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ACCOUNTANTS' LIABILITY FOR NEGLIGENCE—A CONTEMPORARY APPROACH FOR A MODERN PROFESSION

INTRODUCTION

Almost half a century ago, in *Ultramares Corp. v. Touche*,¹ the New York Court of Appeals sought to protect the accounting profession against attacks by third parties in negligence actions by shielding accountants with the doctrine of privity. Although *Ultramares* has never been overruled, several courts have chosen to allow liability by distinguishing later cases on their facts.²

This Note contends that the use of the privity doctrine as a shield from liability to third parties is no longer appropriate in negligence actions against accountants. Part I examines the present state of the accounting profession to show that the audit today is much more sophisticated than the audit that existed when *Ultramares* was decided. In Part II, the Note contrasts accountants' liability with the law of products liability in which the privity limitations have been essentially abolished in favor of policy goals similar to those applicable in accountants' liability. Finally, Part II examines the policy considerations addressed in *Ultramares* and formulates an "outer perimeter of liability" that will both protect the accounting profession from unlimited liability and give third parties recourse to recover damages they sustained by reliance upon negligently prepared financial statements.

I. THE ACCOUNTING PROFESSION TODAY

An accountant's function may be divided into the three major categories of the audit,³ tax practice, and management advisory services.⁴ The audit

1. 255 N.Y. 170, 174 N.E. 441 (1931).

2. *E.g.*, *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 91-93 (D.R.I. 1968); *White v. Guarente*, 43 N.Y.2d 356, 361-62, 372 N.E.2d 315, 318-19, 401 N.Y.S.2d 474, 477-78 (1977); *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 111-12, 15 N.E.2d 416, 418-19 (1938); *Duro Sportswear, Inc. v. Cogen*, 131 N.Y.S.2d 20, 25 (Sup. Ct. 1954), *aff'd*, 285 A.D. 867, 137 N.Y.S.2d 829 (1st Dep't 1955). Nevertheless, the *Ultramares* doctrine has been extensively criticized. See Besser, *Privity?—An Obsolete Approach To The Liability of Accountants to Third Parties*, 7 Seton Hall L. Rev. 507, 516-17 (1976); Seavey, *Mr. Justice Cardozo and the Law of Torts*, 39 Colum. L. Rev. 20, 48-49, 52 Harv. L. Rev. 372, 400-01, 48 Yale L.J. 390, 418-19 (1939); Solomon, *Ultramares Revisited: A Modern Study of Accountants' Liability to the Public*, 18 De Paul L. Rev. 56, 74-75 (1968).

3. R. Montgomery, *Auditing* 4-5 (9th ed. P. DeFiese, K. Johnson & R. MacLeod 1975). "[T]he purpose of any audit is to enable an auditor to understand the subject matter to the extent and in the particular terms needed to express an expert opinion. He must know enough about the subject matter on which the opinion is given to make it an informed opinion. An expert understanding of the subject matter is required for an expert opinion. Thus, an adequate professional understanding is the basis for an auditor's opinion on which he and others can rely with confidence.

"However, an auditor's opinion must be defined within certain limits because auditors, like other experts, are qualified only within the limits of their expertise. Thus, more than a fine point of semantics is involved in limiting the understanding required to the frame of reference of the opinion to be expressed. One kind of understanding is required for an opinion on a company's financial statements, obviously another kind is needed for an opinion on the quality of the goods

function represents the bulk of the work performed by accountants and makes up approximately seventy to eighty percent of an accounting firm's revenues.⁵ The audit function basically consists of the examination of the financial records of a business entity that leads to a collection of data, the formulation of a conclusion based upon that data, and the presentation of that conclusion in a report on the financial statements.⁶

Particular audits vary according to the needs and requirements of the client. Sometimes clients require a "complete audit," or a reconstruction of all their financial transactions for the period under audit. Other situations may only necessitate a formulation of conclusions from a sample of financial transactions. Accountants characterize this form as a "test audit." Nevertheless, all audits may be broken down into four stages that describe the course of an audit from its inception to its conclusion.⁷

The first stage is the preliminary survey of facts that is usually conducted by a member of the accounting firm upon the first audit engagement by the client. It focuses primarily on planning the audit to conform with the specifications of the engagement letter. The accountant familiarizes himself with the general nature of the client's business including marketing and manufacturing techniques, industry conditions, management characteristics, and possible financial reporting methods. The preliminary survey provides the accountant with knowledge of the basic accounting policies of the client through analysis of prior financial statements and the study of ratios and trends.⁸

The accountant next plans the audit program⁹ that describes the applicable "audit procedures."¹⁰ Among other things, an accountant develops audit

it produces, and still other kinds are necessary for opinions on personnel practices or management policies.

"Standards that define what an auditor's opinion is supposed to mean are needed to avoid the confusion that would result if each user were left to supply his own. The [American Institute of Certified Public Accountants] definitions of auditing limit the understanding to a particular technical context—*fairness of presentation of financial statements in conformity with generally accepted accounting principles consistently applied.*

"The subject matter that an auditor must understand, and bring to bear in the process of his auditing, falls into two main areas: the body of theory and practice comprising generally accepted accounting principles, and the financial and accounting characteristics of the enterprise being reported on." *Id.* (emphasis in original).

4. See, e.g., Price Waterhouse & Co., Annual Report of the United States Firm 35 (June 30, 1979) [hereinafter cited as P-W Report].

5. See, e.g., *id.*; Fiftis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 Vand. L. Rev. 31, 35 n.14 (1975).

6. Hawkins, *Professional Negligence Liability of Public Accountants*, 12 Vand. L. Rev. 797, 803 (1959).

7. For a comprehensive examination of the four stages of an audit, see Fiftis, *supra* note 5, at 37-42.

8. *Id.* at 37. Examples of ratios and trends are cost of goods sold to sales, inventories to cost of goods sold, and accounts payable to disbursements. R. Montgomery, *supra* note 3, at 342. Account balances should not vary greatly from one audit period to another. The accountant should make careful studies of the various accounts and ratios, and any material change should be a sign to the auditor that he should apply additional auditing procedures. *Id.*

9. *Id.*

10. It is important to distinguish between Auditing Procedures, Generally Accepted Account-

procedures to ensure the reliability of internal control.¹¹ He also verifies various account balances with outside sources such as bank and accounts receivable verifications. After completing the preliminary plans, the auditor makes a skeleton audit that is based on the trial balance that he will review after he makes tests upon internal control.¹² The more an auditor can rely on the internal control function, the fewer auditing procedures he needs to formulate an opinion on the financial statements.¹³ No matter how much reliance he gives to internal control, however, some auditing procedures are still necessary.¹⁴

The audit program is then revised to specify the auditing procedures that remain to be applied in the final audit. The revised audit program may be expanded as circumstances require, such as in a case of fraud. If certain evidence arises during the audit indicating the possibility of fraud, the auditor should revise his audit program to emphasize the fraudulent act.¹⁵ Once the audit program is set, the auditor applies the specified auditing procedures to the financial statements of the client. Each of the various applications is recorded in the auditors' working papers¹⁶ which always consist of the trial

ing Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). "Auditing standards differ from auditing procedures in that 'procedures' relate to acts to be performed, whereas 'standards' deal with measures of the quality of the performance of those acts and the objectives to be attained by the use of the procedures undertaken. *Auditing standards* as distinct from *auditing procedures* concern themselves not only with the auditor's professional qualities but also with the judgment exercised by him in the performance of his examination and in his report." 1 American Institute of Certified Public Accountants, Professional Standards § 150.01, at 81 (1977) (emphasis in original) [hereinafter cited as Auditing Standards]. The American Institute of Certified Public Accountants (AICPA) has adopted GAAS. In addition to prescribing general standards of quality and care, GAAS encompasses specific standards relating to field work and reporting. *Id.* § 150.02, at 81-82. To comply with GAAS, the auditor must make a report that states whether the financial statements were prepared in accordance with GAAP. *Id.* GAAP "is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures." *Id.* § 411.02, at 485. Rather than a set of codified procedures, GAAP is fluid in definition and may change as a result of pronouncements by agencies designated by the AICPA or through procedures that "become acceptable as a result of common usage by business." *Id.* § 411.06, at 487. For a comprehensive discussion on the difference between GAAS and GAAP see, P. Grady, *Inventory of Generally Accepted Accounting Principles for Business Enterprises* 47-54 (1965); Fiflis, *supra* note 5, at 41.

