Over-Accountable Accountants? A Proposal for Clarification of the Legal Responsibilities Stemming from the Audit Function

Geoffrey T. Chalmers
OVER-ACCOUNTABLE ACCOUNTANTS? A PROPOSAL FOR CLARIFICATION OF THE LEGAL RESPONSIBILITIES STEMMING FROM THE AUDIT FUNCTION

GEOFFREY T. CHALMERS*

_The risk reasonably to be perceived defines the duty to be obeyed._ —Benjamin Cardozo

With the issuance of the Trueblood Committee Report in October 1973, the accounting profession began a new period of examining the objectives of financial statements. Recognizing that a review of guidelines to improve accounting and financial reporting must begin with a clear understanding of objectives, this report noted: "An objective of financial statements is to serve primarily those users who have limited authority, ability or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities." Financial statements purport to enable these users to evaluate a business on the basis of information about such matters as cash flow, enterprise earning power, and management's ability to utilize enterprise resources. In this regard, the report noted several criticisms leveled against the practices of financial accounting, including concentration on reporting historical events rather than predictions, emphasis on values derived from exchange transactions rather than current valuation, use of different accounting methods to describe similar transactions, and generally excessive concentration on the appearance of regularity rather than economic substance.

The Trueblood Report was, of course, but one development in the accounting profession's recent effort to meet these and other criticisms of published financial statements; these criticisms also have generated an increasing amount of litigation.


3. TRUEBLOOD REPORT 17.
4. _Id._ at 62-63.
5. _Id._ at 15-16.
6. For a summary of the essential liability developments, see Gormley, _Accountants' Pro-
To analyze the legal liabilities of auditors, several questions must be considered. Of initial importance is the process involved when independent public accountants prepare reports on published financial statements as auditors. Does their liability flow from what they say they do or from what the public, the courts, or the Securities Exchange Commission (SEC) thinks they do — or should do? Can the objectives and criticisms cited in the Trueblood Report be met solely by looking at the form and content of published financial statements? Or does the profession need, as well, an overhaul of the legal consequences of its relationship to those statements as independent auditors? This Article will examine these questions and propose some amendments to the federal securities laws that may help the profession attain the objectives and overcome the criticisms set forth in the Trueblood Report.

**The Reporting Process**

What does an independent auditor actually undertake when he performs the audit and attest functions? The rules of the American Institute of Certified Public Accountants (AICPA) provide that the auditor is to examine the client's books, records, and properties, and report on the client's financial statements, all in accordance with "generally accepted auditing standards." Besides matters of professionalism, independence, evaluation of the client's internal con-

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7. See AICPA, Restatement of the Code of Professional Ethics 26 (app. A) (1973) [hereinafter cited as CPE Restatement]; id. at 35 (Interpretation 203-1); 1 AICPA, Statement on Auditing Standards 80 (1973) [hereinafter cited as CPA-SAS].

8. For a concise statement of the current legal problems stemming from misunderstanding of the audit and attest functions, see Gormley, supra note 6, at 1209-14. See also Mautz, Accounting Principles—How Can They Be Made More Authoritative? 43 CPA J. 135 (1973); Reiling & Burton, Financial Statements: Signposts as Well as Milestones, 50 HARV. BUS. REV. 45 (1972); Address by SEC Commissioner A.A. Sommer, Jr., The Four Musts of Financial Reporting, Meeting of AICPA, Jan. 8, 1974; Address by Robert R. Sterling, Distinguished Lecture Series, Oklahoma State University, Mar. 16, 1972, in J. ACCOUNTANCY, Jan. 1973, at 61.

trol, and the evidentiary basis for the opinion, these rules contain a section entitled “Standards of Reporting,” which provides:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor’s name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor’s examination, if any, and the degree of responsibility he is taking.  

It is clear that the auditor does not purport to make “factual representations with respect to the financial statements or books of account [but] rather . . . an opinion on financial data consisting of management representations.”  

In other words, the auditor does

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10. CPE Restatement 27 (app. A).

Ambiguities in the concept of presenting information fairly “in conformity with generally accepted accounting principles” recently have been explored in Rosenfield & Lorensen, The Auditors’ Responsibilities and the Audit Report, J. Accountancy, Sept. 1974, at 73. SEC Reg. S-X, Rule 2-02(c), 17 C.F.R. § 210.2-02(c) (1974), applicable to all “certificates” on financial statements filed with the SEC, provides: “The accountant’s report shall state clearly: (1) The opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and (2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements as required to be set forth in Rule 3-07(a).” This rule formerly used the term “certificate” to refer to what the profession now prefers to call a “report.” See D. Carmichael, The Auditors Reporting Obligation — The Meeting and Implementation of the Fourth Standard of Reporting 11-31 (1972).

11. CPA-SAS 133. Auditors have noted the difficulties of communicating this thought to the public. At the First Seaview Symposium on corporate financial reporting in 1968, Joseph L. Roth, then Chairman of the AICPA Committee on Auditing Procedure, stated:

Do the users of auditor’s reports understand very much about this role of the independent auditor? There seems to be plenty of evidence that they do not. If so, why not? Doesn’t his report make clear what the auditor has done and what responsibility he is assuming with respect to the financial statements? Some of us are convinced that the present standard form of auditor’s report not only does not make either of these clear but, unfortunately, may even be a major contribu-
not guarantee numerical accuracy, but says only that in his opinion on the basis of evaluations and tests performed by him in accordance with professional practices, the numbers, taken as a whole, give an undistorted picture of the company's financial position and that the form complies with professional rules for such a presentation, including "all informative disclosures necessary to make the statements not misleading."\(^2\)

As seen by an authoritative commentator, the general objectives of the reporting standards are "equity," "communication," and "environment."\(^3\) "Equity" requires a balancing of the advantages and disadvantages of various forms of reports to serve the competing interests of different users.\(^4\) "Communication" represents the desire to provide a report that is comprehensible to its readers,\(^5\) while "environment" connotes the need for uniformity and compliance with regularity requirements.\(^6\)

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These concerns, then, underlie the almost universal use of a "short-form" report by auditors to fulfill the requirements of the fourth standard of reporting. This report form, which originated in 1934 in an effort to reduce uncertainty about the meaning of an opinion, contains a form of words that must be used whenever the auditor expresses an unqualified opinion. The Statement on Auditing Standards delineates four situations that prevent the use of the standard short-form report: (1) when the scope of examination has been limited or affected by various constraints, (2) when financial statements have not been presented in conformity with generally accepted accounting principles, including adequate disclosure, (3) when accounting principles have not been applied consistently, and (4) when unusual uncertainties exist concerning future developments, the effects of which reasonably cannot be estimated or otherwise resolved satisfactorily.

The SEC has indicated that a less than unqualified opinion will be accepted in connection with public offerings only if within the fourth category regarding future uncertainties. Furthermore, the AICPA Restatement of the Code of Professional Ethics states: "If a CPA disagrees with a client on a significant matter during the course of an audit, the client has three choices — he can modify the financial statements (which is usually the case), he can accept a qualified report or he can discharge the CPA." Accordingly, audi-

17. See text accompanying note 10 supra.
18. CPA-SAS 80-81. For a discussion of the evolution of the "short-form" and other reports, see D. Carmichael, supra note 10, at 11-31. Early reports sometimes stated that certain specified items had been "verified" and that the auditor "certified" that the financial statements correctly set forth the client's financial condition. This was the so-called "long" or "descriptive" certificate, which was thought to be misleading. The AICPA Statement on Auditing Standards sets forth the relatively limited categories of circumstances when an opinion may be qualified, CPA-SAS 97, and states that an adverse opinion must be rendered "where the exceptions are so material that in the independent auditor's judgment a qualified opinion is not justified." Id. at 83. A disclaimer of opinion, which means that no opinion can be expressed, must be made if the "examination has not produced sufficient competent evidential matter to form an opinion on the financial statements taken as a whole ...." Id.
19. CPA-SAS 97. Nothing prevents the addition of descriptive or explanatory material to the opinion, as long as this clearly does not qualify the opinion. Id. at 112-13. A "long-form opinion" can be issued, including "details of the items in these statements, statistical data, explanatory comments, other informative material, some of which may be of a nonaccounting nature, and sometimes a description of the scope of the auditor's examination more detailed than the description in the usual short-form reports." Id. at 132.
20. Id. at 153.
A "subject to" or "except for" opinion paragraph in which these phrases refer
tors sometimes are constrained by the current reporting framework to a choice between taking an exception based on a judgmental evaluation, which might invite SEC inquiry and foreclose the client's effort to raise capital, with consequent risk of discharge, or remaining silent, which creates an appearance of regularity and invites potential liability. This dilemma necessitates an inquiry into the expectations of the public, the courts, and the SEC regarding this reporting process.

**Responsibilities and Liabilities**

Recent commentaries on the reporting process by leading writers and regulators have emphasized a need for auditors to do more than merely inspect accounts and evaluate the use of generally accepted accounting principles (GAAP). Dr. John C. Burton, Chief Accountant of the SEC, has pointed to the need for financial statements that "make sense within the framework of the accounting model." Similarly, according to SEC Commissioner A. A. Sommer, the financial statements must "represent an unbiased selection of relevant data presented in an understandable way that makes sense to the careful reader." But are these standards more strict than, or differ-

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22. CPE Restatement 10.

23. Dr. Burton has stated:

I think that it is important, however the [Financial Accounting Standards Board] articulates the standard, that the accountants not forget to sit back and 'see if the end product makes sense in the particular factual circumstances. We have been concerned in some circumstances by a tendency to look at specific transactions but not to consider the impact upon the whole, or to look at the form of transactions rather than the substance. We think that in the final analysis accountants have to have a responsibility for saying that the financial statements, taken as a whole, make sense within the framework of the accounting model.


