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The Fairness Myth

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Accounting firms are increasingly the targets of suits brought under the antifraud provisions of the federal securities laws.[1] While it has not yet been determined whether a cohesive body of law will emerge—there are significant differences among and within the circuits—the thrust of some recent opinions is toward a redefinition of the role of the auditor, focusing upon his responsibility to those who are potential investors and lenders rather than upon his responsibility to his client, the existing body of shareholders.

Today when an auditor is called upon to make a difficult accounting judgment, he is aware that any decision he makes may result in an action that could impose substantial, perhaps ruinous damages upon him and his firm. If the accountant is to carry out successfully his assumed obligations both to the investing public and to existing shareholders (an attempt to redefine the role of the accountant must still recognize the traditional relationship between accountant and client), [2] he needs a legal standard of liability that is something more than a collection of the adventitious, random decisions of judges and juries who are untrained in accounting matters.

The accounting profession has enlarged its efforts to establish bodies of generally accepted auditing standards and accounting principles to guide the accountant in conducting his audit and expressing his professional opinion. Although there is always a need for narrowing alternative accounting principles and developing additional authority, the existing bodies of accounting and auditing literature offer the auditor substantial guidance in determining whether he should give an opinion on the financial statements of a client, how he should arrive at that opinion, and in what form that opinion should be expressed.

The courts have generally encouraged the auditor to adhere to these professional standards by shielding him from liability when he

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1. Securities Exchange Act of 1934 §10(b), 15 U.S.C. §78j (1970); Securities Exchange Act of 1933 §§ 11, 12, 17, 15 U.S.C. §§ 77k, q (1970); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974). Although § 11 of the 1933 Act is not technically an antifraud provision, it is treated as such in this discussion.

2. *See, e.g.*, Hocbfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

does. Judge McLean expressed this attitude in writing that "[a]ccountants should not be held to a standard higher than that recognized in their profession."[3] Other decisions, however—in particular *United States v. Simon*[4] and, recently, *Herzfeld v. Laventhol, Kreskstein, Horwath and Horwath*[5]—can be read to suggest that the liability of accountants will be judged by a vague lay standard of fairness rather than the criteria systematically developed by the accounting profession. That is to say that an accountant may be found to have violated the law notwithstanding his adherence to generally accepted auditing standards and accounting principles; he must also undertake to do whatever it is that the trier of fact may later deem to be "fair." If a fairness test were adopted by the courts, the ramifications of requiring such clairvoyance in auditors would be far-reaching—subverting the efforts of the profession to establish uniform standards of accounting and distorting the already exaggerated public expectations concerning the purpose of an accountant's report. I submit that the *Simon* decision does not in fact call for a fairness standard of liability, and that such dicta to the contrary in the *Herzfeld* opinion are simply wrong. These two opinions must be read against the entire body of case law adjudicating accountants' liability: that an auditor may not be held liable for damages when in good faith he has acted in accordance with the relevant auditing standards and accounting principles generally accepted by his profession.

THE AUDITOR'S ROLE UNDER THE SECURITIES LAWS[6]

The independent auditor's responsibility (and liability) to the investing public is thought to arise out of those provisions of the

3. Escott v. BarChris Construction Corp., 283 F. Supp. 643, 703 (S.D.N.Y. 1968). *See also Hochfelder*, 503 F.2d at 1108. This is equally true of doctors and lawyers. Dorf v. Relles, 355 F.2d 488 (7th Cir. 1966) (lawyers); Price v. Neyland, 320 F.2d 674 (D.C. Cir. 1963) (doctors).

4. 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

5. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶94,547 (S.D.N.Y. May 29, 1974).

6. Common law cases are excluded from this discussion because there was never any doubt as to the standard of care. An accountant was liable to his client for negligence, and negligence meant the failure to perform with the due care commonly exercised by other members of the same profession. This liability was limited primarily to clients. Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931). Even with the latter-day attempts to expand the accountant's common-law liability to third parties, no court has even hinted that good faith compliance with professional standards would not be an absolute defense. *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968). The debate has centered instead on whether such expanded liability should require gross negligence, knowledge of falsity, or mere ordinary negligence (as originally defined in the first-party suits brought by clients) coupled with foreseeability as to relying third persons.

federal securities laws that require financial statements filed thereunder to be accompanied by the report of an independent public accountant.[7] Beyond the requirement of independence, the securities laws do not specifically define the duties of the public accountant. Pursuant to Regulation S-X, the SEC's basic accounting regulation, the accountant's report accompanying the registrant's financial statements shall (i) state whether the audit was conducted in accordance with generally accepted auditing standards, and designate any omitted auditing procedures and the reasons for their omission; (ii) state the accountant's opinion on the accompanying financial statements and the accounting principles and practices reflected therein, and his opinion on consistency or material change; and (iii) identify any matters to which the accountant has taken exception, and state the effect of each exception on the financial statements.[8]

Although the Commission has the authority to formulate the accounting principles to be applied by registrants in the preparation of their financial statements, it has exercised this authority only sparingly by issuing occasional accounting releases. In general, the SEC has been satisfied to let the accounting profession develop

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7. 15 U.S.C. §77aa(26) (1970). The initial draft of the Securities Act of 1933 contained a provision calling for the use of government auditors to review financial statements filed pursuant to the Act. Congress rejected that proposal, however, in favor of one providing for examination by "independent public or certified accountants." The SEC has assumed this requirement also applies to certain filings under the Securities Exchange Act of 1934. The extent of accountants' liability, if any, under the 1934 Act is, to say the least, unclear.

