Accountant's Liability: Past, Present, and Future

An Honors Thesis (ID 499)

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The accounting profession is in a constant state of change. New pronouncements and rulings are but a few of these changes. Perhaps one of the most striking developments in recent years in the accounting profession is the sharp increase in litigation against accountants. Many firms from the smallest to the largest have been affected by this increased litigation. The large number of civil as well as criminal cases against accountants and accounting firms in recent years has created an awareness of this development among accountants.

The auditor is affected most by this new atmosphere. He can no longer feel safe knowing he complied completely with generally accepted auditing standards. Even claiming that his audit is not intended to uncover fraud is not enough any more. The current legal environment creates more liability for the independent auditor than ever before. Practitioners who ignore this trend or who do not understand it may find themselves in a position where they cannot operate profitably.

This trend towards increased liability has been developing for many years. Court cases against accountants have continually challenged the standards of time, and through the years have changed these standards. The Securities and Exchange Commission, with its Acts of 1933 and 1934, has also played a major roll in increasing the
accountant's liability. What does this all mean for an accountant today?

An accountant in today's world must understand his rights, duties, and liabilities well in order to be successful. The best way to comprehend the legal climate today is to study the development of accountant's liability from its very beginnings. This thesis is a comprehensive study tracing the legal climate in accounting from the past to the present. Hopefully, this will enable the accountant to better understand this new era in accounting, and possibly allow him to anticipate future developments.

BEGINNINGS OF ACCOUNTING RESPONSIBILITY

The accounting profession in America is a relatively recent development. It wasn't until the late 1800's that Scottish and British accountants began to come to the United States to check on British investments in American industries.¹ The beginnings of accounting responsibility began before this, though, in England.

In 1844, England enacted the Joint Stock Companies Act, which established the basis of today's corporate entity.² Businessmen could create a corporation with transferable shares of stock. With this development came the problem of verifying the financial statements of these entities. Balance sheets were required to be filed with the government. Since distrust of businessmen has always seemed to exist, a need for verification arose.

In 1845, auditors were empowered to employ accountants
to assist them with their audits. Although auditors were required to be stockholders, distrust of directors was obvious in the fact that auditors could not hold any office in the company. Although these early auditors were not completely independent of the firms they audited, this directors rule could be a distant antecedent to today's auditing standard of independence.

These early audits were quite a bit different from today's sophisticated methods. They mainly consisted of reviewing vouchers to verify that disbursements were properly supported. Many people considered them a farce. These bookkeeping type audits had as their main purpose the detection of fraud. They relied mainly on checking the arithmetic and postings of the accounting records. For the most part, they were useless. The public, who was already suspicious of business, found little comfort in these early audits.

The public found even less comfort in 1856 when Parliament abolished their compulsory accounting and audit requirements. They left these matters to private concerns. For the next forty years or so, English corporations were left to police themselves. Slowly, Parliament began re-establishing audit requirements. Finally, in 1900, all companies registered under the Joint Stock Companies Act of 1844 were once again required to undergo an annual audit.
EARLY LITIGATION

Prior to 1900, several important court cases were decided which had an important impact on the liability of accountants. In 1887, the first English case against an auditor was brought to trial. In the case of Leeds Estate Building and Investment Co. vs. Shepherd, the duty of the auditor to go beyond merely verifying the arithmetical accuracy of the balance sheet was brought to question. In Leeds, a company formed to lend money on security, paid dividends to directors once a year. These dividends were restricted so that they could be paid only out of profits. Their manager prepared a balance sheet which overstated assets, and thus dividends were paid out of capital. In 1882, they went bankrupt.