24. Commissioner Sommer observed:

While fraud and error are two sources of misleading data, an even more distress-
ent from, those set forth in the Restatement of the Code of Professional Ethics, or the AICPA Statement on Auditing Standards? Must independent auditors say, as these statements indicate, whether the client has chosen the best available generally accepted accounting principles, and must they see that the financial statements are intelligible to laymen?

Some examples will illustrate the possible distinction being drawn. If, in a year of sharply rising prices, a client switches from the LIFO (last-in, first-out) to the FIFO (first-in, first-out) method of inventory accounting producing a large "inventory profit," must an auditor qualify his opinion if, without the "inventory profit," the client's reported earnings otherwise would appear flat? Most AICPA members probably would answer "no," so long as the foot-

ing phenomenon which occasionally appears is the use of generally accepted accounting principles to produce a misleading result. Some managements, with the concurrence of their auditors, are prepared to embellish their performance by the use of accounting tricks which reflect accounting results dramatically different from economic results. Ultimately the market place exacts a penalty for such activities.

In most cases it can be said that such problems arise because of differences in the deferred accounting model and the solution can be argued to be an improvement in the model. While the Commission strongly endorses attempts to improve the accounting model and has encouraged standard setting bodies such as The Financial Accounting Standards Board to do so, quite frankly I do not believe that this is a sufficient approach. In the final analysis, we need a standard of fairness as the fourth "must" in financial reporting and public accountants must be ready to insist that the standard is met.

I do not belittle the problem of definition, but it does not seem consistent with the public responsibility of professionals to say that the blind application of prescribed formulae is sufficient to meet the obligation imposed by society. The auditor must be satisfied in his own mind that financial statements represent an unbiased selection of relevant data presented in an understandable way that makes sense to the careful reader. If they do not meet that test, they are not fair . . .

Address by SEC Commissioner A.A. Sommer, Jr., The Four Musts of Financial Reporting, Meeting of AICPA, Jan. 8, 1974.

The development of a "fairness" concept that is satisfactory to the SEC and the financial community would seem to be one of the cornerstones of the SEC's recently announced policy on "differential disclosure." See, e.g., Address by SEC Chairman Ray Garrett, Jr., Improved Disclosure—Opportunity and Responsibility for Financial Analysts, Financial Analysts Federation Annual Conference, Apr. 29, 1974; Address by SEC Commissioner A.A. Sommer, Jr., Differential Disclosure: To Each His Own, Second Emanuel Saxe Distinguished Accounting Lecture, Baruch College, Mar. 19, 1974.

25. See Wallich & Wallich, Profits Aren't as Good as They Look, FORTUNE, Mar. 1974, at 126; FORBES, Jan. 16, 1974, at 49. See also Taking the Measure of Last Year's Profits, Bus. Week, Mar. 9, 1974, at 133; The Profits Dip That Wasn't, Bus. Week, Apr. 20, 1974, at 33.

The Accounting Principles Board has made such switches more difficult by requiring the new method to be clearly preferable. See AICPA, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD No. 20, at 390-91 (1971).
notes disclose adequately the magnitude of the inventory profit in
the current and prior periods in accordance with AICPA and SEC
rules.\textsuperscript{26} It is doubtful, however, that the SEC would agree in every
such case that an independent auditor should accommodate his
client's decision.

Similarly, when management's own internal marketing studies
indicate that a newly introduced product will recoup its capitalized
development costs over a five-year period, and the auditor believes
that the study's conclusions are not unreasonable, should the audi-
tor commission an independent marketing study to evaluate the
reasonableness of the client's choice? Such detective work is not
explicitly required by the Statement on Auditing Standards.\textsuperscript{27} Nev-
ertheless, the SEC might not approve a "clean" opinion without
such an independent inquiry where the development costs involved
were "material."

Judicial standards appear to differ, at least in part, from those
developed by the AICPA. The Court of Appeals for the Second
Circuit has ruled that where an auditor helped prepare and ren-
dered a "clean" opinion on financial statements that were mislead-
ing to investors in an area of unclear accounting principles, he could
not rely completely on a defense that the statements as a whole
fairly presented the client's financial position in accordance with
generally accepted accounting principles.\textsuperscript{28} But if the auditor has
not rendered a "clean" opinion, he may be able to use the qualifica-
tion or disclaimer as a defense if the report sets forth clearly the

\textsuperscript{26} See SEC Accounting Series Release No. 151 (Jan. 3, 1974); SEC Securities Act Release
No. 5427 (Oct. 4, 1973). \textit{See also} Financial Accounting Standards Board, Reporting the
Effects of General Price-Level Changes in Financial Statements, Feb. 15, 1974 (discussion
memorandum).

\textsuperscript{27} The Statement on Auditing Standards reviews the "third standard of field work," which states that "sufficient competent evidential matter is to be obtained . . . to afford a
reasonable basis for an opinion regarding the financial statements under examination." CPA-
SAS 55. "An auditor typically works within economic limits; his opinion, to be economically
useful, must be formulated within a reasonable length of time and at reasonable cost. The
auditor must decide . . . whether the evidential matter available to him within the limits of
time and cost is sufficient to justify formulation and expression of an opinion." \textit{Id.} at 57. The
effect of such review on the ability to give a "clean" opinion is explored in the case of three
companies with problems similar to the development cost question, in \textit{All Numbers Are Not

\textsuperscript{28} United States v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969), cert. denied, 397 U.S. 1006
(1970). \textit{See Comment, Generally Accepted Accounting Principles and Fair Presentation, 43
U. Colo. L. Rev.} 51 (1971). The \textit{Simon} holding is not absolutely clear, beyond the ruling that
where a defendant must prove that he acted in good faith in a judgmental matter, proof of
form and content of presentation in accordance with generally accepted accounting principles
is persuasive but not conclusive.
nature of the qualification or disclaimer on the basis of a proper review of the client’s affairs in accordance with the applicable standard of care.\textsuperscript{29} At present, however, that standard of care is uncertain. Until recently, common law rules of auditor liability provided that, where a client sues an auditor, on the basis of their contractual relationship, the auditor is liable for failure to exercise the care of an ordinarily prudent man in the performance of the audit function; where persons, including investors, not in privity sue an auditor, however, his liability arises only for fraud or gross negligence.\textsuperscript{30} This holding of \textit{Ultramares Corp. v. Touche, Niven & Co.}\textsuperscript{31} has been questioned, and in some jurisdictions auditors have been held liable to an actually foreseen group of persons not in privity of


\textsuperscript{30} Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931). \textit{See also} Restatement (Second) of \textit{Torts} § 552 (Tent. Draft No. 12, 1966):

\begin{enumerate}
\item One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
\item Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered
\begin{enumerate}
\item by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
\item through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.
\end{enumerate}
\item The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created in any of the transactions in which it is intended to protect them.
\end{enumerate}

The \textit{Restatement} thus imposes liability to a foreseen class of persons for negligence in the audit function. The Reporter, Professor Prosser, stated that there were few cases, as of 1966, that analyzed this liability; the limits on the size of the group were not clear. Clause (3) clearly broadens an auditor’s negligence liability, where he is “under a public duty,” to cover a foreseeable class of persons. Except in cases applying the \textit{Securities Act of 1933}, 15 U.S.C. §§ 77a-77aa (1970) (see notes 33-36 \textit{infra} & accompanying text), it is not clear that the law has moved this far.

\textsuperscript{31} 255 N.Y. 170, 174 N.E. 441 (1931); \textit{accord}, Stephens Indus., Inc. v. Haskins & Sells, 438 F.2d 357 (10th Cir. 1971); Investment Corp. v. Buchman, 208 So. 2d 291 (Fla. Ct. App. 1968).
contract for negligent auditing and financial reporting, even where the report contained a disclaimer of opinion.\textsuperscript{32}

The standard under the federal securities laws also is uncertain. \textit{Escott v. BarChris Construction Corp.}\textsuperscript{32} states that a false assertion in financial statements within a prospectus and covered by an auditor’s report results in liability under section 11 of the Securities Act of 1933,\textsuperscript{34} even if the auditor had no fraudulent intent, unless he can show that he made a “reasonable investigation.”\textsuperscript{25} At the very minimum, an auditor must show that he followed generally accepted auditing standards if his “due diligence” defense to section 11 liability is to be successful.\textsuperscript{36} Accordingly, negligent reporting of financial statements may be a basis for liability under the Securities Act of 1933; that proper observance of generally accepted accounting principles is adequate evidence of due care under section 11 has not yet been clearly established.

In actions under section 18 of the Securities Exchange Act of 1934\textsuperscript{37} and SEC rule 10b-5\textsuperscript{11} the plaintiff must show some willful or grossly negligent conduct on the part of the defendant. There has been no express holding that auditors are liable to security holders based on negligent certification of financial statements; there has been language, however, implying that such liability exists, and some courts evidently recognize that rule 10b-5 liability can be based on negligence.\textsuperscript{39} Moreover, rule 10b-5 liability has been im-

\textsuperscript{32} In Rhode Island Hosp. Trust Nat’l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847, 861-53 (4th Cir. 1972), the court held that public accountants could be liable in negligence to a foreseen class of persons (creditors) relying on the financial statements. The auditors had referred in their opinion to items they were unable to confirm, but failed to state specifically that they had not verified the existence of certain leasehold improvements. This case departed from the announced principle of Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968), in which the court pointed out that “[n]o appellate court, English or American has even held an accountant liable in negligence to reliant parties not in privity.” Id. at 90. \textit{See also} Shatterproof Glass Corp. v. James, 466 S.W.2d 873 (Tex. Ct. Civ. App. 1971); \textit{Restatement (Second) of Torts} § 552, comment \textit{h} (Tent. Draft No. 12, 1966) (auditor’s disclaimer may provide protections).


