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THE DELINEATION OF ACCOUNTANTS' LEGAL LIABILITY TO THIRD PARTIES: BILY AND BEYOND

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INTRODUCTION

In August 1992, in a rare display of unity designed to influence public opinion, the heads of the six largest ("Big Six") U.S. firms of certified public accountants ("CPAs") issued a position statement that decries the current state of accountants' legal liability. In addition, the Big Six, the American Institute of Certified Public Accountants ("AICPA"), and several statewide CPA societies are lobbying for changes in state and federal laws. Among the proposals suggested are (1) enacting federal laws that regulate securities transactions to replace joint and several liability with proportionate liability, (2) requiring plaintiffs to pay the defendant's legal fees in meritless suits, and (3) prohibiting third par-

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** Wilsey Meyer and Company, P.C.
2 J. Michael Cook et al., The Liability Crisis in the United States: Impact on the Accounting Profession, J. Accr., Nov. 1992, at 19 [hereinafter Liability Crisis]. In addition to Mr. Cook, the chairman and chief executive officer of Deloitte & Touche, the statement was signed by Eugene M. Freedman, chairman, Coopers & Lybrand; Ray J. Groves, chairman, Ernst & Young; Jon C. Madonna, chairman and chief executive, KPMG Peat Marwick; Shaun F. O'Malley, chairman and senior partner, Price Waterhouse; and Lawrence A. Weinbach, managing partner and chief executive, Arthur Andersen & Co. Id.

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ties, such as stock brokers, from receiving payments for referring plaintiffs to attorneys.\textsuperscript{4} Efforts are also being made to remove legislative, regulatory, and professional restrictions that prohibit CPA firms from operating as limited liability organizations.\textsuperscript{5}

One of the main goals of those who seek a legislative remedy to the "liability crisis" is replacing joint and several liability with proportionate liability as the basis for assessing damages. The efficacy of this approach is questionable. Assuming proportionate liability replaced joint and several liability as the basis for assessing damages, accountants would continue to confront the threat of litigation whenever third parties incurred financial losses. Plaintiffs are likely to argue that their reliance on accounting information, such as an unqualified audit opinion, formed the principal basis that motivated the plaintiffs to make their investments or loans. Rather than focusing on liability, one should first address the standing of third parties to bring suits alleging auditor negligence.

In the analysis that follows, this Article argues that the 1992 California Supreme Court's decision in \textit{Bily v. Arthur Young \& Co.}\textsuperscript{6} provides a standard for determining auditors' liability to third parties that is fair to both plaintiffs and defendants. The \textit{Bily} court held that the liability of accountants for general negligence in conducting an audit of its client's financial statements is confined to the client.\textsuperscript{7} Only when accountants make negligent misrepresentations to specifically intended recipients of their services does the potential for liability to third parties for negligence arise.\textsuperscript{8} \textit{Bily} is important because it rejects the expansive interpretation of auditors' liability for negligence to third parties under the foreseeability standard\textsuperscript{9} the court had previously embraced.\textsuperscript{10}


\textsuperscript{5} See Liability Crisis, supra note 2, at 23.

\textsuperscript{6} 834 P.2d 745 (Cal. 1992).

\textsuperscript{7} \textit{Id.} at 767.

\textsuperscript{8} \textit{Id.}

\textsuperscript{9} Under the foreseeability standard, discussed in detail in the analysis of common law precedents, infra note 84 and accompanying text, auditors' liability for negligence extends to third parties whom the auditor could reasonably foresee as recipients of the audited financial statements.

\textsuperscript{10} \textit{Bily}, 834 P.2d at 774; see International Mortgage Corp. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986).
In the absence of restrictions on the standing of third parties to sue auditors for negligence, auditors bear many of the risks of business failure. Part I of this Article provides support for this assertion and discusses the impact risk shifting has on the practice of accounting and the availability of investment capital. We also present the profession's position on the limitations of auditing procedures for evaluating management ability and honesty and for predicting business success or failure. Next, we trace the course of legal precedents in defining accountants' liabilities to third parties. Based on judicial interpretation of section 552 of the Restatement (Second) of Torts, and common-law cases, we conclude that Bily appropriately confines auditor liability for negligence to clients and specifically intended third parties. Finally, we argue that developing improved procedures to meet accountants' obligations to third parties, as defined by Bily, will serve both the accounting profession and the public. We discuss proposals offered by the Public Oversight Board ("POB") of the AICPA and endorsed by the AICPA board of directors, which have the potential for improving the audit process and better defining the assurances that audited financial reports provide.

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11 See Public Oversight Board, SEC Practice Section, In the Public Interest: Issues Confronting the Accounting Profession (1993) [hereinafter Public Interest]. The Public Oversight Board ("POB") is an independent board that the AICPA created in 1977 to oversee and report on the AICPA Peer Review Program. See The Mandatory SECPS Membership Vote, J. Acct., Aug. 1989, at 42. As of 1990, the AICPA has required that firms auditing SEC clients be members of the SEC Practice Section and participate in triennial reviews by the Peer Review Committee ("PRC"). Public Interest, supra at 16. The Quality Control Inquiry Committee ("QCIC") examines the quality controls of firms against whom allegations of audit failure have been made. Id. If deficiencies are found, the Executive Committee of the SEC Practice Section can impose sanctions such as requiring that the firm take corrective measures and provide additional continuing professional education for firm members. Id. at 79. It can accelerate or require special peer reviews, issue admonishments, censures or reprimands, suspend the firm's membership in the SEC Practice Section, and expel the firm from membership in the AICPA.

The members of the POB select successive members, hire and compensate its staff, set the compensation of the members, and choose the chairman. The present members are A. A. Sommer, Jr., chairman, Robert K. Mautz, vice chairman, Melvin R. Laird, Paul W. McCracken, and Robert F. Froehlke.

I. THE IMPACT OF LITIGATION ON THE ACCOUNTING PROFESSION

According to the Big Six and several commentators, unprecedented numbers of investors and creditors who experience economic losses are turning to the courts to recover their funds. In addition, as guarantor of the obligations of savings and loan institutions ("S&Ls"), the federal government is suing the former auditors of S&Ls that are now defunct. By the time guarantors, creditors, and investors seek legal redress for their losses, those who received the funds, either failed S&Ls or other business entities and their officers and directors, are frequently bankrupt or have modest assets. Although independent CPAs, unlike the borrower or recipient of invested funds, seldom play a direct role in business failures, the accounting firms are solvent and are perceived as "deep pockets" from which to recoup losses. In the past two years, litigation-related expenditures by the Big Six increased by fifty percent and are now equal to eleven percent of U.S. auditing and accounting revenues. The Big Six claim that the poten-

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15 PUBLIC INTEREST, supra note 11, at 5.


17 Stephen H. Miller, AICPA Announces Major Initiative to Strengthen Financial Reporting and Further Tort Reform Prospects, J. Acct., Aug. 1993, at 15-16 (citing J. Michael Cook, chairman and chief executive officer of Deloitte & Touche); see also Liability Crisis, supra note 2, at 20. Including the cost of legal services, settlements, judgments, and liability insurance premiums, less insurance reimbursements, litigation-related costs incurred by the Big Six in 1991 were $477 million, 9% of audit and accounting revenues in the United States. Id. In 1990, the figure was $404 million, 7.7% of revenues. Id.
tial for excessive damage assessments often makes it economical to settle with plaintiffs, rather than defend themselves in jury trials.¹⁸ In November 1992, for example, Ernst and Young agreed to a $400 million settlement with federal bank and thrift regulators to satisfy all current and potential claims relating to Ernst and Young's audits of depository institutions that failed during the past ten years.¹⁹ Today in the United States, there are an estimated $30 billion in damage claims outstanding against all professional CPAs.²⁰

Litigation is creating a financial burden that more and more CPAs are either unable or unwilling to bear. In 1990, Laventhol & Horwath, formerly the seventh largest CPA firm in the United States, declared bankruptcy. The firm faced liability claims totaling $2 billion and the cost of defending those claims in court. The former partners agreed to pay $48 million as part of the liquidation of the firm in order to avoid personal bankruptcy.²¹ In 1992, Pannell Kerr Forster closed or sold approximately ninety percent of its offices, and its principals formed individual professional corporations. Legal liabilities under the partnership mode of organization contributed to the dissolution of the firm.²²

Insurers consider accountants' liability insurance to be among the more risky lines of business, and in recent years, they have abandoned or sharply curtailed the coverage they offer, sometimes by as much as 25%.²³ Although insurers reduced the protection

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¹⁸ See Liability Crisis, supra note 2, at 20 (noting possibility of jury awarding twenty times settlement amount); Auditor's S&L Tab is $82 Million, Bus. Ins., Aug. 9, 1993, at 22. Arthur Andersen & Co. agreed to pay the Resolution Trust Corp. $82 million to settle all charges that negligent audits contributed to the collapse of several thrifts, the largest of which was the 1989 failure of Houston-based Benjamin Franklin Savings Association. Id.; Paul Geoghan, Punitive Damages: A Storm over the Accounting Profession, J. Accr., July 1992, at 46. Although the parties ultimately settled for an undisclosed amount, a Texas jury assessed punitive damages in the amount of $200 million against Coopers & Lybrand for allegedly conducting faulty audits and approving false financial statements. Id. at 47.


