Accountants' Liability for Unaudited Historical and Prospective Financial Statements

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Accountants' Liability For Unaudited Historical And Prospective Financial Statements

The dramatic increase in the use of non-audit services is posing an increased litigation burden on the accountant. In negligence actions concerning non-audit services, courts have been reluctant to fully accept the profession's internal guidelines as recognized standards of care. Certain courts have also taken an expansive view, holding accountants liable to virtually all third parties. This Comment advocates that the courts fully adopt the standards of care outlined by pertinent AICPA pronouncements. Courts should also restrict accountants' liability for non-audit services to third parties who are in privity with the accountant.

I. INTRODUCTION

Until recently, the traditional function of the accountant was to perform an examination of financial statements1 to enable the accountant2 to issue a report expressing an opinion that the financial statements were fairly presented.3 As the highest level of service that

2. The term "accountant" in the context of this Comment refers to a certified public accountant (CPA). A CPA must be licensed by the state in which he or she wishes to practice. CPA licenses are only issued to candidates who have passed the nationally uniform comprehensive exam and fulfilled certain education and experience requirements. See R. Berger, Jr., Practical Accounting for Lawyers 6 (1981).
3. The basic form of a standard accountant's audit report is as follows:

   We have examined the balance sheet of X Company as of December 31, 19XX, and the related statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

   In our opinion, the financial statements referred to above present fairly the financial position of X Company at December 31, 19XX, and the results of its
can be provided by the accountant, the examination requires the accountant to perform extensive auditing procedures translating into higher fees.

During the past thirty years, increased competition and an inflationary economy resulted in small businesses becoming more dependent on financing from creditors and third party investors. These investors and creditors required some form of assurance from an independent party that the company’s financial statements were fairly presented. However, small companies were typically unable to afford the fees for a complete financial statement examination. As a result, many third party investors and creditors began accepting a new form of limited assurance from accountants which was below the assurance given in an audit performed in accordance with generally accepted auditing standards (GAAS).

Many accountants responded to the needs of small businesses by performing various non-audit procedures on financial statements. Accountants began to issue reports to creditors and investors indicating some level of assurance, even though the financial statements were not audited. During this time, the American Institute of Certified Public Accountants (AICPA) issued standards for examinations of financial statements of large companies; however, these standards did not address the performance of non-audit services. At the same time, the public’s perception of the unaudited report was that the accountant’s level of inquiry was higher than that specified in the report. Hence, the profession, the public, and the courts became confused as to the standard of care required by an accountant in a non-audit situation.

Consequently, the AICPA promulgated Statement on Standards for Accounting and Review Services No. 1 (SSARS No. 1) which set forth two levels of services to be performed by accountants with re-

operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

4. The terms “examination” and “audit” of financial statements are used interchangeably.
5. In order for an accountant to issue an audit report, he must perform the procedures in accordance with generally accepted auditing standards. J. SULLIVAN, supra note 3, at 30.
6. Note, supra note 1, at 761.
8. Id. at 423.
9. One of the functions of the AICPA is to promulgate standards for the profession. See generally D. CARMICHAEL, supra note 7, at 69-74.
10. Id. at 422.
spect to unaudited historical financial statements. The first service is a review of financial statements in which the accountant performs certain procedures to achieve a level of assurance that the financial statements are fairly presented. The second is a compilation of financial statements in which the accountant does not perform any procedures unless information provided to him for the purpose of the compilation is unsatisfactory or the financial statements are obviously not in conformity with generally accepted accounting principles (GAAP).

Over the past decade, there has been increasing interest in prospective financial statements. Potentially, investors and creditors will focus more on prospective, rather than historical information because the future will have a greater bearing on their decisions. This heightened reliance increases the likelihood of legal action against the accountant should the financial statement user experience losses as a result of the examined company's business failure.

Until recently, the professional pronouncements created some confusion as to the standard of care required of accountants in performing services on prospective financial information. In 1985 the AICPA responded by issuing Statement on Standards for Accountants' Services on Prospective Financial Information (SSASPF1). Under the new standards, an accountant can provide only three types of service for a financial forecast or projection:

11. Statements on Standards for Accounting and Review Services No. 1 § 1 (Am. Inst. of Certified Pub. Accountants 1979) [hereinafter SSARS No. 1].
12. Id. at 3. See infra text accompanying note 38.
13. SSARS No. 1, supra note 11, at 3.
15. Id.
16. Id.
17. SSASPF1 distinguishes a financial forecast from a projection and defines them as follows:

Financial forecast. Prospective financial statements that present, to the best of the [company's] knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. A financial forecast is based on the [company's] assumptions reflecting conditions it expects to exist and the course of action it expects to take. A financial forecast may be expressed in specific monetary amounts as a single point estimate of forecasted results or as a range, where the [company] selects key assumptions to form a range within which it reasonably expects, to the best of its knowledge and belief, the item or items subject to the assumptions to actually fall. When a forecast contains a range, the range is not selected in a biased or misleading manner, for example, a range in which one end is significantly less expected than the other.

Financial projection. Prospective financial statements that present, to the best
tion, (2) compilation, or (3) application of agreed-upon procedures.

The levels of responsibility assumed by the accountant in performing non-audit work on historical versus prospective financial statements are very similar. Therefore, the same legal arguments used for limiting the accountant's liability as to historical financial statements can be applied to prospective financial statements.