\textsuperscript{35} 283 F. Supp. at 688.

\textsuperscript{36} \textit{Id.} at 703. To sustain the defense, the auditor at least must seek documentation to verify management’s material representations. \textit{Id. See also} United States v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 575-79 (E.D.N.Y. 1971).


\textsuperscript{38} 17 C.F.R. § 240.10b-5 (Supp. 1973).

\textsuperscript{39} In Drake v. Thor Power Tool Co., 282 F. Supp. 94 (N.D. Ill. 1967), defendant’s motion to dismiss was denied; purchasers of securities registered under the Securities Exchange Act
of 1934 could have a private right of action under section 10 and rule 10b-5 against the issuer's auditors for an intentional or negligent misrepresentation because of the application of improper auditing procedures or the utterance of untrue certifications of the issuer's financial statements. *Id.* at 104. See also Annot. 46 A.L.R.3d 979 (1972). The *Drake* court questioned and distinguished *Heit v. Weitzen*, 260 F. Supp. 598 (S.D.N.Y. 1966), which had held that sale of stock, without disclosing that certain corporate reports had overstated net assets and income, is not actionable under section 10(b) of the Securities Exchange Act because the fraud was directed against the Government and not connected with any purchase or sale of stock. *Heit* later was reversed, the Court of Appeals for the Second Circuit holding that open market purchasers of the issuer's securities could base a rule 10b-5 claim, sufficient to withstand a motion to dismiss, on allegations that defendant auditors knew or should have known that statements in the issuer's annual reports and press releases, as well as documents filed with the SEC, were materially false and misleading. *Heit v. Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969).

But see *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (proof of scienter is an essential element of a rule 10b-5 claim). The dissent in *Lanza* points out, however, that the Seventh, Eighth, Ninth, and Tenth Circuits have authority which questions the need for proof of scienter. *Id.* at 1319.

*Drake* and *Heit* raise anew on the American legal scene the debate over retaining, where "business fraud" is involved, the historic rule of *Derry v. Peek*, 14 A.C. 337 (1889), that an allegation of simple negligence would not support an action for misrepresentation. The statement complained of in *Derry* was in the prospectus of a tramway company. There was no doubt that the statement was false and material, and that it had been relied upon by the plaintiff. The House of Lords, however, ruled that there must be proof "that a false representation has been made (1) knowingly, or (2) without belief in its truth or (3) recklessly, careless whether it be true or false." *Id.* at 374. For a discussion of this decision and its effect, see W. PROSSER, LAW OF TORTS § 107 (4th ed. 1971). The basic scienter requirements of *Derry* have been accepted in this country and find expression in the American Law Institute's RESTATEMENT OF TORTS:

A misrepresentation in a business transaction is fraudulent if the maker

(a) knows or believes the matter to be otherwise than as represented, or

(b) knows that he has not the confidence in its existence or non-existence asserted by his statement of knowledge or belief, or

(c) knows that he has not the basis for his knowledge or belief professed by his assertion.

RESTATEMENT OF TORTS § 526 (1938). For an explication of the modern scienter concept, see W. PROSSER, supra, § 107, at 700-02.

Prosser also notes that liability for damages resulting from erroneous statements or omissions can be extended to include responsibility for negligent statements or even to invoke strict liability. *Id.* at 704-14. When, as so constituted, it extends to unknown persons not in privity, it amounts to warranty, on the theory of *Rylands v. Fletcher*, [1868] L.R. 3 H.L. 330, and *MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916). Courts in this country have not extended warranty liability to business misrepresentation (see, e.g., *Lanza v. Drexel & Co.*, supra) but judicial consumerism conceivably could induce a court to make issuers and their auditors insurers of adequate disclosure. Judge Cardozo emphasized early that auditors' legal responsibility must be limited to avoid the impracticalities of imposing broad liability to unknown persons. Ultramares Corp. v. Touche, Niven & Co., 285 N.Y. 170, 180, 174 N.E. 441, 444-45 (1931). It is no less important today, however, that some body of statutory law clearly establish a basis for liability, including reasonable liability limits. See notes 87-109 infra & accompanying text.

The English cases can be analyzed similarly. The leading case is *Candler v. Crane, Christmas & Co.*, [1951] 2 K.B. 164, holding an auditor not liable to a foreseeable third party in
posed in a stockholder's derivative action in which it was alleged that the corporation was deceived through auditor collusion with management. In other words, auditors now must be concerned not only with responsibilities flowing directly from acts or omissions in the course of the audit, but also with claims that they were "aiding and abetting" management through association with a course of dealing that was misleading to investors.

In the absence of fraud, while some dicta imply that English courts might hold an auditor liable in simple negligence to a foreseeable class of unknown persons (see, e.g., Hedley Byrne & Co. v. Heller & Partners [1964] A.C. 465), the law has not moved this far, despite the inclination of English accountants to assume that it has. See, e.g., Accountants' Liability to Third Parties—The Hedley Byrne Decision, J. Accountancy, Oct. 1965, at 66.

In White v. Abrams, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,457 (9th Cir. Mar. 15, 1974), the court rejected either a "negligence" or a "common law fraud" standard of liability for rule 10b-5 cases in favor of what the court called "the flexible duty standard," essentially based upon an analysis of the defendant's relationship to the plaintiff in the light of the plaintiff's access to information. This is an analysis not unlike that of SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (applicability of private offering exemption under Securities Act of 1933 depends upon whether the class of persons affected needs the Act's protection). The duty of care sounds in negligence where an ignorant plaintiff relies entirely on a highly trusted defendant, and more in fraud where a well-informed plaintiff gets casual information from the defendant, a business acquaintance. See White v. Abrams, supra at 95,610. While it seems difficult to apply in a uniform manner, perhaps this formulation may articulate what the courts actually do in this area.

40. See Seeburg-Commonwealth United Litigation, [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277 (S.D.N.Y. 1971). See also 18 Wayne L. Rev. 1675 (1972). The court found that a claim under rule 10b-5 was stated against the auditors for aiding and abetting management's waste of corporate assets by approving, in advance of the transactions in question, the allegedly improper manner in which management proposed to account for the transactions in financial statements to be published after the transactions had been completed. [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,277, at 91,598. The case has been settled by the accounting firm involved. See Wall Street Journal, Sept. 4, 1973, at 24, col. 1.

41. Thus, it was held recently that an auditor could be liable for common law deceit or violation of section 18 of the Securities Exchange Act of 1934 because he failed to correct previously certified financial statements after they were discovered to be false and misleading to investors. Fischer v. Kletz, 266 F. Supp. 189, 197 (S.D.N.Y. 1967). This ruling resulted in a new AICPA rule on subsequent events. AICPA COMMITTEE ON AUDITING PROCEDURE, STATEMENT ON AUDITING PROCEDURE [SAP] No. 41 (1969). SAP 41 has been consolidated into the statement on auditing standards, CPA-SAS 127-31. The Committee on Auditing Procedure has stated that if a CPA finds that unaudited financial statements "with which he may become associated" are not in conformity with GAAP, he must insist on a revision and, if necessary, withdraw. He is "associated" when he prepares or helps prepare the financial reports or they appear in a document that, with his consent, uses his name. AICPA COMMITTEE ON AUDITING PROCEDURE, STATEMENT ON AUDITING PROCEDURE No. 38 (1967). In May 1973, the AICPA issued APB 28, governing interim financial statements. AICPA, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD No. 28 (1973). While there has been no specific Financial Accounting Standards Board (FASB) pronouncement on unaudited or interim financial reports, there is undoubtedly a heightened concern. Marshall Armstrong of the FASB said recently, "... I doubt that there are many CPA's in this country who have not reassessed and probably altered the nature of their association with unaudited financial statements as a result of the decisions in two or three relatively minor legal actions." Armstrong, supra note
Herzfeld v. Laventhol, Krekstein, Horwath & Horwath\textsuperscript{2} indicates the current judicial view of an auditor's disclosure responsibilities. The defendant in Herzfeld was held liable to a foreseen private placement securities purchaser in a rule 10b-5 action involving the defendant's special audit of the issuer. Because of the audit, the defendant had expressed concern about profits shown by the issuer on the sale of certain nursing home properties. Although ultimately agreeing to include these profits in the income statement on a deferred basis, the defendant qualified its report by a notation that the report was "subject to the collectibility of the balance receivable on the contract of sale (see Note 4 of Notes to Financial Statements)."

There was evidently no testimony that this type of qualification was not in compliance with generally accepted accounting principles. The court found, nevertheless, that note 4 was misleading because it did not give details of the possible noncollectibility and contained some statements that were clearly misleading, despite defendant's actual knowledge of the facts. Furthermore, it was determined that including the sale profits in the income statement itself was misleading, given the omissions in the footnote. The plaintiff testified that he had read the income statement and the report but had not read footnote 4. The court concluded that the plaintiff nevertheless had relied on the misleading income statement that the defendant had helped to prepare for the plaintiff's benefit. It determined that the defendant knew that the qualification alone, "absent disclosure of the reasoning and facts which prompted it, would not alert potential investors to the uncertainties" of which the defendant had knowledge.\textsuperscript{4}

This court's message to auditors is clear and not new: to rely on


\textsuperscript{4} Id. at 95,993.

