informed that upon dissolution there would probably be no funds available for distribution among the holders of the common shares. The Commission requested the corporation to circularize the shareholders with further information disclosing these facts, but the corporation at first refused. The Commission then made it apparent that it would take action to procure an order restraining the use of the proxies obtained. Thereupon, the management complied with the Commission's request by sending the additional information and by also sending a form of revocation or confirmation to the shareholders. Only proxies confirmed or obtained on the basis of the additional information were permitted to be voted upon.

Conclusion.

The purpose of the Act to eliminate the misuse of proxies by providing that full disclosure be made to the shareholder solicited has unquestionably been effectuated. The innumerable solicitations examined by the Commission during the fiscal year of 1938, and the many follow-up letters which were required to be sent to the shareholders in order to clarify the matters contained in the original soliciting material evince the benefits accruing to the shareholders. In fact, the procedure of the Commission has been so efficacious that as yet no judicial proceeding to restrain the use of proxies obtained in violation of the rules has been instituted under Section 21 of the Securities Exchange Act. Undoubtedly, the notorious evils and the innocuous practices attending the solicitation of proxies have been substantially curtailed by the Act.

Louis J. Gusmano.

Accountants' Liability.

Accountants are members of one of the most important professions...
sions of modern economic society. They have long been held to be engaged in a skilled profession, and to owe the duty to use reasonable skill and care. During the past twenty years numerous attempts have been made to adopt some basic principles of financial reports. The results, unfortunately, have not been too successful. "An examination of hundreds of statements filed with our Commission," writes the former Chief Accountant of the Securities and Exchange Commission, "almost leads one to the conclusion that aside from the simple rules of double entry bookkeeping there are very few principles of accounting upon which accountants are in agreement."

Liability for Negligent Misrepresentation.

In spite of this disagreement among accountants the principles of liability for negligent misrepresentation are now well established.


2. Greer, Application of Accounting Rules and Standards to Financial Statements (1938) 13 Accounting Rev. 333; "** accounts cannot agree, even as to what a principle is." W. W. Wermitz, Chief Accountant of the Securities Exchange Commission, in a speech before the Controllers Inst. of America, Sept. 27, 1938, at Waldorf Astoria Hotel, New York, said: "It is almost unbelievable how many times questions are presented upon which it is impossible to find uniformity of opinion among text book writers or among accountants."


4. There is no doubt today that negligent misrepresentation is actionable. Smith, Liability for Honest Misrepresentation (1911) 24 Harv. L. Rev. 415; Bohlen, Misrepresentation as Deceit, Negligence, or Warranty (1929) 42 Harv. L. Rev. 733; Carpenter, Responsibility for Intentional Negligence and Innocent Misrepresentation (1930) 24 Ill. L. Rev. 749; Bohlen, Should Negligence Be Treated as Negligence or Fraud (1932) 18 Va. L. Rev. 703.
in New York. Ultramares v. Touche\(^8\) laid the foundation, and the closeness with which State Street Trust Co. v. Ernst\(^9\) followed leaves little doubt as to the present state of the law. In the Ultramares case,\(^10\) accountants who prepared a balance sheet which they knew in the usual course of business would be shown to banks, stockholders, purchasers, and sellers, as a basis of financial dealing, failed to verify fictitious accounts fraudulently inserted by their employer. The plaintiff granted credit in reliance upon the certified balance sheet which reflected the business as solvent. Actually, the business was insolvent and the plaintiff sustained loss thereby. In the State Street case,\(^11\) in certifying the balance sheet which they knew would be used to obtain credit, the accountants failed to verify fictitious accounts fraudulently inserted by their client, and to point out the stagnant condition of, and the inadequate reserves for other accounts. Thirty days later—after the plaintiff had lent money in reliance upon the certified balance sheet—the accountants directed a private communication to their client in which they accurately described these conditions. In both cases the accountants were charged with negligent misrepresentation. And in both cases the courts held as follows: The duty of care owed by the accountant arises out of his contract with his employer, and, therefore, only those in privity of contract may recover on the theory of negligence for the accountant’s misrepresentations.\(^12\) To those not in privity—creditors and investors—the accountant owed only the duty to make his certificate without fraud.\(^13\) Mere negligence alone

\(^\text{8}\) 255 N. Y. 170, 174 N. E. 441 (1931); Notes (1930) 30 Col. L. Rev. 1066; (1930) 44 Harv. L. Rev. 134; (1930) 40 Yale L. Rev. 128; (1931) 31 Col. L. Rev. 858.

\(^\text{9}\) 278 N. Y. 104, 15 N. E. (2d) 416 (1938); see (1938) 13 St. John’s L. Rev. 156.

\(^\text{10}\) See note 8, supra.

\(^\text{11}\) See note 9, supra.

\(^\text{12}\) Holmes, The Arrangement of the Law—Privity (1931) 44 Harv. L. Rev. 738. The requirement of privity is as old as assumpsit, but it has been weakened by many exceptions: Contracts: Seaver v. Ransom, 224 N. Y. 233, 120 N. E. 639 (1918) (showing the four situations in which a third-party beneficiary may maintain an action in New York); Whitney, Contracts (3d ed. 1937) 200 et seq. Torts: MacPherson v. Buick Co., 217 N. Y. 382, 111 N. E. 1050 (1916) (the leading case on the subject of manufacturer’s liability to those not in privity); see Note (1938) 12 St. John’s L. Rev. 281 for an excellent review of the extension of tort liability in the absence of privity.

\(^\text{13}\) Equitable Easements: See Note (1938) 13 St. John’s L. Rev. 93 for a discussion of Equity’s loosening of the common law requirement of privity of estate.

For additional authority for the proposition that to hold accountants liable for negligent misrepresentation there must be privity: O’Connor v. Ludlam, 92 F. (2d) 50 (C. C. A. 2d, 1937); Landell v. Lybrand, 264 Pa. 406, 107 Atl. 783 (1919); Notes (1931) 31 Col. L. Rev. 858; (1937) 37 Col. L. Rev. 126.

