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Accountant's legal responsibility

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INTRODUCTION

Attainment of professional standing requires acceptance of responsibility. Nominal responsibility is incompatible with professional status. Observance of a code of conduct, high standards of education, self-discipline, public service — all of these are marks of a profession, but the quality that really sets the professional endeavor apart is the presence of significant responsibility and willingness to accept it within a claimed sphere of competence.

In law as a profession the responsibility relates to the protection of the civil, the constitutional, and the statutory rights of the individual or business enterprise. In medicine it relates, of course, to the physical well-being of the individual. In accounting, as we know, it concerns economic well-being.

At the outset, let me say that it is not my intention to offer interpretations of the cases or of the law bearing upon accountants' legal liability. This is not my field. Here, I borrow mainly from Saul Levy who has written competently about this subject, particularly in his book, *Accountants' Legal Responsibility*. It is my intention, however, to consider some of the legal hazards facing us in our work and some of the things that we might do as accountants to minimize the risks inherent in our exposure to them.

Before doing this, however, I think it well to consider that the possible incidence of claims against accountants is not confined to the accountants of any particular region or to accounting firms of any particular size. Moreover, important as liability insurance is, it cannot furnish immunity from all of the losses, economic and otherwise, attending the defense of a claim. Loss of time may be considerable. In addition, there may be a great deal of personal strain if the case receives public attention, regardless of its merits or of its outcome.

The number of claims against accountants that have been carried into the courts and to the point in litigation where there is a record that the court acted upon the claim is not outstandingly large. The number of cases where claims were withdrawn or settled short of a judgment by the court is unknown. Continuing improvement of the work of the auditor lessens the chances that claims will be asserted successfully against him, but at the same time there may be factors present while a profession is maturing that may react to increase the frequency of claims that are brought against its members. First, as the nature of the work of the profession and of the responsibility of its members for their work is clarified and gains wider public understanding, more claims may be brought if for no other reason than that more people know about the extent of the responsibility. Second, the incidence of claims may increase as the raising of a new point in one case prompts another claim based on the same point. Even though this may be a mark of the ripening of a profession and thus an indication of a salutary development, the individuals against whom claims might be asserted will find no comfort in it.

This brings us then to our principal considerations. What is the basis of accountants' legal responsibility? What are the legal hazards that we face? How do we minimize our exposure to them?

BASIC CONSIDERATIONS

The hazards confronting the accountant may concern disciplinary action or an action at law; the latter may be by reason of common law or may pertain to statutory law. Disciplinary hazards in the accountant's work may stem from his membership in professional societies attending which he accepts a responsibility to observe prescribed rules of professional conduct and other regulations. Also, there may be disciplinary hazards in the work that an accountant does for a client who is filing with the Securities and Exchange Commission. Statutory liability also attends work done by an accountant in connection with the Securities Act of 1933 and the Securities Exchange Act of 1934 and other similar acts. These are important matters, but they will not have my principal attention. Instead, I should like to consider the principal benchmarks in the common law and what they mean to us in our practice.

A little over fifty years ago a New York court held that the standards of responsibility applying to skilled workmen also applied to public accountants. The court said:

> "The plaintiffs do not challenge the proposition of law advanced by the defendant that public accountants now constitute a skilled professional class and are subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions. And such is doubtless the law."

The court then referred to *Cooley on Torts* where it was stated:

"Every man who offers his service to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith or dishonesty, but not for losses consequent upon mere errors of judgment."

A few English cases in the late 1800's served as milestones in sharpening the standards of accountants' responsibility in the United States. For example, in the London and General Bank case, it was said:

"An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. . . . Such I take to be the duty of the auditor; he must be honest – i.e., he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of the case."

Elaborating further upon these concepts of care and competence, another English case in re Kingston Cotton Mill Co., stated:

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound."

As Saul Levy has pointed out, however, it remained for the Irish Court of Appeal in The Irish Woollen Co. Ltd. v. Tyson case to say that this

". . . was very unfair to the bloodhound, who was just as little likely to have his sense of suspicion aroused as the watchdog. Applying this instance of the dogs to the present case, was not the watchdog bound to bark? And if, when sniffing round, you hit upon a trail of something wrong, surely you must follow it up, and there is just as much obligation on the auditor who is bound to keep his eyes open, and his nose, too. As in the case of the hound, the auditor will follow up this trail to the end, and the first things he will 'root up' are those statements of account, and then the fraud is discovered."