11. Internal control is subdivided into accounting controls and administrative controls. The auditor is primarily concerned with accounting controls, which the Committee on Auditing Procedures defined in 1958: "Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing." Auditing Standards, *supra* note 10, § 320.10, at 243 (quoting AICPA, Statement on Auditing Procedure No. 29 (1958)).

12. See Auditing Standards, *supra* note 10, § 320A.21-.22, at 286.

13. *Id.* § 320.71, at 262.

14. *Id.*

15. *Id.* § 327.14, at 323-27.

16. "Working papers serve mainly to: a. Aid the auditor in the conduct of his work.

balance,¹⁷ corporate charter and by-laws, minutes of board meetings and letters of representation.¹⁸ Other documents that may be included in the working papers are "work programs, analyses, memoranda, letters of confirmation . . . , abstracts of company documents and schedules or commentaries prepared or obtained by the auditor."¹⁹

Finally, after the discussion of any outstanding questions with management and the completion of field work, the auditor forms his opinion on the financial statement based upon his findings in the audit.²⁰ This "auditor's report" states whether the financial statements are presented in accordance with generally accepted accounting principles, consistently observed in the current period in relation to the preceding period, and expresses an opinion regarding the financial statements as a whole.²¹

Notwithstanding the comprehensive procedures that the accounting profession has developed to ensure the accuracy and integrity of its audits, it has been criticized since the mid-1960's by the Securities Exchange Commission (SEC).²² Moreover, accountants have been involved in a large amount of litigation that amounted to three hundred lawsuits pending against the largest domestic accounting firms²³ in 1975.²⁴ In large part, this litigation and criticism coincides with the dramatic change that has occurred in the accounting profession. Barely fifty years ago, in *Ultramares Corp. v. Touche*,²⁵ the

b. Provide an important support for the auditor's opinion, including his representation as to compliance with the generally accepted auditing standards." *Id.* § 338.02, at 441.

"Working papers are the records kept by the independent auditor of the procedures he followed, the tests he performed, the information he obtained, and the conclusions he reached pertinent to his examination. Working papers, accordingly, may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor." *Id.* § 338.03, at 441.

"Working papers should fit the circumstances and the auditor's needs on the engagement to which they apply. The factors affecting the independent auditor's judgment as to the quantity, type, and content of the working papers desirable for a particular engagement include (a) the nature of the auditor's report, (b) the nature of the financial statements, schedules, or other information upon which the auditor is reporting, (c) the nature and condition of the client's records and internal controls, and (d) the needs in particular circumstances for supervision and review of the work performed by any assistants." *Id.* § 338.04, at 441-42.

17. The trial balance was "the work sheet on which an auditor brought a client's accounts into balance and entered his numerous adjustments to them." R. Montgomery, *supra* note 3, at 183. Although clients now keep their books in balance at all times the auditor's trial balance is still an integral part of his working papers. *Id.*

18. The letter of representation, or liability certificate, is an assurance from the client that to the best of its knowledge all of its liabilities are entered in its books. *Id.* at 334-35.

19. D. Sweeney & H. Hendrickson, *Unofficial Answers To the Uniform Certified Public Accountant Examinations of the American Institute of Certified Public Accountants* 30 (1972).

20. Fiflis, *supra* note 5, at 40.

21. *Auditing Standards*, *supra* note 10, § 150.02, at 82.

22. See D. Causey, *Duties and Liabilities of the CPA* 4 (Rev. ed. 1976).

23. The eight largest domestic firms, usually referred to as the "Big Eight," audit 80% of the companies traded on the New York and American stock exchanges. They are: Arthur Andersen & Co., Arthur Young & Co., Coopers & Lybrand, Ernst & Whinney, Deloitte Haskins & Sells, Peat, Marwick, Mitchell & Co., Price Waterhouse & Co., and Touche Ross & Co.

24. See Besser, *supra* note 2, at 507 n.2.

25. 255 N.Y. 170, 174 N.E. 441 (1931).

New York Court of Appeals defined the function of the accountant's audit as primarily for the benefit of the client. The audit function was "a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the client] and his associates might exhibit it thereafter."²⁶ This characterization reflects the purpose served by the accountant during the first part of the century when the accounting profession was still in its infancy, and accountants performed substantially less work per audit than they do today. Because professional standards were relatively primitive, the auditor was more likely to miss discrepancies in the clients' records.²⁷

The accounting profession rapidly became more sophisticated in the 1930's,²⁸ yet as late as 1938, the New York State Society of Certified Public Accountants still allowed the auditor to rely on the representations of management concerning the accuracy of physical quantities and the costs of its inventory.²⁹ The mandated auditing standards and procedures were not improved until 1940, when the SEC issued an accounting release concerning the *McKesson & Robbins* case.³⁰ The SEC criticized the accountants for inaccuracies in the corporation's audited financial statements and set forth several findings. First, the accounting firm "failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing."³¹ Second, although the accounting profession claims that the auditor is not a guarantor and should not be liable for fraud, the SEC ruled that "the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that [the audit] might not disclose every minor defalcation."³² Third, the SEC advised the accounting profession to take physical inventories and to require confirmations of accounts and notes receivable.³³ Finally, it recommended that the board of directors nominate the auditors and that the activities of management be included in the audit.³⁴ The SEC also made

26. *Id.* at 183, 174 N.E. at 446.

27. "Prior to the stock-market crash of 1929, there were no authoritative standards governing corporate financial reports." 2 J. Carey, *The Rise of the Accounting Profession* 5 (1970). In a speech presented to the American Institute of Accountants in 1937, Robert H. Montgomery stated that: "Fifty years ago in the United States the public accountant was little known, little recognized, little wanted. . . . He was little recognized because the matters which were referred to him at that time were relatively unimportant, and this unimportance tended to reduce him to the level of a clerk. . . ." *Id.* at 3-4.

28. *Id.* at 5-19.

29. D. Causey, *supra* note 22, at 30.

30. SEC Accounting Series Release No. 19, *In re McKesson & Robbins, Inc.* (1940), reprinted in 5 Fed. Sec. L. Rep. (CCH) ¶ 72,020 (1977). See generally Derieux, *Public Accountability Under Securities Laws*, 35 Ohio St. L.J. 255, 255-56 (1974); Ernst & Ernst v. Hockfelder: *Narrowing The Scope of Accountants' Professional Liability Under the Securities Laws*, 6 Cap. U.L. Rev. 683, 686-87 (1977).

31. SEC Accounting Series Release No. 19, *In re McKesson & Robbins, Inc.* (1940), reprinted in 5 Fed. Sec. L. Rep. (CCH) ¶ 72,020, at 62,110 (1977).

32. *Id.* at 62,111.

