165 (Dec. 20, 1974); see Hawes, *Stockholder Appointment of Independent Auditors: A Proposal*, 74 COLUM. L. REV. 1 (1974).

46. See 2 J. CAREY, *THE RISE OF THE ACCOUNTING PROFESSION* 191-203 (1970) for a description. A student has suggested that the practice of many firms in placing ex-employees with clients also hinders independence.

47. Rule 102, Code of Professional Ethics, 2 CCH AICPA PROF. STANDS. ET § 102.01 (1974); Interpretations of Rules of Conduct, 2 CCH AICPA PROF. STANDS. ET § 101.04 (1974). In ASR No. 126, the Commission stated: (a) "Write-up work" for the client prevents independence as does certain recordkeeping not involving preparation of the basic records but including any on which the auditor's report will be based. (b) Systems design including computer programming would not affect independence.

48. 12 U.S.C. § 24. That act required separation of investment banking from commercial banking. Only the statute as originally enacted contains the effective date of the divorce. Ch. 89, § 16, 48 Stat. 184-85.

49. A. LITTLETON, *ACCOUNTING EVOLUTION TO 1900*, at 289 (1933, reissued 1966).

tion of accountants by the SEC,⁵⁰ and selection of accounting principles by the auditor rather than management.⁵¹ The judge in one case suggested that some procedure should be developed for permitting a court, presumably on petition of the auditor or some interested person, to order the retention of an auditor under certain circumstances even after dismissal by management.⁵²

Despite all these other efforts and suggestions, perhaps the greatest force for independence today is liability of accountants to SEC administrative and injunctive actions and criminal sanctions together with civil liability to private parties. This liability plus the *Simon* rule, discussed below,⁵³ requiring statements that comply with GAAP also to pass a lay jury's test of whether they are misleading, appear to have had a great effect on the independence of auditors.

C. *Impartiality of the Profession*

In addition to the problem of the personal independence of accountants from corporate managements, a problem of institutional dependence also exists. The erstwhile principle-making arm of the AICPA, the Accounting Principles Board, and before it, the Committee on Accounting Procedures, were staffed by practitioners—usually partners in the Big Eight firms. Frequently they were the object of heavy pressures exerted by some of the large corporate clients of their accounting firms as well as their own partners—with the result that many accounting principles were more the result of political pressure than of public discussion, research and reasoned deliberation.⁵⁴

50. Johnson, *Management and Accounting Principles*, 30 LAW & CONTEMP. PROB. 690, 701 (1965).

51. *E.g.*, A. BRILOFF, THE EFFECTIVENESS OF ACCOUNTING COMMUNICATION, 55-85, 114-47 (1967); Kripke, *Conglomerates and the Moment of Truth in Accounting*, 44 ST. JOHN'S L. REV. 791, 792-94 (Spec. ed. 1970); Sterling, *Accounting Power*, 135 J. OF ACCOUNTANCY, Jan. 1973, at 61, 65-67.

52. *Pacific Acceptance Corp. Ltd. v. Forsyth*, [1970] 92 W.N. (N.S.W.) 29, 126 (Moffitt, J.).

53. *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), discussed at text accompanying notes 138-44 *infra*.

54. See Brief of Arthur Andersen & Co., Before the Study Group on Establishment of Accounting Principles of the AICPA (1971). The Committee on Accounting Procedure issued 51 Accounting Research Bulletins and 4 Accounting Terminology Bulletins from 1939 until its termination in 1959. These were non-binding and merely advisory in nature. They were poorly drafted, unsupported by significant research or public discussion, not guided by agreed-upon fundamental criteria, and generally avoided controversial problems. The Committee was replaced by the Accounting Principles Board which issued 31 Opinions and 4 Statements through 1973. The Board did establish a research program to form a basis for its opinions, and to date 15 Accounting Research Studies have been published. However, little

Recognizing this institutional dependency, the defects in existing procedures, inadequate research and non-existent public input, and aware of the most logical cure—establishment of accounting principles by some governmental agency—accountants recently have made what most of them concede to be their last ditch effort to keep this principle-making power from the governmental sector. The founding of the Financial Accounting Standards Board (FASB) was a desperate attempt to keep government out as well as to form a centralized authority free of untoward influences.

The FASB was established in 1972 pursuant to the recommendation of the AICPA Study Group on Establishment of Accounting Principles chaired by Francis M. Wheat.⁵⁵ It is composed of seven members appointed for staggered, five year terms. To assure independence, members must cease all other existing employment and are paid a handsome salary, currently about 100,000 dollars per annum.

The members of the Board are appointed by the Trustees of the Financial Accounting Foundation, an independent corporation. Eight of the nine trustees of the Foundation are elected by the Board of Directors of the AICPA and the ninth is the senior elected officer of the Institute. In addition to the Board, the Trustees nominate members to an advisory body, named the Financial Accounting Standards Advisory Council, who function strictly as advisers to the FASB.

Under its published Rules of Procedure, sound research and wide public participation in establishing standards is assured by the FASB's process of research, public hearings, and exposure for comment of draft statements. The FASB probably has power under the broad wording of its mandate to fix auditing standards⁵⁶ but the general understanding is that it is to deal exclusively with accounting principles.

After a slow start resulting in its first pronouncement in December 1973,⁵⁷ the Board tackled several major issues including report-

effort was made to obtain public input. At the October 1964 meeting of the Council of the Institute, a statement was adopted which provided that material departures from Opinions of the APB must be disclosed in footnotes or in the auditor's report. See APB Op. No. 6, App. A, 2 CCH AICPA APB ACCOUNTING PRINCIPLES 6531 (1965).

It was not until the last year of the APB that the Code of Professional Ethics Rule 203 was adopted compelling observance of formal statements of a body "designated by Council." 2 CCH AICPA PROF. STANDS. ET § 203.01 (1974).

55. See FASB, RULES OF PROCEDURE (1973); FINANCIAL ACCOUNTING FOUNDATION, CERTIFICATE OF INCORPORATION/BY-LAWS (1973) which form the major bases for the immediate discussion.

56. See FINANCIAL ACCOUNTING FOUNDATION, *supra* note 55 at 1, 3.

57. FASB, Statement of Financial Accounting Standards No. 1, Disclosure of Foreign

ing effects of general price level changes and accounting for intangibles. With only three published statements in nearly two years and the largest crisis in accounting history overhanging the profession, the deliberate speed of the FASB has been criticised.⁵⁸ The AICPA, through its Ethics Rule 203 and its Council's designation of the FASB as the principle-making body,⁵⁹ the SEC⁶⁰ and the New York Stock Exchange,⁶¹ however, have given their full endorsement to the FASB. Success seems likely, especially since no other program, including one that would involve a governmental agency as the primary principle-making body, seems attractive or feasible.

One aspect of the constitution of the Board bears comment. Perhaps more nonaccountants should be on the Board. Recognizing that accountants will consider others to be amateurs in the field to which accountants have devoted their careers, nevertheless it is not remiss to suggest that many of the problems of the Board are not professional accounting problems. Many are legal and drafting problems. Anyone studying the old pronouncements of the Committee on Accounting Procedure (ARB's) and Accounting Principles Board (APB) Opinions will find many of them to be quite wanting in analysis and draftsmanship.⁶² More importantly many of the problems of accounting are problems in developing processes for the resolution of problems rather than rules to solve particular problems. For example, the problem of independence is similar to lawyer-type problems involving fiduciaries. Further, such matters as the purchase or pooling battle involve problems of establishing

Currency Translation Information, 3 CCH AICPA PROF. STANDS. AC § 7001 (1973); No. 2, Accounting for Research and Development Costs (1974); No. 3, Reporting Accounting Changes in Interim Financial Statements (1974).

For a brief history of the AICPA's struggle to achieve independence of its principles-setting body, see Brief of Arthur Andersen & Co., Before the Study Group on Establishment of Accounting Principles of the AICPA, App. C (1971); D. CAUSEY, DUTIES AND LIABILITIES OF THE CPA 19-22 (1973). For the fuller story, see S. ZEFF, FORGING ACCOUNTING PRINCIPLES IN FIVE COUNTRIES: A HISTORY AND AN ANALYSIS OF TRENDS 110-268 (1971).

58. See Anreder, *By the Numbers? The Financial Accounting Standards Board Goes to Work*, Barron's, Nov. 18, 1974, at 3.

59. Since the AICPA no longer looks to its own committees to make principles, it has appointed a committee to study principles and make its position known to the FASB. See 136 J. OF ACCOUNTANCY, Dec. 1973, at 12.

60. The Commission in SEC Accounting Series Release No. 150 (Dec. 20, 1973) stated that for purposes of its longstanding policy of considering accounting practices, without substantial authoritative support to be misleading, promulgations of the FASB in both its Statements and Interpretations would be considered as having substantial authoritative support and those contrary would be considered not to have such support.

61. NYSE, WHITE PAPER, RECOMMENDATIONS AND COMMENTS ON FINANCIAL REPORTING TO SHAREHOLDERS AND RELATED MATTERS 4-5 (1973).

62. For an illustration, analyzing ARB 45, pointing out the defects of ARB 45, see Herwitz, *Accounting for Long-Term Construction Contracts: A Lawyer's Approach*, 70 HARV. L. REV. 449 (1957).

standards for the exercise of judgment by the auditor—this is a lawyer's work ground. Moreover, lawyers are trained to cope with new and unusual situations and frequently can bring unique talent to the Board. Accountants' prejudices concerning lawyers, and vice versa, should not be allowed to prevent maximum utility of the FASB by limiting its membership.

III. THE LOCUS OF INITIAL JURISDICTION TO ESTABLISH AUDITING STANDARDS AND PROCEDURES AND ACCOUNTING PRINCIPLES: MANAGEMENT, THE PROFESSION, OR THE SEC?

The FASB is now, and the APB was formerly, the primary principle-making body of the profession. But does the profession have the exclusive or the final power over accounting principles? And, who has power over auditing standards?

A. *Auditing Standards and Procedures.*

After the 1929 crash, the securities industry and the government quickly surmised that investor confidence in business must be restored, and that the best means for doing this was to require fuller financial disclosure. The preliminary drafts of the federal Securities Act of 1933 established the requirement that registration statements be filed (originally with the Federal Trade Commission, and, since 1934, with the then newly established Securities and Exchange Commission) and that a prospectus be delivered to securities purchasers.⁶³ At first it was not contemplated that financial statements be independently audited unless a special investigation was requested by the FTC. Some consideration was given to audits by government officials but this was rejected after the profession impressed upon the drafting committee the desirability and the greater benefits of private sector audits. The result was Section 19(a) of the 1933 Act and paragraphs (25), (26) and (27) of Schedule A thereto.⁶⁴

63. See generally 1 J. CAREY, *supra* note 11 at 181-92 (1969).

64. "(a) The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this subchapter. Among other things, the Commission shall have authority, for the purposes of this subchapter, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person

In the course of the hearings Senator Gore astutely noted that the 1929 debacle occurred despite the fact that 85% of stock ex-

directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but insofar as they relate to any common carrier subject to the provisions of section 20 of Title 49, the rules and regulations of the Commission with respect to accounts shall not be inconsistent with the requirements imposed by the Interstate Commerce Commission under authority of such section. The rules and Regulations of the Commission shall be effective upon publication in the manner which the Commission shall prescribe. No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." Securities Act of 1933 § 19(a), 15 U.S.C. § 77s(a) (1970).

Schedule of information required in registration statement.

"(25) a balance sheet as of a date not more than ninety days prior to the date of the filing of the registration statement showing all of the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the Commission shall prescribe (with intangible items segregated), including any loan in excess of \$20,000 to any officer, director, stockholder or person directly or indirectly controlling or controlled by the issuer, or person under direct or indirect common control with the issuer. All the liabilities of the issuer in such detail and such form as the Commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created, all as of a date not more than ninety days prior to the filing of the registration statement. If such statement be not certified by an independent public or certified accountant, in addition to the balance sheet required to be submitted under this schedule, a similar detailed balance sheet of the assets and liabilities of the issuer, certified by an independent public or certified accountant, of a date not more than one year prior to the filing of the registration statement, shall be submitted;

"(26) a profit and loss statement of the issuer showing earnings and income, the nature and source thereof, and the expenses and fixed charges in such detail and such form as the Commission shall prescribe for the latest fiscal year for which such statement is available and for the two preceding fiscal years, year by year, or, if such issuer has been in actual business for less than three years, then for such times as the issuer has been in actual business, year by year. If the date of the filing of the registration statement is more than six months after the close of the last fiscal year, a statement from such closing date to the latest practicable date. Such statement shall show what the practice of the issuer has been during the three years or lesser period as to the character of the charges, dividends or other distributions made against its various surplus accounts, and as to depreciation, depletion, and maintenance charges, in such detail and form as the Commission shall prescribe, and if stock dividends or avails from the sale or rights have been credited to income, they shall be shown separately with a statement of the basis upon which the credit is computed. Such statement shall also differentiate between any recurring and nonrecurring income and between any investment and operating income. Such statement shall be certified by an independent public or certified accountant;

"(27) If the proceeds, or any part of the proceeds, of the security to be issued is to be applied directly or indirectly to the purchase of any business, a profit and loss statement of such business certified by an independent public or certified accountant, meeting the requirements of paragraph (26) of this schedule, for the three preceding fiscal years, together with a balance sheet, similarly certified, of such business, meeting the requirements of paragraph (25) of this schedule of a date not more than ninety days prior to the filing of the registration statement or at the date such business was acquired by the issuer if the business was acquired by the issuer more than ninety days prior to the filing of the registration statement" Securities Act of 1933, Schedule A, §§ 25-27, 15 U.S.C. § 77aa (25)-(27) (1970). Subsequent statutes contain varying formulations generally not increasing greatly the 1933 Act authority. See Securities Exchange Act of 1934 §§ 3(b), 12(b)(1)(J)-(L), 13(b), 17(a), 15 U.S.C. §§ 78c(b), 781(b)(1)(J)-(L), 78m(b), 78q(a) (1970); Public Utility Holding Company Act of 1935

change listed companies *had* been audited.⁶⁵ Apparently not willing to rely on the probabilities of a mending of the ways of companies and their advisers, Congress enacted the express civil, administrative and criminal liability provisions of sections 11, 12, 15, 17, 20 and 24 of the 1933 Act,⁶⁶ imposing substantial liability for misleading statements.

The following year saw the adoption of the Securities Exchange Act of 1934⁶⁷ with its requirements of company registration, periodic reporting and proxy regulation giving additional impetus to the establishment of the central importance of financial disclosure. Soon after these enactments, a remarkable incident in American business history occurred and caused a great change in the techniques of establishing audit standards and procedures. The AICPA had participated with the Federal Reserve Board as early as 1917 in developing rudimentary audit standards⁶⁸ and by 1936 had issued a third version, this time under its own auspices.⁶⁹ The Institute by then had come to be spokesman of the profession. As was customary with its pronouncements whenever disagreement occurred, the Institute in the 1936 statement took an ambivalent position on two important auditing problems that divided the profession—the need for independent verification of inventories and external confirmation of receivables with the firm's debtors.

The equivocal statement enabled one Philip Musica, a twice-convicted confidence man, who rose to the presidency of McKesson & Robbins, Inc., to falsify the statements of that company to the tune of about 20 million dollars, about half being overstated accounts receivable and the rest, fictitious inventories. Musica and his henchmen pretended to order goods from vendors who supposedly retained the goods in storage in their own warehouses for shipment to customers of McKesson & Robbins. Musica then caused checks to be issued in the names of the vendors, intercepted them and used the proceeds to make partial payments to McKesson & Robbins on resales pretended to have been made for the company. About 2.8 million dollars remained glued to the Musica gang's fingers. The result was that inventories as well as receivables were fictitious. The accountants failed to confirm the receivables or take any physical

§§ 5(b)(2)(H)-(I), 14, 15, 20(a), 15 U.S.C. §§ 79e(b)(2)(H)-(I), 79n, 79o, 79t(a) (1970); Trust Indenture Act of 1939 § 319(a), 15 U.S.C. § 77sss(a) (1970); Investment Company Act of 1940 §§ 30(e), 31(c), 38(a), 15 U.S.C. §§ 80a-29(e), 80a-30(c), 80a-37(a) (1970).

65. See extract from Senate Committee Hearings at 1 J. CAREY, *supra* note 11, at 188.

66. Securities Act of 1933 §§ 11, 12, 15, 17, 20, 24, 15 U.S.C. §§ 77k, 77l, 77o, 77q, 77t, 77x (1970).

67. 15 U.S.C. §§ 78a-78hh (1970).

68. SAS No. 1, App. A., *supra* note 20, at 2061; 1 J. CAREY, *supra* note 11, at 132.

69. SAS No. 1, App. A., *supra* note 20, at 2061; 2 J. CAREY, *supra* note 11, at 20-21.

views of the inventories and hence failed to detect the wrongs.⁷⁰

The enormity of the fraud spurred the accounting profession, through the American Institute Committee on Auditing Procedures, to begin in early 1939 to put its auditing in order by publishing the first of over fifty Statements on Auditing Procedures.⁷¹ The first one required that thereafter inventories be actually observed and that the amount of receivables be confirmed with the debtors.

The SEC, in the meantime, not happy with its impression of the low standards followed in the McKesson & Robbins audit, conducted an extensive investigation culminating in *Accounting Series Release (ASR) 19*, issued in 1940.

ASR 19 concluded:

We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure that acceptable standards of auditing procedure will be observed, that specific deviations therefrom may be considered in the particular instances in which they arise, and that accountants will be more independent of management. Until experience should prove the contrary, we feel that this program is preferable to its alternative—the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us—and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers.

Thus in the first important battle involving auditing standards and procedures, the Institute acted prior to the conclusion of the SEC's investigation to obviate the specific problems of auditing for receivables and inventories. Prodded by the Commission, the AICPA began issuing general standards and continued to consider and publish procedures for auditing. Similar post-calamity reform occurred in connection with the development of auditing standards for goods held in public warehouses after the Salad Oil scandal.⁷² Similarly, the Institute now is in the process of developing auditing standards to remedy the Equity Funding-type failures.⁷³

Regardless of whether the seat of power to fix "auditing standards" is in the profession or the SEC, a question deferred for con-

70. See D. CAUSEY, *DUTIES AND LIABILITIES OF THE CPA* 14-17 (1973).

71. 1 CCH AICPA PROF. STANDS. App. A., at 2063 (1974).

72. SAS No. 1, *supra* note 20 at AU § 901. See N. MILLER, *THE GREAT SALAD OIL SWINDLE* (1965).

73. See note 193 *infra*.

sideration shortly, the bulk of the determinations of auditing standards and procedures, as in the McKesson & Robbins case, has been by the AICPA. At any rate, unlike accounting principles, no one suggests that auditing standards or procedures are to be selected by corporate managements.⁷⁴

In one major area of auditing standards, however, as we have seen, that of "independence," the Commission has not been hesitant to establish its own views.⁷⁵ Occasionally it has fixed other auditing standards. For example, it has developed detailed audit rules for national securities exchanges, brokers and dealers,⁷⁶ and investment companies.⁷⁷ It also has provided standards concerning opening inventories on new audit engagements⁷⁸ and review of the work of subordinates of the auditing firm.⁷⁹ As in McKesson & Robbins, inventory verification was required in another case on facts arising before the profession adopted its standards but decided thereafter.⁸⁰ In addition, certain requirements for the auditor's report are spelled out in SEC Regulation S-X, Rule 202.⁸¹

Although some doubt has been expressed,⁸² the express terms of the securities statutes probably confer adequate authority to permit the Commission to establish auditing standards. Certainly the audit standard of "independence" is within the Commission's 1933 Act authority because paragraphs (25), (26) and (27) of Schedule A of the Act prescribe certification by "independent" public accountants and section 19(a)⁸³ expressly authorizes definition of accounting terms used in the Act. As to other audit standards and procedures, the express authority to define accounting terms and prescribe methods to be followed in preparation of accounts is clearly a nonexclusive description of the Commission's powers: section

74. Of course governmentally regulated companies are subject to specific auditing regulations established by specific legislation. Also, it is understood that our discussion of SEC power over auditing relates only to financial statements subject to SEC regulation.

75. See text accompany notes 38-54 *supra*.

76. See SEC Form X-17A-5, 17 C.F.R. § 249.617 (1974), 3 CCH FED. SEC. L. REP. ¶¶ 33,921-38 (1974).

77. 17 C.F.R. § 270.17f-1 (1974) (concerning securities held by investment companies); SEC Accounting Series Release Nos. 113 & 118 (Oct. 21, 1969).

78. SEC Accounting Series Release No. 90 (Mar 1, 1962).

79. Interstate Hosiery Mills, Inc. 4 S.E.C. 706 (1939).

80. Illinois Zinc Co., 6 S.E.C. 850 (1940).

81. SEC Reg. S-X, 17 C.F.R. § 210.2-02 (1974).

82. *E.g.*, Burton, *The SEC and the Accounting Profession: Responsibility, Authority and Progress*, in INSTITUTIONAL ISSUES IN PUBLIC ACCOUNTING, 265-71 (R. Sterling ed. 1974); Liggio, *Expanding Concepts of Accountant's Liability*, CALIF. CPA Q. 18, 20 (Sept. 1974); Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 268-69 (1974).

83. 15 U.S.C. § 77s(a) (1970).

19(a) expressly authorizes "such rules and regulations as may be necessary to carry out the provisions of this subchapter," and then uses the draftsman's special words for denoting nonexclusiveness "including . . . defining accounting . . . terms" and "[a]mong other things" prescription of "methods to be followed in the preparation of accounts."⁸⁴

A court should have no difficulty in construing the "necessary" clause to include the authority to regulate audits given the Supreme Court's repeated admonitions that the securities acts are to be construed liberally.⁸⁵ Furthermore financial statements are "accounts" in common parlance and "preparation" arguably may include audits without doing violence to the ordinary meaning of the word. Thus, the power to prescribe auditing "methods" would include procedures and probably standards for those procedures.

The other cited provisions of the securities statutes would seem to be equally susceptible to this construction. For example, § 17(a) of the 1934 Act, compelling broker-dealers, securities exchanges and associations to keep such accounts and make such reports as the Commission may prescribe "as necessary or appropriate in the public interest or for the protection of investors"⁸⁶ was not even questioned as a sufficient basis for establishing specific audit procedures concerning internal controls in *Hochfelder v. Ernst & Ernst*.⁸⁷

Despite this overwhelming basis for jurisdiction to regulate auditing, counsel for the AICPA insists that the Commission has no general authority over auditing standards and procedures.⁸⁸ This position is somewhat distressing inasmuch as it was most recently published during an interesting set of occurrences in connection with the drafting of the ALI Federal Securities Code § 1503(a),⁸⁹ which purports to deal with this subject matter. Because all activities in drafting the Code prior to publication of Tentative Drafts are expressly made confidential, it would be inappropriate to detail the full history even if it were known.⁹⁰ Suffice it to say that § 1503(a) states:

84. *Id.* (Emphasis added). Section 13(b) of the 1934 Act uses the word "reports" instead of "accounts," 15 U.S.C. § 78m(b) (1970).

85. *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 151 (1972); *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

86. 15 U.S.C. § 78q(a) (1970).

87. 503 F.2d 1100 (7th Cir. 1974).

88. See Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 269 at n.46 (1974).

89. ALI FED. SECURITIES CODE § 1503(a) (Tent. Draft No. 3 1974).

90. See my remarks and those of Professor Loss in discussion of § 1503 in Proceedings, ALI 51st Ann. Meeting (May 24, 1974) (yet to be published).

Sec. 1503. [Accounting and records.] (a) [Rule-making authority.] For purposes of this Code and in addition to its authority under section 1502, the Commission, by rule, may (1) define accounting terms, (2) prescribe the form and content of financial statements and the accounting principles and standards used in their preparation, (3) require the examination of and reporting on financial statements by independent public accountants, (4) establish standards of independence for public accountants insofar as they practice before it, and (5) prescribe the form and content of the independent public accountant's report.

Section 1502, referred to in section 1503, permits the Commission to "adopt . . . rules and orders to implement specific provisions of" the Code and perhaps therefore carries full power to regulate audits under any of the provisions calling for audited financial statements. Section 1503 expressly authorizes establishing standards of independence and the form and content of the accountant's report and only arguably would authorize audit supervision by the Commission. Moreover, the reporter's note mysteriously states:

This draft of § 1503 is advanced on the assumption (1) that nothing in it is designed to subtract from the authority (express or implied) that the Commission already has under all the source provisions, or to change the basic relationship between the Commission and the accounting profession, and (2) that § 1503(a) necessarily subsumes a degree of authority with respect to the scope (or standards) of, and the procedures to be followed in, audit examinations.

One can only speculate about why all this ink need be spilled and the risk of uncertainty be endured when the addition of one more line to § 1503(a) could obviate the problem. Why not add: "(6) prescribe auditing standards and procedures"?

When the SEC's authority is not applicable it, of course, does not have authority to regulate audits although its determinations may provide authoritative support by analogy or otherwise. Thus in most audits for other than SEC purposes, the profession retains the primary power to fix standards, although presumably other administrative agencies will have the power in certain cases.

B. Accounting Principles

The power of the Commission to prescribe accounting principles, as opposed to auditing standards and procedures, is based on the same statutory sections, but seems unquestioned.⁹¹ And section 1503 of the proposed ALI Code also is clear in authorizing the Commission to prescribe "accounting principles."

Although the Commission has been less reticent in establishing

91. See, e.g., SEC Accounting Series Release Nos. 4 (April 25, 1938) & 150 (Dec. 20, 1973).

accounting principles than it has been for auditing matters, it has never exerted its full power but instead has deferred to the profession in most cases.⁹² For the first dozen years of its existence the Commission played a relatively active role in developing accounting principles, both through publication of its Accounting Series Releases and formal administrative proceedings.⁹³ Then quiescence set in for over two decades until the outbreak of scandals in the late '60's. Since 1969 the Commission has issued a torrent of ASR's, many of which deal with accounting principles.⁹⁴ Most of these recent developments have dealt with the quality of earnings reported.⁹⁵

A further example of the Commission's interest in quality of earnings is contained in its proposals providing for disclosure of accounting policies.⁹⁶ The release proposes, among other things, to require disclosure of the impact on earnings caused by choosing one of two alternative accounting principles. Thus, if under an installment method income is 2,000 dollars, whereas under ordinary accrual accounting it would be 10,000 dollars, whichever method is chosen, disclosure in a footnote or otherwise of the other figure will be necessary. Another illustration of the SEC's active interest in the quality of earnings was provided in a recent suit against Avis, Inc. In that case the Commission complained that "Avis omitted to disclose . . . the material fact that a substantial part of . . . earnings . . . , approximately seventy percent . . . before taxes . . . , were realized from sales of vehicles in the first quarter of 1973, and that only . . . approximately thirty percent . . . were realized from car rental, leasing and other operations."⁹⁷

92. For discussions of the relationship of the SEC and the AICPA, see Burton, *The SEC and the Accounting Profession: Responsibility, Authority and Progress*, in INSTITUTIONAL ISSUES IN PUBLIC ACCOUNTING 265 (R. Sterling ed. 1974); Lamden, Response at *id.* 276; *id.* 281; Armstrong, *Will Washington Listen to the Private Sector?* FINANCIAL EXECUTIVE Mar. 1974, at 52; Pines, *The Securities and Exchange Commission and Accounting Principles*, 30 LAW & CONTEMP. PROB. 727 (1965); Kripke, *The S.E.C., The Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151, 1176-86 (1970); Horngren, *Accounting Principles: Private or Public Sector*, J. OF ACCOUNTANCY, May 1972, at 37.

93. For a good description of the SEC's principle-making activity, see Pines, *The Securities and Exchange Commission and Accounting Principles*, 30 LAW & CONTEMP. PROB. 727 (1965).

94. SEC Accounting Series Release Nos. 1-116 were issued through 1970. In 1971, Nos. 117-122 were issued; in 1972, Nos. 123-133; in 1973, Nos. 134-150; in 1974, Nos. 151-166.

95. *E.g.*, Nos. 150, 151, 153, 162, 166.

96. SEC Securities Act Release No. 5427 (Oct. 4, 1973).

97. SEC v. Avis, Inc., SEC Securities Exchange Act Release No. 10672 (Mar. 7, 1974) (No. 74-1065, S.D.N.Y. 1974); BNA SEC. REG. & L. REP. No. 243 at A-14 (1974). See also SEC Securities Act Release No. 5520 (Aug. 12, 1974) (requiring interpretation and evaluation of earnings summaries by management).