²⁰ Liability Crisis, supra note 2, at 20.


²² Liability Crisis, supra note 2, at 21; see also Kathy Seal, PKF Partners Push Ahead, HOTEL & MOTEL MGMT., Jan. 13, 1992, at 13 (reporting new consulting group forming in attempt to "abandon a sinking ship").

²³ See Dan Goldwasser, Policy Considerations in Accountants' Liability to Third Parties for Negligence, 3 J. ACCT., AUDITING & FIN. 217, 226 (1988). Underwriting practice and insurance regulations typically require that the amount of insurance premiums accepted be limited to a multiple of the insurer's capital. The ratio is be-
provided for professional liability during the period from 1985 to the present, they increased policy premiums by large amounts. In 1985, for example, the largest accounting firms had their coverage cut from approximately $200 million to $100 million.24 A 1992 AICPA survey of firms other than the Big Six indicates that in 1991, public accounting firms paid liability insurance premiums that were three hundred percent higher than the premiums paid in 1985. During this same period, deductibles increased from a median $42,000 to $240,000.25 The AICPA survey also indicates that forty percent of firms, excluding the six largest, decided against carrying professional liability insurance as a result of the high cost of premiums.26 For the six largest firms, premium increases were higher than for other CPA firms, and in 1992 the deductibles exceeded $25 million for the first loss.27

To reduce the risk of exposure to litigation, accounting firms have restricted their auditing practices. The Big Six have begun avoiding clients in high-risk categories such as banking, insurance, real estate, high technology, and mid-size firms in general.28 In California, thirty-two percent of small and medium-size accounting firms are discontinuing audits in high-risk sectors.29 A survey conducted by insurance broker Johnson & Higgins found that fifty-six percent of mid-sized CPA firms will not do business with clients in high-risk industries.30 As Richard C. Breeden, former chairman of the Securities Exchange Commission (“SEC”) ac-

tween 2 1/2 and 5 to 1, with the higher ratios allowed for the lower risk lines, e.g., fire and marine, and the lower ratios for the higher risk categories, e.g., professional liability. Id. at 226 n.30. From 1985 to 1987, when confronted with market losses on investments and high insurance claims, insurers faced capital reserves that were at the limit for the amount of premiums collected. In order to correct this situation insurers reduced the number and value of policies in high risk categories. Id.

24 Id. at 226.
25 See Liability Crisis, supra note 2, at 20.
26 Id. at 21 (choosing not to insure is known as “going bare”).
27 Id.
28 Liability Crisis, supra note 2, at 22; see also Hill & Metzger, supra note 14, at 329-31.
29 Id.; see Michael Bradford, E&O Insurance for Accountants, Costly, Plentiful, Bus. Ins., Oct. 8, 1990, at 82. The Johnson & Higgins survey results are based on 500 telephone interviews of CPAs at mid-sized firms (over 50 accountants and not among Big Six) across the nation; see also Lee Berton, Legal-Liability Awards are Frightening Smaller CPA Firms Away From Audits, WALL St. J., Mar. 3, 1992, at B1 (reporting many firms turning down auditing work); Mariann Caprino, Lawsuit-Wary CPAs Screening Potential Clients to Avoid Risk, Chi. TRIB., Nov. 19, 1990, at 5 (stating that accountants are now more selective in choosing clients).
knowledged, this disturbing trend affects both accounting practitioners and the U.S. economy as a whole.\textsuperscript{31} Small and medium-sized businesses are responsible for most employment growth and often need the services of CPAs to gain access to potential creditors. High-technology businesses contribute to U.S. competitiveness in world markets, but they are also high risk. When their share prices decline, these businesses and their CPAs often become defendants in lawsuits initiated by stockholders. This results in higher costs of funds, fewer initial public offerings ("IPOs"), and slower growth in an important sector of the economy.\textsuperscript{32}

Expectations that an unqualified audit opinion guarantees a fail-safe investment are unrealistic.\textsuperscript{33} CPAs issue opinions on financial statements which are the product and responsibility of company management.\textsuperscript{34} CPAs are hired by management to examine the company’s books and records to determine whether management’s representations fairly present the results of operations and the financial position of the company in accordance with

\textsuperscript{31} Liability Crisis, supra note 2, at 22 ("At some point, these increasing litigation costs will increase the cost of audit services and tend to reduce access to our national securities markets.") (quoting letter from SEC Chairman Richard C. Breeden to Rep. John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (May 5, 1992)).

\textsuperscript{32} See S. P. Kothari et al., Auditor Liability and Information Disclosure, 3 J. Acct., Auditing & Fin. 307, 328-31 (1988) (discussing empirical studies that provide support for these conclusions). The authors’ own time-series analysis, however, did not support the hypothesized association between increased auditor liability and fewer IPOs. \textit{Id.}

\textsuperscript{33} See SEC v. Arthur Young, 590 F.2d 785, 788 (9th Cir. 1979). The court rejected the SEC’s argument that audited financial statements should reveal the financial risks that investors presently bear or might bear in the future if they invested in the audited company. \textit{Id.} at 787-88. In rejecting the SEC position, the court noted that such a requirement “would go far toward making the accountant both an insurer of his client’s honesty and an enforcement arm of the SEC.” \textit{Id.} at 788; see also George H. Sorter et al., Accountant’s Legal Liability: A Determinant of the Accounting Model, 3 J. Acct., Auditing & Fin. 233, 233-44 (1988) (proposing “tiered” liability system that distinguishes between risks arising from accountants’ failure to exercise due care (which accountants should bear) and risks inherent in financial marketplace (which investors and management should bear)). The authors argue that the existing legal liability system provides incentives for accountants and management to withhold information, such as sales projections, that could reduce financial risk. \textit{Id.} Under the current legal system, such nonmandatory disclosures would inevitably increase litigation when projections, which are necessarily based on estimates, fail to be realized.

\textsuperscript{34} CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, § 110.02 (Am. Inst. of Certified Pub. Accountants 1993) [hereinafter Auditing Standards are designated with “AU,” followed by a section number and page number, e.g. AU § 110.02, at 19].
generally accepted accounting principles ("GAAP"). Limitations inherent in an audit are numerous. First, the examination is based on selective testing of the data because the cost and time required to examine all data outweigh the benefits. Second, many items reported in financial statements are estimates of amounts that depend on the outcome of future events, such as the net realizable value of inventory or accounts receivable. Third, management can override internal controls, fail to record transactions that the auditor may be unable to detect, or collude with others to conceal misstatements or irregularities. And fourth, subjective judgments of materiality are critical to the auditor's evaluation of whether financial statements follow GAAP. An audit report is not a simple statement of verifiable fact that can be measured against uniform standards of indisputable accuracy. Given the uncertainties inherent in the auditing process, it is unreasonable to expect that a CPA's unqualified opinion on a company's financial statements is a warranty against fraud or mismanagement on the part of the company's management.

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35 Id. § 411.05, at 310. Generally accepted accounting principles ("GAAP") include accounting principles and procedures, customs, expert judgment, formal accounting standards, and materials written by accountants.

36 Id. § 350.07, at 279.

37 Id. § 342.01, at 267.

38 Id. § 316.03, at 75. Section 316.07 of the ALCPA Codification of Statements on Auditing Standards Comments:

Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is an auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

§ 316.07, at 16.

39 Materiality is the auditor's estimation of the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, would make it probable that the judgment of a reasonable person relying on the information would have been changed or influenced. QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, 68-71 (Fin. Accounting Standards Bd. 1992/93). Estimations of materiality are the basis for determining the type and amount of evidence required to corroborate management's financial statement representations. AU § 326.11, at 154; AU § 350.21, at 282.