The accountant's liability in the non-audit situation, depends upon the level of care required of the accountant and whether the financial statement user has a cause of action for the accountant's negligence.

This Comment will address two main legal issues related to accountants' liability for negligently performed non-audit procedures on historical and prospective financial statements. The first issue is whether the AICPA pronouncements related to non-audit services are sufficiently defined to enable courts to use them as a standard of reasonable care.

Recent decisions indicate judicial reluctance to accept the new AICPA pronouncements as a sufficient determination of the standard of care required of the accountant in a non-audit engagement. This Comment argues that the courts should accept the AICPA pronouncements, with minor modifications, as the required standard of care to be followed by accountants. Acceptance of these standards would likely decrease the courts' reliance on extrinsic sources in determining the standard of care required.

The second is whether accountants' liability for non-audit services should extend to third parties not in privity. This Comment argues that policy reasons dictate that a lack of privity should bar third party actions seeking to impose liability for accountants' negligence in all non-audit engagements.

Finally, this Comment urges the state legislatures to statutorily establish clear negligence criteria based on the type of services to be performed, specifically, audit versus non-audit criteria. At the same

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of the [company's] knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and changes in financial position. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation as in response to a question such as "What would happen if . . .?" A financial projection is based on the [company's] assumptions reflecting conditions it expects would exist and the course of action it expects would be taken, given one or more hypothetical assumptions. A projection, like a forecast, may contain a range.


18. The discussion of examinations of prospective financial statements is beyond the scope of this Comment.

time, accountants must specifically indicate to users of non-audit reports the level of reliance that should not be placed on these financial statements. This will better educate the business community and the public as to the limitations of non-audit services.

In addressing the above issues, this Comment will trace the historical response of the courts to accountants’ liability for non-audit services. Further, the Comment will discuss the courts’ apparent unwillingness to accept the current AICPA pronouncements as a basis of the standard of professional care. Next, the Comment will explain the split in authority regarding accountants’ liability for non-audit services to third parties. Finally, the Comment will discuss the policy arguments for and against extending accountants’ liability to third parties and will conclude that such liability should be limited only to parties who are in or approach privity with the accountant.

II. ACCOUNTANTS’ LIABILITY FOR NON-AUDITED SERVICES: THE COURTS’ HISTORICAL RESPONSE

A. Case History

During the past twenty years, courts have generally refused to shield accountants from liability on grounds that the accountant specified that the financial statements were unaudited.\(^\text{20}\) The reason was partly due to an “expectation gap” between the perceived and actual responsibilities assumed by an accountant in performing non-audit work.\(^\text{21}\) Financial statement users, as well as courts, believed that accountants were required to perform certain audit type procedures even though the parties contracted for a non-audit compilation.

The major early case, holding accountants liable for damages in a non-audit engagement, was 1136 Tenants Corp. v. Max Rothenberg & Co.\(^\text{22}\) The Rothenberg court held that an accountant was liable to his client for the failure to discover a $237,279 embezzlement during a compilation engagement costing $600.\(^\text{23}\) The accounting profession was disturbed by the Rothenberg decision because the court seemingly required the performance of onerous procedures for the com-

\(^{21}\) D. CARMICHAEL, supra note 7, at 430.
\(^{22}\) 36 A.D.2d 804, 319 N.Y.S.2d 1007.
\(^{23}\) Id. at 805, 319 N.Y.S.2d at 1008.
pletion of a straightforward compilation. The dissenting judge argued that to require an accountant engaged in a simple compilation to investigate and inform the client of all potentially suspicious activities "would expand the obligation from bookkeeping to criminal detection." Moreover, the Rothenberg court specified the level of service to be performed by the accountant where the nature of the engagement had not been specifically clarified by the parties.

The Iowa Supreme Court in Ryan v. Kanne extended accountants' liability for non-audit services to third parties not in privity. In Ryan, a company in need of financing sought the assistance of an accountant to qualify for a loan. The purpose of the engagement was to determine the correct amount of accounts payable. The financial statements prepared by the accountant were clearly marked unaudited and included a description of the actual procedures employed. The accountant, however, failed to secure an engagement letter which enumerated the specific services to be performed by the accountant. The court refused to accept the profession's distinction between audited and unaudited statements and the corresponding different levels of responsibility assumed by the accountant. Instead, the court held that "[accountants'] liability must be dependent upon their undertaking, not their rejection of dependability."

In 1972, the federal district court in Blakely v. Lisac also imposed additional audit type procedures on the accountant performing non-audit work. The court held that "[e]ven when performing an unaudited write-up, an accountant is under a duty to undertake at least a minimal investigation into the figures supplied to him."

B. SSARS No. 1

As a result of the above cases, the accounting profession became painfully aware that the existing professional standards were obsolete. In 1979, the AICPA responded by issuing SSARS No. 1,

24. Id.
25. Id. at 806, 319 N.Y.S.2d at 1009 (Stever, J., dissenting).
26. Id. at 805, 319 N.Y.S.2d at 1008.
27. 170 N.W.2d 395 (Iowa 1969).
28. Id. at 397.
29. Id.
30. Id. at 398.
31. Id.
32. Id. at 404.
33. Id.
35. Id. at 266.
36. The only promulgated standard was Statement of Auditing Procedure (SAP) No. 38 (1967) which essentially provided that the accountant had no responsibility to apply any auditing procedures to unaudited financial statements. See Note, supra note 1,
which established two distinct standards for the issuance of an accountant's report when the historical financial statements are not audited. The first is a compilation, which involves preparation of financial statements based on "information that is the representation of management [owners] without undertaking to express any assurance on the statements." The second is a review which entails "[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 statements in order for them to be in conformity with GAAP."