\(^\text{14}\) There is one important exception to the rule that the accountant owes only the duty to make his certificate without fraud to those not in privity: if the “end and aim of the transaction” is reaching the third party, recovery will be allowed on the theory of negligence though privity is lacking: Glanzer v. Shepard, 233 N. Y. 236, 135 N. E. 275 (1922); Kaufman v. Simonoff, reported in N. Y. L. J., Oct. 17, 1938, p. 1158, col. 3. Mortgagors have recovered from abstractors of titles for damages caused by negligently drawn abstracts, where
was not equivalent to fraud, but if the accountants were grossly negligent, that was evidence from which the triers of fact might infer fraud.\(^4\)

Accountants who have adhered to accepted standards of audit procedure will not be held liable, as a general rule, for misrepresentation. But, as it has been pointed out, accountants disagree as to what are “accepted standards of procedure”. Expert testimony is therefore produced by the defendant accountants to the effect that the defendants were not negligent in making their audit because they acted as reasonable accountants would have acted under the circumstances. The plaintiff amasses an equal number of experts who testify that the defendants were grossly negligent in violating all the accepted rules of accounting. If the court finds that the accountants followed the “accepted rules”, or, at most, were “merely” negligent, the complaint would be dismissed as to those not in privity of contract. If, on the other hand, the accounting errors were indicative of “gross” negli-

defendant knew the plaintiff contemplated becoming a mortgagee on the basis of the abstracts. Shine v. Nash Abstract Co., 217 Ala. 498, 117 So. 47 (1928); Western Loan and Savings Co. v. Silver Bow Abstract Co., 31 Mont. 448, 78 Pac. 774 (1904); Anderson v. Spriesterbach, 69 Wash. 393, 135 Pac. 166 (1912). In Doyle v. Chatham and Phenix Nat. Bank, 253 N. Y. 369, 171 N. E. 574 (1930), a trustee under a deed of trust to secure an issue of bonds certified them falsely and was liable to a subscriber of the bond because the certification was made for the very purpose of influencing the conduct of such subscribers. This, it is submitted, is evidence that where the third party is not known to the defendant but is a member of a definitely ascertainable class of people who would ordinarily rely upon the statements, a recovery will be allowed in the absence of privity. See (1938) 13 St. John's L. Rev. 156, 157.

Another exception to the rule that there is no liability for negligent misrepresentation in the absence of privity involves those persons engaged in a “public calling”; Burdick, The Origin of the Peculiar Duties of Public Service Companies (1911) 11 Col. L. Rev. 514; Arteburn, The Origin and First Tests of Public Callings (1927) 75 U. of Pa. L. Rev. 411. Because of the accountants' importance today it would seem that they could be logically placed within the groups engaged in “public callings”. The New York courts, however, have refused to consider them as such. Ultramares v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931); State Street Trust Co. v. Ernst, 278 N. Y. 104, 15 N. E. (2d) 416 (1938).

\(^4\) The court in Ultramares v. Touche, 255 N. Y. 170, 174 N. E. 441 (1931) and in State Street Trust Co. v. Ernst, 278 N. Y. 104, 15 N. E. (2d) 441 described the negligent conduct from which fraud may be inferred as follows:

1. A representation certified as true to the knowledge of the accountant when knowledge there is none.

2. A reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth.

3. A refusal to see the obvious, a failure to investigate the doubtful if sufficiently gross.

4. Heedless and reckless disregard of consequence.

See Green, Deceit (1930) 16 Va. L. Rev. 749.

If the accountants certify as a fact true to their own knowledge that the balance sheet is in accordance with the books of account, and their statement is false, the above two cases are authority for the proposition that the accountants will not be exonerated because they believed it to be true.
gence, they would be sent to the jury as evidence from which fraud might be inferred.

There are only a few cases in which the courts have been confronted with the problem of accountants' negligence in preparing a balance sheet. For the most part, the accounting errors have appeared on the balance sheet in the items *Cash*, *Accounts Receivable*, and *Inventory*, and the courts have reached the following conclusions.

**The Balance Sheet.**

**Cash.** This much is settled: The duty of an accountant with respect to cash is not limited to the mathematical accuracy of the figures; he is required, in addition, to test their soundness. There is a duty to ascertain the validity of cash payments, and to test the genuineness of cancelled checks. Accountants must scrutinize paid vouchers to see if the payments were properly authorized. Failure to observe these principles, on the part of accountants, will be evidence for the jury from which they might infer fraud.

In *National Surety Co. v. Lybrand*, the plaintiff as assignee, sued the defendant accountants for their failure to discover substantial cash shortages after auditing the books of Halle & Steiglitz, and for representing that there was a "verification of cash". Halle & Steiglitz had at least twenty-seven bank accounts, and the shortages were a result of embezzlements by their cashier. The accountants never requested or examined duplicate deposit slips; never pointed out late deposits or bank transfers; never observed the difference between the items on the deposit slips and the entries on the deposit books; and never noticed that the "kiting" checks were taken from the check

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16 Thomas v. The Corporation of Devenport, 1 Q. B. 16 (1900).
17 RICH, LEGAL RESPONSIBILITIES AND RIGHTS OF PUBLIC ACCOUNTANTS (1935) 39-47.
18 Cuff v. London, 1 Ch. 440 (1912); Fox and Son v. Morrish, Grant & Co., 35 T. L. R. 126 (1918).
19256 App. Div. 226, 9 N. Y. S. (2d) 554 (1st Dept. 1939) (Plaintiff was a surety on a fidelity bond and paid the loss to Halle & Steiglitz, and now sues as assignee, claiming, among other things, that the accountants were negligent in their work and made fraudulent misrepresentations as to the financial condition of Halle & Steiglitz).
20 Judge Untermyer, in *National Surety Co. v. Lybrand*, 256 App. Div. 226, 9 N. Y. S. (2d) 554, 556 (1st Dept. 1937) states: "The embezzlements consisted of a series of abstractions from petty cash. The ever accumulating shortage of petty cash in banks was concealed by delaying and substituting bank deposits from day to day, and when outside audits were made, by 'kiting' checks from one bank to another on the audit date. The effect was that the sums covered thereby appeared in two banks at the same time. This lapping or kiting practice resulted in a credit in the payee bank on the same day that the check was deposited making up a shortage previously existing there, while the amount would not be debited at the drawee bank until at least a day thereafter."
book out of their numerical order. The court held that the representation that there had been a "verification of cash" was a pretense of knowledge when they did not know the condition of the bank accounts and had no reasonable basis to assume they did. This the jury could have found amounted to constructive fraud, and a new trial was granted for a determination of these facts.