40 Bily v. Arthur Young & Co., 834 P.2d 745, 762 (Cal. 1992) ("An auditor is a watchdog, not a bloodhound."). Because management is responsible for and directly controls the preparation of the financial statement to be used in an audit, an auditor cannot, in the limited time available, become an expert in the client's business. Therefore, indisputable accuracy cannot be attained. Id.
In the following analysis, this Article reviews the common-law basis for accountants’ liability to third parties for professional negligence. 41 According to the Big Six, the greatest liability exposure resides in states in which cases are brought under common law theories or specific state laws. 42 Common-law precedent, therefore, is extremely important in defining accountants’ liability.

II. COMMON LAW AND ACCOUNTANTS’ LEGAL LIABILITIES TO THIRD PARTIES FOR PROFESSIONAL NEGLIGENCE

In providing professional services, accountants may incur legal liabilities for negligence, fraud, and the violation of federal and state statutes. Liabilities arising under federal statutes in connection with the registration or sale of publicly traded securities are beyond the scope of this Article. 43 Similarly, other federal and state statutory provisions are not encompassed in this analysis. 44

To find a defendant liable for fraud, a plaintiff must show that (1) the defendant made a false representation of material fact; (2) the defendant intended to induce the plaintiff to act; (3) the defendant made such representation with knowledge that it was

41 This Article is limited to the typical case in which an auditor’s liability for negligence to third parties is alleged. In such a case, plaintiffs assert that had the auditor not been negligent in the conduct of the audit, material misstatements or omissions in the audited financial statements or other financial information would have been detected. Typically, financial statements are prepared by the auditor’s client, and the auditor attests to their material accuracy. In the usual case, the client (the corporation or other business entity, officers or directors, or employees) is alleged to have acted negligently or fraudulently in providing financial information. It is the auditor’s negligence, however, rather than his or her knowledge of the misstatement (scienter), which is the subject of the litigation.

42 See Liability Crisis, supra note 2, at 23. Of the total cases pending against the Big Six in 1991, only 30% claimed Rule 10b-5 violations, which are violations of federal securities laws. Id. Of that 30%, less than 10% were exclusively Rule 10b-5 claims. Id.


44 See id. Since 1985, legal actions against accountants have been brought under the federal Racketeer Influenced and Corrupt Organizations Act of 1970 (“RICO”), 18 U.S.C. §§ 1961-1968 (1988). Id.; see also Hill & Metzger, supra note 14, at 267 n.29. Auditors are defendants in numerous suits brought by the FDIC in connection with the failures of savings and loan institutions. Id.
false or without knowledge of its truth or falsity, but that the plaintiff reasonably believed it was true; and (4) the plaintiff relied on the representation to his detriment.\textsuperscript{45} The knowledge requirement is satisfied if the plaintiff can show that the representations were made with reckless disregard for their truth or falsity.\textsuperscript{46} Moreover, accountants may be held liable not only to their clients but also to reasonably foreseeable third persons for intentional fraud in the preparation and dissemination of an audit report.\textsuperscript{47}

In contrast to the case law involving fraud, judicial decisions vary greatly when the issue is accountant liability to third parties for negligence or negligent misrepresentation. The following analysis discusses the application of the privity requirement, the foreseeability standard,\textsuperscript{48} and section 552 of the Restatement (Second) of Torts.

A. Privity Standard

Traditionally, professional liability arose pursuant to the doctrine of privity, which was derived from a classic enumeration of the rationale in Winterbottom v. Wright.\textsuperscript{49} According to Winterbottom,
tom, only parties to the contract have enforceable rights under that contract. In *Savings Bank v. Ward*, the Supreme Court created two exceptions to the privity requirement: fraud and acts that are "imminently dangerous" to the lives of others.

In 1916, *MacPherson v. Buick Motor Co.* eliminated the privity defense in product liability cases involving third parties. MacPherson sued when he was injured as a result of the collapse of a defectively manufactured wheel on his Buick automobile. Buick Motor Co. claimed lack of privity, but the court rejected the defense and adopted a tort-based liability concept. The duty stemming from tort-based negligence is a general duty owed to all those who may use one's products or services. This differs from the duty arising from a contract-specific obligation, which is owed only to those with whom one has contracted. Although tort-based liability for negligence that results in physical injury was recognized in *MacPherson*, the courts have been reluctant to extend this liability to cases in which damages were entirely economic in nature.

In *Glanzer v. Shepard*, Judge Cardozo tacitly rejected the privity defense against charges of negligence brought by certain narrowly defined third parties. The plaintiff in *Glanzer* sought monetary damages for an overpayment that arose out of a faulty weight certification by the defendant, a public weigher. The court held that privity was not required because the third-party reliance on the certificate was the "end and aim" of the transaction. For liability to third parties to arise under *Glanzer*, how-

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60 100 U.S. 195 (1879).
61 Id. at 205-06.
63 Id. at 1051.
64 Id. at 1053.
65 See RESTATMENT (SECOND) OF TORTS § 552 cmt. a (1977); W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 100, at 707-08 (5th ed. 1984); see also Onita Pacific Corp. v. Trustees of Bronson, 843 P.2d 890, 908-09 (Or. 1992) ("Negligence liability . . . is based on a paradigm which is fundamentally different than that on which contract liability is predicated. . . . [T]he scope of liability is . . . determined by the reasonably foreseeable consequences of one's actions and by considerations of policy that at times limit the scope of the liability.").
67 135 N.E. 275 (N.Y. 1922).
68 Id. at 276.
69 Id. at 275.
70 Id.
ever, the contracting party must know that his or her services are intended for the use of the third parties.\(^\text{61}\) In addition, the contracting parties control the extent of the duty and thus, the extent to which they are liable to third parties for their losses.

In *Ultramares Corp. v. Touche*,\(^\text{62}\) Judge Cardozo further defined the requirements under which liability to third parties may arise. The plaintiff in *Ultramares*, extended credit to Fred Stern & Company, Inc. ("Stern"), Touche’s audit client, in reliance on a certified balance sheet that portrayed a net worth in excess of $1 million.\(^\text{63}\) Stern was, in fact, insolvent. The court held that liability for negligence did not extend to parties who did not share privity of contract. Judge Cardozo distinguished *Ultramares* and *Glanzer* by analyzing the "end and aim of the transaction."\(^\text{64}\) The court held that the accountant’s work product was intended primarily for the use of the client and only incidentally for the third party.\(^\text{65}\)

Judge Cardozo rationalized this limitation of an accountant’s liability for negligence by stating, “[i]f liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.”\(^\text{66}\) Judge Cardozo concluded that, because of the tremendous potential for liability, Touche could not be held liable to a third party for mere negligence.\(^\text{67}\) According to *Ultramares*, liability for general negligence extends to contracting parties or third parties in a relationship with the auditor that is “akin to privity.”\(^\text{68}\)

Subsequent decisions in numerous jurisdictions have cited *Ultramares* and Judge Cardozo’s reasoning therein as the basis for restricting liability for general negligence to clients and a narrow class of third parties who were known or foreseen by the accountant, reasoning that such third parties have the equivalent of

\(^{61}\) *Id.* at 276.

\(^{62}\) 174 N.E. 441 (N.Y. 1931).

\(^{63}\) *Id.* at 442.

\(^{64}\) *Id.* at 445.

\(^{65}\) *Id.* at 446.

\(^{66}\) *Id.* at 444.

\(^{67}\) *Ultramares* 174 N.E. at 447-48.

\(^{68}\) *Id.* at 441.
privity. In Credit Alliance v. Arthur Andersen & Co., the New York Court of Appeals reaffirmed Ultramares as follows:

Before accountants may be held liable for negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountant must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants’ understanding of that party or parties’ reliance.

When the above conditions are met, general negligence applies if, in fulfilling a contract for professional services, an accountant fails to exercise that degree of skill and competence reasonably expected of persons in his profession. An accountant has a duty to act honestly, in good faith, and with reasonable care in the discharge of his professional obligations. An accountant or auditor discharges his professional obligations with reasonable care by complying with industry standards, i.e., GAAP, and generally accepted auditing standards (“GAAS”). Compliance with GAAP and GAAS, however, will not immunize an accountant from liability for fraud when he consciously chooses not to disclose a known, material fact.

The duty to disclose known, material facts extends beyond the date that the CPA issues an opinion on a client’s financial statements. In Fischer v. Kletz, subsequent to issuing an unqualified

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70 483 N.E.2d 110 (N.Y. 1985).

