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Accountants' Legal Responsibility— What Has Been Accomplished

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Legal Responsibility

The most important basis of the accountant's legal responsibility is the contractual relationship that exists between the accountant and his client. From this relationship arises the accountant's duty to perform the services agreed upon and to perform these services with ordinary competence and care. The accountant's responsibility to exercise ordinary competence and care extends to specific third parties. As to remote third parties the accountant owes the duty of exercising slight competence and care. However, when the accountant's services come within the scope of the Securities Act of 1933 and the Securities Exchange Act of 1934, he owes a duty to remote third parties of exercising ordinary competence and care. In rendering services to all parties—clients, specific third parties, and remote third parties—the accountant has a duty not to commit fraud.

Ordinary competence and care vary in that what might be considered ordinary in one case might be considered less than ordinary in another case. Therefore, what constitutes ordinary competence and care will vary with the circumstances and localities. In all cases, however, the requisite degree of competence and care will be determined by the average of the public accounting profession under similar conditions. When professional standards are available, the standards serve as the level of competence and care deemed average by the profession.

Professional Accounting Services

The accountant's legal responsibility has been at issue in the field of auditing and has been argued and discussed to a considerable extent in various court cases¹ and accounting publications. Over the years, however, the scope of the services of the certified public accountant has grown beyond the function of auditing into the areas of tax, technical, and management advisory services. Tax services involve the preparation and review of tax returns, representation of taxpayers before tax officials, and tax planning. Technical services consist of routine book-keeping, preparation of unaudited financial

statements, and preparation of various statistical and governmental reports. Management advisory services include systems installation, establishment of budgetary controls, arbitration in commercial disputes, and financial advice. The accountant's legal responsibility has not been examined as thoroughly in these newer areas of professional public accounting services as there are only a few court cases² and little or no published discussions.

What Has Been Done

Two of the steps taken by the public accounting profession to cope with its members' legal responsibility are the adoption of generally accepted auditing standards and the acquisition of professional liability insurance coverage. These might be termed *preventive* and *protective* measures, respectively. Only by the establishment of professional standards can the profession hope to *prevent* liability occurring from acts of its members. *Legal responsibility* will still exist, but *legal liability* may be prevented. In the absence of professional standards there is no uniform measure of competence and care upon which members can rely and which the public can expect. In the areas of tax, technical, and management advisory services, for which there are no uniform standards, the accountant may have difficulty in preventing liability and therefore must protect himself in the event of liability.

Present professional liability insurance policies will insure accountants against breach of contract, negligence, constructive fraud, and civil libel and slander.³ The insurance companies will defend the accountant in suits alleging the above charges even though the charge is groundless. Even in the field of auditing, where there are uniform standards to use as a guide in performing services, the accountant may incur liability for small errors regardless of his competence and the degree of care he exercised, and in the non-auditing fields the accountant faces a greater risk of liability. Professional liability insurance coverage is therefore as excellent protective measure available to the accountant for all of his professional accounting services. Insurance should not, however, be allowed to displace the importance of maintaining the

Officers and Chairmen for ASWA



A meeting of the Board of Directors of the American Society of Women Accountants was held in conjunction with the joint annual meeting in Milwaukee. Officers and committee chairmen participating were: (seated) E. Virginia Barnett, junior past president; Phyllis Peters, secretary; Anne D. Snodgrass, president; Erma Sembach and Pearl Isham, first and second vice presidents; Leatrice Harpster, treasurer; (standing) Nellie V. Joling, publicity; Mary Louise Miller, auditor; Madeline A. Cassi, award; Margaret Bailey, public relations; Irene V. Chapel, coast-to-coast editor, ASWA Coordinator; Anna M. Jackey, membership; and Bernadine Meyer, education. Other committee chairmen in attendance were: Helen V. Kennard, editor ASWA Coordinator; Shirley T. Moore, legislation; and Ruth Reynolds, program.

highest level of competence and care. Although the insurance coverage can save the accountant direct monetary damage, it cannot protect his reputation.