This case is particularly interesting not only because the procedure as to the "verification of cash" is generally recognized by accountants, but because the defendant accountants had either written or edited text books defining the duties of a reasonable, cautious auditor with respect to cash, and they had, literally, neglected to take their own advice.

Accounts Receivable. The cases of Ultramares v. Touche and State Street Trust Co. v. Ernst contain valuable information on how the courts handle questions involving accounts receivable. In the Ultramares case, after the total accounts receivable had been posted from entries in the journal by the junior accountant, $706,843.07 of fictitious accounts receivable were added by an employee of the company who had general charge of the accounts. The accountant testified that he supposed the entries were correct and he included them in making up his footings. He thought the verification would come later, but it was never made. If it had been made it would have been discovered that the interpolated item was not supported by any entry in the journal, nor in the books from which the journal was made up. Going farther he would have found seventeen invoices which had neither shipping number, nor customers' order number, and which varied in terms of credit and other respects from those

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21 For a good explanation of the principles to be followed in verifying cash, see Kester, Advanced Accounting (3d ed. 1933) 118; Eggleston, Auditing Procedure (2d ed. 1935) 51 et seq.; Bacas, Madden and Rosenkampff, Auditing Procedure (1937) 201 et seq.; Sherwood and Culey, Auditing Theory and Procedure (1939) 83 et seq.; see note 49, infra, for additional citations.

22 Dicksee, Manual on Auditing (1909) (edited by one of the defendants); Montgomery, Auditing, Theory and Practice (1912) (defendant herein). The accountant's own books agree that where the cash balance consists of several bank accounts care must be taken to see that the entire balance is certified simultaneously. "Instances are known," writes Montgomery, in Auditing, Theory and Practice (1912) 94, "where auditors are deceived through one balance, after being inspected, having been transferred and used on a later day in connection with another balance." The court also quoted from Bell and Powelson, Auditing (1924) to the effect that where there is more than one bank account a test should always be made of deposits during the last days of the audit period. It is also agreed in the texts that auditors should see that no checks have been abstracted from the back of the check book.

23 "When the item 'accounts receivable' appears on the balance sheet without qualification, those who rely on the balance sheet are justified in assuming that the item represents one of the best current assets." Montgomery, Auditing, Theory and Practice (3d ed. 1922) 101; Sherwood and Hornberger, Fundamentals of Auditing (2d ed. 1933) c. 3.

24 255 N. Y. 170, 174 N. E. 441 (1931).

usual in the business.\textsuperscript{26} The accountants claimed that they were excused from inspecting the invoices because of the practice of "testing and sampling".\textsuperscript{27} But the court said that "testing and sampling" was insufficient as to accounts not entered on the books where inspection of invoices was necessary to see if there were accounts.\textsuperscript{28}

The accountants had discovered that the same accounts receivable had been pledged to at least four banks at the same time. This should have made the accountants look further, said the court. In certifying the balance sheet, the court held that the accountants had made a statement as true to their own knowledge when a jury could have found they had no knowledge; and from all the facts a jury might infer fraud.

In the \textit{State Street} \textsuperscript{29} case, the certified balance sheet showed accounts which amounted to one-quarter of the total assets as "good",\textsuperscript{30} though in a delayed covering letter in which the accountants explained their statements, they were classified as comparatively inactive and appeared slow of collection. Of these two million dollars in accounts receivable, over \$768,000 worth of accounts had unpaid advances at the end of the year amounting to 125\% of the total sales during the year. This showed that the borrowers owed more money at the end of the year than their total sales during the year, thus indicating a stagnation of inventories. The true financial condition of the company, it was conceded, could not have been truthfully expressed without mention of this condition on the balance sheet, but no mention of it was made.

The accountants set up only \$19,000 of reserves\textsuperscript{31} which was to cover not only the \$768,000 mentioned above, but all the other commission accounts as well. Good accounting practice, according to uncontradicted testimony, required the accountants to establish either a large allowance for uncollectable accounts, or, at least, to indicate all the facts on the balance sheet. One of the accounts was in bankruptcy,

\textsuperscript{26} See Testimony in the Matter of McKesson & Robbins, before the Securities Exchange Committee, Docket 1-1435, Jan. 6, 1939, 154-288, 177, 189, 192.

\textsuperscript{27} In the practice of "testing and sampling" a random choice of accounts is made from the total number on the books and these, if found to be regular when inspected and investigated, are taken as a fair indication of the mass.

\textsuperscript{28} The court said that the accountants were put on their guard to scrutinize the accounts receivable with special care and a jury might find that, "with suspicions thus awakened, they closed their eyes to the obvious, and blindly gave assent." 255 N. Y. 170, 191, 174 N. E. 441, 449 (1931). See note 70, \textit{infra}.

\textsuperscript{29} 278 N. Y. 104, 15 N. E. (2d) 416 (1938).

\textsuperscript{30} The item appeared on the balance sheet as follows:

\begin{quote}
\textit{"Commission Accounts Receivables—Secured by Merchandise}
\textit{"Advances ..........................................................\$2, 043, 337 .81}
\textit{"Less Allowances .................................................. 19, 767. 15}
\hline
\$2, 023, 570 .66"
\end{quote}

\textsuperscript{31} See note 30, \textit{supra}.
and the court said that a warning that the account required a substantial reserve was given to the accountants by the fact that this account, upon which nothing had been received for over four years, was being padded year after year by monthly interest charges.