8. SEC Reg. S-X, 17 C.F.R. §210.2-02(h), (c), *as amended* (1974). It is a common misconception of many lawyers and businessmen that an accountant "certifies" the objective accuracy of every numerical figure appearing in the financial statements. The SEC has never expected the accountant to be a guarantor of the accuracy of the financial information appearing in his client's financial statements. The Commission, the accounting profession, and the courts have recognized that it would be impractical, even impossible, for independent accountants to conduct 100% examinations of their clients' transactions and countless journal and ledger entries. Even if such a total examination were carried out by the auditor, there is no way he could be completely assured that all of his client's business transactions were recorded and therefore verifiable or that collusion had not occurred between the client and third parties.

Simply stated, it is unrealistic to expect that an auditor can "certify" in any absolute sense the accuracy of the statistical representations contained in financial statements. The company, not its auditors, makes financial statement representations to the public, and the responsibility for their accuracy must lie with it. *See, e.g., In re* Interstate Hosiery Mills, Inc., 4 S.E.C. 706, 721 (1936); SEC Accounting Series Release No. 62 (June 27, 1947); AICPA, Committee on Auditing Procedure, Statement No. 1, at 10 (1939); AICPA, Committee on Auditing Procedure, Statement No. 33, at 9-10 (1963); SEC v. Republic Nat'l Life Ins. Co., 378 F. Supp. 430, 440 (S.D.N.Y. 1974) (Pollack, J.) (". . . an accountant is not a guarantor of the reports he prepares and is only duty bound to act honestly, in good faith and with reasonable care in the discharge of his professional obligations. . . ." *Id.* at 440).

these principles for the business community. From the outset, the Commission has expressly relied upon the profession:

> In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commissioner has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant.[9]

The "authoritative support" necessary to overcome this negative presumption is general acceptance by the accounting profession.[10]

GAAS AND GAAP

As recognized by Regulation S-X, the accounting profession has articulated a body of "generally accepted auditing standards" (GAAS) and "generally accepted accounting principles" (GAAP). It is intended that the application of these standards and principles in appropriate situations will, as nearly as possible, result in financial reporting that is not misleading.

The profession's generally accepted auditing standards guide the accountant in the conduct of his audit and in the preparation of his report. Such standards may be technical rules of procedure or fundamental statements of objectives and policy. In actual appli-

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9. SEC Accounting Series Release No. 4 (Apr. 25, 1938); *cf.* SEC Accounting Series Release No. 62 (June 27, 1947).

10. *See* RAPPAPORT, SEC: ACCOUNTING PRACTICE AND PROCEDURE 3.1-3.9 (3d ed. 1972); Kripke, *The SEC, The Accountants, Some Myths and Some Realities,* 45 N.Y.U.L. REV. 1151, 1177 (1970). To be sure, the Commission has criticized the accounting profession, prodded it into action and even taken exception to some of its pronouncements. By and large, however, it has encouraged the profession to exercise leadership in developing the authoritative literature.

On the other hand, the Commission has not always cooperated with individual members of the profession when they are conducting audits. In SEC v. Republic Nat'l Life Ins. Co., Judge Pollack's memorandum opinion of October 18, 1974, criticizes the Commission for having withheld from the 2 accounting firm defendants information that might have been material to their examination:

> Unless the SEC's pronouncements of cooperation with public accountants in the interests of providing full and understandable disclosure to the investing public are to be taken as mere exercises in public relations, the SEC must genuinely indicate that cooperation is indeed a two-way street. Surely the SEC would not choose to have accountants judge it by the percept 'do as I do, not as I say.'

(Opinion at 8).

cation they deal with such matters as how to draft and implement the audit program, how to conduct tests and checks to verify the internal accounting controls of the client, how to decide what opinion is to be expressed in the auditor's report (an unqualified or "clean" opinion, a qualified opinion, an adverse or negative opinion, or a disclaimer of opinion) and how to express that opinion. Auditing standards gain "authoritative support" through formal adoption by the American Institute of Certified Public Accountants (AICPA). The Committee on Auditing Procedures of the AICPA has issued and reissued statements on auditing standards and policy that guide the auditor in selecting and applying auditing procedures.[11]