Adequacy

The question would appear to be whether or not the professional standards established by the public accounting profession and professional liability insurance coverage are adequate means by which accountants can cope with their legal responsibility. Since the establishment of professional standards and the adoption of professional liability insurance coverage, the number of court cases involving accountants' liability in the field of auditing is negligible. Even the number of insurance claims involving accountants' liability for auditing services is negligible, which may be the result of the establishment of generally accepted auditing standards.

These two facts would indicate that generally accepted auditing standards have accomplished their purpose, and that the accountant's liability in the area of auditing has been substantially prevented.

As yet, there are no uniform standards of competence and care in the nonauditing areas. Recent court cases involve questions of accountants' liability in the areas of tax and technical services. In response to a questionnaire three insurance companies reported a total of 113 claims. The replies disclosed a startling number of tax claims and a significantly large number of claims involving technical accounting services. These facts indicate that the accountant's liability is being protected but not prevented. More important is the fact that the accountant's legal responsibility to exercise competence and due care exists in all professional accounting services. Apparently what is happening is that history is repeating itself:

AWSCPA Officers and Committee Chairmen



At the joint annual meeting of the American Woman's Society of Certified Public Accountants and the American Society of Women Accountants, held in Milwaukee, October 25-28, the Board of Directors of AWSCPA held a regularly scheduled meeting. Those who participated are shown above: (seated) Marguerite Baumann, secretary; Grace S. Highfield, second vice president; Winifred D. Owens, president; Mary F. Hall, first vice president; (standing) Lucille Preston, director and membership chairman; Loretta Culham, legislation chairman; Margaret E. Lauer, treasurer; Doris Parks, award chairman; and Doris Michalske, editor AWSCPA News. Gertrude Hindelang, junior past president was also present. Other directors include: Margaret Conley, Margaret Gniirk, and Pearl Scherer.

CLAIMS DISTRIBUTED BY PROFESSIONAL ACCOUNTING SERVICES

<i>Services</i>	<i>No. of Claims</i>
Auditing	11
Tax	79
Technical	21
Management Advisory	2
Total Claims	113

At first the accountant performed auditing services; his legal responsibility for auditing services was established; the public accounting profession realized that something should be done; generally accepted auditing standards were established; professional liability insurance was developed to take care of the element of human error and errors in judgment. Now the accountant performs other services;

his legal responsibility is being established in these new areas; professional liability insurance is the sole means of protection, aside from the individual accountant's judgment and conscience.

What Can Be Done

An obvious recommendation would be that uniform standards be established for each of the areas of tax, technical, and management advisory services before more damage is done to accountants in these fields. However, such a step would be impractical and unnecessary for several reasons:

1. The errors committed by accountants in cases involving nonauditing services were due to carelessness. In cases involving tax services accountants failed to file various tax returns on time or failed to properly supervise the work of their assistants. Had the accountants exercised due professional care, as

set out in generally accepted auditing standards, by being aware of filing dates and supervising the work of their assistants, liability could have been avoided. It would appear unnecessary to set up standards that repeat generally accepted auditing standards.

2. The errors committed by accountants in the seventy-nine tax claims were due to carelessness in failing to file various tax returns on time, mathematical errors, and failure to understand and follow the various tax laws. Again, had the accountants exercised due professional care and had they possessed adequate competence in knowing and understanding the tax laws, liability could have been avoided. Thus, it would appear unnecessary to repeat generally accepted auditing standards in establishing uniform standards for tax services.

3. Errors committed in the twenty-one technical services claims were due to carelessness in failing to supervise properly the work of assistants, failing to file statistical reports on time, and failing to use correct accounting terminology. These errors could also have been avoided had the accountants followed generally accepted auditing standards by exercising due professional care and properly supervising the work of their assistants.