An action for damages was brought against Leeds and its auditor by creditors. Locking, the auditor, contended that his only duty was to confirm that the balance sheet was a fair representation of the books of the company. In his report, he stated, "I certify that I have examined the above accounts and find them to be a true copy of those shown in the books of the company." The English courts, however, decided that an auditor is responsible for more than verifying the arithmetical accuracy of the balance sheet. In his decision, Justice Stirling stated:

It was in my opinion the duty of the auditor not to confine himself merely to the task of verifying the arithmetical accuracy of the balance sheet,
but to inquire into its substantial accuracy, and to ascertain that it contained the particulars specified in the articles of association (and consequently a proper income and expenditure account), and was probably drawn up, so as to contain a true and correct representation of the state of the company's affairs.

Thus, the auditor was held liable for damage resulting from payment of improper dividends.

This was a landmark decision. For the first time, an auditor was involved in a suit concerning his responsibility. The decision that an auditor is responsible for more than simply verifying mathematical accuracy set a precedent for future cases.

Another important case occurred just eight years later, in 1895. In the London and General Bank case, the question of the use of a "subject to realization" qualification in the auditors report was decided.11 Theobald, the auditor, made a full report to the directors of the London and General Bank concerning the state of their loans and securities. In his report to the stockholders, though, all that was mentioned about this was, "The value of the assets as shown on the balance sheet is dependent upon realization."12 Dividends were paid out of capital, and a suit was filed. Theobald was held liable on the grounds that he failed in his duty to communicate information. Had he disclosed the situation of the loans to the stockholders as well as the directors, his duty would have been fulfilled.

This case set an important precedent concerning the communication of information. It forewarned that an auditor
would be held liable for failure to communicate any material information which, through his investigation, he found to be questionable. He would not be responsible for exercising more than reasonable care, but he would be liable for anything less.

DEVELOPMENT OF LIABILITY IN THE UNITED STATES

Since Scottish and English auditors first started coming to the United States around 1900, the development of accounting liability in America has progressed rapidly. The corporate entity appeared in the United States between about 1837 and 1900 when most states passed laws permitting incorporation. With the growth of big business came the need for independent verification of financial statements.

The introduction of the corporation in America also brought about a change in accounting objectives. The purpose of accounting up to this time was to provide information for management. When the number of investors in corporate stock increased dramatically between 1900 and 1930, there was a push to provide more and better information for the investors. This opened up the auditing field and at the same time, exposed the auditor to increased liability.

The development of accountant's liability in the United States has followed two paths. Accountants can be liable under either common law or statutory law. According to Kent St. Pierre, "Common law evolves from judicial rulings
on matters of law in specific cases. Statutory law, enacted by the legislative branch of a government, may codify or change the common law with interpretations of the statutes. An accountant's liability may be different under common and statutory law, and to correctly study the development of this liability, common law and statutory law should be studied separately.

**COMMON LAW LIABILITY TO CLIENTS**

Under common law, an accountant's liability can be divided into two parts: (1) liability to clients and (2) liability to third parties. Liability to these two groups can often differ. Each must be studied separately to better understand the full scope of an accountant's liability under common law.

An accountant's liability to clients can be based on several different things. For one, he may be held liable for a breach of contract. Breach of contract is a "failure to carry out a duty created by mutual assent of the parties ..." In other words, if an accountant contracts with a company to perform an audit, then only finishes half of it, he would be liable for a breach of contract.

Also, an accountant can be liable for tort action for negligence. Tort liability is a "failure to carry out a duty created by either social policy or social policy and a contract." If an accountant fails to perform up to an expected standard, he may be liable for negligence.

Accountants have been held liable for negligence for
many years. Professional men who have special skills are responsible for a standard higher than the average man. Negligence is a deviation from this standard. As R. James Gormley states:

At common law, if the matter is one that requires investigation, the supplier of the information must exercise reasonable care and competence to ascertain the facts on which his statement is based. He must exercise the competence reasonably expected of one in his business or professional position in drawing inferences.... He must exercise reasonable care and competence in communicating the information so that it may be understood by the recipient....

In other words, an accountant is liable for negligence the same as any other professional person.