There was another group of accounts called “Ocean Bankrupt Accounts” amounting to $72,000. The accountants claimed that their failure to set up a reserve against this item was justified because they were covered by policies of credit insurance. A cursory examination of the policies, however, showed that $32,000 of the accounts were not covered at all, and the accountants’ own working sheets showed $14,000 of these bankrupt accounts were with the insurance company from three to fifteen months without action.

The accountants also failed to make a more extended examination of a certain account, the monthly sales of which never exceeded $191,000 and which averaged $129,000. In the month preceding the report of the accountants the sales jumped to $491,000 in which were included $300,000 of wholly fictitious sales. The court said that at least an investigation was called for.

Upon all these facts it could not be said, the court held, that the plaintiff had failed to make out a prima facie case, and a new trial was granted. These accounting errors were held to be sufficient evidence of gross negligence from which a jury might infer fraud.

Inventory. The inventory situation has never been a particularly happy one for the accountant. Of all the items on the balance sheet it is the most difficult to verify. And yet the accuracy of the profit and loss account is absolutely dependent on the accuracy of the inventory.

There are not many cases involving the duty of accountants with respect to inventory. In an early English case accountants, who

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It is impossible in the length of this note to discuss all the items of the balance sheet but mention might be made here of a $10,000.00 demand note in the State Street case, supra, which was listed as a part of the assets without any reserve, although it had been overdue and in the hands of an attorney who had been unable to collect it for two years.

In the N. Y. Times, Feb. 21, 1939, S. J. Broad was reported to have testified before the S. E. C. to the effect that accountants should have the right to verify accounts receivable without permission of the client. The N. Y. Times, Feb. 22, 1939, in which C. O. Wellington testified before the S. E. C., that complete audits would raise accounting fees by a quarter or a third. However, test-checking of accounts receivable was declared desirable. For a discussion of what accountants’ duties with respect to accounts receivable should include, see notes 4, supra and 49, infra; on test-checking see note 42, infra.

N. Y. Herald-Tribune, Jan. 8, 1939, interview with F. W. Kilduff. See also KILDUFF, INVENTORY PRACTICE AND MATERIAL CONTROL (1st ed. 1925).


accepted the certificate of a manager that the inventory sheets correctly stated the value and amount of the cotton yarn on hand, were held not negligent, even though the amount of cotton yarn was overstated so that the certified balance sheet failed to reveal the true financial condition of the company. The English court said that the accountant had no duty to take stock, and that there was no duty to check the value of inventory given by responsible officers of the business, though there was a duty to ascertain the competency of the manager.

_Ultramares v. Touche_ is one of the few New York cases in point. In this case inventory as given to the accountants totalled $347,219.08. The accountants then discovered errors in the sum of $303,863.20 and adjusted the balance sheet accordingly. The court said there was ground for suspicion because of this inflation in the inventory; and that "both the extent of the discrepancy and its causes might have been found to cast discredit upon the business and the books."  

Aside from the above statements there is little evidence of what the courts will consider gross negligence to warrant a submission of the facts to the jury. It is submitted that if accountants have not verified inventory there must be a clear statement to that effect. To say that "inventory has been certified by responsible officials" is inadequate and misunderstood, not only by the investing public but by corporate executives as well. Nothing less than a clear statement that "inventory has not been verified" shown clearly on the balance sheet is acceptable today. The present trend is to require spot checks of inventory, while the most advanced corporations, realizing that

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[255 N. Y. 170, 174 N. E. 441 (1931).]
[Id. at 178.]
[Robinson, _Are Present Forms of Financial Statements Satisfactory?_ (1936) 62 J. Acc'y. 426, in which the author answers the question in the negative; Blough, _Accountants' Certificates_ (1938) 65 J. Acc'y. 106; H. V. McCall and M. Furman, in _Report on Accounting Practice and Procedure, Pursuant to the Order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939_; N. Y. Times, Jan. 25, 1939: W. H. Bell testifying as an expert before the S. E. C. said that the public does not understand the accountants' certificates.]
[See note 48, infra.]
[See note 39, supra.]
[N. Y. Herald-Tribune, Feb. 21, 1939: S. J. Broad reported as testifying as an expert before the Securities and Exchange Commission in the Matter of McKesson and Robbins, that he believed auditors should make tests and inquiries of quantities and the condition of the stock listed in the inventories. N. Y. Times, Feb. 22, 1939. C. O. Wellington, an expert accountant, testified before the Securities and Exchange Commission on accounting practice, that his firm makes test checks; N. Y. Times, Feb. 29, 1939: Testimony of N. J. Lenhart as an expert witness in the Securities and Exchange Commission's investigation into the accounting aspects of McKesson and Robbins: "Some years ago it used to be our practice to make limitations in our audits. We would not examine receivable or inventories. We have discarded that practice. We consider it highly dangerous." On inventory practice generally: F. W. Kilduff, _Inventory Practice and Material Control_ (1st ed. 1925); _Sherwood and Hornberger, Fundamentals of Auditing_ (2d ed. 1933); _Montgomery, Auditing_,]
accounts lack the specialized knowledge necessary to a verification of inventory, have hired expert engineers to perform this function. 43

One must not forget in this discussion that a large element of judgment is involved in accountants' audits, and that the contract between the accountant and his client, and the fee which he receives, largely controls the extent of his audit. But if accountants attempt to limit their responsibility to the public by hiding behind the terms of their contract with their client, they are violating their true professional duty. 44

It was charged before the Conference on Accounting called pursuant to the order of the Attorney General, 45 that leading members of the accounting profession "do not hesitate to take the stand in important cases and confuse the juries by uttering rules of accounting which any young student applying for the degree of certified public accountant would be flunked on." 46 As evidence, O'Connor v. Ludlam 47 is cited. In that case plaintiff brought an action in deceit against defendant accountants who prepared a balance sheet for a company, knowing it would be used to induce the public to buy the company's

