Guarding the Guardians: Expanding Auditor Negligence Liability to Third-Party Users of Financial Information

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I. INTRODUCTION

The dynamic nature of our economic system and its explosive rate of growth over the past one hundred years, has occasioned an alarming rate of growth in both the business community and its related support industries. Law firms have grown to immense pro-

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portions in response to an ever-increasing demand for professional services. And, more germane to this Article, accounting firms have likewise ridden this rising tide, providing support services to all members of this growing business community.

This growth in both the business community and its support services counterparts has occasioned much discussion, analyzing the extent to which these participants should be responsible to the persons whose lives are affected by this growth. To the extent that sellers of goods and services draw sustenance from the open streams of commerce, these waters should be protected from the pollutants of defective goods. Courts readily recognize that defective goods injure not only the purchasers but also users of these goods otherwise removed from the contractual, buyer-seller relationship. But what of sellers of defective services? Until recently the courts have been unwilling to expand the liability of accountants for negligently rendered audit services beyond the immediate auditor-client contractual relationship. However, this trend is changing. In recent years, the notion that accountants should be likewise responsible to all users of audited financial statements is gaining in popularity.¹

Congress acted first on behalf of the investing public by recognizing the need for someone to police the nature and quality of available financial information. Congress interposed the Certified Public Accountant (CPA) between industry and the investing public, choosing to protect the public by requiring full disclosure of relevant information in the issuance of securities, rather than the passage on the quality of the investment itself. The main thrust of the federal legislation was to “place the owners of securities on a parity, so far as possible, with the management of the corporations, and to place the buyer on the same plan so far as available information is concerned with the seller.”²

¹. This is due in part to the nature of the economic development of the American business community. One commentator has identified three historical trends and events, which themselves have greatly contributed to the growing scope of professional responsibility. These are: first, the beginning of the modern capitalistic system at the turn of the century; second, the enactment of federal securities legislation intended to implement a policy of full disclosure; and third, the rise of public ownership of the American corporation. Mess, Accountants and the Common Law: Liability to Third Parties, 52 NOTRE DAME L. REV. 838 (1977). No longer does the “age-old axiom that physicians bury their mistakes while . . . accountants file theirs away” ring true. Id. at 838.

². Marinelli, The Expanding Scope of Accountants’ Liability to Third Par-
Because of his unique relationship to the subject financial information, the auditor is the most likely screener of this information. As between a corporation and its investors, his professional judgment is a filter of cynicism, ensuring that the investor has complete information upon which to base an investment decision. However, the auditor does not pass on the quality of the investment but rather the quality of the information respecting the investment. Financial statements are a principal means of communicating business information to outside investors. It is this information, over which the auditor exercises his professional judgment, that is the subject of this Article.\textsuperscript{3}

ties, 23 CASE W. RES. 113, 126-27 (1971). "In the broadest sense the function of accounting and of the audit by an independent public accountant is to facilitate the operation of our economic system." D. CAUSEY, DUTIES AND LIABILITIES OF PUBLIC ACCOUNTANTS 1 (rev. ed. 1982). "Accountants and auditors... play an important role in enabling our free market to allocate private property rights to their highest valued uses as measured by the dollar votes of demand. Perfect competition requires efficient markets supplied with complete information." Furthermore, "accurate information is essential to the efficient use and exchange of property," which "forms the basis of our economic freedom." Id.

3. While publicly-held entities are required to disclose information in audited financial statements, nonpublicly held entities have the option of preparing: (1) audited financial statements; (2) financial statement reviews; or (3) financial statement compilations.

A financial statement review involves "[p]erforming inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the [financial] statements in order for them to be in conformity with generally accepted accounting principles..." Statements on Standards for Accounting and Review Services No. 2, § 110.04 (Am. Inst. of Certified Pub. Accountants 1987) [hereinafter Professional Standards].

A financial statement compilation involves merely assisting in the preparation of financial statements "without undertaking to express any assurance on the statements." Id. at §100.04.

For purposes of analysis, this Article is devoted to discussing auditor liability with respect to audited financial statements. Here it is critical to outline the distinction between the objectives of an audit and those of a lesser undertaking, such as a financial statement review. The objective of a financial statement review also differs significantly from the objective of an examination of financial statements in accordance with generally accepted auditing standards. The objective of an audit is to provide a reasonable basis for expressing an opinion regarding the financial statements taken as a whole. A review does not provide a basis for the expression of such an opinion because a review does not contemplate a study and evaluation of internal accounting control, tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation or confirmation, and certain other procedures ordinarily per-
The nature of today’s financial information is changing faster than the public user can respond. The public is beginning to rely more heavily on the auditors of this information, imposing upon the professional a level of social responsibility unparalleled by that of prior years.\textsuperscript{4} This increasing reliance on the accounting profession is the focus of this Article. This paper will raise and discuss two interrelated issues. First, to whom, if anyone, should an auditor be held liable for negligence in the performance of his professional duties? Second, accepting the current system of legal responsibilities, what is the profession doing to satisfy society’s demands for more and better information?

This Article will present and analyze these questions in terms of the accountant’s common law negligence liability to third-party users of financial information. This Article will discuss the distinction between professional standards and legal standards. It will then focus on a discussion of the common law as it relates to the notion of holding a CPA liable to a third-party user of audited financial statements. It will conclude by discussing some policy implications of expanding the scope of the CPA’s responsibility to third persons and suggest a few general guidelines for a more effective system of allocating the risks and responsibilities of financial information among the producers and users of the information.

II. THE LEGAL STANDARD

This section is devoted to identifying the proper legal standard of liability, considered in light of the various standards of quality and disclosure applicable to the profession. However, one must first divorce these notions of legal standards from considerations of whom these standards protect. Assuming that auditors owe some duty to third-party users of audited financial information, this section endeavors to identify the proper legal standard against which the given duty is measured. When that which is given falls short of that which is owed, legal liability should follow. This sec-

\textsuperscript{4} Formed during an audit. A review may bring to the accountant’s attention significant matters affecting the financial statements, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit. Professional Standards No. 2, § 100.04 (Am Inst. of Certified Pub. Accountants 1987). For discussion concerning accountant liability for financial statement review and compilation engagements, See Note, Accountant’s Liability for Compilation and Review Engagements, 60 Tex. L. Rev. 759 (1982).

tion begins with a discussion of generally accepted accounting principals (hereinafter "GAAP") and then focuses on a discussion of the law as it relates to professional responsibility based on the nature of financial information.

Financial statements are prepared in accordance with GAAP. GAAP describes a body of accounting principles, with which an auditor must be versed to express an opinion on the financial statements. GAAP is a mixture of the proclamations of many different sources. And while uniformity is a desired element of any financial reporting system, GAAP is not the panacea that its name seems to indicate.

GAAP do not supply ready made answers. Since financial statements are the responsibility of the client's management, not the auditor, the client's accounting and other officers have both authority and responsibility to determine the relevance, appropriateness and manner of application of specific rules and to make accounting judgments reflected in the financial statements . . . .

Whatever problems are inherent in defining GAAP, they pale when compared to those encountered in giving life and legal substance to that definition. An accounting system, shaped and contoured by accounting principles and procedures, is nothing more than a model. A model which, when given raw data, is capable of generating a pre-programmed result, the financial statements. Much of the difficulty associated with understanding financial information stems from a misunderstanding of the nature of the re-

5. GAAP "is a technical accounting term which encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures." Professional Standards No. 1, § 411.02 (Am. Inst. of Certified Pub. Accountants 1987).

6. These sources include:
(a) SEC Accounting Rules;
(b) SEC Accounting Series Releases;
(c) Pronouncements by the Financial Accounting Standards Board on accounting and financial reporting;
(d) Pronouncements by the American Institute of Certified Public Accountants [hereinafter "AICPA"];
(e) Interpretations and other publications of the Financial Accounting Standards Board, the AICPA, and other professional bodies;
(f) Other professional accounting and auditing publications; and,
(g) Accepted application in accounting and auditing practice.


7. Id. at 1-30.
sults produced by this model. There is a tendency among lay persons using financial information to treat this information as "facts," items of independent significance. This is entirely inconsistent with the fundamental nature of financial information, that it is the end result of many and varied assumptions, policies and economic hypothetications.  

Thus, the current accounting model is likely to mislead the layman, unaware of its qualifications, into believing it depicts the facts of the real world and therefore is inappropriate for lay users. The next logical question is whether we can develop a model that can be used by laymen. In the meantime, the question of immediate interest... is whether accountants should be held liable for the limitations of the current accounting model which mislead lay investors.  

The above discussion raises the immediate issue of whether and to what extent the professional standards of GAAP coexist with and serve as the legal standard of professional responsibility. A leading case respecting this issue is United States v. Simon.  

The case involved a criminal action brought against accountants alleging criminal violations of the federal securities regulations. The accountants disclaimed criminal responsibility, asserting in their defense their purported compliance with GAAP. In their defense, the accountants proffered the testimony of eight expert witnesses, each affirming the defendants compliance with GAAP. Thereon, the accountants argued that the jury should be conclusively bound by the expert testimony respecting their compliance with GAAP. The correctness of this argument was at issue in United States v. Simon.  

8. One commentator has described this erroneous tendency as the Pygmalion Syndrome; "believing that the facts, rather than a modular abstraction of the facts, are contained in financial statements. They are not." Fiflis, Current Problems of Accountants' Responsibilities to Third Parties, 28 VAND. L. REV. 31, 42 (1975). This fact-result distinction is best illustrated by example. Assuming that a business purchased equipment for a certain price, it must then decide over what life and under what method it will depreciate this equipment. The depreciation method and life chosen will directly dictate the amount of depreciation expense and accumulated depreciation the business shows on its financial statements. In this situation, it is erroneous to consider the depreciation information as a set of facts because their existence is subject to change based on the method of depreciation followed. Following this analysis, it is clear that the "facts" contained in financial statements are not facts at all, they are merely results.  

9. Id. at 45.  
10. 425 F.2d 796 (2nd Cir. 1969).  
11. Id. at 798.  
12. Id. at 805.
with GAAP. The accountants argued that, insofar as their required disclosures were mandated by GAAP, expert testimony that GAAP did not require disclosures would preclude liability for their absence.

Judge Friendly laid this argument to rest in short order. The court held that the critical test was not compliance with GAAP but whether the financial statements, taken as a whole, present fairly the enclosed financial information. Of the proper consideration of expert testimony, Judge Friendly wrote:

We do not think the jury was also required to accept the accountants' [expert witnesses'] evaluation whether a given fact was material to overall fair presentation, at least not when the accountants' testimony was not based on specific rules or prohibitions to which they could point, but only on the need for the auditor to make an honest judgment and their conclusion that nothing in the financial statements themselves negated the conclusion that an honest judgment had been made. Such evidence may be highly persuasive, but it is not conclusive . . . .

Having established that GAAP represents but a small portion of the auditor's duty to disclose, the next question involves a determination of to whom does he owe this duty? The answer to this question invites a discussion of the common law as it relates to an auditor's liability to third parties for negligence in the audit

13. Id. Professor Fiflis discusses the general nature of liability, in the face of conformity with the standards of GAAP, beginning with what he calls the “Inapt Analogy of Medical Malpractice.” Fiflis, supra note 8, at 66. Fiflis describes this by analogy to evidentiary considerations involved in medical malpractice cases. These evidentiary considerations bind the jury to the testimony of an expert witness concerning the custom in the profession and require that the plaintiff produce evidence of nonconformity with the custom of the profession, before he is entitled to recover damages. Id. Although acknowledging their erroneous juxtaposition, Fiflis notes the tendancy among many commentators and judges to apply this medical standard to accountant liability cases. Id. at 67.


15. Id. at 805-06.

16. Id. at 806. This statement presumably foretells a different result when specific rules or prohibitions, rather than expert testimony, are involved. However, such result is not to be. In Hertzfeld v. Laventhol, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 94,574 (S.D.N.Y. 1974), the court precluded a CPA from asserting GAAP as a shield. The court upheld the legal duty as one of full disclosure, noting that this duty “cannot be fulfilled merely by following [GAAP]. . . . [A]ccountants . . . must take pains to lay bare all the facts needed by investors to interpret the financial statements accurately.” Id. at 95,999. See United States v. Natelli, 527 F.2d 311 (2nd Cir. 1975), cert. denied, 425 U.S. 934 (1976).
III. COMMON LAW ACCOUNTANTS' LIABILITY

The liability of accountants at common law has been the subject of extensive litigation, resulting in a substantial difference of opinion among the states as to the proper standard of liability.