In order for negligence to exist, certain requisites must also exist. First, there must be a duty with respect to a standard of conduct. In this case, this would be the duty of the accountant to act with reasonable care. Second, there must be a failure to meet the duty. Third, there must be a causal connection between the negligence and the injury. Finally, an actual loss or damage to the plaintiff must have occurred. If all these requisites are met, a case for negligence may be established.

The accountant has several defenses for negligence. If the accountant can show that he followed established standards in good faith, then he may be able to prove that negligence did not exist. An accountant is only responsible for reasonable care, not correct judgement. If he uses reasonable care in his work and an error still occurs, he is not necessarily liable for negligence.
A second defense is if the accountant can show that his negligence was not the cause of the client's loss.\textsuperscript{23} The plaintiff has the burden of proving that he relied on the accountant's work, the accountant's work was negligent, and this negligence resulted in a loss. If this connection cannot be made, the accountant cannot be held liable.

Third, the accountant may be able to prove that the plaintiff's own negligence contributed to the loss.\textsuperscript{24} This "contributory negligence" defense is the hardest to prove. It must be quite clear that the plaintiff's own negligence contributed to the loss before a court will allow this defense. Since there have been few such cases so far, it is still uncertain how much this defense will aid the accountant.

Finally, if the accountant can prove that the plaintiff already recovered his loss from another source, the accountant will not be responsible for damages.\textsuperscript{25} The law allows the plaintiff to recover damages in full from only one party.

An auditor may be liable for fraud if it was his negligence which prevented his discovery of the fraud. Otherwise, he is not responsible for the detection of fraud. Kent St. Pierre states, "The courts have found that the auditor is not a guarantor, and an audit cannot be relied upon to discover fraud, especially if the fraud was immaterial."\textsuperscript{26} If a fraud exists, and the accountant was not negligent in his examination, he will not be liable for the fraud. An accountant's best defense for fraud is to use
one of the above negligence defenses and prove that negligence did not exist.

LITIGATION CONCERNING COMMON LAW LIABILITY TO CLIENTS

The first American case against an auditor concerned his liability to clients for negligence. In the case of Smith vs. London Assurance Corp., the question of an auditor's responsibility for fraud was first tackled. An employee of the plaintiff had embezzled a large sum of money. The auditor failed to uncover this in his examination. The plaintiff sued on the grounds that, had the auditor exercised reasonable care in his audit, he would have discovered the fraud. The court decided that the plaintiff was correct in his claim, and held the auditor liable for the embezzlement losses. This set the precedent for liability for fraud if the accountant's negligence was responsible for failing to detect the fraud.

Another case along these same lines occurred about thirty years later, in 1939. In the case of National Security Corp. vs. Lybrand, it was ruled that it is part of an auditor's duty to show the true financial position of the company, including the verification of cash. A cashier in the firm confessed to fraudulent activities over a period of years. Through "lapping" and "kiting", he had embezzled a large sum of money and was able to hide this from the auditor. The plaintiff sued on the grounds that if the auditor had verified the cash in bank, he would definitely have discovered the fraud. The court ruled that since cash
in bank can be verified absolutely, the auditor was negligent in not doing so. This upheld the concept of negligence and fraud as decided in Smith vs. London Assurance Corp. If an auditor is negligent, he can be liable for any errors in the financial statements which he missed.

**COMMON LAW LIABILITY TO THIRD PARTIES**

An accountant's liability to third parties under common law has undergone quite a few changes in the past few years. Originally, third parties were very limited in their ability to recover damages due to the lack of a contractual relationship between the third party and the accountant. Over the years, though, third party rights have slowly expanded. Today, accountants must be as aware of their liability to third parties as they are of their liability to clients.

First, it would be helpful to define what is meant by a third party and a client. A client, or primary beneficiary, is the identified person for whom services are performed. This would be the actual client whose business the auditor is examining. An accountant's liability to a primary beneficiary was discussed in the section preceding this one.

The next class of person is known as a foreseen person. A foreseen person is "one or more specifically identified persons or entities known by the auditor to be intended recipients, directly or indirectly, of the audit opinion for the purpose of reliance in a particular business transaction known to him." These people are not considered
a primary beneficiary and thus they do not have the same rights. A foreseen person might be a bank, whose decision to loan money is based in part on an audit of the business requesting the loan.