43 Porter, Financial Post Marks, N. Y. Post, Feb. 27, 1939: "Engineering firms rather than accountants are to be consulted in the future by at least one big banking house whenever it is planning to participate in a financial deal"; N. Y. Times, Mar. 7, 1939: Schenley Distillers Corp. included a certificate of consulting engineers as to the verification of quantities and condition of inventories, as well as the usual certificate of independent auditors, in their report for 1938; Hendershot, Wall Street, N. Y. World-Telegram, Mar. 8, 1939: "Schenley Distillers Corp. has set a splendid example for big business * * *." In the Wall St. J. of Jan. 18, 1939 it was reported that Canada Dry Ginger Ale, Inc. will have an independent audit of inventories every three months.

44 McCall, Assistant Attorney General in charge, and Furman, Senior Securities Accountant, stated in the Report on Conference on Accounting Practice and Procedure, pursuant to the order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939: "When an accountant permits himself to be so restricted [to the terms of his contract], he becomes nothing more than an employee and is forsaking his true professional duty to the public." See note 67, infra.

For example, when an audit is to include an examination of cash, it is not unknown for accountants to omit an examination of deposit slips, even though the courts, the statements of rules of accounting procedure issued by the Fed. Res. Bd., and those issued by various accounting societies, and the majority of text-books, recognize that the examination of deposit slips is a vital factor in the examination of cash. The accountants have escaped liability by showing that their contract with their client limited the extent of their audits. See National Surety v. Lybrand, note 19, supra. See also notes 17–22 incl., supra.


46 Statement by Reis, contained in Report on Conference on Accounting Practice and Procedure, pursuant to the order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939, 75. See also Reis, False Security (1937).

47 92 F. (2d) 50 (C. C. A. 2d, 1937).
stock. Plaintiff purchased shares in reliance upon the certified balance sheet. Thereafter, the company went into bankruptcy and plaintiff lost his investment. The accountants were charged with fraud for their failure adequately to disclose, among other things, that the asset "cash" as listed on the balance sheet included $1,477,000 of trust funds which did not belong to the company and which it had commingled with its own cash. The accountants claimed they gave a sufficient explanation of the character of the cash on the liability side of the balance sheet. Even though it was admitted that 99% of the public, for whose use the balance sheet was prepared, would not have understood their explanation, the accountants said they followed accepted accounting procedure, and they were able to call leading members of the accounting profession to substantiate their claim. In spite of much authority to the contrary, the defendant's experts convinced the jury not only that accepted methods of accounting were used, but that there was no duty upon accountants to reveal their client's violation of the trust relation.

The higher court held that as a correct

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18 Testimony of Dr. J. Klein, O'Connor v. Ludlam, Folio No. 14,493, Vol. 3 of Transcript of Record, 3749.

Accountants must be aware by this time that unless they make clear unequivocal statements the public is unable to understand them. In the Report on Conference on Accounting Practice and Procedure, Pursuant to the Order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939, Redmond, Pres. of the N. Y. Credit Men's Ass'n, said, "Nine out of ten cannot understand a financial statement," and a larger percentage do not know the meaning of an accountant's certificate." In the same report the Assistant Attorney General in charge, and the Senior Securities Accountants, H. V. McCall and Max Furman respectively, stated that the public believes that when a certified public accountant's name appears on the face of a balance sheet that the accountant has assured himself that it truly reflected the financial condition of the company.

Reference to some of the standard texts on Accounting reveals the following: KESTER, Advanced Accounting (3d ed. 1933) 118: "Cash on Balance sheet only such portions of cash should be shown as is being available for the liquidation of current liabilities." MONTGOMERY, Auditing, Theory and Practice (5th ed. 1934) 132: "The reader of the statement has the right to assume that the item [cash] is realizable in the amount stated and is completely available for the conduct of the business and the payment of debts." BELL, Accountants' Report (3d Rev. ed. 1934) 269: "Cash on deposit for restricted purposes should not be classified as current assets unless they represent funds for the payment of current liabilities." In the Pamphlet issued by the Am. Inst. of Accnts (Jan. 1936) Examination of Financial Statements: "Funds subject to withdrawal restrictions should be so described on the balance sheet" (it would seem that such a rule would apply equally well to trust funds). BACAS, MADDEN AND ROSENKAMPF, Auditing Procedure (1937) 211: "items which are of the nature of cash but which are not available to discharge liabilities should not be stated as cash."

principle of accounting they believed the accountants had a duty to show clearly on the balance sheet that the trust funds did not belong to their client and, that there was much evidence which tended to cast doubt on the good faith of the accountants, but since it did not persuade the jury, and since there was no error in the lower court's charge, they would not upset the jury's verdict for the defendant.\footnote{51}

If it is actually good accounting practice to prepare a balance sheet for the purpose of inducing the public to buy stock, and to explain on the liability side of the balance sheet that the asset "Cash" included trust funds, when it is admitted that 99\% of the public would not understand the explanation, then it is time that such practice was changed, expert testimony to the contrary notwithstanding. It is this unwillingness on the part of some accountants to conform to the standards of a twentieth century economy\footnote{52} which gives rise today to distrust of accountants and demands for their stricter regulation.\footnote{53} In considering the federal legislation a solution to the prob-

\footnote{51}{In asking Dr. Klein whether to prevent the public from being misled it actually would have been better not to include on the balance sheet a statement: "Less a million and a quarter of cash held as trustee," Dr. Klein said, "I should say that in the exercise of reasonable judgment on the part of the maker of the balance sheet, he was justified to coming to some such conclusion as to the necessity and non-necessity, wisdom or non-wisdom of doing it." Testimony in O'Connor v. Ludlam, Folio No. 14,493, Vol. 3 of Transcript of Record 3749.}

