

# Notes

## Judicial and Administrative Treatment of Accountants' Qualifications and Disclaimers

In the last ten years, litigation involving accountants has experienced a meteoric rise.<sup>1</sup> This Note seeks to introduce the reader to the various types of opinions issued by auditors, to examine judicial and Securities and Exchange Commission treatment of auditors' attempts to limit liability, and to explore methods by which auditors can better protect themselves from liability through improved disclosure techniques.

### I. A VIEW FROM THE ACCOUNTING PROFESSION

#### A. Definitions

Auditing is perhaps the most misunderstood and, consequently, the most litigated function that public accountants perform. This is in large part due to a misunderstanding of the significance of an auditor's opinion and a failure to recognize that financial statements should primarily be viewed as managements' representations.<sup>2</sup> The American Institute of Certified Public Accountants (A.I.C.P.A.), in a recent codification of professional standards, described the objective of the audit process as follows:

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. The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion. In either case, he states whether his examination has been made in accordance with generally accepted auditing standards.<sup>3</sup>

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<sup>1</sup>A recent estimate indicated that between 500 and 1,000 suits were pending at that time and over 200 decisions had been reported. Liggio, *Expanding Concepts of Accountants Liability*, 18 CALIF. C.P.A. Q. 19, 20 (1974). See also Besser, *Privity?—An Obsolete Approach to the Liability of Accountants to Third Parties*, 7 SETON HALL L. REV. 507, 507 n.2 (1976).

<sup>2</sup>See note 23 *infra*. In addition to auditing, public accounting firms perform considerable tax work, management services (such as developing management information systems), and write-up work.

<sup>3</sup>1 A.I.C.P.A., AICPA PROFESSIONAL STANDARDS *Auditing* § 110.01, at 61 (CCH 1976).

The following two key phrases contained in this description also appear in any opinion written by an accountant on financial statements: (1) "[I]n conformity with generally accepted accounting principles" (GAAP), and (2) "in accordance with generally accepted auditing standards" (GAAS).

Generally accepted accounting principles incorporate the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed and which financial statements should be prepared.<sup>4</sup>

Although the A.I.C.P.A. has formulated elaborate general definitions of the term GAAP, it has not as yet codified all GAAP into a single writing.<sup>5</sup> The Accounting Principles Board (A.P.B.) and more recently the Financial Accounting Standards Board (F.A.S.B.) of the A.I.C.P.A.<sup>6</sup> have issued statements in a piecemeal fashion on specific items but have not as yet detailed all GAAP. Consequently, the profession is often confronted with the task of determining whether a particular accounting principle is generally accepted.<sup>7</sup> Problematically, an auditor's opinion must state whether the financial statements are presented fairly and in accordance with GAAP,<sup>8</sup> but in some in-

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<sup>4</sup>2 A.I.C.P.A., *APB Statement No. 4*, APB ACCOUNTING PRINCIPLES ¶ 137, at 9083-84 (CCH 1973). See also 2 A.I.C.P.A., *Accounting Terminology Bulletin No. 1*, APB ACCOUNTING PRINCIPLES ¶¶ 16-17, at 9505-06 (CCH 1973).

Perhaps the most concise definition of GAAP was that offered by the A.I.C.P.A. Special Committee on Opinions of the Accounting Principles Board, which defined GAAP as principles having "substantial authoritative support." *APB Statement No. 4*, *supra*, at 9505 n.38.

<sup>5</sup>For a recent article discussing this problem, see Carmichael, *What Does the Independent Auditor's Opinion Really Mean?*, 138 J. ACCOUNTANCY, Nov. 1974, at 83.

<sup>6</sup>At this point it would be wise to explain the various organizations having a direct impact on the accounting profession. The A.I.C.P.A. is the governing body of all C.P.A. members. From 1938 to 1959, the A.I.C.P.A.'s Committee on Accounting Procedure was the senior technical committee that was authorized to issue pronouncements on accounting principles. The Accounting Principles Board (A.P.B.) took over this function from 1959 to 1973, when it was replaced by the Financial Accounting Standards Board (F.A.S.B.). R. MONTGOMERY, *MONTGOMERY'S AUDITING* 25-26 (9th ed. 1975).

<sup>7</sup>*APB Statement No. 4*, *supra* note 4, ¶¶ 137-206, at 9083-103, offers a general discussion of how to determine whether a principle is generally accepted and the basic rules governing GAAP.

<sup>8</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 410.01. See also A.I.C.P.A. CODE OF PROFESSIONAL ETHICS, Rule 203, *reprinted in* A.I.C.P.A. PROFESSIONAL STANDARDS, *supra* note 3, § 509.18. The SEC has a similar requirement for all financial

stances the auditor may not be sure whether a principle is generally accepted due to a lack of official pronouncements.