Another class of person is the foreseen class. The foreseen class is a "defined group, of any size, specifically identified to the auditor by class, although not known to him individually, any one or more of whom rely upon the auditor's opinion." This could be a group of banks interested in the audit for financing purposes, where the individual banks are not identified to the auditor. This foreseen class has the same rights against auditors as does a foreseen person.

The final class of financial statement users is foreseeable persons and classes. A foreseeable person or class is a person or large number of persons who, though unknown to the auditor, may receive an auditor's report and use it in some way or rely upon it. Their use of the report can "foreseeably" be expected. This could be a public investor, a supplier, or even an employee, just to name a few. An accountant is not liable to anyone in this class for negligent misrepresentation, although he would be liable for gross negligence or fraudulent misrepresentation.

In almost all cases of third party litigation against an auditor, the burden of proof lies with the plaintiff. In most instances, the plaintiff must prove that he suffered damages, that the financial statements were materially misstated, and that he relied on the audited statements and
suffered damage due to this reliance. If the accountant can disprove any of the above items, then he would not be liable for negligence to the third party.

The major defense for an accountant against litigation by a third party is known as due professional care. "Due professional care is in general, sufficient to establish no liability to third parties." It is established when an auditor performs the services with a level of skill expected of a reasonably prudent person possessing an accountant's training. Thus, an accountant's liability to third parties is limited to less than that of primary beneficiaries. Still, the threat of third party litigation exists.

LITIGATION CONCERNING COMMON LAW LIABILITY TO THIRD PARTIES

There have been many important cases involving third party suits against auditors. By studying some of these cases and following the decisions handed down, the development of third party liability can be traced from its very beginnings to current times.

The earliest case of third party beneficiary suing an accountant occurred in 1919. In Landell vs. Lybrand, the court decided that an accountant could not be held liable for negligence to a third party since there was no intent to deceive. Also, since the accountant had no contractual obligation to the third party, he could not be held liable. This case set the precedent in common law that an accountant is not liable to third parties for negligence if there was no intent to deceive. This allows the "due professional care" defense.
Another very important case was decided three years later, in 1922. The case of Glanzer vs. Shepard extended liability to third parties when the accountant knows that the third party, in this case a foreseen person, will rely on the accountant's report. A public weigher issued a report which was incorrect. They knew that the third party would rely on their report. The third party sued and the weigher was held liable for negligence. This opened the door to liability to foreseen third parties.

Perhaps the most important third party case ever occurred in 1931. In the case of Ultramares Corp. vs. Touche, the question of third party liability was once again confronted. Fred Stern and Co. hired Touche to audit its financial statements. After Touche issued its report, Ultramares Corp. made loans to Fred Stern and Co., relying on the audited financial statements as a true view of the company's financial condition. After it was learned that the audit had failed to discover significant fictitious accounts receivable and the company went into bankruptcy, Ultramares Corp. filed suit against Touche for negligence.

Judge Cardozo of the Court of Appeals ruled that accountants owed no duty to third parties to perform without negligence. They would be liable, though, for fraud. In his decision, Judge Cardozo said:

Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud. It
does no more than say that, if less than this is proved, if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made. We doubt whether the average businessman receiving a certificate without paying for it, and receiving it merely as one among a multitude of possible investors, would look for anything more.

This landmark decision set the precedent for years to come that an auditor could be held liable for ordinary negligence to primary beneficiaries, but not third party beneficiaries. Third parties can only sue for intentional misrepresentation.

The Ultramarines decision was extended in the 1938 case of State Street Trust Co. vs. Ernst. In this case, the court established third party liability on the basis of gross negligence instead of fraud. St. Pierre states, "The result of Ultramarines and State Street Trust was that 'heedlessness' and reckless disregard of consequences substituted for deliberate intention and created a liability to third parties." In other words, liability to third parties had been extended beyond fraud to include gross negligence. This made the auditor liable for more to third party beneficiaries.