Whereas auditing standards are directed toward the accountant and guide him in the conduct of his audit and preparation of his report, accounting principles are directed toward management and deal with the proper method of recording the results of economic operations in concise, comprehensible financial statements. These principles incorporate the current consensus concerning which economic resources and obligations should be recorded as assets and liabilities; which changes in assets and liabilities should be reflected; when these changes should be reflected; how the operations, assets and liabilities, and changes in them should be measured; what financial information should be disclosed and how it should be disclosed; and which financial statements should be prepared. They include broad guidelines of general application as well as detailed practices and procedures.[12]

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11. The profession first attempted to standardize auditing procedures in the wake of the Commission's *McKesson & Robbins* investigation (SEC Accounting Series Release No. 19 (1940)), which exposed the unsettled state of auditing standards for verification of inventories and receivables. In 1940, the Committee on Auditing Procedure issued Statement on Auditing Procedure No. 1, thereby establishing procedures for observation of inventories and confirmation of receivables. In 1947, 1951, 1954, and 1963 (with Statement No. 33), the Committee consolidated its prior pronouncements into one authoritative exposition of auditing standards. In 1973, the Committee (now the Auditing Standards Executive Committee) incorporated statements 33-54 into its Statement on Auditing Standards No. 1 (SAS No. 1). The auditing standards set forth in SAS No. 1 have been fully supported by the SEC. *See* ASR No. 153; Liggio, *Expanding Concepts of Accountant's Liability*, CALIF. CPAQ. 23 (Sept. 1974).

12. AICPA, Accounting Principles Board ("APB"), Accounting Principles §1026.01-.02 (1970). The short form accountant's report refers to financial statements which "present fairly the financial position of X company . . . in conformity with generally accepted accounting principles." The APB has defined this phrase to mean that these financial statements meet the following conditions:

> (1) Generally accepted accounting principles applicable in the circumstances have been applied in accumulating and processing the financial accounting information, (2) changes from period to period in generally accepted accounting principles have been appropriately disclosed, (3) the information in the underlying records is properly reflected and described in the financial statements in conformity with generally accepted

The Accounting Principles Board (APB) of the AICPA and now the Financial Accounting Standards Board (FASB) have attempted to establish a uniform set of specific accounting principles, binding upon members of the profession and dealing with all areas of financial accounting.[13] The potentially infinite number of financial situations, of course, precludes comprehensive coverage by the FASB. In untouched areas, and even in some of the areas previously treated by APB opinions, accounting principles attain "authoritative" status by convention—that is, by agreement (often tacit) among certified public accountants and within the business community. Thus, a prerequisite to the exercise of sound professional judgment by the auditor is a thorough, up-to-date knowledge of acceptable accounting practices.

THE AUDITOR'S LIABILITY TO HIS CLIENTS

The accountant is ordinarily retained by a company for the purpose of rendering an opinion that the shareholders, investors, creditors, and the Commission (if the company is a registrant) will consider to be a reasonable assurance that the financial statements of the company upon which the opinion is rendered are not misleading. The SEC has effectively acknowledged that the accountant's report is appropriate if based on an audit that complies with generally accepted auditing standards and that the registrant's financial statements are not misleading when they conform to generally accepted accounting principles.[14] The terms of the accountant's engagement, which presumably are the source of liability to his client, will ordinarily require him to conduct his audit in accordance with generally accepted auditing standards. If he fails in a material way to follow these professional standards, the auditor may be liable for

> accounting principles and (4) a proper balance has been achieved between the conflicting needs to disclose important aspects of financial position and results of operation in accordance with conventional concepts and to summarize the voluminous underlying data into a limited number of financial statement captions and supporting notes.

APB Accounting Principles §1027.15, at 356 (1970).

13. The Institute's efforts to standardize accounting principles date back to 1939, when it began publishing Accounting Research Bulletins that articulated theoretical and practical solutions to then-current accounting problems. In 1959, the APB was established to advance the written expression of generally accepted accounting principles. It has issued Accounting Principles Board Opinions, many of whicb have had a major impact on financial accounting. One of the express goals of the APB was to reduce the areas of difference and inconsistency in accounting practice. The APB was succeeded in 1972 by the Financial Accounting Standards Board, which is independent of the AICPA and whose composition partly includes expertise outside the accounting profession. *See* AICPA, Report of the Study on Establishment of Accounting Principles (1972).

14. SEC Accounting Series Release No. 4 (Apr. 25, 1938).

failure to act with the due care commonly exercised by members of his profession.[15]

This potential liability places considerable pressure on the auditor when he must make close judgments. If he mistakenly decides that the accounting policies of his client do not conform to generally accepted accounting principles, he may be sued for the damage caused by the alleged misjudgment. Every accountant is aware that his expression of an adverse, qualified, or disclaimer of opinion on the client's financial statements exposes him to the risk of litigation if his client subsequently establishes that the company's accounting policies are authoritatively supported in the professional literature. This is not an attempt to excuse the accountant who too readily delivers an unqualified opinion, but to emphasize a consideration that is too easily overlooked. As matters now stand, the auditor faces the possibility of suit whichever way he decides: by management, on the one hand, or by third parties, on the other.[16] No other profession is obliged to pick its way through such a mine field.