71 Id. at 118.

72 Bancroft v. Indemnity Ins. Co. of N. Am., 203 F. Supp. 49, 52 (W.D. La.), aff’d, 309 F.2d 959 (5th Cir. 1962).

73 SEC v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979).

74 Rhode Island Hosp. Trust Nat’l Bank v. Swartz, 455 F.2d 847, 852 (4th Cir. 1973); see supra note 35. Generally accepted audit standards (“GAAS”) are general standards, standards of field work, and standards of reporting with which all members of the AICPA must comply. See AU § 150.02, at 21; AU § 161.01, at 23.


audit opinion, Peat, Marwick & Mitchell discovered misstatements in its client's prior period financial statements. The financial statements and derivatives of the financial statements were later used to solicit investments. The court held that accountants have a continuing duty to divulge information discovered after the conclusion of the audit.\textsuperscript{77} Quoting from an SEC case, the court noted that "[t]he public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client."\textsuperscript{78}

Strict interpretation of the privity requirement was followed in two recent cases in which summary judgment was upheld in favor of the accountants. In \textit{Security Pacific Business Credit, Inc. v. Peat Marwick Main & Co.},\textsuperscript{79} the vice president of Security Pacific Business Credit ("SPBC") made a single telephone call to an audit partner at Main Hurdman, Peat's predecessor firm, indicating that SPBC would be relying on an audit of the financial statements of Top Brass Enterprises, Inc. to extend a line of credit to be secured by Top Brass's accounts receivable.\textsuperscript{80} The New York Court of Appeals reasserted the test established in \textit{Credit Alliance} and concluded that Peat's work was only incidentally for the use of SPBC and did not impose liability to SPBC for negligence.\textsuperscript{81} A mere telephone call did not convert the relationship between SPBC and Peat's predecessor accounting firm into a relationship "sufficiently approaching privity."\textsuperscript{82}

In \textit{Venturtech II v. Deloitte, Haskins & Sells},\textsuperscript{83} the United States District Court for the Eastern District of North Carolina dismissed charges brought by venture capital investors alleging they relied on Deloitte's audits of Learning Resources, Inc. The court ruled that the investors could not maintain an action for negligence against Deloitte because they were never designated as third party beneficiaries, they never received annual audit reports

\textsuperscript{77} Id. at 188 ("The common law has long required that a person who has made a representation must correct that representation if it becomes false and if he knows people are relying on it.").

\textsuperscript{78} Id. at 180 (quoting \textit{In re Touche}, 37 S.E.C. 629, 670-71 (1957)).

\textsuperscript{79} 597 N.E.2d 1080 (N.Y. 1991).

\textsuperscript{80} Id. at 1082-83.

\textsuperscript{81} Id. at 1085.

\textsuperscript{82} Id.

directly from Deloitte and, with the exception of the 1982 audit, there was no evidence Deloitte knew the financial statements would be distributed to or used by the investors.84

B. Foreseeability

In a 1983 law review article, Howard B. Wiener, an associate justice of the California Court of Appeal, advocated the rejection of the rule in *Ultramares*.85 He argued that accountant liability based on foreseeable injury would serve the dual functions of compensation for injury and deterrence of negligent conduct.86 The foreseeability basis for defining third-party claimants to whom an auditor is liable was applied in *Rosenblum, Inc. v. Adler*.87 In *Adler* the New Jersey Supreme Court upheld a claim for negligent misrepresentation asserted by stock purchasers. The court concluded that it found no reason to distinguish accountants from other suppliers of products or services to the public and no reason to deny recovery to third-party users of financial statements for economic loss resulting from negligent misrepresentation.88 From a public policy standpoint, the court emphasized the potential deterrent effect of a liability-imposing rule on the conduct and cost of audits when it stated:

The imposition of a duty to foreseeable users may cause accounting firms to engage in more thorough reviews. This might entail setting up stricter standards and applying closer supervision, which should tend to reduce the number of instances in which liability would ensue. Much of the additional cost incurred either because of more thorough auditing review or increased insurance premiums would be borne by the business entity and its stockholders or its customers.89

To prevail, plaintiffs must rely on the audited statements pursuant to the business purposes for which the statements were provided.90 Moreover, the plaintiffs must be reasonably foreseeable recipients of the audited company's statements pursuant to its

84 Id. at 583.
86 Id. at 260.
88 Id. at 143-47.
89 Id. at 152. *But see supra note 23 and accompanying text (noting insurance industry's reluctance to provide coverage for types of policies to which Rosenblum court refers).*
90 *Rosenblum*, 461 A.2d at 153.
proper business purposes. The court’s rule precludes auditor liability to an institutional investor, portfolio manager, or prospective stock purchaser who does not obtain the statements directly from the audited company. Those, however, who obtain audited statements from stockbrokers, friends, or otherwise acquire them are no less foreseeable users. As noted in the Bily decision, the Rosenblum approach suggests a concern for the potentially unlimited liability of auditors to foreseeable users, but offers no explanation for limiting that liability on the basis of the company’s distribution of the financial statements, a factor over which the auditor has no control.

In Citizens State Bank v. Timm, Schmidt & Co., a Wisconsin bank sued the accounting firm of Timm, Schmidt & Co. to recover losses it sustained when it allegedly made loans in reliance on Clintonville Fire Apparatus’ 1973-1976 audited financial reports that contained material errors. The Wisconsin Supreme Court relied on compensation, risk-spreading, and deterrence rationales to hold Clintonville’s accounting firm liable to third parties. The court concluded that, without an imposition of liability, the cost of credit to the general public would increase because creditors would either have to absorb the cost of bad loans or hire independent accountants to verify the information in audited reports. Nevertheless, the court acknowledged that in specific cases “public policy factors,” such as the burden upon the defendant of paying damages and the possibility of encouraging fraudulent claims by providing for recovery, might call for a limitation of liability to the broad class of foreseeable users.

The foreseeability approach was also followed in International Mortgage Co. v. John P. Butler Accountancy Corp., a California case subsequently overruled by Bily v. Arthur Young & Co.
Butler issued an unqualified audit opinion on the 1978 financial statements of its client, Westside Mortgage, Inc.\textsuperscript{101} Relying upon Westside's audited financial statements, International Mortgage Co. ("IMC") entered into an agreement to purchase and resell Westside's loans in the secondary mortgage market.\textsuperscript{102} Westside failed to deliver the promised trust deeds to IMC and defaulted on its promissory note.\textsuperscript{103} The principal asset on Westside's balance sheet was a $100,000 note receivable secured by a deed of trust on real property.\textsuperscript{104} The promissory note was actually worthless because of a prior foreclosure of a superior deed of trust that IMC alleged Butler should have discovered in its audit.\textsuperscript{105} The California Court of Appeal stated that the role of the independent auditor had evolved since the time of the \textit{Ultramares} decision.\textsuperscript{106} The court concluded that an accountant was negligent when he failed to fulfill a duty of care to those third parties who may reasonably and foreseeably have relied on the audited financial statement prepared by that accountant.\textsuperscript{107}

The Mississippi Supreme Court adopted the foreseeability rule in \textit{Touche Ross & Co. v. Commercial Union Insurance Co.}\textsuperscript{108} \textit{Touche Ross}, however, has little precedential value for two reasons. First, the court's statement of the rule is dictum; it held that there was no liability on the part of the auditor because the loss suffered by the third party resulted from criminal conduct occurring after the audit.\textsuperscript{109} Second, the reasoning for adopting the foreseeability rule was based on a unique Mississippi statute that does not require privity to maintain a negligence action, including one alleging economic loss.\textsuperscript{110}

\textsuperscript{101} Butler, 223 Cal. Rptr. at 219.
\textsuperscript{102} Id.
\textsuperscript{103} Id. at 219-20.
\textsuperscript{104} Id.
\textsuperscript{105} Id. at 223.
\textsuperscript{106} BUTLER, 223 Cal. Rptr. at 226. The court stated that "the protectionist rule of privity announced in Ultramares is no longer viable . . . [because at that time] the primary obligation of the auditor was to the client who hired him or her . . . [whereas] today [the accountant] occupies a position of public trust." \textit{Id.}
\textsuperscript{107} \textit{Id.} at 227; \textit{see also} Biankanja v. Irving, 320 P.2d 16 (Cal. 1958) (applying similar foreseeability requirement). \textit{But see} Thomas L. Gossman, \textit{The Fallacy of Expanding Accountants' Liability}, 1988 COLUM. BUS. L. REV 213, 221 (1988) (noting defendant in \textit{Biankanja} knew plaintiff would be relying; hence, case is consistent with \textit{RESTATMENT (SECOND) OF TORTS} \textsection{552} and \textit{Ultramares}).
\textsuperscript{108} 514 So. 2d 315 (Miss. 1987).
\textsuperscript{109} \textit{Id.} at 323-25.
\textsuperscript{110} \textit{Id.} at 321; \textit{see MISS. CODE ANN.} \textsection{11-7-20} (Supp. 1986).
With the exception of the above cases, the foreseeability approach has not attracted a substantial following in the twelve years since it was formally proposed. Indeed, commentators have criticized the approach because of the indeterminate liability that it imposes on CPAs.\(^{111}\) They have also rejected the arguments that the adoption of this approach will lead to improved audit quality, and that increases in cost from higher insurance premiums or more thorough audits will be borne by the entities for whom the audits are conducted.\(^{112}\) Several states continue to follow the privity standard.\(^{113}\) Others have generally rejected the foreseeability basis in favor of the Restatement's intended beneficiary approach discussed below.\(^{114}\)