A more recent case has extended third party liability even further, and confirmed the precedent set in Glanzer vs. Shepard. In 1955, the case of C.I.T. Financial Corp. vs. Glover extended an accountant's liability for ordinary negligence to third parties when the reports are for the primary benefit of the identified third party.
when the third party is identified, and is the primary beneficiary of the audit, can an accountant be liable to a third party for ordinary negligence.

STATUTORY LIABILITY

Accountants may be liable for their actions under statutory law as well as common law. While common law is developed from judicial rulings and precedents, statutory law is laws which are enacted by the legislative branch of government. Most of the statutory law which concerns accountants is formulated by the SEC, a commission established to foster honest and open securities markets. There were attempts to regulate the securities market before the SEC, but none were extremely successful.

The first regulation of the securities industry occurred in 1911 in Kansas. These laws, known as blue sky laws, originally "relied on some combination of antifraud and registration provisions to accomplish their goals." The antifraud provisions allowed criminal sanctions on people found guilty of fraudulent purchases or sales of securities. The registration provisions, on the other hand, attempted to limit the types of transactions that could legally occur. These blue sky laws were enacted to protect the public from securities scandals which were increasingly becoming a problem.

Many states enacted blue sky laws within the next twenty years. Unfortunately, none were extremely successful. This failure has been attributed to four causes.
First, the blue sky laws, as originally written, were poorly constructed and administered. Second, the laws were not adequately enforced. A lack of funds on the part of the state was often the cause. Third, many of the laws had big loopholes as written. There were so many exemptions allowed that they were ineffective. Finally, since these were state laws, anyone operating on an interstate level could effectively avoid them. In short, the blue sky laws were not very effective in regulating the securities market.

As the need for security regulation increased, the federal government began studying the problem. The result was the Securities Act of 1933 and 1934. It was under the Securities Act of 1934 that the Securities and Exchange Commission was formed.\(^{47}\) The SEC was established to insure that all material facts concerning securities were fully disclosed, and they were given the authority "to regulate and to prescribe the form, content, and compilation process of financial statements and other reports."\(^ {48}\) Obviously then, the SEC has had a large impact upon the accounting profession.

It is from the Securities Act of 1933 and 1934 that an accountant's statutory liability comes. The Securities Act of 1933 was initiated with two basic objectives in mind.\(^ {49}\) First, it strives to provide investors with financial information on new securities offered to the public. Second, it attempts to stop fraudulent acts in the sale of securities. Since accountants are involved with the financial statements of security offerors, this act has had an effect on accounting
liability.

Under the 1933 Securities Act, when registering a security, financial statements which are certified by an independent public accountant must be submitted to the SEC. This opens up the accountant to liability to any purchaser of securities. All that a purchaser of a security must prove to establish liability is that the financial statements contained false statements or misleading omissions. If this can be proved, the accountant is liable to that purchaser.

If, however, the accountant can show that after reasonable investigation he believed the financial statements to be true, or that the plaintiff's damages were a result of causes other than the false statements or omissions, he will not be held liable for the damages. This differs from the common law wherein the plaintiff, not the defendant, has the burden of proof. Thus, an accountant can be liable for negligence to any purchaser of securities.

While the Securities Act of 1933 focused on new security offerings, the Securities Act of 1934 dealt with securities already traded on the national market. The 1934 Act was established to regulate the securities. This is accomplished in part by requiring reports and statements from the issuers of these securities. Since accountants are involved in the preparation and review of these reports, they can be held liable for them.

The main threat of liability to the accountant under
The 1934 Act is Section 18. It reads in part:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation there under or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.54

Thus, under the 1934 Act, the burden of proof is with the plaintiff. He must prove that he relied on the misstated financial statements, and that this reliance was the cause of the damages. All the accountant must show to avoid liability is that he acted in good faith with no knowledge that the statements were misleading. It is easier for an accountant to avoid liability under the 1934 Act than under the 1933 Act.