\textsuperscript{4} Id. at 95,002-03.
a qualification as a defense, it must be explicit. The notion that the qualification must contain or refer to a detailed statement of the facts giving rise to the qualification and the reasoning that led to it is novel, however. The emphasis given to the qualification is as important as the fact that it has been made. It is insufficient, evidently, merely to follow the standard format of the auditor's report in accordance with generally accepted accounting principles. Court rulings that auditors may have duties to investors that arise from the auditor's association with the client and cover more than the proper audit of year-end financial statements give rise to troublesome implications regarding the courts' and the public's views of the audit function.

These difficulties are not laid to rest by the position of the SEC. In 1957, the SEC articulated its long-held point of view: "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 he certifies." Moreover, this degree of responsibility is more than that required by the profession or the courts, who, until recently, have been concerned with whether the terms of the engagement, as defined by the profession, have been met. The SEC continually has sought more, even to the point of holding the auditor responsible for making both audited and un-

45. Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670 (1957). See also SEC Accounting Series Release No. 153 (Feb. 25, 1974) (SEC reiteration of its position in disciplining a "big eight" accounting firm for failing to make adequate inquiry of its predecessor firm's reasons for disagreement with the client, an inquiry that would have yielded information tending to raise a suspicion of fraud); Bus. Week, Mar. 2, 1974, at 76-77. The SEC position was articulated formally in SEC Accounting Series Release No. 19 (Dec. 5, 1940):

In approaching his work with respect to companies which file with us or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to managers or to owner-managers, he must now recognize fully his responsibility to public investors by including the activities of the management itself within the scope of his work and reporting thereon to investors.

But see D. Carmichael, supra note 10, at 129:

Auditors are qualified to examine financial facts objectively and to express opinions on them, but they are not professionally qualified judges of human character. Consequently, the reporting criterion of management intent does not imply that audit programs contain a procedure that states "review and evaluate management's motivation in choosing accounting methods." This is far from the case. Rather, the criterion operates contingently in much the same fashion as the going-concern assumption.

46. See CPE Restatement 8-16. See also Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 566 (E.D.N.Y. 1971) (primary function of the detail in financial statements is to enlighten the expert rather than the average reader).
audited financial statements comprehensible by average investors.\textsuperscript{47} This concern was expressed in \textit{SEC v. National Student Marketing Corp.}\textsuperscript{48} in which the SEC asserted that an auditor has an affirmative duty to investors to ensure that unaudited interim financial statements, which follow the audited statements in a merger proxy statement, are not misleading. This duty includes informing the SEC of the reasons for its withdrawal from the engagement if the client fails to modify the statements in order to render them not misleading.

The foregoing discussion suggests disparate opinions among auditors, the public, the SEC, and the courts regarding the nature of the audit function. Liabilities are being imposed on the profession partly because of its inability to develop a clear definition of its relationship to the investor in a manner satisfactory to the courts. A few writers have analyzed this problem, mostly in terms of "power," trying to develop a solution. Professor Mautz, for example, after analyzing the failures of the Accounting Principles Board to make substantial progress in promoting uniform generally accepted accounting principles, warned: "In the past, accounting has been unable to establish effective authority for its principles. Can it do so in the future? Unless accounting can find some solid base for

\textsuperscript{47} See Burton, \textit{supra} note 23; Address by Ray Garrett, Jr., Improved Disclosure—Opportunity and Responsibility for Financial Analysts, Financial Analysts Federation Annual Conference, Apr. 29, 1974; Address by William J. Casey, The Partnership Between The Accounting Profession and the SEC, Meeting of AICPA, Oct. 2, 1972 ("In my view, an auditor must carry a responsibility for knowing what is going on at his client, what the fundamental business situation is and whether the public reports being prepared adequately reflect these things. In this connection, I would expect him to review interim reports before they are issued to the public and to consult with his client on reporting problems as they arise."). SEC Commissioner Sommer has observed:

Both former Chairman William J. Casey and present Chairman Ray Garrett have properly suggested that auditors should be more involved in the interim reporting problems of their clients . . . . "Auditor of record" is an emerging concept in the accounting profession and I would hope that it will be increasingly filled with content. As I understand it, it is intended to identify the independent accountant of the issuer and is intended to connote a continuing relationship — something akin to the concepts of "general counsel" in the legal profession and "attorney of record" in the litigation scene.


The SEC has stressed for many years the auditor's obligation to look beyond formal compliance with "principles, practices and conventions" accepted at the time: "We believe that, in addition to the question whether the individual items of financial statements are stated in accordance with accounting principles, practices and conventions, there must be considered the further question whether, on an overall basis, the statements are informative." \textit{Associated Gas & Elec. Co.}, 11 S.E.C. 975, 1059 (1942).

political authority, prospects for progress in financial reporting are not bright." In a speech entitled "Accounting Power," Professor Sterling also noted the absence of a power base for the profession, while former SEC Chairman Casey has analyzed the problem as a direct relationship between reduced liability and increased responsibility. These efforts, however, although expressing concern about the auditor's position, do not suggest precisely how increased responsibility will lead to reduced liability exposure, nor is it clear what balance of liability and responsibility would be acceptable to the profession. Some answers will now be suggested, based upon the profession's own emerging analysis that emphasizes that not all precisely quantified information presented in financial statements can be verified; rather, it is "interpretive," based on judgment and prediction.

49. Mautz, supra note 8, at 190. See also Gormley, supra note 6, at 1205.
50. Professor Sterling stated:

The major problem facing public accounting today is its lack of power. First, in comparing the power or authority to the responsibility, we find that the responsibility far outweighs the authority. The public accountant must act judicially but he has not been given the power to enforce his rulings. His ultimate weapon is resignation and silence, which puts him in a conflict-of-interest position . . . . The authority is lessened further by the existence of competition among accounting firms. Resignation from an engagement might be an effective means of enforcement if it were not for the fact that other firms may take the engagement and issue an opinion.

Second, in comparing the power of the public accountant to that of management, we find that management's power far outweighs the accountant's. This imbalance is not undesirable per se. When one considers the fact that accountants must judge managements, however, it is not only undesirable, it is intolerable . . . . It would be equally damaging to the legal system if litigants were able to select from diverse or flexible laws as they saw fit. The same is true in regard to accounting: if accountants are to judge managements, then we must deny managements the power to hire and fire accountants and the power to select from diverse accounting principles as they see fit.

Sterling, supra note 8, at 66.
51. Chairman Casey has stated:

My own view, and a strong one, is that one gets better protection from liability from moving forward to broaden the area of responsibility rather than trying to narrow or restrict it . . . .

The message seems to me to be clear. The accountant must be willing to meet the enlarged expectations of a critical public. I do believe he should seek and take responsibility for appraisals of internal control, the content of annual reports and even future oriented data. If he does this with professionalism and with good faith I believe the threat of liability will become less rather than more capricious and dangerous.

52. See Trueblood Report 33-34.
Categories of Information in Financial Statements

In a rare foray into accounting, the Supreme Court stated:

To make a fetish of mere accounting is to shield from examination the deeper causes, forces, movements and conditions which should govern rates. Even as a recording of current transactions, bookkeeping is hardly an exact science. As a representation of the condition and trend of a business, it uses symbols of certainty to express values that actually are in constant flux. It may be said that in commercial or investment banking or any business extending credit success depends on knowing what not to believe in accounting. Few concerns go into bankruptcy or reorganization whose books do not show them solvent and often even profitable. If one cannot rely on accountancy accurately to disclose past or current conditions of a business, the fallacy of using it as a sole guide to future price policy ought to be apparent. However, our quest for certitude is so ardent that we pay an irrational reverence to a technique which uses symbols of certainty, even though experience again and again warns us that they are delusive.53

This judicial commentary finds a curious echo in recent statements by accountants about the content of financial statements.54 Thus it appears that an emphasis on precision and certainty in the body of the financial statements themselves, coupled with the delphic pronouncement of the auditor that the statements "fairly present" the company's financial position, may create public expectations, and, ultimately, auditor liabilities, that may be unduly large in view of the uncertainties involved.

How, qualitatively, can information in financial statements be categorized from the standpoint of the auditor's task? The Trueblood Report emphasized a distinction between "factual" and "interpretive" information:

Economic decision-makers need both factual and interpretive information—identified separately to the extent possible—

54. Users often misunderstand the judgments that are required to quantify many financial statement items as well as their level of accuracy. Because the presentation of financial statements implies a high degree of precision, users do not realize that what seems precise often, in fact, is not. In a conventional statement of financial position, cash may be the only asset that can be stated with a relatively high degree of precision and reliability. The amounts shown for all other assets, as well as some liabilities, are less precise.

TRUEBLOOD REPORT 45. See also Burton, supra note 23; Reiling & Burton, supra note 8.
about transactions and other events in order to assess uncertainty. Factual information can be measured objectively. Interpretive information is largely subjective and frequently cannot be easily quantified. Unfortunately, much information is neither purely factual nor purely interpretive, so that, as a practical matter, the distinctions between factual and interpretive information are not as precise as users would like them to be.55

As an objective of financial statements,56 the Trueblood Committee emphasized the need to serve primarily users "who have limited authority, ability, or resources to obtain information . . . ." This objective is not unlike that propounded by the SEC's Dr. Burton, suggesting that financial statements "taken as a whole, make sense within the framework of the accounting model,"57 or the rule 10b-5 holding in at least one case that presentation according to generally accepted accounting principles, without more, is no defense to a claim that financial statements are misleading.58 The auditor must do more than assure the presentation's fairness and completeness; he must, in a sense, place himself in the position of a reasonably prudent investor having no acquaintance with the company and ask

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55. TRUEBLOOD REPORT 33. Elsewhere, the report made specific suggestions: "Financial statements are more useful if they include but distinguish information that is primarily factual, and therefore can be measured objectively, from information that is primarily interpretive." Id. at 14. "In all reporting, the assumptions, interpretations, predictions, and estimations that underlie the preparer's conclusions should be set forth. The nature and extent of detail given in support of these conclusions is a matter of application. The test is whether the information presented enables users to make their own assessments of uncertain matters and of the conclusions of the preparer." Id. at 34. "To satisfy the individual preferences of users for predicting and controlling the impact of current events on enterprise earning power, some apparently simple quantifications should be supplemented to represent their actual complexities by disclosing ranges of precision, reliability and uncertainty." Id. at 40. "To accomplish this basic objective, it may be that financial statements should not be limited solely to quantified information. Amplification, in narrative form, of data included in statements may be required." Id. at 13. See also McGarraugh, The Viewpoint of the Credit Grantor, in SEAVMw I, supra note 11, at 113, 118.