The Commission's previous long period of hibernation during which the AICPA pressed forward vigorously, first with pronouncements of the Committee on Accounting Procedure (ARB's) and then Opinions of the Accounting Principles Board (APB's), and finally by establishing the independent Financial Accounting Standards Board, gave a mindset to the profession from which it came to be quite jealous of its function of establishing accounting principles. An illustration of this attitude recently was evidenced in the ever-bubbling "purchase or pooling" area.⁹⁸

It previously had been suggested that unlike the lawmaking powers of stock exchanges and securities dealers associations, which the SEC was, by statute, expressly authorized to establish,⁹⁹ nothing in the federal securities acts expressly contemplated that the Commission should delegate such power to any professional association of accountants.¹⁰⁰ Hence, it was contended, if accounting principles of the AICPA were to be adopted by the Commission, that must be done by the Commission pursuant to the provisions of section 4 of the Administrative Procedure Act¹⁰¹ requiring the observance of formal rule-making procedures.¹⁰² The Commission had never done that; instead, it simply followed the AICPA pronouncements.

After the lid was precariously placed on the purchase or pooling imbroglio in 1970 by the AICPA's Accounting Principles Board Opinions No. 16 and 17,¹⁰³ the SEC became uneasy about the loose construction put on one part of Opinion 16 in filings with the Commission. In that Opinion the APB, in establishing guidelines for choosing between accounting on a purchase or a pooling basis for a business combination through stock issuances, stated that if the transaction was a true pooling of the interests of two entities, neither company should change its book values. But, if the combination was in reality an acquisition of one company by the other, it should be treated as a purchase, with the acquired company's assets coming on the books of the acquiring company at the purchase price. A pooling involved a continuity of interest of the equity owners of both firms while a purchase basically was a discontinuance of the interest of the owners of the acquired firm.

In a publicly traded company, if shares are acquired by the

98. The FASB has announced it will reconsider the subject matter of business combinations and related intangibles so called "purchase or pooling" accounting, the subject matter of APB Op's. 16 and 17. FASB, status Report No. 10, p.2 (2-28-74).

99. Securities Exchange Act of 1934 §§ 6, 15A, 15 U.S.C. §§ 78f, 0-3 (1970).

100. Cf. T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS 596 (1971).

101. 5 U.S.C. § 553 (1970).

102. Cf. T. FIFLIS & H. KRIPKE, *supra* note 100, at 597.

103. AICPA, APB Op. Nos. 16 & 17 (1970).

corporation, eliminating certain shareholders, and then those treasury shares are reissued to shareholders of another firm in a business combination, the overall effect is a discontinuance of interest of the former owners of the treasury shares. An AICPA interpretation of Opinion 16 says that in these circumstances a presumption arises that the transaction was a purchase not a pooling.¹⁰⁴ As always, pressures for pooling frequently caused the presumption to be ignored. The Commission, in an effort to make the presumption effective, issued ASR 146,¹⁰⁵ which supplemented the two AICPA pronouncements by covering additional details.

Arthur Andersen & Co., viewing the Commission's release as an incursion on the profession's law-making power, filed a suit to enjoin enforcement of the SEC's claimed interpretive release on the basis that it in fact was a rule made without complying with the Administrative Procedure Act notice and hearing provisions and that it was an unconstitutional *ex post facto* rule.¹⁰⁶ The Commission suspended its release,¹⁰⁷ heard public comments and then reissued the release with minor supplements to apply prospectively, in effect overcoming both objections.¹⁰⁸ Andersen then apparently dropped its suit.

Perhaps it became apparent to Andersen's attorneys in the course of these proceedings that if the SEC must follow the Administrative Procedure Act in making its own statements on purchase or pooling accounting, simple logic would require the same procedure when the Commission adopted the AICPA's pronouncements through a process of incorporation by reference. If this were required, the profession would end up with less influence than it now has, since despite the SEC's *de jure* power to make accounting principles, the *de facto* exercise is usually by the AICPA.¹⁰⁹

Although the profession considers that it has the power to establish GAAP at least when the SEC has not spoken, and has exercised that power in quite limited areas through its Accounting Principles Board Opinions and its Accounting Research Bulletins and Financial Accounting Standards Board statements, most of the thousands of accounting principles applied in practice have not

104. AICPA, Accounting Interpretation No. 20, 3 CCH AICPA PROF. STANDS. AC § U 1091.067 (1974).

105. SEC Accounting Series Release 146 (Aug. 24, 1973).

106. *Arthur Andersen & Co. v. SEC*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94, 147 (D.D.C. 1973).

107. SEC Securities Act Release No. 5429 (Oct. 5, 1973).

108. SEC Accounting Series Release 146A (April 11, 1974).

109. An earlier court battle evidencing the views of several erstwhile high SEC officials as to who has actually made most accounting principles—the AICPA—is described in T. FIFLIS & H. KRIPKE, *ACCOUNTING FOR BUSINESS LAWYERS* 489-91 (1971).

been the subject of these formal statements. Who has the power to make GAAP in these cases in which neither the SEC nor the profession has acted?

In addressing these situations, accountants are fond of litanizing that the financial statements are those of management and that the auditor's duty is to report on the statements, among other things, indicating whether they comport with GAAP.¹¹⁰ The result of this position is that when the SEC or the profession have not issued a statement of principle, it is not the individual auditor who determines what principles are applied; it is the management of the audited firm that selects them.

The power that the individual auditor does have with respect to the use of management's principles is to state his opinion whether the financial statements are presented fairly in conformity with GAAP. Despite the fact that even prior to enactment of the federal securities laws, accountants and securities lawyers were well aware of the abuses of trust by auditors in accepting statements that applied principles most favorable to management by minimizing the natural meaning of the words "present fairly,"¹¹¹ the effect of the fairness requirement has never been settled by the profession. In fact lawyers for the profession finally came to articulate the view that those words are nearly meaningless and that the only requirements were that the accounting principles used be generally accepted and that accountants consider them fair.¹¹²

Fortunately, the courts were able to see clearly through that absurdity in the Continental Vending case, *United States v. Simon*, described below.¹¹³ We will see that there has been a 180 degree turn to a state in which fairness is all-important and general acceptance is taken for granted as a minimal requirement.

IV. ACCOUNTING AND AUDITING STANDARDS IN THE COURTS

A. *Potential Sanctions*

Private damage actions, remarkable for the large size of judgments or settlements, are not the only basis for the profession's current trepidation. Criminal convictions have been obtained in the Continental Vending¹¹⁴ and National Student Marketing¹¹⁵ situa-

110. See SAS No. 1, § 110.02 (1973).

111. See 10 SEC ANN. REP. 13-14 (1944).

112. See brief amicus curiae of AICPA in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969).

113. See text accompanying notes 137-74 *infra*.

114. See *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969).

115. SEC Litigation Release 6599, 5 SEC DOCKET 586 (Nov. 22, 1974).

tions, both of which involved activity in which the auditors did not appear to go far beyond mere negligence.¹¹⁶

Suits for injunctions also have been brought by the Commission.¹¹⁷ Although Judge Moore, dissenting in *Texas Gulf Sulphur*,¹¹⁸ pointed out the severe effects of injunctions, the mentality of *SEC v. Capital Gains Research Bureau, Inc.*¹¹⁹ has prevailed, to the effect that an injunction is nothing more than a slap on the wrist. Judging by the large number of consent decrees being entered,¹²⁰ counsel for some defendants may be taking inadequate notice of these effects. A battle is being waged now to point up the dangers.¹²¹ These include: use in subsequent private damage actions;¹²² civil and criminal contempt exposure; 1933 Act disqualifications to participate in Regulation A offerings and Rule 2(e) exposure to disbarment from SEC practice.¹²³

In addition to criminal and injunctive proceedings, "Rule 2(e) proceedings" to enforce standards of practice before the Commission have been used effectively to supervise accounting and auditing.¹²⁴ Other administrative proceedings against clients may affect the auditors.

One aspect of recent administrative orders and consent decrees

116. See also *United States v. Goldblum*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,700 (The Equity Funding case); *Wall Street J.* 32, cols. 1-6 (Jan. 8, 1975) (describing opening of trial); *United States v. Clark*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,745 (S.D.N.Y. 1972) (The Four Seasons Case; acquittal of one partner and employee of auditing firm and hung jury on another partner); Note, *Federal Criminal and Administrative Controls for Auditors: The Need for a Consistent Standard*, 1969 WASH. U.L.Q. 187.

For a survey see SEC Enforcement Techniques, BNA SEC. REG. & L. REP. No. 237 at B-1 Jan. 30, 1974.

117. E.g., *SEC v. Liberty Equities Corp.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,745 (D.D.C. 1970); *SEC v. Nat'l. Student Mktg. Corp.*, 360 F. Supp. 284 (D.D.C. 1972); *SEC v. Geo. Tek. Resources Fund, Inc.*, BNA SEC. REG. & L. REP. No. 204 at A-3 (N.D. Cal. 1973); *SEC v. Talley Indus. Inc.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,198 (S.D.N.Y. 1973); *SEC v. Republic Nat'l Life Ins. Co.*, BNA SEC. REG. & L. REP. No. 243 at A-11 (S.D.N.Y. 1974).

118. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 870 (2d Cir. 1968) (dissenting opinion).

119. 375 U.S. 180 (1963).

120. See Address by Matthews, *Liability of Lawyers Under the Federal Securities Laws*, at ABA National Institute on Advisors to Management, Responsibilities and Liabilities of Lawyers and Accountants, in New York, Oct. 3-5, 1974.

121. *Id.*; BNA SEC. REG. & L. REP. No. 266 at A-8 (Aug. 21, 1974).

122. 71 COLUM. L. REV. 1329 (1971).

123. Matthews, *supra* note 120.

124. See Laventhol, Krekstein, Horwath & Horwath, SEC Accounting Series Release No. 144 (May 23, 1973); Touche Ross & Co., SEC Accounting Series Release No. 153 (Feb. 25, 1974) [formal institution of Rule 2(e) proceedings waived]; *In re Loux, Gose & Co.*, SEC Accounting Series Release No. 160 (Aug. 27, 1974). See also SEC Accounting Series Release No. 59 (Jan. 23, 1947); 68 (July 5, 1949); 73 (Oct. 30, 1952); 78 (Mar. 25, 1957).

that seems worthy of comment is the inordinate intrusion of government into professional activity which they portend. For example, in one case involving attorneys, not only was illegal activity enjoined, but also a process for assuring compliance was developed which included an agreement to:

- (1) meet as a firm every two weeks to discuss the firm's active cases and obtain approval of all partners before any opinions are issued;
- (2) investigate bond offerings to assure independent auditors are used and to check background of participants;
- (3) use an appropriate "engagement letter" emphasizing the law firm's duty to the bondholders;
- (4) have partners and associates, at least annually, attend continuing education workshops and seminars.¹²⁵

As to issuers of securities, a similar intrusion is illustrated by *SEC v. Mattel, Inc.*¹²⁶ in which an amended decree required appointment of a majority of disinterested directors and establishment of an audit committee of the board and a litigation committee, all composed of members satisfactory to the SEC. In *SEC v. Canadian Javelin Ltd.*¹²⁷ forty percent of the board was required to be outsiders satisfactory to the Commission and special counsel was required, among other things, to pursue rights under Canadian law. Similarly, accountants have recently been subjected to peer review procedures by virtue of the settlement of Rule 2(e) proceedings.¹²⁸

This agency governance of issuers, their accountants and their lawyers, whatever its constitutional infirmities, seems like too much candy for a nickel and may give indigestion to the Commission if too large an accumulation occurs. It also would seem likely to bog down the various firms in bureaucratic controls. One would hope

125. *In re Ferguson*, Securities Act Release No. 5523 (Aug. 21, 1974); 5 SEC DOCKET No. 2, at 37-38 (Sept. 3, 1974), BNA SEC. REG. & L. REP. No. 268 at A-25 (Sept. 11, 1974). This case illustrates the Commission's new approach of using leverage against professionals to cure ills not solely in the securities markets. The findings included the determination that a project developer for a municipality was to split profits with a consultant who had passed on the need for the project and that these facts should have been disclosed in the bond prospectus.

126. SEC Litigation Release No. 6467, 4 SEC DOCKET No. 20 at 724 (1974), amended, SEC Litigation Release No. 6531 (Oct. 2, 1974), 5 SEC DOCKET No. 8 at 241 (1974); Litigation Release No. 6532 (Oct. 3, 1974), 5 SEC DOCKET No. 8, at 242 (1974).

127. SEC Litigation Release No. 6441 (Aug. 24, 1974), 4 SEC DOCKET No. 18 at 620 (1974), BNA SEC. REG. & L. REP. No. 262 at A-18 (July 24, 1974).

128. *In re Loux, Gose & Co.*, SEC Accounting Series Release No. 160 (Aug. 27, 1974). See also *SEC v. Raffer*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,632 (S.D.N.Y. Mar. 23, 1970).

that the Commission will not become overly zealous in the use of such imaginative arrangements.¹²⁹

B. Standards of Conduct

When considering legal standards of conduct for accountants in the absence of an SEC or other statutory or regulatory agency rule, the courts must keep in mind several different matters:

(a) The actual conduct of the accountant in the particular case, including his own firm's standards,¹³⁰ and the conduct of the engagement;

(b) Customs and practices of the profession, if any, dealing with the particular problem;

(c) Formal professional standards, if any, covering the situation, established by some organization such as the AICPA, the stock exchanges or the FASB;

(d) Expert testimony of appropriate conduct in the circumstances;

(e) Writings of accountants and others in treatises and journals; and

(f) The legal standard of conduct to be established for the case. Items (b), (c), (d) and (e) often are referred to, individually or collectively, as sources of GAAS or GAAP without discrimination.

As previously stated, usually no formally established standard or no custom for the particular question will be available. For this reason in litigation the most important source of comparison with the accountant's actual conduct will be expert testimony concerning what the expert would have done under similar circumstances.¹³¹ Sometimes two or more of the above six items will coincide, but often they will not. Thus, formal generally accepted auditing standards¹³² ((c) above) may require use of particular auditing procedures to review events subsequent to the balance sheet date, but the custom ((b)) may be limited to searching for unrecorded liabilities,¹³³ and the accounting firm's audit program ((a)) may omit all procedures for subsequent events. Furthermore, an expert may tes-

129. For concern about other aspects of the use of consent decrees, see Freedman, *A Civil Libertarian Looks at Securities Regulations*, 35 OHIO ST. L.J. 280 (1974); Sargent, *The SEC and the Individual Investor: Restoring His Confidence in the Market*, 60 VA. L. REV. 553 (1974).

130. *E.g.*, *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

131. For convenience the term "expert judgment" will be used to describe this type of testimony.

132. SAS No. 1, *supra* note 20 at, AU § 560.

133. See Practitioners' Forum, *J. OF ACCOUNTANCY*, Sept. 1974, at 104-05.

tify that he would not consider any increase in a particular account receivable to be a matter of concern ((d)), and a court may determine that in addition to events required to be noticed some additional matters such as the increase in the account receivable should be checked and disclosed ((f)).¹³⁴

The same may be true for accounting principles especially when not formally established by the AICPA or FASB.

The question in this part of the paper is, what is the appropriate legal standard of conduct for audits and the use of accounting principles in relation to the above listed pertinent formal professional standards, customs, writings and expert judgments? In this consideration it may be helpful to keep in mind the modular nature of accounting; it will not do to excuse an accountant from liability if he merely complies with the model unless society determines that the accounting model should be the legal standard.

1. The Inapt Analogy of Medical Malpractice

In the area of medical malpractice the more general view is that: (a) the standard of conduct to which the courts will hold a defendant is the custom of the profession or, even in the absence of a custom, the view of experts; the jury usually is not authorized to question the wisdom of the custom or expert judgment as being itself unreasonable; and (b) the plaintiff cannot prevail unless he produces expert testimony of nonconformity by the defendant with custom or expert judgment.¹³⁵

The effect of the dual requirements that the plaintiff show nonconformity with custom or expert judgment and that he do so with medical experts provides a very real insulation for medical practitioners from the vicissitudes of litigation. The costs in terms of injustice in the cases of nonrecovery is considered to be appropriate when weighed against such benefits as the availability of medical practitioners and the willingness to serve—benefits that some fear might be lost if a different standard of conduct were imposed.

But in one area of medical malpractice, termed "informed consent," which deals with the question of whether a patient who consents to a particular treatment has been adequately informed of

134. Cf. *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969).

135. See, e.g., *McCoid, The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549 (1959); *Morris, Custom and Negligence*, 42 COLUM. L. REV. 1147 (1942). There are exceptions. The doctrine of *res ipsa loquitur* has been invoked in some types of cases, 1 D. LOUISSELL & H. WILLIAMS, *MEDICAL MALPRACTICE* ¶ 14.06 (1973), and in others, typified by the surgical sponge problem, a jury is allowed to exercise its wisdom as to the reasonableness of the defendant's conduct.

risks, a few courts hold that the adequacy of the practitioner's communication of the risks is not to be tested by practitioners' customary disclosures but is a question for the lay jury. Hence, expert testimony of judgment or custom is not indispensable to the plaintiff's case. Nor is the defendant's expert evidence of custom invulnerable to a jury determination of unreasonableness.¹³⁶

Similarly to the informed consent cases, but in contrast with the other rules in the medical malpractice area, most courts hold that for most other occupations, questions about the reasonableness of the defendant's conduct under the circumstances are for the jury, although evidence of custom may be relevant. Expert judgments, however, concerning the reasonableness of the defendant's conduct are generally inadmissible except to prove custom. Further, the custom may be ignored by the jury as constituting an unreasonably low standard of conduct.¹³⁷

Many writers and judges, generalizing from the fact that both medicine and accounting often are referred to as "professions," without additional warrant, conclude that in litigation against accountants as with medical practitioners (a) professional standards are conclusive, and (b) expert witnesses to prove nonconformity for the plaintiff are indispensable.

Aside from the demonstrable flimsiness of the analogy between doctors and accountants, the generalization does not hold up. Let us consider the question as it relates to accounting principles and auditing standards and procedures separately.

2. Accounting Principles in the Courts

In *United States v. Simon*,¹³⁸ accountants, supported by the AICPA as *amicus*, sought to obtain the same insulation as medical practitioners for their misleading financial statements. They urged

136. See generally, Comment, *Informed Consent in Medical Malpractice*, 55 CALIF. L. REV. 1396 (1967). In one case the court held no expert testimony was necessary to prove the custom of disclosure because the custom was so nebulous as to vest discretion in the individual physician. *Cobbs v. Grant*, 8 Cal. 3d 229, 502 P.2d 1, 104 Cal. Rptr. 505 (1972). See also *Wilkinson v. Vesez*, 295 A.2d 676 (R.I. 1972); *Cooper v. Roberts*, 220 Pa. Super. 260, 268 A.2d 647 (1971).

137. W. PROSSER, *LAW OF TORTS* 168 (4th ed. 1971) states that custom must meet the challenge of "learned reason," but "[o]ne apparent exception arises in the case of professional customs, such as those of physicians and surgeons." *Id.* at n.90. The phrase "learned reason" is derived from Allen, *Learned and Unlearned Reason*, 36 JURID. REV. 254 (1924). Allen said, "Every custom adduced in support of an alleged right must pass the test of reasonableness: and the true rule seems to be not that a custom will be admitted if reasonable, but that, it will be admitted unless it is unreasonable." *Id.* at 263. For a fine analysis of the substantive effect of custom in the law of negligence and problems of proof, see Morris, note 135 *supra*.

138. 425 F.2d 796 (2d Cir. 1969).

that for purposes of determining whether published financial statements were materially misleading, a jury should be conclusively bound by expert testimony that the statements were prepared in accordance with GAAP.^{138,1}

The case involved a criminal conviction of three accountants for certifying false or misleading financial statements in violation of several federal statutes.¹³⁹ Upon conviction, the defendants appealed on the grounds of insufficiency of the evidence, incorrect instructions as to the applicable rules of law, and the improper refusal by the trial judge to charge the jury as defendants had proposed.

The facts supporting the jury verdict were that Harold Roth, president and controlling shareholder of Continental Vending, had been borrowing indirectly from Continental through loans to its sister corporation, Valley Financial, also controlled by him, and

138.1. Accountants' reports generally state that the statements present fairly the financial data in conformity with GAAP. But there has never been general agreement in the profession on what this means. For the latest confirmation of this, see Carmichael, *What Does the Independent Auditor's Opinion Really Mean?*, 138 J. OF ACCOUNTANCY, Nov. 1974, at 83. The APB's Statement No. 4 (1970) at ¶189 purports to define the term as follows:

189. The qualitative standard of *fair presentation in conformity with generally accepted accounting principles* of financial position and results of operations is particularly important in evaluating financial presentations. This standard guides preparers of financial statements and is the subjective benchmark against which independent public accountants judge the propriety of the financial accounting information communicated. Financial statements "present fairly in conformity with generally accepted accounting principles" if a number of conditions are met: (1) generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in conformity with generally accepted accounting principles, and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operations in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

There are large areas in most balance sheets for which GAAP are not settled. In a letter of the AICPA, accounting standards division, to the SEC's Chief Accountant, dated February 20, 1974 and described in Carmichael, *supra*, it is said that the following areas are the only ones in which use of the available alternative accounting principles is arbitrary:

- (1) The investment credit;
- (2) Preoperating costs, start-up costs and similar deferrals;
- (3) Inventories;
- (4) Depreciation; and
- (5) Goodwill and other purchased or acquired intangibles.

Even if the letter is correct, there is not much left on the asset side of the typical firm's balance sheet that is governed and not arbitrary.

139. Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff (1970), the Mail Fraud Act, 18 U.S.C. § 1341 (1970), and a provision concerning false statements in matters before U.S. agencies generally, 18 U.S.C. § 1001 (1970).

loans from Valley to himself, to finance various stock market ventures of his own. At the end of the year in question, 1962, Continental's books showed a receivable of 3.5 million dollars, owing from Valley, which was owed the same amount by Roth. Continental, on the other hand, had borrowed 1 million dollars from Valley evidenced by notes which Valley had then negotiated to two banks; therefore the notes could not be offset against the debt of Valley to Continental. Roth's financial condition was such that he was unable to repay his debts. Under pressure from the auditors, he and other members of his family transferred 3 million dollars in securities to a trustee as security for his debt to Valley and Valley's debt to Continental. About eighty percent of the value of these securities consisted of Continental stock and debentures. At that time a prior lien of 1 million dollars existed against these securities in favor of third parties. These facts were known to the defendant accountants but the financials prepared by them merely described the receivables as being adequately secured.

The prosecution contended that Continental's financial statements wrongfully failed to disclose that: (1) the 3.5 million dollar receivable from Valley was uncollectible because Valley had re-loaned it to Roth who was unable to make repayment, (2) eighty percent of the collateral purportedly securing the Valley receivable was Continental's own securities, (3) the receivable could not be offset by the 1 million dollar debt owing by Continental to Valley and the 3 million dollar collateral was therefore insufficient, and (4) the amount receivable from Valley had increased by 400,000 dollars since the year end.¹⁴⁰ As a consequence of the decline in market price

140. The court contrasted the actual disclosure of Continental with that proposed by the government, by comparing the prosecution's proposed footnote with the actual footnote which read:

2. The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable.

The government's proposed footnote read:

2. The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder), which bears interest at 12% a year, was uncollectible at September 30, 1962, since Valley had loaned approximately the same amount to Mr. Roth who was unable to pay. Since that date Mr. Roth and others have pledged as security for the repayment of his obligation to Valley and its obligation to Continental (now \$3,900,000, against which Continental's liability to Valley cannot be offset) securities which, as of February 15, 1963, had a market value of \$2,978,000. Approximately 80% of such securities are stock and convertible debentures of the Company.

of Continental stock immediately after publication of the financial statements, which were discouraging even without the omitted facts, the collateral became nearly valueless and bankruptcy ensued.

Eight expert accounting witnesses called by the defense testified that the financial statements treated the Valley receivable in accordance with GAAP and GAAS and fairly presented the year end financial position except for the erroneous intimation that the million dollars owing to Valley by Continental could be offset against the 3.5 million-dollar receivable from Valley, an error that the defendants attributed to negligence, not intent. The experts specifically testified that nothing need be said about the eighty percent of the collateral which was Continental's own securities (although three said that, on hindsight, disclosure would be preferable) or about the 400,000 dollar post-balance-sheet-date increase in the receivable or about the fact that Roth was the ultimate recipient of the loans to Valley and could not repay them. The government's two experts took a contrary view.

The defendants argued in their briefs that if the financial statements complied with GAAP, they must be acquitted on the ground that the fairness of disclosure was to be judged by what GAAP established as fair. "Fairness" as used here in establishing the duty of disclosure was equated by the parties with absence of material misrepresentations. Thus the accountants' position was that if GAAP, as related by the experts, did not require disclosure, no liability would ensue. In other words, if the current accounting model was properly followed, no liability could be imposed.

The Second Circuit, in a thorough opinion by Judge Friendly, neatly laid the accountants' arguments to rest. He upheld the trial judge's instructions that the "critical test" was whether the financial statements as a whole fairly presented the financial data, that proof of conformity with GAAP was persuasive but not conclusive, and that the jury could determine whether the testimony was supported by reason.¹⁴¹ Thus, the court aligned the case with those involving nonprofessional occupations and the minority view in the medical cases involving informed consent. The profession appears to have accepted *Simon*.¹⁴²

141. 425 F.2d at 805-06.

142. E.g., Kapnick, *Let's Abandon "Generally Accepted,"* in INSTITUTIONAL ISSUES IN PUBLIC ACCOUNTING 375-76 (R. Sterling ed. 1974); cf. Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 270 (1974); and Sterling, *Accounting Power*, 137 J. OF ACCOUNTANCY, Jan. 1973, at 61, 65.

One must be careful, however, to note that the court did no more than hold that the expert judgment of the expert witnesses was not conclusive. This was not a case of GAAP composed of proven custom or formal professional standards enacted by the AICPA or FASB. This was the typical case of facts not expressly covered by custom or formal pronouncements, calling for the exercise of professional judgment, and the court merely held that, as with lay occupations other than medicine, when the issue of the reasonableness of the defendant's conduct under the circumstances is for the jury, then the issue of whether the financial statements contained material misrepresentations also was for the jury.

Judge Friendly indicated his view of the similarity of the negligence issue (reasonableness of the defendant's conduct under the circumstances) with the materiality issue in *Simon* when he said:

We do not think the jury was also required to accept the accountants' [expert witnesses'] evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made. Such evidence may be highly persuasive, but it is not conclusive, and so the trial judge correctly charged.¹⁴³

This quoted paragraph contains another important point. The statement concerning "specific rules or prohibitions" is a *caveat*; it is not a *dictum* that if "specific rules or prohibitions" had been present the result would be different.¹⁴⁴ It would not be unreasonable to assume that Judge Friendly had in mind such specifics as APB Opinions or ARB's—formal professional pronouncements. He may even have been thinking of customs or writings of accountants, al-

In accord is *United States v. Colasurdo*, 453 F.2d 585, 594 (2d Cir. 1971); *cf. Republic Technology Fund, Inc. v. The Lionel Corp.*, 483 F.2d 540 (2d Cir. 1973). *But see Franklin Supply Co. v. Tolman*, 454 F.2d 1059 (9th Cir. 1972). In *Shahmoon v. General Development Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,308 (S.D.N.Y. 1973) in which a company sold homesites on installment contracts and receivables were carried at face value, without allowance for bad debts even though there was no personal liability of the obligors, the court held no fraud occurred since the statements complied with GAAP. The court also found that the plaintiff, a sophisticated investor, was not misled. This is in no way inconsistent with *Simon* since that case does not hold that all GAAP are misleading.

The SEC in its complaints in the *Penn Central* and *National Student Marketing* cases drew a clear distinction between observance of GAAP and fairness, obviously embracing the *Simon* principles. See Paragraph 31 of Complaint in *SEC v. Penn Central Co.*, CCH FED. SEC. L. REP. ¶ 94,527 (1974); Complaint in *SEC v. National Student Marketing Corp.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,360 at paragraphs 28(e)(2),(3).

143. 425 F.2d at 806.

144. For the view that the inference is that if such specifics had been present the decision would be different, see Isbell, *The Continental Vending Case: Lessons for the Profession*, J. OF ACCOUNTANCY, Aug. 1970, at 36.

though inclusion of the latter seems unlikely. At any rate, he simply wrote narrowly, deciding the case before the court—one involving expert judgment—and did nothing more than indicate that a different case would require individual consideration.

What would a court do if a charge of misrepresentation were defended on the basis that an accounting custom was followed by the defendant? Some cases decided prior to *Simon* held that observance of a customary accounting principle was no defense to a charge of misrepresentation. In *Baumel v. Rosen*¹⁴⁵ former shareholders of a retail land sales firm charged successfully that use of a conventional installment method of reporting income from sales understated income, and thereby misled the plaintiffs into selling their shares at a depressed price. And, in *Kaiser-Frazer Corp. v. Otis & Co.* the Second Circuit held that a footnote, which failed to note that a dramatic rise in fourth quarter income for a new company was the result of an inventory adjustment allocable to other quarters, was misleading, "regardless of whether [the] accounting system was a sound one."¹⁴⁶

If, after *Simon*, any doubt remained that compliance with GAAP is not conclusive when customary treatment is given, that doubt must have been dispelled by *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*.¹⁴⁷ In that case, land was sold with a small down payment to a weakly capitalized corporation under circumstances making collection problematical and the nature of the contract doubtful. The auditors, Laventhol, Krekstein, after extensive study by various members of the firm, refused to recognize the full \$2,030,500 gross profit and instead limited recognition to \$235,000 consisting of \$50,000 cash received and \$185,000 promised as liquidated damages in the event of the buyer's default. The accountants also described the contract in detail and gave only a qualified opinion "subject to the collectibility of the balance receivable on the contract of sale." This treatment is the customary cautious treatment when collectibility is doubtful.