The Securities Act of 1934 also established the SEC. The SEC has had a significant influence on the accounting profession. While they do not formulate auditing standards and procedures, the SEC motivates the accounting profession to correct its deficiencies by reviewing some cases.55 In 1947, because of problems with the difference between auditing standards and auditing procedures, the SEC suggested to the American Institute of Accountants that a distinction
be made. The AIA promptly released "Tentative Statement of Auditing Standards." These original standards are still followed today.

**LITIGATION CONCERNING STATUTORY LIABILITY**

An important case in the study of statutory liability would be Escott vs. Barchris Construction Corp. Barchris Construction sold securities to the public and went into bankruptcy shortly afterwards. Purchasers of the securities sued based on material false statements and material omissions in the registration statement. The court found the auditor liable under the Securities Act of 1933. It said that he failed to prove "due diligence" in his audit, and was thus liable for damages to the purchasers of the securities.

Perhaps the most important statutory liability case ever brought to light is the McKesson & Robbins case. On December 5, 1938, a federal judge granted a petition for appointment of a receiver for McKesson & Robbins, Inc. They had included in their assets fictitious inventories and accounts receivables in excess of $10 million. The 1937 financial statements had been audited by Price Waterhouse & Co. Action was brought against McKesson & Robbins and its auditors by one of the stockholders. The case against the auditors was settled without litigation when over $500,000 in audit fees was returned to McKesson & Robbins by Price Waterhouse & Co.

The SEC immediately conducted an investigation of the
McKesson & Robbins case. Its findings stressed four major points. First, it found that Price Waterhouse & Co. did not employ the degree of professionalism necessary in an audit. If it had, the fraud should have been discovered. Second, it stated that the major purpose of an audit is the discovery of gross overstatements in accounts. Third, the SEC recommended that auditors be elected by stockholders and that nonofficer board members make all nominations of auditors. Finally, it commended the accounting profession for the adoption of Statement on Auditing Procedures No. 1. SAP No. 1 requires physical observance of inventories and confirmation of receivables. The results of the McKesson & Robbins case improved auditing standards and procedures for years to come.

CURRENT TRENDS AND DEVELOPMENTS

It would appear that accountants today are facing more liability to the public than ever before. K. Fred Skousen states, "there has been a general trend during the past ten years towards increasing legal action that attempts to hold companies and those associated with them, including accountants, liable to the consuming public." It seems that accountants are held responsible for more than ever.

Accountants in the bank auditing field are finding this true. Where bank audits used to be relatively easy, they are considerably tougher nowadays. It use to be a breeze to value the bank's loan portfolio. Now, with many recent bank failures, the auditor must be very careful in evaluating
a loan's credit worthiness. In March of 1984 alone, the Federal Deposit Insurance Corp. considered court action against five accounting firms who were involved in the audits of six banks that later failed.63 In December, the FDIC sued Peat, Marwick, Mitchell & Co. for an improper audit of the failed Penn Square Bank.64 Obviously, the accountant must use extreme caution when working with a bank these days.

Recent court rulings have also changed other areas of accounting liability. Recently, courts have held that "recklessness by auditors establishes liability."65 This is a change from earlier common law decisions. A limit on confidentiality has also surfaced recently.66 Accountants have a fiduciary responsibility to keep client information confidential. With the recent rise in consumerism, the limits on confidential information has been tightened.

Courts have also broadened their common law rulings on other issues. Liability to third parties under common law for negligence has been expanding. Third person plaintiffs are also being considered primary beneficiaries in some cases.67 Also, since federal rules relating to class action suits have been relaxed a bit, suits against accountants are easier to start. All in all, these developments have placed more liability against accountants.

This increased liability is evident in the large increase in court cases recently. Jonathan J. Davies points out, "A survey conducted over the 1966-1967 period concluded that there were between eighty and 100 cases pending,
involving damages of no less than $20 million." This is quite a large number of cases against accountants for only one year.