COMPETENCE AND CARE

Underlying, then, the accountant's responsibility to his client is the imposed duty to bring to the engagement competence that measures up to the learning, skill, and experience commonly possessed by the members of the profession and, further, to exercise the required competence with reasonable care. Expertness and reasonable care in its application are the building blocks of legal liability to clients. Essentially, the accountant's work culminates in a written communication. Ordinarily, it contains either an opinion, or a denial of one, about financial information or a recommendation about such things as a system of internal control or perhaps about matters of financial management and organization. I emphasize – the accountant's responsibility ordinarily turns on what he does or does not say in a written communication and on the quality of the work that he did in forming the basis of his opinion or views.

THIRD PARTY LIABILITY

Thus, the dimensions of an accountant's responsibility to his client were defined early in the development of the profession in the United States. Definition of his responsibility to third parties came later. Since the actions of third parties, such as credit grantors and investors may be influenced by the accountant's report, it was inevitable that there would evolve a standard of responsibility of accountants to such third parties. Justice Cardozo furnished the standard in 1931 when in the Ultramares case he concluded that there might be liability to third parties for the fraud of the accountant and that such fraud might grow out of the expression of opinion, if it were given recklessly.

Cardozo saw that the burden would be too onerous if the accountant were made responsible to the whole wide world for ordinary negligence. When the Securities Act of 1933 was enacted, however, Congress took the step that the courts have consistently refused to take. It made the accountant responsible to third parties for ordinary negligence. In searching for a reasonable circumscription, Cardozo held that the accountant, when he knew that his reports were likely to be shown by his client to others, owed a duty to such third parties to perform his work without fraud, and that negligence may be offered as evidence of fraud. The negligence may be so gross as to sustain an inference of fraud.

Among other things, two other matters in particular in Ultramares have had a significant influence on accounting practice. The court indicated that the accountants might have been liable for ordinary negligence if their report had been prepared primarily for the benefit of specifically identified third parties. Also, it held that when an accountant represents a matter to be true to his knowledge, he has engaged in a type of deceit if his representation is false. Thus, in New York State – and federal courts have alluded to the matter in later cases – a representation of fact may amount to a warranty.

IMPACT ON DEVELOPMENT OF SHORT-FORM REPORT

All of these factors have weighed heavily in the development of the accountant's short-form report. Since Ultramares it has been customary to address the opinion to the client, that is, to the company (if a corporation) or to its board of directors or to its stockholders or to a combination of these. Such a procedure may aid in showing that the report was prepared primarily for the benefit of the client. The short-form report represents it to be a fact that the financial statements were examined in accordance with generally accepted auditing standards. It does not represent it to be a fact that the books were examined or that the accounts were reviewed. To say that the books were reviewed might raise several questions. First, there would be the questions of what constitutes the books and whether the auditor could assure himself that he had seen all of the books. All of this is apart from the question of what is meant by a review – a term without technical meaning. Second, the question might be raised, if reference is made to the books or to the accounts, as to whether the financial statements are the representations of the client or of the accountant. To say that "we have examined the financial statements of the XYZ Company" makes clear this distinction. Finally, as we all well know, the short-form report contains the opinion of the accountant as to the fairness of the financial statements.

This is the aftermath of Ultramares. We would do well to carry the same notions into our reports about other matters and into long-form or commentary reports.

UNDERSTANDING WITH CLIENT

Since the duty that an accountant owes his client rests upon a contractual relationship, it is important that there be an accord as to what the accountant undertakes to do. In a first engagement it is particularly important to obtain agreement as to the nature and exent of the services to be performed. If an ordinary audit is desired, written communication concerning it probably should make use of the standard phrases in the short-form report. For example, the letter, if such is used, may say in substance that the accountant undertakes to examine the financial statements in accordance with generally accepted auditing standards so that he may express an opinion as to a fair presentation in conformity with generally accepted accounting principles. These are terms that have been defined by the profession in its literature.

There are circumstances, of course, in which the accountant will wish to have an exchange of letters or will wish to obtain written acknowledgment of the terms of the engagement, in the form of either a signed copy of the accountant's letter or a separate document. As to other than first engagements, the accountant may feel that continuing the course of past conduct, offering the report which contains the opinion, and the client's accepting it may be sufficiently evidential of the work that the accountant undertook to do.

An engagement requiring examination of financial information other than the usual financial statements or an examination in which other than generally accepted auditing standards are applied should be precisely described in the correspondence which is exchanged concerning it. The considerable attention which has been given to generally accepted auditing standards in the literature of the profession makes it particularly important that any intended limitations on their application be clearly understood. In the absence of such clarification it might be held that the accountant was required to apply the procedures called for in the ordinary audit. Now, some working-paper matters.