17. While this Article does not take up the issue of auditor liability under the federal securities laws, a brief discussion is nonetheless included here. Under many provisions of the federal securities laws, negligence actions will lie against accountants in favor of third parties. This is in part due to the nature and purpose of the securities regulations, which interpose the auditor between the corporation and its investors, in order that management's representations are scrutinized and that any information bearing on a reasonable person's investment decision is included in the audited financial statements.

Some provisions of the federal securities laws impose standards of responsibility more stringent than those of common law on persons associated with securities transactions, including secondary defendants such as accountants and auditors. See Gormley, supra note 6, at 1-11.

Section 11 of the Securities Act of 1933 imposes substantial liability on persons associated with registration statements containing any misstatement of a material fact or any omission of a material fact required to be stated or necessary to make the statements not misleading. Persons responsible under section 11 for the contents of a registration statement are the registrant itself, its chief executive, financial and accounting officers who are required to sign the registration statement, each present and prospective director or partner of the registrant, every accountant and other professional expert whose profession gives authority to a statement made by him with his consent (e.g., and audit opinion), and every underwriter of the registered securities. Securities Act of 1933, 15 U.S.C. § 77b(11)(9a)(1-5) (1982).

The prerequisite to liability under this section is a material misstatement or omission in a registration statement for shares registered under the 1933 Act. Under this section, unlike any of the common law approaches, the plaintiff need not prove:

(a) negligence or fraud by the auditor in auditing financial statements;
(b) reliance on the auditor's opinion;
(c) a causal relationship between the omission or misstatement and the plaintiff's loss; or,
(d) any contractual relationship between the plaintiff and the auditor.

See Gormley, supra note 6 at 7.2 to 7.3. Rather, the touchstone of liability is materiality. In Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), the court first attempted to define materiality under section 11. The Escott plaintiffs sued the corporate registrant, alleging material misstatements and omissions in financial statements included in the registration statement, joining as defendants Peat, Marwick, Mitchell & Co., the corporate auditors. Id. at 652. The basis of the suit was an overstatement of income and assets, alleged by the investors as the basis for their investment in convertible debentures otherwise considered speculative investments, based on the growth potential of the corporate is-
From this morass, there have emerged four distinct theories of lia-
suer. *Id.* at 652-53. In defining materiality, the *Escott* Court noted:

> [t]he average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.

*Id.* at 651. The court went on to note that materiality is, by definition, a subjective inquiry. The determination of what is in fact material “comes down to a question of judgment, to be exercised by the trier of fact as best he can in light of all the circumstances.” *Id.* at 652. The court then held that the fact that the earnings had increased only 256% from the prior year, as opposed to the reported 276% increase, was not a sufficient disparity so as to deter the ordinary investor from his investment decision. *Id.* at 651.

The Securities Exchange Act of 1934 imposes similar liability on the auditors of information filed pursuant to its provisions. Under section 18(a), an auditor can be held liable for losses suffered by purchasers or sellers of securities who relied on a materially false or misleading opinion on audited financial statements. Unlike liability under the 1933 Act, the plaintiff here must prove reliance on the allegedly false or misleading statement in making his investment decision and that at the time of his action he was not aware that the information was false or misleading.

The leading case imposing section 18(a) liability is *Rich v. Touche, Ross & Co.*, 415 F. Supp. 95 (S.D.N.Y. 1976). In *Rich*, the plaintiffs sued the corporate auditor, alleging reliance on materially misstated financial statements, as the basis for their lost investment. Respecting the section 18(a) allegation of fraud, the court described the section 18(a) cause of action as requiring a “strict ‘double-barreled’” causation requirement. *Id.* at 103. Under section 18(a), the plaintiffs must prove: first, that his damages were caused by his reliance on the false or misleading statement; and second, that the purchase or sale price was affected by the false or misleading statement. *Id.* at 103. Thus, the plaintiff must prove reliance and causation under section 18(a) of the 1934 Act, whereas there are no similar requirements under Section 11 of the 1933 Act.

In recent years, the notion that the SEC itself could impose sanctions, independent of investors’ rights or recovery under the above discussed sections, has come to fruition. In *Touch, Ross & Co. v. SEC*, 609 F.2d 570 (2nd Cir. 1979), the Second Circuit held that the SEC could impose sanctions against an accounting firm, under rule 2(e) of the 1934 Act. Rule 2(e) provides in pertinent part that:

> [t]he Commission may deny . . . the privilege of appearing or practicing before it in any way to any person who is found by the Commission . . . (i) not to possess the requisite qualifications to represent others or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws . . . or the rules or regulations thereunder.

17 C.F.R. § 201.2(e) (1979).

In *Touche*, the court for the first time upheld the sanction authority of the SEC against accountants. The action began when the SEC enjoined Touche from
further representations, pending an investigation of whether the firm had "enacted in unethical, unprofessional or fraudulent conduct in their audits of the financial statements . . ." of several of their audit clients. 609 F.2d at 573. The SEC alleged numerous violations of the relevant securities laws provisions as a basis for sanction. In upholding the validity of the rules, the court held that:

Rule 2(e) . . . represents an attempt by the Commission to protect the integrity of its own processes . . . . As such, the rule is "reasonably related" to the purposes of the securities laws . . . . We therefore sustain the validity of the Rule as a necessary adjunct to the Commission's power to protect . . . the public in general.

Id. at 574. For an interesting opinion respecting the administrative authority of the SEC to issue a "stop order" based on a material overstatement of inventories presented in financial statements, see Miami Window Corp., 41 S.E.C. 68 (1962). The SEC issued a "stop order" to prevent the corporation from filing a registration statement under the 1933 Act, pending resolution of an inventory valuation issue. The Commission asserted that the auditors did not comply with generally accepted auditing standards in their observations of inventories and had not adequately justified their departure from GAAP. The stop order was directed at the registration statement itself, of which the audit report was an integral part. Id. at 71.

Much of the legal tension respecting accountants' liability to third-party users of financial information, however, has been in the state law forums. This raises the issue of whether there is any good reason for imposing different standards of liability, in essentially the same situations, when such liability is so closely tied to the forum in which the dispute is settled. Fiflis denies any good reason at all. Fiflis, supra note 8, at 105.

The federal courts, construing the federal securities laws, have long since recognized the fact that the profession is responsible not just to its immediate employers, but also to the investing public. How can courts continue the ludicrous fiction that accountants serve their payors only for state law purposes, but the public investors for federal purposes?

Id. at 105-06. The strength of this argument is apparent when considered in light of the standard of responsibility that the profession accepts for itself in its code of professional ethics; "[a] distinguishing mark of a professional in his acceptance of responsibility to the public." Professional Standards No. 2, § 51.01 (Am. Inst. of Certified Pub. Accountants 1987). "The responsibility of a [certified] public accountant is not only to the client who pays [his] fee, but also to investors, creditors and others who may rely on the financial statements which he certifies." Touche, Niven, Bailey & Smart, 37 S.E.C. 629 at 670 (1957).

18. This difference of opinion has also occasioned extensive scholarly commentary. See, e.g., Besser, Priuity? - An Obsolete Approach to the Liability of Accountants to Third Parties, 6 SETON HALL 507 (1976); Eizenstat & Speer, Accountants' Professional Liability: Expanding Exposure, 22 FED. INS. COUNS. Q. 7 (1972); Fiflis, Current Problems of Accountants, Responsibilities to Third Parties, 28 VAND. L. REV. 31 (1975); Gormley, The Foreseen, the Foreseeable, and Beyond: Accountants' Liability to Nonclients, 14 SETON HALL 528 (1984); Griffin, The Beleaguered Accountants: A Defendant's Viewpoint, 62 A.B.A.J. 759 (1976);
expansion of the common law negligence cause of action to allow recovery by an expanding group of plaintiffs. Common to each of these discussions are the judicial concerns of unlimited liability, the notion that an auditor may eventually be held accountable to the entire world, and attenuation, the notion that a given plaintiff's injuries are so remote that they cannot possibly have sprung forth from the auditor's negligent act.

Historically, the law has denied tort recovery for the negligent performance of a contract when the claimant was no party to the contract. In 1916, Judge Benjamin Nathan Cardozo broke with tradition. Judge Cardozo's insight opened the courthouse doors to persons claiming negligent injury, not as an element of a contract involving the defendant, but as a separate legal action standing on its own. In MacPherson v. Buick Motor Co., Judge Cardozo allowed the buyer of an automobile with a defective wheel to bring an action directly against the manufacturer of the car, without regard to the fact that the wheel was actually built by another party. Judge Cardozo held that a negligently built automobile was a thing of danger to the ultimate user. Where "danger was to


21. Id. at 1051.
be expected as reasonable certain, there was a duty of vigilance . . .”22 The defendant’s failure to respond to this duty was actionable by the plaintiff.23 This was the first American case allowing tort recovery for personal injury for a negligently manufactured item, apart from any allowable contractual recovery.

Judge Cardozo expanded the scope of this rule six years later to include tort recovery for negligently inflicted economic injury in *Glanzer v. Shepard.*24 In *Glanzer*, the court allowed a bean buyer to bring an action against the public weigher hired by the seller to certify the weight of the beans.25 The buyer asserted that the weigher was negligent in his duties. Accordingly, the certificate of weight, which was the basis of the contract between the seller and buyer, was significantly overstated.26 In holding that the buyer could recover his economic loss from the weigher, the court advanced the notion that one can recover for negligently inflicted economic injury, based upon his close relationship to the actual parties to the contract. The court held that:

> [t]he plaintiff’s use of the certificates was not an indirect or collateral consequence of the action of the weighers . . . . It was . . . the end and aim of the transaction . . . . The defendants held themselves out to the public as skilled and careful in their calling . . . . In such circumstances, assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed.27

Under this analysis, the fact that the plaintiff was not in privity with the original contract did not bar recovery. The recovery was based on the relationship between the plaintiff and the parties to the contract. Practical substance triumphed over legal form.

A. Privity and the Primary Benefit Rule

In 1931, Judge Cardozo declined the opportunity to expand tort liability for economic loss against an accounting firm in *Ultrimares v. Touche, Niven & Co.*28 Instead, Judge Cardozo re-
treated to privity notions, exculpating the accounting profession from negligence liability for the next fifty years. In Ultramares, a creditor sued the accounting firm that audited the financial statements of the then-bankrupt debtor. The creditor claimed a loss due to reliance on erroneous information in the debtor's financial statements, arguing that Touche, Niven & Co. had been negligent in performing their audit procedures and citing numerous discrepancies and falsifications in the accounts receivables reported on the audited financial statements.\[29\]

\[\text{information was Landell v. Lybrand, 264 Pa. 406, 197 A. 783 (1919). In Landell, the court denied liability absent a showing that the plaintiff stood in a relationship of privity with the accountant such that there is a duty imposed under the law to act with due care respecting this third part. Landell, 264 Pa. at }\]

\[\text{Ultramares, 255 N.Y. at }\]

\[\text{The audited balance sheet indicated a net worth of over one million dollar based, in part, however, on overvalued and fictitious accounts receivable. In fact, the company was insolvent at the balance sheet date and at all times thereafter when plaintiffs extended credit to the bankruptcy debtor. Plaintiff's original complaint asserted claims for both negligence and fraudulent misrepresentation. The trial court dismissed the fraud claim and granted a judgment notwithstanding the verdict on the negligence issue, based on lack of privity. While Ultramares is widely known as the privity impediment to negligence claims, it is the privity element, when considered with the nature of the claim, that determines the outcome of the case. 255 N.Y. at }\]

\[\text{The lack of privity was a bar to plaintiff's negligence claim, a cause of action sounded in fraud suffers no similar frailty, 255 N.Y. at }\]

\[\text{Inherent in this fraud-negligence distinction is the realization that, while Judge Cardozo did not foreclose liability for negligence, he recognized the then-limited influence of the accounting profession in the business community. Despite evidence of negligence, Judge Cardozo refused, on policy grounds, to expand the accountant's negligence liability beyond its professional relationship with its client:}

\[\text{To creditors and investors to whom [Stern] exhibited the certificate, the defendants owed a like duty to make it without fraud, since there was notice in the circumstances of its making that the employer did not intend to keep it to himself . . . . A different question develops when we ask whether they owed a duty to these to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.}

\[\text{255 N.Y. at }\]

\[\text{id. at 444.} \]
Chief Justice Cardozo described the tort of negligent misrepresentation as occurring when one who supplies information fails to exercise reasonable care and, as a result, misinforms someone to whom he owes a duty of care.\textsuperscript{30} The court held that an accountant could be liable only to the person who hired him or to a person whom the accountant, at the time he audited the financial statements, knew would rely on them.\textsuperscript{31} Although speaking in terms of privity, it is important to note what the court did not do. The court did not limit accountant liability along traditional privity of contract lines. Instead, the court included within the permissible scope of plaintiffs those whose use of the corporate representations were the end and aim of the transaction.\textsuperscript{32} The court also considered the holding of \textit{Glanzer} but distinguished it, noting:

\begin{quote}
[in \textit{Glanzer}, there] was something more than the rendition of a service in expectation that the one who ordered the certificate would use it thereafter in the operations of his business as occasion might require. Here was a case where the transmission of the certificate to another was not merely one possibility among
\end{quote}