Another survey of court cases against accountants gives yet another clue as to the increase in liability recently. During the 1960's and 1970's, the greatest number of lawsuits against auditors in the history of the profession occurred. There were as many lawsuits filed against accountants in 1968 as there were in the previous twelve years combined. Although an auditor's responsibility often depends on which court the case is tried in, this statistic alone is enough to frighten the most prestigious accountants around.

The Securities and Exchange Commission has played a role in this increase in liability. According to Jill Andresky, "Over the past five years...the SEC has found nine accounting firms—industry giants as well as little known practitioners—guilty of accounting improprieties." The usual cause is failure on the part of the accounting firm to follow Generally Accepted Accounting Standards. One such recent case was the Coopers and Lybrand/Digilow dispute. After the SEC found error in Coopers and Lybrand's audit of Digilow, Inc., the accounting firm reached a settlement without challenging the findings.

Not all accounting firms have been able to reach such a simple settlement. Sometimes the SEC must use its authority to punish a firm. The usual punishment given out by the SEC is censure, a written reprimand. This may only
be a minor punishment, but it can clearly hurt an auditor's business. In April of 1984, the SEC decided to censure the accountants in Fox & Co. who were involved with an audit of Alpex Computer Corp. They accepted the punishment without admitting or denying the charges. It is in this type of atmosphere that an accountant must operate today.

What will be the effect of this current legal environment? Already the effects can be seen. Recently, an independent commission established by the American Institute of Certified Public Accountants to study an auditor's responsibilities reported on the current legal climate and its effects on the accounting profession. In their conclusions, they stated, "Legal penalties and public disclosure of them have clearly spurred the profession and firms to reexamine and strengthen technical standards and compliance with them." From this point of view, the legal environment has been beneficial to the accounting profession. It has motivated the profession to try to improve itself.

Not all of the effects of this growth in liability have been beneficial, though. It has also had a negative effect to some degree. Auditors may be reluctant to accept expanded responsibilities which could bring about greater legal liability. New areas, such as forecasting, which could expose the accountant to more liability are being viewed with caution. Accountants are wondering if it is in their best interests to deal with these potentially problem areas.

Two further effects of the current legal climate have
been suggested by the AICIA, although it is unclear whether they actually exist or not. First, since many of the court cases have involved financially distressed businesses, auditors may be reluctant to accept marginal companies and new ventures as clients. They may be content to continue with the business they already have. Also, wasteful "defensive auditing" is taking place to a certain degree. Auditors are performing procedures only to provide a defense in case of later litigation. Neither of these items has a very healthy effect on the accounting profession.

One further effect on accounting has not made accountants very happy. With the recent increase in litigation against accountants, liability insurance rates have soared. Carl D. Liggio, general counsel for Arthur Young & Co. has said that insurance rates for accounting liability may double by the middle of 1985. This means large increases for most accounting firms. Already, the average deductible for a Big Eight firm carrying legal insurance is over $1 million per lawsuit. This all adds up to increasing legal expenses for accountants today.

CONCLUSION

Accounting liability has grown tremendously in the past century. We have moved from "let the buyer beware" to required disclosure of all material information. Where accountants could simply test the arithmetical accuracy of the financial statements before, now they must carefully examine much more, from physical inventories to accounts
receivables. Also, an accountant's liability to third parties has grown from liability for fraud to liability for anything short of "due diligence." Today, the auditor has much more to worry about in a legal sense.

What does all this mean for the accountants of the future? If these current trends towards greater liability continue, accountants will have to work increasingly harder to tighten their standards and adherence to them. It appears that accountants will continue to be exposed to more liability to more people than ever before. Liability insurance rates are on the rise. All indicators point towards increased liability. No one can accurately predict what the future will hold, but it appears that the future of the accounting profession will see an ever increasing liability to the public.
NOTES

2. Causey, p. 11.
3. Causey, p. 11.
4. Causey, p. 11.
5. Causey, p. 11.
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