4. As yet there are no true claims concerning management advisory services, although there will probably be claims in the future with the increasing demand for the installation of accounting systems and budgetary controls.

Perhaps the wisest step that could be taken by the public accounting profession to help minimize accountants' liability in non-auditing services would be the issuance of statements in the form of memoranda urging accountants to observe the following provisions of generally accepted auditing standards when rendering nonauditing services:

1. The accountant should undertake to perform professional accounting services only if he possesses expert knowledge and training in the area of these services.

2. The accountant should exercise due professional care in the performance of all professional accounting services. Proper supervision of the work of assistants in the performance of all professional accounting services is mandatory.

These statements would serve as reminders to accountants that all services they perform

are professional in nature and should be performed with utmost care and competence. If the accountant professes to be an expert in any particular area of accounting services, he should be expertly qualified to perform that service for the public.

It is concluded that the greatest weakness in the nonauditing services is perhaps the unawareness of accountants that their legal responsibility extends to these areas. So much stress has been placed on auditing services in the past that these new services have not received the proper professional recognition. It is therefore recommended that perfection should be the unending goal of professional public accountants in rendering all professional accounting services. In striving to reach this goal accountants will be able to avoid damaging litigation and at the same time strengthen public confidence in the public accounting profession.

¹*National Surety Corporation v. Lybrand*, 256 App. Div. 266, 9 N. Y. Supp. 2d 554 (1st Dept. 1939); *Smith v. London Assurance Corporation*, 109 App. Div. 882, 96 N. Y. Supp. 820 (2d Dept. 1905); *Dantzler Lumber & Export Company v. Columbia Casualty Company*, 115 Fla. 541, 156 So. 116 (1934); *Board of County Commissioners of Allen County v. Baker*, 152 Kan. 164, 102 Pac. 2d 1006 (1940); *Cereal Byproducts Company v. Hall*, 132 N.E. 2d 27 (1956); *Craig v. Anyon*, 242 N. Y. 569, 152 N.E. 431 (1926); *O'Neill v. Atlas Automobile Finance Corporation*, 139 Pa. Super. 346, 11 Atl. 2d 782 (1940); *City of East Grand Forks v. Steele*, 121 Minn. 296, 141 N.W. 181 (1913); *Maryland Casualty Company v. Jonathan Cook*, 35 F. Supp. 160 (Michigan, 1940); *American Indemnity Company v. Ernst & Ernst*, 106 S.W. 2d 763; *Fidelity & Deposit Company v. Atherton*, 47 N. M. 443, 144 Pac. 2d 157 (1943); *O'Connor v. Ludlam*, 92 F. 2d 50 (2d Cir. 1937); *Shonts v. Hirliman*, 28 F. Supp. 478 (S. D. Cal., 1939); *Ultramares Corporation v. Touche*, 225 N. Y. 170, 174 N.E. 441 (1932); *Flagg v. Seng*, 16 Cal. App. 2d 545, 60 Pac. 2d 1004 (1936); *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N.E. 808 (1934); *CIT Finance Corporation v. Glover*, 224 F. 2d 44 (1955); *State Street Trust Company v. Ernst*, 278 N. Y. 104, 15 N.E. 2d 416 (1938); *Grammer v. Ernst & Ernst*, 245 Minn. 249, 72 N.W. 2d 364; *Duro Sportswear, Inc. v. Cogen*, 137 N. Y. 2d 829.

²*L. B. Laboratories, Inc. v. Mitchell*, 39 Cal. 2d 56, 244 Pac. 2d 385 (1952); *Hagan v. Flesher*, Superior Court, Los Angeles County #606515 (March, 1954); *Rassieur v. Charles*, 188 S.W. 2d 817; *Cafritz v. Corporation Audit Company*, 60 F. Supp. 627.

³Some insurance companies offering professional liability insurance coverage to public accountants are as follows: American Surety Company of New York, Continental Casualty Company, Indemnity Insurance Company of North America, and St. Paul Mercury Insurance Company.