\textsuperscript{30} 255 N.Y. at 174 N.E. at 444. The simplicity of this rule cloaks an interesting issue with respect to an accountant's professional obligations. To the extent that the financial statements remain the representations of management, not the auditor, management supplies the information to a prospective investor. Professional Standards No. 1, § 100.02 (Am. Inst. of Certified Pub. Accountants 1987). In the audit context, however, the auditor expresses an opinion on management representations. To the extent that an investor relies on the audit opinion, this rule correctly imposes liability on the auditor for his negligence. But what of lesser engagements such as a financial statement review or compilation which involve no similar auditor assurances? Negligence liability should be harder to maintain in that the rule should account for the lesser degree of work performed in these situations. To disregard the inherent limitations on the scope of the accountant's work is tantamount to disregarding the nature of the instant contract between the accountant and his client.

\textsuperscript{31} In \textit{Ultramares}, the auditor gave the client the audited balance sheet and 32 sequentially numbered counterparts of the original. 255 N.Y. at \textsuperscript{-}, 174 N.E. at 442. The auditor knew that the client would use the balance sheet but did not actually know the intended use of the counterparts. \textit{Id.} at \textsuperscript{-}, 174 N.E. at 443-44.

\textsuperscript{32} Fiflis, 28 \textit{VAND. L. REV.} at 105. Subsequent interpretations of \textit{Ultramares} support the conclusion that the rule permits actions by parties not directly in privity where the accountant knows and understands that the financial statements are intended for use by a particular party, for a particular purpose, and that the accountant manifests his understanding of these circumstances through some direct contact with that particular party. See Credit Alliance Corp. v. Arthur Anderson & Co., 65 N.Y.2d 536, 483 N.E.2d 110 (1985); See \textit{infra} notes 35-39 and accompanying text.
many, but the "end and aim of the transaction . . . ." In a word, the service rendered by the defendant in Glanzer v. Shepard was primarily for the information of a third person, in effect, if not in name, a party to the contact, and only incidentally for that of the formal promisee. In the case at hand, the service was primarily for the Stern Company, a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom Stern and his associates might exhibit it thereafter. Foresight of these possibilities may change with liability for fraud. The conclusion does not follow that it will change with liability for negligence.3

Later cases, following the primary benefit notion of liability to third parties, give considerable support to the continued vitality of the primary benefit rule.4 In Credit Alliance Corp. v. Arthur Andersen & Co.,5 the New York bench again reaffirmed its com-

33. Id. at 176, 174 N.E. at 445-48. The first serious challenge to the policies of Ultramares is in the dissent of Lord Denning in Candler v. Crane, Christmas & Co., 2 K.B. 164 (1951). Lord Denning concluded that the requirement of privity disregards the realities of the audit function by insulating from liability the very parties whose work is most heavily relied upon by investors stating:

[Accountants make reports on which other people . . . other than their clients . . . rely in the ordinary course of business . . . [They are] in my opinion, in proper cases, apart from any contract in the matter, under a duty to use reasonable care in preparation of their accounts and in the making of their reports.

2 K.B. at 185.

34. In State Street Trust Co. v. Ernst & Ernst, 278 N.Y. 104, 15 N.E.2d 416 (1938), the court interpreted Ultramares to insulate an auditor from negligence liability to third parties, in the absence of a contractual relationship:

We have held that in the absence of a contractual relationship or its equivalent, accountants cannot be held liable for ordinary negligence in preparing a certified balance sheet even though they are aware that the balance sheet will be used to obtain credit . . . . Accountants, however, may be liable to third parties, even where there is lacking, deliberate or active fraud . . . [H]eeful and reckless disregard of consequence may take the place of deliberate intention.


mitment to the primary benefit theory of liability. The court held that as a prerequisite to holding an accountant liable to a third-party user of financial information not directly in privity of contact with the accountant:

(1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and, (3) some conduct on the part of the accountants linking them to that party or parties, which evinces the accountant's understanding of that party or parties' reliance.36

The court noted that the above criteria do permit some measure of flexibility; however, they "do not represent a departure from the principles articulated in Ultramares [and] Glanzer ... but, rather, they are intended to preserve the wisdom and policy set forth therein."37

The court dismissed the creditor's complaint against the accountant despite an allegation in the complaint that the debtor provided the creditor with copies of the audited financial statements upon request of the creditor as a prerequisite to obtaining credit and that the accounting firm knew, or should have known, or was on notice that, the audited financial statements were being shown to potential creditors for the purpose of obtaining credit.38 In so holding, the court analyzed the facts as alleged in light of existing state law noting:

[T]here is no allegation that [the accounting firm] had any direct dealings with the [creditor], had specifically agreed with [the debtor] to prepare the report for the [creditor's] use or according to the [creditor's] requirements, or had specifically agreed with [the debtor] to provide [the creditor] with a copy or actually did so. Indeed there is simply no allegation of any word or action on the part of [the accounting firm] directed to [the creditor], of anything contained in [the accounting firm's] agreement with the [debtor] which provided the necessary link between [the accounting firm and the creditor].39

A number of other courts have followed this limited approach to accountant liability to third-party users of financial statement

36. Id. at ____, 483 N.E.2d at 118.
37. Id. at ____, 483 N.E.2d at 118.
38. Id. at ____, 483 N.E.2d at 119.
39. Id. at ____, 483 N.E.2d at 119.
information;\textsuperscript{40} none straying too far from the original privity of contract argument advanced by Judge Cardozo fifty-seven years ago.

B. The "Actually Foreseen" Standard and the Restatement of Torts Section 552

In recent years courts have begun to adopt the more liberal view of the Restatement of Torts, section 552,\textsuperscript{41} as an alternative to the narrow approach of \textit{Ultramares} and its progeny. Section 552 imposes liability for negligent misrepresentation on one who in the course of his business, supplies false information for the guidance of others in their business affairs when the information is justifiably relied upon by the user and this reliance gives rise to a pecuniary loss.\textsuperscript{42} Section 552 limits liability in favor of those persons "for whose benefit and guidance,"\textsuperscript{43} and in favor of losses suf-

\textsuperscript{40} See, e.g., Investment Corp. of Florida v. Buchman, 208 So.2d 291 (Fla. 2d Dist. Ct. App. 1968); Canaveral Capital Corp. v. Bruce, 214 So.2d 505 (Fla. 3d Dist. Ct. App. 1968); See also MacNerland v. Barnes, 129 Ga. App. 367, 199 S.E.2d 564 (1973) (\textit{Ultramares} is the general rule); Stephens Industries, Inc. v. Haskins and Sells, 438 F.2d 357 (10th Cir. 1971) (accountant is not liable to a known third-party user of the financial statements not in privity with the accountant); Nortek, Inc. v. Alexander Grant Co., 532 F.2d 1013 (5th Cir. 1976) (same); Koch Industries, Inc. v. Voisko, 494 F.2d 713 (10th Cir. 1974) (accountant not liable to the ultimate purchaser of a business); McLean v. Alexander, 599 F.2d 1190 (3d Cir. 1979) (same).

\textsuperscript{41} RESTATEMENT (SECOND) OF TORTS § 552 (1978). This section provides in pertinent part:

\textit{Information Negligently Supplied for the Guidance of Others}

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) [T]he liability stated in subsection (1) is limited to loss suffered,

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.


\textsuperscript{43} RESTATEMENT (SECOND) OF TORTS § 552(2)(a).
ffered as a result of reliance upon the information in a transaction that the provider "intends the information to influence as . . . in a substantially similar transaction."\textsuperscript{44}

Early cases purporting to apply the Restatement (Second) theory did so with a bent of uncertainty. One such early case is \textit{Rusch Factors v. Levin}.\textsuperscript{45} In \textit{Rusch}, the court let a creditor sue the accounting firm that audited the debtor's books before the debtor went into receivership.\textsuperscript{46} Adopting the end and aim analysis of \textit{Glanzer}, the court distinguished \textit{Ultramares} by defining this particular plaintiff as a party whose reliance was actually foreseen by the defendant.\textsuperscript{47} The \textit{Rusch} Court equated the law in \textit{Glanzer} with the Restatement approach taken in the case at bar.\textsuperscript{48} Expanding

\begin{quote}
\textsuperscript{44} \textit{Id.} § 552(2)(b).
\textsuperscript{46} \textit{Id.} at 87.
\textsuperscript{47} \textit{Id.} at 91. The \textit{Rusch} plaintiff requested audited financial statements of the debtor with which to gauge the debtor's financial condition. The debtor engaged the accounting firm whose audited financial statements "represented the [debtor] to be solvent by a substantial amount. In fact, the corporation was insolvent." \textit{Id.} at 86. Of the relationship between the auditors and the plaintiff, the court distinguished \textit{Ultramares} noting:

"[In \textit{Ultramares}] the plaintiff was member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable. Here the plaintiff is a single party whose reliance was actually foreseen by the defendant."

\textit{Id.} at 91.
\textsuperscript{48} \textit{Id.} at 91-92. More specifically, the court purported to apply the Restatement approach embodied in a tentative draft of section 552 as follows:

(1) One who, in the course of his business, profession or employment, or in a transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transaction, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

(2) Except as stated in subsection (3), the liability stated in subsection (1) is limited to loss suffered:

\begin{enumerate}
\item [(a)] by the person or one of the persons for whose benefit and guidance he intends to supply the information, or knows that the recipient intends to supply it; and
\item [(b)] through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.
\end{enumerate}

(3) The liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them.
Glanzer, the court held that "[t]he defendant knew that his certification was to be used for, and had as its very aim and purpose, the reliance of potential [creditors] of the . . . corporation."49

That the court claimed to follow the Restatement approach, yet retreated to the Glanzer "end and aim" analysis, raises two interesting questions. First, would the result have been the same had the court followed the strict Glanzer approach? Second, does this retreat to Glanzer signal an inherent limitation in the Restatement (Second) theory of liability?

To the extent that the auditor knew of the plaintiff-creditor at the time of his work and that this plaintiff's use of the financial statements was contemplated by all parties to the audit contract, the plaintiff's use was the end and aim of the audit engagement. While the Rusch Court noted that the Glanzer principle had been effectively adopted by the Restatement,50 the court would not so limit the scope of Restatement recovery. Instead, the Rusch Court held that an "accountant should be liable in negligence for careless financial misrepresentations relied upon by an actually foreseen and limited class of persons."51 That Rusch represented the first

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49. Id. at 93. The court held: "the wisdom on the decision in Ultramares has been doubted . . . and this court shares the doubt. Why should an innocent reliable party be forced to carry the weighty burden of an accountant's professional malpractice? Isn't the risk of loss more easily distributed and fairly spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers who can in turn pass the cost onto the entire consuming public? Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession? For these reasons it appears to this Court the decision in Ultramares constitutes an unwarranted inroad upon the principle that the risk reasonably to be perceived defines the duty to be obeyed."