THE AUDITOR'S LIABILITY TO THIRD PARTIES

Predictably, the federal courts have generally held that liability cannot exist if the accountant has complied with generally accepted auditing standards and insisted that his client adhere to generally accepted accounting principles.

In *Escott v. BarChris Construction Corp.*,[17] an action based on Section 11 of the Securities Act, a bowling construction company, its management, underwriters, and independent auditors were held liable for material omissions and misstatements in financial statements issued in 1961 in an offering of debentures. Section 11 provides that the independent accountants will be liable for any material omissions, or false or deceptive statements in the expertized portion of a prospectus[18] unless it can be shown that they pursued a reasonable course of investigation, and had reasonable grounds to believe and did believe that the statements were true and contained no material omissions.[19]

The court specifically held that it would not judge the company's expertized accounting principles by any other criteria than

15. *See, e.g.*, National Surety Corp. v. Lybrand, 256 App. Div. 2d 226, 9 N.Y.S.2d 554 (1939); Gormley, *Accountants' Professional Liability—A Ten Year Review*, 29 BUS. LAW. 1206 (1974).

16. *See* Earle, *Accountants on Trial in a Theatre of the Absurd*, FORTUNE, May, 1972.

17. 283 F. Supp. 643 (S.D.N.Y. 1968).

18. 15 U.S.C. §77k(a) (1970).

19. 15 U.S.C. §77k(b)(3) (1970).

those of the accounting profession. For example, although plaintiffs had attacked the use of the percentage of completion method of accounting for income, the court upheld the use of this method after expert testimony confirmed its acceptability for long-term construction contracts. There was no discussion of or investigation into the "fairness" of this professional judgment. Similarly, as to auditing standards, the accountants were required to discover only what a reasonable examination would have revealed. Thus, in the absence of documentary evidence showing that a cash inflow had been "arranged" by management and was only temporary, the accountants were not expected to have discovered the true nature of this asset.

On the other hand, the court did impose liability upon the accountants for not conducting what it considered to be a limited "S-1 review" in compliance with professional standards:

> Peat, Marwick, prepared a written program for such a review. I find that this program conformed to generally accepted accounting principles [sic].
>
> . . . .
>
> Accountants should not be held to a standard higher than that recognized in their profession. I do not do so here. Berardi's review did not come up to that standard. He did not take some of the steps which Peat, Marwick's written program prescribed. He did not spend an adequate amount of time on a task of this magnitude. Most important of all, he was too easily satisfied with glib answers to his inquiries.[20]

BarChris thus demonstrates that, at least under Section 11, auditors' liability will be determined solely by measuring their performance against professional standards.[21]

Shahmoon v. General Development Corp.[22] involved an unsuccessful challenge to the accounting policies of a Florida land sales company under Section 10(b) of the 1934 Act and Rule 10b-5.[23] Plaintiffs alleged they had purchased stock in reliance upon false and misleading information in defendant's 1960 annual report and 1961 prospectus. Specifically, the complaint charged that the method by which defendant recorded its installment purchase con-

20. 283 F. Supp. at 701, 703. There has been some criticism of the court's interpretation of auditing standards so as to require the auditor (Berardi) to do more than he did. *See* Sommer, *Accountant's Counsel—Advice to My Client,* 24 Bus. Law. 593 (1969). Whether or not this criticism is justified, it does not reach the court's holding that the test of an accountant's liability is non-compliance with professional standards.

21. *Cf.* Norte & Co. v. Huffines, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶92,204 (S.D.N.Y. 1968), a suit charging 5 corporate directors with violations §§10(b) and 14 of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The court held that the unaudited earnings figures contained in a proxy statement were misleading because they were not adjusted as required by generally accepted accounting principles.

22. [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,308 (S.D.N.Y. 1973).

23. The company's auditors were not named as defendants, but the case revolved around the financial statements reviewed by them.

tracts (and thereby arrived at figures for accounts receivable and allowance for contract cancellations) was fraudulent. The standard against which Judge Carter measured the appropriateness of that method was identical to the *BarChris* standard: conformity to generally accepted accounting principles.[24] The court decided which principles were generally accepted by considering first whether other Florida land development companies had used these same accounting methods (most had), and then whether the SEC had given approval to these methods by act or omission (it had).[25] Perhaps most importantly, Judge Carter refused to consider the expert testimony of an accounting professor who offered his opinion that the application of defendant's method of accounting had made the financial statements misleading and deceptive. Once it had determined that the expert's opinion did not represent the majority view within the profession, the court rejected his testimony—without so much as a fleeting comment on whether the majority view was "fair."