Four states (Illinois, Utah, Arkansas and Kansas) have enacted statutes following the privity standard. In the Kansas statute, KAN. STAT. ANN. § 1-402 (Supp. 1987), a third party can recover if the auditor is aware of the third party's reliance, the party has been identified in writing to the auditor and the specific transaction has been described. The Illinois statute, ILL. ANN. STAT. ch. 225, para. 450/30.1 (Smith-Hurd 1984), the Utah Statute, UTAH CODE ANN. § 58-26-12 (1990), and the Arkansas statute, ARK. CODE ANN. § 16-114-302 (Michie 1987), all provide that the auditor can limit its negligence liability to those third parties the auditor identifies in writing to the client. See also Paul J. Herskovitz, Auditors and Third Party Negligence Suits: Judicial Approaches and Legislative Reforms, Ohio C.P.A. J., Winter 1990, at 21.

\(^{114}\) See, e.g., First Nat'l Bank of Commerce v. Monco Agency, Inc., 911 F.2d 1053, 1057-63 (5th Cir. 1990) (applying Louisiana law and rejecting argument that all potential lenders of audited company constitute "limited group" under section 552); Selden v. Burnett, 754 P.2d 256, 259 (Alaska 1988) (holding that accountant owes duty of due care to third party only if accountant specifically intends third party to invest relying on his advice and only if accountant makes intent known); First Fla. Bank, N.A. v. Max Mitchell & Co., 558 So. 2d 9, 12-15 (Fla. 1990) (rejecting foreseeable approach in favor of Restatement rule); Badische Corp. v. Caylor, 356 S.E.2d 198, 199-200 (Ga. 1987) (requiring actual notice that financial statements would be shown to third party for liability); Raritan River Steel Co. v. Cherry, Bekaeht & Holland, 407 S.E.2d 178, 182-83 (N.C. 1991); Bethlehem Steel Corp. v. Ernst & Whinney, 822
C. Restatement (Second) of Torts

According to section 552 of the Restatement (Second) of Torts, an accountant breaches his professional obligations if, in performing his services, he makes negligent misrepresentations.115 When a defendant makes false statements he honestly believes are true, but without reasonable grounds for such belief, he may be liable for negligent misrepresentation, a form of deceit.116 Moreover, when a party holds itself out as possessing superior knowledge, information, or expertise regarding the subject matter, and a plaintiff is so situated that the plaintiff may reasonably rely on such supposed knowledge, information, or expertise, the defendant’s misrepresentation may be treated as one of fact.117

One who negligently “supplies false information for the guidance of others in their business transactions” is liable for the economic loss suffered by the recipients in justifiable reliance on that information.118 The liability is limited to those for whose benefit and guidance the information is intended or to whom the supplier of the information knows the information will be provided.119 The scope of liability of a negligent supplier of information is appropriately more narrowly restricted than that of an intentionally fraudulent supplier.120 There is no liability to those to whom the auditor had no reason to believe the information would be made available, or when the client’s transaction, as represented to the auditor, changes so as to increase materially the audit risk.121

The first case in which a party without privity successfully maintained a negligence action against an accountant was Rusch Factors, Inc. v. Levin.122 In Rusch Factors, Inc., a Rhode Island


119 Id. § 552(2)(a).
120 Id. § 552(2) cmt. h.
121 Id. § 552(2) cmts. i, j.
corporation provided audited financial statements that the plaintiff relied on in granting the corporation a $337,000 loan. The corporation was actually insolvent and subsequently went into receivership. Rusch Factors successfully brought a lawsuit against Levin, the auditor. The Rusch Factors court stated that any class of plaintiffs must be actually foreseen (not just foreseeable) and limited. The court reasoned that, in cases in which the accounting work was intended to influence a limited number of foreseen third parties, liability to those third parties arises.

In the Iowa case of Ryan v. Kanne, an accountant negligently prepared the unaudited financial statements of a lumber business. Consistent with the Restatement, and notwithstanding the absence of privity, the court ruled that the accountant was liable for a negligent financial misrepresentation relied upon by known prospective users of the financial statements. In Shatterproof Glass Corp. v. James, a Texas court ruled that the accountants who had been authorized by their client to furnish financial statements directly to the client's creditor were under a duty of care to the relvant third party.

In the Missouri case of Aluma Kraft Manufacturing Co. v. Elmer Fox & Co., the auditors knew that the book value of Aluma Kraft stock, as determined from its audited financial statements, was to be the purchase price of the company by Solmia, Inc. Assuming that the negligence of the auditors resulted in an inflated book value, the court concluded that an accountant is liable to known third parties for negligence. The court outlined several factors that should be used to determine an accountant's liability for negligence: (1) the degree to which the transaction was intended to influence the plaintiff; (2) the foreseeability of the injury to the plaintiff; (3) the possibility that the plaintiff would suf-

124 Id. at 86.
125 Id. at 92-93.
126 Id. at 91-93.
127 Id. at 92-93.
128 170 N.W.2d 395 (Iowa 1969).
129 Id. at 397-99.
130 Id. at 402-03.
132 Id. at 876-77.
133 493 S.W.2d 378 (Mo. Ct. App. 1973).
134 Id. at 383-85.
135 Id.
fer damages; and (4) the proximity between the defendant's conduct and the plaintiff's injury. Several other cases have endorsed the *Restatement* approach in this and related contexts.

III. *Bily v. Arthur Young & Co.: A Necessary Delineation of Accountants' Legal Liability*

*Bily v. Arthur Young & Co.* provides an analysis of accountants' legal liability to third parties that rejects the potentially unlimited liability of the foreseeability standard and the narrow scope of the privity doctrine. The court utilizes section 552 of the *Restatement (Second) of Torts* to support the position that the liability of accountants for general negligence in the conduct of an audit of its client's financial statements is confined to the client; third parties may recover under certain conditions only when an accountant makes negligent misrepresentations.

*Bily* arose from the failure of Osborne Computer Corporation. In early 1983, some of the plaintiffs, who included individual investors and pension and venture capital investment funds, provided direct loans or letters of credit to secure bank loans to Osborne Computer. These loans were intended as "bridge loans" to provide operating funds until the time of an initial public offering ("IPO") that Osborne planned for 1983. In exchange for their assistance in obtaining the loans, several plaintiffs received warrants that entitled their holders to purchase blocks of the company's stock at prices that were expected to yield sizable profits if a public offering took place. During this same period, other plaintiffs purchased Osborne Computer common stock in private placements. In early 1983, for example, Robert Bily, who was also a director of the company, purchased 37,500 shares of stock for $1.5 million from Adam Osborne, the company founder.

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136 Id. at 382.
137 *See supra* note 114 (listing cases that adopted *Restatement* approach in finding or rejecting accountants liability).
139 Id. at 757-59.
140 Id. at 747.
141 Id.
142 Id.
143 *Bily*, 834 P.2d at 747.
144 Id.
Arthur Young & Co. issued unqualified opinions on the privately held corporation's 1981 and 1982 financial statements. The partner-in-charge personally delivered 100 copies of the 1982 audited statements to the company. The company's sales began to falter in 1983, and Osborne filed for bankruptcy on September 13, 1983. The plaintiffs' investments in Osborne were not recovered. Except for one plaintiff, who did not receive or read the 1982 audit report, the plaintiffs claimed that in making their investments they relied on the unqualified 1982 audit report that they received from Osborne Computer.

At trial, an expert witness testified to more than forty deficiencies in the audits, including a $3 million understatement of liabilities, a failure to detect weaknesses in internal control procedures, and a failure to disclose discovered deviations. The expert concluded there was gross professional negligence on the part of Arthur Young. The jury returned a verdict against the auditor for professional negligence, with no comparative negligence on the part of the plaintiffs. On appeal, the decision was affirmed by the California Court of Appeal and then reversed and remanded by the California Supreme Court.