50. Id. at 90-91.

51. The Rusch analysis was at least facilitated, if not compelled, by the following commentary accompanying the tentative draft: A is negotiating with a bank for a credit of $50,000. The bank requires an audit by certified public accountants. A employs B & C Company, a firm of accountants, to make the audit, telling them he is going to negotiate a bank loan. A does not get his loan from the first bank but does negotiate a loan with another bank, which relies upon B & C Company's certified statements. The audit carelessly overstates the financial resources of A, and in consequence the second bank suffers pecuniary loss. B & C Company is subject to liability to the second bank.
meaningful departure from privity motions is undeniable. The Rusch Court clearly followed the Glanzer rule, identifying the Restatement (Second) approach as the Glanzer approach applied to accountants. However, such analysis ignores the clear distinction between the actual knowledge of an identified plaintiff required by Glanzer and the specifically foreseen person standard used in the Restatement (Second) approach. But as the auditor in Rusch knew that he was engaged to prepare audited financial statements to be used by his client, the Rusch result is justifiable by reference to either the Glanzer or the Restatement (Second) approach.

C. The North Carolina Approach

On May 5, 1988, twenty-seven months after the North Carolina Court of Appeals ruled on the matter, the North Carolina Supreme Court adopted the approach embodied in Restatement (Second) section 552 in Raritan River Steel Co. v. Cherry, Bekaert &

52. Id. at 91.
54. In Ryan v. Kanne, 170 N.W.2d 395 (Iowa 1969), the court purported to follow the approach taken in Rusch, expressly adopting the Restatement position respecting third-party liability. However, as the court held that the plaintiff was a member of a group whose use was actually foreseen by the accountant at the time of the audit, the gap between the Glanzer approach and that of the Restatement was not completely filled. This was remedied, however, in Shatterproof Glass Corp. v. James, 466 S.E.2d 873 (Tex. Civ. App. 1971). There the court expressly adopted the Restatement approach, holding that an accountant could be held liable to all those whom he should reasonably expect to rely on his certification of financial statements. Id. at 880.

The seemingly indiscriminate use of such language as "specifically foreseen," "actually foreseen," "reasonably foreseeable," and the like has prompted criticism from one commentator:

Regardless of the clarity of the Restatement formulation, interpretation of . . . Section [552] is sometimes obscured by misunderstandings of the difference between the terms foreseen and foreseeable. Some opinions, though accepting and applying the foreseen rule . . . have misinterpreted it insofar as they employ the word foreseeable or some derivative of that term. Conversely, one opinion refers to auditors' "further duty to those persons whom they can reasonably foresee will need to use and rely upon" . . . the audited financial statements . . . .

See Gormley, supra note 18, at 530. Moreover, to the extent that each adjective has its own definition, these expressions confuse rather than clarify, creating distinctions where none, in fact, exist.
Holland. In *Raritan*, a creditor alleged negligent misrepresentation in the audit opinion of the then-bankrupt debtor. The creditor did not allege either reliance on the financial statements themselves or that the auditor knew of the existence of the creditor or his intended use of the statements. Instead, the creditor-plaintiff alleged that:

1. at the time [of the audit, the defendant] knew that such financial statements would be used for, among other purposes, general representations by the [debtor] of its financial condition, and that extensions of credit to [the debtor] would be based on such statements;
2. that [the defendant] knew that it was customary and foreseeable for the audited financial statement of [the debtor] to be relied upon by creditors; and,
3. that [the defendant] knew that it was customary and foreseeable for audited financial statements to be widely circulated to credit reporting agencies.

Significant to this case is that the court of appeals allowed a cause of action against the accountants without regard to the fact that the plaintiffs did not allege reliance on the financial statement themselves. Instead, the plaintiffs relied on a Dun & Bradstreet credit report which contained an excerpt from the financial statements showing a corporate “net worth” of approximately $7,000,000.

The North Carolina Court of Appeals originally adopted a six-factor public policy test as the standard to govern auditor's liability to third parties. In adopting the six-factor test as the control-
ling rule of law, the court rejected a reasonably foreseeable test\textsuperscript{61} as being overbroad in its scope. The court noted:

\begin{quote}
[e]specially in the field of accounting, 'it [is] necessary to adopt a more restricted rule of liability [for pecuniary loss], because of the extent to which misinformation may be, and may be expected to be, circulated, and the magnitude of the losses which follow from reliance upon it.'\textsuperscript{62}
\end{quote}

Similarly, the court of appeals rejected the Restatement (Second) approach as tending to arbitrarily define the class of plaintiffs entitled to relief.\textsuperscript{63}

The [six-factor] test, by contrast, avoids the necessity of an arbitrary, purpose-based determination of liability by allowing a court to weigh the purpose of the audit as one of several determinative factors.\textsuperscript{64}

There is little question but that the court of appeals greatly expanded the notion of liability to third-party users of financial statements far beyond that of its predecessors to consider the is-

\begin{quote}
of harm to him: (3) the degree of certainty that he suffered injury; (4) the closeness of the connection between the defendant’s conduct and the injury; (5) the moral blame attached to such conduct; and, (6) the policy for preventing further harm.
\end{quote}

\textit{Biakanja} at \textit{-----}, 320 P.2d at 19.

61. \textit{Id.} at \textit{-----}, 320 P.2d at 19; \textit{See also} H. Rosenblum v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); \textit{See infra} notes 96 to 107 and accompanying text. This raises the question of whether the reasonably foreseeable standard of \textit{Rosenblum} differs in application from the foreseeableliy of harm standard of the six-factor test. Clearly it does. The \textit{Rosenblum} standard defines a permissible class of plaintiffs in terms of whether a particular plaintiff’s use of the statements was reasonably foreseeable to the auditor. Under any analysis, it is difficult to imagine a situation in which anyone doing business with a corporation, be they a shareholder, creditor or potential buyer, would not be included in the group of users, reasonably foreseeable to the auditor. Contrary to this broad brush treatment, the six-factor test will define the class of permissible plaintiffs in terms of both, intended use and foreseeability of harm. Thus, the six-factor test should preclude recovery by a person whose use is so remote from the purpose of the audit, that notwithstanding any foreseeable degree of harm, the use could not have been contemplated by the auditor.


63. \textit{Id.}

sue. However, even a cursory reading of the opinion highlights its glaringly deficient analysis. This deficiency becomes apparent when considered in light of the fact that the court cites the holding of *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*,\(^6\) in support of its expansionist posture, yet ignores the factual underpinnings which based liability on the accountants only where they knew of the plaintiff's use of their report.\(^6\)

Thus, the North Carolina Court of Appeals laid bare a landscape of legal precedent, littered with confusion and the jagged outcroppings of unrefined analysis. It was against this backdrop that the North Carolina Supreme Court undertook the matter and adopted the approach of the Restatement (Second) section 552.\(^6\)

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65. *Raritan*, 79 N.C. App. at 90, 339 S.E.2d at 68 (citing *Aluma Kraft Mfg. Co. v. Elmer*, 493 S.W.2d 378 (Mo. Ct. App. 1973)). This case upheld the use of the six-factor test in light of evidence that the accountant knew the intended use of the audited financial statements.


It is here that the analytical deficiencies in the court of appeals' reasoning become apparent. The court cites these North Carolina cases in support of the proposition that the six-factor test as applied to other professions should be extended to the accounting profession in the instant case. However this ignores the underlying factual settings in these cases, which are easily distinguished from the case at bar. In *United Leasing Corp.*, the court allowed an equipment lessor to bring action against the attorney whose negligently prepared title opinion, as prepared by the attorney and delivered to the lessor by the attorney, caused the loss to the lessor. *United Leasing Corp.*, 45 N.C. App. at 407, 263 S.E.2d at 316. In *Jenkins*, the court allowed the sole beneficiary of an estate to bring an action against the representing attorney for failing to inform the administratrix of her available cause of action for the wrongful death of the decedent. At the time of the engagement of the attorney, the attorney knew the plaintiff and knew that the plaintiff was the sole beneficiary of the estate. *Jenkins*, 69 N.C. App. 141-142, 316 S.E.2d at 356.

As both of these cases represent instances where the defendant knew the plaintiff at the time of the engagement, neither supports the proposition for which the court of appeals cites them; that being, that a third-party user of the accountant's information work product, where it is neither alleged that the professional-defendant knew the plaintiff at the time of the engagement nor that the plaintiff directly relied on the work product of the professional to his detriment, may hold the accountant liable for audit negligence.

In *Raritan*, the supreme court undertook an analysis of the consolidated claims of two creditors of Intercontinental Metals Corporation (IMC), the Raritan River Steel Company and Sidbec-Dosco, Inc. The plaintiffs allegedly extended credit to IMC on the basis of what they contend was an incorrect overstatement of the company's net worth, as reflected in the audit report prepared by the defendants. Critical to understanding this case, however, is an analysis of the complaints filed by the separate plaintiffs. Whereas Sidbec-Dosco alleged reliance on IMC's audited financial statements, *Raritan* did not allege reliance on these financial statements. Instead, *Raritan* alleged that it relied on a Dun & Bradstreet credit report which indicated that IMC had a net worth of roughly $7,000,000. Each of these claims were dismissed in the

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68. *Raritan*, 322 N.C. at 203, 367 S.E.2d at 611 [hereinafter "IMC," "Raritan" and "Sidbec-Dosco" respectively].
69. *Id.*
70. *Id.* at 207, 367 S.E.2d at 613. Sidbec-Dosco alleged in relevant part:
17. That based upon financial information showing substantial net worth of IMC, the Plaintiff extended substantial unsecured credit to IMC during 1982... 24. That the Plaintiff has incurred substantial expenses and damages as a direct result of its extension of credit to IMC and IMTC in reliance on the reported financial condition of these entities.
71. *Id.* at 205, 367 S.E.2d at 612. *Raritan* alleged in relevant part:
4. Defendant Cherry Bekaert was engaged pursuant to a valid and enforceable contract, to examine the financial statements of Intercontinental Metals Corporation, Intercontinental Metal Trading Corporation and other related companies (collectively hereafter "IMC") as of September 30, 1981 and September 30, 1980, in accordance with Generally Accepted Auditing Standards and to express an opinion as to whether or not such financial statements presented fairly the financial position of IMC and the results of its operations and changes in its financial position for the years ending September 30, 1980 and September 30, 1981. Defendant Cherry Bekaert published its Report of Certified Public Accountants, Consolidated Financial Statements. Years ended September 30, 1981 and 1980 on or about January 30, 1982... 6. Plaintiff had over a period of years sold hot-rolled carbon wire rod (raw steel) to IMC on open account, relying on information available to plaintiff with respect to the financial condition of IMC.
7. Subsequent to May 6, 1982, IMC placed orders for hot-rolled carbon wire rod (raw steel) to IMC in substantial amounts. Plaintiff's inquiry with respect to the current financial position of IMC on or about May 6, 1982, included a report from Dun & Bradstreet, Inc. showing IMC's audited net worth as of September 30, 1981, to be $6,964,475.00. The Dun & Bradstreet, Inc., report made specific reference to defendant Cherry Bekaert's Report of Certified Public Accountants as the source of...
However, the court of appeals reversed the trial court's determination on the issue of negligent misrepresentation. The supreme court affirmed the court of appeals' determination with respect to that of Sidbec-Dosco.

The supreme court focused on two questions of first impression. First whether plaintiffs "who have relied on financial information in an accountant's audit report must demonstrate that they obtained the information from the actual report itself." The court held that "a party cannot show justifiable reliance on information contained in audited financial statements without showing that he relied upon the actual financial statements themselves to obtain this information." To the extent that Raritan alleged reli-

information contained in its report.

8. In reliance upon information contained in the Dun & Bradstreet, Inc. report, as supplied by defendant Cherry Bekaert's Report of Certified Public Accountants, plaintiff extended credit to IMC in excess of $42,247,844.61.

Id. at 204-5, 367 S.E.2d at 611-12.

72. Id. at 204, 367 S.E.2d at 611.

73. Id.

74. Id.

75. Id. at 203, 367 S.E.2d at 611. The Raritan Court noted:

Interesting questions of first impression are presented. The first deals with whether plaintiffs who have relied on financial information in an accountant's audit report must demonstrate that they obtained the information from the actual report itself. We conclude that they must. The second question involves the scope of an accountant's liability to persons other than the client for whom the audit report was prepared. We conclude that the scope of liability is best measured by the approach set out in the RESTATEMENT (SECOND) OF TORTS § 552 (1977).

Id. at 203, 367 S.E.2d at 611.