The court said that the duty of full disclosure "cannot be fulfilled merely by following generally accepted accounting principles [A]ccountants, as well as insiders, must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately."¹⁴⁸ The court held that this would require

145. 283 F. Supp. 128 (D. Md. 1968), *aff'd* 412 F.2d 571 (4th Cir. 1969).

146. 195 F.2d 838, 843 (2d Cir. 1952). The opinion is ambiguous and may not have been intended to mean what is suggested. *Cf. In re Associated Gas & Elec. Co.*, 11 S.E.C. 975, 1058-59 (1942).

147. [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,574 (S.D.N.Y. 1974).

148. *Id.* at 95,999.

disclosure of the primary facts on which the defendants based their reservations. The client, FGL, had purchased the real estate from a company called Monterey and then resold it to Continental, controlled by one Ruderian. The court held disclosure inadequate and listed the additional disclosures required:

Thus, we believe that the full disclosure mandated by the Act required Laventhol to include in its report *at least* the following facts: (1) Continental's net worth; (2) the ambiguity of the language in the contracts which might have suggested to some that they were options; (3) Ruderian, on whose reputation and representations Laventhol was depending, was not personally liable on the contracts; (4) Ruderian's practice of reselling property before he paid for it; (5) neither of the transactions was recorded in FGL's books of original entry or corporate minute books; (6) this transaction was the largest in which FGL had ever participated; (7) FGL would show a loss if the income from the Monterey transactions were not realized; (8) FGL had not acquired title to the nursing home properties from Monterey; (9) no deed, title search or title insurance on the properties had ever been obtained by FGL; and (10) the legal opinion sought by Laventhol, on which it relied in treating the transaction as an enforceable purchase and sale, had been obtained over the telephone from an attorney who not only never saw the contract but never even had it read to him on the telephone.¹⁴⁹

If the courts follow the *Simon* principles not only when the GAAP in question consist of experts' judgments on what would be appropriate accounting under the circumstances, but also, as in *Herzfeld*, when the GAAP are customs, will they hold similarly if the GAAP are formal pronouncements such as APB or FASB Opinions or ARB's?

Although the vast majority of accounting decisions require *ad hoc* determinations based on reasoning from principles that do not precisely cover the problem, several very significant accounting questions are covered expressly by formal statements. Furthermore, these statements often involve close choices among alternatives on which reasonable men could differ. Often the very reason for the formal pronouncement is to resolve these differences one way or the other. For example the purchase or pooling debate continues simply because good cases can be made for numerous differing treatments. This being so, if formal professional standards are not conclusive, a lay jury will be allowed to second guess the profession. And, since the formal pronouncements are customarily reviewed by the SEC when promulgated, with power to override them, the jury would in fact be third guessing. It is at least the formal pronouncement which

149. *Id.* at 96,001-02. The *Herzfeld* holding is consistent with the better view in the informed consent cases in medicine. D. LOUISELL & H. WILLIAMS, *MEDICAL MALPRACTICE* 594, 600 (1969) disposes of the "doctor knows best" slogan there by commenting that although the doctor can best assess needs, "it hardly follows that his is the right to make the decision as to whether the risks shall be run."

Judge Friendly doubtless had in mind when he uttered the *caveat* in *Simon*.

If a jury believes that the accounting in a particular case results in a material misrepresentation even though based on a formal pronouncement, may the accountants be held responsible if the other elements of an action are established?

The question is not likely to arise in this simple form. Often, all that will be required to avoid being misleading will be some additional disclosure, which will permit the use of the formal principle without harm. Many times, the poor exercise of judgment by the accountant will be the actual reason for the deception. The particular accounting principle may not be appropriate for the circumstances. Or, the misrepresentation will result from the cumulative impact of individually acceptable applications of accounting principles all skewed to a biased presentation.¹⁵⁰

The case that comes closest to illustrating the truly difficult problem of a formal pronouncement—there the historical cost convention—is another Second Circuit decision by Judge Friendly, *Gerstle v. Gamble-Skogmo, Inc.*¹⁵¹ Although the historical cost convention is not embodied in a formal pronouncement as such, it is evidenced in different ways in many of them¹⁵² and is a fundamental conception on which the present accounting model is built.¹⁵³ If it is not in a formal pronouncement, that is only because none is necessary.¹⁵⁴

150. See *Associated Gas & Elec. Co.*, 11 S.E.C. 975, 1058 (1942). One able commentator has suggested that practitioners must determine:

- (a) Not only whether the accounting principles used are generally acceptable in the abstract, but also:
- (b) whether they are appropriate for the particular situation;
- (c) and their cumulative effect is not misleading; and
- (d) whether an accounting principle selected is applied to the transaction in a manner that properly recognizes the economic impact of the transaction in terms of the firm's present and future cash flows.

He also goes on to say, "I believe that auditors have a general conception of how the success or failure of a business should be measured. That general conception was through accounting theory and gives some idea of the purpose of accounting. It is a simple guide by reference to which it can be seen whether the chosen accounting principles are operating satisfactorily. To succeed, a business must ultimately take in more cash than it spends. If the business is failing by that simple guideline, the financial statements should not portray a picture of success." Carmichael, *What Does the Independent Auditor's Opinion Really Mean?* J. OF ACCOUNTANCY, Nov. 1974, at 86.

151. 478 F.2d 1281 (2d Cir. 1973).

152. E.g., ARB 43 c.4 (Inventory Pricing); c.5, ¶ 4 (Intangible Assets); c.9, §§ A, B (Depreciation); APB Op's No. 6, ¶ 17; No. 16.

153. For an explanation of how the cost convention varies from price level and from fair value accounting, see T. FIFLIS & H. KRIPKE, ACCOUNTING FOR BUSINESS LAWYERS c. 6 (1971).

154. "Actually, accounting theory maintains that original costs (or values) are not always and without exception to be adhered to, but that new values may be properly entered

In *Gerstle*, two companies solicited proxies for approval of a merger using a proxy statement containing financials based on historical cost in accordance with the universal convention. One company, General Outdoor Advertising ("GOA"), was controlled by the other, Gamble-Skogmo ("Skogmo"), and held outdoor advertising plants of a value far in excess of book (historical cost).

Prior to the merger, GOA had been in the process of liquidating these plants at prices far greater than book value but it discontinued plant sales at the beginning of the merger deliberations until after consummation. It had been negotiating some sales within days before the shareholders' meeting, however, and either had firm offers or appraisals of all remaining plants. Further, it was found that Skogmo intended to pursue aggressively the policy of selling the plants.¹⁵⁵ The SEC was told no firm sale negotiations were in process and refused to require disclosure of these possible sale values in a hearing requested by an unrelated stockbroker. The Commission branch chief disallowed the disclosure of values on the strength of the note to Rule 14a-9 of the Proxy Regulations giving examples of what may be misleading statements, including "[P]redictions as to specific future market values"¹⁵⁶

The merger terms called for the GOA shareholders to receive forty-dollar par value convertible preferred for each share of GOA held. The book value of the GOA shares was approximately thirty-seven dollars and underlying asset values were estimated at fifty dollars. The proxy statement disclosed that the market value of the plants was "considerably in excess of book value" and described the prior sales at 250 percent of book. The allegedly misleading statements were in a paragraph stating:

If the merger becomes effective, it is the intention of Gamble-Skogmo, as the surviving corporation, to continue the business of General Outdoor, including the policy of considering offers for the sale to acceptable prospective purchasers of outdoor advertising branches or subsidiaries of General Outdoor with the proceeds of any such sales, to the extent immediately available, being used to further expand and diversify operations now being conducted or which might be acquired and conducted by Gamble-Skogmo or its new, wholly-owned subsidiary, GOA, Inc. There have been expressions of interest in acquir-

when historic costs are no longer a significant measurement of the accountability of the corporation for those assets." [Citing May, *Postulates of Income Accounting*, 86 J. OF ACCOUNTANCY, Aug. 1948, at 107, 109 and mentioning that "a number of accounting authorities . . . are said to have made 'cautiously vague remarks' that indicate possible approval of revaluing fixed assets to a present-value basis. [H. HATFIELD, T. SANDERS & N. BURTON, ACCOUNTING PRINCIPLES AND PRACTICES 347 (1940)]. In practice, however, historical acquisition costs remain the only valuation basis used." Hackney, *Accounting Principles in Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 810 (1965).

155. 478 F.2d 1281.

156. Note to Rule 14a-9 of Proxy Rules, 17 C.F.R. § 240.14a-9 (1974).

ing many of the remaining branches of General Outdoor and discussions have taken place in connection therewith, but at the present time there are no agreements, arrangements or understandings with respect to the sale of any branch and no negotiations are presently being conducted with respect to the sale of any branch.¹⁵⁷

Within a year after the merger, commencing with a major sale within a week, all the remaining plants were sold at an 11 million-dollar profit representing twenty-five percent of GOA's net worth.

The district judge found the proxy statement misleading for failing to disclose the appraisals and firm offers for the plants, but on appeal the Court of Appeals held that requiring disclosure of appraisals, as opposed to firm offers, would run counter to the Commission's long standing practice and the imposition of liability on this ground would be unfair. It also decided not to rest liability on the existence of the firm offers, holding instead that the proxy statement was misleading for failing adequately to disclose Skogmo's intent to pursue aggressively the policy of selling GOA's plants while giving an impression of an intent to continue GOA's business.¹⁵⁸

Thus the court did not hold historical cost accounting to be misleading when asset values are far in excess of book. But that may have occurred because it had another means of finding the proxy statement misleading. The court expressly stated that it was loath to impose liability on Skogmo on the basis of what it regarded as a subsequent reversal of the SEC's position on appraisals from prohibition of disclosure to compulsion.

Manifestly one could find numerous grounds for distinguishing *Gerstle* from the problem at hand. Among other things, the argument was not that the financial statements should have shown the appraised values or firm offer values of the plants. No accounting witnesses appeared and the defendants were not accountants. No reference was even made to *Simon*, although Judge Friendly wrote both opinions and would not have overlooked *Simon* if he had thought it relevant. Moreover, the court refused to impose liability

157. 478 F.2d at 1288.

158. *Accord*, *Chris-Craft Industries, Inc. v. Bangor Punta Corp.*, 480 F.2d 341 (2d Cir. 1973); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), *aff'd with modification of damages*, 235 F.2d 369 (3d Cir. 1956). Absent the factor of failure to disclose an intent to sell, the courts have not held failure to disclose market values different from book values to be actionable. *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-94 (2d Cir. 1973); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972); *SunRay DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447, 450-51 (10th Cir. 1968); *Brown Co. Securities Litigation*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,751 (S.D.N.Y. 1973). *See also* Trienens & Smith, *Legal Implications of Current Value Accounting*, FIN. EXEC. MAG. 44 (Sept. 1972).

on the basis that conventional accounting was misleading and chose another ground of decision. Thus, no one could argue that *Gerstle* modified *Simon* in the eyes of the court.

Nevertheless the issue was present; the historical cost figures were ultimately held misleading in the absence of additional disclosure of the intent to liquidate and the higher figures obtainable on liquidation as indicated by the firm offers.

Gerstle and several other cases cited¹⁵⁹ all dealt with historical cost as a potential misleading misrepresentation. Because the model is based on historical cost, the result of a decision of liability would have been to make all present day accounting obsolete. When the law is reformed, every effort is made to avoid such a revolutionary sweep. The winds of change are blowing, however, and the accountants in their renewed interest for fair value accounting doubtless will have a weather eye out.

Suppose some less fundamental but nevertheless significant formal accounting principle came under attack. For example, now that the FASB has issued its Opinion No. 2¹⁶⁰ requiring immediate expensing of all research and development costs, cases of such write-offs will occur, with resultant decreases in profits and sales of securities by existing shareholders at market prices affected by the resulting lower reported profits. It would seem that *Baumel v. Rosen*, noted earlier, might be sound precedent for holding the statements misleading unless adequate disclosure of the effects of expensing the research and development costs is made.¹⁶¹ Even in a *Gerstle*-type situation, it seems reasonable to hold that the financial statements (as opposed to the text of the proxy statement) were misleading absent footnote disclosure of the intent to sell.

A more timely illustration is supplied by current efforts to define away some of the problems caused when an auditor requests information from the attorney for their mutual client with respect to contingent liabilities. One of the concerns is that certain types of potential claims, such as antitrust violations or title disputes to the client's land holdings, more likely will be recognized and asserted if they are disclosed in the financial statements. For example, if a client has held possession under a defective title for six years and

159. See cases cited note 158 *supra*.

160. FASB, Statement of Financial Accounting Standards No. 2, Accounting for Research and Development Costs (1974).

161. Since the writing of the above statement, *id.*, the SEC has proposed the suggested disclosure, lending some weight to the view expressed. See SEC Securities Act Release No. 5541 (Nov. 21, 1974). Compare *Independent Protective League v. AVCO*, [Current Binder] CCH FED. SEC. L. REP. ¶ 94,943 (S.D.N.Y. 1975).

seven months and will acquire title by adverse possession at the end of seven years, disclosure before that time expires may excite the adverse claimant to action and cause loss to the client.

Such factual situations probably are no more common now than ever,¹⁶² but auditors and lawyers, alerted to their own duties of disclosure under the securities acts, are concerned about the dilemma caused when an auditor (through the client) asks an attorney if he is aware of any contingent liabilities of their mutual client and the lawyer knows of the land title defect under the above circumstances. If the lawyer says he is aware of no defect, he is lying and is knowingly causing the issuance of a false financial statement. If the falsity is material, it may be actionable against the lawyer, the client, and perhaps even the auditor. If the lawyer discloses, the auditor either must publish the information or himself be a principal defendant with the client, and probably the lawyer (on some theory that he has a duty to "blow the whistle").¹⁶³ If the lawyer simply says he is aware of a contingency but is under a duty of confidentiality,¹⁶⁴ the auditor must qualify his report, making it unacceptable for certain securities law functions.¹⁶⁵

In the past, doubtless these problems were solved by the lawyer exercising his professional judgment in consultation with the client and perhaps even the auditor. Presumably nondisclosure usually resulted, based on the pre-10b-5 precept that one should let sleeping dogs lie.

Except for the fact that the financial statements will be published and any omission will result in at least a half-truth (and the auditor's report may be an affirmative misrepresentation) it might be possible to invoke the "business purpose" rule of the *Texas Gulf Sulphur* case.¹⁶⁶ *Texas Gulf*, however, involved not a question of the right to tell a lie but only the right not to say anything so long as no trading occurs. Hence, logically it does not apply. But strict logic

162. However, with "consumerism" and the "environmental movement," it is probable that potential large claims of a wholly new type are now more likely. Certainly more securities acts claims are being made now than before.

163. See text accompanying notes 421-43 *infra*.

164. ABA CODE OF PROFESSIONAL ETHICS No. 37.

165. See *Report of Committee on Corporate Law and Accounting, Scope of Lawyers' Responses to Auditors' Requests for Information*, 29 BUS. LAWYER 1391, 1395 (1974).

166. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 864 (2d Cir. 1968); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971); and *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333, 1338 (S.D.N.Y. 1969), all recognized that because Texas Gulf's land acquisition program would fail if its Timmins ore strike were disclosed, the company was under no duty to disclose the strike to its existing shareholders even though many of them sold their shares below fair value prior to the disclosure and were thus damaged. See also *Financial Indus. Fund, Inc. v. McDonnell, Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973), which fleshes out the business purpose rule in the duty to disclose area.

has never been the life of the law.¹⁶⁷ Further, the *Texas Gulf* "business purpose" rule itself is based on the broader determination that when a conflict of interest arises between the corporation and those investors who may sell their securities, the better course is to serve the corporation, whose constituency also includes all the non-selling shareholders, creditors, consumers, employees and everyone else who has become dependent on the entity. Therefore the course favoring the corporation would best comport with the expectations of all and the mores of the times.

On this ground, would it not be equally defensible for the lawyer who knows of the land title defect to keep it under his hat after obtaining the client's approval to do so? Perhaps with this in mind, the recommendation has been made to the Financial Accounting Standards Board that, under these circumstances, no disclosure of the matter should be made.¹⁶⁸

If the suggestion is adopted and thus becomes GAAP, will the courts nevertheless apply *Simon* to this very specific GAAP if they do not buy the rationale above and hold it can be misleading?¹⁶⁹ Or, will the caveat of Judge Friendly regarding specific GAAP become an exception to *Simon*?

Does *Simon* further mean that if financial statements are fair, they need not comply with GAAP? For example, if GAAP are not followed but the auditor states in his report that they were, but nevertheless the information is fairly presented, will liability ensue for misrepresenting the nonconformity? Again the issue is not

167. O. HOLMES, *THE COMMON LAW* 1 (1881).

168. Letter from the Joint Task Force on Contingent Liabilities of the AICPA and the Committee on Corporate Law and Accounting, Section of Corporation, Banking and Business Law, American Bar Association, to the FASB, Dec. 12, 1974. The letter suggests an amendment to the FASB's proposed redefinition of contingent liabilities to add the following:

In the case of . . . a contingency involving an unasserted claim or assessment where there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment, no disclosure of such contingency is required by this paragraph unless the assertion thereof is considered reasonably likely to occur.

Incidentally, it should be noted that in the case where a GAAP is established by an SEC rule, a defendant sued under the securities acts would have the defense of § 19(a) of the 1933 Act (15 U.S.C. § 77s (1970)) or § 23(a) of the 1934 Act (15 U.S.C. § 78w (1970)) both of which make the liability provisions of the statutes inapplicable to acts done in good faith in conformity with Commission rules. The court in *Gerstle* so stated. 478 F.2d at 1294. This suggests that the SEC should be asked to adopt a rule like that suggested by the Joint Task Force.

Query whether § 19(a) and 23(a) together with the SEC's endorsement of FASB and AICPA opinions in ASR 150 would largely obviate the problem discussed in the text. Does ASR 150 make the AICPA and FASB formal statements of accounting principles into SEC rules under §§ 19(a) and 23(a)?

169. See remarks of now Commissioner Pollack at PLI, *SECURITIES REGULATION TRANSCRIPT SERIES NO. 4, FOURTH ANNUAL INSTITUTE ON SECURITIES REGULATION 235* (Mundheim, Fleischer, Schupper eds. 1973) who would hold the silence misleading.

whether a misrepresentation of fact occurred, but whether the misrepresentation is material.¹⁷⁰

It is now apparently well-established that financial statements must in most cases not give a misleading impression to a layman as determined by a lay jury even if the statements comply with GAAP. Neither custom nor expert judgment will be binding on the jury and perhaps this is true of even formal pronouncements of the profession. Evidence of GAAP is relevant, however.

The significance of all this is great. If the accounting model established by GAAP subjects accountants to great liabilities, they may abandon it and develop a new model based on fair value, which is closer to the real world. In addition, since mere conformity to GAAP is insufficient to insulate accountants from liability, corporate managements, which traditionally choose the GAAP to be applied, no longer will have the dominant voice in the content of financial statements. Instead the auditor who is responsible for fairness will be the principal judge—as many reformers have suggested he should be.¹⁷¹

3. Auditing Standards and Procedures in the Courts

As with GAAP, the sources of GAAS, auditing standards and

170. See, e.g., *Bunge Corp. v. Eide*, 372 F. Supp. 1058, 1061, 1063, 1064 (D.N.D. 1974) (no misrepresentation if fair even if GAAP not followed).

171. A. BRILOFF, *THE EFFECTIVENESS OF ACCOUNTING COMMUNICATION* 55-84, 114-46, 224-25 (1967). Kripke argues that management's selection of accounting principles is the crux of the accountant's difficulties. Kripke, *Conglomerates and the Moment of Truth in Accounting*, 44 *ST. JOHN'S L. REV.* 791 (Spec. ed. 1970); Kripke, *The Objective of Financial Accounting Should Be to Provide Information for the Serious Investor*, in A. RAPPAPORT & L. REVSINE, *CORPORATE FINANCIAL REPORTING: THE ISSUES, THE OBJECTIVES AND SOME NEW PROPOSALS* 107 (1942) (reprinted in 42 *C.P.A.J.* 389 (1972)); Kripke, *Book Review*, 73 *COLUM. L. REV.* 1681, 1686 (1973).

The assertion in the text is disapproved by the 1972 report of Price-Waterhouse & Co. for The Lihierian American-Swedish Minerals Company. In one paragraph of its report Price-Waterhouse stated its belief that unrealized foreign currency losses should be reflected in the 1972 statements although they occurred in early 1973. But finding authoritative support for management's treatment, the auditors went on to give an opinion that the statements were presented fairly.

A serious question arises whether this is adequately based on the "buried facts" concept. Cf. *Mills v. Electric Autolite Co.*, 403 F.2d 429, 433-34 (7th Cir. 1968), *vacated on other grounds*, 396 U.S. 375 (1970), in which a disclosure, although accurately made, was held misleading when it appeared on a remote page of the proxy statement. Unsophisticated users of financial statements may read only the figures in the statements, not the report. Hence data in the report may be held to be "buried" at least insofar as the client's liability, as opposed to the auditor's liability, is concerned. See *Swanson v. American Consumer Indus., Inc.*, 415 F.2d 1326, 1330 (7th Cir. 1969); *Gould v. American Hawaiian S.S. Co.*, 331 F. Supp. 981, 995 (D. Del. 1971); *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331, 1362 (E.D. Pa. 1970), *modified on other grounds*, 458 F.2d 255 (3d Cir. 1971); *Beatly v. Bright*, 318 F. Supp. 169, 174 (S.D. Iowa 1970); *Norte & Co. v. Huffines*, 304 F. Supp. 1096, 1110-11 (S.D.N.Y. 1968), *aff'd in part, remanded in part on other grounds*, 416 F.2d 1189 (2d Cir. 1969). *Contra*, *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 601-03 (5th Cir. 1974).

procedures, may be customs, formal professional standards, expert judgment, or writings of accountants and others. The same analysis applied to GAAP would seem applicable here and will not be repeated. Instead some problems unique to GAAS will be pursued.

One of the three principal types of GAAS, as articulated by the AICPA, consists of the previously listed "Standards of Reporting,"¹⁷² which concern presentation of data to readers of the financial statements. When a question of auditing involves such a communication, *Simon* will apply. Thus, in the *Herzfeld* case¹⁷³ the failure of the auditor's report to spell out the basis for the qualification that the net income was subject to collectibility was held actionable even though it was customary.

Despite intimations to the contrary in numerous informal statements, it would not be inconsistent for the courts to apply lay standards to accounting principles as in *Simon* and to auditing standards of reporting as in *Herzfeld* while at the same time applying the standards of the profession to other auditing questions. For example, in *BarChris*, the case most often cited for the proposition that the standards of the profession must control auditing, the court determined, consistently with *Simon*, and without even referring to the profession's accounting principles for such activities, that the inclusion in income of proceeds from a sale and leaseback transaction was misleading.¹⁷⁴ Thus, in the same case a court looked to the standards of the profession for an auditing question but to its own judgment for an accounting question.

A court could rationally defend these differing treatments for auditing and for accounting principles by pointing out that communication of financial data to lay readers, based on accounting principles and reporting requirements, should be tested by the standard of meaningfulness to the layman, while those processes of auditing, consisting of data collection, testing, and drawing of inferences, are a matter for the expertise of an auditor, to be regulated by those who know something about the processes.¹⁷⁵ That argument merely supports the relevance of expert judgments and customs, not their conclusiveness. In other occupations, such as pipefitting, experts are allowed to explain their technology but their opinions do not bind the jury.

172. See note 24 *supra*.

173. See text at accompanying notes 145-49 *supra*.

174. *Escott v. BarChrist Constr. Corp.*, 283 F. Supp. 643, 658-59 (S.D.N.Y. 1968).

175. *Cf.* text accompanying note 136 *supra*. (Distinction between the medical malpractice cases involving surgical techniques and the different and minority view for those involving informed consent).

When *BarChris* stated that accountants should be held to the standard of the profession, the inquisitive mind must naturally ask, why? Why not a higher or lower standard? Why precisely the standard of the profession? Any suggestion of a lower standard cannot be followed because accountants in their reports purport to have conducted their audit in conformity with GAAS and they should be held at least to that representation. Further, there would seem to be no social utility to fixing a lower standard.

What of the suggestion that accountants, like tugboat operators,¹⁷⁶ may be held to a higher standard than the customary, when the custom is not supported by learned reason?¹⁷⁷

BarChris is itself only a dictum that the custom is the standard since in that case the defendant failed to reach even the level of custom. The court did not hold that he had reached that level and hence would be excused. A dictum by the Fourth Circuit, in *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs*,¹⁷⁸ said that industry standards may in some cases be too low. In two recent cases involving auditing standards, also contrary to *BarChris*, the courts expressly stated, by dicta, that customs of auditing are not binding. In *Pacific Acceptance Corp. Ltd. v. Forsyth*,¹⁷⁹ a New South Wales trial court said:

When the conduct of an auditor is in question in legal proceedings it is not the province of the auditing profession itself to determine what is the legal duty of auditors or to determine what reasonable skill and care requires to be done in a particular case, although what others do or what is usually done is relevant to the question of whether there had been a breach of duty.

It follows, if the auditing profession or most of them fail to adopt some step which despite their practice was reasonably required of them, such failure does not cease to be a breach of duty because all or most of them did the same.

Despite the fact that this was a trial court opinion in a foreign jurisdiction, it is sound authority because the trial lasted about a year, the issue was thoroughly litigated and the opinion is well-reasoned throughout its 105 printed pages. Further, American accounting, like Australian, is even more closely related to English practices than is the American common law—not only by reason of their common origins in English and Scottish accounting¹⁸⁰ but also because the large accounting firms, more than any of the large law firms, conduct their business on an international scale in order to

176. *The T. J. Hooper*, 60 F.2d 737, 740 (2d Cir. 1932).

177. See note 137 *supra* and accompanying text.

178. 455 F.2d 847, 852 (4th Cir. 1972).

179. [1970] 92 W.N. (N.S.W.) 29, 75.

180. See 1 J. CAREY, *supra* note 11, at 1-35.

serve their international business clients.¹⁸¹ Indeed the accountants in *Pacific Acceptance* were members of Price, Waterhouse & Co.

Further, the Seventh Circuit, in *Hochfelder v. Ernst & Ernst*,¹⁸² in dictum recently said:

And, although the defendant [accountant] correctly states that generally accepted auditing standards do not ordinarily require such investigation, we do not find that entirely compelling. The teaching of *The T. J. Hooper*, 60 F.2d 737 (2d Cir. 1932), is not lost to us for we recognize that we are not constrained to accept faulty standards of practice otherwise generally accepted in an industry or profession.^{182.1}

Moreover, we have already seen in the *Herzfeld* case that one type of GAAS—reporting standards—are not binding on the courts. In *Fischer v. Kletz*¹⁸³ an auditing standard was fashioned by a court without any fear of limitation by professional standards. Only after the decision did the AICPA adopt a ten paragraph auditing standard complying with the rationale of that decision.¹⁸⁴ Also, in *Interstate Hosiery Mills, Inc.*¹⁸⁵ the SEC made clear its own view that professional auditing standards were not the test of liability.

4. The Appropriate Legal Standards for Accounting Principles and Auditing Standards and Procedures

The question whether the legal standards of auditing may in some cases be higher than professional standards seems particularly appropriate in the circumstances of *BarChris* because the liability in that case was for false statements in a registration statement under section 11 of the 1933 Act, and section 11(c) has an express standard for defendants' conduct—"that required of a prudent man in the management of his own property." Should not the court apply the statutory standard and, in doing so, ascertain the policies of this portion of the securities acts and the history that led to enactment? And might not this result in a statutory standard higher than custom? If Congress was content with customary performance of companies and their auditors, section 11 would not have been needed. Doubtless it had in mind upgrading performance. This is clear from the fact that section 11(c) was even more strict as originally enacted. It originally read:

181. 2 *Id.* 369-72 (1970).

182. 503 F.2d 1100 (7th Cir. 1974).

182.1. *Id.* at 1113.

183. 266 F. Supp. 180 (S.D.N.Y. 1967).

184. SAS No. 1, *supra* note 20, at AU § 561.

185. 4 SEC 706, 715 (1939). For a further explication of the SEC's views see L. RAPPA-PORT, SEC ACCOUNTING PRACTICE AND PROCEDURE ch. 5 (3d ed. 1972).