The objectives of both a review and a compilation differ from the objective of an examination in accordance with GAAS. Financial statements users should be able to readily identify the degree of responsibility, if any, the accountant is assuming with respect to such statements. Therefore, SSARS No. 1 requires the accountant to issue a report describing the procedures performed and level of assurance given by the accountant.

at 787.

37. SSARS No. 1, supra note 11, § 1.
38. Id. § 4.
39. Id.
40. SSARS No. 1 distinguishes the objective of an audit and review as follows:

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 performed 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.

Id.

41. Id.
42. SSARS No. 1 suggests that the accountant issue the following standard compilation report upon the completion of a compilation engagement:

The accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended have been compiled by me (us).

A compilation is limited to presenting, in the form of financial statements, information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Id. § 17.

SSARS No. 1 suggests the following standard form report for a review engagement:

I (we) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 19XX, and the related statements of income, retained earnings, and changes in financial position for the year then ended, in accordance
C. SSASPFI

The growing involvement of accountants with their clients' prospective financial statements has also sparked the need for detailed standards of performance. In prior years, there was no significant litigation arising out of the accountant's association with prospective financial statements. However, recent judicial willingness to hold accountants liable for a variety of non-audit services has increased the potential of future litigation in this area. In response to the profession's needs, the AICPA issued SSASPFI.\(^4\) Pursuant to this standard the accountant is able to provide two non-audit type services; a compilation and an application of agreed upon procedures to the financial statements.\(^4\)

In a compilation of prospective financial statements, the accountant is required to determine whether the prospective financial statements are in conformity with AICPA presentation guidelines and whether the underlying assumptions are obviously inappropriate.\(^4\) Further, the accountant must issue a report which expresses no conclusion and provides no assurance on the compiled prospective financial statements or on the assumptions underlying such statements.\(^4\) In an engagement which requires an accountant to apply agreed-upon procedures to prospective financial statements, the procedures

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with standards established by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management (owners) of XYZ Company.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.

Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying financial statements for them to be in conformity with generally accepted accounting principles.

\(^4\) Id. § 35.

43. SSASPFI, supra note 17, § 1.

44. Id.

45. Id. § 10.

46. SSASPFI requires the accountant's standard report on a compilation of prospective financial statements to include the following:

\(a\). An identification of the prospective financial statements presented by the responsible party.

\(b\). A statement that the accountant has compiled the prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants.

\(c\). A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the prospective financial statements or the assumptions.

\(d\). A caveat that the prospective results may not be achieved.

\(e\). A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

\(\)Id. § 4.

764.
applied may be limited or extensive, according to the specified user’s desire.47 The accountant is required to issue a report which enumerates the procedures performed, states the accountant’s findings and restricts distribution of the report to the specified parties.48

III. CURRENT AICPA PRONOUNCEMENTS AS A STANDARD OF PROFESSIONAL CARE

A. Unaudited Historical Financial Statements

Recent court decisions have essentially been silent as to the courts’ acceptance of SSARS No. 1 as a standard of professional care.49 In Robert Wooler Co. v. Fidelity Bank,50 liability was extended to accountants performing an unaudited review for failing to inform company management of weaknesses in internal control which led an employee to defraud the company.51 The accountants had not represented to management that a review of the company’s internal control would be performed. Moreover, the review report was silent as to the internal control matters.52

In setting forth standards for accountants, SSARS No. 1 specifi-
cally states that “[a] review does not contemplate a study and evaluation of internal accounting control.”

In contrast, an accountant performing an audit is required by GAAS to review and evaluate the company’s internal control environment. The standard review report clearly indicates that a review “is substantially less in scope than an examination in accordance with GAAS.”

In Robert Wooler Co., the court refused to shield the accountant from liability, even though the review report specifically included similar unambiguous statements as to the scope of the accountant’s work. The court held that an accountant, by simply agreeing to perform non-audited services, undertook to exercise that degree of accounting skill possessed by other accountants in the community. Hence, the standard of care is based heavily on the subjective opinions of expert witnesses rather than a clear professional standard as set forth by the AICPA. Inconsistencies will result as the judgment of reasonable accountants may differ, “especially when one of these accountants is a plaintiff’s expert offering his opinion with the benefit of hindsight.”

The essence of the Robert Wooler Co. decision requires the accountant to do more than he or she has contractually agreed to do. It requires the accountant to perform procedures not normally employed in an unaudited review. This situation will inevitably lead accountants to incur more billable hours. The result will ultimately defeat the key purpose for a review—lower fees to companies unable to bear the burden of a costly audit.