76. Id. at 203, 367 S.E.2d at 611.

77. Id. at 206, 367 S.E.2d at 612. The court however acknowledged the potential for liability without reliance, referring to the case of H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 461 A.2d 138 (1983); See infra notes 96 to 107 and accompanying text. However, the Raritan Court noted the limitation inherent in Rosenblum, also in favor of foreseeable users of financial information:

The principle that we have adopted applies by its terms only to those foreseeable users who receive the audited statements from the business entity for a proper business purpose to influence a business decision of the user, the audit having been made for that business entity. Thus, for example, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle.

ance, not on the financial statements themselves, but on excerpted information contained in a Dun & Bradstreet report, Raritan did not plead reliance sufficient to maintain a claim against the accounting firm. Accordingly, the supreme court reversed the lower court's determination and affirmed that of the trial court, dismissing Raritan's complaint against the accounting firm. Because Sidbec-Dosco alleged reliance on the financial statements, the court undertook to determine the proper standard of liability to be applied against the accounting firm with respect to Sidbec-Dosco's allegations.

In opting in favor of the Restatement (Second) approach, the Raritan Court examined all four of the prevailing theories of liability currently followed by the courts of various states. The court specifically rejected the Ultramares privity approach because "it provides inadequately for the central role independent accountants play in the financial world. Accountants' audit opinions are increasingly relied upon by the investing and lending public in mak-


78. Raritan, 322 N.C. at 207, 367 S.E.2d at 613. The court noted: Our holding that reliance on the audited financial statements is required in these kinds of cases stems in part from an understanding of the audit report. An audit report represents the auditor's opinion of the accuracy of the client's financial statements at a given period of time. The financial statements themselves are the representations of management, not the auditor. Isolated statements in the report, particularly the net worth figure, do not meaningfully stand alone; rather, they are interdependent and can be fully understood and justifiably relied on only when considered in the context of the entire report, including any qualifications of the auditor's opinion and any explanatory footnotes included in the statements.

Id. at 207, 367 S.E.2d at 613 (citations omitted).

79. Id. at 207, 367 S.E.2d at 613.

80. Id. at 207-8, 367 S.E.2d at 613. The court noted: Because Sidbec-Dosco does not allege that it relied on sources other than the audited financial statements it has not pleaded facts which defeat its claim and its complaint is not dismissible on this ground. Under the liberal rules of notice pleading Sidbec-Dosco's complaint may not be dismissed unless it appears to a certainty that Sidbec-Dosco is not entitled to relief under any 'state of facts.' Under its pleading Sidbec-Dosco may be able to prove at trial that it did indeed rely on the audit report prepared by defendants.

The more difficult question raised by Sidbec-Dosco's complaint is whether it alleges enough to show that defendants owed a duty of care.

Id. (citations omitted).
ing financial decisions." Because of this heavy public reliance on audited financial information, the court held that "an approach that protects those persons, or classes of persons, whom an accountant knows will rely on his audit opinion, but who may not otherwise be in 'privity or near privity' with him is desirable." Moreover, the court specifically declined to adopt a more liberal standard, which would otherwise extend an accountant's liability to all "reasonably foreseeable" foreseen users of financial information. While this "reasonably foreseeable" standard had some inherent appeal, the court noted that its origins in products liability law made it particularly inadequate to comprehend the duties of an accountant with respect to a third-party user of financial information. Because auditors have little control over the distribution of their reports and because they must necessarily rely on their clients' financial records as a basis for forming an opinion, the "reasonably foreseeable" standard imposes too great a threshold of liability on the accounting profession.

81. Raritan, 322 N.C. at 211, 367 S.E.2d at 615.
82. Id.
83. Id.
84. Id. at 212-213, 367 S.E.2d at 616. The court continued:
A more fundamental difference between product designers and manufacturers and accountants lies in their differing expectations concerning their work product. Manufacturers and designers fully expect that their products will be used by a wide variety of unknown members of the public. Indeed, this is their hope, for with wider use will come increased profits. This is not the case when an accountant prepares an audit. An accountant performs an audit pursuant to a contract with an individual client. The client may or may not intend to use the report for other than internal purposes. It does not benefit the accountant if his client distributes the audit opinion to others. Instead, it merely exposes his work to many whom he may have had no idea would scrutinize his efforts. We believe that in fairness accountants should not be liable in circumstances where they are unaware of the use to which their opinions will be put. Instead, their liability should be commensurate with those persons or classes of persons whom they know will rely on their work. With such knowledge the auditor can, through purchase of liability insurance, setting fees, and adopting other protective measures appropriate to the risk, prepare accordingly.

Id. at 213, 367 S.E.2d at 616.
85. Raritan, 322 N.C. at 213, 367 S.E.2d at 616.
Between the production and distribution of an accountant's audit report and the design and manufacture of a product we perceive significant differences which justify establishing a narrower class of plaintiffs to whom the accountant owes a duty of care. Designers and manufacturers have

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The Raritan Court also specifically rejected the six-factor test adopted by the court of appeals. The court noted that the six-factor test:

requires that the 'moral blame' of the defendant and the 'policy of preventing future harm' be considered in determining whether the defendant should be held liable. These factors are not capable of precise application and seem to add little to an assessment of whether a defendant violated a particular duty of care.

The court held that the standard set forth in the Restatement (Second) approach:

represents the soundest approach to accountants' liability for negligent misrepresentation. It constitutes a middle ground between the restrictive Ultramares approach advocated by the defendants and the expansive 'reasonably foreseeable' approach advanced by plaintiffs. It recognizes that liability should extend not only to those with whom the accountant is in privity or near privity, but also to those persons, or classes of persons, with whom he knows and intends will rely on his opinion, or whom he knows his client intends will so rely. On the other hand, it prevents extension of liability in situations where the accountant 'merely knows of the ever-present possibility of repetition to anyone, and the possibility of action in reliance upon [the audited financial statements], on the part of anyone to whom it may be repeated.'

control over the processes by which the products enter the stream of commerce. Manufacturers, and to a lesser extent designers, can limit their potential liability by controlling the number of products they release into the marketplace. Auditors, on the other hand, have no control over the distribution of their reports, and hence lack control over their exposure to liability. Moreover, as noted previously, auditors do not control their client's accounting records and processes. While in the final analysis, an auditor renders an opinion concerning the accuracy of his client's records, he necessarily relies, in some measure, on the client for the records' contents. Because of the accountant's inability to control the distribution of his report, as well as his lack of control over some of the contents of the statements he assesses, a standard which limits his potential liability is appropriate.

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Id. at 212-13, 367 S.E.2d at 616 (citations omitted).

86. Raritan, 322 N.C. at 214, 367 S.E.2d at 617.

87. Id. "Furthermore, the Biakanja test approximates a 'reasonable foreseeability' test. One of the factors in the test is 'the foreseeability of harm to the plaintiff . . . [W]e decline to adopt a standard which would extend accountant's liability to all reasonably foreseeable plaintiffs.' Id.

88. Id. at 214-15, 367 S.E.2d at 617. "As such it balances, more so than other standards, the need to hold accountants to a standard that accounts for their con-
As to the practical application of the Restatement (Second) approach, the court held that:

under the Restatement approach an accountant who audits or prepares financial information for a client owes a duty of care not only to the client but to any other person, or one of a group of persons, with whom the accountant or his client intends the information to benefit; and that the person reasonably relies on the information in a transaction, or one substantially similar to it, that the accountant or his client intends the information to influence. If the requisite intent is that of the client and not the accountant, then the accountant must know of his client’s intent at the time the accountant audits or prepares the information.89

Thus, the court recognizes the dual nature of the Restatement (Second) approach. First, the court recognizes that the Restatement (Second) approach defines a class of persons to whom the accountant or his client intends the information to benefit. Second, the court also recognizes the transactional nature of the Restatement (Second) approach. Notwithstanding that a third-party user is an intended user of financial information, under the Restatement (Second) approach, the user must rely on the information “in a transaction, or one substantially similar to it, that the accountant or his client intends the information to influence.”90

The transactional element of the Restatement (Second) calculus merits brief consideration in this case. Because this element implicates the accountant-client relationship, the identity of the client is paramount to imposing liability against the accountant. To the extent that the audit client is typically the corporation under review, it is this client’s use of financial information that should determine the auditor’s extent of liability therefor. Clearly, corporate creditors and shareholder investors are the intended users of this financial information in most cases. But what of the cases involving small or closely held corporations? If a sole shareholder of a closely held corporation uses his audited financial statements to obtain personal credit, does this individual creditor have recourse against the accountant in the event that the accountant was negligent in performing his audit responsibilities? Or

temporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking. Id. at 215, 367 S.E.2d at 617.

89. Id. at 210, 367 S.E.2d at 614.
90. Id.
must the accountant know that the shareholder will use this information to verify his personal wealth as a prerequisite to obtaining such credit? The Raritan interpretation of the Restatement (Second) approach seems to blur this distinction by making reference to the auditor’s knowledge of the intended use of his report:

The Restatement (Second) approach does not demand that the accountant be informed by the client himself of the audit report’s intended use. [The Restatement (Second) approach] requires only that the auditor know that his client intends to supply information to another person or limited group of persons. Whether the auditor acquires this knowledge from his client or elsewhere should be make no difference. If he knows at the time he prepares his report that the specific persons, or a limited group of persons, will rely on his work, and intends or knows that his client intends such reliance, his duty of care should extend to them.\(^91\)

Accordingly, the supreme court upheld Sidbec-Dosco’s complaint on the grounds that the creditor stated a legally sufficient claim against the defendants for negligent misrepresentation.\(^92\) Sidbec-Dosco alleged that “when the defendants prepared the audited financial statements for IMC they knew: first, the statements would be used by IMC to represent its financial condition to creditors who would extend credit on the basis of them; and second, plaintiff and other creditors would rely on the statements. These allegations are sufficient to impose upon defendants a duty of care to Sidbec-Dosco under the Restatement approach . . .”\(^93\)

The Restatement (Second) approach continues to be widely followed as the rule respecting third-party liability.\(^94\) In recent

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92. *Id.* at 216, 367 S.E.2d at 618.
93. *Id.*
94. The court has, on occasion, expanded the scope of third-party users of financial information under the Restatement approach. In *Merit Insurance Co. v. Caleo*, 603 F.2d 654 (7th Cir. 1979), the court held that an insurance company was among the foreseeable class of users of an insurance agent’s financial statements. *Id.* at 658-59. In another case involving an insurance company, the court stretched the foreseeable user notion of liability to a ridiculous extreme. In *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976), the court held that the general agents of an insurance company were among the class of users whose use was reasonably foreseen by the auditors. However, the court’s reasoning was based on the stair-step reasoning which first requires the assumption that the state insurance commissioner was an agent of the general agents and that the direct reliance of the commissioner on the financial information is imputed to the general agents. *Id.* at 299-301.
years, motivated by compelling notions of public policy, courts have begun to expand the scope of accountant liability beyond that of either the Primary Benefit or Restatement (Second) rules.

D. The "Reasonably Foreseeable" Standard

On occasion courts have been willing to enlarge the scope of auditor liability to the fullest limits of reason. Far beyond Ultramares and the Restatement (Second) standards of liability lie the liberal New Jersey and Wisconsin rulings in H. Rosenblum v. Adler and Citizens State Bank v. Timm.

The Rosenblum Court allowed shareholders of a publicly traded corporation to bring an action for the negligent performance of the auditor's duties to the corporation. In Rosenblum, plaintiffs acquired stock in Giant Stores Corporation ("Giant") in conjunction with the sale of plaintiff's business to Giant. Giant provided financial statements to plaintiffs during the merger discussions, which formed the basis for valuing the transaction. Plaintiffs sued Giant's corporate auditors when the financial statements were discovered to be fraudulent and the Giant stock to be worthless.

The New Jersey Supreme Court discussed the nature of the auditor's work, concluding that the use of financial statements by third parties is now a matter of common knowledge. Analogizing to a product liability theory of recovery, the court noted that

[t]he fundamental issue is whether there should be any duty to respond in damages for economic loss owed to a foreseeable user neither in privity with the [accountant] or intended by the [ac-


95. "Why the development of the common law of accountant's liability has proceeded so cautiously, in what is almost universally perceived to be an activist judicial world, is inexplicable." Weiner, Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation, 20 SAN DIEGO L. REV. 233, 249 (1983).