WORKING PAPERS

Working papers serve several purposes. Essentially, they are intended to furnish a record of the work that was done, that is, to leave a wellmarked trail. The nature of the information and the quantity of the details contained in them vary with a number of factors. One approach, of course, is that the working papers should contain the minimum information necessary to enable the principal or partner who reviews them to satisfy himself that the study of internal control was adequate to support the conclusions concerning the reliance that can be placed upon the records. Also, as a minimum, the working papers should furnish the reviewer with the basis for a conclusion as to the adequacy of the disclosures and the reasonableness of the opinion contained in the report. While the working papers may be used to demonstrate the adequacy of the audit, they frequently have been used by the plaintiff to show that the auditor failed to apply necessary procedures in particular areas or that matters had come to his attention which should have excited his suspicion, but did not.

When a claim against an accountant is pursued in the courts it is likely that he will be required to furnish the court with all of the working papers relating to the engagement, including the permanent file and correspondence. Such papers are then scrutinized by the plaintiff for damaging evidence against the accountant. Such scrutiny, followed by consideration by the court or the jury, is made, of course, with the full benefit of hindsight. With the benefit of knowledge concerning subsequent developments, meaning may be given to matters mentioned in the papers that could not reasonably have been perceived when the papers were being prepared, or even when they were being reviewed. The accountant may be hard put to reconstruct the setting in which the audit was performed, that is, the step-by-step procedure by which he obtained information leading to the expression of opinion. Information unfolds gradually during the audit. The working papers can never reflect in sharp focus the dimension of time.

As a result, misleading inferences may be drawn from tentative drafts of reports or memorandums that may be in the working papers concerning the significance of matters that came to the attention of the auditor. For example, when tentative drafts of a report are considered after, and therefore apart from, the discussions that were taking place when the report was being developed, the contention that the accountant had forsaken his independence and acceded to the request of his client to change the report might seem plausible to a jury. Similarly, a memorandum raising a question that came up during the audit may be used to support the contention that the auditor had overlooked a "red flag," unless there is some indication that the question was adequately considered and laid aside for a valid reason. It may be desirable to destroy superseded drafts that serve no purpose in demonstrating adequate performance. In terms of legal responsibility, the practice followed, at least occasionally, in England in connection with working papers may have considerable merit. In some instances there the working papers consist only of a list of things to be done and the initials of the staff accountant who did them. Such an approach would, of course, have practical limitations.

The lessons to be learned from all of this relate mainly to the significance of the final review of the working papers, the last defense against the hazards that may be present in the papers. This is the point at which that last added touch of alertness should be brought to bear on the engagement. The partner or principal making the review should watch for open questions, that is, for questions raised by a staff accountant for which there is no indication of the attention given them by those supervising the audit. When a matter referred to in the report has gone through several draft stages, and all of the tentative drafts remain in the papers, the reviewer should satisfy himself that the papers also show the reasons for the changes as to substance. If it is not practicable to do so, he will wish to consider disposing of the superseded drafts.

He will be alert for cases where it might be concluded from the working papers that a great deal of work was done on a relatively unimportant item and that little attention had been given to an important item.

INTERNAL CONTROL

Auditors have established for themselves the specific standard that

> ". . . there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

Another Institute publication states that the auditor also is concerned with the system of internal control because he may wish to recommend improvements in the system to his client.

The first of these standards relates the study of internal control to the extent of the tests. There may be a hazard therefore in a situation where deficiencies in the system are brought to light and are mentioned in a memorandum or questionnaire but for which there is no indication that the tests were extended or that additional procedures were applied because of the deficiencies. There also may be a hazard in a situation where the working papers show that the accountant concluded that, because of things that came to light this year, certain steps, not performed this year, should be taken in connection with the next audit. Such a circumstance might cause the question to be raised as to why such steps were not taken currently.

A letter to a client calling attention to deficiencies in the system of internal control may create a hazard if, in the interest of convincing the client of the need for improvements, the significance of the deficiencies is overstated. References to an extremely bad situation may sustain the contention that the accountant should have extended his work or possibly have qualified his opinion. If the accountant's recommendations for improvements have gone unheeded for several years, there may be a hazard in ceasing to communicate with the client about them. Discontinuance might be pointed to as supporting the contention that the client could have reasonably assumed that the deficiencies had been corrected.

The question of whether the letter or report dealing with recommendations for improving internal control should be addressed to the chief accounting officer, the president of the company, the board of directors, or in extreme cases, possibly to the stockholders is one that must be decided in the light of such factors as the way in which the auditors were appointed, the nature of the deficiencies and the positions on which they touch, and where the recommendations are most likely to be acted upon. Ordinarily, it would seem satisfactory to address the letter to the chief accounting officer.