Unlike GAAP, GAAS have been the subject of a comprehensive codification by the A.I.C.P.A. GAAS are divided into three broad areas: General standards, standards of field work, and standards of reporting.<sup>9</sup> The following general standards are concerned with the qualifications of the auditor and the quality of his work:<sup>10</sup> (1) "The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor;"<sup>11</sup> (2) "[i]n all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors;"<sup>12</sup> and (3) "[d]ue professional care is to be exercised in the performance of the examination and preparation of the report."<sup>13</sup>

The following standards of field work focus on the mechanics of the audit and what is considered proper in the audit cycle: (1) "The work is to be adequately planned and assistants, if any, are to be properly supervised";<sup>14</sup> (2) "[t]here is to be a proper study and evaluation of existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted";<sup>15</sup> and (3) "[s]ufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for opinion regarding the financial statements under examination."<sup>16</sup>

The following standards of reporting concern the content of the work product of the audit—the opinion: (1) "The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles";<sup>17</sup> (2) "[t]he report shall

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statements certified by auditors. 17 C.F.R. § 210.2-02 (1977); Accounting Series Release No. 4, 5 FED. SEC. L. REP. (CCH) ¶ 72,005 (1938). Further compounding the problem, the SEC has taken the position that the F.A.S.B. should continue to determine GAAP for the purpose of compliance with securities laws. Accounting Series Release No. 150, 5 FED. SEC. L. REP. (CCH) ¶ 72,172 (1973).

<sup>9</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 150.02.

<sup>10</sup>*Id.* § 201.01.

<sup>11</sup>*Id.* § 210.01.

<sup>12</sup>*Id.* § 220.01; A.I.C.P.A. CODE OF PROFESSIONAL ETHICS, Rule 101, *reprinted in* R. MONTGOMERY, *supra* note 6, at 18. The SEC also requires "independence in mental attitude" of an auditor certifying financial statements under the securities laws. 17 C.F.R. § 210.2-01(b) (1977). *See also* Accounting Series Release No. 126, 5 FED. SEC. L. REP. (CCH) ¶ 72,148 (1972); Accounting Series Release No. 47, 5 FED. SEC. L. REP. (CCH) ¶ 72,065 (1944).

<sup>13</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 230.01.

<sup>14</sup>*Id.* § 310.01.

<sup>15</sup>*Id.* § 320.01.

<sup>16</sup>*Id.* § 330.01.

<sup>17</sup>*Id.* § 410.01.



state whether such principles have been consistently observed in the current period in relation to the preceeding period";<sup>18</sup> (3) "[i]nformative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report";<sup>19</sup> and (4) "[t]he report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons should be stated. In all cases wherein an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."<sup>20</sup>

This final standard of reporting mandates the ultimate work product of an audit—the auditor's opinion. The acceptable forms of opinions and the impact of deviations from them are the focal point of this Note. Before analyzing the A.I.C.P.A.'s technical requirements pertaining to an auditor's opinion, it is necessary to examine the procedures involved in a typical audit in order to fully appreciate what an opinion purports to represent and what duties an auditor assumes.

### B. The Audit Cycle<sup>21</sup>

The primary function of an audit is to test the integrity and accuracy of the client's internal control,<sup>22</sup> thereby enabling the accountant to judge the accuracy and reliability of the client's financial statements.<sup>23</sup> The audit process can be divided into five general steps. The auditor must first obtain an understanding of the client's system and the nature of the client's business. Typically, the auditor examines prior working papers of predecessor auditors, interviews

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<sup>18</sup>*Id.* § 420.01.

<sup>19</sup>*Id.* § 430.01.

<sup>20</sup>*Id.* § 509.04.

<sup>21</sup>See generally R. MONTGOMERY, *supra* note 6, chs. 4-7.

<sup>22</sup>Internal control has been defined as comprising "the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies." AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 320.09.

<sup>23</sup>The basic purpose of auditing is to verify the accuracy and acceptability of financial statements that management has prepared, not to draft the financial statements. The drafting of financial statements and resulting representations contained therein are primarily the responsibility of management, not the auditors. *Id.* § 110.02. Furthermore, the auditor does not purport to examine every account or physically count every item of inventory; rather his examination is based upon predetermined sampling techniques. Hence, a necessary element of imprecision is present in any audit.

operations management directly involved with the company's internal control, and refers to industrial source books for a general understanding of the nature of the client's business.

The second step is a preliminary evaluation of the client's internal control. Because auditing consists of gathering evidence by means of testing, the tests must be preceded by a preliminary evaluation of the client's internal controls to determine what to test and how extensively. The preliminary evaluation also aids in organizing the "audit program," which is a list of detailed steps to be performed at specified times.

Next, the auditor must perform functional tests to ascertain whether the internal control system on which the auditor intends to rely is functioning properly. Such tests seek to determine if pre-existing internal control guidelines are consistently and properly followed.