97. 113 Wis. 2d 376, 335 N.W.2d 361 (1983).
98. Rosenblum, 93 N.J. at ___, 461 A.2d at 140-141.
99. Id. at ___, 461 A.2d at 149.
100. Id. at ___, 461 A.2d 146-47.
countant] to be the user of his statement or opinion.\textsuperscript{101}

The court then turned to a discussion of the relative fairness of holding the accountant liable to a foreseeable user of the audit report. The court phrased its inquiry by noting:

[t]here remains to be considered whether the public interest will be served by a proposition holding an auditor responsible for negligence to those persons who the auditor should reasonably foresee will be given the audit to rely upon and do in fact place such reliance to their detriment. Should there by such a duty?\textsuperscript{102}

To this, the court held that the fundamental question was one of fairness. This inquiry involves a "weighing of the relationship of the parties, the nature of the risk, and the public interest in the proposed solution."\textsuperscript{103} To the extent that the auditor can reduce his risk of liability through more thorough audit procedures as well as through malpractice insurance,\textsuperscript{104} the auditor remains the party

\begin{footnotesize}
\begin{enumerate}
\item 101. Id. at ____, 461 A.2d at 147.
\item 102. Id.
\item 103. Id. at ____, 461 A.2d 138, 147 (1983). The Rosenblum court then discussed several factors relevant to its determination of liability including: [T]he burden [that the suggested duty] would put on defendant's activity; the extent to which the risk is one normally incident to that activity; the risk and the burden to [the] plaintiff; the respective availability and cost of insurance to the two parties; the prevalence of insurance in fact; the desirability and effectiveness of putting the pressure to insure on one rather than the other, and the like. \textit{Id.}
\item 104. Id. at 350, 461 A.2d at 152. For an excellent discussion of some practical problems which inhere in an auditors attempts to reduce his risk of liability, see Weiner supra note 95. Among other problems, the Commentator accurately summarizes some problems attendant to professional liability insurance: Professional liability insurance does not appear to offer a viable damages solution to accountants. Because of the increased litigation to which accountants are exposed, the premiums of such coverage have become so costly as to necessitate either large deductibles or even self-insurance. Even if accountants could afford to acquire such coverage, policies have not been standardized and vary greatly. The very nature of the accounting profession causes other problems with insurance. One such problem is determining proximate cause, especially when the accountant/client relationship has existed over an extended period of time. The problem of determining the specific occurrence which gave rise to a pecuniary loss is important because of the way it affects the amount of coverage. \textit{Id.} at 538-29. . . . A further problem is posed by punitive damages. Punitive damages will not always be covered by professional liability insurance. The conflict
\end{enumerate}
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best postured to bear the risk of his negligence.

When the independent auditor furnishes an opinion with no limitation in the certificate as to whom the company may disseminate the financial statements, he has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes, provided that the recipients rely on the statements pursuant to those business purposes. Thus, the court held that the underlying policies of protecting the user who relies on the information in financial statements and holding the profession accountable for the quality of their work product are best served by allowing recovery for negligent audit performance by all whose use is reasonably foreseeable to the accountant. The court stated:

Certified financial statements have become the benchmark for various reasonably foreseeable business purposes and accountants have been engaged to satisfy those ends. In those circumstances, accounting firms should no longer be permitted to hide within the citadel of privity and avoid liability for their malpractice. The public interest will be served by the rule we promulgate this day.

In Citizens State Bank v. Timm, Schmidt & Co., the Wisconsin bench came out in favor of a similar scope of liability, noting that "unless liability is imposed, third parties who rely upon

here is one of public policy. If punitive damages by definition are meant to punish and therefore deter, it can be argued that to have such damages covered by insurance deters the basic purpose of the damages. Id. at 536-37.

See Weiner, supra note 95, at 1936, n. 173 (citations omitted).


106. Id. The Rosenblum Court did, however, suggest several factors which will militate against unlimited liability. First, the third party must receive the financial statement from the company pursuant to a property company purpose. Second, the plaintiff must reasonably rely on the financial statements. Third, the misstatement in the financial statement must result from the auditor's negligence and must be the proximate cause of injury to the plaintiff. Fourth, the plaintiff's own negligence could bar or limit recovery. Last, when the accountant's client contributes to the misstatement and the resulting loss, the accountant may seek indemnification or contribution from the client company.

Id. at 350-351, 461 A.2d at 152.

107. Id. at 350-351, 461 A2d at 153.

108. 113 Wis. 2d 376, 335 N.W.2d 361.
the accuracy of the financial statements will not be protected.”109 However, the court did not favor unlimited liability in all circumstances. “Liability will be imposed on those accountants for the foreseeable injuries resulting from their negligent acts unless . . . as a matter of policy to be decided by the court, recovery is denied on the grounds of public policy.”110 Of the policy justifications for not imposing liability on the accountants, the court noted the following:

(1) [t]he injury is too remote from the negligence; or (2) the injury is too wholly out of proportion to the culpability of the [defendant]; or (3) in retrospect it appears too highly extraordinary that the negligence should have brought about the harm; or (4) because allowance of recovery would place too unreasonable a burden on the [defendant]; or (5) because allowance of recovery would be too likely to open the way for fraudulent claims; or (6) allowance of recovery would enter a field that has no sensible or just stopping point.111

These decisions support the proposition that an accountant may be held liable to any person whose use of the financial information is reasonably foreseeable to the accountant. When considered in an analytical vacuum, these decisions appear harsh in that their effect extends far beyond the scope of the ordinary accountant client relationship. However, this extension is easier to accept when considered in light of the purpose of the audit and the use of the audited financial statements. Inherent in the notion of auditing the information of another is the presumption that the audited information will be read and relied upon, at least to a limited extent, by a third party. The question addressed by the courts analyzing this relationship of reliance involves determining who has a legal right to rely on the information. The Rosenblum Court answers “everyone!” The court thus recognizes the practical limitations which inhere in any decision making process. There simply must come a point where one should be allowed to rely on the declarations of another, especially when the declarant is an expert in his field. To preclude another from relying on this expert's opinion is tantamount to allowing the auditor to say that “the audited financial statements, to which our opinion is attached, present fairly the financial position of ABC Corporation, but don’t take our word for

109. Id. at ___, 335 N.W.2d at 365.
110. Id. at ___, 335 N.W.2d at 366.
111. Id. at ___, 335 N.W.2d at 366.
E. The Six-Factor Test

In recent years, another expansive theory of tort liability has emerged from the morass of decisions. This is the six-factor balancing test of Biakanja v. Irving. In Biakanja, the sole beneficiary of an estate brought an action against a notary public, through whose negligence the will was denied probate. In allowing the beneficiary to maintain an action against the notary, the court adopted a six-factor test, expanding the Restatement (Second) approach to include an analysis of relevant policy considerations:

Whether or not a party has placed himself in such a relation with another that the law will impose on him an obligation, sounding in tort and not in contract, to act in such a way that the other will not be injured calls for the balancing of various factors: (1) the extent to which the transaction was intended to affect the other person; (2) the foreseeability of harm to him; (3) the degree of certainty that he suffered injury; (4) the closeness of the connection between the defendant's conduct and the injury; (5) the moral blame attached to such conduct; and, (6) the policy of preventing further harm.

Several courts have addressed the applicability of the six-factor test in cases involving accountants. In Alum Kraft Mfg. Co. v. Elmer Fox & Co., the court allowed the buyer of a business who relied on the audited financial statements in determining the purchase price to bring an action against the accountant for the negligent preparation of the statement. The court focused on the allegation that the "auditors knew that the said audit was being prepared for the purpose of determining the amounts which the plaintiff . . . would pay . . . and that the plaintiff . . . would rely upon the [report]." The court expressly rejected the requirement of privity as a prerequisite to tort recovery. The court carefully distinguished between the Ultramares reasoning, that being that the audit services are only of incidental or collateral benefit to the users of the statements, and the instant case. The court denied effect to the privity analysis where the evidence clearly demon-

112. 49 Cal.2d 647, 320 P.2d 16 (1958).
113. Id. at 650, 320 P.2d at 19.
114. 493 S.W.2d 378 (Mo. App. 1973).
115. Id.
116. Id. at 383.
strated that audit services were performed for the benefit of a class of potential buyers stating:

Our rejection of the requirement of the strict rule of privity . . . comports with the concepts of the functions and duties of the modern [certified] public accountant, the purpose of a modern audit and is consistent with the development of the liability of an accountant under the securities laws and is consistent with the recent development in England where the doctrine of privity was born.117

The Aluma Kraft Court, while expanding the scope of accountant liability beyond arcane principles of privity, still relied on the fact that both the existence and identity of the purchaser were known to the accountant at the time of his engagement. Later cases following this line of reasoning have similarly held in favor of recovery where it is shown that the accountant knew of the existence of the plaintiff at the time of the audit. In Tiffany Indus. v. Harbor Ins. Co.,118 the court upheld recovery by an indemnity insurance company, against the auditors as third-party defendants, where it could be shown that the financial statement was prepared for the benefit of the insurer and that the accountant knew that the insurer would use the statement at the time of the audit.119 Similarly, the court in 999 v. Cox & Co.,120 upheld the applicability of the six-factor test where it is alleged that the defendant-accountant "knows that the recipient of the audit intends to supply [the statements] to a limited class of persons . . . ."121

At first blush, this test smacks of the Restatement (Second) approach in that it purports to limit recovery to a class of plaintiffs whose use and reliance on the statements is foreseen by the accountants at the time of the audit. However, several fundamental differences become apparent upon closer scrutiny. Liability under the Restatement (Second) approach depends in large part on a determination of whether the plaintiff was a member of a group of persons actually foreseen by the auditor as relying on the financial statements. This limitation is born of the language of section 552 itself122 which limits liability in favor of a "person as one of a lim-

117. Id. at 383-84.
118. 536 F. Supp. 432 (W.D. Mo. 1982).
119. Id. at 434.
120. 574 F. Supp. 1026 (E.D. Mo. 1983).
121. Id. at 1031 (emphasis added).
ited group of persons for whose benefit and guidance [the accountant] intends to supply the information or knows that [his client] intends to supply it . . . ."\textsuperscript{123} Thus, the class of plaintiffs entitled to recover under the Restatement (Second) approach is determined by the extent of the auditor's knowledge of their existence. If the auditor actually foresees their use, the plaintiffs are entitled to recovery.

The six-factor test, on the other hand, enlarges the scope of permissible plaintiffs to include those, although not actually foreseen by the auditor, whose pecuniary loss was nonetheless foreseeable in light of the existing circumstances. Thus, liability under the six-factor test is based on the subjective inquiry of foreseeability of harm. Whereas the Restatement (Second) approach is the more objective approach, focusing not on what is foreseeable but on what was actually foreseen by the auditor.

This distinction becomes apparent when considered in light of the result in \textit{Aluma Kraft}.\textsuperscript{124} The \textit{Aluma Kraft} Court held that the plaintiffs were entitled to recover, based on evidence that the auditors knew they would rely on the financial statements in forming their investment decision.\textsuperscript{125} As the auditors actually knew of the plaintiff's use, the plaintiffs were necessarily members of the limited group of users defined by objective inquiry. By extension, as they were well within the parameters of this limited group of plaintiffs, they were also within the broader group of plaintiffs contemplated by the subjective standard. Applying either the subjective or objective approach, the result will be the same. Under either analysis, the plaintiffs are entitled to recover. However, assume for the moment that the auditors did not know of any prospective buyers for the business. Assume, instead, that the auditors only knew that their clients were considering a sale of their business at an undetermined date in the future, but as yet, their clients had no prospective purchasers. Under these modified facts, the buyers may be denied recovery under the Restatement (Second) approach. Any objective inquiry would force the conclusion that the buyers were not within the group of persons whose use of the statements was actually foreseen by the auditors at the audit date. However under the subjective, six-factor test, the courts can consider whether the harm suffered by the buyers foreseeable resulted

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123. \textit{Id. at} § 552(2)(a).
124. 493 S.W.2d at 378.
125. \textit{Id. at} 383.
\end{flushright}
from the auditor's negligence. Where, as in Aluma Kraft, the financial statements present information essential to negotiating the purchase price of the business, the buyer's loss may have foreseeably resulted from the misstated information. Thus, the subjective standard of foreseeability will operate to allow recovery, whereas the objective approach will deny relief, under the same set of facts.