\footnote{52}{In the N. Y. Times of Jan. 7, 1939, p. 30, col. 1, it was stated that a charge had been made that 90\% of all the brokerage and investment firms listed on the Stock and Curb Exchanges were audited by six or seven great firms which dominated the N. Y. State Soc. of Cert. Pub. Accn'ts and the Am. Inst. of Accn'ts, which resulted in a too lenient interpretation by the association of principles which should be applied to all accounting activity.}

\footnote{53}{Plaintiff requested the lower court to charge the jury that it was the duty of the accountants to reveal that the trust funds did not belong to their client. But the lower court refused this charge, saying that the only issue for the jury was whether the accountants were guilty of fraud. But the lower court refused this charge, saying that the only issue for the jury was whether the accountants were guilty of fraud.}

\footnote{54}{Benson (Pres. Am. Bankers Ass'n), \textit{Serving a Public Need}, a speech delivered at a dinner given in his honor by the Am. Inst. of Accn'ts. and the N. Y. State Soc. of Cert. Pub. Accn'ts., Jan. 30, 1939: "All business is coming to realize more and more that it must be conducted on the highest standards, and that it has social responsibilities. * * * Your responsibility as accountants extends to the stockholders of the company. Many of the stockholders are not business people. \textit{Every statement in your reports should be clear} * * * You undoubtedly have responsibility to protect the investing public."}

\footnote{55}{Smails, \textit{Auditing} (1933) 25: "The certificates of a qualified accountant upon a financial statement inspires general confidence today because * * * in consciousness of their great moral obligations they [accountants] have applied a degree of skill and care far exceeding that judicially demanded." Blough, \textit{The Need for Accounting Principles} (1937) 12 \textit{Accounting Rev.} 30, 31: "Almost daily principles which I had thought were definitely accepted are violated by some accountants in whom I have high confidence." (Blough was the former chief accountant of the Securities and Exchange Commission.)}

lems presented by the character of the testimony offered, and the disagreement among accountants as to what are accepted standards, may be found.


The Securities Act of 1933 discarded the requirement of privity in an action for negligent misrepresentation. Even the traditional requirements of deceit, i.e., reliance, scienter, and causation, were no part of the plaintiff’s proof in the first draft. By the 1934 amendments a provision on reliance and causal connection between the untruth and the loss was added. The accountants, under the Securities Act, were not liable if they had reasonable ground to believe and did believe that their statements in the registration statements were true.

The Exchange Act imposed liability for misleading statements as distinguished from untruths in the registration statements and in the variety of documents required to be filed with the Securities and Exchange Commission. Under the Exchange Act the accountants

of McKesson & Robbins, Inc.; N. Y. Times, Jan. 18, 1939: “The licensing of all public accountants ** was recommended ** to Attorney General John J. Bennett, Jr. ** See REPORT ON CONFERENCE ON ACCOUNTING Practice and Procedure, pursuant to the order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939. Hendershot, Wall Street, N. Y. World-Telegram, Mar. 24, 1939, p. 32, col. 2: “Bills have been introduced ** in the New York State Legislature designed to meet the public demands for regulation ** on persons practicing public accountant **”

THE SECURITIES ACT OF 1933, § 1, 48 STAT. 74 (1933), 15 U. S. C. § 77a (1934) as amended by § 201, 48 STAT. 905, 15 U. S. C. § 77b (1934). PRASHER, PRIVATE CORPORATION (1937) 611. The primary purpose of the Securities Act was to provide for a full and fair disclosure of securities issued for sale by means of interstate instrumentalities or the mails. Disclosure is to be effected by: “(1) filing a registration statement with the Securities and Exchange Commission and (2) delivering a prospectus to the purchaser.”

THE SECURITIES ACT OF 1933, § 11, 48 STAT. 82 (1933), 15 U. S. C. § 77k (1934): “Any person acquiring a security ** on the basis of a registration statement which contained a material fact ** could sue every accountant ** who prepared or certified any part of the statement.”

HARPER, TORTS (1933) § 216; EDGAR AND EDGAR, TORTS (3d ed. 1936) § 132; Bohlen, Misrepresentation as Deceit, Negligence, and Warranty (1929) 42 HARV. L. REV. 733.


THE SECURITIES AND EXCHANGE ACT OF 1934, § 1, 48 STAT. 881, 15 U. S. C. § 78a (1934). PRASHER, PRIVATE CORPORATIONS (1937) 620: “This is the first federal statute by which the stock exchanges of the United States are regulated. The purposes of the act were: (1) regulation of securities exchanges and markets; (2) control of credit; (3) prevention of unfair practices; (4) control of corporations.”

Section 12 of the Exchange Act authorizes the commission to require balance sheets and profit and loss statements contained in the registration
could prove they acted in good faith and had no knowledge that such statements were false and misleading.61

It is hoped that these provisions will guide those courts which admit of no exception to the doctrine, that the absence of privity is sufficient reason in itself to deny recovery for negligent misrepresentation. It is with the Security and Exchange Commission’s extensive control over the form of financial statements, and over the principles to be followed with types of financial facts62 that, it is submitted, the solution of what is “good accounting practice” lies. By rules and regulations and releases of the Securities and Exchange Commission, attempts have been made and will continue to be made by the Commission to standardize certain accounting principles.63 Complete acceptance of the Commission’s rules as a guide for the courts, and the elimination of the jury as arbiter of whether accounting was practiced would be a great step forward. At least the Securities and Exchange Commission and the many commissions functioning under uniform accounting systems64 would be the ideal nucleus for the development of standards for the accounting profession.