The courts’ continued insistence on holding accountants liable for negligence resulting from non-audit work is not limited to the Robert Wooler Co. decision. In Spherex, Inc. v. Alexander Grant & Co., an accountant was engaged to prepare unaudited financial statements based on information provided by the client. The plaintiff, a third party, alleged that the accountant’s negligent preparation of financial statements caused him to rely on the statements to his det-

53. SSARS No. 1, supra note 11, § 29.
54. See generally J. Sullivan, supra note 3, at 241-342.
55. SSARS No. 1, supra note 11, § 35.
57. The court relied on the RESTATEMENT (SECOND) OF TORTS § 299A holding: “Unless he represents that he has greater or less skill or knowledge, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities.” Id. at 1031 (quoting RESTATEMENT (SECOND) OF TORTS § 299A (1982)).
58. The court relied on an expert witness opinion that an accountant possessing reasonable accounting skill would have been aware of the potential for theft inherent in plaintiff’s internal control. Id. at 1033.
59. D. Carmichael, supra note 7, at 433-34.
The court held the accountant liable even though the financial statements specifically stated they were unaudited. Further, it was not unreasonable for a third party "to rely upon an accountant to verify the substantive accuracy of the information presented in an unaudited financial statement." A statement that the financial statements were unaudited was insufficient for the accountant to escape a duty of reasonable care. Instead, the duty of care to be exercised was to be determined by the specific understanding between the parties as to the scope of the work.

A recent decision of the New York Supreme Court Appellate Division might signal a break in the courts' silence with respect to SSARS No. 1 and the corresponding refusal to accept the audit/review distinction. In *William Iselin & Co., Inc. v. Landau*, the court refused to hold the accountant liable for negligence in an non-audit engagement. In *Landau*, the plaintiff was in the business of factoring receivables from various companies. The plaintiff sustained losses when a company, whose financial statements were reviewed by the defendant accountant, filed for bankruptcy. The accountant's review report specifically indicated that the financial statements were unaudited and that no opinion was expressed by him as to their fairness. Moreover, the plaintiff performed his own independent analysis of the company's financial condition.

The court held that no negligence cause of action existed, basing its decision on three factors. First, the plaintiff was not entitled to place reliance on the financial statements as they were only reviewed and not audited by the accountant. Second, the plaintiff did not rely on the statements as he conducted an independent analysis of the company's financial statements. Third, the plaintiff was not in privity with the accountant because his relationship to the accountant was insubstantial. The *Landau* court seemingly accepted the audit/re-

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61. *Id.* at 900, 451 A.2d at 1309.
62. *Id.* at 906, 451 A.2d at 1313.
63. *Id.* at 905, 451 A.2d at 1313.
64. The accountant prior to commencing work typically issues a letter to the client setting forth the specific understanding as to the scope of non-audit work to be performed. This letter describes the nature of service (compilation or review) and generally enumerates the procedures to be performed.
66. *Id.* at 453, 513 N.Y.S.2d at 4.
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
view distinction along with its differing duties of care. This could imply the court's acceptance of SSARS No. 1 as a guideline for determining the standard of care.

Nevertheless, the Landau decision leaves certain questions unanswered. Narrowly construed, Landau might apply only where the plaintiff has also performed an independent analysis of a company, thereby diminishing the reliance on the accountant's report. Further, the standard of due care remains undefined since the court did not expressly discuss SSARS No. 1. Lastly, because lack of privity is a total bar to extending accountants' liability to third parties in New York, it could be argued that the court's discussion of the audit/review distinction is dictum and not binding precedent on future New York cases. In Landau, even if the accountant was negligent, he would not be liable to the plaintiff because lack of privity would bar recovery.

After Landau, the standard of due care to be applied remains unclear. The courts have generally remained unwilling to move away from the traditional "expert accountant witness" approach. Continued judicial reliance on the traditional approach has led to a general uncertainty as to the level of effort required by the accountant in order to avoid liability. Faced with uncertainty, accountants will tend to expand their procedures in performing reviews and compilations, passing on the additional cost to their client companies. Consequently, many companies, unable to afford higher accountants' fees, will be forced to eliminate the valuable service of having independent accountants perform unaudited reviews of their financial statements. This will have a chilling effect on the financing and expansion of small businesses. Therefore, courts should adopt the standards set forth in SSARS No. 1 to provide the accounting profession with an objective criteria for determining the minimum procedures necessary to avoid malpractice liability.

B. Unaudited Prospective Financial Statements

In contrast with historical financial statements, the accountants' only recent involvement with prospective financial statements has led to minimal judicial interpretation regarding the standards of due care to be followed by accountants in performing non-audit work on financial forecasts and projections. In light of the certain similarities between historical financial statements and prospective financial statements, courts may draw on the more established legal doctrines.

71. Id.
72. Id.
73. See supra note 59 and accompanying text.
74. Note, supra note 1, at 761.
developed with respect to the accountant's level of care required in preparing unaudited historical financial statements.

In *Margolies v. Landy & Rothbaum*, the defendant accountant prepared, without an audit, a net earnings projection upon which the sale price for plaintiff's business was based. After the plaintiff sold the business, the actual earnings materially exceeded the projected amount. The plaintiff claimed that the negligent preparation of the projection caused him to receive less than he was entitled from the sale of the business. On appeal, the court held that the accountant satisfied a level of care that "is a very high level of professional responsibility similar to any other profession; legal [or] medical." Further, the level of responsibility assumed by the accountant was reduced because the accountant's report indicated that the projection was unaudited. "[T]he nature of the obligation undertaken by the accountant is a factor in every malpractice case." Both sides employed expert witnesses to enable the fact finder to determine whether the accountant was negligent.