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship.¹⁸⁶

Similarly, for liability under other sections of the securities acts, the standards of conduct must be determined with due regard for the policies of the securities acts, which require a higher degree of fairness to investors than had ever been customary.¹⁸⁷ The acts are intended to give a reasonable opportunity to make informed and intelligent investment decisions in fair and honest markets.¹⁸⁸

It would seem that the securities acts establish a legislative mandate not subject to modification by the courts. Hence the common law grounds for special treatment of doctors in medical malpractice cases would not seem to be relevant. As stated by the Second Circuit panel in a related situation involving an attorney's conduct in issuing opinions on exemptions from 1933 Act registration requirements:

The public trust demands more of its legal advisors than 'customary' activities which prove to be careless.¹⁸⁹

But what of cases not regulated by the securities acts? The arguments for merely following the standards of the profession in auditing matters would seem to be the same as those considered for accounting principles. The bases for the view that professional standards should be conclusive in the medical malpractice cases have been (1) practicality (viz. it is said that judges and juries are usually

186. Securities Act of 1933, ch. 38, § 11(c), 48 Stat. 83 (amended to present form by the Securities Exchange Act of 1934, ch. 404, § 206(c) 48 Stat. 907).

187. See Morris, *Custom and Negligence*, 42 COLUM. L. REV. 1147, 1154-55 (1942), in which it is suggested that the question is whether the policy of the law is to simply accept custom or to encourage a particular standard of conduct.

188. *Manor Drug Stores v. Blue Chip Stamps*, 492 F.2d 136, 140 (9th Cir. 1973), cert. granted, No. 74-124, Nov. 11, 1974. In *Investors Management Co., Inc.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163, at 80,517 (SEC 1971) it was said that "the maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets are primary objectives of the federal securities laws." With regard to Rule 10b-5, see *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974) ("In short, whether invoked in an SEC injunction action or in a private damage action, 'the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information' SEC v. Texas Gulf Sulphur Co., . . . 401 F.2d at 848." The court went on to quote further from *Texas Gulf Sulphur*, "It was the intent of Congress that all members of the investing public should be subject to identical market risks. . . . [And] inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected." 401 F.2d at 851-52." 495 F.2d at 236 n.13.

See generally 3 A. BROMBERG, *SECURITIES LAW: FRAUD* §§ 12.1-12.7 (1973).

189. *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 542 (2d Cir. 1973).

not competent to determine whether a doctor acted reasonably, and hence no other rule is workable)¹⁹⁰ and (2) a policy to preserve the profession from second guessing by jurors, which might result in inhibiting doctors from exercising their best judgment.¹⁹¹ A third justification might be based on an application of economic principles leading to the conclusion that custom always perfectly balances the costs and benefits.¹⁹²

Whatever the persuasiveness of these reasons for making custom conclusive in the medical malpractice cases, a question we need not consider, it does not seem overpowering when the questions involve the reasonableness of accounting principles or the conduct of an audit. First, as to practicality, auditing and accounting seem no more complex than certain other highly technical occupations when the questions are narrowed down by the judge and the lawyers. For example, a case likely to arise some day will involve the reasonableness of auditing a computerized set of records when none of the auditors on the scene knows anything about computers.¹⁹³ The question can be made to appear complex but it would seem that in some cases, at least, it would not be different from a question of whether a reasonable safety precaution for a steel mill is to require high friction stair treads in work areas.¹⁹⁴ As to the second basis, encouraging the best judgment of auditors, one would intuit that fear of liability would sharpen judgment. In any case, these two bases for fixing custom as the standard require behavioral study for verification of the asserted practicality and enhanced room for professional judgement. The third basis, the assertion purportedly based on an economic analysis, suffers from the fact that some of its supporters are afflicted with the Pygmalion Syndrome—they must not forget that their economic model is not the real world and therefore can be nothing more than a basis for establishing hypotheses for experi-

190. Morris, *supra* note 187, at 1164.

191. McCoid, *The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549, 608 (1959).

192. Cf. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 71-72 (1972).

193. Auditors are now very conscious of their incapacities concerning computer systems; their problem is in how to remedy the shortcomings. See, e.g., Levine, *Auditing Requirement for Advanced Systems*, 137 J. OF ACCOUNTANCY Mar. 1974, at 74.

Proposed audit standards were issued July 26, 1974, in an exposure draft entitled, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control*. J. OF ACCOUNTANCY, Sept. 1974, at 24. See also AICPA Audit Guide, *Audits of Service-Center-Produced Records* (April 1974).

194. Even in the medical malpractice area, if the issue is not beyond the comprehension of a jury, as when the claimed negligence is that surgical sponges were not removed, no requirement of expert testimony is placed on the plaintiff. Morris, *supra* note 187, at 1165; James & Sigerson, *Particularizing Standards of Conduct in Negligence Trials*, 5 VAND. L. REV. 697, 701 & n.15 (1952).

mentation. Thus it too requires empirical verification. But logic can supply us with help, and we do not need experience in this particular case. Even if the model were realistic, to say that custom will rise to a point at which the costs of the customary care will be balanced by the benefits in a doctor-patient or businessman-customer situation is one thing; to say this in the auditor-public investor situation is another. One of the proponents of economic analysis points out that in the doctor-patient situation the patient will pay extra for treatment until the last dollar spent buys just one dollar of accident cost reduction. "However, no firm [e.g., of auditors] will have an incentive to take precautions against accidents that are dangerous only to people [e.g., public investors] with whom the firm does not, and due to high transaction costs cannot, deal."¹⁹⁵

Perhaps the conventional technique of lawmaking should instead be used here—*i.e.*, gradual improvements in the standards may be made, taking into account current social conditions and adjusting the standards as experience dictates. Insofar as the federal securities laws establish a standard, courts deciding cases not regulated by those acts probably would be well-advised to conform to the standards in both types of cases.

C. *Proof of Accounting Principles and Auditing Standards and Procedures*

If expert testimony of expert judgment as well as customs and formal pronouncements on matters of accounting principles are relevant and admissible although not binding on the basis that lay standards control:

(a) a plaintiff need not introduce such evidence to make his case,

(b) but a defendant will probably introduce it in defense in most cases. Many times the plaintiff will wish to introduce expert evidence either to establish nonconformity with GAAP or GAAS or to counter the defendant's witnesses. More often than not he will be met with a wall of silence by accountants whom he seeks to enlist as expert witnesses.¹⁹⁶ This phenomenon, once common in the medi-

195. R. POSNER, *supra* note 192, at 71 (words in brackets supplied).

196. This silence may be more similar to affirmative acts of conspiracy than to mere conscious parallelism. See the editorial statement in the AICPA's *Journal of Accountancy* of a president of the AICPA urging accountants to "examine their consciences" before testifying against their brethren and if they have doubts on the merits to consider the effects on their own self-respect and the respect of their fellow practitioners. Editorial, *The Specter of Auditor's Liability*, 120 J. OF ACCOUNTANCY, Sept. 1965, at 33-34. And see the inadequate language of AICPA, Code of Professional Ethics 2 CCH AICPA PROF. STANDS. ET § 55.02 (1974).

cal malpractice area, is partially balanced by the *Simon* holding.¹⁹⁷ But is that enough? As a practical matter, will not an array of defendant's experts opposed to none for the plaintiff be likely to result in injustice?¹⁹⁸ If so, it behooves the courts as well as the accounting profession to cure the situation.

Perhaps the courts should exclude defense testimony from experts on the basis of unfairness to plaintiffs until the profession establishes panels of experts available to testify against accountants. Such an exclusionary rule, however, may not withstand due process arguments. More reasonably, courts should be more receptive to fashioning doctrines in the nature of *res ipsa loquitur* or presumptions in favor of plaintiffs to redress the imbalance from the expert testimony for defendants. Further, the courts might admit articles and books and nonexpert testimony of accounting practices as well as plaintiff's evidence of unsuccessful efforts to procure experts.¹⁹⁹ Courts should also freely comment on the expert evidence if it seems unreasonable.

In the final analysis, though, it is the responsibility of the AICPA to take steps to establish panels of experts available to testify for reasonable compensation.²⁰⁰

V. FOUR CURRENT PROBLEMS OF DAMAGE LIABILITY TO THIRD PARTIES FOR AUDITED STATEMENTS

An accountant may be charged with liability in damages for

197. 425 F.2d 796 (2d Cir. 1969). In that case itself one suspects that the government's extremely careful preparation must have included efforts to procure expert witnesses but those efforts failed as the only two government experts were SEC staffers. 425 F.2d at 805. Experience with other litigation makes clear that peer pressure as well as a misconceived notion of impropriety make it nigh impossible to obtain expert witnesses against accountants. In *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1110 (7th Cir. 1974), the plaintiff hit on a fruitful source in retaining retired accountants.

198. For illustrations of apparent willingness of medical experts to approach perjury, see 1 D. LOISELL & H. WILLIAMS, *MEDICAL MALPRACTICE* 420 n.3 (1973). Accounting experts seem prone to stretching a point. See the description of the expert testimony in *Evans v. Commissioner*, 264 F.2d 502, 511-12 (9th Cir. 1959), *rev'd sub nom. Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960). In that case the experts testified that useful life and salvage value of fixed assets for depreciation purposes are the economic lives and salvage value to the ultimate user—despite all the texts and treatises to the effect that it is the useful life and salvage value to the business which is relevant. See the authorities cited at 364 U.S. at 106 n.7 and *MONTGOMERY'S AUDITING*, *supra* note 13, at 271.

199. Even in the medical malpractice cases nonexperts like chiropractors sometimes have been allowed to testify, and books and articles, although usually prohibited as hearsay, in a few states are admitted under common law or statute. See *McCoid, The Care Required of Medical Practitioners*, 12 *VAND. L. REV.* 549, 619-21 (1959). For a discussion of arguments in favor of admissibility of treatises see 6 J. WIGMORE, *EVIDENCE* §§ 1691-92 (3d ed. 1940).

200. For a description of such panels in the medical area see 1 D. LOISELL & H. WILLIAMS, *MEDICAL MALPRACTICE* 10-12 (1973).

materially misleading financial statements whether audited or not, or for misleading statements or failure to speak up when a duty arises even absent any misleading financial statements. In this part, some aspects of liability to third parties on audited statements only will be considered. And, since this paper is not a treatise, we will consider only a few of the questions that seem particularly interesting at this time. They will include: first, whether more than the audited statements should be considered "expertised" by the auditors under section 11 of the 1933 Securities Act; secondly, the duty to discover fraud; thirdly, who can sue accountants for misleading financials; and lastly, whether the flexible duty standard should supplant culpability. Liability on other than audited statements and the auditor's duty to "blow the whistle" on his client will be the subjects of the next part. Numerous other questions will be left unexplored.

A. "*Expertised*" Portions of the Registration Statement Under § 11 of the 1933 Act

Section 11 of the 1933 Securities Act²⁰¹ imposes on various participants in a registered offering of securities liability for damages for misleading registration statements. The right is limited to persons who purchase the registered securities,²⁰² and the liability is imposed unless the defendant establishes his own due diligence (the issuer has no "due diligence" defense).

Among those liable are:

every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him. . . .²⁰³

The literature is replete with fine discussions of section 11 liability, especially concerning the *BarChris* case,²⁰⁴ and what has already been said need not be repeated. There is, however, one question peculiar to accountants' liability under section 11 that deserves further consideration: Does the accountant's "expertised" portions of the registration statement mean only the audited financial state-

201. 15 U.S.C. § 77k (1970).

202. *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967).

203. 15 U.S.C. § 77k(a)(4) (1970).

204. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). See, e.g., *Folk, Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 199 (1969).

ments or does it include other financial data such as unaudited interim statements, summaries, and charts? This issue was raised and resolved in *BarChris* but it rests on a factual determination in each case.

In the typical underwritten registered offering the auditor performs three tasks with respect to the financial statements. He usually:

(a) audits a set of statements for the preceding year, which are contained in the prospectus;

(b) performs an "S-1 review" of events up to a date on or closely before the effective date of the registration statement;²⁰⁵

(c) conducts certain procedures to enable him to write a "comfort letter" for the underwriters delivered at the closing date (i.e., the date when the proceeds of the offering are delivered by the underwriter to the issuer or seller).²⁰⁶

All three activities involve substantial investigation of events subsequent to the balance sheet date²⁰⁷ and the latter two extend far beyond the normal audit and typically will involve events subsequent to the original auditor's report. The comfort letter investigation will even include some period after the effective date of the registration statement.

Thus on the original audit of financials for a period ending December 31 of Year One, because the auditor's report will be executed some time after the year end, it has become standard practice to consider additional evidence with respect to conditions existing at the date of the balance sheet and which affect the data therein. These include matters such as a loss on an uncollectible account receivable that became certain after the balance sheet date but was the result of prior conditions, or a repurchase pursuant to a "put" agreement with a purchaser of the company's product.²⁰⁸ That type of post-balance-sheet-date event affects the figures on the Year One financials and must be taken into account. A second type of information may become available which, although it does not affect the Year One figures, is so material as to require disclosure. For example, disclosure should be made of securities issuances or business

205. This is required by § 11(a) of the 1933 Act, which fixes responsibilities as of the effective date. For descriptions of an S-1 review, see *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 701-03 (S.D.N.Y. 1968) and SAS No. 1, *supra* note 20, at AU § 710.08.

206. For a description of the recommended procedures on a comfort letter engagement, see SAS No. 1, *supra* note 20, at AU § 630. These are not *prescribed* auditing procedures. *Id.* at AU § 630.02.

207. For the post balance sheet date auditing duties on a normal audit, see SAS No. 1, *supra* note 20, at AU § 560.

208. See *In re Touche Ross & Co.*, SEC Accounting Series Release 153 (Feb. 25, 1974).

acquisitions occurring after the end of Year One. The auditor's duty with respect to facts arising between the balance sheet date and the auditor's report date includes, according to SAS No. 1,²⁰⁹ a duty to read the latest available interim statements, to interview officers regarding post balance sheet date events, to review corporate minutes and to perform other procedures. A failure to perform these duties properly may result in the auditor's liability for resultant misleading statements.

The S-1 review similarly entails post-balance-sheet-date investigation as above, plus study of the proposed registration statement.

The comfort letter for underwriters is a matter of contract between the parties, but usually includes specific representations by the auditor of his independence, and compliance as to form with SEC requirements for audited and interim unaudited statements, changes in certain items after year-end and other financial data. The comfort letter usually is dated after the offering date and at or shortly before the closing date. It ordinarily is addressed to the lead underwriter and expressly is made exclusively for his use without right of publication.

Despite all this activity beyond the audited statements, *BarChris*, construing section 11 of the 1933 Act, held auditors liable only for misrepresentations in the audited statements²¹⁰ because the statute imposes liability only for a matter for which the accountant has consented to be named as having prepared or certified²¹¹ any part of the registration statement or a report which is used in connection with the registration statement and which is itself misleading. In the eyes of the court, the auditors in *BarChris* apparently did not consent to such use beyond the audited statements. Nevertheless, as in that case, the post-balance-sheet-date investigation may be inadequately performed to establish the accountant's due diligence defense under section 11 with respect to the audited state-

209. SAS No. 1, *supra* note 20, at AU § 560.11-560.12.

210. 283 F. Supp. at 684.

211. Accountants' reports do not "certify" anything although they once did [*see Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931)] and accountants claim that they do not prepare the statements, which they say are management's. See note 110 *supra*. They might thus claim that the first two italicized words in the quoted portion of § 11(a)(4) have no applicability to them in the usual case. But the term "certify" is used in Schedule A, items (25), (26), and (27) as describing the required auditor's report. Thus it has a technical meaning under the Act that includes reporting. At any rate, the accountant has "prepared" his "report" (see the next three italicized words), which is used in connection with the registration statement and thus even if a court were prone to hold accountants' reports to not be certifications, and financial statements to be prepared by management, the express language of § 11(a)(4) is sufficient to cover the matter.

ments. *BarChris* also held that the contractual terms of the comfort letter would preclude finding a duty based on the representations therein running to persons other than the underwriter.²¹²

The scope of section 11 liability for auditors is important because although auditors may be held liable on audited or unaudited statements under other securities acts sections, the section 11 case for a plaintiff is relatively simple since he need merely prove the existence of misrepresentations in the registration statement. Is *BarChris* correct in holding the auditors liable only for the audited statements under section 11?

Since the issue under section 11 is whether the auditors have *with their consent* been named as having prepared or certified any part of the registration statement or any report used in connection with it, the question in each case is a factual one. Given his extensive post-balance-sheet-date activities, even if an auditor merely is named as the firm's accountant in the registration statement, it would seem that he might be held liable under section 11 for misleading unaudited interim statements or summaries of earnings and similar accounting data. The point is that the statute does not limit liability to audited statements but limits liability to matters that the auditor has "with his consent been named as having prepared or certified." If a reader might reasonably infer that the auditor has prepared misleading data, he should be held liable under section 11.

Since under section 11(b)(3)(C) nonexperts have no duty to investigate expertised portions of the registration statement, the nonexpert underwriter, directors and others will have some interest in the expansion of the accountant's expertised work.

In addition to liability for statements in a prospectus or a registration statement under section 11, liability under the ubiquitous Rule 10b-5 also may ensue. Different legal issues will arise in that situation, including the issue whether section 11 and Rule 10b-5 may both apply to a prospectus misrepresentation case,²¹³ the proper

212. 283 F. Supp. at 698. If the terms of the comfort letter read differently, contract or tort law principles might yield a different result. For example it would not take much to enable fashioning a third party beneficiary case. Nevertheless the typical comfort letter is drafted as in *BarChris* to avoid this type of claim. Of course, a claim under Rule 10b-5 (in addition to a contractual claim) by the underwriter against the authors of the comfort letter may be present when, as is usual, the underwriters have purchased the securities. Cf. *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967); *H.L. Green Co. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960). And, the auditors may be considered "participants" with the issuer for purposes of § 12(2) of the 1933 Act. See *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964); 2 A. BROMBERG, *SECURITIES LAW: FRAUD* § 8.5 (315) (1973); Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 199, 201-07, 215-16 (1969).

213. For varying views see, e.g., *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961) (private

test of materiality, causation of the transaction and of the loss, justifiability of the plaintiff's actions, and the measure of damages. Moreover, Rule 10b-5 liability is not limited to statements for which the auditor has consented to the use of his name.

Certain express liabilities also exist under section 12(2) of the 1933 Act but, since privity is required thereunder, an auditor could be liable only as a "participant" in a section 12(2) wrong.²¹⁴ Section 17 of that Act also has been the basis for implied private actions in many courts.²¹⁵

If the registration statement is also doubling as a proxy statement as is frequently the case in a merger transaction, liability may also arise for violation of the proxy rules under section 14 of the 1934 Act.²¹⁶ Finally, section 18 of the 1934 Act, which covers false reports to the Commission, may be a basis for liability for misleading statements in registration statements.²¹⁷

These other liability provisions may prove of practical importance if section 11 is unavailable as, for example, when the section 13 period of limitations has run or the plaintiff is unable to establish the linear privity with the issuer or secondary seller as required by *Barnes v. Osofsky*.²¹⁸ Usually a plaintiff will include claims under one or more of these sections to avoid the narrow limitation of section 11 to statements for which the accountant has consented to have his name used.

suit available); *Jordan Bldg. Corp. v. Doyle, O'Connor & Co.*, 282 F. Supp. 87 (N.D. Ill. 1967) (no private suit against any seller under 10b-5), *rev'd*, 401 F.2d 47 (7th Cir. 1968); *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964) (if scienter present, 10b-5 is available); *Montague v. Electronic Corp. of America*, 76 F. Supp. 933 (S.D.N.Y. 1948) (no suit against sellers under 10b-5 if an express remedy is available). For a recent analysis, see *Stewart v. Bennett*, 359 F. Supp. 878 (D. Mass. 1973).

214. See *Lennerth v. Mendenhall*, 234 F. Supp. 59 (N.D. Ohio 1964) and *In re Caesar's Palace Sec. Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973), upholding an aiding and abetting claim under § 12(2).

215. See, e.g., *Hanraty v. Ostertag*, 470 F.2d 1096 (10th Cir. 1972); *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152 (5th Cir. 1969); *Dasho v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 788-91 (8th Cir. 1967); *Harris v. Palm Springs Alpine Estates, Inc.*, 329 F.2d 909, 912 (9th Cir. 1964); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 787 n.2 (2d Cir. 1951); *Dorfman v. First Boston Corp.*, 336 F. Supp. 1089 (E.D. Pa. 1972). But see *Horton, Section 17(a) of the 1933 Securities Act—The Wrong Place for a Private Right*, 68 Nw. U.L. Rev. 44 (1973).

216. SEC Rule 145 relating to business combinations treats a merger proxy statement as a § 11 registration statement. Thus the same document will be subject both to § 11 of the 1933 Act and § 14 of the 1934 Act.

217. See, e.g., *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967).

218. 373 F.2d 269 (2d Cir. 1967).

B. *The Auditor's Duties Concerning Discovery of Management's Creative Accounting and Frauds by Others*

Accountants frequently state that their duties do not include discovery of fraud. The scope of duty concerning fraud is a crucial aspect of the question of liability to third parties, for if auditors have no duty to use care to discover frauds, including management misrepresentations in the financial statements, or if having such a duty, it is owing only to the client, no liability could arise to third parties on the part of auditors except in the rare case in which the auditor is an active swindler.²¹⁹

Thus, two pertinent questions arise:

(a) What duties, if any, does an accountant have concerning frauds on the client or misrepresentations by the client's management in the financials?

(b) If the duty arises, to whom is it owed?

The AICPA has stated abundantly and clearly that the auditor must be aware of the potentiality for fraud and be on the lookout for it;²²⁰ GAAS require that an auditor must develop and properly apply tests of the client's internal control system²²¹ and that if suspi-

219. Only infrequently is the auditor guilty of seeking consciously to defraud third parties. The following observation, of ancient vintage, remains true:

[D]erelictions by accountants are for the most part not a result of greed to share in the loot produced by fraud. On the contrary, accountants have been led astray by their desire to help their clients out of a particular embarrassment by stretching a point of auditing or accounting principle. Unless the affairs of the client improve, the accountants subsequently find themselves committed to the same intentional errors but to a greater degree, until a day of reckoning, when third parties, usually creditors, stockholders, or the government, delve into the affairs of the client and discover the fraud . . . almost invariably the facts show that except for the retention of the particular client of doubtful value, accountants have not profited by the schemes. . . . Kostelanetz, *Accountants Responsibilities and the Criminal Law*, THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT 401 (July 1943), quoted approvingly in Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 669 n.59 (1957).

220. SAS No. 1, *supra* note 20, at AU § 110.05 states:

In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

221. *Id.* AU § 110.06.

cious circumstances arise, he must probe thoroughly if he is to continue the engagement.²²² The frauds to which these GAAS apply include employee defalcations and other violations of the firm's well being, but even "more closely associated with the objective of the ordinary examination" is misrepresentation by management in the financial statements.

Thus, no duty to guarantee discovery of all fraud is imposed, but a duty to investigate is present, especially for misrepresentations by management in the financials. And, if suspicious circumstances arise a further duty to probe arises. Indeed, often this is the very purpose of the engagement.²²³ Because the source of the duty to investigate and the duty to inquire into suspicious circumstances is GAAS, when the standards are incorporated in state law rules, the duty is a state law duty, whereas it is a federal law duty when incorporated in a federal law rule.²²⁴

Several recent cases illustrate both the duty to probe suspicious circumstances and the duty to investigate for fraud or management misrepresentations even absent suspicions.

1. The Duty To Inquire Into Suspicious Circumstances

The essential basis of *Simon*²²⁵ was that the Second Circuit panel simply could not bring itself to sanction nondisclosure, no matter what GAAP provided, when it was known by the auditors that the controlling person of the client corporation was misusing corporate funds for his personal stock speculations. In *dictum* the court further stated that when the auditor has reason to doubt that the corporate affairs are being honestly conducted, he must extend his audit procedures to determine whether his suspicions are justified. If so, full disclosure is required "unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established."²²⁶

Other cases deal with the duty to probe suspicious circumstances. For example, in *1136 Tenants Corp. v. Max Rothenberg & Co.*²²⁷ the defendant accountants were charged with failure to uncover defalcations of the building manager. The Appellate Division held that on becoming aware that invoices purportedly paid by the

222. *Id.* AU § 110.07.

223. *National Surety Corp. v. Lybrand*, 256 App. Div. 226, 235-36, 9 N.Y.S. 2d 554, 563 (1939).

224. *Cf. Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974).

225. *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969).

226. 425 F.2d at 806-07.

227. 36 App. Div. 2d 804, 319 N.Y.S. 2d 1007 (1971), *aff'd*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

manager were missing, the accountant had a duty at least to inform the client. "Defendant was not free to consider these and other suspicious circumstances as being of no significance and prepare its financial reports as if same did not exist."²²⁸

*United States v. Benjamin*²²⁹ also involved suspicious circumstances that the court held were enough to substantiate a finding of criminally intentional misrepresentation. In this case the defendant accountant, among other things, was victimized by his client's lack of credit to cover a 200 dollar hotel bill; yet he reported that the company had fine prospects. The court used an apt phrase to describe in a negative form the accountant's duty to probe suspicious circumstances, saying that intent was shown when the "defendant deliberately closed his eyes to facts he had a duty to see."²³⁰

One recent case of failure to inquire into suspicious circumstances, the U.S. Financial fiasco,²³¹ is of timely import because it is typical of the epidemic of creative accounting cases. These cases were most dramatically portrayed in the Penn Central outrages²³² but were also exemplified in the Westec, IOS, Franklin National, Republic National Life Insurance, Westgate California Corporation, and other situations.²³³ The basic fraud in these situations was the use of some related entity (or an unrelated entity with a side agreement protecting it from loss) with which a transaction is made, usually involving little or no real cash from the other party and artificially high values, which are usually indefensible, designed to result in accounting profits. One also is led to suspect, because of the sophistication displayed, that more often than not some accountant, if not the auditor, has advised upon and condoned the

228. 36 App. Div. 2d 804, 319 N.Y.S.2d at 1008 (1971); *accord*, *Blakely v. Lisac*, 357 F. Supp. 255, 266 (D. Ore. 1972) (dictum).

229. 328 F.2d 854 (2d Cir. 1964).

230. *See also* *United States v. Sarantos*, 455 F.2d 877, 880-81 (2d Cir. 1972); *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968).

231. SEC Accounting Series Release No. 153 (Feb. 25, 1974).

232. STAFF REP. OF THE SEC TO SPEC. SUBCOMM. ON INVESTIGATIONS, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (1972); *SEC v. Penn Central Co.*, CCH FED. SEC. L. REP. ¶ 94,527 (E.D. Pa. 1974) (complaint); COMM. ON BANKING AND CURRENCY, THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS, Staff Rep. H.R. 92d Cong., 1st sess. (1972); COMM. ON INTERSTATE AND FOREIGN COMMERCE, INADEQUACIES OF PROTECTIONS FOR INVESTORS IN PENN CENTRAL AND OTHER ICC-REGULATED COMPANIES, Staff Rep. H.R. 92d Cong. (1971); *Hearings Before Spec. Subcomm. on Investigations, Comm. on Interstate and Foreign Commerce, Penn Central Trans. Co.: Adequacy of Investor Protection*, H.R. 91st Cong., 2d sess. (1970).

233. *See* A. BRILOFF, UNACCOUNTABLE ACCOUNTING (1972) for one generally available description of some of these matters. They have been documented in dozens of news and other articles over the past several years. Regarding Republic National, see Accounting Series Release No. 167 (Dec. 24, 1974) and SEC Litigation Release No. 6652 (Jan. 6, 1975); 5 SEC Docket 799.

scheme.²³⁴ The use of related persons to inflate income artificially is an ancient device and auditors from the beginning have been taught that whenever a sale is made between such persons the price is not to be taken at face value unless face value is fair value.²³⁵ Thus, if an asset with a fair value of twenty dollars is sold by a parent to an unconsolidated subsidiary for one hundred dollars, even if for cash, the eighty-dollar difference that would have been sales income in an arm's length transaction is simply a dividend or contribution to the capital of the parent and perhaps waste by the subsidiary.

In *U.S. Financial*, according to a consent order that did not constitute an admission of facts, the transactions were more complicated. In one deal, USF purportedly sold some land and uncompleted buildings to a company called Burnham at a profit of 550,000 dollars under a letter agreement that was never closed. The agreement committed USF to complete construction, to use its best efforts to secure permanent financing for the buyer, to pay underwriting costs for Burnham's planned syndication of the property, and to guarantee Burnham against loss from operations. After the year end USF was forced to take back the properties under a verbal "put" agreement and found two so-called buyers who were in fact nominees of USF, one of whom used USF's own funds. According to the consent order, the USF auditors, Touche, Ross & Co., reportedly knew that the closing was never documented, received the document containing the guarantee against loss but failed to examine it, and failed to pursue the post-balance-sheet-date resales.

Other transactions involved the use of USF's own funds to finance pretended purchases or swaps of real estate, or joint ventures or partnerships, some of which were elaborately constructed on the misrepresented basis that "tax reasons" required it. In addition a pattern developed whereby USF made very few but very large transactions, all very complex and usually at year end. Further, an atmosphere developed of keen interest by management in reported profits.