The SEC has announced the adoption of Guide No. 22 of Guides to Preparation and Filing of Registration Statements, effective September 30, 1974, requiring a registration statement to include a management discussion and analysis of the summary of earnings. SEC Securities Act Release No. 5520 (Aug. 12, 1974). The effect of this added disclosure on the scope of auditors' responsibilities and liabilities is not yet entirely clear.

56. See note 3 supra & accompanying text.

57. TRUEBLOOD REPORT 17.

58. Burton, supra note 23, at 153-54. See also Address by SEC Commissioner A.A. Sommer, Jr., Differential Disclosure: To Each his Own, Second Emanuel Saxe Distinguished Accounting Lecture, Baruch College, Mar. 19, 1974.

whether this person, if he read the financial statements carefully, nevertheless would remain unaware of their essential import. The auditor is responsible not merely for the reasonableness of what the statements say but also for what they mean to the average investor; he must communicate or translate the statements where, on their face, they are unintelligible to that class of users.

The Trueblood Report’s analysis implies that financial statements tend to be unintelligible to the average investor when information of an “interpretive,” rather than a “factual,” nature is presented. In these situations, such as valuation of assets, size of reserves, or capitalization of deferred costs, the auditor must be particularly concerned that his liability may exceed the scope of his engagement. It is submitted that liability will be reduced to the extent the auditor moves away from implying that he has conferred certainty upon financial statements and to the extent that, through professional or statutory rule, he takes affirmative steps to “translate” financial statements to reveal their judgmental nature where necessary for the understanding of average investors. Several procedures are available to auditors to reduce their exposure to liability, with varying degrees of effectiveness. An examination of them will demonstrate, however, that there is a need to seek a more promising alternative.

**Present Attempts To Specify Responsibility**

*Auditor Disagreements: The Form 8-K Procedure*

SEC requirements for reporting auditor changes, first adopted in 1971, were revised in December 1974 to increase their effectiveness. When a reporting company learns of the impending withdrawal of the principal accountant for its own most recently filed financial statements, or those of a significant subsidiary, and when it engages a new accountant, it must report such changes to the SEC on Form 8-K within 10 days after the month the announcement is made.60 The company also must state in the form whether, in the two years preceding the announcement, there were any disagreements concerning accounting matters or whether the prior auditor’s report...

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contained an adverse opinion or a disclaimer of opinion or was qualified because of uncertainty, audit scope, or accounting principles. The nature of each such adverse opinion, disclaimer, or qualification must be described. In addition, the company must obtain from the prior auditor a letter commenting on the statements contained in the company's report; this letter must be sent to the SEC where it will be on public file.

Because the Form 8-K device is new, and because it has unresolved interpretive uncertainties, its success as a means to allow auditors to meet their disclosure objectives cannot be predicted. One effect, however, should be noted: a recent study of the 250 instances of auditor changes reported on a Form 8-K between November 1971 and February 1973 indicates only 14 cases (5.6 percent) of disagreement concerning accounting matters. One-hundred forty-one of these 250 companies responded to a supplemental researchers' questionnaire. Of these, 47 percent indicated that the auditor's fee was too high and 44 percent indicated that dissatisfaction with services provided was a reason for the change; eleven percent indicated disagreement on accounting matters as a reason. These figures are consistent with an informal count by the SEC of 450 auditor changes made in 1973, which showed that 10 percent changed because of disagreement. The Form 8-K device thus apparently has not revealed the existence of all accounting disputes that have a bearing on auditor changes. Recent changes in the procedure to expand the scope of matters reported on and to require that the registrant describe relations with its auditors in its annual meeting proxy material may improve this record. It is difficult at this time to evaluate the effectiveness of the new

64. Id. at 17. On February 25, 1974, the SEC announced a consent order disciplining a major accounting firm for, among other things, failing to make adequate inquiry of the predecessor auditor in a Form 8-K switch involving U.S. Financial Inc. See SEC Accounting Series Release No. 153 (Feb. 25, 1974). See also When Companies and Auditors Fight and Switch, Bus. Week, Mar. 2, 1974, at 76-77.
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The 8-K procedure in reducing auditor liability exposure. Undeniably, the procedure increases the stakes for both auditor and client in the event of a disagreement and tends to promote an adversary relationship with respect to the presentation of interpretive information in financial statements. These effects by themselves would seem to exacerbate the difficulties of auditors where their engagement is thought to lead to a representation that a single set of numbers does or does not express a fair statement of financial position. No doubt the 8-K device is useful; it probably does not reduce an auditor’s liability exposure on the financial statements he reports, however.

The Audit Committee

As part of a 1940 administrative order, the SEC urged that an audit committee of the board of directors be established, composed of “outside” directors, to review the company’s financial statements with the independent auditor. Since then, the audit committee has been accepted by a significant number of large corporations as a useful device to improve communication between auditors and the board.

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66. See SEC Accounting Series Release No. 153 (Feb. 25, 1974). To an extent, an adversary position must be recognized as a reality in the management-auditor relationship. For an unusually frank analysis of the various management incentives to depart from strict adherence to the basic goals of financial reporting, see Hayes, Ethical Standards in Financial Reporting: A Critical Review, in Corporate Financial Reporting: Ethical and Other Problems, 79-80. (J. Burton ed. 1972) [hereinafter cited as Scrave III]. Yet the literature indicates that the professional goal of auditors is to resolve the conflicts responsibly within the context of a confidential relationship, rather than by public discussion of differences. CPA-SAS 78-79, 128; CPE Restatement 12, 23 (Rule 301), 36 (Interpretation 301-1). But see Olson, Ethical Problems of the Auditor in Financial Reporting, in Scrave II 153-54 (“Under no circumstances should the auditor allow confidentiality to take precedence over his responsibility to see that the client’s financial statements are fair and not misleading.”). State statutes relating to confidentiality of auditor communications tend to make the decision to disclose more difficult. Sixteen states now provide by statute that accountant-client communications in certain contexts are privileged. The efficacy of these provisions in litigation under the revised Federal Rules of Evidence has been questioned. See Jentz, Accountant Privileged Communications: Is it a Dying Concept Under the New Federal Rules of Evidence? 11 Am. Bus. L.J. 149 (1973). See also Note, Couch v. United States: The Supreme Court Takes a Look at the Accountant-Client Privilege—or Does It? 62 Ky. L.J. 263 (1973).


68. See R. Mautz & F. Neumann, Corporate Audit Committees (1970). A series of questionnaires yielded responses from 385 corporations, 121 (32 percent) of which indicated that they had audit committees. Thirty-six of the 52 responding corporations with more than $500 million in sales had audit committees. The authors state: “Our interviews reinforced the hypothesis that audit committees are not commonly found. This is further supported by the
With its emphasis on communication, the audit committee device seemingly would foster financial statements that are properly understandable by the average investor. In practice, this result is not entirely clear, although audit committees undoubtedly improve communications between auditors and directors. The committee's duties generally do not seem to be defined in a manner that encourages a review of the presentation; the typical appointing resolution apparently emphasizes the audit function. Further, it is not clear that the members of the committee generally tend to view their task as one of refining the presentation. Indeed, a study by Professors Mautz and Neumann indicates that most of the non-officer directors questioned about the audit function indicated that it was the province of management or the outside auditors. Members of the audit committees did not seem to be particularly expert in accounting and auditing. This reluctance to become involved in a review

findings of the NICB study made in 1966." Id. at 16, citing J. Bacon, CORPORATE DIRECTORSHIP PRACTICES, STUDIES IN BUSINESS POLICY, No. 125, at 135 (1967). The report listed the most frequently cited functions of such committees, in order of importance: reviewing and transmitting to the board of directors the auditor's report, reviewing the auditor's evaluation of internal controls, defining the purpose and scope of the audit, appointment and nomination of independent auditors, and a variety of less significant functions. R. MAUZ & F. NEUMANN, supra, at 23. For further data on the audit committee, see Price Waterhouse & Co., The Audit Committee, The Board of Directors and The Independent Accountant (1973). This pamphlet proposes the following responsibilities of an audit committee: to "provide assistance to the board in fulfilling its audit responsibilities" and to "maintain, by way of regularly scheduled meetings, a direct line of communications between the directors and independent accountants to provide for exchanges of views and information." Id. at 8. This is in accord with the AICPA Executive Committee Statement on Audit Committees of the Board of Directors. See J. ACCOUNTANCY, Sept. 1967, at 10. See also SEC Accounting Series Release No. 126 (July 5, 1972); NEW YORK STOCK EXCHANGE, RECOMMENDATIONS AND COMMENTS ON FINANCIAL REPORTING TO SHAREHOLDERS AND RELATED MATTERS 6 (1973); Arthur Anderson & Co., The Audit Committee of the Board of Directors (November 1972); Touche, Ross & Co., Corporate Audit Committees (December 1970); Farrell, The Audit Committee—A Lawyer's View, 28 Bus. LAW. 1089 (1973) (supporting the usefulness of such a committee of outside directors).