In *Margolies*, the court adhered to the traditional and subjective approach of using other accountants as expert witnesses in determining whether the standard of care was breached. But the court also acknowledged that the accountant's labeling of a report as unaudited is at least a partial shield against malpractice liability. Hence, the court's willingness to draw the audit/non-audit distinction could be an indication of at least partial acceptance of the standards set forth by the AICPA in SSASPF1 as a minimum standard of due care.

### IV. Accountants' Liability for Non-Audit Services to Third Parties

The landmark decision regarding accountants' general liability to third parties is *Ultramares Corp. v. Touche*. In *Ultramares*, Justice Cardozo introduced the privity doctrine which shields accountants

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76. Id. at 636-7, 483 N.E.2d at 628.
77. Id. at 636, 483 N.E.2d at 628.
78. Id. at 638, 483 N.E.2d at 629 (quoting the trial court).
79. Id. at 638, 483 N.E.2d at 629.
80. Id.
81. Id.
82. Id.
83. Id. at 639, 483 N.E.2d at 630.
84. See supra notes 43-48 and accompanying text.
85. 255 N.Y. 170, 174 N.E. 441 (1931).
from liability to third parties who are only incidental beneficiaries to a contract. Cardozo reasoned that if liability for negligence to third parties were imposed, "the failure to detect 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." Although Ultramares involved a negligently performed audit, the court's policy arguments similarly apply to accountants' involvement with unaudited financial statements.

Cardozo distinguished the Ultramares facts from cases involving third party recovery for physical injuries resulting from the negligent manufacture of a product. Although the same court which decided Ultramares had eliminated the privity rule in physical injury cases, the court stated that a similar limitation of the privity rule was not warranted as to non-physical (economic) injuries.

In an effort to provide third parties with a remedy against negligent accountants, other jurisdictions have continually assaulted the citadel of privity thereby eroding the effects of Ultramares. Courts have fashioned four alternatives to the Ultramares approach which have led to a split in authority among the various jurisdictions. This section discusses the four approaches and how they apply to accountants' liability to third parties in a non-audit environment.

A. Modified Privity Approach

As discussed earlier, Landau did not extend accountants' liability to third parties for an unaudited review. The court relied on Credit Alliance v. Arthur Andersen & Co. which follows the privity doctrine set forth in Ultramares with certain modifications.

The Credit Alliance court set forth three criteria which must be met before accountants' liability extends to third parties. They are as follows:

1. the accountants must have been aware that the financial reports were to

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86. Id. at 174, 174 N.E. at 445-48.
87. Id. at 173, 174 N.E. at 444.
88. Id. at 174, 174 N.E. at 445.
90. In creating the distinction between physical and economic injuries, the Ultramares court appeared to have placed a premium on injuries which caused bodily harm. The court justified the lower premium placed on economic injuries from a policy standpoint which favors limitation of liability for injuries to property. Ultramares Corp. v. Touche, 255 N.Y. at 174, 174 N.E. at 445.
be used for a particular purpose or purposes; (2) in the furtherance of
which a known party or parties was intended to rely; and (3) there must
have been some conduct on the part of the accountants linking them to that
party or parties, which evinces the accountants' understanding of that party
or parties' reliance. 94

The court's approach was not intended as a significant departure
from Ultramares. Instead, it was designed to "preserve the wisdom
and policy" set forth by Justice Cardozo. 95 The Credit Alliance
decision echoes the Ultramares doctrine that accountants' liability
should extend to third parties only when the relationship between the
accountant and the third party is clearly one approaching "that of
privity, if not completely one with it." 96

In Toro Company v. Krouse, Kern & Company, Inc., 97 the Sev-
enth Circuit adopted the modified privity approach of Credit Alli-
ance. The court reiterated the policy reasons for distinguishing be-
tween economic and physical injuries. 98 The court stressed that lack
of privity should be a shield to protect accountants from liability for
economic but not for physical injuries. 99

Therefore, it appears certain courts have adopted the modified
privity approach as a way to limit accountant's liability to third
parties.

B. Restatement Approach

Another approach taken by the courts with respect to accountants' liability to third parties is known as the restatement approach. The Second Restatement of Torts rejects the privity doctrine and favors extending liability to third parties specifically foreseen by the ac-

94. Id. at 544, 483 N.E.2d at 118, 493 N.Y.S.2d at 443.
95. Id.
96. Id. at 545, 483 N.E.2d at 119, 493 N.Y.S.2d at 444 (quoting Coleco Indus.,
97. 827 F.2d 155 (7th Cir. 1987).
98. Id. at 160.
N.E.2d 998 (Ind. 1985)).
100. See RESTATEMENT (SECOND) OF TORTS § 552 (1977). This section provides,
in pertinent part, as follows:
Information Negligently Supplied for the Guidance of Others
(1) One who, in the course of his . . . profession . . . supplies false information
for the guidance of others in their business transactions, is subject to liabil-
ity for pecuniary loss caused to them by their justifiable reliance upon the in-
formation, if he fails to exercise reasonable care of competence in obtaining or
communicating the information.
(2) [ . . .] [T]he liability stated in subsection (1) is limited to loss suffered
countant knew his or her clients intended to influence with the financial statements, as well as those the accountant actually intended to influence with the financial statements.