In Bily the California Supreme Court declined to permit all merely foreseeable third-party users of audit reports to sue the auditor on a theory of professional negligence. This holding was based on three central concerns: (1) given the secondary "watchdog" role of the auditor, the complexity of professional audit opinions, and the potentially tenuous relationship between audit reports and economic losses from investing and lending decisions, the auditor faces liability to all foreseeable third parties far out of proportion to its degree of fault; (2) the sophisticated class of plaintiffs in auditor liability cases (lenders and investors) permits the use of contract rather than tort liability to control and adjust risks; and (3) the asserted benefits of more accurate auditing and more efficient loss spreading using the foreseeability approach are

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145 Id.
146 Id. at 748.
147 Id.
148 Bily, 834 P.2d at 748.
149 Id.
150 Id.
151 Id. at 749.
152 Id.
153 Bily, 834 P.2d at 761.
unlikely to occur; instead, increased expense and decreased availability of audit services are the probable consequences of expanded liability.\textsuperscript{154} The court stated that, as a matter of economic and social policy, "third parties should be encouraged to rely on their own prudence" rather than being permitted to recover from the auditor for mistakes in the client's financial statements.\textsuperscript{155} To do otherwise compels the auditor to become, "in effect, an insurer of not only the financial statements, but of bad loans and investments in general."\textsuperscript{156}

\textit{Bily} departs from \textit{International Mortgage Co. v. John P. Butler Accountancy Corp.} by restricting the class of plaintiffs to whom the accountant may be held liable for general negligence.\textsuperscript{157} As discussed previously, the decision of the California Court of Appeal in \textit{Butler} reflects the view that negligence recovery should be permitted to all foreseeable users of audit reports.\textsuperscript{158} Writing for the \textit{Bily} majority, Judge Lucas disagreed with this view,\textsuperscript{159} holding that the rejection of the \textit{Ultramares} requirement that third parties must have the equivalent of privity is without support or analysis.\textsuperscript{160} According to Judge Lucas, a foreseeability rule applied to accountants' reports would produce large numbers of expensive and complex lawsuits of "questionable merit as scores of investors and lenders seek to recoup business losses."\textsuperscript{161}

In addition to rejecting the foreseeability standard, the court acknowledged several limitations on the auditor's ability to discover errors or irregularities in the client's financial statements.\textsuperscript{162} The client engages the auditor, pays the audit fee, communicates with the auditor throughout the audit, and controls the data to which the auditor has access.\textsuperscript{163} There are no absolute standards to verify the accuracy of the financial statements; auditors must interpret and apply hundreds of professional standards in a complex judgment process.\textsuperscript{164} Further, the client controls dis-

\begin{itemize}
  \item \textsuperscript{154} \textit{Id.}
  \item \textsuperscript{155} \textit{Id.} at 765.
  \item \textsuperscript{156} \textit{Id.}
  \item \textsuperscript{157} \textit{Id.} at 766 (overruling International Mortgage Co. v. John P. Butler Accountancy Corp., 223 Cal. Rptr. 218 (Cal. Ct. App. 1986)).
  \item \textsuperscript{158} See \textit{supra} notes 99-107 and accompanying text.
  \item \textsuperscript{159} \textit{Bily}, 834 P.2d at 766-67 n.15.
  \item \textsuperscript{160} \textit{Id.} at 766-67.
  \item \textsuperscript{161} \textit{Id.} at 767.
  \item \textsuperscript{162} \textit{Id.} at 762.
  \item \textsuperscript{163} \textit{Id.}
  \item \textsuperscript{164} \textit{Bily}, 834 P.2d at 763.
\end{itemize}
semination of the reports, creating a huge body of potential claimants. The nature of the economic loss, should it occur, creates an uncertain and disproportionate liability for the auditor, who cannot control the management of the audited company, but is often the only solvent defendant.

In determining auditors' legal liabilities, Bily argued for a distinction between the tort of negligent misrepresentation and the separate tort of negligence. Judge Lucas contended that negligent misrepresentation is a species of the tort of deceit, and the person or class of persons entitled to rely upon the misrepresentations is restricted to those to whom or for whom the misrepresentations were made. Although not in privity, those specifically intended and known beneficiaries of the accountant's or auditor's services are a class to whom the professional may incur liability. Recovery on the grounds of negligent misrepresentation requires that the plaintiff prove "justifiable reliance" on a materially false statement made by the defendant. Thus, negligent misrepresentation requires proving that misrepresentations were made by the defendant with the intent to influence the plaintiff, and that actual and justifiable reliance on those misrepresentations is responsible for the plaintiff's loss. In contrast, the charge of general negligence directs the jury's attention to the defendant's level of care and compliance with professional standards in performing his or her duties. The tort of general or professional negligence imposes a duty to exercise due care toward contracting parties and intended third-party beneficiaries. When an audit engagement contract expressly identifies a particular third party

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165 Id. at 762.
166 Id. at 763.
167 Id. at 768.
168 Id. at 768 (citing Witkin, supra note 116 § 721, at 820); see Restatement (Second) of Torts § 552 cmts. g, h (1977); see also Christiansen v. Roddy, 231 Cal. Rptr. 72, 75 (Cal. Ct. App. 1986) (listing elements of cause of action for negligent misrepresentation).
169 Bily, 834 P.2d at 767.
170 Christiansen, 231 Cal. Rptr. at 75.
171 Bily, 834 P.2d at 772.
172 Id. at 770 (citing Restatement (Second) of Torts § 552 cmt. a (1977)); see also Goodman v. Kennedy, 556 P.2d 737, 748 (Cal. 1976) (Mosk, J., dissenting) (employing similar multi-factor analysis to determine liability to third parties); Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 128 Cal. Rptr. 901, 905-06 (Cal. Ct. App. 1976) (discussing attorney's duties to clients and third parties).
or parties, those parties may under appropriate circumstances possess the rights of parties to the contract.\textsuperscript{173}

Judge Lucas argued that confining liability for general negligence to those whom the accountant’s engagement is intended to benefit is consistent with the Restatement (Second) of Torts.\textsuperscript{174} According to the Restatement, liability for merely negligent behavior is appropriately restricted to those cases in which the supplier of information “manifests an intent to supply the information for the sort of use in which the plaintiff’s loss occurs.”\textsuperscript{175} Judge Lucas further argued that section 552(b) of Restatement (Second) of Torts recognizes commercial realities by avoiding both unlimited liability for economic losses in cases of professional mistake and exoneration of the auditor in situations in which the auditor clearly intended to influence third parties.\textsuperscript{176}

By permitting recovery for negligent misrepresentation, Bily provided reasonable protection for those to whom accountants supply information. It also established a basis for restricting accountants’ legal liability for negligence to those with whom or for whom the accountant has contracted to provide services. By receiving notice of the third parties to whom potential liability may be incurred, the auditor can decide whether to accept the engagement, adjust the audit plan to meet the needs of third parties, and negotiate audit fees that are commensurate with the scope of liability. If, on the other hand, the supplier of the information “merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the information] on the part of anyone to whom it may be repeated,” the supplier bears no legal responsibility.\textsuperscript{177}

IV. IMPROVING AUDIT PRACTICE AND ACKNOWLEDGING THE INHERENT LIMITATIONS OF AUDITS

The Bily decision established reasonable parameters for accountants’ liabilities to third parties. It also recognized the limitations to the assurances that auditors’ opinions on the financial statements of their clients provide. The accounting profession should endeavor to meet its obligations to third parties through

\textsuperscript{173} Bily, 834 P.2d at 767.
\textsuperscript{174} Id. at 769.
\textsuperscript{175} RESTATEMENT (SECOND) OF TORTS § 552, cmt. a (1977).
\textsuperscript{176} Bily, 834 P.2d at 769.
\textsuperscript{177} RESTATEMENT (SECOND) OF TORTS § 552, cmt. h (1977).
improved self-regulation. In March 1993, the POB issued a report that proposes changes in audit practice and additional disclosures in accountants' reports. Although the POB was criticized for its support of the profession's drive to limit liability through the passage of federal and state laws and for its conclusion that higher auditing fees are needed, the POB deserves credit for advocating that accountants should accept greater responsibility for the detection of management fraud. The following is a discussion of the POB recommendations that have the greatest potential for improving the audit practice and clarifying the limitations of audited financial statements.

A. Audit Practice

The report includes recommendations for action by several parties that influence the practice of auditing. The POB recognizes that the current self-regulatory system is unable to impose appropriate sanctions against firms that do not belong to the SEC Practice Section, but nevertheless audit SEC clients. To address this, the POB recommends that the SEC amend its rules to require SEC registrants to disclose whether their auditors have had a peer review, the date of the most recent review, and its results. This information would enable those who obtain audited financial statements filed with the SEC to receive explicit information about the compliance or noncompliance of the SEC registrant's auditor with peer review requirements.