69. For example, the AICPA Executive Committee Statement, Audit Committees of the Board of Directors, J. ACCOUNTANCY, Sept. 1967, at 10, indicates essentially that the audit committee is to "discuss," "review," "invite views," and "communicate" regarding the auditor's functions. See also R. MAUZ & F. NEUMANN, supra note 68, at 41-42: "[P]erhaps no other characteristic of corporate audit committees varies so much from company to company as to the duties assigned to the committee . . . . In some cases the function of the committee is not stated at all, the only record being a notation in the minutes designating the membership of the Committee . . . ."

70. R. MAUZ & F. NEUMANN, supra note 68, at 47-48.

71. The Mautz and Neumann study states: Over and over, from all types of persons interviewed, we heard the statement that if a person will make a good board member he will make a good member of the corporate audit committee. The consensus regarding requirements for satisfactory membership on the corporate audit committee in order of import-
of the audit function may be based to some extent on the realization that, in suits based on the financial reports, defenses are available to a director under federal securities and state corporate laws, if he relied on the opinion of an expert. 72

It may well be that the audit committee's functions could be altered by rule or statute to require it to review the presentation, to require that it be composed of persons competent in auditing, and to refine its "expert reliance" defenses. 73 Auditors possibly could be

ance seems to be: first, high-level executive experience and responsibility; second, some financial background; and third, some experience in working with CPA's. The last of these was considered to be much less significant than the first two."


A recent study of 553 corporate directors of 46 "Fortune 500" companies indicates that 55 percent of these directors were "insiders" and 32 percent of the "outside" directors were executives of other companies. Seventy-five percent of the directors spent less than 10 hours per month on board activities. See Financial Executive, Jan. 1974, at 7. On the question of effectiveness of the board as a protector of shareholder and public interests, see Clendenin, Company Presidents Look at the Board of Directors, Calif. Management Rev., Spring 1972, at 60. See also Blumberg, Reflections on Proposals for Corporate Reform Through Change in the Composition of the Board of Directors: "Special Interest" or "Public" Directors, 53 B.U.L. Rev. 547 (1973).

There is a well-respected viewpoint that the board cannot function at all as it is supposed to function without full-time independent directors who are professional, highly compensated, properly supplied with their own staff, and given specific powers of inquiry. See Schwartz, A Plan to Save the Board, 28 Record of N.Y.C.B.A. 279 (1973). Observations of this nature tend to question the utility of audit committees without the existence of more fundamental reform in the legal structure of the board. The outlook for such reform is not particularly promising, however. For example, one article reported: "The Investor Responsibility Research Center, a Washington-based public interest group, surveyed a group of chief executives recently and found that few wanted the board selection process opened to greater shareholder participation. Similarly, there was little interest in opening the board to constituency representatives." Burgen, Commentary/Chief Executive, Bus. Week, May 4, 1974, at 86.

72. Section 11 of the Securities Act of 1933 provides a "due diligence" defense to directors who rely on "expert" portions of a registration statement. 15 U.S.C. § 77k (1970). Certain state corporate statutes provide similar defenses. For example, section 65 of the Massachusetts Business Corporation Law, Mass. Ann. Laws ch. 156B, § 65 (1970), reads in part as follows: "In discharging his duties, any [director or officer], when acting in good faith, shall be entitled to rely upon the books of account of the corporation or upon written reports made to the corporation by any of its officers, other than such person, or by an independent public accountant." See also Scott, Enforcement of Ethical Standards in Corporate Financial Reporting, in Seaview II, supra note 65, at 107.

encouraged to address specific questions of emphasis to the committee. Even if altered, however, the audit committee device does not help the auditors directly to limit their exposure. Ultimately, the auditors themselves should decide whether financial statements carry the right import; an audit committee can be useful only to guarantee that management does not always have the final word on company disagreement with that decision.

Statutory Provisions Relative to Auditors

To the extent that auditor responsibilities are related to a statutory measure of liability, concomitant statutory improvement of the mechanics of auditor selection and delineation of duties can help auditors clarify their responsibilities while limiting their exposure. American corporate statutes generally do not include audit requirements, however. Special corporate statutes relating to banks and certain types of insurance companies do provide for independent audit, but these laws are not directly analogous because the auditors often are state officials with quasi-investigatory power to enforce state laws regarding the maintenance of reserves, liquidity ratios, legality of investments, and other features designed to protect customers.74 England has had mandatory auditor appointment provisions in its corporate statutes for some time.75 Canada has had man-

74. See, e.g., N.Y. BANKING LAW §§ 122-23 (McKinney 1971); N.Y. INS. LAW § 29 (McKinney 1966); MASS. ANN. LAWS ch. 175, § 4 (1972).

Only one state has adopted the European system of mandatory audits in its general corporate statutes. See MASS. ANN. LAWS ch. 166B, § 109A (1970). Section 109A requires an annual statement of condition to be filed, which, in most cases, must be accompanied by a written oath of the auditor. The section provides:

The auditor shall state that he has examined the statement of assets and liabilities included in such report, that his examination was made in accordance with generally accepted auditing standards, and that in his opinion said statement of assets and liabilities presents fairly the financial position of the corporation as of the date thereof, in conformity with generally accepted accounting principles. The state secretary may in special circumstances, in his discretion, approve the inclusion of an auditor's statement expressing a qualified opinion or no opinion of the statement of assets and liabilities taken as a whole, provided the auditor states his reasons therefor.


datory appointment provisions in its general corporate statutes and now is adding audit committee provisions. This legislation, in general, requires annual appointment of auditors by the board and ratification by shareholders. 78

In Europe’s civil law countries, the mandatory auditor has been in public corporate statutes for many years. 77 The audit and attest functions are much more limited than in the United States, however; the auditors are usually individuals rather than firms, and they do not report on the fairness of presentation, but only that statutory recordkeeping and reporting requirements regarding such things as capitalization and reserves have been observed. 77 If these requirements have not been observed, the auditors can, and in some cases must, report this to the authorities, 77 and, in certain cases, they can convene a special shareholders’ meeting. 79 The liabilities of the statutory auditor are not spelled out clearly in all cases. 80

76. See note 73 supra. See also Hawes, supra note 63, at 10-12.
78. See Kovarik, Le Commissaire aux Comptes et Le Wirtschaftsprufer, in COLLECTIONS HERMES (Ed. Cujas 1971), for a discussion of the basic approach of auditors with respect to the statutory requirements. See also Kohler, supra note 77. For a comprehensive review of the modern requirements, see A. Tyra, Companies Laws and Financial Reporting (1971) (Univ. Wash. Grad. School of Bus. Adm.) Of interest are the German requirements that auditors report on a management summary of major interperiod changes in the financial statements, id. at 7, and that dismissed auditors be present at subsequent shareholders' meetings to be questioned, id. at 12. A management report also is required in France, id. at 26-31, and England, but evidently it need not be reported on by the auditor in the latter country, id. at 56, where no “statutory audit” of a set of prescribed accounts exists. Id. at 66.
79. See A. Tyra, supra note 78, at 12, 31-32.
80. See id. at 31 (France); Hawes, supra note 63, at 4-9 (England).
81. In France, the Commissaire Aux Comptes (statutory auditor) performs the functions set forth in the statute, but, curiously, he need not have any accounting expertise. He is subject to an administrative tribunal, however, which, like the SEC, can revoke his license and, unlike the SEC, can fine him for improper conduct. Every statutory auditor is civilly liable only for neglect of professional duties, false statements, ill-considered valuations, or insufficient checking. See A. Tyra, supra note 78, at 33. Tyra states, “[T]he art of accounting may have suffered in France because professional accountants have not been assigned a role in the implementation of the law. The statutory auditors need not possess demanding professional qualifications, and they earn low, government-set fees for their audits.” Id. at 66.
European statutory auditor thus serves more as a policeman than as a professional guide to disclosure.

It is difficult to evaluate the potential effectiveness in this country of the concept of the European statutory auditor. 82 European accounting principles allow considerably more latitude to an auditor than comparable principles in the United States. The public company in Europe usually has two boards: a supervisory board and a management board. The former, with overall responsibility for the quality of management and financial reporting, contains no management representation; the latter runs the company. Corporate statutes require the statutory auditors to report to the supervisory board. 83 This board, however, often is dominated by management through banks and other financial institutions that have shareholder voting power. 84 Thus the European auditors have a wide range of statutory powers, but, as in this country, these powers probably are not very effective against management where the quality of reporting is in issue. The need for this effectiveness, although increasing, is somewhat less in Europe, because public share ownership is less widespread than in this country. 85 More importantly, the entire audit and attest function is much less discretionary than the processes required of American independent auditors. 86

Germany apparently has no comparable provisions. In England, public companies' financial statements must be reported on by members of a nationally recognized institute of chartered accountants. Id. at 49. The report must state that the financial statements give a "true and fair view" of a company's operations and position. Id. at 57. Apparently, there is no statutory provision imposing liability.

82. For a discussion of the applicability of the German corporate structure to this country, see Vagts, Reforming the "Modern" Corporation: Perspectives from the German, 80 Harv. L. Rev. 23 (1966). For an update, see Vagts & Waelde, The Societas Europaea: A Future Option for U.S. Corporations?, 29 Bus. Law. 823 (1974). See also Roth, Supervision of Corporate Management: The "Outside" Director and the German Experience, 51 N.C.L. Rev. 1369 (1973); Schoenbaum & Lier, Reform of the American Corporation: The "Two Tier" Board Model, 62 Ky. L.J. 91 (1973). Vagts and Roth both note that a major drawback of the German system, also said to exist in the United States, is the inability to prevent management from dominating "outside" directors and, ultimately, the mechanism of its own reappointment. See also Van Gerven, Some Recent Developments in Corporate Law Within the Common Market, 6 Int'l. Law. 494 (1972).