The Commission, with its usual sophistication, held that these characteristics were badges of nonarms-length transactions that should have aroused suspicions entailing extended audit proce-

234. "A really successful fraud can scarcely be accomplished in our complex financial worlds without the help of accountants and lawyers. This may be active and intentional connivance or it may be more passive and subtle, but it is frequently essential." Speech of Chairman Ray Garrett, Jr. of the SEC before ABA National Institute on Professional Liability, May 30-31, 1974, Montreal.

235. W. PATON ON ACCOUNTING 466 (1964); SEC Accounting Series Release No. 95 (Dec. 28, 1962).

dures. The Commission stated very specifically that it was not going beyond GAAS. It quoted from the McKesson and Robbins release stating:

[W]e believe that . . . [with respect to] examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits, whether resulting from fraud or otherwise. We believe that alertness on the part of the entire [audit] staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. . . . [W]e feel that the discovery of gross overstatements in the accounts is a major purpose of . . . an audit. . . .²³⁶

Significantly, the Commission refused validity to a defense being raised frequently of late to the effect that the auditors were themselves victims of the fraud, having been misled by USF. The Commission quite properly made it clear that it is part of the auditor's job to detect management deceptions and that it is not sufficient to obtain assurances from management itself that transactions are legitimate. Thus, when one of the aforesaid badges of a nonarms-length transaction appears, "it is critical that the accountant not only receive assurances that [it] . . . does not involve members of management, but also that he obtain information concerning the nature and extent of the [transaction] as well as the identity of the [participants]."²³⁷

2. The Duty To Investigate Even Absent Suspicious Circumstances

The auditor's duty does not permit him to wait for an alarm bell to arouse him to investigation. He has a duty in the first instance to focus a skeptical eye on the accounts. That is the purpose of an audit—it is not merely an arithmetical check and a determination of compliance with form. One of the things GAAS specifically include is a duty to look for the suspicious circumstances that in turn will raise the auditor's duty to probe to the bottom.

One recent case illustrating the existence and scope of the duty to investigate is *Hochfelder v. Ernst & Ernst*.²³⁸ In this case, one Leston Nay, president and ninety-two percent stockholder of a bro-

236. SEC Accounting Series Release No. 19 (Dec. 5, 1940).

237. SEC Accounting Series Release No. 153 (Feb. 25, 1974). The Commission similarly dismissed Arthur Andersen's defense that it had been defrauded by its client in *In re Arthur Andersen & Co.*, SEC Accounting Series Release No. 157 (July 8, 1974).

238. 503 F.2d 1100 (7th Cir. 1974).

kerage firm audited by the defendants, induced the plaintiffs to put their funds in a special account established for the purpose of yielding a high return. In fact, Nay used the funds for his own purposes as disclosed in his suicide note. The defendants were charged with aiding and abetting Nay's fraud, even though they had no knowledge of it, on the basis that they had been guilty of negligently failing to discover and follow up by further procedures the existence of Nay's "mail rule," whereby he directed that all mail addressed to him or to his attention was to be opened by no one but himself, even if he was away from the office.

The Seventh Circuit panel held that there were both common law and federal securities acts duties to investigate by virtue of the undertaking to make the audits and that the appropriate standard of conduct was the AICPA statement of GAAS. The court quoted from the predecessor of SAS No. 1, § 110.05²³⁹ and then determined the scope of the duty in the circumstances. It held that the auditor's duty to study and evaluate the client's internal control system²⁴⁰ raised two issues for the trier of facts:

(1) whether Nay's "mail rule" constituted a material inadequacy in [the brokerage firm's] system of internal accounting control; and

(2) whether [the defendants] failed to exercise the due care required of a professional auditor in that it did not discover a material inadequacy in internal accounting control.²⁴¹

In an extremely thorough opinion, the court in *Pacific Acceptance Corp. Ltd. v. Forsyth*,²⁴² spelled out the auditor's duty to investigate as well as his additional duty to probe irregularities. In that case one Thomson, a director and principal shareholder, had procured loans from Pacific Acceptance Corporation, Ltd., on the security of fictitious real estate mortgages. The auditors had verified the mortgages through Thomson's attorney but had not physically examined the documents themselves. When Thomson failed, Pacific lost over a million dollars.

The court found that the auditors had failed in their duty to study and evaluate the internal control system by ascertaining the nature of the system, appraising its reliability and sampling its operation. Numerous other acts of negligence also were found, in-

239. See note 220 *supra*.

240. SAS No. 1, *supra* note 20, at AU § 150.02.

241. 503 F.2d at 1111.

In re Touche Ross & Co., ASR No. 153 (Feb. 25, 1974) also contains further illustrations of the duty to investigate. See the descriptions of the deals involving Palm Springs Mobile Country Club and Coastal Land Corporation.

242. *Pacific Acceptance Corp. Ltd. v. Forsyth* [1970] 92 N.S.W. 29.

cluding a failure to follow up numerous irregularities beyond an inquiry of employees. The court said that detecting speculations by employees was incidental to the main task, "but the auditor should satisfy himself that the internal control, together with his audit procedure, guard against major frauds."²⁴³

From this discussion one can see readily that it is deceptive to urge that GAAS do not impose a duty to discover fraud. As the trial judge in *Pacific Acceptance* accurately stated, the audit must be designed so "that if fraud exists there are reasonable prospects of it being revealed."²⁴⁴ And, *Hochfelder* demonstrates that a question of fact is posed by a failure to discover the fraud.

One further aspect of the duty to investigate, which is illustrated by *Pacific Acceptance*, should be mentioned; that is the ques-

243. *Id.* at 65. One particularly meaningful passage is quoted here rather extensively since the report is not generally available. At page 65-66 the court stated:

The magnitude of the possibility of fraud and its possible nature to be considered in any particular audit will depend on the nature of the organization involved and the manner in which its business is conducted and the auditor pays due regard to the possibility by considering it in its particular context. It is possible it may occur within or outside the company . . . or at a low or high level of authority for these human frailties may extend to any such person. The possibility of fraud may be greater in certain organizations, particularly where the temptations or opportunities for fraud are greater or control is weaker. Fraud usually does not appear on the face of a company's records, but often indications of it will appear in the form of irregularities, and often it is only by examining the irregularities that fraud is revealed.

An auditor pays due regard to the possibility of fraud or error by framing and carrying out his procedures, having in mind the general and particular possibilities that exist, to the intent that if a substantial or material error or fraud has crept into the affairs of the company he has a reasonable expectation that it will be revealed. The problem is an intensely practical one. On the other hand, it may be unjust to criticize a procedure, particularly with hindsight, merely because it was not apt to reveal some fraud devised with particular ingenuity or some isolated or minor fraud or error In such instances in particular it is important with resolution to exclude the operation of hindsight, because after the event it is often so easy to think of procedures that could have been adopted that would have revealed even the ingenious fraud, whereas in fact the auditor looking at the matter as it then presented itself was acting reasonably. A judge can only guard against this danger by constantly reminding himself of it, as I have endeavoured to do. On the other hand, it should be recognized that an auditor has an opportunity to plan much of work in advance and to work out a programme, which is often built up over a period of time, having some general application, based on some understanding of the possible points of danger in the financial affairs of an organization. He therefore has an opportunity, with some deliberation and forethought, to design procedures which take some account at least of the fact that experience has shown that frauds or their concealment commonly involve manipulation at particular points in the financial operations of a business—for example, cash manipulations near a balance date, which manipulations often fall into various well-known patterns; or, for example, manipulation by means of various descriptions of fictitious sales, purchases, loans or borrowings; or, for example, misappropriation of moneys received or intended to be paid out, usually covered up by well-known devices; or, for example, manipulations of various types in respect of stock or securities or supposed stock or securities of the business.

244. 92 N.S.W. at 64.

tion of delegability of responsibility. Frequently an auditor must rely on the attorney of the client, or on other auditors of subsidiary companies or recent merger partners. As to the right to rely on attorneys, for example, concerning the existence of contingent liabilities, it seems that the right to rely extends only to matters within the attorney's legal expertise. Thus, *Pacific Acceptance* held the auditor must examine the original mortgage documents to ascertain whether they existed and he may not rely on an attorney's statement of their existence since that is not a technical legal question.²⁴⁵ If personal inspection was not feasible, a system of testing the reliability of the attorney's responses, such as spot checking, would have to be devised. The court did indicate that if a legal question arose the attorney's advice might be observed unless circumstances indicated it was unreliable.

Further authorities indicating that auditors may not avoid responsibility by delegating their own duties exist in analogous cases. Thus, in *BarChris* the court would not contemplate excusing the underwriters' counsel on the basis of their reliance on issuer's counsel.²⁴⁶ Also, *Gould v. American Hawaiian SS. Co.*²⁴⁷ held proxy solicitors had no right to depend on the corporate counsel to correct proxy statements that became false. On the other hand, a case indirectly upholding the auditor's right to rely on an attorney for legal questions is the dictum in *SEC v. Frank*²⁴⁸ that would permit an attorney's reliance on a chemist's technical description.

If it is the rule that an auditor may delegate responsibility to an attorney only for legal matters, certain questions arising in the current debate concerning an attorney's responses to auditor's requests for information²⁴⁹ should be dealt with in a different manner than currently proposed in some quarters. For example, one proposal is that an auditor should rely on an attorney's determination that certain liabilities are not material.²⁵⁰ Doubtless, materiality often will be a legal question, as when a claim is considered to be without any legal basis. On the other hand, when the determination of materiality is made on a quantitative basis, it is more an accounting question than a legal one.

245. 92 N.S.W. at 30, 83-4, 86.

246. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

247. 351 F. Supp. 853, 867 (D. Del. 1972).

248. 388 F.2d 486, 489 (2d Cir. 1968).

249. See, e.g., Committee on Corporate Law and Accounting, *Scope of Lawyers' Responses to Auditors' Requests for Information*, 29 BUS. LAWYER 1391 (1974); Deer, *Lawyers' Responses to Auditors' Requests for Information*, 28 BUS. LAWYER 947 (1973).

250. ABA COMMITTEE ON CORP. LAW AND ACCT'G., SEC. OF CORPORATION, BANKING AND BUSINESS LAW, REPORT ON ATTORNEYS' RESPONSES TO AUDITOR'S REQUESTS FOR INFORMATION 3, item (4), 16.

Another area in which the delegability problem presents acute practical difficulties is the right to rely on other auditors. Only a brief mention of some questions will be made here.

When one auditor prepares consolidated statements and a subsidiary's statements have been audited by another auditor, a frequent situation in these days of conglomerates and multi-nationals, is it enough for the auditor's report merely to state that the audit of the subsidiary was conducted by another firm, as was done in one case?²⁵¹ As a minimum it would seem that the consolidating auditor should make some inquiry into the reputation of the other, his independence, and perhaps take other steps to assure accuracy.²⁵² Indeed GAAS may require it.²⁵³

There is, however, a further consideration. As recognized in *Pacific Acceptance*²⁵⁴ the relationship of the consolidating auditor to the shareholders is different from that of the subsidiary's auditors to the shareholders. They may be (a) answerable only to management or (b) operating under a lesser practical and legal duty in relation to management's own activities.

The AICPA has addressed the problem of multiple auditors by providing generalized guidelines for the reporting auditor.²⁵⁵ The guidelines do not resolve the above questions but seem to assume they do not exist by often referring to a "division of responsibility."

The problems have prompted at least one firm not to accept engagements unless it audits all affiliates. The court in *Pacific Acceptance* recommended a single auditor for all companies when practicable, and when it was not, identification of the other auditors and confirmation of their selection by the parent's shareholders.²⁵⁶

251. *Beardsley v. Ernst*, 47 Ohio App. 241, 244-45, 191 N.E. 808, 810 (1934). Reg. S-X, § 2-05 provides minimal requirements in this situation, 17 C.F.R. 210.2-05 (1974).

252. See SEC Rel. No. 33-5275 (7-26-72), CCH FED. SEC. L. REP., Special Rep. No. 434, pp. 11-12 (1972) in which a participating underwriter in an offering was said to be entitled to delegate the § 11 duty to investigate to lead underwriters, although "he must take some steps to assure the accuracy of the statements in the registration statement. To do this, he at least should assure himself that the manager made a reasonable investigation."

253. SAS No. 1, *supra* note 20, at AU § 543.10.

254. See 92 N.S.W. at 32, 48-49, 112-16.

255. SAS No. 1, *supra* note 20, at AU § 543. See also SAS No. 2 ¶ 14 (1974).

256. 92 N.S.W. at 126. According to *The Wall Street Journal*, one alleged fraud in *Equity Funding* was facilitated by the fact that two different auditors were retained. At one point the parent company pretended to have paid out cash of \$16 million for certificates of deposit when in fact the cash was paid to a subsidiary purportedly as insurance premium receipts.

The subsidiary's auditors did not bother to check the source of the \$16 million as it was cash and hence not suspect. After the subsidiary's audit, the cash was repaid to the parent whose auditors again did not consider it necessary to check the source. If the same auditor had performed both audits the money shuffle might have been discovered. *Wall Street J.*, Jan. 6, 1975, at p. 32, cols. 1-6.

3. Auditors' Duties To Third Parties Concerning Discovery of Fraud

The issue whether auditors' duties run to third parties (i.e., to other than clients) will be discussed immediately below.

C. *Common Law Liability To Third Parties for Negligence—The Replacement of Privity*

The common law liabilities for misrepresentation have not been uniformly settled. The difficulties arise from (a) the fact that misrepresentation is the common nexus of various liabilities, criminal and civil, legal and equitable, in tort²⁵⁷ and in contract,²⁵⁸ as well as (b) an unwillingness to establish tight definitions of the elements of liability.

Thus, even if a particular jurisdiction establishes a set of elements for the single common law action in *deceit*, the statement of elements does not describe fully the law of *misrepresentation* in that jurisdiction because additional remedies, for example, negligence or equitable rescission, may be available. Also, as between different jurisdictions and even from case to case in a single jurisdiction, the content of the elements of the deceit action may vary, as when the jurisdiction requires "scienter," but it is defined in one case to include only a "conscious awareness" of falsity and in another to include a "reckless disregard" for the truth or falsity of the statement. Even if one verbal formula is used, the evidence to meet it varies from case to case.

Further, because of the subjective nature of such elements as materiality, scienter and reliance, much circumstantial evidence and imprecise methods of dealing with the evidence compound the chaotic picture of this field of law.²⁵⁹ The tort writers have not been able to systematize satisfactorily the law in any intellectually comfortable form.²⁶⁰

Nevertheless, perhaps we can isolate one major problem for

257. Misrepresentation is often found at the root of tort actions no one conceives of as being misrepresentation actions. See W. PROSSER, *LAW OF TORTS* 683-84 (4th ed. 1971) for a catalogue.

258. The debate over whether actions for innocent misrepresentation lie in tort or contract continues. See Hill, *Damages for Innocent Misrepresentation*, 73 *COLUM. L. REV.* 679 (1973).

259. See Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 *U.C.L.A.L. REV.* 583 (1958); Comment, *Warranty and Deceit—Remedy for Misrepresentation in Contract Negotiations*, 43 *MARQ. L. REV.* 244, 247-49 (1959) (describing the confusion in the Wisconsin decisions).

260. For one treatment, see W. PROSSER, *LAW OF TORTS* 683-736 (4th ed. 1971) and Prosser, *Misrepresentation and Third Persons*, 19 *VAND. L. REV.* 231 (1966).

scrutiny—the need for privity between plaintiff and defendant in a damage suit for negligent misrepresentation—since this issue is often raised and has been the subject of some interesting recent developments.

To place the question in context, the following simplistic, yet convenient, sketch of the various liabilities for misrepresentation should be kept in mind. When a misrepresentation of a material fact is made by one party to another in a business transaction, causing some injury, an action may lie in contract for breach of warranty. For example, when an accounting firm misrepresents that it has conducted an audit in accordance with GAAS, resulting in some loss to the client, the client may sue for breach of the engagement contract to perform the audit in accordance with GAAS. Or, the action may be for the torts of deceit or negligence. In addition to those three legal remedies, numerous equitable remedies may be sought, for example, raising the misrepresentation as a basis for rescission or reformation of the contract. Or, the misrepresentation may be a defense in a legal or equitable action by the auditor.

When the injured person, instead of being the client, is a third party, such as an investor in the audited firm, the range of choice of actions is narrowed (assuming a stockholder's derivative action is not appropriate). The third-party common-law action is most likely to be one for deceit or negligence when the injury is pecuniary, as opposed to physical harm to person or property.

If in deceit, the plaintiff will have to prove (1) a false representation, (2) some form of knowledge of the falsity, (3) an intention to induce the plaintiff to act or refrain from action, (4) justifiable reliance, and (5) resultant damage.²⁶¹

If the action is for negligence, the first question is whether negligence under the circumstances is at all actionable.²⁶² Assuming it is, the second element of deceit, knowledge, would of course be replaced by: "a failure to exercise reasonable care or competence in obtaining or communicating the information."²⁶³ The first, fourth and fifth elements of negligence probably could be subsumed in the same above-numbered elements of deceit, although the factual contents of the elements may differ.

As noted, one difficult question is whether an action should lie for mere negligence, but the cited materials indicate that the question has been much discussed, and little can be added on the sub-

261. W. PROSSER, *LAW OF TORTS* 685-86 (4th ed. 1971).

262. See, e.g., Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 U.C.L.A.L. REV. 583 (1958); 1 F. HARPER & F. JAMES, *THE LAW OF TORTS* 545-51 (1956).

263. RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

ject.²⁶⁴ Much recent activity concerning the third element has occurred, involving the question of the relationship between plaintiff and defendant required to sustain the action.²⁶⁵ This is our concern here.

The requirement of privity for negligent torts resulting in pecuniary loss, once based in historical sources,²⁶⁶ acquired a policy ground in *Ultramares Corporation v. Touche*.²⁶⁷ In that case, Judge Cardozo, forced to distinguish the newly decided cases eliminating privity for physical torts, and fearing the possible ruin of the accounting profession from exposure to third-party claims, suggested that the legislature, not the courts, should be the agency to change the law if alteration was desirable. The unlimited publicity that misleading financial statements might obtain was viewed as a potential cause of widespread reliance and loss, and a change in the law to liability for such loss was considered too radical for judicial reform like that which altered the law of physical torts in *McPherson v. Buick Motor Co.*²⁶⁸ It is important, however, to note two features of *Ultramares*.

First, the court did not hold that only those in privity of contract with the accountant could recover for negligence; the circle of liability encompassed persons who were recipients of the defendant's representation as the end and aim of the transaction, some-

264. The tandem nature of the two questions of whether an action will lie for negligent misrepresentation and if so, what relationship will be required between the parties, may be noted. If it is said that the negligence action may be maintained but only by one in privity with the defendant, what is also being said is that the action cannot be maintained by a third party. Because the existence of the two variables complicates discussion, and to anchor the problem for analysis, Prosser suggests discussing the cases by dividing them into 3 categories of constants: (a) intentional misrepresentation; (b) negligent misrepresentation; (c) innocent misrepresentation. Another approach, perhaps more efficient from the parties' viewpoint is to organize them according to whether they are either of two constants: (a) suits between parties in privity, or (b) third party actions.

265. The cases are collected and well analyzed in Annot., 46 A.L.R.3d 979 (1972).

266. Privity was originally required because actions for misrepresentation were thought to arise *ex contractu*, and only a party to the contract could enforce it. But even contract rights were extended somewhat by the third party beneficiary concept of *Lawrence v. Fox*, 20 N.Y. 268 (1859). Before long, however, misrepresentation became a basis for tort action; but then, even physical torts required some direct relationship between the parties. It was not until *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916) that the citadel of privity finally fell in the United States. For an early case involving negligent accounting and requiring privity of contract, apparently on the historical ground that there is not duty of care owed to third parties to avoid pecuniary torts, only a contractual duty to parties in privity, see *Landell v. Lybrand*, 264 Pa. 406, 107 A. 783 (1919).

For the genesis of the historical rule that the duty of care in performance of a contract ran only to parties to the contract, see *Winterbottom v. Wright*, 152 Eng. Rep. 402 (Ex. 1842).

267. 255 N.Y. 170, 174 N.E. 441 (1931).

268. 217 N.Y. 382, 111 N.E. 1050 (1916).

times known as the "primary beneficiary,"²⁶⁹ a bond "so close as to approach that of privity" but nevertheless not identical with it. Secondly, the reason for not extending liability further was based on the fact that extension would be a change of the law and Judge Cardozo felt it not feasible for a court to determine whether the economic impact of further liability would destroy the profession;²⁷⁰ rather, "[a] change so revolutionary, if expedient, must be wrought by legislation."²⁷¹ Thus, Judge Cardozo did not find the wide exposure; he merely hypothesized its possibility and, as a matter of his perception of the legal process, thought it would be better for the legislature rather than a court to decide it.

Despite the first feature, it was not long before the case came to be cited for requiring privity.²⁷² Only recently have a few courts been persuaded to read the opinion more carefully.²⁷³ More importantly, the second aspect of *Ultramares*, opting for the status quo in the face of unknown exposure, must be recognized as a product of the times—a period when the role of the auditor and the maturity, power and prestige of the profession were vastly different from their present status. Can anyone suggest that a modern court would say, as did Judge Cardozo, that "public accountants are public only in the same sense that their services are offered to anyone who chooses to employ them"? Is the "public" in "public accountant" still akin to the "public" in "public stenographer"?

If in the 1920's accountants were solely responsible to those who paid them, they have since then sold their wares with respect to publicly-held companies on the basis of their being not only available to the public for hire but also responsible to the public investors in audited companies. The federal courts, construing the federal securities laws, have long since recognized the fact that the profession is responsible not just to its immediate employers, but also to the investing public.²⁷⁴ How can courts continue the ludicrous fic-

269. 255 N.Y. at 182-83, 174 N.E. at 446.

270. "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." 255 N.Y. at 179, 174 N.E. at 444.

271. 255 N.Y. at 187, 174 N.E. at 447.

272. See Leviton, *Accountants' Scope of Liability for Defective Financial Reports*, 15 HASTINGS L. J. 436, 447 (1964).

273. See, e.g., *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968); *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa 1969). The great misunderstanding of *Ultramares* is noted in Levitin, *supra* note 272, at 447-50 and Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797, 815-21 (1959).

274. *In re Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670-71 (1957); *In re American Finance Co.*, 40 S.E.C. 1043, 1049 (1962); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974). Of course, in some circuits this responsibility will not be actionable for negligence

tion that accountants serve their payors only for state law purposes, but the public investors for federal purposes?

Virtually every pronouncement on the subject from the profession either expressly states the public responsibility of accountants or takes it for granted. The very first sentence of the AICPA's Code of Ethics asserts: "A distinguishing mark of a professional is his acceptance of responsibility to the public."²⁷⁵ The same page refers to the shift to the current relationship to the public:

The ethical Code of the American Institute emphasizes the profession's responsibility to the public, a responsibility that has grown as the number of investors has grown, as the relationship between corporate managers and stockholders has become more impersonal and as government increasingly relies on accounting information.

The remainder of the Code reads in a similar vein. The Preface to the *1953 Restatement of Accounting Research Bulletins*²⁷⁶ also adverts to the "increasing interest by the public in financial reporting."

The trend of the profession toward assuming a duty to public investors mentioned in these pronouncements did not begin until after *Ultramares* was decided, although previous enlightened talk had concerned public responsibility.²⁷⁷ Nevertheless, corporate financial statements in the 1920's were still an exercise in creative accounting.²⁷⁸ In 1933, two years after *Ultramares*, the climax came as the true state of affairs of public financing became clear to all. An AICPA committee, operating under the chairmanship of one of the most outstanding leaders of the profession, George O. May, reported that "[t]he passage of the Securities Act seems to your committee to make a clearer definition of the responsibilities of auditors more imperatively necessary."²⁷⁹ Adolph Berle, the keenest early student of law and accounting, in a paper presented to the 1933 annual meeting of the AICPA stated the culmination of the prior decades of history: "It becomes plain that accounting is rapidly ceasing to be in any sense of the word a private matter."²⁸⁰

John Carey, in his recent historical study,²⁸¹ provides more de-

under Rule 10b-5 since "scienter" is required. Negligence alone may be "scienter" in the case of an auditor who fails to observe his duty of inquiry of suspicious circumstances on an audit, or his duty to investigate. *Cf. Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir. 1973).

275. Code of Professional Ethics, 2 CCH AICPA PROF. STANDS. ET § 52.09 (1974).

276. AICPA, ARB 43 Preface (1953).

277. See 1 J. CAREY, *supra* note 11, at 77-80.

278. See *supra* note 3.

279. 1 J. CAREY *supra* note 11, at 172.

280. *Id.* at 173.

281. *Id.* at 172 *et seq.*

tails to this same effect that accountants believe and advertise that they have a duty to the public. The point need not be labored further here.

Clearly the role of accounting in 1931, the time of *Ultramares*, was only beginning to become a public one and had not attained its current public service status. Hence, the *Ultramares* decision, after a long and active life, may now be obsolete.

Further reason to eliminate privity as a common-law requirement is the changing perception of the basis of tort liability in general. Even the middle-aged view that tort liability should be imposed on the person best able to distribute the loss would be sufficient for judicial experimentation with the imposition of the loss on accountants.²⁸² Thus, if no liability existed whatsoever for misrepresentations in financial statements, losses would be visited fortuitously in large amounts on investors or companies. One way to spread the loss adequately among all those who participate in investment activity would be to legislate establishment of a single governmental insurance fund, such as the Federal Deposit Insurance Corporation, with premiums paid on share transactions.

Another loss-spreading technique, feasible for court law making, is to impose liability on management, directors, lawyers and auditors, who, knowing of the risk, can pass along the costs by increasing their fees in order to either pay their own increased insurance premiums or establish a self-insurance fund. This is much less harsh than holding the client whose financial statements are misleading solely responsible because frequently the client will be insolvent (the loss to investors that forms the basis for suit being the cause of that insolvency). In that case, innocent parties, the shareholders and other constituents of the client, would bear the loss.

If privity is no longer a viable limiting doctrine, but recovery should not extend to the universe, what should replace the crumbling citadel?²⁸³ Although some courts continue to honor the privity requirement,²⁸⁴ many have moved toward effectuating the language

282. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91 (D.R.I. 1968) stated that the auditor is an efficient loss distributor.

283. The English case which finally eliminated privity as a requirement for negligent torts resulting in pecuniary damages, *Hedley, Byrne & Co. Ltd. v. Heller & Partners Ltd.*, [1964] A.C. 465, [1963] 2 All E.R. 575 (House of Lords 1963) posed this question by first eliminating privity and then, in 5 extremely lengthy speeches, posing various relationships that might have been sufficient had the defendants not been excused from liability on the defense that they had disclaimed responsibility for the representation.

284. *Koch Industries, Inc. v. Vosko*, 494 F.2d 713 (10th Cir. 1974); *Stephens Industries v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971); *Milliner v. Elmer Fox & Co.*, CCH BLUE SKY L. REP. ¶ 71,178 (Utah 1974); *Canaveral Capital Corp. v. Bruce*, 214 So.2d 505 (Fla. Dist. Ct. App. 1968); *Investment Corp. v. Buchman*, 208 So.2d 291 (Fla. Dist. Ct. App. 1968);

of *Ultramares* which distinguished *Glanzer v. Shepard*.²⁸⁵ They hold accountants liable to third parties whose reliance actually could be foreseen.²⁸⁶ Some, including the draftsmen of the *Restatement* and *Restatement (Second) of Torts*²⁸⁷ would go further and impose liability on members of a class whose reliance in the same or a similar transaction is foreseen although the individual plaintiff was unknown. Others would impose liability coextensively with liability for physical torts—to all those whose reliance is foreseeable,²⁸⁸ following the principal for physical torts that “the risk reasonably to be perceived defines the duty to be obeyed.”²⁸⁹ No court construing state law has suggested that no limitation by virtue of the relationship of the parties should exist—that suggestion presumably would call for liability whenever “but for” causation existed or even without causation, on some basis of deterrence.²⁹⁰

One must be careful to note that implicit in most of these

MacNerland v. Barnes (Ga. App. 1973) (Unreported; see J. ACCOUNTANCY, Sept. 1973, at 71). Cf. *Bunge Corp. v. Eide*, 372 F. Supp. 1058, 1062 (D.N.D. 1974). Except for the unreported Georgia case, all the cited decisions were decided by courts constrained to follow law established by other courts. The Utah case and the 2 Florida decisions were by intermediate courts bound by higher court decisions and *Buchman* contained intimations that if the court had had its “druthers” it might have ruled otherwise. *Stephens Industries* was a federal diversity case applying *Erie* to determine what the Colorado court would have done if it had had the question. *Koch Indus., Inc. v. Vosko* purporting to find Kansas or Bahamian law, misconceived *Hedley, Byrne*, which would have been controlling in the Bahamas.

285. 233 N.Y. 236, 135 N.E. 275 (1922).