This standard was also used in *Colonial Realty Corp. v. Brunswick Corp.,*[26] *Crane Co. v. Westinghouse Air Brake Co.,*[27] and *Kohler v. Kohler.*[28] In *Colonial Realty,* the plaintiff was unsuccessful when expert testimony at trial established that the method of accounting used in defendant's prospectus was the method most commonly employed by other companies in the same line of business. In *Crane,* the Second Circuit upheld a finding that the proxy statement of the

24. "Defendant's financial statements and accounting procedures cannot be considered fraudulent when they conform witb generally accepted accounting procedures as that term is understood by at least a majority of accounting experts in the field and when the metbods used are endorsed by tbe accounting profession as a whole . . . . [D]efendant cannot be charged with fraud or with misleading the plaintiffs for preparing its financial statements pursuant to the method presently favored and used in its field. GDC cannot be held to an individualistic standard at odds with prevailing and accepted accounting yardsticks." [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep., at 95,039.

25. The court decided that the SEC had at least tacitly approved GDC's accounting policies by not questioning them and had probably given affirmative approval when it required a major competitor to adopt them. *Id.*

In fact, tbat major competitor, GAC Corporation, and its accountants were also sued for adhering to these very policies. Spiegler v. Wills, 60 F.R.D. 681 (S.D.N.Y. 1973). A theory of liability advanced by the plaintiffs in *Spiegler* was that when the accounting profession (and therefore GAC) adopted a new method for recording installment sales contracts in 1972, the previous use of the former method somehow became fraudulent. The complaint was dismissed for its failure *inter alia* to state a claim for relief. "It is clear that the mere allegation of a change in accounting procedure—from one accepted practice to another—is not sufficient in itself to state a claim upon which relief may be granted, no matter how characterized." *Id.* at 682-83.

26. 337 F. Supp. 546 (S.D.N.Y. 1971).

27. 419 F.2d 787 (2d Cir. 1969).

28. 208 F. Supp. 808 (E.D. Wisc. 1962).

defendant corporation was not misleading, relying upon the expert testimony in the record that defendant's independent public accountants had complied with professional standards in computing the level of foreign results and charging foreign currency losses against income. Similarly, *Kohler* involved a suit brought against a company and its auditors attacking the use of the LIFO method of valuing inventories; the court summarily dismissed the challenge to this method when the plaintiff conceded that LIFO was generally accepted in similar circumstances.

Compliance with professional standards, of course, will protect an accountant only when those standards are relevant to his situation. If he finds the accounting literature silent or unsettled on a particular point, he will review the current practice and apply his professional judgment.[29] When the accountant is placed in this position, he will not be judicially second-guessed unless his judgment was not reasonably intended to avoid a misleading presentation.[30]

THE *Simon* CASE (CONTINENTAL VENDING)

United States v. Simon[31] was a criminal prosecution in which two partners and an associate in a national firm of public accountants were convicted of mail fraud and violations of the 1934 Act. The charges stemmed from the report on the 1962 balance sheet of Continental Vending Machine Corporation. While conducting their examination of Continental, the auditors became aware that an affiliated company, Valley Commercial Corporation, was unable at the time to repay funds it had borrowed from Continental. Valley had loaned these funds to Harold Roth, president of both Valley and Continental, for his private use. The auditors knew of these advances to Roth before they issued their opinion on Continental's financial statements; they also knew that Roth was not then in a position to repay these advances to Valley. They agreed that if adequate collateral was posted for the Valley receivable, it would not be necessary for them to await an audit of Valley's financial

29. For example, in the *Kohler* case, the innovative use of an "unusual" method of accounting for pension annuities was approved. The court recognized that the AICPA Committee on Accounting Procedure permitted exceptions to its general rule regarding annuities due to the unsettled state of professional opinion on the subject. After hearing expert testimony that the treatment used by management and permitted by the defendant accountants was "acceptable . . . in view of the unusual features of the pension plan," the court upheld the treatment as a "good faith judgment . . . . in the handling of a complex accounting problem." *Id.* at 819.

30. *Id.; cf.* Colonial Realty Corp. v. Brunswick Corp., 337 F. Supp. at 557 ("There is no evidence that the accounting judgment utilized in allocating the reserves was clearly wrong or misleading.").

31. 425 F.2d 796 (2d Cir. 1969), *cert. denied* 397 U.S. 1006 (1970).

statements. The collateral was posted and consisted of securities held by Roth and his family; eighty percent of these securities were common stock and convertible debentures of Continental itself.

Continental's financial statements, including notes, disclosed the loans to Valley and the fact that these loans were secured by Valley's equity in "certain marketable securities." While the statements explained that Roth was president, director, and a stockholder of Valley, they did not reveal that he was the ultimate recipient of the loans to Valley. The auditors, on behalf of their firm, rendered an unqualified opinion on these financial statements. A few days after the statements were mailed to the stockholders, and probably as a response to the losses shown in the financial statements, the market for Continental stock collapsed.