83. For an analysis and comparison with the American situation, see Blumberg, supra note 71. Blumberg states: "So long as the 'public' or 'professional' director is without a constituency or an appointing agency with public influence, the extent of change of corporate objectives will not be major." Id. at 558. For a different approach to the problem, see Schwartz, Federal Chartering of Corporations: An Introduction, 61 Geo. L.J. 71 (1972).

84. See Vagts, supra note 82; Vagts & Waelde, supra note 82.

85. See Hawes, supra note 63, at 7 n.34.

86. See Pittendrigh, supra note 75.
LIABILITY OF ACCOUNTANTS

The Need for Change

Publicizing disagreements with auditors through Form 8-K disclosure, use of audit committees, and statutory auditor provisions all give more legal recognition to the major role of the auditor when seeking improved corporate financial disclosure. It is doubtful, however, that these procedures will induce the profession to satisfy those standards of performance that have been set by the courts, the SEC, and the public, nor will the Trueblood Report's objectives be attained. Indeed, these approaches may circumscribe auditors' freedom to exert their professional influence on clients in a confidential setting, thereby reducing the available options when disagreements arise. Moreover, these techniques do not affect the substantial increase in liability exposure implied by the performance standards being urged, and the use of such procedures also may raise expectations that the higher standards are being met before the profession is equipped to meet them.

The inherent inadequacies of the techniques outlined illustrate the need for reformers to concentrate on a dual objective: requiring auditor's reports that will satisfy recently developed judicial and administrative reporting standards, while fashioning liability rules that shield from excessive exposure auditors who prepare these reports in a professional manner. These goals could be met by modifying existing state corporation laws, but several factors indicate the difficulties of this approach, even if attempted through the Model Business Corporation Act. First, state legislators, dependent on the good will of corporate citizens, might be dissuaded from the task. Secondly, such action by state law might necessitate development of a complete set of financial disclosure provisions essentially duplicative of federal law, with a resulting regulatory complexity rivaling that of state corporate taxation. Finally, because the affected statements often emanate from companies whose activities are nationwide and because the statements themselves may receive nationwide dissemination, it would be preferable to deal with these problems by national regulation.

87. For a discussion of the Massachusetts corporate statute, see note 74 supra.
89. There is, of course, the alternative of a federal corporate statute. For a discussion of the numerous difficult administrative problems with such a statute, see Symposium—Federal Chartering of Corporations, 61 Geo. L.J. 71 (1972).
A Proposal

The changes needed to clarify the auditor's role must focus on a revision of reporting ground rules, while placing clear statutory limitations on liability flowing from the engagement. Although it is with trepidation that any changes are suggested in reporting ground rules and documents that have been tested so thoroughly in the crucible of experience, the attempt is necessary because the courts and the SEC persistently have mandated extending auditors' responsibilities beyond the AICPA "fairness" concept. Paragraph 511 of the AICPA Statement on Auditing Standards provides some guidance in this effort:

An unqualified opinion that financial statements present fairly financial position, results of operations, and changes in financial position may be expressed only when the independent auditor has formed the opinion, on the basis of an examination made in accordance with generally accepted auditing standards, that the presentation conforms with generally accepted accounting principles applied on a consistent basis and includes all informative disclosures necessary to make the statements not misleading.

The "fairness" formula thus might be rephrased to require financial statements that include "all informative disclosures necessary to make the statements not misleading." Requiring auditors to make this express representation may well focus their efforts, and those of the client, upon preparation of a presentation that will satisfy developing legal doctrines.  

90. CPA-SAS ¶ 511.01, at 80-81.
91. Controversy exists within the American profession about whether the auditor's phrase "present fairly . . . in conformity with [GAAP]" should be read conjunctively or disjunctively. The former reading would be "fair GAAP are applied" or "GAAP are applied fairly," while the latter would read, for example, "GAAP are applied fairly and the financial statements are fairly presented." See Rosenfield & Lorensen, supra note 10, at 74. Rosenfield and Lorensen claim that a disjunctive standard will undermine the uniform application of GAAP. Id. at 82. They note, however, that the Canadian Institute of Chartered Accountants has required a disjunctive auditor's opinion for several years, thereby causing auditors to assume responsibility for fairness of presentation generally as well as for adequate application of GAAP. Id. at 77.

The practical value of this approach has been recognized for some time. As early as 1969, the Wheat Report noted:

Where seriously misleading disclosures do occur [in the annual report to shareholders] they are most frequently found in textual references made to, or condensed presentations of, the results of operations . . . . The Study considered the possibility of requiring by rule that all financial disclosures in an annual report to shareholders wherever located in the report, be reviewed by the audi-
The Financial Accounting Standards Board (FASB) seemingly would be the best forum in which to implement this change. Concurrently, the FASB and the SEC could consider the entire issue of "qualified" versus "subject to" opinions in light of the proposed change, for, if the Trueblood Report's intent has been determined correctly, auditors reasonably should be called upon to be less cryptic in their analysis of disclosure problems. Several cases strongly indicate that a careful examination of disclaimers in the auditor's report will be made to determine if disclosure responsibilities are being met. By allowing the auditor to elaborate his concerns more fully in the reports without risk of SEC rejection, he will be encouraged to speak in a manner more comprehensible to the average investor.


The presentation of financial statements is the responsibility of corporate management. The professional accountant attests as to their correctness. The user and interpreter of these statements is the investor, or the financial analyst acting for the investor. In theory, these parties have a common interest in accurate financial statements. In fact, however, their immediate interests tend to diverge. The resulting conflicts are at the root of some of the accounting and reporting problems plaguing investors today . . . .

The public accountant is the man in the middle of this conflict. Thought by analysts and other users to be the final arbiter of accounting questions arising in a corporate financial statement, he is in fact responsive to the wishes of management so long as they are within accepted accounting principles, which are very broad. The accountant is retained by management, not by investors (despite occasional formalities of stockholder approval). His attestation to a financial statement is thought by users to reflect a fiduciary responsibility, but in fact, it is a limited certificate. This misunderstanding of the extent of liability of accountants in their attest function seems to be reflected in the growing number of suits filed against accounting firms on grounds that certified statements were misleading . . . .

The accounting profession can resolve its conflicting middle position by fully assuming the fiduciary role that is being thrust on it anyway. Its certificate on a financial statement is valuable to the issuer and therefore the accountant has a point of leverage to secure adherance to new and stricter accounting principles by his clients. The scope of the certificate might well be enlarged to include financial data in the texts accompanying the statements and possibly, on some basis, interim reports.

Norby, The Needs and Responsibilities of the Investor in Equities, in Seaview I, supra note 11, at 95, 105-08.

92. See notes 28-48 supra & accompanying text.
It is understandable that auditors are reluctant to accept changes in the formal nature of their engagement and the representations they make, for, as already documented, the profession is undergoing considerable strain and uncertainty regarding the expansion of its liabilities. Accordingly, a corollary of the foregoing proposed change in the report would place some clearly understood statutory liability limits on auditors' responsibilities arising from the engagement. With the exception of cases arising under section 11 of the Securities Act of 1933, where damages are limited to the price of the securities sold, most courts today retain a scienter requirement for auditor liability to foreseeable, but not foreseen, persons based on an improper report. Contrary language in a few cases probably can be explained by the facts in those cases, since the errors were particularly glaring or the plaintiffs were clearly foreseen beneficiaries of the report at the time it was prepared.

Not all federal courts, however, require scienter as an essential element of the plaintiff's case. Moreover, even where required, the judicial notion of scienter does not rule out possible liability for ordinary negligence if, for example, an auditor negligently fails to make an adequate investigation in accordance with generally accepted auditing procedures, or qualifies his opinion in a manner that negligently fails to reveal the details of concern in a manner intelligible to investors. Such lapses can lead to a finding that the defendant auditor was conscious that he had no adequate basis for the statements made in his report, or even that he was conscious that his report would be misleading to the average investor. This expansion of the scienter requirement's parameters undoubtedly will be increased as documents required by the Securities Exchange Act come to include information of the type needed to satisfy the Securities Act's provisions, thus allowing the resulting higher disclosure standards to be enforced by rule 10b-5 actions.

In a sense, the cautious insistence on a scienter requirement in

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95. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962).
rule 10b-5 cases is an artificial attempt to limit liability. If these limits were clearly secured by statute, it would be easier to develop a standard of care to unforeseen third parties, at least in rule 10b-5 cases, similar to that applicable to auditors in their relationships with persons in privity. This, in turn, would eradicate the need for a strained definition of scienter, which would be limited to willful or grossly negligent conduct entitling the plaintiff to punitive damages.

Accordingly, a desirable amendment to the Securities Exchange Act of 1934 would set a specific damage limit on an auditor’s liability, such as “out of pocket” costs to the plaintiff. The proposed Federal Securities Code of the American Law Institute contains limits on liability in civil damage suits that merit serious consideration by the accounting profession; these provisions could complement the suggested revision of the form of the auditor’s report.

The Code, which is expected to be ready for legislative presentation within the next few years, will contain nineteen parts that consolidate existing federal securities statutes and rulings. In its basic approach to corporate disclosure, the Code creates a system of registering issuers rather than issues, mandates a regular reporting and disclosure system for those issuers, and sets forth the disclosure conditions under which distributions of securities may be made. Part VI, entitled “Postregistration Provisions,” and Part XV, entitled “Administration and Enforcement,” give the SEC authority to require annual, quarterly, and other reports, including the annual report to shareholders, and to regulate their content, as well as the form and content of auditors’ reports.