The New Hampshire Supreme Court in *Spherex, Inc. v. Alexander Grant & Co.*\(^{103}\) adopted the Restatement approach and held accountants liable to third parties for inaccurately prepared unaudited financial statements. The court elected not to follow the privity doctrine set forth in *Ultramares* for two reasons.\(^{102}\) First, the court noted that many judges have not hesitated to permit recovery where the plaintiff's identity was specifically known to the negligent defendant.\(^{103}\) Second, the court distinguished *Ultramares* "as a relic of a bygone economic era."\(^{104}\)

*Spherex, Inc.* drew parallels between accountants' liability for negligence and the strict product liability doctrine for manufacturers.\(^{108}\) The court noted that accountants, like manufacturers, are in a position to regulate the effects of their conduct by controlling the degree of care exercised.\(^{108}\) "The accountant, through the fee structure, can pass along to his clients the cost of insuring against financial loss sustained by them through reliance upon his negligent misstatement of fact."\(^{107}\) The court, however, stressed that section 552 of the *Second Restatement of Torts* provided the necessary boundary of liability. "[T]he law must not arbitrarily extend that liability beyond . . . [the accountant's] reasonable expectations as to whom the information will reach."\(^{108}\)

In *Seedkem, Inc. v. Safranek*,\(^{109}\) an accountant was engaged by a company to prepare its financial statements without an audit. The financial statements, prepared by the accountant, identified the plaintiff-creditor's major relationship to the company.\(^{110}\) From this, the Federal District Court, applying Nebraska law, implied that the accountant had actual knowledge of the plaintiff's reliance on the

\(^{102}\) Id. at 903, 451 A.2d at 1311.
\(^{103}\) Id. This approach is not contrary to the *Ultramares* social utility rationale of protecting professionals from the dangers of unlimited liability.
\(^{104}\) Id. The court stated further that "[b]oth the sophistication of modern accounting procedures and the accountant's central role in the financing and investment industry are a far cry from the fledgling profession in need of judicial protection that existed at the time of *Ultramares*." Id. at 903-4, 451 A.2d at 1311.
\(^{105}\) Id. at 904, 451 A.2d at 1312.
\(^{106}\) Id.
\(^{107}\) Id.
\(^{108}\) Id. at 905, 451 A.2d at 1312.
\(^{110}\) Id. at 343.
financial statements. The plaintiff sued the accountant when it became aware of the financial statements’ inaccuracies resulting from the accountant’s negligence. The court, in denying the accountant’s motion to dismiss the suit, indicated a reluctance to “cling to the outmoded and restrictive doctrine of privity as a precondition to a finding of accountant’s liability.” The decision stated that settled Nebraska law appeared to be favoring the *Second Restatement of Torts* approach. The court rejected the accountant’s argument that the Restatement approach was only acceptable in negligence actions involving audited financial statements.

From the above it is apparent that a few courts have chosen to follow the restatement approach in determining the extent of accountants’ liability to third parties.

C. Balancing Test Approach

Certain courts have accepted a third approach which focuses on various policy and factual considerations. The balancing test approach, as it applies to professional malpractice, was first introduced in *Biakanja v. Irving*. The *Biakanja* court found a notary public liable to a beneficiary of a will because the notary failed to obtain proper attestation.

A similar balancing test was applied in Missouri in *Aluma Kraft Manufacturing Co. v. Elmer Fox & Co.* In *Aluma Kraft*, the court extended liability to accountants where no privity of contract existed. The court considered and balanced certain factors such as the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm, the degree of certainty that the plaintiff was injured, and the proximity between the defendant’s conduct and the injury suffered. The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury suffered, the moral blame attached to the defendant’s conduct, and the policy of preventing future harm.

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111. *Id.*
112. *Id.* at 341.
113. *Id.* at 343.
114. *Id.* at 344.
115. *Id.*
117. *Id.* The Court in *Biakanja* held as follows:

The determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury suffered, the moral blame attached to the defendant’s conduct, and the policy of preventing future harm.

*Biakanja* v. *Irving*, 49 Cal. 2d at 650, 320 P.2d at 19.
and the plaintiff’s injury.\textsuperscript{119}

In \textit{Raritan River Steel Co. v. Cherry, Beckaert & Holland},\textsuperscript{120} a company engaged accountants to audit its financial statements. The company forwarded the financial statements to Dunn and Bradstreet (D&B) for publication.\textsuperscript{121} The plaintiff, a third party vendor relying on the D&B report, extended over two million dollars in credit to the company.\textsuperscript{122} Subsequently, the company went bankrupt and it became apparent that the audited financial statements had overstated the company’s net worth by a significant amount.\textsuperscript{123} The plaintiff then sued the accountants, \textit{inter alia}, for negligent misrepresentation. The North Carolina Court of Appeals held that privity of contract was implied because the plaintiff was an intended third party beneficiary of the contract between the accountant and the company.\textsuperscript{124}

Moreover, another vendor, who did not rely on the D&B report, also sued the accountants, alleging damages incurred as a direct result of its extension of credit to the company.\textsuperscript{125} Although the vendor was not a third party beneficiary, the court found a cause of action against the accountants for a negligently prepared audit.\textsuperscript{126}

In establishing a standard for liability, the court refused to follow the Restatement approach because it “is similar to the privity rule in that it draws an arbitrary limit on the class of potential plaintiffs.”\textsuperscript{127} A “reasonably foreseeable” approach was also rejected because of the magnitude of losses that could result from widespread circulation of misfortune.\textsuperscript{128}

Instead, the court balanced the following factors: (1) The extent to which the transaction in question was intended to affect a third party, (2) the foreseeability of harm to third party, (3) the degree of certainty that the third party suffered injury, (4) the proximity between accountant’s conduct and injury suffered, (5) the moral blame attached to the accountant’s conduct, and (6) the policy of preventing future harm.\textsuperscript{129}

Although the above cases discuss accountants’ liability in an audit environment, courts may be inclined to follow the balancing test ap-
proach to extend accountants’ liability to third parties for the prepa-
ration of unaudited financial statements.