The prosecution sought to prove that the defendant accountants had acted fraudulently in expressing their opinion on Continental's financial statements, because the company had failed to disclose (i) that a substantial part of the collateral for the Valley receivable consisted of securities of Continental itself; (ii) that the ultimate beneficiary of the loans was Roth, who had used the funds for private investment; and (iii) that the Valley receivable had increased after the balance sheet date by 500,000 dollars.[32] Thus the "primary, predominant and pervasive" issue in the case was the defendants' failure to insist on a disclosure that Continental's loans to Valley were not for a business purpose, but to help Roth in his personal financial problems.[33]

The defendants called eight eminent accounting experts to testify that these disclosures were not required by generally accepted accounting principles. These expert opinions, however, were not based upon specific rules or prohibitions in the accounting literature devoted to the necessity of disclosure in circumstances raising a suspicion of corporate looting or other mismanagement. Rather, the experts concluded that since the auditors had honestly believed the collateral for the Valley loan was adequate, nothing in the financial statements themselves negated the conclusion that an honest judgment had been made[34]—in effect, an opinion not based upon accounting expertise, but on the experts' views of defendants' good faith. The trial judge refused to give a blanket instruction to the jury

32. The prosecution also attacked the statement in a note implying that a Valley payable could be offset against the Valley receivable. Defendants (and their experts) conceded this was improperly implied by confusing wording in the note, but contended it was not an intentional error.

33. 425 F.2d at 806 (quoting from the defendants' brief).

34. *Id.* at 805-06.

that it must acquit the defendants if it believed they had complied with the standards generally accepted by the profession as presented by the eight experts. Instead, he instructed the jurors to weigh all of the expert testimony, decide whether the principles relied upon by the auditors were "authoritative" and then determine whether these principles "contemplate, deal with, and apply to the type of circumstances found by you to have existed here . . . ."[35]

Judge Friendly, writing for the Second Circuit, upheld this charge:

> We think the judge was right in refusing to make the accountant's testimony so nearly a complete defense. The critical test according to the charge was the same as that which the accountant's testified was critical. We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material to overall fair presentation, *at least not when the accountants' testimony was not based upon specific rules or prohibitions to which they could point.*[36]

This passage has been read by some to suggest that a court in judging the performance of an auditor may substitute its view of what is material to fair presentation in accordance with GAAP for that of the accounting profession. This is not, however, what Judge Friendly said. The experts at trial had not relied upon specific principles to dictate the disclosure necessary in the unusual (and arguably suspicious) circumstances surrounding the Valley receivable. Instead, the experts first assumed that the defendants had trusted Roth and the reliability of the collateral, and then testified that the accounting judgments reflected in the financial statements were acceptable. As it turned out, this assumption proved false; the jury must have concluded that the defendants knew the true purpose of the loans was to enable Roth to loot Continental for his own gain. In other words, the jury believed the auditors had not acted in good faith, and hence the question of compliance with GAAP became academic.[37]

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35. *Id.* at 806.

36. *Id.* (emphasis added). The "critical test" referred to by Judge Friendly—he also called it the "basic issue" in the case—was: did the defendants make a good faith judgment in the absence of any authoritative accounting principles precisely governing these circumstances? The reference to "specific rules or prohibitions" is surprising, because it suggests that even in the presence of bad faith, i.e. an intent to deceive, an accountant could escape liability by relying upon an accounting principle exactly on point. Although obviously exculpatory, such a proposition would be contrary to the ethics of the accounting profession. *See* AICPA, Code of Professional Ethics, Rule 203 (1973).

37. An earlier jury apparently believed otherwise. The defendants had been tried before on the same charges but the jury, unable to agree, was discharged, reportedly standing 11-1 for acquittal.

Thus *Simon* does not repudiate or draw into question the *BarChris* standard that an accountant may not be held liable if he has relied in good faith upon relevant principles generally accepted by his profession.[38] Far from denigrating generally accepted accounting principles as a standard of conduct, the *Simon* opinion seems to encourage their further definition so as to provide specific guidance to both accountants and courts.

THE *Herzfeld* CASE[39]

The *Herzfeld* litigation involved the issue of how much information an accountant must insist be disclosed when he has qualified his opinion on his client's financial statements. The defendant accounting firm had examined the financial statements of a California real estate syndicate, Firestone Group, Limited, and discovered that a large acquisition-resale transaction was not properly reported in FGL's draft financial statements. In November 1969, FGL had executed contracts by which it purchased certain nursing home properties for $13,362,500 and then, four days later, sold them for $15,393,000. FGL had treated this $2 million profit as current income. After an investigation, the auditors concluded that this treatment was improper, since only $25,000 of the $15,393,000 sales price had actually been received from the purchaser. FGL's management reluctantly agreed to change its income statement and record $235,000 of the profit as current income, deferring the remainder.[40] In the course of the audit the accountants discovered that the purchaser had a net worth of only $100,000. Accordingly, and because the initial down payment was so small, the accountants concluded that the collectability of this contract receivable was doubtful. They therefore decided to qualify their opinion on FGL's financial state-

On November 14, 1974, a jury in another case rejected a good faith defense and returned a guilty verdict against an audit partner and a former professional employee of Peat, Marwick, Mitchell & Co. in connection with an allegedly false proxy statement filed by National Student Marketing Corporation. Wall Street J., Nov. 15, 1974, at 8, col. 2.