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63 Speech delivered by W. W. Werntz, Chief Accountant, Securities and Exchange Commission, Sept. 27, 1938, before the Controllers’ Institute of Am.; Rule 650, effective March 15, 1936, Promulgated by General Rules and Regulations Jan. 21, 1936, Securities Act of 1933, on the qualifications of accountants; Rule 651, effective March 15, 1936, Promulgated by General Rules and Regulations Jan. 21, 1936, Securities Act of 1933, on accountants; S. E. C., Securities Exchange Act 1934, Accounting Series Release No. 4, April 25, 1938: “If financial statements filed pursuant to the Securities Act 1933, or the Exchange Act 1934, are prepared in accordance with accounting principles for which there is no authoritative support such financial statements will be presumed misleading * * * despite disclosure in the accountant’s certificate or in the footnotes.”
64 Uniform classification of accounts for common carriers were first instituted by the I. C. C. in 1907. This was revised in 1914. The National Association of R. R. and Utilities Comm. adopted uniform accounting in 1922. The Fed. Com. Comm. followed suit in 1936; and 1937 found the Fed. Pow. Comm., and the Securities and Exchange Comm. under the Public Utility Act also adopting uniform accounting. See Couchman, Uniform Accounting for Industry (1934) 58 J. Acc’ty. 333; Morehouse, Innovations in Public Utility Accounting Regulation (1937) 46 Yale L. Rev. 955: “It has long been recognized by forward looking commissions that chapter one of effective regulation begins with revealing and uniform accounts and accounting statements.”

With the McKesson & Robbins case as a springboard, the Securities and Exchange Commission may well take the first practical step towards the solution of the problem of accountants' liability. Not only is the Commission interested in the extent to which prevailing and generally accepted standards of audit procedure were followed by the accountants for McKesson & Robbins, and the adequacy of those standards, but the Commission is seeking information as to the basis of future legislation.65

At this date the hearings in the McKesson & Robbins case have not been completed, and, as yet, there have been no findings by the Securities and Exchange Commission. Various problems have been presented in reference to the accountants' practices in auditing the books of McKesson & Robbins. Some of these problems have been before the courts in the past, many have not. Among the questions raised by the testimony are the following:

(1) How far should an accountant be permitted to go in limiting the extent of his examination by his contract? 66

(2) Is it good accounting practice for an accountant to make a mere book reconciliation of cash, and to exclude from his audit an examination of bank deposit slips, or duplicate deposit slips, and such further steps as might disclose a misappropriation of funds? 67

(3) Where it appears that in a substantial number of the books of a corporation none of the customers ever failed to pay in the past; none of the accounts were ever overdue; and no reserves were ever considered necessary against the possible failure of customers to make good, would it be good accounting practice to scrutinize the accounts with special care? 68

66 There has been little judicial interpretation of this point, but see note 44, supra, and note 67, infra.
67 For testimony on the examination of cash in McKesson & Robbins, see Testimony in the Matter of McKesson & Robbins, before the Securities and Exchange Commission, Docket 1-1435, Jan. 10, 1939, 437 et seq. and Docket 1-1435, Jan. 18, 1939, 985 et seq. See also N. Y. Times, Jan. 18, 1939, p. 8, col. 3, and note 44, supra. With respect to auditors' duties as to cash see notes 17-22, supra. In National Surety Co. v. Lybrand, 256 App. Div. 226, 9 N. Y. S. (2d) 554 (1st Dept. 1939), the court said that a mere book conciliation of cash was insufficient where the accountants contracted to make a "verification of cash".
68 See Testimony in the Matter of McKesson & Robbins before the Securities and Exchange Commission, Docket 1-1435, Jan. 9, 1939, 229-403, 332-385; N. Y. Times, Jan. 10, 1939, p. 20, col. 5. In Ultramares v. Touche, 255 N. Y. 170, 191, 174 N. E. 441, 449 (1931), the court said that because of the conditions of some of the accounts, the accountants were put on their guard to scrutinize the accounts receivable with special care, and a jury might find that, "with suspicions thus awakened, they closed their eyes to the obvious, and blindly gave assent." See notes 24-28, supra.
(4) Should a large increase in net worth and sales arouse suspicion or excite inquiry? ⁶⁹

(5) Is it good accounting practice to test check receivables, to test the existence of banking firms, and to test customers’ accounts to determine if customers really existed and owed the amounts stated on the books of the company? ⁷⁰

(6) When it is admitted that a complete physical examination of inventory is prohibitive because of expense, or undesirable because of accountants’ lack of specialized knowledge to make such examination effective, is it good accounting practice to make test checks of inventory? ⁷¹

Conclusion.

There can be little doubt that the extension of liability of accountants is a pressing problem. The following conclusions and suggestions are submitted:

1. There is only one valid legal reason for not holding accountants liable to third parties on the theory of negligence for their misrepresentations, namely, that the accountants did not know and had no reason to know who would be the object of their making a certified financial report. ⁷² It should be recognized that the social responsi-

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⁶⁹ See Testimony in the Matter of McKesson & Robbins before the Securities and Exchange Commission, Docket 1-1435, Jan. 5, 1939, 1–153, 57. In the McKesson and Robbins case there was testimony that there was an increase in sales from Dec. 31, 1934 to Nov. 30, 1936 of from $295,028.12 to $1,306,338. In the State Street Trust Co. v. Ernst case, 278 N. Y. 104, 120, 15 N. E. (2d) 416 (1938), sales which averaged $129,000 for eleven months jumped to $491,000 in December. The court said that at least an investigation was called for by the sudden increase in sales.


⁷¹ See note 42, supra.

Gould, Financial Editor of the N. Y. Journal-American, was reported as stating in the Report on Conference on Accounting Practice and Procedure Called Pursuant to the Order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939: “If this is good accounting practice [not to test-check inventory] it should be changed or the law will change it.”