After examining the strengths and weaknesses of the client's internal control system by functional testing, the auditor must re-evaluate his audit program and modify it to conform to the functional test results. The results of the functional tests determine the extent to which the substantive tests will be applied. Substantive tests consist of validatory and analytic tests, such as obtaining confirmations from debtors and creditors, random sampling of inventory quantities, examining the accounting principles applied to management's recordation of financial resources, and evaluating judgments made by management that have an impact on valuation estimates.

Finally, the auditor must evaluate the information on the client's internal control system in light of the client's financial statements in order to determine if the statements accurately reflect the auditor's view of the recorded transactions. The results of this evaluation appear in the auditor's written opinion.

### *C. Forms of Opinions*

All opinions are typically divided into two parts. In the scope paragraph, the auditor outlines the nature and extent of the audit procedures applied and discloses any irregularities or limitations on the auditor's examination. In the opinion paragraph, the auditor specifies whether adequate disclosures have been made, whether such disclosures comply with GAAP, and whether the accounting principles utilized have been consistently applied.

1. *The Standard Short-form Report.*<sup>24</sup>—The scope and opinion paragraphs of the standard short-form report in essence state that

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<sup>24</sup>A model short-form opinion is as follows:

(Scope paragraph)

We have examined the balance sheet of X Company as of [at] December



the auditor understands the standards of his profession and has made an examination complying with such standards, and that the financial statements report the information fairly and in compliance with consistently applied GAAP. The short-form opinion—or any opinion for that matter—*does not* warrant the absence of fraud in the financial statements or state that the figures in the statements are accurate to the penny.<sup>25</sup> The auditor merely represents that he has not found any material problems or deficiencies, either in carrying out the audit or in examining the financial statements, of which the reader should be aware.

2. *Variations of the Standard Report.*—During the course of an audit, a variety of problems or deficiencies may be uncovered. The auditor is then confronted with the problem of deciding if the irregularity is of sufficient magnitude to require a departure from the standard short-form opinion.<sup>26</sup> If the auditor determines that such a

31, 19XX, and the related statements of income, 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.

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of [at] December 31, 19XX, and the results of its 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.

*Id.* § 509.07 (bracketed language in original).

<sup>25</sup>A common misconception about the auditor's role is that he is expected to detect fraud. From the standpoint of the accounting profession this is simply not correct:

In making the ordinary examination, the independent auditor is aware of the possibility that fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the 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 . . . . The responsibility of the independent auditor for failure to detect fraud . . . arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

*Id.* § 110.05. The courts are not always sympathetic to this position. *E.g.*, 1136 Tenants' Corp. v. Max Rothenberg & Co., 319 N.Y.S.2d 1007, 36 App. Div. 2d 804 (1971) (accountant held liable for \$174,000 plus interest for failure to detect and report defalcations of an apartment manager where the accountant alleged that he was only engaged to do *write-up work*).

<sup>26</sup>Variations from the standard short-form opinion can result where: (1) Limitations are placed on the scope of an audit, (2) the auditor's report is based in part on

departure is required, he must choose between the following forms of opinions: A qualified opinion, an adverse opinion, or a disclaimer of opinion.

(a) *Qualified Opinion*.—"A qualified opinion states that, 'except for' or 'subject to' the effects of the matter to which the qualification relates, the financial statements present fairly [the] financial position, results of operations and changes in financial position in conformity with generally accepted accounting principles consistently applied."<sup>27</sup> The typical grounds for a qualified opinion are: (1) Restrictions on the scope of an audit, (2) departures from GAAP in the financial statements, (3) inconsistent application of accounting principles, or (4) significant uncertainties present as of the statement date.<sup>28</sup>

In a qualified opinion,<sup>29</sup> the auditor should disclose all substantive reasons for the qualification in a separate explanatory paragraph, insert an exception in the opinion paragraph, and make reference to the separate explanatory paragraph in the opinion paragraph. The explanatory paragraph should also disclose the principal impact that the qualification's subject matter will have on the client's financial position and results of operations, if ascertainable.<sup>30</sup>

another auditor's report, (3) financial statements are affected by departures from GAAP or from an accounting principle promulgated by the A.I.C.P.A., (4) accounting principles have not been consistently applied, (5) financial statements are affected by uncertainties concerning future events that are not susceptible to reasonable estimation at the statement date, (6) the auditor wishes to emphasize a matter, or (7) the auditor is not independent. AICPA PROFESSIONAL STANDARDS, *supra* note 3, §§ 509.09, 517.02.

<sup>27</sup>*Id.* § 509.29.

<sup>28</sup>*Id.* See also R. MONTGOMERY, *supra* note 6, at 754.

<sup>29</sup>See generally AICPA PROFESSIONAL STANDARDS, *supra* note 3, §§ 509.32-509.34.