38. Actually, this standard of liability did not originate with the *BarChris* opinion. In an earlier criminal case, presenting many of the same issues as appear in *Simon*, the Second Circuit, also per Judge Friendly, applied professional standards in order to sustain a conviction against an accountant for securities fraud. United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964). *See also* United States v. White, 124 F.2d 181 (2d Cir. 1941), and the common law cases discussed in note 6 *supra*.

39. Herzfeld v. Laventhol, Kreskstein, Horwath & Horwath [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶94,574 (S.D.N.Y. May 29, 1974).

40. The $235,000 figure represented a $25,000 down payment already received by FGL, another $25,000 down payment due within 45 days, and $185,000 in liquidated damages in the event of default.

ments although they had already insisted that the bulk of the profit from the transaction be deferred. FGL's executives strongly disagreed with the defendant's accounting judgment and even threatened to sue the firm if a contemplated private placement of its securities fell through as a result of the qualification. The auditors remained adamant and issued their qualified report; the private placement occurred, but the sale of the nursing home properties did not. Litigation ensued following FGL's bankruptcy in 1971.

Plaintiffs charged that the entire transaction was a sham devised to cover up a net loss that would have otherwise been reported in FGL's income statement. It was alleged that the auditors (i) knew, or should have known, the sham nature of the transaction, and (ii) should have disclosed in their report all of the circumstances prompting the qualification. In support of the second allegation, plaintiffs relied upon a specific AICPA pronouncement on qualified opinions.[41] Although the court rejected plaintiffs' first contention that the auditors knew the transaction was a sham, it upheld plaintiffs' claim on the strength of the second allegation, concluding that the auditors had not fully disclosed the reasons for their qualification or the effect this qualification would have upon FGL's financial position.[42]

Assuming, arguendo, that the court correctly held that the auditors failed to make adequate disclosure in their report or to insist upon fuller disclosure in FGL's financial statements, it automatically follows, in light of SAS No. 1, that they did not comply with GAAS. Assuming further that this failure was deliberate and its significance understood, Judge MacMahon should have held for the plaintiffs solely on this ground.[43] Instead, he disregarded profes-

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41. In their post-trial brief at pages 91-93, plaintiffs cited Statement on Auditing Procedure No. 33 [now SAP No. 1, §512.01], which provides:

> When a qualified opinion is intended by the independent auditor, the opinion paragraph of the standard short-form report should be modified in a way that makes clear the nature of the qualification. It should refer specifically to the subject of the qualification and should give a clear explanation of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable. Reference in the opinion paragraph to a note to the financial statements or to a preceding paragraph in the report that describes the circumstances is an acceptable method of clarifying the nature of a qualification . . . .

42. "[A]dmittedly, Laventhol itself had considerable doubt about the ability of FGL to collect the balance due on the Continental contract . . . . Thus it was incumbent on Laventhol to reveal to investors its reservations and doubts concerning consummation of the transaction and the facts upon which its reservations were based.

"Laventhol claims that its qualification . . . along with Note 4, constituted full disclosure of its reservations. We disagree." [1973-1974 Transfer Binder] CCH FED. SEC. L. REP., at 96,000.

43. For example, in Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yaun-

sional auditing standards, calling them "esoteric accounting norms, comprehensible only to the initiate," and held that the actual test was whether the report fairly presents the "*true* financial position of Firestone . . . to the untutored eye of an ordinary investor."[44]

Another disturbing feature of the *Herzfeld* opinion is its reliance upon *Simon*. *Simon* does not support the extravagant dicta contained in the *Herzfeld* opinion, nor is there any apparent authority for this dicta other than speeches and articles by individual members of the Commission and its staff.[45]

Three months after the *Herzfeld* decision in an opinion involving another accounting firm[46] the Seventh Circuit, without referring to *Herzfeld*, expressly adopted the *BarChris* holding that "the standard of care which generally prevailed in the accounting profession . . . is the standard to which [the defendant accountants] must be held."[47]

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der & Jacobs, 455 F.2d 847, 852 (4th Cir. 1972), the Fourth Circuit was faced with the same issue; unlike Judge MacMahon, it relied exclusively on the passage from SAP No. 33, quoted in note 41 *supra*.

44. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP., at 95,998 (emphasis added). For "true" one can apparently substitute the word "fair." Either word, if not defined by professional criteria, is wholly subjective.