The "actually foreseen" standard places a limitation on the class of persons entitled to recover when the auditor is negligent. The law makes a distinction between persons who rely on financial statements where in practicality none exists. To be sure, a creditor, unknown to an auditor at the time of his engagement, will not rely less on a set of audited financial statements than a creditor who is known by the auditor. The six-factor test avoids this distinction by speaking in terms of foreseeability of injury.

Subsumed within the questions of whether and to whom an auditor should be held liable for his negligence are pressing questions of policy not addressed by many courts. These questions concern the extent to which public policy demands greater professional responsibility and whether these policy goals should be furthered by heightened social responsibility.

IV. EXPANDING THE SCOPE OF THE AUDIT

Inherent in the proposition that "[while] the purpose of a particular audit may be relevant to foreseeability, it should not be exclusively determinative," is the notion that the courts will, on occasion, extend the liability of an accountant beyond that encompassed by the scope of a regular audit. An auditor performs a

126. Id. at 378.
127. Raritan, 79 N.C. App. at 91, 339 S.E.2d at 69.
128. The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Professional Standards No. 1 § 110.01 (Am. Inst. of Certified Pub. Accountants 1987). This objective is typically referred to as the "attest" function, as it describes the nature of the auditor's work. P. DEFLIESE, K. JOHNSON, AND R. MACCLEOUD, MONTGOMERY'S AUDITING, (9th ed. 1975).

Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements . . . . The independent auditor may make suggestions as
service for several parties, whose interests in the information may conflict. The financial statements are used by management to represent the financial position of the corporation. Management intends that third parties, such as creditors and investors, rely on the information therein as a basis for doing business with the corporation. In this situation, the auditor is bound in a way that no other profession obligates its members. He must perform services under the contract with the audit client while maintaining the required objectivity such that his work does not unfairly favor either the interests of his client or those of any later user of the information. It is here that the conflict between the scope of the contract to the form or content of the financial statements or he may draft them in whole or part, based on management’s accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.


129. Rosenblum, 93 N.J. at 461 A.2d at 150.

130. The strength of the public confidence in the role of the auditor, as the impartial guardian of the investor’s interests, is founded on his relationship of independence from his client. “Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners.” Professional Standards 1, § 220.03. “In all matters relating to the assignment, an independence and mental attitude is to be maintained by the auditor or auditors.” Professional Standards No. 1, § 220.01 (Am. Inst. of Certified Pub. Accountants 1987).

Independence is a foremost consideration of all audit practitioners. Most accounting firms have procedures for determining conflicts respecting independence which, if they exist, would necessarily emasculate the meaningfulness of any opinion on the financial statements. In cases where an auditor is not independent, the representation is the audit opinion, that the audit was performed in accordance with generally accepted auditing standards, is by definition a false statement. For an interesting discussion respecting the lack of independence of a cause of action against accountants, See, Comment, Failure to Maintain Independence: A Proposed Cause of Action Against Accountants, 62 Tex. L. Rev. 923 (1984). In Associated Gas and Electric Co., 11 S.E.C. 975 (1942), the S.E.C. held that when an accountant “consistently submerges his preference or convictions as to accounting principles to the wishes of his client [he] is not in fact independent.” Id. at 1047. This holding recognizes that there must be an attitude of openness and willingness, between the accountant and his audit client. However, the auditor must be mindful of the potential of his willingness to deal with his client, especially in light of the nature of the relationship between auditor and the fee payment client, as this
tual relationship between the auditor and his client and the growing trend of accountant liability becomes apparent:

It is widely, but mistakenly, believed that financial statements are issued by the auditor as his responsibility; that the auditor should prove the correctness of the numbers as a matter of mathematics; that the auditor represents that the numbers (and only those numbers) are 'accurate;' [and] that the auditor should be able to detect any irregularity and concealment . . . . From this flows the erroneous legal supposition that his responsibility should be coextensive with that of the client. \[131\]

Rather, the function of the auditor's opinion is to lend credibility to management's representations. This function is becoming increasingly difficult in light of the potential for client-perpetrated fraud and malfeasance and the potential for economic failure of the business. \[132\] Arguably the auditor's professional responsibility requires him to reach beyond the parameters of his audit contract. The duality of the auditor's role in the business community de-

has the potential to create problems with the requirement of independence.

\[131\] See supra, note 6, at 1.23. The position of the AICPA, respecting the distinction between the responsibilities of the auditor and the client is as follows: Management has the responsibility for adopting such accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements, he may draft them in whole or in part, based on management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.


\[132\] An early report in U.S. News & World Report disclosed that of the twenty-five largest U.S. corporations, seven had been implicated in criminal conduct since 1976 and another seven had reached out-of-court settlements relating to non-criminal activities. See Kelly, Corporate Crime The Untold Story, U.S. News & World Report, Sept. 6, 1982 at 25; see also Comment, supra note 93, at 1393 n. 156.
mands this extension. Certainly the auditor remains independent of his client. With this independence comes the objectivity which itself lends credence to the audit opinion. However this relationship of independence is less than perfect. Because the client pays for audit service, notions of client service and client advocacy may interfere with professional judgment. Imposing a level of social and legal responsibility, sufficient to remind the auditor of his overriding obligation of independence of judgment, is necessary to ensure quality financial information. Heightened responsibility to the public recognizes the contractual nature of the auditor-client relationship and mitigates against any infirmity of judgment occasioned by the desire to best serve those who pay the fees.

The profession now faces a burgeoning problem of increasing public expectations. The public expects far more from the profession than the profession has in the past given willingly. The courts have forced on the profession a growing level of social responsibility consistent with their growing role in the business community. This expansion of the auditor's role in the business community is the genesis of many of the public policy arguments in favor of expanding the scope of the auditor's social responsibility.

A. Fraud and the Audit

At one time, the detection of fraud was paramount to the audit process. However, with the development of the accounting profession and the increasing sophistication of information reporting processes and systems, the profession has adopted a more relaxed attitude regarding the detection of fraud. In 1987, the

133. Id. at 3.7.
134. Id. at 3.8. Prior to 1977, the auditor assumed almost a passive role with respect to the detection of fraud. "[T]hat ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result . . . The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and to others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards." Professional Standards No. 1, § 110.05 (Am. Inst. Certified Pub. Accountants 1973).

In 1977, the AICPA revised its prior position in favor of auditing standards which describe the auditor's responsibility for the detection of errors or irregularities. "The term 'errors' refers to unintentional mistakes in financial statements and includes mathematical or clerical mistakes in the underlying records and accounting data from which the financial statements were prepared . . . ." Professional Standards No. 1 § 327.02 (Am. Inst. Certified Pub. Accountants 1987).
AICPA revised its approach to detecting and reporting errors and irregularities in financial statements. These revised policies provide that:

1. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements;
2. Because of the characteristics of irregularities, particularly those involving forgery and collusion, properly designed and executed audit may not detect a material irregularity;
3. The auditor should exercise:
   a. due care in planning, performing, and evaluating the results of audit procedures;
   b. the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected;
4. The subsequent discovery that a material misstatement exists in the financial statements does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.\footnote{135}

To the extent that this professional responsibility with respect to detecting fraud imparts on the auditor an obligation to search for fraud,\footnote{136} the auditor now must assume an active role with respect to detecting fraud.

“The term ‘irregularities’ refers to intentional distortions of financial statements, such as deliberate misrepresentations by management, sometimes referred to as management fraud, or misappropriations of assets, sometimes referred to as defalcations.” \textit{Id.} at § 327.03. Section 327 embodies the new Statement on Auditing Standards 16 (SAS 16). Under SAS 16, the independent auditor had the responsibility to plan his examination to search for errors or irregularities that would have a material affect on the financial statements. \textit{Id.} at § 327.05. In this regard, SAS 16 represented a conscious departure from the prior passive role of the auditor in the detection of fraud. SAS 16, however, is not the final word. In 1987, the Auditing Standards Board (ASB) approved issuance of nine new Statements on Auditing Standards (SAS). SAS 16 was revoked and replaced by SAS 53, \textit{The Auditor’s Responsibility To Detect and Report Errors and Irregularities}. SAS 53 defines errors as referring to “unintentional misstatements or omissions of amounts or disclosures in the financial statements. Irregularities include fraudulent financial reporting undertaken to render financial statements misleading (i.e., management fraud) and misappropriation of assets (i.e., defalcations).” AICPA Strategic Briefing Report on the New Statements on Auditing Standards at 53-1 [hereinafter “AICPA Strategic Briefing Report”].

\footnote{135. AICPA Strategic Briefing Report at 53-1.}

\footnote{136. Numerous cases emphasize the point that, professional responsibilities}
respect to the detection of errors and irregularities.\textsuperscript{137} This does not suggest that all audits must be specifically designed and implemented to detect fraud. An audit specifically designed and implemented toward the detection of fraud is far more extensive and costly than a regular audit oriented toward the expressing of an opinion on a set of financial statements. The auditor performs a number of special tests and extensively investigates a great many transactions in an exacting detail far and again more extensive than the procedures followed in a regular audit. Additionally, at least at the outset of the engagement, the client is the one who will be forced to bear the costs of these additional procedures.

Indeed, the question of who should bear the burden of committing these additional resources to the detection of fraud depends in large part on the proper allocation of the risk of fraud as it impacts financial information.\textsuperscript{138} There must come a point where a user of financial information is forced to bear the burdens of his reliance. The investment decision must be based on more than a reading of financial statements. The investor must investigate the notwithstanding, the auditor has the duty to probe suspicious circumstances and the duty to investigate for fraud or management misrepresentations even absent suspicious audit evidence. See United States v. Sarantos, 455 F.2d 877 (2nd Cir. 1972); United States v. Simon, 425 F.2d 796 (2nd Cir. 1969), \textit{cert. denied}, 397 U.S. 1006 (1969); S.E.C. v. Frank, 388 F.2d 486 (2nd Cir. 1968); United States v. Benjamin, 328 F.2d 854 (2nd Cir. 1964); and 1136 Tenants Corp. v. Max Rothenberg & Co., 36 App. Div. 2d. 804, 319 N.Y.S.2d 1007 (1971), \textit{aff’d.}, 30 N.Y.2d 585, 281 N.E. 2d 846, 330 N.Y.S.2d 800 (1972). Professor Fiflis maintains that the existence of a legal duty to use due care to discover fraud is an essential element of an auditor’s responsibility to third parties. Fiflis, \textit{28 VAND. L. REV.} at 93. Fiflis argues that there is a legal duty supported by case law, to make an inquiry into suspicious circumstances, and in the absence of circumstances, there is nonetheless the duty to investigate, but to a lesser degree. \textit{Id.} at 102.

137. SAS 53 requires that the auditor design the audit to provide reasonable assurance that material errors and irregularities will be detected. By contrast, its predecessor, SAS 16, required only that the auditor plan the audit to search for material irregularities. The former represents an increased responsibility. SAS 53 also identifies cases where auditors may have a responsibility to report fraud to people outside the client, including auditor changes reported to the S.E.C. on Form 8-K, inquiries from successor auditors, responses to court subpoenas, and reports on governmental audits. However, SAS 53 does not establish new responsibilities for reporting fraud outside the client; those responsibilities exist now. AICPA Strategic Briefing Report at 53-9.

reputation, qualifications, and past performance of management to identify risk factors not otherwise expressed in the audited financial statements. Now the investor is allocated a portion of the risk of investment which will more equitably distribute any potential loss among the parties best suited to bear the risks. If the accountant is negligent and as such is the cause of the investor’s loss, then the accountant should bear the burden of this loss. “In the final analysis the injured party should recover damages due to an independent auditor's negligence from that auditor. This would shift the loss from the innocent creditor or investor to the one responsible for the loss.” However, if the investor relies on a properly audited set of financial statements and loses his investment, the investor is better postured to bear this risk of loss. This risk allocation results in a form of social insurance, each party bearing the loss and reaping the benefits of success based on his inherent responsibilities to the decision making process.

Unfortunately, implementing this approach is problematic. Much of the information required to adequately analyze investment risk far exceeds the reach and analytical ability of the average investor. Indeed, the task of identifying and allocating risk is so intertwined with the audit process itself that the auditor is often the only party to analyze this risk based on full information. Thus the problem of allocating responsibility for analyzing environmental risks has been settled by conflicting misperceptions. Such conflicting perceptions, when considered in light of the fact that the auditors only contact with the public users of their work product is through their written audit opinions, has led to the expectation gap, a serious state of miscommunication between the accounting profession and the public at large.