<sup>30</sup>The following is a model of an opinion that is qualified due to departures from GAAP:

(Scope paragraph)

Same as short form unqualified report

(Separate explanatory paragraph)

The Company has excluded from property and debt in the accompanying balance sheet certain lease obligations, which, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$XXX, long term debt by \$XXX, and retained earnings by \$XXX as of December 31, 19XX, and net income and earnings per share would be increased (decreased) by \$XXX and \$XXX respectively for the year then ended.

(Opinion paragraph)

In our opinion, except for the effects of not capitalizing lease obligations, as discussed in the preceding paragraph, the financial statements present fairly . . . .

*Id.* § 509.36. For models of qualifications arising due to lack of consistency, uncertainties, and scope limitations, see *id.* §§ 509.38, .39, & .40, respectively.



The auditor may abbreviate the explanatory paragraph by incorporating these disclosures into footnotes to the financial statements, provided the explanatory paragraph refers to the footnotes. This format is permissible in all but one situation. Limitations as to the scope of the audit cannot be explained in footnotes, since a description of the audit's scope is the auditor's responsibility, not the client's.<sup>31</sup>

(b) *Adverse Opinion.*—An adverse opinion is one which states “that financial statements do *not* present fairly the financial position, the results of operations, or the changes in financial position in conformity with generally accepted accounting principles.”<sup>32</sup> A typical ground for an adverse opinion is the failure of the financial statements to comply with GAAP. Another ground is inadequate disclosure on the part of the client—that is, the client declines to include information essential for fair presentation.<sup>33</sup> In determining whether to issue a qualified or adverse opinion, the materiality of the objectionable matter is the guiding element.<sup>34</sup>

In expressing an adverse opinion, the auditor should state in separate paragraphs all of the substantive reasons for such an opinion and the principal effects of the objectionable matter, if determinable. Furthermore, the auditor should clearly indicate in the opinion paragraph that the financial statements do not make an acceptable presentation.<sup>35</sup> As a practical matter, adverse opinions are very

<sup>31</sup>*Id.* § 509.34. This limitation is explained by examining the respective roles of management and the auditor, as viewed by the A.I.C.P.A. Since the A.I.C.P.A. considers the financial statements to be primarily representations of management, and representations as to the scope of an audit to be the accountant's, the auditor should not intermingle his required disclosures with those of his client. *Id.* § 110.02.

<sup>32</sup>*Id.* § 509.41.

<sup>33</sup>*Id.* § 509.17. *See id.* §§ 430.01, .06, 545.04-545.05.

<sup>34</sup>*See* note 45 *infra* and accompanying text.

<sup>35</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.42. A model opinion reads as follows:

(Separate paragraph)

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles, in our opinion, require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from generally accepted accounting principles identified above, as of December 31, 19XX, inventories have been increased \$..... by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is [sic] carried at \$..... in excess of an amount based on the cost



rare and are usually found only if financial statements are prepared for a special and limited purpose.<sup>36</sup>

(c) *Disclaimer of Opinion.*—A disclaimer of opinion states the auditor *does not* express an opinion on the financial statements.<sup>37</sup> Due to some significant defect, in either the auditing process or the financial statements themselves, the auditor is not in a position to express an opinion or assume responsibility for the financial statements. The auditor must disclose in separate paragraphs all reasons for declining to express an opinion, as well as any other reservations he may have regarding the fairness of presentation of the financial statements in conformity with GAAP and their consis-

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to the Company; and allocated income tax of \$..... has not been recorded; resulting in an increase of \$..... in retained earnings and in appraisal surplus of \$..... For the year ended December 31, 19XX, cost of goods sold has been increased \$..... because of the effects of the depreciation accounting referred to above and deferred income taxes of \$..... have not been provided, resulting in an increase in net income and earnings per share of \$..... and \$..... respectively.

(Opinion paragraph)

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19XX, or the results of its operations and changes in its financial position for the year then ended.

*Id.* § 509.43.

<sup>36</sup>R. MONTGOMERY, *supra* note 6, at 755.

<sup>37</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.45. The following is an example of a disclaimer resulting from the auditor's inability to obtain sufficient evidential matter:

(Scope paragraph)

Except as set forth in the following paragraph, 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.

(Separate paragraph)

The Company did not take a physical inventory of merchandise, stated at \$..... in the accompanying financial statements as of December 31, 19XX, and at \$..... as of December 31, 19XX. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19XX is no longer available. The Company's records do not permit the application of adequate alternative procedures regarding the inventories or the cost of property and equipment.

(Disclaimer paragraph)

Since the Company did not take physical inventories and we were unable to apply adequate alternative procedures regarding inventories and the cost of property and equipment, as noted in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements referred to above.