There is one additional hazard here that may require the attention of the profession. The literature defines internal control broadly to include, in addition to the usual accounting matters, such things as the plan of organization, quality control, budgeting, and quality of personnel. The literature does not restrict the auditors' concern about internal control only to a part of these features. In other words, our own literature might be used to support a claim that the auditor should have investigated all of the matters comprehended by the broad concept of internal control and should have reported any deficiencies in them to his client. As you can see, some of these matters may be outside of the competence of the auditor.

REPORTS

At common law, to sustain a claim against an accountant, a third party must show that he relied upon the report or opinion of the accountant, that the report contained a material misrepresentation, that the misrepresentation was fraudulently made, and that damage was suffered as a result of such reliance. As mentioned previously, however, intent to deceive need not be shown – gross negligence sufficient to support an inference of fraud may be enough. The report thus becomes the focal point of most claims asserted by third parties. What did the accountant say? Did he have a sufficient basis for believing what he said? These are fundamental questions. Since Ultramares, as mentioned previously, accountants have done much to develop a short-form report that is on all-fours with their expertness and with the responsibility that they may reasonably assume.

Similarly, the profession has given attention to the ways and circumstances in which qualifications of their opinions and denials of them should be given. Because qualifications and denials relate mainly to unusual situations and because the circumstances calling for one or the other are closely tied to materiality, a judgmental factor, it is difficult to standardize them. This is a hazard in itself. Wherever a standard is absent, a jury may impose one of its own choosing. For example, in the C.I.T. case tried in the federal courts a few years ago a seemingly pivotal matter was whether the phrase "together with the foregoing comments" immediately following "in our opinion" constituted a qualified certificate. The lesson here, I think, is that the language in the certificate should be unequivocal if a qualification is intended. The phrases that do this are "except for" and "except that"; others may leave some question of doubt as to the responsibility the accountant is taking.

A disclaimer of opinion likewise should be stated in unequivocal terms. For example, it may be better to say "we do not express an opinion" than "we are not in a position to express an opinion," the latter being a bit equivocal as to whether an opinion actually had been denied. Other hazards may attend a piecemeal opinion.

A piecemeal opinion consists of two parts: a denial of opinion as to the fairness of the financial statements taken as a whole and an opinion as to the fairness of the items in the financial statements that were unaffected by the matter leading to the denial. Particular care should be taken to state the opinion as to the fairness of items in such a way as not to contradict the denial as to the over-all presentation. This may require reference to the specific items intended to be covered by the opinion. In other circumstances it may require negative assurance such as, "nothing came to our attention which in our judgment indicates that. . . ."

The State Street Trust Company case showed us that there may be a hazard in co-existing long-form and short-form reports. When both types are issued, and particularly when there is a period of time separating their issuance, it might be contended that there are disclosures in the long-form report that are necessary for the financial statements not to be misleading or that there is a disclosure in the long-form report that amount to a qualification of the opinion. Exposure to these hazards probably can be minimized if the two reports are issued concurrently and thus can be considered together in their preparation. Frequently, it is not practicable to issue them at the same time. Issuance of the long-form report often is delayed several weeks. Such a situation requires especial alertness to the need for weighing the information included in the long-form report as to whether its absence from the short-form report might cause misleading inferences to be drawn about the financial statements covered by the short-form opinion.

Not infrequently, an accountant is called upon to make a special-purpose examination and to report on financial information other than the usual financial statements. Such circumstances are varied. They may concern, for example, compliance with the terms of an agreement or an indenture, a sales figure upon which a rental is based, a royalty calculation, figures filed with a government agency, a comfort letter in connection with a financing engagement, and a number of other circumstances. Some of these examinations either precede or follow an ordinary audit. Others may be independent of an audit engagement. Despite the dissimilarities of such engagements, there are sufficient common characteristics to warrant noting a few important standards of practice applying to them.

There is no over-all term to describe the scope of work leading to a special-purpose report such as "generally accepted auditing standards" which underlies an opinion concerning financial statements which purport to show financial position and results of operations. Review, limited review, and even cash audit are vague terms. The risk probably is minimized if the report is quite specific as to the several steps that were taken.

The importance of the distinction between a representation of fact and an expression of opinion should not be overlooked in a special-purpose report. It is not unusual to find in them a generous sprinkling of such terms as "determined," "calculated," "computed," and "ascertained," or, an affirmative statement that figures are, or were found to be, such and such. There are times, of course, when it is within the competence of the accountant to state a matter as a fact, but the circumstances are unusual when he can speak with such finality.