286. *Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs*, 455 F.2d 847 (4th Cir. 1972); *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 93 (D.R.I. 1968); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. App. 1973) (noted 39 Mo. L. REV. 466 (1974)); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971); *Ryan v. Kanne*, 170 N.W.2d 395 (Iowa, 1969). The newest cases in New York contain only intimations of a possible departure from the older ones. *Compare Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); *Mutual Ventures, Inc. v. Barondess*, 17 Misc. 2d 483, 186 N.Y.S.2d 308 (1959) (dictum); and *C.I.T. Financial Corp. v. Glover*, 224 F.2d 44 (2d Cir. 1955) (dictum) with *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931); *O'Connor v. Ludlam*, 92 F.2d 50 (2d Cir. 1937); and *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938). See Gormley, *Accountants' Professional Liability—A Ten-Year Review*, 29 Bus. LAWYER 1205, 1208-12 (1974). The author, a very competent writer, draws a distinction between the “end and aim,” “primary beneficiary” rule of *Glanzer v. Shepard* and the actually foreseen test, citing *Rhode Island Hospital Trust* in accord. In any event, the varying relationships are on a single continuum and, the slices of the continuum may vary in thickness depending on the commentator.

287. RESTATEMENT OF TORTS § 552 (1939); RESTATEMENT (SECOND) OF TORTS § 552 (Tent. Draft No. 12, 1966).

288. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968) (dictum).

289. *Palsgraf v. Long Island R. Co.*, 248 N.Y. 339, 162 N.E. 99 (1928).

290. Cf. *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) (holding “causation in fact” to be the appropriate basis in a Rule 10b-5 case against tipping insiders and tippees who sold without disclosure of material inside information to plaintiffs who purchased during the period of non-disclosure but would have acted differently had they known).

statements is the concept that not only the parties should have the indicated relationship, but also the type of transaction in which the plaintiff incurred his injury should be foreseen, foreseeable or be the end and aim of the defendant's actions.

As a matter of abstract justice it seems impossible to develop a simple generally acceptable rule for all cases. From the viewpoint of the injured party, and perhaps those who would seek to sterilize the market in corporate securities, "but-for" causation is not too severe a test. That view, however, is tempered by the policy consideration that the slightest error very often would result in total ruin of the auditor or at least a very severe cost, disproportionate to the wrong. What then is the solution?

One possibility is a flexible balancing process which has been applied in California to resolve this question in a group of three cases involving defectively drafted wills. The intended beneficiaries were allowed actions for negligence although the contracts to draft the wills were made only with the respective testators. In the first, *Biakanja v. Irving*,²⁹¹ the court held that a notary public liable in negligence to a named beneficiary under a will drafted by the notary when the will was held invalid for improper attestation. The court stated:

The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm. . . . Here, the "end and aim" of the transaction was to provide for the passing of Moroevich's estate to plaintiff. See *Glanzer v. Shepard*, 244 N.Y. 236, 135 N.E. 375, 23 A.L.R. 1425.²⁹²

In each of the other two cases, the claim was against an attorney for failure to execute properly the testator's intention to cause the plaintiff to take under the will.²⁹³

These cases illustrate the wisdom of the balancing approach. If

291. 49 Cal. 2d 647, 320 P.2d 16 (1958).

292. *Id.* at 650, 320 P.2d at 19.

293. *Heyer v. Flaig*, 70 Cal. 2d 223, 449 P.2d 161 (1969) (recovery against attorney who failed to provide against spouse's statutory share); *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685 (1961) (recovery denied for lack of negligence); *accord*, *Licata v. Spector*, 26 Conn. Supp. 378, 225 A.2d 28 (1966).

The reasoning of these cases was merely a specific application of the modern flexible approach to torts, eschewing the old view based on often artificial categories that might have been justified by conditions in earlier times. See, e.g., *Rowland v. Christian*, 69 Cal. 2d 108, 443 P.2d 561 (1968) (eliminating the classification of trespassers, licensees, and invitees for purpose of fixing duties of care of owners of land).

one were to speak in the wooden, conventional terms of privity or foreseeability, he might reach the same result as was achieved in these cases, stating a rule that one not in privity may recover if he actually is foreseen as a potential victim of negligence. This view would leave no room for the very real consideration in a case involving auditors because of the difference between the limited amount of exposure to injury caused by the failure of the will and the much wider exposure of the auditor.²⁹⁴ Even in cases involving auditors the facts will vary. In one case the audit may be of a closely held company for use in making a new public offering, or in another case, for reporting to the existing management. One would not be offended in the former case with a finding of liability to the investors despite the absence of privity, whereas in the second case imposition of liability for loss in an unintended transaction would be unthinkable.

Of course the "actually foreseen" test could resolve these last two cases. But the merit of the balancing process is that it permits the court to weigh *any* pertinent considerations as they appear more or less relevant in each case, including changing public policy.

The federal courts, construing Rule 10b-5 in cases of misrepresentations in connection with the purchase or sale of securities, have had to fashion a federal common law concerning these same issues. As with state law, the two tandem major questions have been, first, the necessity for intent and, if it is necessary, its definition, and secondly, the required relationship of defendant and plaintiff.

On the second question it was thought early in the process that privity might be required,²⁹⁵ but this position soon was dispelled.²⁹⁶ Now it goes unmentioned because the courts have concerned themselves with the next question of what *is* required if privity is not.²⁹⁷ Clearly, privity is not required for accountants' liability under Rule 10b-5.²⁹⁸

Privity, however, has always been relevant in the sense that its

294. For an interesting realization of the need to view each case on its own facts, see *Rozny v. Marnul*, 43 Ill. 2d 54, 250 N.E.2d 656 (1969), where the Illinois court in a case involving a surveyor's alleged negligent preparation of a plat of survey, purported to eliminate privity for all pecuniary torts but reversed the question of accountants' liability as a special case.

295. *Joseph v. Farnsworth Radio & Television Corp.*, 198 F.2d 883 (2d Cir. 1952). *But see* 3 L. LOSS, *SECURITIES REGULATION* 1767-71 (1961).

296. *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968).

297. *See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

298. *See, e.g., Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968); *Fischer v. Kletz*, 266 F. Supp. 180, 189-94 (S.D.N.Y. 1967); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 104 (N.D. Ill. 1967).

presence or absence affected other elements of liability. Thus in a non-10b-5 case, discussing the Rule, the court said:

Privity of contract between the plaintiffs and the defendants is not a fixed condition precedent to the implication of a private remedy for a statutory violation that injured the plaintiffs, members of the protected class. In that situation, privity is not an ultimate or operative fact. It is an evidentiary fact to be considered in conjunction with other material facts in determining whether the relationship (such as it is) between the plaintiffs and the defendants and the nature of the particular acts and transactions involve the duty created by the statute.

The relationship between the plaintiffs and the defendants, the nature of the defendants' participation in the challenged transactions, and the plaintiffs' reliance upon the defendants' acts may vary. The relationship may be as direct as that of vendor and purchaser or that of a corporation and its active directors who personally profited. Other relationships that shade off into remote and indirect connections may be hypothesized.

In the case of a corporation, for example, the defendant-directors may not have personally participated or profited from the allegedly wrongful acts.²⁹⁹

This system under Rule 10b-5, considering the whole mosaic of the relationship of the parties, the degree of culpability of the defendant, whether the defendant profited, and the plaintiff's reliance on the defendant, is nothing less than the same sort of consideration used in the California balancing process.

Absent legislation, other courts interpreting state law would be best able to administer a rough form of justice through application of this technique. At the cost of predictability, a court could at least consider and weigh the factors calling for liability. Presumably predictability will develop as the courts through accretion of cases fill in the doubtful spaces in the normal common-law way.

In any event, the trial court should do the weighing as a question of law.³⁰⁰ Even if a jury does the weighing, it should be reviewable on a basis that it is a question of law, not of fact. Perhaps if the question is given to the jury, trial courts should be required to exact

299. *Brown v. Bullock*, 194 F. Supp. 207, 229-30 (S.D.N.Y. 1961). The quoted portion was cited and followed in *Cochran v. Channing Corp.*, 211 F. Supp. 239, 245 (S.D.N.Y. 1962) and *Miller v. Bargain City, U.S.A., Inc.*, 229 F. Supp. 33, 37-38 (E.D. Pa. 1964). See L. Loss, *SECURITIES REGULATION* 1064 (1951); L. Loss, *SECURITIES REGULATION* 371-72 (Supp. 1955). See the discussion following the "flexible duty standard" at text accompanying notes 364-76 *infra*.

300. It may be suggested that *White v. Abrams*, 495 F.2d 724, 735-36 (9th Cir. 1974), may make the question solely one of fact. I do not concur with this argument. Primary facts, of course, such as whether the plaintiffs relied on the defendant's acts are for the fact-finder. But *White*, at the cited pages, although not free of ambiguity, does not say that the fact-finder should be instructed that if it finds reliance, etc., it *may* find either a duty or no duty. Rather, the language of the opinion is not inconsistent with the position taken in the text to the effect, for example, that the instruction to the jury should be that if the jury finds reliance, etc., it *shall* find a duty. In short, the issue is not answered in *White*.

The relationship of *White* to the instant decision should become apparent after reading the text accompanying notes 305-64 *infra*. See also note 348 *infra* and accompanying text.

special verdicts to enable a reviewing court to know the primary facts as determined by the jury. Then the jury's or judge's determination could be tested on something other than the standards applied to factual determinations. It may be best to permit full power to the reviewing court to perform its own balancing. The merit would be in avoiding disparities and arbitrariness.

In most cases, one could expect that an actually foreseen reliant plaintiff's injury would be compensated under the balancing test. The results in cases of actually foreseen classes or reasonably foreseeable plaintiffs would be more variant.

Would a legislative resolution be more desirable? It seems likely that most conceivable legislation would work a rougher justice on plaintiffs than would be worked by the California balancing process on defendants. One model that has been suggested is the ALI Proposed Federal Securities Code.³⁰¹ That Code establishes differing requirements as to materiality, culpability, causation, etc., depending, among other things, on the issue of whether the plaintiff and defendant are in privity or whether the injury was foreseeable. Thus, it is designed in a way analogous to the balancing technique except that the elements of the various torts are balanced by the draftsman in the abstract.

Because of the intricacies of the Code's draftsmanship, it is quite difficult to discern that the Code virtually would eliminate accountants' liabilities except for misleading 1933 and 1934 Act type registration statements and form 10K's unless the accountant had knowledge of falsity or was a party to a securities transaction.³⁰² Neither of these fact events occurs frequently or needs a securities law sanction when it does. The design of the Code will be the subject of further comment, but for present purposes another aspect of the Code is pertinent.

After the Code fashions its quite limited substantive rights of action, a further limitation is placed on liability of parties under which, if a party is liable for negligence, liability is limited to 100,000 dollars per defendant, regardless of the plaintiff's loss. Thus, an auditor who would be held for the issue price under section 11 of the 1933 Act, will, under the Code,³⁰³ be held to a limit of 100,000 dollars. The Code surmounts the problem of exposure, not by limiting the class of plaintiffs to those who are in privity, but by limiting the amount for which the defendant may be held liable.

301. See note 8 *supra*.

302. ALI FED. SEC. CODE §§ 1402-06 (Tent. Draft. No. 2, 1973).

303. *Id.* § 1403.

A state legislature might choose this approach because it will obviate the difficulties of defendants, but this would be unjust to injured parties while working unevenly as to defendants. For many defendants, a 100,000 dollar liability would be ruinous. For the large firms it could be of no concern.³⁰⁴ On balance, it seems that the California and federal common-law balancing technique commends itself above this legislative method and any of the judicially devised limiting doctrines such as foreseeability, actual foreseeability or privity.

D. Rule 10b-5: Scienter, Negligence, Flexible Duty, Privity, Foreseeability, Causation in Fact

1. Flexible Duty.

This section is concerned with the other side of the privity coin, the tandem question whether scienter should be required for 10b-5 liability of auditors.³⁰⁵ Enough has been written on the topic³⁰⁶ so that concentration might be placed on the latest development—the flexible duty standard—to ascertain whether it is an aberration or the wave of the future.

The genius of the law of Rule 10b-5 is the genius of the common law. The federal courts in interpreting the Rule are, for the most part, developing judge-made law, not construing legislation. Because cases must be adjudicated whether or not a pertinent rule exists to apply, the judges allow the facts to guide the direction of their thought with the result that the best justice of which they are capable is decreed.

In the early stages of such a process, great discomfort is experienced by legal planners, since predictability is difficult. Nevertheless, through accretion, common patterns of policies, principles and results emerge, making future cases more easily predictable. Thus,

304. Arthur Andersen & Co., not the largest firm, had gross revenues of \$271 million in fiscal 1973 and active and inactive partners' distributions amounted to \$66.5 million. Arthur Andersen & Co. 1973 Ann. Rep. 32. Better tailoring of the lines of liability could be achieved, for example, by limiting liability to a multiple of the fee received by the auditor for the engagement in which the breach of duty occurred; or a multiple of fees received from the client during a particular period; or a multiple of gross revenues from all clients for a particular period.

For a study of the amount of audit fees, see MACHINERY AND ALLIED PRODUCTS INSTITUTE, SURVEY ON COMPANY APPROACHES TO REDUCE OUTSIDE AUDIT FEES (1974), summarized in FINANCIAL EXEC. 42 (Sept., 1974).

305. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78 (1970); 17 C.F.R. 240.10b-5 (1974).

306. See, e.g., 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.21(4) (1974); 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.5 (1973); 3 L. LOSS, SECURITIES REGULATION 1766 (1961); 6 L. LOSS, SECURITIES REGULATION 3883-88 (Supp. 1969).

ten years ago, no lawyer could have predicted confidently the liabilities that would arise if a director of a natural resource company purchased shares of his company on a stock exchange after learning nonpublic information that the company had made a drill hole showing substantial mineralization likely to result in a material discovery of valuable ore. Today, although the factual determination of materiality, the measure of damages, and perhaps other questions of relief remain as difficulties, the risk is clear that the purchase may be illegal, and may expose the purchaser to damage liability to concurrent sellers,³⁰⁷ restitutionary or injunctive relief in a suit by the SEC³⁰⁸ or a private person,³⁰⁹ and criminal sanctions.³¹⁰

The tough questions of the last decade are being settled. The fact that it was a stock exchange transaction is no longer of concern. Lack of common-law reliance by the seller because nothing was said on which to rely is not troublesome; similarly, lack of privity is no bother. Other difficult questions presently in litigation, such as the extent of the buyer-seller requirement and the inclusion of nondeceptive breaches of duty, also presumably will be settled soon.

One important question, decided variously in hundreds of 10b-5 cases, has defied rationalization until recently. That is, what should be the standard of knowledge, purpose, or care required of the defendant for 10b-5 liability? The first difficulty with the question is that the words of the Rule and enabling statute³¹¹ provide little guidance in determining the standard: The statute has been said to require some degree of scienter³¹² and no degree of scienter,³¹³ the Rule, in clause (2), clearly could be read to prohibit innocent misrepresentations;³¹⁴ clause (3) may be read to prohibit activities which, although not constituting "fraud or deceit," have the same effect on the victim.³¹⁵

307. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

308. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

309. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

310. 3 A. BROMBERG, *supra* note 306, at § 10.3.

311. 17 C.F.R. 240.10b (1974).

312. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

313. Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 683 (1965) [hereinafter cited as *Comment*].

314. *See id.*

315. *E.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); Sonde & Freedman, "Seagulls on the Water—Some Ships in a Storm": A Comment on *Lanza v. Drexel*, 49 N.Y.U.L. REV. 270, 290 (1974); *Comment, supra* note 313, at 683 (10b-5(3) "covers action which 'operates' as a fraud, and seems concerned with the effect of conduct, not the intent with which it is performed."); *cf. Schoenbaum v. Firstbrook*, 405 F.2d 215, 219-20 (2d Cir. 1968).

The second great difficulty with the question of the proper standard is that courts and commentators for the most part assume that a single answer exists to this single question. But 10b-5 is a many splendored thing—it is a congeries of torts and other wrongs involving securities transactions. It is like common-law misrepresentation, which involves much more than deceit, negligent misrepresentation, and rescission, and extends to battery for feeding someone poisoned chocolates, false imprisonment resulting from a pretense of power to make an arrest, obtaining goods by false pretenses, a malicious lie resulting in mental suffering, a misleading signal by a driver about to make a turn in the opposite direction, defamation through falsehood, interference with contracts by false statements, etc.³¹⁶ In the poisoning case, reliance or privity are not considered worth discussing although scienter is essential. On the other hand, scienter in the wrong-turn-signal situation is incongruous.

One describing all these common-law misrepresentation cases would speak in terms of several distinct torts and each tort could be described in terms of the duty and right of action. Similarly, courts and commentators now realize that Rule 10b-5 involves many different varieties of wrong. Although at first the Rule was thought to include only misrepresentation and insider trading without disclosure, now equally large numbers of cases involve insider tipping, breaches of fiduciary duty,³¹⁷ and broker-dealer sharp-dealing, as well as other cases not fitting these categories.³¹⁸ Given this rich variety, it seems incredible that anyone could ever have asked, which of scienter or negligence (choose one) is required by Rule 10b-5? Yet the question continues to be posed in that form.³¹⁹

The third great difficulty with the question of the proper standard of knowledge, purpose, or care, is that the contents of words like scienter, intent, knowledge, negligence, recklessness, fraud and

316. W. PROSSER, *LAW OF TORTS*, 683-84 (4th ed. 1971).

317. See Comment, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, 86 *HARV. L. REV.* 1007 (1973), refining and updating the original analysis of Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement*, 15 *N.Y.L.F.* 332 (1969).

318. *E.g.*, *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Hooper v. Mountain State Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960); *Pettit v. American Stock Exch.*, 217 F. Supp. 21 (S.D.N.Y. 1963).

319. *E.g.*, *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir. 1974); *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

The Tenth Circuit has its own mode of coping with the problem. It simply uses inscrutable language which can be of little utility as precedent and fails to follow even that small clue to the state of the law. For the latest illustration, quoting from and purporting to rationalize a long line of mysterious statements on the subject, see *Clegg v. Conk*, *CCH FED. SEC. L. REP.* ¶ 94,897 (10th Cir. 1974).

deceit, have never been delimited—they are open-ended and have no blueprint brightly marking their bounds.

Given this state of affairs, a lawyer seeking to systematize the cases may adopt any number of techniques. He may take all the decided cases, grouping those with several common characteristics and describe each set, supplementing his description as new irregular cases are decided. Or he may establish a few broad categories using fewer characteristics and describe them as cases of insider trading or tipping, affirmative misrepresentation, breach of fiduciary duty and broker-dealer wrongs, with a catch-all class at the end. A different system might use one set of characteristics, such as the nature of the transaction, to separate the cases and then within each set, subdivide further using another set of characteristics like standard of conduct, reliance, etc. Or, recognizing that the combinations and permutations of wrongs in securities transactions will cover a nearly unlimited number of situations, he may determine that classification would strain the understanding and provide little utility until more decisions are on the books. Instead he might simplify the consideration by asking for each case: did defendant owe a duty to plaintiff that was violated, and if so, should the breach be compensated? This approach has newly come to be consciously applied to 10b-5 cases by the Ninth Circuit under the designation of, the "flexible duty standard."³²⁰

In *White v. Abrams*, in which the phrase, "flexible duty," was coined, an elaborate "Ponzi scheme" was inflicted on the plaintiff by a long-term trusted investment advisor acting as loan broker for the main operator. After first determining that the original treatment of 10b-5 cases had been "a compartmentalized approach . . . requiring some semblance of the traditional elements of common law fraud: materiality, scienter, reliance, causation and damages," the court found a trend "to modify or completely eliminate some of these elements."

Relying heavily on a student comment,³²¹ it cogently described the Supreme Court's process of resolving *Affiliated Ute Citizens v. United States*.³²² It found that the Supreme Court, although it did not discuss the scope of the defendant's duty, had considered factors such as the relationship of the parties, the benefit to defendants

320. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974); *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974); *Marx v. Computer Sciences Corp.*, CCH FED. SEC. L. REP. ¶ 94,904 (9th Cir. 1974); see note 293 *supra*.

321. Comment, *Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5*, 1973 UTAH L. REV. 119, 121-31.

322. 406 U.S. 128 (1972).

from the transaction, access of the parties to the relevant information, and the degree of activity of the defendants. The Ninth Circuit stated:

We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all 10b-5 cases by the use of one standard for state of mind or scienter is confusing and unworkable. Consequently, we reject scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action. The proper standard to be applied is the extent of the duty that Rule 10b-5 imposes on this particular defendant. In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions.³²³

The concept of flexible duty was not invented by the Ninth Circuit; it was discovered. Previously decided Rule 10b-5 cases pointed very clearly toward the conclusion that the concept was in fact adopted by the courts long before it was christened.

One might suggest that the evolution of the flexible duty standard proceeded through the several following stages:

(a) First Stage.—The common law of misrepresentation, which developed liability under certain combinations of circumstances, with the only common elements being materiality and misrepresentation.

Ultramares itself illustrates the concept: the court upheld one claim against the defendant accountants in which scienter was present but not privity. But in a second count, it required privity to be joined with negligence to constitute a claim. Thus, to oversimplify, the accountants in *Ultramares* owed the duties:

- (1) not to misrepresent material facts intentionally to persons who are the intended recipients of the information and who act on it to their prejudices;
- (2) not to misrepresent material facts negligently to parties in privity.

Prosser has in effect determined that a flexible duty standard was established by the pattern of the common law cases of misrepresentation, although in his zeal to systematize the law he failed to recognize what he had found. Thus, in an analysis of cases for the entire field of misrepresentation, he found certain patterns in the cases and described five groups of factors that the courts weighed in determining rights and liabilities. The factors he found to be of consequence are:

323. 495 F.2d 724, 736 (9th Cir. 1974).

- (1) nature of the injury—physical injury to person or property v. pecuniary harm;
- (2) basis of liability—intent, negligence or strict liability without fault;
- (3) purpose, expectation, or foresight that the plaintiff may act;
- (4) size of the group of which plaintiff is a member;
- (5) character of the transaction by plaintiff and whether it was the type intended to be affected by defendant or is similar thereto.³²⁴

What emerges from Prosser's analysis is not a picture of the courts looking to a rigid formula contained in Prosser's restatement of the cases, but a pattern of courts weighing flexibly all the factors in the case to determine whether a compensable breach of duty has occurred.

(b) **Second Stage.**—The balancing process for determining when privity is necessary, set forth in the California and Rule 10b-5 cases earlier described.

The articulation of the balancing process in the California and federal 10b-5 cases dealing with privity was the second step in the development of the flexible duty standard. The balancing process is simply the crude reciprocal of the flexible duty standard for defendant's knowledge, purpose, or care: if, in applying the balancing process a court considers the defendant's knowledge, purpose, or care as an element, then of necessity, in determining the standard of knowledge, purpose, or care required, the court is considering the presence of privity or the particular relationship of the parties.³²⁵ In short, the flexible duty standard is the balancing process previously described, not from the perspective of one asking whether privity is necessary, but rather from the perspective of one asking whether scienter is required.

(c) **Third Stage.**—The early groping about for need of scienter and its definition under Rule 10b-5.

Under Rule 10b-5, one variable, the remedy sought, has been a basis for courts establishing negligence as the standard for a prospective injunction even though some form of scienter was required

324. Prosser, *Misrepresentation and Third Persons*, 19 VAND. L. REV. 231 (1966).

325. *E.g.*, *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 270 (3d Cir. 1972) (Adams, J., concurring in part and dissenting in part).

in damage cases in the same courts.³²⁶ In *SEC v. Texas Gulf Sulphur Co.*,³²⁷ Judge Friendly suggested that negligence should not be enough to grant money relief against the corporation although it would be enough for a prophylactic remedy. In numerous other cases,³²⁸ strong intimations of the flexible duty standard presaged the statement of it in *White v. Abrams*.

Another case, involving accountants' liability, which could be said to be grounded at least in part in the rudimentary flexible duty concept, is *Drake v. Thor Power Tool Co.*,³²⁹ in which the court expressly adverted to the special relationship of accountants to the public in upholding a claim for negligent reporting.³³⁰ The court distinguished accountants from corporate officers³³¹ and found a higher duty for the accountants.

In *Fischer v. Kletz*,³³² auditors discovered that prior audited statements on which they had reported were materially misleading, and did nothing. The court held that a common-law duty existed to correct the misimpression caused. The court rebelled at the constraint of having to decide whether the failure to correct was due to scienter or something less. It recognized that the straightforward approach was best when it held that the question was one of duty, not mental state:

Liability in a case of nondisclosure is based upon the breach of a duty imposed by the demands of 'good faith and common honesty.' . . . The imposition of the duty creates an objective standard against which to measure a defendant's actions and leaves no room for an analysis of the subjective considerations inherent in the area of intent. Thus, to base liability in part upon subjective standards of intent of the nondisclosing defendant would blur and

326. *E.g.*, *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967).

327. 401 F.2d 833, 863, 866-68 (2d Cir. 1968).

328. *E.g.*, *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971) (distinguishing *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965) as involving "significantly different circumstances."). *See also* *Financial Indus. Fund. Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 395, (2d Cir. 1973) (opinion of Mansfield, J.); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 276-88 (3d Cir. 1972) (concurring opinion of Adams, J.); *Lanza v. Drexel & Co.* 479 F.2d 1277 (2d Cir. 1973); (dissent of Hays, J.). *Cf.* *Gould v. American Hawaiian SS Co.*, 351 F. Supp. 853 (D. Del. 1972), in which the court construing § 14a to impose liability for negligence on outside directors discretely noted that this visits liability based on the particular defendant's due diligence, and, "[t]herefore, the negligence standard embodies a criterion which would permit consideration of the individual's particular position with the corporation and his relationship to the pertinent information held to be erroneously or incompletely stated in the proxy materials." 351 F. Supp. at 865.

329. 282 F. Supp. 94 (N.D. Ill. 1967).

330. *See Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. Rev. 1206, 1213 (1970) suggesting that *Drake* substantiates this thesis.

331. 282 F. Supp. at 105.

332. 266 F. Supp. 180 (S.D.N.Y. 1967).

weaken the objective basis of impact of nondisclosure upon the plaintiff. In the alternative, if this rationale be deemed unacceptable, it can be persuasively urged that in a nondisclosure case, intent can be sensibly imputed to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false.³³³

(d) Fourth Stage.—The articulation of a rudimentary flexible duty concept by perceptive commentators.

At this point, the commentators began to force a pattern, or perhaps, more accurately, the pattern emerged from the cases as it became apparent that the courts were imposing liability for certain types of conduct in some cases but not others. By 1969, a few perceptive 10b-5 buffs, the earliest of whom was a student writer, were aware that several courts, regardless of what they were saying, were not in fact woodenly applying or not applying a scienter requirement, but were intuitively applying differing standards dependent on the circumstances.³³⁴

(e) Fifth Stage.—The opinions of Judges Adams in *Kohn v. American Metal Climax, Inc.*, Mansfield in *Chris-Craft*, and Hays in *Lanza v. Drexel & Co.*

The Second Circuit, in determining liability of underwriters, in two cases found their duties depended on the circumstances. In *Lanza v. Drexel & Co.*³³⁵ a member of an underwriting firm, sitting as a director, and his firm were held to have no duty to disclose unfavorable facts to persons with whom management was negotiat-

333. 266 F. Supp. at 188. See Green, *The Duty to Give Accurate Information*, 12 U.C.L.A.L. REV. 464 (1965). See also Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147, 155 (7th Cir. 1969); Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963).

334. E.g., 2 A. BROMBERG, SECURITIES LAW: FRAUD § 8.4 (513) (1971); Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. REV. 1206 (1970); Comment, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L.J. 1108, 1115-17 (1969). For a critique of the current crude state of the flexible duty standard, see Bateman, *Flexibility and Precision in the Development of a 10b-5 Standard of Culpability: A Refined Approach to Balancing Along a Continuum of Conduct* (unpublished seminar paper, U. of Colo. Law School; scheduled for publication in revised form in 46 COLO. L. REV., 1975).

Judge Mansfield in *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 480 F.2d 341, 395 (2d Cir. 1973) (concurring opinion), and Judge Adams in *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 276-88 (3d Cir. 1972), both discussed at text accompanying notes 337-47 *infra*, perceive a truncated continuum of conduct stopping short of "mere negligence." In *Chris-Craft*, however, the failure in the duty to investigate, held actionable there as "scienter," would be described as negligence by some courts. E.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974). At any rate, the process is identical, contemplating a continuum of conduct to satisfy the Rule, depending on circumstances.