*Id.* § 509.47. See *id.* §§ 517.03, 542.05, 546.15 for other model disclaimer forms.

tent application. The disclaimer paragraph must make reference to the explanatory paragraph.<sup>38</sup>

Common situations giving rise to a disclaimer are: (1) Significant scope limitations of an audit,<sup>39</sup> (2) major uncertainties that cannot be resolved as of the statement date,<sup>40</sup> and (3) lack of independence of the auditor.<sup>41</sup>

(d) *Piecemeal Opinion*.—A piecemeal opinion is the converse of a qualified opinion. A qualified opinion expresses an opinion as to the entire financial statement and makes exceptions for particular items while a piecemeal opinion disclaims or is adverse as to the financial statement as a whole but renders an affirmative opinion as to specific items.<sup>42</sup> The A.I.C.P.A. indicated that as of January 31, 1975, it would no longer consider piecemeal opinions acceptable,<sup>43</sup> primarily because they "tend to overshadow or contradict a disclaimer of opinion or adverse opinion."<sup>44</sup>

Although more than one of the above forms of opinion could be appropriate for the same defect, the auditor must determine which form to employ, based upon the degree of materiality that the defect presents. The problem with this approach is there is no authoritative statement by the accounting profession that outlines what defects are "material" and should give rise to a disclaimer or adverse opinion rather than a qualified opinion. Five factors have been suggested as guidelines in making the decision: (1) The usefulness of the financial statements containing the defect, (2) the auditor's assessment of the reader's ability to understand the problem, (3) the auditor's ability to measure the potential impact of the problem, (4) the auditor's ability to describe his reservations about the financial statements with clarity, and (5) the extent of the auditor's disagreement with his client's handling of the matter.<sup>45</sup>

<sup>38</sup>*Id.* §§ 509.45-509.46.

<sup>39</sup>*Id.* § 509.10.

<sup>40</sup>*Id.* § 509.25 n.8.

<sup>41</sup>*Id.* § 517.02.

<sup>42</sup>R. MONTGOMERY, *supra* note 6, at 760.

<sup>43</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.50.

<sup>44</sup>*Id.* § 509.48.

<sup>45</sup>R. MONTGOMERY, *supra* note 6, at 762. The following factors have been suggested by the A.I.C.P.A. as guidelines in determining the materiality of the defect: Dollar magnitude of the effects, significance of an item to a particular enterprise, pervasiveness of the misstatement, and the impact on financial statements taken as a whole. AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.16. "Materiality" has never been the subject of a specific A.I.C.P.A. release; however, several A.P.B. statements and opinions generally discuss "materiality." See, e.g., *APB Statement No. 4*, *supra* note 4, ¶ 128 at 9081. See generally Reininga, *The Unknown Materiality Concept*, 125 J. ACCOUNTANCY, Feb. 1968, at 30.

For the SEC's definition of "materiality," see 17 C.F.R. § 210.1-02(n) (1977); Accounting Series Release No. 41, 5 FED. SEC. L. REP. (CCH) ¶ 72,059 (1942); Securities



In light of the general criteria offered by the profession, an auditor's decision on the most suitable type of opinion is a difficult one. The impact of this decision, when considered in connection with the potential extent of resulting liability, presents a very real obstacle to the continued existence of public accounting firms unless clearer standards are advanced and put into operation.

## II. JUDICIAL AND ADMINISTRATIVE TREATMENT OF AUDITOR'S OPINIONS

Technical compliance with GAAS and GAAP becomes most important when an auditor is confronted with a suit by disgruntled users of the financial statements. Although compliance with the professional standards is not always a complete defense, it is clear that the courts look to GAAS and GAAP for guidance. Similarly, the Securities and Exchange Commission has indicated that it views the A.I.C.P.A. principles and standards as authoritative sources when examining financial statements and their supporting opinions for compliance with the federal securities laws.

### A. Common Law

1. *Introduction.*<sup>46</sup>—The most common basis for suits against auditors at common law is misrepresentation. The important question is whether negligent misrepresentation rather than fraudulent misrepresentation will lie for third-party suitors not in privity.

The privity requirement presents a rather formidable obstacle to third parties not in privity who seek to recover damages from auditors for negligent misrepresentation. This requirement originated in England in 1842<sup>47</sup> and was quickly established in the

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Exchange Act Releases Nos. 5092 & 8995, [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,915. Judicial attempts at defining materiality have resulted in a number of verbal formulations that generally apply a "reasonable man"-type test. *See, e.g.*, T.S.C. Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (proxy solicitation); SEC v. Texas Gulf Sulfur Co., 401 F.2d 833 (2d Cir. 1968) (insider trading); *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968) (prospectus). *See also* Kripke, *Rule 10b-5 Liability and "Material" "Facts,"* 46 N.Y.U. L. REV. 1061 (1971).