33. *Id.*

34. *Id.* at 62,108.

recommendations to the American Institute of Certified Public Accountants (AICPA). It suggested that the AICPA distinguish auditing "standards" from auditing "procedures,"³⁵ and that the auditor's certificate should state whether "the audit was made in accordance with generally accepted auditing standards applicable in the circumstances."³⁶ Subsequently, the AICPA adopted these procedures and eventually codified them in the Statement on Auditing Standards.³⁷ Given the comprehensive standards to which today's accountants must comply, there is no longer any reason to protect them when they commit "a thoughtless slip or blunder, [or fail] to detect a theft or forgery beneath the cover of deceptive entries."³⁸ The accountant is obligated to prevent such errors.³⁹

35. 2 J. Carey, *supra* note 27, at 147.

36. *Id.* at 148. Until recently there were five types of reports that an auditor could supply. Four of these were in the form of opinions. The auditor supplies an "unqualified" or "clean" opinion when he reports that the financial statements are a fair representation of the financial position of the company, presented in accordance with a consistent application of GAAP. Such an opinion may only be rendered when the auditor conducts his examination in accordance with GAAS. Auditing Standards, *supra* note 10, § 509.28, at 639-40. The second form of report is a "qualified opinion" in which the auditor renders a report that is substantially an "unqualified opinion" but for one or more limitations. He generally makes a qualified opinion when he believes that the financial statements depart from GAAP, there has been a material change between the audit periods, or "there are significant uncertainties affecting the financial statements, and he has decided not to express an adverse opinion or to disclaim an opinion." *Id.* § 509.29, at 640. The third form of report is the "adverse opinion" in which the accountant states that the financial statements are not a fair presentation of the company's financial position. He renders such an opinion when the statements, taken as a whole, are not presented in accordance with GAAP. *Id.* § 509.41, at 644. Fourth is the "disclaimer of opinion," which he makes if he does not express an opinion on the financial statement. If he disclaims an opinion, the auditor should also report the substantive reasons for his action as well as any reservations he may have concerning the statements' conformity with GAAP or the consistency of its application. *Id.* § 509.45, at 645-46. Whenever the accountant makes no examination he must issue a disclaimer stating that the financial statements are unaudited. As of July 1, 1979, however, the AICPA has disapproved of the unaudited financial statements in favor of the "compilation of financial statements." See AICPA, Statement on Standards for Accounting Review Services No. 1, Compilation and Review of Financial Statements § 1, at 1 (Dec. 1978). "Compilations" are presented in the form of financial statements but are representations of the management without any expression of assurance by the auditor. *Id.* §§ 4, 9-22, at 3, 5-9. With a "review," the auditor performs the "inquiry and analytical procedures" to provide him "with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting." *Id.* §§ 4, 23-38, at 3, 9-14.

37. See note 10 *supra*.

38. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931).

39. Recently the accounting profession adopted statistical sampling as an auditing procedure designed to minimize the chance of error. Although sampling is not yet required as a GAAS, it is frequently used on audits. Statistical sampling is used for examination of vouchers, inspection of paid checks, confirmation of accounts receivable, inventory testing and pricing.

The AICPA Committee on Statistical Sampling issued a report entitled "Statistical Sampling and the Independent Auditor." The Committee described statistical sampling as follows: "Statistical samples are evaluated in terms of 'precision,' which is expressed as a range of values, plus and minus, around the sample result, and 'reliability' (or confidence), which is expressed as the proportion of such ranges from all possible similar samples of the same size that would

Not only has the accounting profession changed in terms of the procedures and standards of the audit, but also in terms of its role in the investment industry. Today the accountant's audit serves less for the purposes of internal management than for the use of the public in its evaluation of a company's financial stability. As described by the SEC in 1966:

A public accountant's examination is intended to be an independent check upon management's accounting of its stewardship. Thus he has a direct and unavoidable responsibility of his own, particularly where his engagement relates to a company which makes filings with the Commission or in which there is a substantial public interest.⁴⁰

Moreover, in 1957, the SEC issued a statement revealing its opinion that this check on management benefits all classes of property interests. "The responsibility of a public accountant is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies."⁴¹ Although the primary responsibility of the accountant had been to inform a client of possible irregularities in the audited business, today's accountant serves as an independent source of information from which the client's investors and creditors evaluate their own potential risks. The accountant may have no contract with these persons, but their decisions and conduct are influenced by his findings.⁴² Nevertheless, the

include the actual population value. Although statistical sampling furnishes the auditor with a measure of precision and reliability, statistical techniques do not define for the auditor the values of each required to provide audit satisfaction.' " Auditing Standards, *supra* note 10, § 320A.03, at 281-82 (quoting AICPA, Committee on Statistical Sampling, *Statistical Sampling and the Independent Auditor* (1962)). "Evaluation of the precision of an audit sample in monetary terms contributes directly to the auditor's ultimate purpose since such evaluation can be related to his judgment as to the monetary amount of the errors that would be material. Evaluation of precision in terms of the frequency of deviations from internal control procedures or of other errors not evaluated in monetary terms contributes to the auditor's ultimate purpose by influencing his judgment as to the reliability of the records and the likelihood of errors having a material effect." *Id.* § 320A.11, at 283. "In making decisions with respect to the results of a sample, the auditor should consider the precision of the sample as well as the estimate derived from it. For the purpose of some audit tests, the auditor may be concerned with both the upper and lower precision limits; for others, he may be concerned with only one of these limits. For example, if a sample results in an estimate that an asset is overstated by \$10,000 with an upper precision limit of \$12,000 at the reliability level desired by the auditor, he usually would be concerned with the estimate of \$10,000 and the upper limit of \$12,000 because his primary interest in such circumstances would center on the maximum amount by which the asset might be overstated." *Id.* § 320A.12, at 283-84. "Whether audit tests of details are applied by statistical or nonstatistical sampling, the common purpose of both is to form a conclusion about an entire population by examining only a part of it. The distinguishing feature of statistical sampling is that it provides a means for measuring mathematically the degree of uncertainty that results from examining only a part of the data. Auditors who prefer statistical sampling believe that its principle advantage flows from this unique feature. By mathematical measurement of such uncertainty, the auditor can determine the sample sizes necessary to confine the uncertainty to limits that he considers acceptable in any particular situation." *Id.* § 320.08, at 292-93.

40. SEC Accounting Series Release No. 105, *In re Homer E. Kerlin* (1966), *reprinted in* 5 Fed. Sec. L. Rep. (CCH) ¶ 72,127, at 62,278 (1970).

41. SEC Accounting Series Release No. 78, *In re Touche, Niven, Bailey & Smart* (1957), *reprinted in* 5 Fed. Sec. L. Rep. (CCH) ¶ 72,100, at 62,220 (1977).

42. See Comment, *Auditors' Responsibility for Misrepresentation: Inadequate Protection for*

liability of negligent accountants to third parties is still subject to the privity limitations formulated by the New York Court of Appeals in 1931. Although the court has expanded the scope of an accountant's liability to a limited degree, a majority of persons who may be damaged by an accountant's negligence may still be denied a remedy.⁴³

Users of Financial Statements, 44 Wash. L. Rev. 139, 178 (1968). Moreover, in its Code of Ethics, the AICPA recognized the duty owed by accountants to the public. "The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity." AICPA, Code of Professional Ethics § 51.02, at 7 (1977).

43. The scope of this Note is limited to cases in which the privity limitation on an accountant's liability precludes any inquiry into the alleged negligent conduct. Once past the barriers of privity, however, and the duty owed by the accountant to the third party is established, a plaintiff has to prove that the duty was breached. The standards of care an accountant must exercise on any given audit are divided among three bodies of authority: the AICPA, the SEC and the courts.