D. Reasonably Foreseeable Approach

In recent years, several courts have allowed a “reasonably foreseeable” user of financial statements to recover in negligence against an accountant despite the lack of privity.130

In International Mortgage Co. v. John P. Butler Accountancy Corp.,131 the accountants audited the financial statements of Westside Mortgage, Inc. (Westside). Westside arranged financing for real property by originating the loans and subsequently selling them to mortgage bankers such as the plaintiff.132 The plaintiff, relying on the audited financial statements, entered into a business arrangement with Westside to buy and sell certain real estate loans. The audited financial statements were materially misstated since Westside’s major asset was a worthless note. As a result of the misstated financial statements, Westside was legally unable to perform on the contract, resulting in over $400,000 in damages to plaintiff.133 Subsequently, the plaintiff sued Westside and the accountants.

The California Court of Appeals held that the independent auditor owed a duty of care to reasonably foreseeable plaintiffs who relied on negligently audited financial statements.134 The court rejected the privity doctrine set forth in Ultramares “as no longer viable, for the role of the accountant in our society has changed.”135 The court stressed that the independent auditor’s function is to analyze the client’s financial status and make public the ultimate findings in accordance with recognized accounting principles. Such a responsibility creates public trust in the accountant, requiring him or her to realize that the audited financial statements will be relied upon by creditors, stockholders or anyone else involved in the financial aspects of the client.136 The Restatement approach was not accepted by the court as it failed to meet California’s concept of tort

131. 177 Cal. App. 3d 806, 223 Cal. Rptr. 218.
132. Id. at 808, 223 Cal. Rptr. at 219.
133. Id. at 811, 223 Cal. Rptr. at 220.
134. Id. at 820, 223 Cal. Rptr. at 227.
135. Id. at 819-20, 223 Cal. Rptr. at 226.
136. Id. at 817, 223 Cal. Rptr. at 224.
liability for negligence.  

The court set forth the following policy reasons as a further justification for the foreseeability approach:

An innocent plaintiff who foreseeably relies on an independent auditor's unqualified financial statement should not be made to bear the burden of the professional's malpractice. The risk of such loss is more appropriately placed on the accounting profession which is better able to pass such risk to its customers and the ultimate consuming public. By doing so, society is better served; for such a rule provides a financial disincentive for negligent conduct and will heighten the profession's cautionary techniques.  

Courts have yet to address the question of whether the reasonably foreseeable approach applies to accountants' non-audited services. The previously mentioned policy arguments could be made for allowing such an extension of liability to third parties. However, courts must recognize that they are treading on dangerously thin ice when they excessively expand accountants' liability in the non-audit area. The following section will discuss the numerous policy arguments for and against expanding accountants' liability in the non-audit area.

V. GENERAL EXTENSION OF ACCOUNTANTS' LIABILITY FOR NON-AUDIT SERVICES — POLICY CONCERNS

Proponents of expanding accountants' liability to non-audit work traditionally have set forth four basic arguments. First, it is unfair for the public to bear the risk of misstated financial statements. Second, imposition of negligence liability encourages more diligent performance by the accountant. Third, the accountant is in a better position to spread the losses through insurance. Fourth, increased assumption of responsibility by the accountant can be justified by the public perception that the accountant owes some special duty of care as a financial "policeman." The United States Supreme Court in United States v. Arthur Young & Co., stated a similar argument as follows:

By certifying the public 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. (Emphasis in original).

137.  Id. at 820, 223 Cal. Rptr. at 227.
138.  Id.
139.  See supra text accompanying notes 137-38.
141.  Id. at 905, 451 A.2d at 1312.
142.  Id. at 904, 451 A.2d at 1312.
144.  Id. at 817-18.
This notion of public responsibility has motivated courts to erode the accountants’ privity defense in negligence actions by third parties for audit as well as non-audit services.\footnote{145. See generally Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 451 A.2d 1308 (1982); International Mortg. Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986).}

Several policy arguments support the limitation of accountants’ liability with respect to non-audit work. First, the fundamental distinction between an audit and an unaudited review or compilation of financial statements justifies different levels of accountants’ liability. In an audit, the accountant is properly held liable if the financial statements are misstated since the accountants’ report expresses an opinion as to their fairness. In this situation, the risk of misstated financial statements is properly shifted to the accountant. But in issuing a non-audit report, the accountant specifically disclaims an opinion as to the fairness of the financial statements. This puts the user on notice that the accountant will not totally assume the risk of misstated financial statements. By accepting an unaudited report the investor or creditor in essence must bear some of the risk of financial misstatements.\footnote{146. Note that the total risk is not shifted to the user of the financial statements as he or she has a cause of action if the financial statement misstatement results from an accountant’s non-audit work falling below the standards set forth by the AICPA in \textit{SSARS No.1} or \textit{SSASPFI}. Also, assumption of risk by investors and creditors is not new as it is the key to any investment decision.}

Second, expanding liability will result in a disincentive for accountants to perform any non-audit work. An accountant will refuse to perform a financial statement review if held to a standard of an audit or some other standard which is higher than the one set forth by the AICPA for unaudited reviews.