The POB report also includes recommendations to make the Quality Control Inquiry Committee ("QCIC") more effective in addressing audit failures. Presently, when civil suits or criminal indictments are filed against an SEC Practice firm or its personnel, or when the firm is investigated by a regulatory agency, the firm is required to notify the QCIC, which conducts an investigation to determine whether corrective measures should be taken.

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178 See Public Interest, supra note 11.
180 See Public Interest, supra note 11, at 17; see also Daniel Pearl, How 2 Florida Firms Fooled Stockholders, Auditors, and the SEC, Wall St. J., July 8, 1992, at A1 (discussing audits of Cascade International Inc. and College Bound Inc.).
181 See Public Interest, supra note 11, at 18 (Recommendation II-1).
182 See Public Interest, supra note 11, at 18-26; supra note 11.
183 See Public Interest, supra note 11, at 18-21. The determination of whether an audit failure has occurred and the imposition of sanctions is the responsibility of the courts, the SEC, and other regulatory and government bodies. The QCIC does not
To enable the profession to learn from its mistakes and improve its performance, the POB proposes that firms be required to report to the QCIC the audit guidance that the firms believe might have avoided the allegations made against them. This would include reporting business, accounting, and auditing practices that pose new or special problems for auditors. The QCIC would then analyze this information, along with that gathered by peer-review teams, as a basis for developing audit guidelines for accounting professionals.

The POB's strongest call for change is in the area of accountants' responsibilities for detecting fraud. The report states:

[Users of audited financial statements must obtain some measure of additional assurance that the company's affairs are being conducted in accordance with specified laws (to the extent auditors have the ability to make such judgments); that the company's internal controls meet the criteria recently adopted by the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting; and that management is not manipulating its financial reports or committing other frauds.

The POB contends that auditors are not consistently complying with the auditing standard that requires them to assess the risk that management fraud may cause the financial statements to be materially misstated. To assist auditors in identifying symptoms that indicate an increase in the likelihood of management fraud, the POB recommends that the profession develop comprehensive guidelines to help them identify and respond to potential issues. If a member firm does not cooperate with the QCIC, however, the Executive Committee of the SEC Practice Section may impose sanctions.}

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184 See Public Interest, supra note 11, at 27-30 (Recommendation III-1).
185 See Public Interest, supra note 11, at 30 (Recommendation III-2 and 3).
186 See Public Interest, supra note 11, at 33 n.22. Prior to the twentieth century, the detection of fraud was perceived by auditors and their clients as the principal purpose of an audit. See also Gary J. Previts & Barbara D. Merino, A History of Accounting in America 129-30 (1979).
187 Public Interest, supra note 11, at 33; Committee of Sponsoring Organizations of the Treadway Commission, Internal Control — Integrated Framework (1992). For a discussion of the efforts of the SEC and responses of management and accounting professionals to proposals to require reporting on the effectiveness of internal controls, see infra note 193.
188 See Public Interest, supra note 11, at 42; see also AU § 316 (requiring auditors assess risk that management fraud may cause financial statements to be materially misstated); AU § 317, at 87 (discussing nature and extent of auditor's consideration, in audit of client's financial statements, of possibility of illegal acts by client and responsibilities of auditor when possibly illegal act is detected).
hensive audit guidelines and specify additional audit procedures to be implemented when fraud is suspected. These measures, in addition to the previously discussed recommendation that the QCIC analyze the factors contributing to audit failures, should enable accountants to improve their ability to detect fraud.

Congress should enact legislation to expand the obligation of auditors to report illegal acts. If the client management or board of directors fails to take the necessary action on suspected illegalities discovered by the auditor, the auditor should be required to report the suspected acts to the appropriate authorities, including the SEC. The POB also suggests that the profession consult with Congress to assure that any legislation enacted makes explicit the limitations of auditors in identifying illegal acts.

The SEC's proposal that management include, in its annual report to investors and in the report filed on Form 10-K, an assessment of the effectiveness of the company's system of internal controls should be supported by the accounting profession. The

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189 See Public Interest, supra note 11, at 43 (Recommendation V-1 and 2).
190 See Public Interest, supra note 11, at 55 (Recommendation V-14).
191 See AICPA Supports Fraud Detection Bill, J. Acct., May 1993, at 15. The AICPA endorses an amended version of H.R. 574, the Financial Fraud Detection and Disclosure Act, which includes language that "principal responsibility for setting accounting standards remains in the private sector," subject to oversight by the SEC. Id.; see Public Interest, supra note 11, at 55. Congressmen Dingell, Wyden, and Markey sponsored the Financial Fraud Detection and Disclosure Act, which would require auditors to report suspected illegal acts to the SEC if the company fails to respond to the auditor's findings. Id. But see AU § 317.23. Existing audit standards do not require the disclosure of illegal acts to parties other than the client's senior management and its audit committee or board of directors except under specific circumstances. These circumstances are (a) when the entity reports an auditor change as required by securities law on Form 8-K, (b) to a successor auditor, when the successor auditor makes inquiries in accordance with AU § 315, which requires the specific permission of the client, (c) in response to a subpoena, and (d) to a funding agency or other specified agency in accordance with requirements for the audit of entities that receive financial assistance from government agencies. Id.
192 Public Interest, supra note 11, at 55 (Recommendation V-14); see also supra note 38 (quoting AU § 316.07 which notes specific limitations of audits for detecting fraud).
193 See Public Interest, supra note 11, at 53-54 (Recommendation V-12); see also Committee of Sponsoring Organizations of the Treadway Commission, Internal Control—Integrated Framework, 89-94 (1992); Marc J. Epstein & Albert D. Spalding, Jr., The Accountant's Guide to Legal Liability and Ethics 134-137 (1993). At various times since the SEC's 1979 proposal entitled, Exchange Act Release No. 34-15772, 44 Fed. Reg. 26,702 (May 4, 1979), the SEC has attempted to impose mandatory internal control reporting requirements on all publicly held U.S. corporations. Committee of Sponsoring Organizations of the Treadway Commiss-
guidelines developed by the Committee of Sponsoring Organizations ("COSO") provide management with a basis for assessing the effectiveness of, and improving internal controls over, financial reporting. With the recent issuance of attestation standards for evaluating management's assertions about the adequacy of internal controls over financial reporting, auditors should be required to express an opinion on management's evaluation of the company's internal controls. Evaluating internal controls should, when problems are found, lead to improvements in those controls. If top management demands conformity with the internal controls, fraudulent activity will become more difficult to com-

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sion, supra, at 90 n.2. Although the current SEC proposal does not include a requirement that auditors assess management's report on internal control, versions introduced in 1979, 1988, and 1989 included such requirements. Epstein & Spalding, supra, at 135. The SEC proposals, none of which were enacted, are based on the belief that the reliability and credibility of financial statements and other management disclosures depends on the effectiveness of the entity's internal control system. Id. In prior years, SEC registrants and accountants objected to the enactment of these proposals on the ground that it was not feasible to evaluate the effectiveness of internal controls as envisioned in the proposals. Committee of Sponsoring Organizations of the Treadway Commission, supra, at 91.

In 1985 several groups, including the AICPA, the American Accounting Association ("AAA"), the Financial Executives Institute ("FEI"), the Institute of Internal Auditors ("IIA"), and the National Association of Accountants ("NAA") (now the Institute of Management Accountants ("IMA")) formed the National Commission on Fraudulent Reporting ("Treadway Commission") in response to SEC and other agency proposals that management evaluate internal controls. Epstein & Spalding, supra, at 136. The commission issued a 1987 report entitled the Report of the National Commission on Fraudulent Reporting that included recommendations for corporate managers, boards of directors, CPAs, the SEC, and other regulatory agencies of specific policies and procedures that should be adopted to improve internal controls and reduce fraudulent reporting. Id.

The 1987 report also called upon COSO, a subcommittee of the Treadway Commission, to review internal control literature and develop a set of internal control concepts and definitions that could be used by public companies in analyzing and improving their systems. Committee of Sponsoring Organization of the Treadway Commission, supra, at 93. The 1992 publication of Internal Control-Integrated Framework represents the efforts of the COSO to provide practical, widely accepted guidance for developing effective internal controls. Id.