The AICPA proposed that the standard of required communication be measured by specific GAAP and GAAS, *see note 10 supra*, and in their absence by the customs of the profession or by expert testimony. It further proposed that the jury not be permitted to question the authority of standards expressed by the profession. *See AICPA Brief as Amicus Curiae to Petition for Certiorari, United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), *reprinted in J. Accountancy*, May, 1970, at 69-73. By setting forth these two rules, the AICPA sought to achieve the same standard of proof that the medical profession achieved in the area of medical malpractice. In medical malpractice actions, the majority of the courts agree that a plaintiff must prove the doctor's negligence with evidence of the custom of the profession or with expert testimony. Once the nature of the custom is established the jury cannot question its merits. *See McCoid, The Care Required of Medical Practitioners*, 12 Vand. L. Rev. 549 (1959).

The SEC, however, has proposed that the auditor's duty goes beyond GAAP and GAAS. He must ask "whether the financial statements performed the function of enlightenment, which is their only reason for existence." *In re Associated Gas & Elec. Co.*, 11 S.E.C. 975, 1058-59 (1942). If there is no GAAS or GAAP, or the specific GAAP is found lacking, the SEC proposed more meaningful standards. It believes that a financial statement should be understood by all educated people; not only accountants, but businessmen, investors and lawyers who can look at the statement and make valid business judgments. *See Gonson, Disciplinary Proceedings and Other Remedies Available to the SEC*, Bus. Law., March, 1975, at 191.

Finally, the courts have developed three bases upon which to establish an accountant's negligence. First, when the profession has established specific GAAP and GAAS for dealing with a prescribed problem, the CPA will not be liable if he follows these standards and the financial statement is informative. *See Shahmoon v. General Dev. Corp.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,308 (CCH) (S.D.N.Y. 1973). "Defendant's financial statements and accounting procedures cannot be considered fraudulent when they conform with generally accepted accounting procedures as that term is understood by at least a majority of accounting experts in the field and when the methods used are endorsed by the accounting profession as a whole." *Id.* at 95,039. *See also Colonial Realty Corp. v. Brunswick Corp.*, 337 F. Supp. 546 (S.D.N.Y. 1971). Second, when misleading financial statements cause damage, the courts may find liability even when the evidence shows that the audit conformed with GAAS and GAAP. *D. Causey, supra note 22*, at 17. Third, proof of compliance with GAAP is persuasive but not conclusive; the critical test being whether the financial statements as a whole were fairly presented. In *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970), for example, the Second Circuit stated that: "We do not think the jury was also required to accept the accountants' 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

II. THE LACK OF PRIVACY DEFENSE

The doctrine of privity in negligence actions was first enunciated in 1842 in *Winterbottom v. Wright*.⁴⁴ The coachman of a mail coach that collapsed sued the seller of the coach for personal injuries. The court limited the duties of the seller to those specifically assumed in the contract, and refused to extend those duties beyond the purchaser to the coachman. "If we were to hold that the plaintiff could sue in such a case, there is no point at which such actions would stop. The only safe rule is to confine the right to recover to those who enter into the contract."⁴⁵

In New York, the strict *Winterbottom* rule was considerably liberalized in products liability cases,⁴⁶ and in 1916 Judge Cardozo essentially disposed of the privity requirement in negligence in *MacPherson v. Buick Motor Co.*⁴⁷ Prior to *MacPherson*, the New York Court of Appeals would lift the privity requirement only when the products involved were inherently dangerous during their normal use,⁴⁸ but Judge Cardozo broadened the exception to privity to include products that are dangerous if negligently made. He stated that the nature of the product

gives warning of the consequences to be expected. If to the element of danger there is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully.⁴⁹

The court justified removal of the privity requirement by reasoning that an automobile manufacturer necessarily invites its dealers' customers to use its product. "The invitation is addressed in the one case to determinate persons and in the other to an indeterminate class, but in each case it is equally plain, and in each its consequences must be the same."⁵⁰

Five years after *MacPherson*, the New York Court of Appeals further

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 . . ." *Id.* at 806.

Even when a specific GAAP is used, a court may require a higher standard. *See, e.g., Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1111-12 (7th Cir. 1974), *rev'd on other grounds*, 425 U.S. 185 (1976). The courts focus "not on whether [the] report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position." *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 121 (S.D.N.Y. 1974), *aff'd in part, rev'd in part on other grounds*, 540 F.2d 27 (2d Cir. 1976). For a comprehensive review of these standards, see D. Causey, *supra* note 22, at 13-19.

44. 152 Eng. Rep. 402 (1842) (Alderson, B.).

45. *Id.* at 405.

46. *E.g., Statler v. George A. Ray Mfg. Co.*, 195 N.Y. 478, 88 N.E. 1063 (1909); *Torgesen v. Schultz*, 192 N.Y. 156, 84 N.E. 956 (1908); *Devlin v. Smith*, 89 N.Y. 470 (1882); *Thomas v. Winchester*, 6 N.Y. 396 (1852).

47. 217 N.Y. 382, 111 N.E. 1050 (1916).

48. *See generally* Besser, *supra* note 2, at 512; Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 Fordham L. Rev. 191, 194 (1967), *see also*, W. Prosser, *Handbook of the Law of Torts* § 96 at 641-43 (4th ed. 1971).

49. 217 N.Y. at 389, 111 N.E. at 1053.

50. *Id.* at 393, 111 N.E. at 1054.

limited the privity requirement in *Glanzer v. Shepard*⁵¹ when it allowed recovery by a third party for negligence when the only damage was economic loss. In *Glanzer*, the defendant was a public weigher hired by a seller of beans to provide certification of the weight of the beans to the buyer, the plaintiff Glanzer. Finding no need to address the privity argument and limit the plaintiff's case to one in contract, Judge Cardozo stated that the "assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed."⁵²

Another possible bar to liability in *Glanzer* was that the defendant's negligence was limited to the delivery of an inaccurate weight certificate. Defendants contended that there could be no liability for mere "careless words." The court dismissed this argument, however, concluding that the liability was "for the careless performance of a service—the act of weighing—which happens to have found in the words of a certificate its culmination and its summary."⁵³

The *Glanzer* court extended a defendant's duty to act with care to a party not in privity when the negligent conduct has "the very end and aim of shaping the conduct of another"⁵⁴ and when the defendant has "knowledge of a prospective use" of his services by a third party.⁵⁵

After *MacPherson* and *Glanzer*, the defense of privity to an action in negligence appeared to be all but dead. Cardozo's language in those opinions was not only unequivocal, but devoid of any limitation imposed by the law of contract. The duty of the defendant to the injured plaintiff was enlarged beyond the "bounds" of his contractual obligations by his "knowledge of a prospective use." Accordingly, without more, it appeared that public accountants too were under a duty to conduct their audits with due care and that this duty would run not only to an accountant's client, but to those whom the accountant should expect to rely upon the financial statements of the client; namely, the investors and creditors in the client's business.

Nevertheless, in 1931 the New York Court of Appeals declined to extend the duty of accountants beyond their contract. In *Ultramares Corp. v. Touche*,⁵⁶ the court recognized that "[t]he assault upon the citadel of privity is proceeding in these days apace,"⁵⁷ yet distinguished the acts of accountants as merely "the circulation of a thought or a release of the explosive power resident in words."⁵⁸

In *Ultramares*, the defendants had supplied Fred Stern & Co. with thirty-two serial-numbered copies of a certified statement in 1924. The defendant had prepared balance sheets for Stern in the three years prior to 1924, and was aware that Stern exhibited the balance sheet to creditors and investors in the regular course of its business. The defendant also knew that Stern needed

51. 233 N.Y. 236, 135 N.E. 275 (1922).

52. *Id.* at 239, 135 N.E. at 276.

53. *Id.* at 241, 135 N.E. at 276 (citation omitted).

54. *Id.* at 242, 135 N.E. at 277.

55. *Id.* at 240, 135 N.E. at 276.

56. 255 N.Y. 170, 174 N.E. 441 (1931).

57. *Id.* at 180, 174 N.E. at 445.