The Code places several limits on potential auditor liability. From section 11 of the Securities Act of 1933, the Code adopts the

98. The Code thus far has been embodied in three tentative drafts, each issued by the American Law Institute. ALI Fed. Securities Code (Tent. Draft No. 1, 1972) [hereinafter cited as Draft No. 1] basically covers registration of issuers (Part IV), offerings (Part V), and reporting by issuers and insiders (Part VI). ALI Fed. Securities Code (Tent. Draft No. 2, 1973) [hereinafter cited as Draft No. 2] essentially covers fraud, manipulation, and civil liabilities for various violations (Parts XIII and XIV). ALI Fed. Securities Code (Tent. Draft No. 3, 1974) [hereinafter cited as Draft No. 3] primarily covers administrative enforcement and general provisions (Parts XV-XVII), including selection of auditors. A general revision of these three drafts is in progress and should be available in 1976. Further drafts then will be made, mostly covering specialized areas such as investment companies.


100. For an overview of the Code’s general scheme, see Draft No. 1, at xiii.

"due diligence" defense available to auditors in suits based on a prospectus. Additionally, an overall damage limit is established equal to the total market price of an offering. In its most recent version, the Code partially coordinates liabilities for misrepresentation as they exist under the Securities Act and the Securities Exchange Act, by imposing section 11-type liability on the issuer and others, including auditors, for "misrepresentations" and omissions of material facts in registration statements and annual reports required to be filed with the SEC, other than the annual report to shareholders. The defenses provided are similar to those now available under the Securities Act, and the damage limit, for all practical purposes, is one hundred thousand dollars per individual defendant. The Code therefore would impose liability on auditors for negligence with respect to prospectuses and SEC forms, but it concurrently would place significant limits on exposure in civil damage suits.

102. Draft No. 1, § 601, governs the content and filing requirements of the reports; Draft No. 3, § 1503, covers the SEC authority over the content of the auditor's report.

103. Draft No. 2, § 1403(a). This section does not apply to the annual report to shareholders, except to the extent that it reflects a deceptive act or a misrepresentation contained in a filing otherwise covered by this section. See id., Comment (1)(b). Liability for misrepresentation in other reports required to be filed, including the annual report to shareholders if the SEC requires it to be filed pursuant to section 601, Draft No. 1, § 601, is covered by section 1404, Draft No. 2, § 1404, which is directed at issuers, including auditors who are "aiders and abettors" under section 1418, Draft No. 2, § 1418. See Draft No. 2, § 1404, Comment (5)(b).

Section 1403(e)(4)(B), covering an expert's "due diligence" defense, applies to "any part of the filing purporting to be made on his own authority as an expert . . . ." Draft No. 2, § 1403(e)(4)(B). This language, of course, tracks section 11 of the Securities Act. Both section 11 and section 1403 limit an expert's liability to statements which purport to be made by the expert. Replacing the Securities Exchange Act's provisions, section 1304 of the Code bases liability on a "deceptive act in connection with, or . . . a misrepresentation in, a press release or other form of publicity relating to an issuer . . . ." Draft No. 2, § 1304(c). The definitions of the types of statements that are actionable here are very broad, and no comfort can be derived from the Code's cautious approach to the difficult problems of causation and reliance. See Draft No. 2, § 215A ("A loss is 'caused' by specified conduct to the extent that the conduct (a) was a substantial factor in producing the loss and (b) might reasonably have been expected to result in loss of the kind suffered").

Hopefully, the Code will recognize current cases that permit auditors to police their exposure from the engagement by specifying those parts of their work that are not for public exposure. See, e.g., Landy v. FDIC, 486 F.2d 139, 169 (3d Cir. 1973) (SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), interpreted to hold that rule 10b-5 liability extends only to assertions made "in a manner reasonably calculated to influence the investing public . . . by means of the financial media.").

104. Draft No. 2, § 1403(g), Comment (11)(d). The limit is one percent (up to one million dollars) of gross income where the defendant has annual gross income over ten million dollars. Draft No. 2, § 1403(g)(2)(B).

105. The proposed Code draws a sharp distinction between the proscription of unlawful conduct, chiefly contained in Part XIII, and the delineation of damage liability in civil suits.
In other areas the proposed Code appears to include a concept of \textit{scienter}. Section 1406 imposes liability on any person who engages in "a deceptive act in connection with," or makes "a misrepresentation in . . . a press release or other form of publicity relating to an issuer," where the violation is "known" by the defendant.\footnote{Draft No. 2, § 1406(a).} Evidently, this section is intended to include annual and quarterly reports to stockholders. In this area, the Code is not quite clear regarding the auditor's specific areas of responsibility. Damages are confined to the plaintiff's out-of-pocket loss, subject also to the one hundred thousand dollars per defendant limit.\footnote{Draft No. 2, § 1418(b).}

The Code carefully provides in section 1418(b)\footnote{Draft No. 2, § 1406(c).} that a person shall not be found to have "aided and abetted" another unless he "substantially assists or induces" the other's conduct giving rise to liability under the Code with "knowledge" or reasonable grounds to believe that the conduct is a violation. This provision, as the comments indicate, should be of significant help to protect auditors contained in Part XIV. The SEC, when seeking a civil injunction or criminal penalties, generally is not required to prove scienter, but only that a "misrepresentation" or a "deceptive act" has occurred. Accordingly, the Code will provide limits governing civil damage recoveries only. See Draft No. 2, § 1404, Comment (1)(a).

\footnote{106. Draft No. 2, § 1406(a). A "deceptive act" is described in the comments to section 225, Draft No. 2, § 225, as an almost verbatim codification of the antifraud provisions of existing federal securities laws. See Draft No. 2, § 225, Comment (1). The term specifically includes acts that are "likely to deceive regardless of whether deception is intended." Draft No. 2, § 225(a)(3). This formulation would appear to allow court decisions, similar to those under rule 10b-5, that do not require scienter as a necessary element of a claim based on conduct toward a foreseeable class of persons. See, e.g., City Nat'l Bank v. Vanderboom, 422 F.2d 221, 229-30 (8th Cir., cert. denied, 399 U.S. 905 (1970); Myzel v. Fields, 385 F.2d 718, 734-35 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374, 379-80 (10th Cir. 1965); Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270, 274 (3d Cir. 1961); cf. SEC v. Van Horn, 371 F.2d 181, 185 (7th Cir. 1966). Ellis and Royal Air have been overruled effectively by White v. Abrams, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,457 (9th Cir. Mar. 15, 1974), which adopted a "flexible" standard of duty. See note 39 supra.}

\footnote{107. Draft No. 2, § 1406(c), contains appropriate cross-references to sections 1402(d)(1) and 1403(g)(2), which impose the liability limits. For discussion of the difficulties of determining what portion of an auditor's work on an annual or interim report is actionable under section 1406(c), see note 103 supra. The auditor's legal responsibilities in this area are not as well defined as they are under the Securities Act of 1933. See notes 33-36 supra.}

A "misrepresentation" is defined in section 259, with the result that, as the Reporter notes, "the \textit{scienter} element (if any) is extraneous to the prescription of the unlawful conduct itself . . . ." Draft No. 2, § 259(a), Comment (3)(c). The Code's current definition of "knowledge," contained in section 251A, Draft No. 2, § 251A, is to be rewritten to include only actual knowledge of the matter, and a new definition is to be added for the term "\textit{scienter}." Although they probably do not represent a final answer, these changes should make it easier to follow the manner in which traditional concepts of liability for misrepresentation have been adopted by the Code.
from "aiding and abetting" claims based on less than actual participation in the activity, since the commentary throughout numerous civil liability sections of the Code applicable to issuers makes it clear that those sections also will apply to "aiders and abetters." While substantial revisions are in process, the proposed Code contains many desirable features limiting auditors' liability, while accommodating the expanded function of the auditor's report that has been suggested.

**Conclusion**

As the law now stands, an auditor's responsibilities are not defined clearly. Judicial opinions and SEC rulings evidence a trend toward treating auditors in the exercise of their professional functions much the same as others engaged in a joint disclosure enterprise. The objective is to get disclosure that is not, on the whole, misleading to the average investor; auditors are just as responsible for achieving this objective as any other person involved in the process, regardless of the effect of devices that limit the scope of their actual engagement. Furthermore, a trend can be discerned to hold auditors and other professionals involved in disclosure to a higher than normal standard of care, on the theory that because they hold themselves out to the public as professionals, they should have a duty of care not to perform their function in a negligent manner. While perhaps laudable in principle, in practice this trend would seem to distort a wide variety of auditor-client relationships and lessen the profession's effectiveness as a responsible servant of business and the public.

If adopted, the proposals set forth in this Article should put the auditors, the courts, and the SEC on notice that the auditor's legal responsibilities are qualitatively no different from those of others who make representations in securities transactions, but that quantitatively they are different. Auditors should perform their engagement prudently to avoid misleading a foreseeable plaintiff and acknowledge publicly that the opinion issued with a financial statement should assist in determining that the statement is not misleading; they should be allowed as much space as they want to express the specifics of their concern about financial statements. Their exposure in damages, however, should be limited in some manner which permits them to function without excessive cost to

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109. See, e.g., Draft No. 2, § 1403, Comment (11)(g); id. § 1404, Comment (5)(b).
themselves and their clients, for "risk spreading" probably does not make sense where professional services are involved.

The profession is not trying to avoid its responsibilities; rather, it seeks only to clarify them, to determine what representations should be made in the report, what standards of disclosure should be set for financial statements, what professional procedures should be adopted to ensure that the representations and standards can be upheld, and what costs to assign to the task. These are legitimate matters of professional judgment, and it is certainly appropriate to allow that judgment to work for the best interests of all concerned.