Third, increased litigation against accountants may lead to a malpractice insurance crisis similar to the one experienced in the medical and legal professions.\footnote{147. See generally Note, \textit{The Price of Health Care Availability: The Economics of Medical Malpractice}, 11 Sw. U.L. Rev. 1371 (1979).} Increased insurance costs of accountants would have to be passed on to the many small companies requiring unaudited services. Such companies may not be able to afford an increase in accountants’ fees. This could lead such companies to bankruptcy as their creditors or investors would be unwilling to continue financing them without financial statements prepared by an independent third party.

Fourth, the financial “policeman” responsibility is more appropriately a function of the state and federal regulatory agencies rather than the courts.\footnote{148. See generally Note, \textit{Accountants’ Liability} in \textit{San Diego Law Review}, 25: 757, 1988.}
than of the accountant. Charging the accountant with such a broad public responsibility will inappropriately heighten the public’s misconception that the accountant should assume total responsibility for any problem concerning a company’s finances.

Last, the traditional arguments fashion by courts for expanding liability to accountants are misplaced. These arguments were derived from the strict products liability doctrines developed in Justice Traynor’s concurring opinion in Escola v. Coca Cola Bottling Co. of Fresno. The courts’ application of these arguments to a negligence action involving economic injuries is inappropriate. Justice Traynor’s arguments in Escola were directed towards the evolution of the strict products liability doctrine in the context of physical injuries and did not advocate an extension of negligence liability in the context of economic injuries.

In light of these policy arguments, the doctrine of modified privilege should be retained to shield the accountant from an expansion of liability to third parties for non-audit work. Furthermore, the state legislatures should establish standards, modeled after the AICPA standards, which set forth the level of care which should be followed by the accountant in performing the various levels of service. Clear guidelines will reduce accountants’ necessity to perform unnecessary procedures which burden companies with greater costs.

Furthermore, the accounting profession should educate the business community and the public as to the degree of reliance that should be placed on the various levels of non-audited services. Non-audit reports should be expanded to enumerate specifically the areas for which the accountant is taking no responsibility. The report should also discuss the limitations to legal recourse available against the accountant in the event that the financial statements are misstated.

The AICPA may consider actively participating in drafting literature designed to educate financial statement users about the limitations of unaudited reviews and compilations. Investors, bankers and others who rely on such financial statements must understand that they themselves must assume some portion of the risk resulting from misstated financial information.

The accountant should be viewed as an unbiased information source regarding a company’s financial condition and operating results, as opposed to an insurer of the company’s financial health. The business community and public, by obtaining a proper understanding of the accountant’s function in a given situation, will less likely suf-
fer economic injury because financial decisions will be made more cautiously, based more on extensive direct investigation and not indirect reliance on accountant prepared financial statements.

VI. CONCLUSION

Court decisions of the past two decades have sent a message to accountants that a lower standard of care for non-audited services was unacceptable. Part of the problem was that the professional guidelines which existed prior to 1980 were inadequate to ensure consistent quality of the unaudited reviews and compilations. The profession responded by issuing detailed standards in the form of SSARS No. 1 for historical financial statements and SSASPF for prospective financial statements.

However, courts remain reluctant to accept SSARS No. 1 and SSASPF as objective standards of professional care to be applied in determining accountants' liability for performing non-audit services. Although the standards are well defined, the courts apparently believe that accountants' work requires significant judgment which the standards cannot adequately reflect. Therefore, courts have traditionally relied on experts to draw the line between accountants' negligent and non-negligent behavior. Over-reliance by the courts on the subjectivity of these experts may have its price. If the standards of performance for non-audit work become too subjective and unpredictable, accountants will be forced to provide only expensive audits to their clients. To ensure the continued availability of unaudited services by accountants, the state legislatures should develop statutory guidelines of due care modeled after the AICPA standards. These guidelines will provide accountants with a reliable criteria for non-negligent conduct.

Courts in various jurisdictions have split over the question of the extent that third parties may seek recourse against accountants for negligence. Certain jurisdictions favor a more expansive approach, holding accountants liable to any reasonably foreseeable plaintiff. Other jurisdictions favor the more restrictive modified privity approach which would extend accountants' liability to third parties only when the relationship between the accountant and the third party is sufficiently close.

152. See supra text accompanying notes 20-35.
153. See supra text accompanying note 36.
154. See supra text accompanying notes 91-138. However, very few courts have specifically addressed the question in the context of accountants' unaudited services.
155. See supra text accompanying notes 130-38.
party is clearly one approaching that of privity.\textsuperscript{156}

Since the accountant in an unaudited report specifically disclaims an opinion as to the fairness of the financial statements, the level of responsibility assumed by the accountant regarding such financial statements should be reduced. An approach which favors limitation of accountants' liability is consistent with the policy of shifting back some of the financial misstatement risk to the financial statement user. Therefore, courts should utilize the modified privity approach discussed in \textit{Credit Alliance} as a shield to protect accountants from most third party claims for damages arising from non-audit work.

\textsc{Andrew L. Kozlowski}

\textsuperscript{156} See supra text accompanying notes 92-99.