⁷² This would only be a slight extension of the rule in Glanzer v. Shepard, 233 N. Y. 236, 135 N. E. 275 (1922) and Kaufman v. Simonoff, reported in N. Y. L. J., Oct. 17, 1938, p. 1158, col. 3, which stand for the proposition that where the plaintiff is the end and aim of the transaction liability may be imposed in the absence of privity; for accountants know in practically all cases why their client hired them to prepare a certified balance sheet, and to whom their statements will probably be shown. It is submitted that the burden should be on the accountant to show that he did not know that the plaintiff or the class of people such as the plaintiff would receive his financial report.
bility of accountants is as great as those engaged in a "public calling". Such a holding would negative to a great extent the possibility of an accountant's proving that he did not know the plaintiff would receive his certified report. A further legal liability might be imposed by considering a certified balance sheet in the nature of a dangerous instrumentality. Even the doctrine of res ipsa loquitur might be applied: that damage to the plaintiff in certain accounting situations could not have occurred unless there was negligence. Accountants could protect themselves against such increases in the ambit of their liability by insurance.

2. There is urgent need today for a statement of fundamental accounting principles. These principles should be drafted by the Securities and Exchange Commission, and should serve as final authority in the courts. The Securities and Exchange Commission should serve in the nature of a "Board of Accounting Appeals" as arbiter in those questions which could not be covered by written rules. This should no longer be a jury function. Expert testimony should lose its potency except as required before the Securities and Exchange Commission.

The Grievance Committee which hears charges against certified public accountants in New York State should be abolished in favor...
of a committee under the aegis of the Securities and Exchange Commission, with accountants composing at the most, two-thirds thereof. They should have the power to initiate investigations into the professional conduct of all accountants, and the further power to appeal to the courts, as in disbarment proceedings, to prohibit the practice of accounting by those accountants, certified or not, who have been found guilty of professional misconduct.

Balance sheets and like financial statements should show clearly on their face items that are not verified. The words “we hereby certify” should be eliminated where exceptions buried in the footnotes have the effect of nullifying the certification. The term “according to information supplied by officers and directors” should be entirely eliminated from the statements issued to the investing public.

The following suggestions have been gleaned from the newspapers in regard to the relation of accountants to the corporations they represent: Stockholders should elect the accountants, and the accountants should be responsible to them. The accountants should be elected at the beginning of the year with the right of access to the books of the concern at all times. There should be a tightening of internal control in the corporation. Test checks of accounts re-
gross negligence against certified public accountants in New York State. It has no power to initiate investigations. The usual procedure involves the filing of a charge with the Commissioner of Education to institute proceedings if in his opinion there appears the possibility or probability that a certified public accountant—it has no jurisdiction over accountants not certified—is guilty of fraud, deceit, or gross negligence. The charges are presented to the Grievance Committee, and their findings are sent to the Regents, who have the power to revoke, suspend, or reprimand the certified public accountant. Even if the right of the accountant to the use of the name “Certified Public Accountant” is revoked, he may still practice accountancy.

39 Statement by Reis contained in Report on Conference on Accounting Practice and Procedure called pursuant to the order of the Attorney General, Jan. 6, 1939, published Jan. 17, 1939; see also Reis, False Security (1937).


82 See notes 39, 42, supra.

83 Wall St. J., Jan. 18, 1939; R. C. A. have amended the by-laws to permit shareholders at each annual meeting to name an independent accountant to audit and certify the financial records of the company. N. Y. Times, Feb. 16, 1939, p. 29, col. 8, reports similar action on the part of Consolidated Edison Company of New York, Inc.; N. Y. Times, Feb. 29, 1939, p. 34, col. 1, reports a suggestion that auditors’ reports be not only addressed to the board of directors but also be mailed individually to each director. See also Hendershot, Wall Street, N. Y. World-Telegram, March 24, 1939, p. 32, col. 1.


86 In the Interstate Hosiery Mills case, S. E. C. Securities Act of 1934, Release No. 2048, March 22, 1939, Findings and Opinion of the Commission, the financial statements in the Interstate Hosiery Mill’s application for registration and annual reports, included an overstatement of “gross profit on sales” and a resulting cumulative overstatement of the balance sheet figures for cash,
receivable and inventory are desirable. Although accountancy is not an exact science, it must be recognized that it is founded upon "certain fundamental principles which are universal and immutable and which give recognition to the fact that there is only one truth in everything and no half truth, or quarter truth, or approximations of the truth."

ROBERT A. KLEIN.

SCIENTIFIC AIDS IN PROOF.

A legal philosopher points to the faithful reconstruction of past events as the basis for just determinations. Under our system of trial by jury, however, such reconstructions rank as rare phenomena. There are at least four obvious reasons for this. First, a substantial portion of the fact-materials available for this task may not be presented to the jury. Second, the main, and often the sole, liaison between the past event and the present trial is oral testimony. Such a connection, constructed of imperfect observation, faulty recollection,

accounts receivable, inventory, and surplus. The author of the falsifications was an employee of Homes & Davis, the auditors of Interstate Hosiery. One of the questions was whether the management of Interstate Hosiery should have discovered the gross overstatements of their position in the financial reports submitted to them by the auditors. The S. E. C. held that the management should have a general conception of its financial position so that it would recognize, for example, the overstatement in its cash position of almost 161%. Said the Securities and Exchange Commission, "The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable."

N. Y. Times, Jan. 31, 1939, p. 35, col. 1: P. A. Benson, President of the American Bankers Association, was reported as urging statutory legislation vesting in auditors the power to demand from corporate managements compliance with specific requirements necessary for accurate and honest accounting. In the Wall St. J., Jan. 18, 1939: reporting that the General Foods Corporation appointed a controller and an assistant controller responsible directly to the board of directors. Suggestions have also been made to rotate the auditors.

See note 42, supra.


2 "** whatever is relevant is admissible unless it is subject to one or another of the exclusionary principles or rules." Michael and Adler, The Trial of an Issue of Fact: II (1934) 34 COL. L. REV. 1462, 1463; 1 WIGMORE, EVIDENCE (2d ed. 1923) §9; cf. WIGMORE, THE SCIENCE OF JUDICIAL PROOF (3d ed. 1937) §1.
3 "To the influence of jury trial may be attributed the most characteristic element of the law of evidence, the exclusionary rules **:" Rosenthal, The Development of the Use of Expert Testimony (1935) 2 LAW & CONTEMP. PROB. 403, 411.