58. *Id.* at 181, 174 N.E. at 445.

extensive credit to finance the day-to-day operation of the business.⁵⁹ The court noted, however, that the accountants had no knowledge of the specific people to whom the statements were shown nor of the number of transactions for which they would be used. Although the plaintiffs had previously sold merchandise to Stern, the accountants were never informed that Ultramares in particular would rely on the statements.⁶⁰

The financial statements prepared and certified by defendant Touche showed a net worth of more than one million dollars when, in fact, the corporation was insolvent.⁶¹ The court of appeals had no doubt that the defendant was negligent in many respects,⁶² but it refused to impose a duty toward the plaintiff because lifting the shield of privity would "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁶³ An examination of each of these indeterminate factors, however, reveals that an extension of accountants' liability for negligence beyond the privity barrier will not create an unreasonable exposure to the profession.⁶⁴ Moreover, the public policy considerations that favor an

59. *Id.* at 173-74, 174 N.E. at 442.

60. *Id.* at 174, 174 N.E. at 442. Specifically, defendant was negligent because (1) it failed to detect a fictitious accounts receivable entry of \$700,000; (2) "[t]here was ground for suspicion as to an item of \$113,199.60, included in the accounts payable as due from the Baltic corporation"; and (3) defendants discovered over \$300,000 in inventory errors when the total inventory was only \$347,219.08. The amount and extent of these discrepancies should have "cast discredit upon the business and the books." *Id.* at 177-78, 174 N.E. at 443-44.

61. *Id.* at 175, 174 N.E. at 442.

62. *Id.* at 176-77, 174 N.E. at 443.

63. *Id.* at 179, 174 N.E. at 444.

64. Judge Cardozo also refused to impose liability for accountants' to third parties because it "will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud." *Id.* at 185, 174 N.E. at 447. At first, the court's reasoning seems sound. The tort of fraud is more difficult to prove than that of negligence because of the element of intent. *See id.* at 187, 174 N.E. at 447. *See generally* W. Prosser, *supra* note 48, § 106, at 695 (4th ed. 1971). In *Ultramares*, however, Cardozo eased the plaintiff's burden of proving fraud when he stated that "negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud." 255 N.Y. at 190-91, 174 N.E. at 449. The fact that the defendants "closed their eyes to the obvious" was all that was needed to prove fraud. *Id.* at 192, 174 N.E. at 449. Plaintiff does not have to prove that defendants willfully and intentionally performed the wrong. W. Prosser, *supra* note 48, § 107 at 701. Fraud also exists if the plaintiff can prove that the defendant was so reckless that he had no genuine belief in the truth of his statement. *See, e.g.,* *United States v. Hanlon*, 548 F.2d 1096, 1100-02 & n.7 (2d Cir. 1977); *United States v. Natelli*, 527 F.2d 311, 322-23 (2d Cir. 1975), *cert. denied*, 425 U.S. 934 (1976); *United States v. Sarantos*, 455 F.2d 877, 881 (2d Cir. 1972).

Seven years after *Ultramares*, the New York Court of Appeals, in *State Street Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416 (1938), affirmed the *Ultramares* rule on fraud when it stated: "Accountants, however, may be liable to third parties, even where there is lacking deliberate or active fraud. A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention." *Id.* at 112, 15 N.E.2d at 418-19.

extension of liability are substantially similar to those addressed when the scope of liability was expanded in products liability cases.

A. *The Deterioration of Privity in Products Liability*

In the nineteenth century there was a general concern that "infant" manufacturers should not be burdened with potentially huge liability for defects in their products.⁶⁵ The doctrine of privity was a means of limiting liability to those who actually contracted with the manufacturer. As a policy matter, industrial growth was favored, and the possibility that a manufacturer might be forced into bankruptcy was sufficient to outweigh any desire to compensate every injured consumer.

As industry grew, however, the fears of unlimited liability began to diminish. As manufacturing grew in sophistication, consumer safety emerged as a necessary factor in the design of a product. Similarly, policy considerations in the law of tort shifted so that the ultimate goal was the protection of consumers. The desire to provide this protection was so great that the new form of liability for unsafe products was a liability without fault, imposed in the form of a warranty implied by law in the sale of goods.⁶⁶ Although negligence actions were no longer barred by lack of privity, the potential liability under no-fault warranties was at first limited to persons in privity. Because the warranty liability arose out of the sales contract, it was generally limited to the parties of the sale.⁶⁷

It was not until 1963, in *Greenman v. Yuba Power Products, Inc.*,⁶⁸ that the California Supreme Court disregarded the privity problem of extending warranty liability to third parties and applied the concept of strict liability in tort. In theory, strict tort liability is basically the same as implied warranty liability without any of the complications imposed by application of the contract doctrine of privity.⁶⁹ The *Greenman* court's rationale was to charge the manufacturers with the risk of injury to third parties, but not to place an undue burden upon the manufacturers. It reasoned that the cost of injury to the consumer was a needless expense because the manufacturers can insure against the risk and distribute the cost among the public in the price of its products.⁷⁰

Although its analysis differed from that of *Greenman*, the New York Court of Appeals eventually adopted the theory of strict liability in tort in 1973. In *Codling v. Paglia*,⁷¹ the court examined the continuous "erosion" of the privity doctrine and concluded that rather than continue to formulate more

65. W. Prosser, *supra* note 48, § 96, at 642.

66. At present this warranty is codified at U.C.C. § 2-314.

67. The privity limitation was incorporated into the U.C.C. in three variations. U.C.C. § 2-318. See generally Note, *Economic Loss in Products Liability Jurisprudence*, 66 Colum. L. Rev. 917, 919-26 (1966).

68. 59 Cal. 2d 57, 377 P.2d 897, 27 Cal. Rptr. 697 (1963). See also Restatement (Second) of Torts § 402A (1965).

69. See *Greeno v. Clark Equip. Co.*, 237 F. Supp. 427, 429 (N.D. Ind. 1965).

70. 59 Cal. 2d at 63, 377 P.2d at 901, 27 Cal. Rptr. at 701; see *Escola v. Coca Cola Bottling Co.*, 24 Cal. 2d 453, 461, 150 P.2d 436, 441 (1944) (Traynor, J., concurring).

71. 32 N.Y.2d 330, 298 N.E.2d 622, 345 N.Y.S.2d 461 (1973).

exceptions to the rule it would adopt a broad principle, eliminating the privity doctrine entirely.⁷²

The court also concluded that the extension of liability to manufacturers, even if such liability is unlimited, is justified not only to protect consumers but as a means to compel manufacturers to produce safe products. The consumer should accept the costs of this safety that the manufacturer adds to the price of its products because he is paying for his own protection.⁷³

In sum, the removal of privity as a bar to warranty liability, which developed into the law of strict liability in tort, resulted from four policy considerations: (1) the cost of injury should shift away from the injured party; (2) the risk of injury can be insured against by the manufacturer, who can spread the cost of insurance among the public through the price of the product; (3) the public needs protection from both physical and pecuniary injury; and (4) manufacturers should be compelled to produce safe products.

Although the time has not yet come to impose strict liability upon accountants, it is no longer reasonable to immunize them from negligence liability with the doctrine of privity. Application of the four products liability policy considerations to the role of certified public accountants in society today illustrates the need to dispense with the privity requirement in negligence actions against accountants.