335. 479 F.2d 1277 (2d Cir. 1973) (en banc; 6-4 decision).

ing an acquisition when he was not a member of the negotiating team.³³⁶

On the other hand, in *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*,³³⁷ the underwriters of a target company's defensive merger in a takeover battle were held liable under section 14(e) of the 1934 Act when they failed to inquire into matters after being put on notice of material undisclosed facts which, if discovered, they would have had a duty to disclose. Here the underwriters were held to have the duty to inquire on behalf of stockholders of the target company. The facts were that the underwriter of a friendly tender offeror had read minutes of the target company, Bangor Punta, mentioning possible sale of the subsidiary Bangor & Aroostook Railroad for \$5 million when it was being carried on the books as an asset at \$18.4 million. The underwriter asked management about the matter and was told no sale was planned. Actually, the sale was made after the defeat of the unfriendly takeover attempt and only then was the loss recognized with the result that the target company shareholders had been misled into overvaluing the company and refusing the unfriendly tender offer. The court said the case was analogous to the common law tort of unlawful interference with an advantageous opportunity of the losing offeror. Hence, misleading the target's shareholders also was a breach of duty to plaintiff, the antagonistic tender offeror.

In squeezing the case into the conventional scienter mold, the court spoke of and found "culpability" from the failure to investigate the facts to the full extent of the duty, somewhere beyond oral inquiry of management. It then held the underwriter liable for the failure to investigate by imposing a duty to assure the accuracy of the statements made by management to shareholders on the theory that this is necessary to promote the policies of section 14(e).

All three judges differed in the process used to resolve the standard of knowledge, purpose, or care required. Judge Timbers followed the conventional approach of first deciding whether scienter or negligence was required and then defining scienter. Judge Gurfein, agreeing with the other two that scienter in some form was required for all 10b-5 damage actions, but recognizing some discomfort with the Timbers process, said he did "not think a litmus paper test of scienter will ever be found" and that "[i]n modern times statutory construction grows case by case much as the common law

336. For the view that the court was incorrect in finding no duty, see Sonde & Freedman, "Seagulls on the Water—Some Ships in a Storm": A Comment on *Lanza v. Drexel*, 49 N.Y.U.L. Rev. 270 (1974).

337. 480 F.2d 341 (2d Cir. 1973).

did when more general rules of law were involved."³³⁸ Judge Mansfield hinted at a recognition of the truncated duty analysis after rejecting the Gurfein "I know it when I see it" view. He stated:

[The scienter standard] of course . . . might vary according to the existence of a fiduciary relationship, the burden of proof and the nature of the relief sought. It might also take into account the nature and duties of the corporate posts held by the defendants, whether they are insiders or outsiders, and whether they are active or inactive participants. See generally Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter, 45 N.Y.U.L. Rev. 1206 (1970).³³⁹

Judge Hays, writing for the four dissenters in *Lanza v. Drexel & Co.*³⁴⁰ one month later, articulated what the *Chris-Craft* panel had done, without referring to that case, in terms of a flexible duty standard:

It is not profitable in considering a case such as this [i.e. *Lanza*] merely to characterize the allegedly unlawful conduct as either negligent or wilful and to impose liability only if the conduct was wilful. Neither the Act nor the Rule creates such a simple dichotomy. The purposes of the Act and the Rule are not furthered by a mechanical application of labels. The relationship of the parties and the transaction involved must be analyzed in order to determine whether the Act and the Rule impose a duty on one party with respect to the other and the nature of that duty. In making this analysis Section 10(b) and Rule 10b-5 'must be read flexibly, not technically and restrictively' so as to further Congress's broad remedial purpose in enacting the statute.³⁴¹

Judge Hays' opinion was relied on heavily in *White v. Abrams*.

In result, even the *Lanza* majority opinion and the Timbers opinion in the *Chris-Craft* case illustrate the flexibility of duties imposed on underwriters. And *Chris-Craft* further illustrates the clumsiness of the common law deceit analogue although the court struggled to the correct result. A straightforward statement of what the court actually did, as set forth by Judge Hays in *Lanza*, would have been a more satisfactory opinion and would have provided better future guidance. Thus, the *Chris-Craft* opinion, reading solely in terms of duty, might have said:

- (1) Underwriters for a merger partner, joining with management of the target company to fight a tender offer, have a duty to disclose material facts to investors;
- (2) Coupled with the duty to disclose is a duty to investigate the facts and inquire into suspicious circumstances, because investors expect that of underwriters;

338. 480 F.2d at 393.

339. *Id.* at 397.

340. 479 F.2d 1277 (2d Cir. 1973).

341. *Id.* at 1317.

(3) A failure of either duty coupled with causation and injury makes the underwriter liable to the unfriendly tender offeror since this is an appropriate way to promote the proper fulfillment of duties.

Similarly, in finding no duty to convey in *Lanza*, the main opinion might better have explained the decision by use of the duty analysis instead of the cumbersome terminology of inapt cases.³⁴²

Judge Adams, in his oft-cited concurring and dissenting opinion in *Kohn v. American Metal Climax, Inc.*,³⁴³ found scienter was required and concluded that a flexible duty approach was appropriate. Like Judge Hays in his *Lanza* dissent, Judge Adams eschewed the simplistic scienter-negligence dichotomy and considered the relationship of the parties, the nature of the relief requested, the nature of the transaction as a face to face transaction or otherwise, and the realities of the business world.³⁴⁴

The slow dawning of the flexible duty standard suggests a compelling logic more powerful than one court's view of the matter. It has the ring of soundness to it. The beauty of the flexible duty conception of 10b-5 is that it frees the mind from the struggle with the sometimes ill-adapted analogy of common law deceit, which courts had frequently found uncomfortable and often unworkable in the past.³⁴⁵ Its alleged drawback is its unpredictability, because both the question of duty and compensability for its breach require an

342. Another decision of the Second Circuit may best be understood in the framework of a duty analysis. In *SEC v. Spectrum, Ltd.*, 489 N.2d 535 (2d Cir. 1973), the court held that an attorney may be held as an aider and abettor in an SEC injunctive case, first, on the traditional ground that negligence is sufficient in cases where prophylactic relief is granted. But the court further emphasized the significance of the special facts of the case. It stressed the "unique and pivotal role" played by attorneys in the "effective implementation of the securities laws," and the need for reliance of the public on attorneys in order to facilitate the smooth functioning of the securities markets. It also noted carefully it was not passing on questions involving more peripheral participants and criminal and damages suits.

343. 458 F.2d 255, 270 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

344. This last factor was a powerful influence on the majority in *Lanza*, which thought it would be undesirable to require all directors to review all of management's negotiations with others. 479 F.2d at 1281-89.

345. Many securities frauds do not fit the stereotyped common-law deceit pattern. Yet at first the courts strained to fit the cases into that pattern, usually reaching the right result, but often in a way opening the decisions to easy criticism. The incongruities are apparent in cases such as the following: *Chris-Craft Indus. Inc. v. Bangor Punta Corp.*, 480 F.2d 341 (2d Cir. 1973) (scienter found from underwriter's failure to observe a duty to investigate facts); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965) (reliance of plaintiff based on mere silence of defendant); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967) (scienter found when accountants, learning of the fact that prior audited statements were incorrect, failed to act); *Cochran v. Channing Corp.*, 211 F. Supp. 239 (S.D.N.Y. 1962) (deceit found from non-verbal conduct in failing to pay dividends).

ad hoc decision by the court in each case.³⁴⁶ It may also be charged that the standard will result in arbitrary decisions.

Taking the last objection first, the courts in deciding the question of duty presumably will look to external sources such as custom, policy of the securities acts, expectations of the parties, culpability, morality, ability to spread the loss, the need of the defendant's trade or profession for protective immunity, etc.³⁴⁷ Hence, it will not be an arbitrary determination but will be supported by reason.

What of the other objection? Is the flexible duty technique unpredictable? The answer would seem to be yes, since courts must weigh numerous factors in determining the existence of the duty, and reasonable men may differ in the weight accorded each. But the quality of the unpredictability should be noted. First, since the question is straightforward—under the circumstances what, if any, is the duty owing by the defendant to the plaintiff—it is one that involves none of the intricate sophistication of the law of deceit. It should be comprehensible to laymen, and the lawyer's task of prediction will not depend on whether all the right turns are made in an intricate maze. Secondly, as the cases accumulate, the unpredictability will diminish.³⁴⁸ Thirdly, since the duty will be determined from existing sources, any new 10b-5 liability will be for failure to meet a previously known duty. This distinguishes the surprise and unfairness of a liability imposed for a newly found duty.³⁴⁹

It should be noted that the use of the flexible duty technique may be said to be nothing more than a semantic exercise, while our concern here is with finding an appropriate process for solving a

346. Professor Loss has said that the flexible duty concept is the "perfectly, logically beautiful view, but it's impractical." Remarks at ABA National Institute, Advisors to Management, Responsibilities and Liabilities of Lawyers and Accountants, in New York, Oct. 3-5, 1974.

347. See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974); *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974).

348. It may be charged that the unpredictability is permanent on the basis that the weighing of the relevant factors is a matter for the fact-finder in each case. I do not concur with that view. Neither *White v. Abrams* nor the cases preceding it seem to make the weighing a factual determination although the presence or absence of a particular factor may be a question of fact. See note 300 *supra*.

Moreover, today's factual determination may be tomorrow's law. For an illustration of the reverse of this process, cf. *Baltimore & Ohio Ry. v. Goodman*, 275 U.S. 66 (1927) (motorist is negligent as a matter of law for failure to stop, look, and listen at a railroad intersection) and compare *Pokora v. Wabash Ry.*, 287 U.S. 98 (1934).

For the intricacies of the law-fact-application-of-law trichotomy see H. HART & A. SACKS, *THE LEGAL PROCESS* 373-85 (Temp. ed. 1958); and see W. PROSSER, *LAW OF TORTS* §§ 35, 37 (4th ed. 1971).

349. See H. HART & A. SACKS, *THE LEGAL PROCESS* 69 (Temp. ed. 1958).

legal problem. Of course, when semantics encumber reasoning, they are bad and ought not to be countenanced; but when a semantic device frees the mind from the cobwebs of inapt concepts, it is useful and should be adopted. The flexible duty concept achieves that result.

*Hochfelder v. Ernst & Ernst*³⁵⁰ illustrates one application of the flexible duty standard for accountant defendants and demonstrates its suitability over the clumsy scienter-negligence analysis. It is remarkably similar to *Chris-Craft* in its essential elements.

In the *Hochfelder* case, described earlier,³⁵¹ the defendants relied on the *Restatement of Torts* rule and argued that the accountants could only be held liable if they knowingly lent encouragement or support to the principal wrongdoer.³⁵² After analyzing the problem in terms of an auditor's duties to investors, the court rejected the *Restatement* rule, which after all was a rule intended to cover all torts with little regard for special duties of such persons as auditors, underwriters and others under the securities laws.³⁵³ Instead, the court first determined that the auditors, pursuant to GAAS, had a duty to investigate the internal control system of the client and to disclose findings, and that these duties under federal law were for the benefit of investors. Next, the court held that a jury should determine whether either of the duties was violated and whether the breach was causally connected with the plaintiff's injuries. The result is sound because the flexible duty standard provides direction. This is in sharp contrast with the possible result that might have been obtained had the sterile *Restatement* rule been examined and aimlessly accepted or rejected.³⁵⁴

Given the *Simon* rule requiring application of lay standards to accounting principles and perhaps even auditing standards,³⁵⁵ the enhanced duties to inquire into suspicious circumstances³⁵⁶ and to investigate absent such circumstances,³⁵⁷ and the expansion at common law of the rights of third parties to recover for accountants' negligence,³⁵⁸ together with the SEC's new leveraging approach to

350. 503 F.2d 1100 (7th Cir. 1974).

351. See text accompanying notes 237-44 *supra*.

352. RESTATEMENT OF TORTS § 876 (1939).

353. See, e.g., *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973); note 342 *supra*.

354. See Speech by Commissioner Sommer to ABA Convention, Aug. 28, 1974 and Sonde & Freedman, "Seagulls on the Water—Some Ships in a Storm." *A Comment on Lanza v. Drexel*, 49 N.Y.U.L. Rev. 270, 296 (1974) for an endorsement by a Commissioner and enforcement staff employees of the Commission.

355. See text accompanying notes 138-85 *supra*.

356. See text accompanying notes 225-38 *supra*.

357. See text accompanying notes 238-56 *supra*.

358. See text accompanying notes 257-304 *supra*.

professionals' responsibilities under the securities acts,³⁵⁹ one may reasonably expect the flexible duty technique to operate expansively to inflict even greater exposure to liability on accountants.

The ALI Federal Securities Code current draft completely rejects the flexible duties imposed by the cases in favor of a rigid pattern of compartmentalization. The Code not only describes when scienter or negligence will be required,³⁶⁰ but also defines "knowledge"³⁶¹ and for the first time in any United States statute, so far as I know, defines "scienter,"³⁶² apparently succumbing to the Latin lure.³⁶³ The admitted³⁶⁴ compelling logic of the flexible duty standard thus is rejected in favor of the conventional approach without even the saving grace supplied by the ambiguities inherent in terms like "scienter," which facilitated the common law development. This kind of legislation does not commend itself to adoption.

2. A Footnote to the Flexible Duty Concept Under 10b-5: Concerning Privity and Its Replacement

The tandem relationships between privity and scienter and the flexible duty and balancing process techniques have already been described. In less confusing terms, the two perspectives may be put more straightforwardly:

(a) In the particular circumstances, what standard of conduct is required by the law in question—scienter, negligence or something else? This is the "flexible duty" concept.

(b) By whom will that duty be enforceable—one in privity, an actually foreseen plaintiff, or someone else? This is the "balancing process."

This is a duty analysis, asking what duty is owed and to whom. Because the policies of Rule 10b-5 are aimed at numerous wrongs going far beyond insider trading, affirmative misrepresentation, tipping, broker-dealer sharp dealing, and breach of fiduciary duty, an intelligent and comprehensible answer to these two questions can be derived only from one source under Rule 10b-5—the policies of the Rule and its enabling act.

Just as the Seventh and Ninth Circuits in *Hochfelder*³⁶⁵ and

359. See note 7 *supra*.

360. ALI FED. SEC. CODE §§ 1402(c), 1403(e), 1404(a), 1405, 1406(a) (Tent. Draft No. 2, 1973).

361. ALI FED. SEC. CODE § 251A (Tent. Draft No. 3, 1974).

362. *Id.* § 296AA.

363. See *White v. Abrams*, 495 F.2d 724, 732 (9th Cir. 1974) where the court referred to "convenient, differently interpreted, shorthand latin [sic] phrases behind which one can sweep complex determinations."

364. See note 346 *supra*.

365. 503 F.2d 1100 (7th Cir. 1974).

*White*³⁶⁶ finally have recognized these facts of 10b-5 life for the standard-of-conduct question, so too, modern decisions already have recognized them for the other question—by whom may the duty be enforced.

Thus, for example, the decisions in *Heit v. Weitzen*,³⁶⁷ *Mitchell v. Texas Gulf Sulphur Co.*³⁶⁸ and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,³⁶⁹ all have held that the duties in those cases were enforceable by persons intended to be protected by the policies of Rule 10b-5. This duty analysis is the same one used in *Hochfelder* and *White*. No historical baggage for Rule 10b-5 requires a court to show why the merely analogous common law of deceit is either an apt or an inapt analogy. Since the common law of deceit, developed for horse traders and used car dealers, is not enlightening for the complex merchandise known as securities and the even more complex securities markets, the common law was not useful and rightly was discarded as a guide to decision-making.

The Supreme Court in *Affiliated Ute*,³⁷⁰ relied on so heavily by the *White v. Abrams* court in its discovery of the flexible duty technique, also is the fountainhead for the Second Circuit's decision in *Shapiro v. Merrill Lynch*, which determined the process for deciding who could enforce the duty not to trade or tip on the basis of inside information. As in the determination of the standard of conduct, *Affiliated Ute*, as interpreted by *Shapiro*, shows that the way to identify those who can enforce the duty is to determine the policies of Rule 10b-5 for the particular fact situation.

Thus, in *Shapiro*, after the court found a duty of the defendants not to trade or tip on the basis of material non-public information,³⁷¹ it went on to consider whether the plaintiffs could enforce that duty in an action for damages.³⁷² It denied any requirement of a showing either of privity or inducement by the defendants of the plaintiffs to act in the transaction resulting in their injury. Instead, it said "the proper test . . . is 'whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.'"³⁷³ The court expressly stated that its decision was "consistent with the underlying purpose of

366. 495 F.2d 724 (9th Cir. 1974).

367. 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

368. 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), *cert. denied*, 403 U.S. 918 (1972).

369. 495 F.2d 228 (2d Cir. 1974).

370. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

371. 495 F.2d at 236-37.

372. *Id.* at 238-41.

373. *Id.* at 239.

Section 10(b) and Rule 10b-5 'to prevent inequitable and unfair practices and to insure fairness in securities transactions generally. . . .' ³⁷⁴

Based on *Affiliated Ute* as interpreted in *Shapiro*, since the policies of the securities acts consistently have been read to establish a special relationship between accountants and public investors,³⁷⁵ any duty of accountants should be enforceable by those to whom it runs without concern for lack of privity. The lower courts now have come to embrace this process in cases against accountants. The most lucid illustration is the Seventh Circuit's recent decision in *Hochfelder*, but the older decisions just cited followed precisely the same process.

VI. DUTIES BEYOND AUDITED STATEMENTS INCLUDING "WHISTLE BLOWING"

A. *The Duty to Correct*

It was held in *Fischer v. Kletz*³⁷⁶ that an auditor may have some duty to correct prior audited statements, at least as a matter of common law, when he later discovers that the statements were materially misleading when made. Based on the reasoning of the opinion, it seems that the court also would have arrived at the same conclusion if the statements, although not deceptive when made, later became misleading.³⁷⁷

One must be careful, however, when dealing with this second type of case. Since audited statements speak as of a particular date or period, the "facts" stated, for example, as to the amount of profits for a year, if "true" when made cannot "become false" merely because profits drop in the next quarter. Another type of case also exists—an assertion made as to profits in the year may have been based on estimations that turn out to be wrong. For example, a year's profits may have been in part determined on the basis of estimated collections on receivables, which estimates, after the auditor's report, turn out to be grossly exaggerated. Would the *Fischer v. Kletz* court impose a duty to "correct" in either of these latter

374. *Id.* at 240.

375. *See, e.g.,* *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974); *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94 (N.D. Ill. 1967); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); *In re American Finance Co.*, 40 S.E.C. 1043, 1049 (1962); *In re Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670-71 (1957).

376. 266 F. Supp. 180 (S.D.N.Y. 1967). *See also* *SEC v. Manor Nursing Center, Inc.*, 458 F.2d 1082, 1096-97 (2d Cir. 1972) (duty to correct prospectus offering on an all or nothing basis when terms are changed after the effective date).

377. 266 F. Supp. at 188-89.

two situations? GAAP and GAAS would only require the accountant to report the loss in the following year.³⁷⁸ The *Fischer* court, however, clearly stated in dictum that in both cases the accountant would be held to a duty to correct. The court discussed *Loewer v. Harris*,³⁷⁹ a case in which a brewery was sold after representations of its profits were made. After the representations but before the closing, subsequent profits dipped materially, but the seller said nothing, and the court held the seller liable. In *Fischer* the court held the accountants liable, saying:

It should be noted that, in *Loewer*, the information contained in one representation was made untrue as a result of a change in the performance of the brewery; while, in the instant case, the representation was rendered false not by a change in conditions but by a discovery that the information on which the representation was based was itself false and misleading.³⁸⁰

Despite the reliance on *Loewer*, it would seem that in a case brought as in *Fischer* by a public investor rather than a contract purchaser, the court would be likely to conclude the financial statements are "stale" and the plaintiff is not as justified in relying on a continuity of performance. Also, other circumstances of the particular case probably would be utilized to distinguish *Loewer*. For example, little ground would be present for claiming misrepresentation when profits for the prior several years in the company or industry had fluctuated widely.

The *Fischer* court itself expressly noted that the issue of the duration of the duty to correct will arise. The basic question would seem to be whether the statements would be misleading to the lay reader, under the *Simon* test. Another one of the questions expressly left open in *Fischer* was, to whom and how should disclosure be made? Presumably the courts will fashion a rule under which those members of the public who likely would be affected by the original statements should be given the best notice feasible. This too will be a question dependent on the particular circumstances.

Assuming a duty to correct, GAAS provide a guide. SAS No. 1³⁸¹ says the auditor "should advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the

378. SAS No. 1, *supra* note 20, at AU § 561.01-.03. AICPA, APB Statement No. 4.

379. 57 F. 368 (2d Cir. 1893).

380. 266 F. Supp. at 185.

381. SAS No. 1, *supra* note 20, at AU § 561.06. Section 561, as previously noted, does not recognize a duty to correct unless facts existed at the date of the auditor's report which might have affected his report had he then been aware of such facts.

related auditor's report." The auditor also should satisfy himself that the client does make the disclosures, and if the client refuses to do so, he should notify the board of directors, and depending on the circumstances, take the following additional steps:

(a) Notify the client that the auditor's report must no longer be associated with the financials;

(b) Notify regulatory authorities that the auditor's report should no longer be relied upon;

(c) Notify each person known to the auditor to be relying on the statements, to the extent practicable.

Hence, even GAAS establish a limited duty to "blow the whistle" on a client. *Fischer v. Kletz* would extend it further to require blowing the whistle when prior audited statements become misleading on any basis, although a court must carefully consider the circumstances to make certain the statements are indeed misleading.³⁸²

B. "Associated With," Unaudited Statements

Other duties of auditors also extend beyond their duties to perform careful and skillful audits. When one allows his name and reputation to be used in lending prestige or credibility to an enterprise, he sometimes is held responsible for what he has done.³⁸³ The accounting profession has recognized the special value given to financial statements when an accountant's name is associated with them. An accountant is associated with statements on which he has

382. See *Shahmoon v. General Dev. Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,308 (S.D.N.Y. 1973) in which a court found statements to be so stale as not to justify the plaintiff's reliance.

383. Cf. e.g., *Blakely v. Lisac*, 357 F. Supp. 255 (D. Ore. 1972); *Black & Co. v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Ore. 1971); *Zachman v. Erwin*, 186 F. Supp. 691 (S.D. Tex. 1960). But not always. Only recently have corporate directors become conscious of the fact that when they lend their names to a corporation by sitting on the board of directors, they may be held responsible for a fraction of the natural consequences of their acts. The following is descriptive of the once prevailing view of a director's responsibilities. It is quoted in R. STEVENS & H. HENN, *STATUTES, CASES AND MATERIALS ON THE LAW OF CORPORATIONS* 657 (1965) from *TIME*, Oct. 5, 1962, at 96:

In Britain, where a company's list of directors often reads like a tear sheet from Burke's Peerage, many a titled tycoon sits on more boards than he can count. Lord Boothby, 62, a longtime Tory backbencher who is one of this happy breed himself (he has 'eight or nine' directorships), explained last week just what directors do in return for adding prestige to corporate letterheads. 'No effort of any kind is called for,' he told an audience of Yorkshire clubwomen. 'You go to a meeting once a month in a car supplied by the company. You look both grave and sage, and on two occasions say "I agree," say "I don't think so" once, and if all goes well, you get \$1,440 a year. If you have five of them, it is total heaven, like having a permanent hot bath.'

Consider also the franchising boom's use of movie stars and sports personalities to lend prestige to hamburgers and corporate securities.

made an audit report, and he also is deemed to be associated with unaudited statements "when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements" or when he "submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing."³⁸⁴

In every case in which the accountant is "associated with" statements, his minimal obligation is to disclaim an opinion on the statements.³⁸⁵ He also has further duties that may best be considered by first analyzing two typical situations in which an accountant is "associated with" unaudited statements: (a) Unaudited interim period statements in registration statements; and (b) Unaudited interim reports to shareholders.

Next a third situation will be examined—the publication of financial data with which the accountant is *not* associated. We will consider what duties, if any, an accountant has in that case. It may be noted that these three cases are merely points on a continuum ranging from maximum activity to minimum activity by the accountant.

1. Unaudited Interim Statements in Registration Statements

When, as is often the case, unaudited interim financial statements appear with audited statements in a prospectus, the auditor will fit within the literal definition of being "associated with" the unaudited statements.³⁸⁶ The AICPA apparently intended this result since the same duties are imposed on the accountant with respect to other, "associated with" statements as are imposed for unaudited "stubs" in the prospectus.³⁸⁷

384. SAS No. 1, *supra* note 20, at AU § 516.03 reads:

.03 A certified public accountant is associated with unaudited financial statements when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements. Further, when a certified public accountant submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements. This association is deemed to exist even though the certified public accountant does not append his name to the financial statements or uses 'plain paper' rather than his own stationery. However, association does not arise if the accountant, as an accommodation to his client, merely types on 'plain paper' or reproduces unaudited financial statements so long as he has not prepared or otherwise assisted in preparing the statements and so long as he submits them only to his client.

385. SAS No. 1, *supra* note 20 at AU § 516.04. An exception is made for unaudited interim statements ("stubs") filed with the SEC. *Id.* AU § 516.12. But other responsibilities arise. *See id.* AU § 710 and the text above; *Stanley L. Bloch, Inc. v. Klein*, 45 Misc. 2d 1054, 258 N.Y.S.2d 501 (Sup. Ct. 1965).

386. SAS No. 1, *supra* note 20, at AU § 516.03.

387. Compare SAS No. 1 AU § 710.09 with AU §§ 516.06 and 516.07.

If the auditor is "associated with" unaudited stubs in a registration statement, what duties arise?

He, of course, may have contractual obligations to the client or the underwriter of the registered offering by virtue of the "comfort letter" engagement. Typically the contract will limit responsibility of the auditor to the parties to that engagement and will limit use of the comfort letter to the underwriter.³⁸⁸

But what duties are owing to third parties on these unaudited interim statements with which the auditor is associated? First, if the auditor knows of violations of GAAP, GAAS require that he first "insist upon appropriate revision; failing that, he should add a comment in his report calling attention to the departure; further he should consider . . . withholding his consent to the use of his report on the audited financial statements in the registration statement."³⁸⁹ Although this express duty is limited to known deviations from GAAP, it would seem that a similar legal duty to disclose known unfairness in the unaudited statements might also exist.

AU § 710.09 reads:

.09 Because the independent auditor has not examined the unaudited financial statements which may be included in the registration statement, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if he concludes on the basis of facts known to him that the unaudited financial statements are not in conformity with generally accepted accounting principles, he should insist upon appropriate revision; failing that, he should add a comment in his report calling attention to the departure; further, he should consider, probably with advice of legal counsel, withholding his consent to the use of his report on the audited financial statements in the registration statement. (See section 516.07.)

AU §§ 516.06-.07 read:

.06 Because unaudited financial statements, by definition, have not been audited by the certified public accountant, he cannot be expected to have an opinion as to whether such statements have been prepared in conformity with generally accepted accounting principles. However, if the certified public accountant concludes on the basis of facts known to him that unaudited financial statements with which he may become associated are not in conformity with generally accepted accounting principles, which include adequate disclosure, he should insist (except under the conditions described in paragraph .05) upon appropriate revision; failing that, he should set forth clearly his reservations in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements.

.07 If, under circumstances such as those described in paragraph .06, the client will not agree to the appropriate revision or will not accept the accountant's disclaimer of opinion with the reservations clearly set forth, the accountant should refuse to be associated with the financial statements and, if necessary, withdraw from the engagement. Further, a certified public accountant should refuse to provide typing or reproduction services or to be associated in any way with unaudited financial statements which, on the basis of facts known to him, he concludes are false or intended to mislead.

388. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 698 (S.D.N.Y. 1968); SAS No. 1, *supra* note 20, at AU § 630.

389. SAS No. 1, *supra* note 20, at AU § 710.09. See also *id.* AU §§ 710.02, 516.04, 516.06, and 516.07.

Thus, if the auditors in the *Simon* case knew of the deficiencies, which instead of being in the audited statements were in unaudited "associated with" statements, one would expect a court to impose a duty to disclose.³⁹⁰

Presumably this duty will be enforceable by persons injured by its breach, including at least those purchasing the registered securities and most likely, within the meaning of *Heit v. Weitzen*,³⁹¹ *Mitchell v. Texas Gulf Sulphur Co.*,³⁹² and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,³⁹³ all those whose injury is caused in fact by the breach of duty.³⁹⁴

Suppose, as in *Fischer v. Kletz*, the discovery of the misleading nature of the statements is made after they have been published. Does the accountant have a duty to correct unaudited "associated with" statements like the *Fischer v. Kletz* duty to correct audited ones?

It would be illogical not to impose the same duty for both. If a duty arises with respect to unaudited "associated with" statements to disclose and perhaps withdraw for deviations from GAAP just as with audited statements, it would seem that the duties would be identical for discoveries of misrepresentations after publication of either audited or unaudited "associated with" statements.

This would be one basis for sustaining the SEC's claim against the accountants in the *National Student Marketing* case.³⁹⁵ It was alleged in that case that audited statements and unaudited "stubs" appeared in a proxy solicitation for an acquisition and the accountants later discovered the stubs were false. Although they notified the client and its attorneys, the Commission urges that they had a further duty, when no one acted, to notify the Commission and investors. Under *Fischer* this would have been an appropriate fulfillment of the duty if audited statements were discovered to be false. It seems appropriate to require the same for "associated with" unaudited statements.³⁹⁶

There are other grounds for requiring the auditor to correct prior unaudited stubs in the registration statement. For SEC filings

390. Thus in SAS No. 1, AU § 630.13 n.1, unfairness discovered in the comfort letter review must be taken "cognizance of" in the auditor's opinion and 1933 Act consent.