<sup>46</sup>The initial discussion in this section on accountants' common law liability in general is not intended to be an exhaustive examination. For a more extensive treatment, *see* Chalmers, *Over-accountable Accountants? A Proposal for Clarification of the Legal Responsibilities Stemming from the Audit Function*, 16 WM. & MARY L. REV. 71 (1974); Note, *Accountants' Liabilities for False and Misleading Financial Statements*, 67 COLUM. L. REV. 1437 (1967).

<sup>47</sup>*Winterbottom v. Wright*, 152 Eng. Rep. 402 (Ex. 1842), is credited with establishing this requirement. In *Winterbottom*, a mail-coach driver brought an action to recover damages against a contractor hired by the Postmaster-General to keep the mail-coaches in repair. Due to the contractor's negligent servicing of the coach and a latent defect, it collapsed, injuring the driver. The Court of Exchequer denied recovery, due to the lack of privity between the driver and the contractor. The court

United States. This doctrine remained a firm barrier to third-party suitors lacking privity until the early part of the twentieth century. In 1919, judicial attitude began to shift, resulting in the first signs of the doctrine's rejection.<sup>48</sup> Shortly thereafter, the privity doctrine was rejected in *Glanzer v. Shepard*,<sup>49</sup> a case closely paralleling the facts of a typical accountant's liability suit. In *Glanzer*, a public weigher was hired by a bean vendor to weigh a quantity of the vendor's product and issue a certificate of weight to the buyer, who in turn remitted the purchase price to the vendor, based on the certified weight. The weigher negligently overstated the weight, causing the buyer to be overcharged. In upholding a directed verdict in favor of the buyer against the weigher for negligent misrepresentation, the court, in an opinion written by Justice Cardozo, specifically rejected the weigher's lack of privity defense.

Nine years after *Glanzer* the New York courts were called upon to decide the privity issue in the context of a suit by a disappointed moneylender against a public accounting firm. In *Ultramares Corp. v. Touche*,<sup>50</sup> an accounting firm was retained by Stern & Co. to prepare and issue an opinion on the company's financial statements. The accounting firm knew that Stern & Co. required extensive borrowing to finance its operations and that the financial statements would be exhibited to lenders to obtain credit. However, the accounting firm did not know the identity of the specific lenders, nor did it know how many loans the company might obtain in reliance upon these financial statements. The balance sheet, carrying an unqualified opinion,<sup>51</sup> represented Stern's net assets to be \$1,070,000. In reality, the company was insolvent as of the statement date due to overstated inventories and inclusion of nonexistent accounts

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stated: "There is no privity of contract between these parties . . . Unless we confine the operation of such contracts as this to the parties who entered into them, the most absurd and outrageous consequences, to which I can see no limit, would ensue." *Id.* at 405. See *Landell v. Lybrand*, 264 Pa. 406, 107 A. 783 (1919), for one of the early American cases refusing recovery to a third party for an accountant's negligent misrepresentation due to the lack of privity.

<sup>48</sup>*MacPherson v. Buick Motor Co.*, 217 N.Y. 382, 111 N.E. 1050 (1916) (automobile manufacturer held liable to third party lacking privity for negligence in the construction of one of its automobiles).

<sup>49</sup>233 N.Y. 236, 135 N.E. 275 (1922).

<sup>50</sup>255 N.Y. 170, 174 N.E. 441 (1931).

<sup>51</sup>The opinion appeared as follows:

We have examined the accounts of Fred Stern & Co., Inc., for the year ending December 31, 1923, and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that . . . in our opinion, [it] presents a true and correct view of the financial condition of Fred Stern & Co., Inc., as at December 31, 1923.

*Id.* at 174, 174 N.E. at 447.



receivable. In reliance on the financial statements, plaintiff advanced \$165,000 to the company, which subsequently was declared bankrupt.

The jury awarded plaintiff damages based on the accounting firm's negligence in performing the audit, but the trial court set aside the verdict. On appeal, Justice Cardozo, writing for the court, noted that although negligence was clearly shown, the crucial question was whether the accounting firm owed plaintiff a duty of reasonable care. Impressed by the potential extent of an auditor's liability if the jury verdict were reinstated,<sup>52</sup> Cardozo decided that the auditors did not owe a duty of reasonable care to plaintiff. The court noted, however, that liability would exist for fraud and that a showing of an auditor's gross negligence could give rise to an inference of fraud.<sup>53</sup>

The court's reasons for distinguishing *Glanzer* were also significant. The court stated that in *Glanzer* the services of the weigher were primarily for the benefit of the buyer, while in *Ultramares*, the auditors' services were primarily for the benefit of the client and secondarily for the benefit of the lenders.<sup>54</sup> This distinction, later referred to as the "primary beneficiary rule," has been applied to require proof of fraudulent misrepresentation in actions by third parties not in privity with auditors, unless the third parties were the primary beneficiaries of the financial statements in which case negligence would suffice.<sup>55</sup> In order to be a primary beneficiary, the

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<sup>52</sup>"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." *Id.* at 179, 174 N.E. at 444.