1. The Cost of Injury Should Shift Away From the Injured Party

Whenever a certified public accountant prepares and audits the financial statements of a corporation, he issues a statement that, in his expert opinion, those figures are fairly presented in accordance with generally accepted accounting principles.⁷⁴ The accountant's professional opinion is the only means available to prospective investors and creditors to evaluate their potential risk in terms of the current financial posture of the company. In the case of a company that is virtually insolvent, for example, a misstatement of assets that conceals such a material fact would most likely cause an investor or creditor to subject itself unknowingly to substantial losses that it could have avoided. The imposition of third-party liability upon the accountant is desirable because most investors and creditors will not realize that the financial statements are inaccurate until the company has few or no assets. The only negligent party to whom they can turn is the accountant, and the cost of injury should shift from the innocent creditor or investor to the wrongdoer.⁷⁵

Moreover, because no third party can be damaged by an accountant's negligence without taking some form of affirmative action, the concept of comparative fault limits the liability of the accountant in cases when his

72. *Id.* at 338-39, 298 N.E.2d at 626, 345 N.Y.S.2d at 466-67.

73. *Id.* at 341, 298 N.E.2d at 627-28, 345 N.Y.S.2d at 468-69.

74. See notes 7-21 *supra* and accompanying text.

75. Moreover, the accounting profession today needs little sympathy and should be treated as any other business. Price Waterhouse & Co., for example, earned gross incomes in the United States of over \$200 million in each of the past five years. Its worldwide revenues grew from nearly \$400 million in 1975 to \$635 million in 1979. P-W Report, *supra* note 4, at 28. For a discussion of the fierce competition for clients among the nation's largest firms, see Cowan, *How C.P.A.'s Sell Themselves*, N.Y. Times, Sept. 25, 1977, § 3, at 1, col.1.

negligence is relatively minor compared to that of the plaintiff, or when the plaintiff could have avoided injury with the exercise of due care.⁷⁶ For example, subsequent to an audit of a company with eight hundred thousand dollars in actual assets, three banks each lend the company five hundred thousand dollars. Each bank bases its decision on an inventory negligently stated at eight hundred thousand dollars. In addition, two factors each lend the company eight hundred thousand dollars on accounts receivable negligently stated at one million dollars. The potential liability, therefore, absent any mitigating factors, is \$3.1 million, or nearly four times the actual assets of the company.

Large financial investors, such as banks and factors, however, rarely lend money until they complete a thorough investigation.⁷⁷ Banks and factors normally secure their loans with inventory as collateral, and file a chattel mortgage on that inventory.⁷⁸ The audited financial statement prepared by the accountant should disclose that the accounts receivable are factored, that a lien has been filed on the inventory, or that the loans payable by the company are subordinated, but even if the accountant negligently failed to disclose the lien, the creditor is left with little recourse against the accountant on that basis alone. The creditor itself was negligent in failing to act diligently and discover the preexisting liens.⁷⁹

In contrast to large commercial investors and creditors, small investors generally commit money to a company by buying stocks or bonds, or as one of an aggregate of small investors that makes a large loan to the company based on the financial statements. These small investors are analogous to the innocent purchaser of the defective product because they do not have the means to discover relevant defects in the financial statement. Therefore, because the investor is less negligent than the accountant, and because he is too remote from the investment industry to discover such negligence, the accountant should bear the expense of the damage.⁸⁰

2. The Risk of Injury Can Be Insured Against By the Accountant and Distributed Among the Public

There is no effective way to compel a company to insure its creditors and investors against its own dissolution. By the time the sanctions are imposed, the company is no longer in existence. Also, most insurance policies exclude

76. See *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 103 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *cf. Codling v. Paglia*, 32 N.Y.2d 330, 343, 298 N.E.2d 622, 629, 345 N.Y.S.2d 461, 470-71 (New York application of contributory fault in strict tort liability). See also *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275 (2d Cir. 1975); *Vohs v. Dickson*, 495 F.2d 607 (5th Cir. 1974); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976); *Arber v. Essex Wire Corp.*, 490 F.2d 414 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

77. See, e.g., *Credit Dep't, National Bank of North America, Request for Financial Statement* (on file with *Fordham Law Review*).

78. "A financing statement must be filed to perfect most security interests . . ." U.C.C. § 9-302; see *id.* § 9-304.

79. See, e.g., *id.* § 9-312.

80. Note, *Public Accountants and Attorneys: Negligence and the Third Party*, 47 *Notre Dame Law* 588, 605 (1972).

liability for fraudulent acts of the company. Moreover, to require the client to insure its investors might solve the problem of injuries to third parties, but it will not make accountants more careful.

The accounting firm, however, is in the best position to insure against negligent misstatements in financial statements because it can include the cost of insurance in its auditing fee.⁸¹ In turn, the client passes this additional cost to the consumer through its business.⁸²

Furthermore, if accountants are aware on each audit that their insurance rates will go up if they are negligent, they will exercise greater care. Accountants will be compelled to weigh and consider any cost-saving factors in their audits against possible increases in their insurance premiums. Accordingly, the diligent accounting firm that makes a sound audit will reap the benefits of low insurance premiums.⁸³ In contrast, if an accounting firm is found liable, its insurance premiums may become so high that it will be prohibitive to pass the cost to the client, and the accounting firm may be forced out of business. There is no sound reason to protect professional firms that act negligently, and accountants' liability can be another means to make the accounting profession more reliable by weeding out the bad firms.

3. The Public Needs Protection From Both Physical and Pecuniary Injury

In 1916, when the New York Court of Appeals abolished the privity requirement for products liability cases based upon negligence, one of its primary concerns was the protection of the public from physical injury.⁸⁴ Later, in *Glanzer v. Shepard*,⁸⁵ lack of privity did not bar an action for pecuniary loss,⁸⁶ and today, both physical and pecuniary damages may be recovered in New York product liability actions.⁸⁷ Therefore, in cases of

81. In 1976, a survey taken by the Practising Law Institute indicated that accounting firms had little difficulty in obtaining insurance at a reasonable cost. One insurance plan is "sponsored jointly by the American Home Insurance Company and the Federal Insurance Company, the American Home writing the initial coverage, with the Federal taking the excess coverage." Practising Law Institute, *Tax Law and Practice*, Transcript Series, No. 4, *Accountants' Liability* 168 (J. McCord ed. 1969). Moreover, a new insurance program sponsored by AICPA covers all claims against the insured including defense costs, except those involving intentional fraud. See Levine & Marks, *Accountants' Liability Insurance—Perils and Pitfalls*, J. Accountancy, Oct., 1976, at 59, 60. The accountant is insured for liabilities up to five million dollars, and the plan is designed for firms with staffs of less than 250 people. Rollins Burdick Hunter, *AICPA Professional Liability Insurance Plan* (1979) (on file with *Fordham Law Review*). Like all insurance policies, these liability policies offer the accounting profession the advantage of risk-spreading.

82. See *Codling v. Paglia*, 32 N.Y.2d 330, 341, 298 N.E.2d 622, 628, 345 N.Y.S.2d 461, 468.

83. In its 1979 annual report, Price Waterhouse & Co. reported that: "Pending litigation at June 30, 1979 is not expected to have a material effect on the worldwide financial position or results of operations. All firms carry the same level of indemnity insurance coverage subject to varying levels of deductible or self-insurance. In the year ended June 30, 1979 the total cost of practice protection, including the cost of insurance premiums, claims, and legal fees, amount to \$9.9 million (\$7.8 million in 1978)." P-W Report, *supra* note 4, at 35.

84. *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916); see *Greenberg v. Lorenz*, 9 N.Y.2d 195, 173 N.E.2d 773, 213 N.Y.S.2d 39 (1961).

85. 233 N.Y. 236, 135 N.E. 275 (1922).

86. See notes 51-55 *supra* and accompanying text.

87. See *Codling v. Paglia*, 32 N.Y.2d 330, 339, 298 N.E.2d 622, 626-27, 345 N.Y.S.2d 461,

accountants' liability, once the duty of the tortfeasor is established, the difference between pecuniary and physical injury should not be determinative of the presence of liability.