194 Committee of Sponsoring Organizations of the Treadway Commission, supra note 193.


196 Public Interest, supra note 11, at 54 (Recommendation V-12).
mit. An effective system of internal controls, however, cannot guarantee the honesty of management or of company employees who may collude to defraud the company, and a statement to this effect should be included in the auditor's report.\textsuperscript{197}

Other suggestions for improving audit practice are intended to assure professional independence. These proposals include more extensive use of concurring partner reviews in order to provide assurances that the audits have been conducted properly, and that the accounting treatments are consistent with GAAP.\textsuperscript{198} When participating in the standard setting-process, and in discussing reporting practices with the SEC, accountants should avoid the appearance of client advocacy.\textsuperscript{199} When conflicts arise, accountants should place reporting the economic substance of financial transactions ahead of lending support to clients' reporting preferences.\textsuperscript{200}

B. Inherent Limitations

The \textit{expectation gap} refers to differences between the assurances that the public or knowledgeable segments of it believe an audit should provide, and the assurances that an audit actually does provide.\textsuperscript{201} Even if auditing standards and practice are im-

\textsuperscript{197} \textit{Public Interest}, \textit{supra} note 11, at 54. To clarify the limitations of internal controls and the auditor's attestation on their effectiveness, Recommendation V-13 states that the Auditing Standards Board should establish standards that require clear communication of the limits of the assurances being provided to third parties when auditors report on the adequacy of client internal control systems. \textit{Id.} at 54 (Recommendation V-13).

\textsuperscript{198} See \textit{Public Interest}, \textit{supra} note 11, at 49. Recommendation V-8 states: The concurring partner, whose participation in an audit is a membership requirement of the SEC Practice Section, should be responsible for assuring that those consulted on accounting matters are aware of all of the relevant facts and circumstances, including an understanding of the financial statements in the context of which the accounting policy is being considered. The concurring and consulting partners should know enough about the client to ensure that all of the relevant facts and circumstances are marshalled. [They should] also possess the increased detachment that comes from not having to face the client on an ongoing basis. The concurring partner should have the responsibility to conclude whether the accounting treatment applied is consistent with the objectives of Recommendations V-6 [that the economic substance of the financial transaction is reported.]

\textit{Id.}

\textsuperscript{199} See \textit{Public Interest}, \textit{supra} note 11, at 43-45 (Recommendations V-3).

\textsuperscript{200} See \textit{Public Interest}, \textit{supra} note 11, at 48-49 (Recommendations V-6, 7, and 8).

\textsuperscript{201} Two investigations conducted by Congress in the late 1970s and one in 1985 dealt with the public responsibilities of CPAs and questioned whether self-regulation
proved, as discussed above, there are inherent limitations to the degree of assurance that can be provided by audited financial statements. Financial statements contain estimates of amounts that depend on future uncertain events. Their relevancy may decline rapidly when conditions within the reporting entity or the external environment change; the statements are only one of the sources of information that should be consulted before making an investment or extending credit to a company.\textsuperscript{202}

The POB recommends that the Financial Accounting Standards Board ("FASB")\textsuperscript{203} add to its agenda a project to design a brief statement explaining the limitations of financial statements. The explanation should be included in every set of financial statements described as being "in accordance with generally accepted accounting principles."\textsuperscript{204} The FASB should also resolve the question of whether the reporting of values and changes in values should be included in audited financial statements rather than, or in addition to, historic transaction prices.\textsuperscript{205} The POB supports the FASB's efforts to include disclosures in the financial statements about the nature of the risks and uncertainties associated

\textsuperscript{202} See \textit{PUBLIC INTEREST}, supra note 11, at 34-35.

\textsuperscript{203} The Financial Accounting Standards Board ("FASB") is an independent standard setting organization established by the AICPA in the early 1970s.

\textsuperscript{204} See \textit{PUBLIC INTEREST}, supra note 11, at 36 (Recommendation IV-1).

\textsuperscript{205} See \textit{PUBLIC INTEREST}, supra note 11, at 38 (Recommendation IV-2). For the most part, the financial statement amounts are recorded at historic cost and not adjusted for changes in market value. \textit{RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISE}, Statement of Financial Accounting Concepts No. 5, 67-69 (Fin. Accounting Standards Bd. 1992/93). Whether financial statement amounts should be recorded at historic cost or current value has been debated by a number of individuals and organizations concerned with financial reporting. \textit{PUBLIC INTEREST}, supra note 11, at 37. The POB believes this issue should be resolved, but takes no official position on the correct reporting basis. Among those that the POB believes the FASB should consult to resolve the issue are the AICPA, the Financial Executives Institute, and the Association for Investment Management and Research. \textit{Id.} It is the position of the POB that failure to resolve issues such as this decreases the confidence of the public in the usefulness of accounting information. \textit{Id.}
with the reporting entity’s operations and financial condition.\textsuperscript{206} Finally, the POB calls for explicit disclosure of the prospective nature of certain accounting estimates and a caveat that estimated results may not be achieved.\textsuperscript{207}

An audit in accordance with GAAS requires numerous subjective judgments by the auditor. It involves the comparison of samples of the asserted facts in the financial statements with evidentiary matter, a search for material errors or irregularities, and an informed opinion on whether the financial reports are, in all material respects, in compliance with GAAP.\textsuperscript{208} Rather than representing a defensive retrenchment, the disclosures that the POB recommends are intended to clarify the subjective nature of much financial information. The auditor’s role in attesting to whether the financial statements prepared by the client fairly present, in all material respects, the results of operations and the financial position of the firm, is to provide an independent, expert opinion based on evidence collected according to GAAS. An audit does not and cannot guarantee that management is honest, that errors or fraudulent reporting will always be detected, or that the company’s past performance will continue into the future.

\textbf{CONCLUSION}

The common-law basis of accountants’ liability for negligence to third parties is traced through cases that extend from the 1842 decision of \textit{Winterbottom v. Wright}\textsuperscript{209} to the 1992 case of \textit{Bily v. Arthur Young & Co.}\textsuperscript{210} The concerns expressed by Judge Cardozo in \textit{Ultramares}\textsuperscript{211} are as relevant today as they were when he formulated his precedent-setting decision in 1931. He questioned the

\textsuperscript{206} \textit{See Public Interest, supra} note 11, at 38-39 (Recommendation IV-3). The AICPA Accounting Standards Executive Committee issued a proposed Statement of Position, \textit{Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility}, (AICPA, File 4290), which was approved by the FASB for public exposure in November 1992, (AICPA, File 4290). Responses during the exposure period, which is four months, will be considered in developing the final SOP.

\textsuperscript{207} \textit{See Public Interest, supra} note 11, at 39 (Recommendation IV-4).

\textsuperscript{208} \textit{See Public Interest, supra} note 11, at 35.

\textsuperscript{209} 152 Eng. Rep. 402 (Ex. 1842).

\textsuperscript{210} 834 P.2d 745 (Cal. 1992). Furthermore, the California Court of Appeal ruled in \textit{Industrial Indem. Co. v. Touche Ross & Co.}, 17 Cal. Rptr. 2d 29, 33, 37 (Cal. App. 1993), that the decision in \textit{Bily} relating to accountant’s liability to third parties applies retroactively to pending cases and reversed the order granting a new trial to Industrial Indemnity, which had previously been awarded damages of $1.

\textsuperscript{211} 174 N.E. 441 (N.Y. 1931).
wisdom of holding accountants liable for negligence to third parties who claimed to have relied on audited financial statements that were the product of a contract between the entity to whom the third parties had extended funds and an independent CPA firm. Judge Cardozo reasoned that holding accountants liable for general negligence to third parties would require accountants to assume a degree of responsibility that was out of proportion to the services for which they contracted when performing a financial statement audit. Ultramares established the rule that accountants owe a general duty of care to contracting parties and to those third parties who bear a relationship with the auditor that is the equivalent of privity.

In Bily, the California Supreme Court analyzed relevant cases from Ultramares to the present and section 552 of the Restatement (Second) of Torts to support its decision to deny recovery to third parties for general negligence. Bily rejects the notion that accountants owe a general duty of care to foreseeable third parties. When the court considered the minor role of the auditor in the success or failure of a business venture, it rejected liability for general negligence to foreseeable parties because such liability is out of proportion to the accountant's degree of fault. The imposition of the foreseeability rule, when applied to accountants' reports, the distribution of which is beyond the accountants' control, encourages third parties to use the legal system to recover their investment losses rather than relying on their own prudence in evaluating business prospects. Accountants should direct their efforts toward influencing other jurisdictions to follow Bily and the long-standing privity or the equivalent of privity standard promulgated by the New York courts.

Developing improved procedures to meet its professional obligations to third parties with privity and those recognized by Bily is another goal to which attention should be directed. The POB's In the Public Interest: Issues Confronting the Accounting Profession provides suggestions for improving auditing standards and practices, particularly in the area of detecting management fraud, and for improving disclosures in accountants' reports that would acknowledge their inherent limitations.212 By focusing its resources on these two objectives, the profession can improve its

212 See PUBLIC INTEREST, supra note 11 and accompanying text.
ability to perform the independent auditor's function and to fulfill its legal duties.