<sup>53</sup>"[N]egligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud." *Id.* at 190-91, 174 N.E. at 449. *See also* State St. Trust Co. v. Ernst, 278 N.Y. 104, 15 N.E.2d 416, 5 N.Y.S.2d 104 (1938) (interpreting *Ultramares*).

<sup>54</sup>255 N.Y. at 174, 174 N.E. at 445-46.

<sup>55</sup>*Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013, 1015 (5th Cir. 1976); *Koch Indus., Inc. v. Vosko*, 494 F.2d 713, 724-25 (10th Cir. 1974); *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357, 359 (10th Cir. 1971); *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505, 505 (Fla. Dist. Ct. App. 1968); *Investment Corp. of Fla. v. Buchman*, 208 So. 2d 291, 293 (Fla. Dist. Ct. App. 1968); *State St. Trust Co. v. Ernst*, 278 N.Y. 104, 15 N.E.2d 416, 5 N.Y.S.2d 104 (1938); *Duro Sportswear, Inc. v. Cogen*, 131 N.Y.S.2d 20 (Sup. Ct. 1954); *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N.E. 808 (1934); *Milliner v. Elmer Fox & Co.*, 529 P.2d 806 (Utah 1974).

A number of decisions purporting to apply the *Ultramares* rule have mistakenly interpreted the case as precluding all negligence suits by third parties not in privity. *See, e.g.*, *O'Connor v. Ludlam*, 92 F.2d 50, 53 (2d Cir. 1937) ("Since there was no contractual relationship between the plaintiffs and the defendants, liability could be imposed only for fraud . . ."); *MacNerland v. Barnes*, 129 Ga. App. 367, 369, 199 S.E.2d 564, 566 (1973) ("The general rule is that in the absence of intentional misrepresentation or fraud, an accountant is not liable for negligence to a third party who is not in privity with the accountant.").

*Ultramares* rule required that the "end aim" of the auditor's engagement be for the benefit of the third-party suitor. The net result of the primary beneficiary rule was that very few third parties recovered from accountants.

This was generally the state of the law until 1965 when section 552 of the *Restatement (Second) of Torts*<sup>56</sup> appeared in tentative draft form. The Restatement gives a very liberal interpretation to the law of negligent misrepresentation by professionals to third parties. The Restatement comments suggest that the class of plaintiffs allowed to recover be expanded to include not only "primary beneficiaries" but also specific persons or classes of persons who will rely on the information in the specific transaction.<sup>57</sup>

The full impact of section 552 on the *Ultramares* rule remains to be seen. However, most recent cases have discussed the Restatement section, and at least one court appears to have adopted it.<sup>58</sup> The balance of the cases are somewhat confused, but it appears that the primary beneficiary rule is being given a more liberal interpretation, and its application now includes a number of situations that heretofore would not have been included.<sup>59</sup>

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<sup>56</sup>RESTATEMENT (SECOND) OF TORTS § 552 (1976) states in full:

(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) Except as stated in Subsection (3), the 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.

(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.

<sup>57</sup>*Id.*

<sup>58</sup>Rhode Island Hosp. Trust Nat'l Bank v. Swartz, Bresenoff, Yavner & Jacobs, 455 F.2d 847 (4th Cir. 1972), involved an action by a bank against an auditor for performing a negligent audit, causing the bank to rely on erroneous financial statements when loaning funds to a soon-to-be defunct corporation. The Fourth Circuit Court of Appeals appears to have construed Rhode Island law as accepting the Restatement position, noting that "an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons." *Id.* at 851 (quoting Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 93 (D.R.I. 1968)). See text accompanying note 83 *infra*.

<sup>59</sup>See Coleco Indus., Inc. v. Berman, 423 F. Supp. 275 (E.D. Pa. 1976); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968); Ryan v. Kanne, 170 N.W.2d 395 (Iowa



2. *Treatment of Attempted Limitations of Liability.*—The first reported case to deal with a departure from the standard short-form report was *Beardsley v. Ernst*,<sup>60</sup> in which Ernst & Ernst performed an audit of the International Match Corp. and issued an opinion<sup>61</sup> that was qualified due to the auditors' reliance on foreign subsidiary statements not verified by their audit. Plaintiff purchased International Match securities in reliance on these financial statements and, after International Match was declared bankrupt, filed suit against the auditors, alleging fraudulent misrepresentation. Plaintiff claimed that the auditors had certified certain facts to be true without actual knowledge of the condition of the foreign subsidiaries. Agreeing with plaintiff, the court found that under the *Ultramares* rule a cause of action for deceit would lie where the auditors certified as true facts of which they had no actual knowledge. However, in *Beardsley*, the court reasoned that because the auditors had disclosed their reliance on the unverified statements from abroad,<sup>62</sup> there was no pretense of actual knowledge, thereby negating the scienter requirement of the fraud action.<sup>63</sup>