4. Accountants Should Be Compelled to Conduct Careful Audits

The client, not the accountant, is primarily responsible for financial statements,⁸⁸ and it is the company, not the accountant, that originally prepares them.⁸⁹ The accountant's opinion serves merely as the "attest function" to the validity and accuracy of the financial statements. Even if the accountant is negligent in the preparation of his opinion, the client, in most cases, is both aware of any misrepresentations and trying to hide them.

One of the most radical changes that will result from the removal of privity as a bar to accountants' liability is that the responsibility for the accurate disclosure of financial information will extend to the accountant as well as the client. In the law of products liability, however, any seller of a dangerous product may be liable for injury caused by that product, even though the wholesaler or retailer has nothing to do with its manufacture. Their responsibility to the consumer does not abate when the manufacturer caused the defect or was in the best position to detect the defect.⁹⁰

If accountants know that they will be held liable for negligent acts to third parties, they will be more diligent in conducting their audits and formulating their opinions. Before commencing an audit, an accounting firm should establish "[p]olicies and procedures . . . for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity."⁹¹ If all companies' financial statements were true representations of their financial condition there would be no need for certified auditors.

B. *The Ultramares Policy Rationale*

Not only do the policy considerations addressed in the law of products liability apply to the law of accountant's liability, but the three factors that constitute the "social utility rationale"⁹² of *Ultramares Corp. v. Touche*⁹³ are

467; *Randy Knitwear, Inc. v. American Cyanamid Co.*, 11 N.Y.2d 5, 13, 181 N.E.2d 399, 402, 226 N.Y.S.2d 363, 368 (1962). See also Sales, *The Innocent Misrepresentation Doctrine: Strict Tort Liability Under Section 402B*, 16 Hous. L. Rev. 239, 266 (1979).

88. Auditing Standards *supra* note 10, § 110.02, at 61-62. The accountant is required to obtain from the client a representation letter that, among other things, states: "We [the client] are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (other comprehensive basis of accounting)." *Id.* § 333A.05, at 352.

89. *Id.* § 110.02. "The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles." *Id.* § 110.01, at 61. "However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management." *Id.* § 110.02, at 62.

90. See Restatement (Second) of Torts § 402A (1965).

91. Auditing Standards, *supra* note 10, § 160.19, at 95 (emphasis omitted).

92. *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85, 90 (D.R.I. 1968).

93. 255 N.Y. 170, 174 N.E. 441 (1931).

no longer valid limitations upon the scope of an accountant's liability. If the veil of privity is lifted, today's accountant will not be subject to liability "in an indeterminate amount for an indeterminate time to an indeterminate class."⁹⁴

1. The Indeterminate Amount

The amount of an accountant's liability to third parties should be limited to the damage actually caused by his negligence. An accountant should not be liable for injury attributable to the conduct of the plaintiff. Moreover, the liability of the accountant should not be multiplied by the intervening acts of the client.

For example, an audited company may have twenty trade suppliers, each requesting a financial statement upon which to base its decision on the amount and duration of an extension of credit. If the accountant was negligent in overstating the company's net worth by fifty thousand dollars, the accountant's liability should be limited to the damages actually caused by his negligence in the financial statements. Accordingly, each of the twenty creditors should only be allowed to recover against the accountant for its pro rata share of the fifty thousand dollars. Once the accountant's liability is limited to the amount of negligent misstatement, the amount of liability is determinable.⁹⁵

2. The Indeterminate Time

In New York, malpractice actions are subject to a three year statute of limitations⁹⁶ that begins to run "from the date of the negligence [no matter] 'whether the ultimate damage is sustained at that time or subsequent thereto.'"⁹⁷ This rule provides plaintiffs with a short period of time to recover damages, and when applied to realistic fact situations, protects accountants more than other professionals. For example, in a situation similar to *Ultra-mares Corp. v. Touche*,⁹⁸ when a supplier requests financial statements as a basis for extending credit on sales of merchandise, it will first extend credit for sixty days, which might be a customary period in the trade. As time goes on, the supplier may be forced to extend that credit for another one hundred

94. *Id.* at 179, 174 N.E. at 444.

95. The general rule of contributory negligence, *see* notes 76-80 *supra* and accompanying text, does not extend to cases involving fraud. *Butler v. Olshan*, 280 Ala. 181, 194, 191 So. 2d 7, 19 (1966); *Seeger v. Odell*, 18 Cal. 2d 409, 414, 115 P.2d 977, 980 (1941); *Roda v. Berko*, 401 Ill. 335, 342, 81 N.E.2d 912, 915-16 (1948); *see Seavey, Caveat Emptor as of 1960*, 38 Tex. L. Rev. 439 (1960). Therefore, if a CPA fraudulently prepares a financial statement showing a net worth of \$50,000 and ten creditors extend \$50,000 in loans based on the financial statement, the CPA may be liable for up to the entire \$500,000 in losses suffered by the creditors. The CPA will not be permitted to rely on contributory negligence as a defense.

96. N.Y. Civ. Prac. Law § 214(6) (McKinney 1972). The statute of limitations for fraud, however, is six years from the date that the fraud is discovered. N.Y. Civ. Prac. Law § 213(8) (McKinney Supp. 1979-1980).

97. *Troll v. Glantz*, 57 Misc. 2d 572, 574, 293 N.Y.S.2d 345, 347 (App. Term 1st Dep't 1968) (quoting *Crowley v. Johnston*, 96 A.D. 319, 321, 89 N.Y.S. 258, 259 (1st Dep't 1904)); *see Dura-Bilt Remodelers, Inc. v. Albanese*, 86 Misc. 2d 172, 382 N.Y.S.2d 455 (Sup. Ct. 1976); N.Y. Civ. Prac. Law § 203(a) (McKinney 1972).

98. 255 N.Y. 170, 174 N.E. 441 (1931); *see* notes 60-61 *supra* and accompanying text.

twenty days, and in many cases the extension of credit will continue beyond the three year limitation period. By that time, the supplier may realize that it has been carrying an insolvent company on its extension of credit, but the supplier will also be barred from suing the accountants for negligence. Therefore, contrary to the consideration expressed in *Ultramares*, the removal of the privity requirement from accountants' negligence actions will subject them to liability for a definite determinate time.⁹⁹

3. The Indeterminate Class

The denial of relief to third parties for accountants' negligence because it would subject the accountant to liability to an "indeterminate class" is perhaps the least tenable of the *Ultramares* rationales. Although the accountant in *Ultramares* supplied Fred Stern & Co., its client "which was in substance Stern himself," with thirty-two serial-numbered copies of the audited financial statement which it knew were for the use of creditors,¹⁰⁰ the New York Court of Appeals held that, at that time, the accountants could not be liable to a particular creditor whom it did not know. Today, however, when the function of accountants is such that they provide their auditing services primarily for the benefit of the public, courts have focused nearly all of their attention on the bounds of the "indeterminate class" when they seek to soften the *Ultramares* bar. Moreover, under the Restatement (Second) of Torts, the class to which accountants will be liable has been similarly expanded.¹⁰¹

99. Accountants, however, may be held liable for a longer period under the doctrine of continuous representation that was initially applied in New York to cases involving continuous treatment by a physician. See *Borgia v. City of New York*, 12 N.Y.2d 151, 187 N.E.2d 777, 237 N.Y.S.2d 319 (1962). The exception was extended to the area of attorney malpractice in *Wilson v. Econom*, 56 Misc. 2d 272, 288 N.Y.S.2d 381 (Sup. Ct. 1968). Accountants who perform a perennial audit on a client should be aware of the particular problems of the client in both the current audit and past audits. If an auditor fails to detect the negligent act in the first year he should be subject to continuous liability in the ensuing years for not detecting the misrepresentation. As an accountant becomes more familiar with the client's business it should be easier to discover past errors. Accordingly, the theory of continuous representation applies to accountants in situations when accountants supply the client with certified audits each year. Frequently, however, a client asks the accountant for a certified audit to satisfy creditors, and the accountant will not be asked to submit certified financial statements in subsequent years. In such situations an accountant's liability is limited to three years.