391. 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

392. 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

393. 495 F.2d 228 (2d Cir. 1974).

394. See text accompanying notes 367-76 *supra*.

395. SEC v. National Student Marketing Corp., Complaint ¶¶ 33 & 48b, [1971-1972 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 93,360 (D.D.C. 1972).

396. But see Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261, 274-79 (1974).

a statutory duty direct to investors is present, which is not found at common law.³⁹⁷ Moreover, an affirmative duty to disclose information known to one in a special relationship to the person with whom the relationship is held, is one of the well-developed principles of both the common law³⁹⁸ and the securities laws.³⁹⁹ Thus, with respect to unaudited statements, an auditor in a securities-act special relationship with investors would seem to have an affirmative duty to correct those statements regardless of whether he is associated with them. Therefore, it seems that a duty probably exists to notify investors of deviations from GAAP and perhaps of unfairness, as well as a duty to correct later-discovered misrepresentations in unaudited "associated with" statements in a registration statement.

Does an auditor also have a duty of care to detect misrepresentation in the unaudited stubs? Perhaps he does. Because under section 11 of the 1933 Act auditors must conduct an S-1 review,⁴⁰⁰ including limited review of the stubs, they have a duty to use care. *BarChris*⁴⁰¹ teaches that, for purposes of section 11, the S-1 review is relevant only to due diligence in detecting misrepresentations in the audited statements. If a failure occurs in carrying out the section 11 duty to catch an error in the stubs, since the auditor is "associated with" those stubs, it would not be too great a step to make the duty enforceable by private action in keeping with the policy of the Supreme Court to enlist private plaintiffs to enforce securities law duties.⁴⁰² The same would seem to hold for failures in the comfort letter review.⁴⁰³

397. See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974) and text accompanying note 274 *supra*.

398. E.g., RESTATEMENT OF TORTS § 551 (1939); RESTATEMENT (SECOND) OF TORTS § 551 (Tent. Draft No. 12, 1966).

399. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967). The finding of no duty to disclose errors in the unaudited interim statements in *Fischer v. Kletz*, 266 F. Supp. at 195, is distinguishable because those statements were not in SEC filings and therefore the special relationship under the securities acts was not present in the view of the court. One may question whether the court properly ignored the special relationship established for securities law purposes just because the particular unaudited statements were not themselves required by the securities laws. Cf. *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 480 F.2d 341 (2d Cir. 1973) (re underwriter's duties).

400. See text accompanying note 206 *supra*.

401. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

402. *J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). See also *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 223, 241 (2d Cir. 1974); *Chris-Craft Indus. Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 356 (2d Cir. 1973); *Speed v. Transamerica Corp.*, 235 F.2d 369 (3d Cir. 1956); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

403. See note 390 *supra*.

Finally, suppose an auditor, associated with unaudited stubs in a registration statement, becomes aware of suspicious circumstances, but not more. Does he have a duty to probe to determine whether the suspicions are well founded, or to inform anyone? GAAS seem to encompass expressly only known deviations from GAAP in the unaudited statements.⁴⁰⁴ Facts known to the accountant that reasonably would have aroused suspicions are not mentioned. A widely noted common-law case is relevant here. In *1136 Tenants' Corp. v. Max Rothenberg & Co.*,⁴⁰⁵ the court held that even when an accountant was hired merely to perform a "write-up" of financial statements from the clients' books, and not to perform any audit procedures, if he discovered that certain claimed payments were not evidenced by invoices, he had a duty "at least" to notify the client of his discovery. In fact none of these payments were made but the clients' manager had falsified them in order to facilitate his embezzlements. Although the duty in this case was to inform the client of circumstances that might evidence employee defalcations, the concomitant and higher duty to be wary of management misrepresentations to investors⁴⁰⁶ would seem to imply a duty to inform investors of suspicions concerning management's representations.

2. Unaudited Interim Reports to Shareholders

At the opposite extreme from unaudited stubs in registration statements are statements with which the accountant has absolutely no association.⁴⁰⁷ Between these extremes are all variations of participation by the accountant. Thus, the accountant may perform an extensive review of financial statements without applying audit procedures to the normal full extent, or he may have a much lesser involvement, as in a write-up engagement, and still be "associated with" the statements. The kind of data of concern here is extremely important because for many reasons current financial information is of greater significance than old information,⁴⁰⁸ and audited statements typically appearing two or more months after year end are not only old when first published but are even older when someone needs financial data during the subsequent year. Probably more

404. SAS No. 1, *supra* note 20, at AU §§ 710.09 and 516.07.

405. 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971), *aff'd men.*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

406. SAS No. 1, *supra* note 20, at AU § 110.05. *See* text accompanying notes 220-25 *supra*.

407. *See, e.g.*, text accompanying notes 421-45 *infra*.

408. *See, e.g.*, *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2d Cir.), *cert. denied*, 344 U.S. 856 (1952).

injuries occur from the use of unaudited data than from audited data.

In the immediate future we may expect much more participation by accountants in the publication of unaudited data. The Coopers & Lybrand firm recently announced a new service that it describes as a "limited review" of interim reports and unaudited data in annual reports to shareholders.⁴⁰⁹ The AICPA also is considering interim statement reviews.⁴¹⁰ Further, the SEC has just proposed that a note be added to annual statements requiring for each quarter of the prior two years disclosure of data concerning net sales, gross profit, and income before extraordinary items.⁴¹¹ Because the note will be part of the audited statements, the audit will of necessity extend to such quarterly data, albeit the report will be made only annually. The effect, of course, will be to disclose, after the event, defects in the quarterly information, and to red-flag claims for potential plaintiffs. Hence most companies may be expected to clear the data with their auditors prior to publication. Because of the brevity of the quarterly period in relation to the typical operating cycle, distinctive problems arise involving GAAP for interim statements.⁴¹² Therefore, substantial expense will be incurred, estimated by the chairman of Arthur Andersen & Co. at twenty-five percent of the present annual audit fees.⁴¹³

All this increased activity for unaudited statements will increase the actual volume of data with which an accountant may become associated. Part of the pressure to expand into this area doubtless was the fact that many laymen presumed auditors to be associated with much unaudited data and some evidence indicates

409. See Wall Street J., Sept. 24, 1974, at 6, cols. 2-3 (Pac. Coast ed.); J. OF ACCOUNTANCY, Nov. 1974, at 16. According to the Wall Street Journal article, "The new Lybrand procedure calls for it to review a company's proposed quarterly statements and supporting documents. In particular, the accounting firm would check whether accounting principles and procedures were 'appropriate' and applied consistently with past periods. If satisfied, Lybrand would give the company a letter for publication describing the review and concluding 'we have no adjustments to propose,' or words to that effect." Lybrand "also proposed to extend its annual audit to 'historical', or past, financial data included in the 'president's letter' and other unaudited portions of annual reports."

It has developed a forty-page manual of procedures for the new services.

410. See CCH FED. SEC. L. REP., Report Letter No. 564, at 10 (1974).

411. SEC Release 33-5549 (1974); [Current Binder] CCH FED. SEC. L. REP. ¶ 80,030 (1974).

412. See Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540 (2d Cir. 1973); Kaiser-Frazer Corp. v. Otis & Co., 195 F.2d 838 (2d Cir.), cert. denied, 344 U.S. 856 (1952); APB Op. No. 28 (1973) amended by FASB, Statement of Financial Accounting Standards No. 3, Reporting Accounting Changes in Interim Financial Statements (1974).

413. Wall Street J., Dec. 23, 1974, at 2, cols. 2-3 (Pac. Coast ed.). This compares to the estimated 10-15% for the more limited Lybrand review. See Wall Street J., note 409 *supra*.

that legal duties might be premised on these lay expectations. For example, SAS No. 1⁴¹⁴ speaks in terms of unaudited statements "with which he may become associated," intimating that a subjective standard may have been intended—the appearance of being "associated with" statements is enough to invoke the standards for "associated with" statements. Also, of late much discussion of an "auditor of record" concept has occurred,⁴¹⁵ which may impose "associated with" status in certain situations. For example, an auditor engaged for several consecutive audits may become known as the company auditor and when he sometimes comments on unaudited data or is known to be consulted frequently with respect to those statements, he may be held to be "associated with" them. One recent example of a case in which the auditors played it safe by commenting on unaudited data subsequent to the balance sheet date may have been based on this consideration.⁴¹⁶

Because of the wide variances in review of unaudited data ranging along the continuum previously mentioned, standards for the reviews have not been determined. When they are, however, presumably they too will vary.⁴¹⁷ For example, the trial court in *1136 Tenants' Corp. v. Max Rothenberg & Co.*,⁴¹⁸ according to a reliable

414. SAS No. 1, *supra* note 20, at AU § 516.06.

415. See, e.g., Speech of Commissioner Sommer, *The Four Musts of Financial Reporting*, Jan. 8, 1974, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,620; Speech of John Burton, Chief Accountant of the SEC, 138 J. OF ACCOUNTANCY, Nov. 1974, at 16. Dr. Burton stated:

Increasingly it is being recognized that the auditor has some responsibility beyond an annual visit to the corporation in order to audit the financial statements of a particular year. I think that the auditor has to recognize that he has a public responsibility in the broad framework of public financial reporting by corporations. This means that as long as he is the auditor of record, which in the case of a public company means that there has been no 8-K filed with the Commission that indicates he has resigned or been fired, he should feel some responsibility to review all public financial reporting to that company on a continuing basis. It is apparent that what has to be done in this respect is to develop meaningful standards for auditor responsibility. I do not contemplate, for example, a quarterly audit. But on the other hand, it seems to me that public accountants with their public orientation and reporting expertise should have greater impact on interim statements than has been the case traditionally.

416. See Report of Arthur Andersen & Co. in Precision Polymers, Inc. 1973 Ann. Rep.:

We have not examined any financial statements as of any date subsequent to December 31, 1973, and accordingly express no opinion thereon. We advised management that it is our opinion that income with respect to certain transactions . . . should be recorded as product is delivered, and therefore, should not be included in the March 31, 1974 financial statements. Accordingly, if we were to render a report on such financial statements, our report would include an adverse opinion thereon.

417. See Carmichael, *The Assurance Function—Auditing at the Crossroads*, 138 J. OF ACCOUNTANCY, Sept. 1974, at 64; Terrell, *Minimum Standards for Unaudited Financial Statements*, 135 J. OF ACCOUNTANCY, May 1973, at 54.

418. No. 10575-1965 (Sup. Ct. 1970); *aff'd on other grounds*, 36 App. Div. 2d 804, 319 N.Y.S. 1007 (1971), *aff'd mem.*, 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

source,⁴¹⁹ held that "a certain amount of auditing procedures is required even in a write-up." Even if this is so, the same may not be true when the determination of the accountant being "associated with" the statements is grounded on facts not including the performance of services by the accountant.

If the auditor is held to be "associated with" statements, presumably he will be held, as a minimum, to the standards of GAAS, which require at least disclosure of known deviations from GAAP.⁴²⁰ Perhaps the previously described duties to disclose known unfairness of suspicious circumstances, to correct later discovered misrepresentations and to use reasonable care in the "associated with" activity also will be imposed. In any event, any duties ultimately imposed probably should be flexibly established so that the policies of the law can be applied to accommodate the varying interests in the best way possible.

C. *Situations Involving Non-"Associated With" Statements and No Financial Statements Whatsoever*

Does an auditor owe any duties to investors with respect to statements with which he has no association or for matters not involving even unaudited data? The question is too broad for a complete answer but it seems probable that in some cases, an auditor may have duties to investors even when he has no association with the financial statements. Three categories of cases will be briefly considered: (a) currently ongoing misrepresentations or non-disclosures, (b) past misrepresentations whose harmfulness has been spent, and (c) anticipated frauds. This will not exhaust the possibilities although given the dearth of decisions, it will reach to the extent of seemly speculation.

1. Currently Ongoing Misrepresentations or Nondisclosure

Keeping in mind that in this part we are not considering auditor's duties concerning audited or unaudited "associated with" statements, when the auditor's client itself has no duty to disclose a known fact, it would seem inappropriate to require a higher duty from the auditor.

The client has duties not to issue material misrepresentations,⁴²¹ or trade itself on the basis of material inside information,

419. Gormley, *Accountants' Professional Liability—A Ten Year Review*, 29 BUS. LAWYER 1205, 1212-14 (1974).

420. See text accompanying notes 388-94 *supra*.

421. See, e.g., *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*,

or tip others.⁴²² The client also has a duty to disclose when it is aware of misrepresentations by another, at least when it is itself somehow benefiting⁴²³ or the representation by the other manifestly will be relied upon by the public.⁴²⁴ Even when the client is not affirmatively misrepresenting, engaging in insider trading or tipping, or benefiting from or acquiescing in material misrepresentations of others, it may have an affirmative duty to disclose material non-public information adjudged ripe by management,⁴²⁵ at least absent a valid business purpose for nondisclosure.⁴²⁶ If the client has a duty in any of these circumstances, does the auditor also have some duty, other than with respect to audited statements or "associated with" unaudited statements?

Even when the accountant is aware of the facts, the American courts so far uniformly have held that no duty is required of accountants to police their clients beyond their duties in connection with audited or "associated with" financial statements,⁴²⁷ which they have reason to believe will reach the investing public.⁴²⁸

The bases for the decisions have not included any suggestion that the accountants' ethical duty to maintain client confidences⁴²⁹ is relevant. Perhaps this is as it should be. In the analogous case of attorneys who have knowledge that their client has perpetrated a fraud on any person, there is no duty to maintain confidences.⁴³⁰ The principle probably applies to continuing as well as past frauds.⁴³¹ The general opinion, however, seems to be that the fraud should be

404 U.S. 1004 (1971); *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

422. "An issuer making a tender offer for its own shares looks like the most inside of insiders . . ." 1 A. BROMBERG, *SECURITIES LAW FRAUD* 125 (1973).

423. *See, e.g., Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

424. *Green v. Jonhop, Inc.*, 358 F. Supp. 413, 419-20 (D. Ore. 1973). But there is not a duty to dispel every false statement no matter by whom made. *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 948-51 (2d Cir. 1969); *Green v. Jonhop, Inc.*, *supra* at 420.

425. *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir.), *cert. denied*, 414 U.S. 874 (1973).

426. *Id.* *See* note 166 *supra*.

427. *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971); *Gold v. DCL, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,036 (S.D.N.Y. 1973); *In re Seeburg-Commonwealth United Litigation*, 362 F. Supp. 568 (S.D.N.Y. 1972); *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967); *cf. Lanza v. Drexel & Co.*, 479 F.2d 1277 (2d Cir. 1973).

428. *Landy v. FDIC*, 486 F.2d 139 (3d Cir. 1973) (no duty where statements were supplied solely for directors' use and not publication); *Wessel v. Buhler*, 437 F.2d 279 (9th Cir. 1971).

429. AICPA, CODE OF PROFESSIONAL ETHICS, Rule 301, 2 CCH AICPA PROF. STANDS. ET § 301 (1974).

430. ABA CGDE OF PROFESSIONAL RESPONSIBILITY, DR 4-101(C)(2), DR 7-102(B)(1).

431. Remarks by Bialkin, ABA Nat. Inst. on Advisors to Management, *Responsibilities and Liabilities of Lawyers and Accountants*, in New York City, Oct. 3-5, 1974.

fairly clear.⁴³² The precise status of the accountants' ethical code may differ from that for attorneys, although in some states ethical rules of conduct have been enacted into positive law⁴³³ that are similar to the attorneys' code of ethics.⁴³⁴

Instead of resting on the ethical ground of maintaining client confidences, the cited cases rely on the fact that the accountant should not be answerable for client actions having nothing to do with audited or "associated with" financial statements even when the accountant is aware of the misrepresentation or nondisclosure.

What of the fact that under the securities laws accountants have a special relationship with investors⁴³⁵ and in other special relationships an affirmative duty to act or inform has been held to exist?⁴³⁶ Is the special relationship of auditor and investor in existence only with respect to audit reports or "associated with" statements? *Fischer v. Kletz* seems to be premised expressly on that basis and the other cited cases would support it. This view does seem somewhat inconsistent with the "auditor of record" concept previously described.⁴³⁷

At any rate, if additional facts were present, it may be that a duty to inform investors would be found when the accountant is aware of its client's misrepresentations. For example, in *Gold v. DCL Inc.*,⁴³⁸ the auditor, Price-Waterhouse, informed its client, DCL, that the 1971 audit report would have to be qualified by a statement that profits were subject to DCL's ability to renew leases of its computers when some danger was present that DCL's computers would become obsolete and not easily leased. The auditors were discharged but not before DCL issued unaudited interim statements without mentioning Price-Waterhouse's intention to qualify its report. Plaintiff purchased some shares in DCL after the interim statements but before disclosure of the dispute between the auditor

432. 4 PLI ON SECURITY REGULATIONS 224 (1973); Remarks by Bialkin, ABA Nat. Inst. on Advisors to Management, *Responsibilities and Liabilities of Lawyers and Accountants*, in New York City, Oct. 3-5, 1974.

433. According to a Memorandum of Covington & Burling addressed to the AICPA dated April 5, 1974, some 44 State Boards of Accountancy have adopted requirements of confidentiality. Attachment to AICPA, PLAN FOR IMPLEMENTATION OF AICPA VOLUNTARY PROGRAM FOR REVIEWS OF QUALITY CONTROL PROCEDURES OF MULTI-OFFICE FIRMS (1974).

434. See, e.g., ARIZ. REV. STAT. § 32-237 (1956) and ARIZ. SUP. CT. R. 29; CAL. BUS. & PROF. CODE § 6076 (1964) and Rules of Professional Conduct following that section (both the Arizona and California schemes empower the governors of the state bar associations to formulate and enforce rules of professional conduct with the approval of the state supreme court); PA. SUP. CT. R. 17-3 (1974).

435. See note 274 *supra*.

436. See note 395 *supra*.

437. See note 415 *supra*.

438. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,036.

and DCL. He then sued Price-Waterhouse but the court found no breach of duty.

It must be noted, however, that the plaintiff testified he did not know Price-Waterhouse was the company's auditor, nor did he consider or care whether the figures were audited. More importantly, the court stated, in finding no basis for holding that the auditor had by its silence aided and abetted the client's wrong:

[F]ar from there being a tacit agreement not to disclose because of mutual benefit (as, say, in the case of an accountant agreeing to certify false figures in order to retain its client), it is undisputed that Price-Waterhouse was fired by DCL because of the parties' disagreement over the validity of the intended qualification.⁴³⁹

This language suggests the question of what the court would have held in the more likely (than *Gold*) case in which misleading, unaudited statements are published without the auditor's participation, but he knows they are misleading and says nothing, and evidence is present to sustain the allegation that his silence was motivated by the fear of losing his client.⁴⁴⁰ Grounds for concern arise here because inaction in certain situations may be a basis for finding liability as an aider and abettor.⁴⁴¹ If a director of a corporation who sits silently through a misleading speech by a codirector may be held as an aider and abettor,⁴⁴² an auditor who sat on the same stage would seem equally guilty. Should he have to be physically present to be liable? Whether accountants thus have a duty to blow the whistle on misleading statements or omissions by their clients is not as clear as the reported decisions would seem to indicate.

2. Past Wrongs Whose Hamfulness Has Been Spent

The salient characteristic of old wrongs in the disclosure area is that they neither die nor fade away. Because of the current reporting requirements of the securities acts, an old misrepresentation or nondisclosure, unless reported, often causes a new misrepresentation or nondisclosure.⁴⁴³ When an auditor on an audit engagement or on becoming associated with unaudited statements learns of some old securities law violation, the strong presumption favors

439. *Id.* at ¶ 94,168.

440. See Sterling, *Accounting Power*, 135 J. OF ACCOUNTANCY, Jan. 1973, at 61, 63 (indicating that fear of losing clientele from being too independent may be a common phenomenon.)

441. See, e.g., 2 A. BROMBERG, *SECURITIES: LAW FRAUD* § 8.5 at 533 (1973).

442. *Sprayregen v. Livingston Oil Co.*, 295 F. Supp. 1376 (S.D.N.Y. 1968).

443. 4 PLI ON SECURITY REGULATIONS 233-37 (1973).

disclosure. But suppose the accountant discovers a client's unlawful misrepresentation or nondisclosure, which under the circumstances raises no *Fischer v. Kletz* type duty to correct prior financial statements. Does he have a duty to disclose his new found data on some other ground if he is not yet reporting on audited statements?

A lawyer may have some ethical duties if it is clearly established that a fraud has been perpetrated.⁴⁴⁴ Both the original Disciplinary Rule quoted in the margin (which did not contain the exception clause) and the exception clause have been the subject of considerable puzzlement,⁴⁴⁵ but that is a matter for another day. The point is that some authority exists for compelling a lawyer to blow the whistle on fraud, and this presumably includes clear securities law frauds⁴⁴⁶—but perhaps not violations not resulting from clearly intentional harms.

No such injunction is present in the accountants' code of ethics, although there is the previously mentioned ethical duty to maintain client confidences,⁴⁴⁷ which would argue for observance by courts, since by our hypothesis no one will any longer be harmed by the prior fraud. Nevertheless, the original victims of the old fraud have been harmed. This dilemma between encouraging client confidence in accountants and repairing a fraud apparently has not been litigated.

A recent bit of terrorizing on the continuing education circuit has occurred, perhaps aided by the popular knowledge of misprision of felony engendered by the Watergate events. Title 18, U.S.C. § 4,⁴⁴⁸ it is suggested, may make professionals guilty of the crime of misprision if they fail to report past crimes of their clients. That section has never been interpreted in this way, however, and always

444. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 7-102(B)(1):

A lawyer who receives information clearly establishing that:

His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal except when the information is protected as a privileged communication.

445. See 4 PLI ON SECURITIES REGULATION 224 (1973); Remarks by Bialkin, ABA Nat. Inst. on Advisors to Management, *Responsibilities and Liabilities of Lawyers and Accountants*, in New York City, Oct. 3-5, 1974.

446. Remarks by Bialkin, ABA Nat. Inst. on Advisors to Management, *Responsibilities and Liabilities of Lawyers and Accountants*, in New York City, Oct. 3-5, 1974.

447. See note 429 *supra*.

448. "Whoever having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or some other person in civil or military authority under the United States, shall be fined not more than \$500 or imprisoned not more than three years or both."

has required some affirmative act in furtherance of the cover-up to establish guilt.⁴⁴⁹ Thus there seems to be no cause for alarm.

3. Anticipated Fraud

A further brief bit of speculation is in order; this one concerns the accountant's duty to warn potential victims of threatened crimes or breaches of duty. The lawyer may not counsel a threatened crime or fraud⁴⁵⁰ and he may reveal the intention to commit a crime and the information to prevent its commission without violating ethical rules.⁴⁵¹ But he has no such express license in the ethics code to reveal anticipated frauds that are not crimes, and he has no express ethical duty to reveal either an anticipated crime or a fraud. The accountants' code of ethics is silent on all of these matters.

The recent California Supreme Court decision in *Tarasoff v. Regents of U. of Calif.*,⁴⁵² is illustrative of these matters. In that case, the court applied a flexible duty analysis and held that a failure of a psychotherapist to warn a homicide victim of a patient's threat to kill the victim that was disclosed in the course of therapy is a violation of a duty to warn giving rise to an action for damages. While there are numerous obvious distinctions from the accounting case under discussion, two significant similarities exist. First, the court expressly held that the duty would exist despite the absence of any special relationship between doctor and victim; thus the absence of a relationship between accountant and investor under the law of many states would be irrelevant. Secondly, the policy of maintaining patient confidences was required to yield to the societal interest in protection of the victim. Similarly, in accounting, the duty to maintain confidences may be found subordinate to the interest in protecting investors.

Still another ground for auditors' liability may be the previously described special relationship of accountants to both clients and investors under the federal securities laws. The *Tarasoff* court referred to previous decisions recognizing a duty to warn when there was a special relationship between the doctor and both the victim and the patient whose threatened conduct is involved. In criminal cases quite unrelated to the type of white collar crime involved here, special relationships have established the duty to prevent crimes.

449. The leading case is *Neal v. United States*, 102 F.2d 643 (8th Cir. 1939). One case did involve an accountant acting in a somewhat unprofessional manner. *Lancey v. United States*, 356 F.2d 407 (9th Cir. 1966) (concealing a bank robber).

450. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DR 7-102(B)(1).

451. *Id.* at DR 4-101(C)(3).

452. 118 Cal. Rptr. 129 (1974).

For example, when a mother threatened a father with drowning herself and their children as they argued next to a pond, and the father walked away, heard a splash and did nothing, he was held to be criminally liable because the obvious had occurred and mother and children perished.⁴⁵³ The alliterative analogy of mother to management and investors to infants may not seem strange to future courts.⁴⁵⁴

Closer, although not totally persuasive, analogies exist in the area of physical crimes. The following suggests some interesting applications in the accounting area:

Duty based upon contract. The duty to act to aid others may arise, not out of personal relationship or out of statute, but out of contract. A lifeguard employed to watch over swimmers at the beach, and a railroad gateman hired to safeguard motorists from approaching trains, have a duty, to the public they are employed to protect, to take affirmative action in appropriate circumstances. . . .

A more difficult problem concerns the duty, not of the one who is employed to safeguard the public in a particular way, but rather of his fellow employee, whose employment contract does not specifically require him to act in that way. What if, for instance, a locomotive engineer standing near a crossing sees a train and car approaching the crossing; does he owe a duty to the motorist to wake up the sleeping gateman, in view of his employment by the railroad to operate trains? It would seem that a duty to act might be imposed on him, though there is authority to the contrary.

[Citing for this last statement, *Anderson v. State*, 27 Tex. App. 177, 11 S.W. 33 (1889) (brakeman has no duty to signal engineer to stop train when he sees child on the tracks.) Perhaps a distinction might be drawn, in the railroad crossing situation, between a railroad employee on duty and one off duty; and between an engineer, whose general duties include affording safety to the public, and a stenographer, whose general duties have nothing to do with safety.]⁴⁵⁵

VII. CONCLUSIONS

Rather than summarizing the foregoing, a few brief words may be said in conclusion. It seems that accountants are now on the

453. *Rex v. Russell*, [1933] Vict. L.R. 59. See also W. LA FAVE & A. SCOTT, *CRIMINAL LAW* § 26 (1972).

454. Still another ground, which may sometimes be present in the accounting cases, is also suggested in *Tarasoff*. There the court held, alternatively, that where the psychotherapist's prior conduct has created or contributed to the danger, he bears a duty to warn. In that case, the therapist had reported the threats to the police, who picked up and detained the patient but released him, and the patient therefore discontinued therapy. The court reasoned that continuance of therapy might have caused the patient to abandon his plan and that therefore the doctor's conduct contributed to the danger. One need not ponder very hard to imagine many situations in which an auditor's conduct might increase the risk of client misrepresentations to investors. E.g., prior "fudging" by an auditor may have encouraged the later fraud.

455. W. LA FAVE & A. SCOTT, *CRIMINAL LAW* § 185. *Contra*, Isbell, *An Overview of Accountants' Duties and Liabilities Under the Federal Securities Laws and a Closer Look at Whistle-Blowing*, 35 OHIO ST. L.J. 261 (1974).

verge of being held legally liable for all the services they claim to provide. They have three unresolved institutional difficulties that I have described as first, the modular, not real, nature of accounting, secondly, individual independence, and thirdly, impartiality of the profession. Nevertheless, the courts, impatient with the accountants' inability to overcome those difficulties, have exacted from accountants a duty to communicate fairly, so that a layman will not be misled, and perhaps a duty to establish auditing standards and procedures that a jury may find supportable by learned reason. Moreover, accountants have substantial duties to anticipate the possibility of fraud and management misrepresentation, and these and other duties may be enforceable at common law by persons well beyond the tie of privity. It has been suggested that those persons whom a court finds entitled to enforce the duties by applying a balancing process should be able to sue.

Further, we have seen that under Rule 10b-5 the flexible duty standard plus the balancing process are the most suitable techniques for determining, respectively, the appropriate standard of conduct and parties to whom duties are owed and liability for damages will lie.

Finally, we have seen that accountants have very substantial obligations beyond audited statements. They have a duty to correct newly discovered misrepresentations in previously published audited financials. And, because auditors are associated in the public mind with numerous unaudited statements, they have certain duties when they know of falsities in them. They also may have duties to inform investors of suspicious circumstances in connection with unaudited statements and to correct prior misrepresentations, as well as certain duties of care.

Even when no audited or unaudited, "associated with" statements are involved, accountants may have certain duties to "blow the whistle" on a client who is engaging in misrepresentations to the knowledge of the accountant or who is planning some fraud.