45. *See* Slain, Fair Presentation, 8 REV. SEC. REG. No. 2 (1975) (author accepts broad reading of Simon while somewhat illogically criticizing *Herzfeld* result); Sonde, *The Responsibility of Professionals Under the Federal Securities Laws—Some Observations*, 68 NW. U.L. REV. 1, 4 (1973); Sommer, *Survey of Accounting Developments in the 60's; What's Ahead for the 70's*, 26 BUS. LAW. 207 (1970). Judge MacMahon also cited and quoted from 2 SEC opinions, *In re* Associated Gas & Elec., 11 S.E.C. 975 (1942) and Touche, Niven, Bailey & Smart, 37 S.E.C. 629, 670 (1957). Although one quoted passage refers to "enlightenment" as the function of financial statements, both opinions suggest that accountants are to be judged by the generally accepted standards of their profession. For example, in *Associated Gas*, using language similar to that employed a generation later by Judge Friendly in *Simon*, the Commission stated:

> Under the circumstances such as those presented in this case, we hold that Haskins & Sells have not put themselves in a position to certify; for the statements neither present the financial condition in accordance with accepted principles of accounting nor adequately indicate the effects of the practices followed, nor provide the reader with the means by which he may work out the financial condition for himself.
>
> Bell and Bowman consistently adopted the position that certain practices now recognized as faulty had not been thought through by the profession when the financial statements in question were certified and that many of registrant's challenged practices were accepted practices at the time. To some extent this may be true of specific practices, and wherever true we have recognized it in this opinion. But we should indeed be loath to believe that it was general practice in the accounting profession at the time of these statements—or at any time—to certify to financial statements so obviously manipulated to suit the purposes of the registrant as those before us.

11 S.E.C. at 1058.

46. Hochfelder v. Ernst & Ernst, 503 F.2d 1100 (7th Cir. 1974).

47. *Id.* at 1108. "This duty to audit in accordance with generally accepted auditing standards does not differ from the duty which is otherwise imposed by law . . . or the accounting profession itself." *Id.*

Conclusion

Commissioner Sommer has suggested that the accounting profession and its spokesmen are unduly disturbed by the fairness debate, and that eventually the profession will be confortable with such a standard.[48] Perhaps Mr. Sommer is confusing the kind of common sense that ought to be a part of any audit (or, for that matter, any professional engagement) with the standard of liability to be applied after the fact by a lay judge or jury. There is simply too much of the accounting literature, stemming from many years of incremental development, that would seem arcane, if not bizarre, to laymen. An example is the basic accrual method of accounting, which every accountant automatically assumes when examining corporate financial statements. A layman who wants to know where the cash receipts are and what expenditures have actually been made has great difficulty with the concept of income or expense that has not actually been received or incurred in the sense of an exchange of cash.

This example is particularly useful because the layman's attitude is not entirely without merit. The Trueblood Committee, which recently reported on objectives of financial statements, suggested that historically the profession had not paid enough attention to realization, and, in terms of receivables and payables, had not attempted to differentiate between their immediate and long-term impact upon cash.[49] The FASB is currently studying this and other recommendations of the Trueblood Committee.[50] It is one thing, however, to suggest that the profession, through its accounting "legislature," develop new law to accommodate a new (or newly recognized) reality in the market place; it is quite another to suggest that when an individual accountant obeys in good faith the existing law, he can later be found liable for vast sums if twelve (or six) laymen decide the accounting principle in question was unfair.

Any type of fairness doctrine for liability, no matter how superficially if not seductively appealing, would effectively destroy the guarantee of professionalism that the securities law and the accounting profession have for so long sought to instill in financial

48. Sommer, *Accountants: A Flexible Standard,* address to ABA National Institute on Professional Liability, Montreal, Canada, May 30, 1974, at 13.

49. *See generally* AICPA, Report of the Study Group on the Objectives of Financial Statements (1973).

50. Ironically, the impetus for establishment of the FASB was the recognized need for a broad perspective, drawn in part from without the profession, in the development of accounting principles. If fair reporting is ever to be found, presumably the FASB is the place, not in ad hoc courtroom determinations.

reporting. Without the assurance that accountants are consistently applying those principles that find general acceptance within the accounting profession, the accountant's opinion will mean nothing to a shareholder, investor, or creditor, unless by some magic he can personally observe the particular "fairness" bias of the individual accountant who performed the audit.[51] Instead of enhancing the stature of the accountant's opinion and the utility and comparability of financial statements, a fairness standard would separate these heretofore vital documents from the conventional wisdom of an entire profession.

Finally, it is unreasonable to expect any professional to operate effectively under such an open-ended standard of care. Indeed, at a time when accountants are already proceeding through a litigation minefield, this additional burden is inappropriate. Fairness, without further definition, means whatever is attractive or unattractive to the particular trier of fact. Such a standard is wholly subjective and unpredictable, varying chaotically according to the predilections, social conscience, and the like, of the various judges and juries who would be called upon to apply it. The fairness doctrine, therefore, is not doctrine but myth—and a dangerous myth at that. One is tempted to suggest that as a standard of liability it is "unfair."

51. *See* Carmichael, *What Does the Independent Auditor's Opinion Really Mean?*, J. OF ACCOUNTANCY, Nov. 1974, at 83-84.