100. 255 N.Y. 170, 173-74, 174 N.E. 441, 442.

101. Restatement (Second) of Torts § 552 (1977). Subsections (2)(a) and (2)(b) are the most relevant to accountants' liability to third parties and can be summarized as follows: 1. The scope of liability in the case of a good faith though negligent misrepresentation is narrower than one made for fraud. *Id.*, comment a at 127. Before the maker of a negligent misrepresentation can be liable, the use for which the representation is supplied must be specifically known to the maker. *Id.* at 128. 2. The plaintiff need not be specifically identified at the time the information is supplied, and it is sufficient that the maker intends to affect "a particular person or persons, known to him, or a group or class of persons, distinct from the much larger class who might reasonably be expected sooner or later to have access to the information and foreseeably to take some action in reliance upon it." *Id.*, comment h at 133. 3. "[T]he liability of the maker of a negligent misrepresentation is limited to the transaction that he intends, or knows that the recipient intends, to influence, or to a substantially similar transaction." *Id.*, comment j at 137. The transaction for which the misrepresentation was eventually used cannot vary from that for

One of the first courts to narrow the limitations on liability announced in *Ultramares* was the United States District Court for the District of Rhode Island in *Rusch Factors, Inc. v. Levin*.¹⁰² In *Rusch*, the defendant prepared the financial statements of a corporation after the plaintiff, a creditor, requested them as part of its evaluation of the corporation's financial stability. The accountants delivered the statements to the corporation,¹⁰³ and were paid for their services by the corporation. Although the court voiced strong objections to the "social utility rationale" of *Ultramares*,¹⁰⁴ it distinguished *Ultramares* on its facts because rather than merely "foreseeable," the *Rusch* plaintiffs were "actually foreseen" and part of "limited classes of persons."¹⁰⁵ The court held further, however, that lack of privity would be no defense when "the defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential financiers of the . . . corporation."¹⁰⁶ The distinction between the facts in *Ultramares* and those in *Rusch*, therefore, is narrow; although accountants can be liable to third parties when they actually know that the financial statements will be relied upon by creditors, they will not be liable if they merely should have known of their reliance.¹⁰⁷

An analysis similar to that in *Rusch* was eventually employed by the New York Court of Appeals in 1977. In *White v. Guarante*,¹⁰⁸ however, the court extended the scope of liability to those whom the accountant "must have" known would rely on the financial statements.¹⁰⁹ The plaintiffs in *White* were

which it was intended. If the circumstances change only slightly, however, a CPA may be held liable. For example, if the statement is used a month later than the CPA intended, he will be held liable. Under the Restatement, liability is generally determined according to the difference between the actual and the intended transaction. The theory and policy considerations behind the Restatement are questionable, however, particularly when applied to accountants. If an accountant knows that his audit will be the basis for a loan from a specific bank, there appears to be no policy justification for protecting him from liability for his own negligence simply because the user obtains a substantially identical loan from a different bank. Similarly, if the auditor is told that a company will request a loan from a bank for \$50,000 and instead the company's suppliers extend it an extra \$50,000 credit, why should the accountant be relieved of liability simply because the type of creditor has changed? Under the Restatement, a clever accountant can easily escape liability by asking his client not to reveal the reasons for which a certified financial statement will be used. Section 552 is designed to apply to all professionals that supply information for the guidance of others, and the class to which they owe a duty of due care is limited to prevent exposure to unlimited liability. *Id.*, comment a at 127. This limitation is not appropriate to accountants' negligence, however, because their liability is limited to the amount of their negligent misstatement. See pt. II(B)(1) *supra*.

102. 284 F. Supp. 85 (D.R.I. 1968).

103. *Id.* at 86-87.

104. *Id.* at 90-91.

105. *Id.* at 91-93.

106. *Id.* at 93.

107. Some courts, however, have utilized distinctions to reject a *Rusch* approach. See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1105-07 (7th Cir. 1974) (plaintiffs were not specifically foreseeable, nor did they rely on the financial statements), *rev'd on other grounds*, 425 U.S. 185 (1976); *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357, 359-60 (10th Cir. 1971) (insufficient proof that the forum state would follow *Rusch*).

108. 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977).

109. *Id.* at 361-62, 372 N.E.2d at 319, 401 N.Y.S.2d at 478.

the members of a limited partnership that had engaged Arthur Andersen & Co. to perform an audit and prepare the partnership's tax returns. They alleged that the defendant accountants knew, or should have known, that two of the general partners withdrew funds from their capital accounts in violation of their partnership agreement. These facts should have been disclosed in the applicable financial statements, but were overlooked by the auditors.¹¹⁰

Arthur Andersen argued, however, that they could not be liable to the limited partners in negligence because there was no privity between the parties. In rejecting this argument, the court held that even if the limited partners were not actually foreseen, they belonged to a definable class that was limited in scope and fixed in number. The statements were prepared for a limited partnership, and therefore, the accountants must have been aware that the partners relied on the statements for various business purposes. Knowing of this reliance, the accountants assumed "a duty to audit and prepare carefully for the benefit of those in the . . . contemplated group whose conduct was to be governed."¹¹¹ The duty, imposed by law, is not subject to the rules of contract or privity.¹¹²

The *White* decision, although still a limited liberalization of the strict privity rule established in *Ultramares*, may be applicable in various factual situations. For example, the long-term creditors of a corporation often require periodic audits by an independent accountant as a condition to a loan. In those situations, the modern accountant should know that the company's audited financial statements will be relied on by the creditors, that are composed of a definable and limited class.

Perhaps the most radical rejection of the privity doctrine, however, was made by the Missouri Court of Appeals in *Aluma Kraft Manufacturing Co. v. Elmer Fox & Co.*¹¹³ Holding that the accountant will be liable to third parties when it "knows the recipient intends to supply the information to prospective users," the court set forth factors to be weighed in any case to determine the liability of accountants to third parties absent privity.¹¹⁴ Those factors are: "(1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to [the plaintiff]; (3) the degree of certainty that the plaintiff suffered injury; and (4) the closeness of the connection between the defendant's conduct and the injury suffered."¹¹⁵

Although *Aluma Kraft* preceded *White v. Guarente* by four years, the New York Court of Appeals never addressed this negligence test that essentially discards *Ultramares* entirely. In cases of accountants' liability for negligence to third parties, the *Aluma Kraft* analysis is preferable to that of *White v. Guarente*, because it eliminates the need to formulate distinctions with the factual conclusions of *Ultramares*.

110. *Id.* at 360, 372 N.E.2d at 317-18, 401 N.Y.S.2d at 476-77.

111. *Id.* at 361-62, 372 N.E.2d at 319, 401 N.Y.S.2d at 478.

112. *Id.*

113. 493 S.W.2d 378 (Mo. App. 1973).

114. *Id.* at 383.

115. *Id.* See also *Biakanja v. Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958); *Besser*, *supra* note 2, at 530.

CONCLUSION

Fifty years ago, accountants may have needed the protection of privity to immunize them from third party liability. Such a rationale, however, does not apply to the modern accountant. Accounting is a sophisticated profession that has virtually eliminated the major oversights that were common in 1931 when *Ultramares* was decided. Those who rely on an accountant's negligent misstatements should be compensated for their injury. The time has come to renew the "assault upon the citadel of privity"¹¹⁶ and treat the accountant as any other member of the business community.

Judah Septimus

116. *Ultramares Corp. v. Touche*, 255 N.Y. 170, 180, 174 N.E. 441, 445 (1931).