139. Rosenblum, 93 N.J. at ——, 461 A.2d at 152.

This problem was highlighted in a 1978 report to the AICPA by the Commission on Auditors Responsibilities.

Recent research suggests that many users misunderstand the auditor’s role and responsibilities ... Users are unaware of the limitations of the audit function and are confused about the distinction between the responsibilities of management and those of the auditor.

Id.

Respecting the auditors responsibilities for the detection of fraud, the report notes:

[D]espite efforts by many auditors to downgrade the importance of the detection of fraud as an audit objective, all segments of the public —
B. Business Failure and The Audit Environment

Coexistent with the increased public reliance on the accounting profession is an increased public scrutiny of the role of an auditor respecting the failure of a business. Inherent in the assumption that an auditor is independent of corporate management is the notion that the auditor is not primarily responsible for faulty deci-

including the most knowledgeable users of financial information — appear to consider the detection of fraud as a necessary and important objective of an audit. Users expect the auditor to be concerned with the possibility of fraud . . . They expect him to protect the interest of shareholders and be independent of management in doing so.

Id. at 31-32.

In 1985, a private-sector research initiative, jointly sponsored and funded by the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants, undertook to research the problems attendant to fraudulent financial reporting practices. The results of their efforts are manifested in the Report of the National Commission of Fraudulent Financial Reporting, October 1987, ("The Treadway Commission"). The Commission had three major objectives:

1. Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud may be the product of a decline in professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulator and law enforcement and environment unwittingly may have tolerated or contributed to the occurrences of this type of fraud.

2. Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether changes in auditing standards or procedures - internal and external - would reduce the extent of fraudulent financial reporting.

3. Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly.


This comprehensive effort resulted in numerous recommendations addressed to corporate management, the S.E.C. and other regulatory agencies, the accounting profession, and the educational system in general. Moreover, these recommendations occasioned scrutiny of then-existing audit standards respecting an auditor's duty to investigate fraud.

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sions on the part of corporate management. This is not to suggest that auditors ignore their client's management information systems in the course of their audit. Before an auditor makes any determination regarding the reliability of a client's accounting system, he must undertake a rigorous review to verify the veracity and reliability of the information that the system generates.

One problem with the nature of this review of accounting systems and internal control is that the risk of business failure is not directly coexistent or coextensive with the risks of veracity and reliability which inhere in the financial reporting system used. In many cases, the risk of business failure depends on the strength and vitality of the management decision making process and the systems used to implement these decisions. This is a decision-making environment, independent of the financial reporting system; yet, a review of the management decision making environment is frequently absent from the auditors review of internal accounting controls and the accounting environment.

The profession has not turned its back to the impact that management decision making plays on the overall financial health of a business. The Statement on Auditing Standards No. 34, The Auditors Considerations When a Question Arises About an Entity's Continued Existence, imposed an affirmative duty on the auditor, as a part of his obligations under the generally accepted auditing standards, to review various forms of financial and nonfinancial information when he becomes aware of information that raises questions as to the continued existence and viability of an entity. However, this was a contingent review, dependent upon the existence of information raising "going concern" questions. It did not impose this responsibility in all situations as a part of the regular audit process.

In 1987, the AICPA withdrew SAS No. 34 replacing it with SAS No. 59, which addressed the auditor's considerations of an entity's ability to continue as a going concern. SAS No. 59 recognizes generally that auditors assume that an entity has the ability to remain a viable going concern. The AICPA recognizes that "information that significantly contradicts the going concern assumption relates the the entity's inability to continue to meet its obligations as they become due without a substantial disposition of

141. AICPA Statement on Auditing Standards No. 34.
142. Id.
143. AICPA Strategic Briefing Report, at 59-1.
assets, restructuring debt, externally forced revisions of its operations, or similar actions." Under SAS No. 59:

1. The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

2. The auditor's evaluation is based on knowledge of relevant conditions and events that exist at or have occurred prior to the completion of field work.

3. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives in the financial statements being audited.

4. The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not, in itself, indicated inadequate performance by the auditor.

5. The absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

If, during the course of an audit, the auditor discovers certain events or conditions which may bear on his determination of the entity's ability to continue as a viable enterprise, the auditor must accumulate information regarding these conditions and events and summarize the same in an explanatory paragraph, as part of the audit opinion, to reflect the results of his determination.

144. Id.
145. Id.
146. The following are examples of such conditions or events: (a) negative trends, for example, recurring operating losses; (b) other indications of possible financial difficulties, such as default on loans or similar agreements; (c) internal matters such as work stoppages or other labor difficulties; and (d) external matters that have occurred, for example legal proceedings, legislation, or similar matters, that might jeopardize an entities ability to operate. AICPA Strategic Briefing Report at 59-2.
147. A sample explanatory paragraph would read: The accompanying financial statements have been prepared assuming that Company Y will continue as a going concern. As discussed in Note X to the financial statements, Company Y has suffered recurring losses from operations and has a net capital deficiency that raises substantial doubt about the entities' ability to continue as a going concern.
Thus, the AICPA recognizes the problems attendant to allocating the risk of detecting potential business failure. This is accomplished by requiring a modification of the audit process to accommodate this new standard of risk allocation.

The problems attendant to allocating the risk of detection of potential business failure to the auditors, require a modification of the audit process to accommodate this new standard of risk allocation. In addition to a general expansion of the audit scope, several additional factors will also aid in the allocation of the risk of loss among the accounting profession and the users of their work product. These considerations revolve around the burden of proof assumed by a plaintiff in an action against an auditor. The nature and extent of this burden must be considered in light of the same policy considerations cited in support of imposing liability on negligent auditors. This requires a distinction between allowing a plaintiff to state a cause of action against auditors for negligence and allowing the same plaintiffs to prevail in damages on this cause of action; there are no foregone conclusions of liability based solely on the information stated in a complaint. Plaintiffs asserting a negligence cause of action must be forced to plead and prove that they received the audited statements from the company pursuant to a proper company purpose, that they, in accordance with that purpose, relied on the statements and that the misstatements therein were due to the auditor's negligence and were a proximate cause of the plaintiff's damage. 148

Seminal to a finding of liability is proof of reliance on misstated financial statements. This reliance is the basis for an intelligent system of risk allocation among the preparers, the auditors, and the users of financial information. However, requiring reliance involves related issues of defining how much reliance is enough and whether the alleged reliance is sufficient to allow a user to be reasonably informed. The requirement of reliance as a basis for imposing auditor liability creates a quasi-contractual relationship between the auditor and the user of his work product. The law allows this relationship to survive the rigors of summary judgment by not imposing the formal privity of contract requirements of the Ul-

AICPA Strategic Briefing Report at 59-4 to 59-5.
148. Rosenblum, 93 N.J. at ___, 461 A.2d at 152.
tramares\textsuperscript{149} genre. And privity notwithstanding, this relationship must exist before the auditor should be forced to bear the cost of his negligence. By implication, this quasi-contractual relationship is born of two distinct suppositions: first, the auditor who uses his expertise to render a service which involves giving his expert opinion, agrees to insure users of his opinion against any loss for his negligence; and second, users, before they seek any indemnification against this loss, agree to use the financial statements and to rely on the statements such that their loss is not attributable to their own negligent financial analysis.

In proving reliance, the plaintiffs must be forced to prove that they relied on all of the information contained in the statements, as the audit opinion extends only to the statements taken as a whole, and cannot be limited to any individual item not considered in this general context. Thus, in cases where the statements contain information in a note which is not mathematically quantified in the income statement, balance sheet, or statement of changes in financial condition, but which is adequately and fully disclosed in the note, then plaintiffs should not be heard to complain of a loss, when their investment decision would have been different but for the fact that they did not read the notes to the financial statement.\textsuperscript{150} The auditor reviews financial statements as a whole body

\textsuperscript{149} 255 N.Y. 170, 174 N.E. 441 (1931).

\textsuperscript{150} Related to the issue of requiring reliance on the financial statements taken as a whole, including footnote disclosures, is the issue of whether the information in the footnotes is adequately presented and whether the information is such that it is better quantified and included in the numerical disclosures in the financial statements. This inquiry is especially important in light of the Raritan Steel holding, in which the creditor maintained a cause of action based on a single numerical excerpt contained in a credit report. This raises the question of whether the financial condition of the corporation, as related to their ability to continue business as a going concern, was adequately disclosed elsewhere in the financial statement, and whether the creditors, had they taken the time to read the entire financial statement, would have been apprised of this investment risk.

Generally, information left for footnote disclosure is either included in footnotes for further explanation or because, at the audit date, there was not a sufficient amount of available data which would lend itself to quantitative disclosure. This distinguishes between information which is quantified and shown in the results of the corporation's operations and information which is qualified, the financial impact or potential impact of which is discussed, but not quantified and included in the results of operations. Generally, this is left to the professional judgment of the auditor, such judgment being limited however, to cases in which the quantitative effect of footnote disclosure cannot be made. Most auditors will try to quantify the information for numerical presentation, before being forced to
of information. Allowing a cause of action for negligence on less than full reliance blunts the force of later arguments in favor of a more rigorous standard of reliance.

Second to proving the extent of the plaintiff's reliance on financial statements is the question of whether this reliance is sufficient to allow a reasonably informed investment decision. An investor must be forced to base his investment decision on more than a mere reading of financial statements. It is not unreasonable to require him to also understand what he is reading. This is not to require the same level of understanding as that of an expert in financial analysis. Rather, the user of financial information must be forced to posture himself such that he is as equally informed as another reasonably prudent investor making a similar decision. If the investor is unfamiliar with financial analysis, he certainly cannot gain any insights by merely reading financial statements. This would be akin to teaching one to cook by allowing him to sample the finished product. An investor must prepare himself in advance of his reading of financial information, with enough basic knowledge of financial analysis, to make his reliance on financial information a meaningful reliance.

Requiring this level of reliance will preserve the integrity of the risk allocation system. It will ensure that only deserving plaintiffs are allowed to recover by forcing them to show that their loss is not predicated on their own negligent decisions. Also, it will force the profession to be held accountable to the users of their work product by allowing recovery to users who take the extra steps to inform themselves prior to making their decision. This way the costs of negligence will be allocated, as between the negligent investor and the negligent auditor, to the parties best suited to bear this cost. When considering in light of the aftermath of a business failure, this risk allocation appears abundantly equitable. Often, in the wake of a business failure, the accounting firms are the only available source of money to compensate the investors for disclose potential problems in the footnotes alone. The disclosure decision is also relevant to the type of opinion issued. In cases there exist certain conditions which may have a material effect on financial statements but which are incapable of quantification, the auditors generally reflect the same in their opinions, by issuing an opinion "quantified" to reflect the unresolved issue. In situations such as this, the auditors often find themselves at odds with management, who, on the one hand, do not want unfavorable information quantified and disclosed with the results of operations, and on the other hand, do not want less than a clean opinion.
their loss. This system of risk allocation will prevent many frivolous claims made against the "only pocket" containing any money, the accounting firms. Those who should bear the loss, will bear the loss, and business failure notwithstanding, the plaintiff who did not reasonably inform himself as a prerequisite to making his investment decision and who did not reasonably rely on the available financial information, will be denied recovery, regardless of the auditor's negligence.

V. Conclusion

There are many policy considerations, sounded in terms of the growing public expectations of the accounting profession, which the profession has been slow to accept. In the future, the courts will consider these policy considerations in any analysis involving suits against auditors. At that time, if the profession is still slow to accept this growing public responsibility, there is little serious question but that the judicial system will impose these obligations on the profession and the profession will be forced to unwillingly accept them. Auditors as professionals have it in their control to voluntarily assume these responsibilities, free from judicial definition, in such a manner as to give a sense of balance to the issue of professional liability for the performance of the audit services. Auditors should be receptive to changes, such as those enacted by the AICPA. They should undertake the changes willingly, as a natural outgrowth of the development of their profession. In addition, they should be willing to be held responsible for their actions, without retreating behind notions of privity or actually foreseen users. The Supreme Court has christened the profession "public watchdog."


By certifying the reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analysis charged with public obligations.

Id. at 817-18.
If the word "public" in "certified public accountant" is to continue to have meaning, the profession must willingly accept increased responsibility for its actions and continually strive for excellence in their increasing areas of public responsibility.