Conscious awareness of the significance of three matters in the short-form report and of their applicability to special-purpose reports would, in my opinion, go a long way in properly limiting the responsibility of the accountant. Wherever possible the report should refer to an examination of a schedule or a tabulation prepared by the client or a computation or representation made by him. Wherever possible, the standard phrase "in our opinion" should be used to introduce the element of judgment into the accountant's report. In addition, the standard phrase "presents fairly" has, by reason of usage, a dimension of reasonableness that seems to fit the limit of responsibility that an accountant is willing to assume. It should have an important place in our special-purpose reports.

STANDARDS OF REASONABLENESS

Patently, exposure to legal hazards is minimized when generally accepted professional standards of competence and care are observed in carrying out the engagement. This means, of course, that an accountant owes it to himself, as well as to the public he serves, to remain abreast of developments in the field, both as to auditing standards and accounting principles. To do this requires keeping up with the literature – a monumental task these days. I think it obvious that it would be quite damaging to the defense of an accountant if, for example, he should have to deny acquaintance with a publication dealing with the type of engagement from which the claim against him arose.

Equally important, is the need for the profession continually to re-examine the standards by which its members wish to have their work judged. This is important. If the profession does not establish standards of competence and make them a matter of public information, the reasonableness of our work may be judged by standards imposed by lay juries. A profession does not minimize its exposure to legal hazards by lowering its standards of competence. It must be mindful of the need for balancing service to clients and the public against the risks that its members can reasonably accept. Maximum service, acceptable responsibility, minimum risk – these hang in delicate balance.

The profession has done much in recent years to articulate its standards. It is presently considering others, and will be doing so tomorrow, and the day after that. For example, the Committee on Auditing Procedure of the American Institute of Certified Public Accountants is studying long-form report practices to the end that the auditor will make clear the responsibility that he is taking for the various types of information included in the typical long-form report, that is, for the basic financial statements, the comments about the scope of the examination and about other matters, the supplementary information (perhaps unaudited), and statistical data. The Committee also is considering the desirability of clarifying the literature as to the concern that the independent auditor should have for the various elements comprising the broad concept of internal control. It is considering standards of reporting where the financial statements are other than the usual ones purporting to show financial position and results of operations of the ordinary commercial enterprise.

LIABILITY INSURANCE

Accountants can minimize their exposure to legal hazards, but they cannot eliminate – and do not strive to eliminate – all of the risks. Liability insurance is available to protect the accountant against the claims that might otherwise prove disastrous to his practice.

In its usual form liability insurance indemnifies the accountant for two types of losses: (1) the amount paid in settling the claims and (2) the amount of the legal and other similar costs incurred in defending the claim. Not the least important of the benefits of liability insurance is the means that it furnishes for defending against a claim that might be asserted against the accountant. It enables the accountant to pursue the defense against a claim which, if settled short of a complete defense, might materially injure his professional reputation. Without insurance the accountant might find it necessary to settle, without an adequate defense, a claim that has little or no merit.

Under the usual policy, whether written with one of the United States companies or with Lloyds, the accountant is indemnified for claims arising from dishonesty, misrepresentation, or fraud, except when there is affirmative dishonesty or actual intent to deceive or defraud. The history of the cases since Ultramares shows that an accountant cannot afford to omit from the policy coverage against claims that are asserted on the basis of constructive fraud.

Under the usual policy there is no indemnification for claims based on libel or slander. Recently, however, the frequency of coverage for such claims has increased.

Coverage as to claims relating to the Securities Act of 1933 is not included in the usual policy, but may be included by endorsement.

The usual policy covers claims brought against the firm or any of its partners, by reason of an alleged breach of professional duty by the members of the firm or its employees. Ordinarily, claims are covered on a discovery basis. Frequently, the policy permits, by payment of an additional premium, the extension of the coverage after termination up to two years (in some cases three years) for claims alleged to have been caused by acts which occurred prior to termination.

The basic premium rate ordinarily depends upon the number of partners and employees, other than telephone operators, porters, messengers, and members of the firm's own bookkeeping staff.

Selection of the insurer with whom the policy is to be written should be based on factors other than the basic premium rate. The actual premium will depend upon the terms and features of coverage sought by the accountant. In one case a desired feature may be covered by the basic premium; in another it may not be. As in any other situation where a service is employed or engaged, the general reputation of the insurer and his demonstrated willingness to serve his clients are important considerations.

CONCLUSION

Liability implies responsibility. Responsibility implies high-quality service, but risk. This, the professional man minimizes by clarifying standards of performance and then by observing them faithfully and competently. Fortunately, as we best serve our clients we best protect ourselves against potential dangers.