This case is of little precedential value today, due primarily to the more rigid A.I.C.P.A. requirements regarding qualifications. The *Beardsley* qualification would undoubtedly be considered inadequate

1969); *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Ct. App. 1971). *But see* *Stephens Indus., Inc. v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971); *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505 (Fla. Dist. Ct. App. 1968); *Investment Corp. v. Buchman*, 208 So. 2d 291 (Fla. Dist. Ct. App. 1968).

<sup>60</sup>47 Ohio App. 241, 191 N.E. 808 (1934).

<sup>61</sup>The opinion read as follows:

We hereby certify that we have examined the books of account and record of International Match Corporation and its American Subsidiary company at December 31, 1929, and have received statements from abroad with respect to the foreign constituent companies as of the same date. Based upon our examination and information submitted to us it is our opinion that the annexed Consolidated Balance Sheet sets forth the financial condition of the combined companies at the date stated, and that the related Consolidated Income and Surplus Account is correct.

*Id.* at 243, 191 N.E. at 809.

<sup>62</sup>"The language used in these certificates gives rise to the indisputable inference that the accountants had not examined the books and records of the foreign constituent companies." *Id.* at 245, 191 N.E. at 810.

<sup>63</sup>The RESTATEMENT OF TORTS § 526 (1938) gave the three accepted forms of scienter required for misrepresentation in the business context:

(a) knows or believes the matter to be otherwise than as represented, or (b) knows that he has not the confidence in its existence or non-existence asserted by his statement of knowledge or belief, or (c) knows that he has not the basis for his knowledge or belief professed by his assertion.

Compare RESTATEMENT (SECOND) OF TORTS § 526 (1976).

by today's standards, particularly in view of the fact that the auditors had not taken an explicit exception in the opinion paragraph.<sup>64</sup> In order to avoid imposing liability, the court was forced to "infer" the required disclosure.

In a more recent case dealing with a qualification, *C.I.T. Financial Corp. v. Glover*,<sup>65</sup> a lending institution, in reliance on audited statements by defendant-accountants, loaned Manufacturers Trading Corp. considerable funds over a period of several years. The corporation's business consisted in part of "purchasing" commercial receivables, relying primarily on the borrower's collateral rather than his overall financial stability because of the shaky position of most debtors. Crucial to the success of this venture was an accurate appraisal of such collateral, which was an extremely difficult task. The corporation's early success was in large part due to the particular genius of one of its officers in appraising collateral. During the course of their audit, the accountants learned of this situation and, recognizing their inability to properly appraise the collateral, issued a qualified opinion.<sup>66</sup> After the corporation was declared bankrupt, the lender filed suit against the auditors, claiming that the auditors had been negligent in conducting pre- and post-loan audits and by concealing the overvalued receivables of the corporation.

Plaintiff claimed that although proper disclosure had been made as to the method of valuing the underlying collateral, no such disclosure was made as to the general collectibility of the receivables, most of which were grossly overvalued. The auditors subsequently prevailed, arguing that the corporation had not relied upon the overall financial stability of the borrowers (or the face value of the receivable) but rather only upon the supporting collateral, and this reliance was appropriately disclosed. The Second Circuit Court of Appeals, in upholding a jury verdict for the

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<sup>64</sup>At the very least, the opinion should have contained a separate paragraph indicating their failure to audit the foreign records, the scope paragraph should have referred to this separate paragraph, and their opinion paragraph should have contained an "except for" sentence disclosing their reliance. See generally AICPA PROFESSIONAL STANDARDS, *supra* note 3, §§ 509.32-509.35.

<sup>65</sup>224 F.2d 44 (2d Cir. 1955).

<sup>66</sup>The opinion read as follows:

While it is not within our province to pass upon or assume responsibility for the legal or equitable title to the commercial receivables purchased by the companies or the valuation of any security thereto accepted and held by them, it was apparent from their books and records and by opinion of counsel, that their contractual and assignment forms are adequate for their legal protection in connection with the collection and liquidation of commercial receivables purchased.

*Id.* at 46 (emphasis added).



auditors, ruled that a jury could have reasonably found that the dichotomy between the face value of the receivable and the appraised value of the collateral was meaningless and that the method of valuation had been adequately disclosed. This finding upheld the auditors' assertion that the qualification as to valuation of the collateral extended to the face value of the receivable as well.<sup>67</sup>

It is difficult to assess the overall adequacy of the auditors' qualification in *Glover*, since the court's opinion only reproduced a limited portion of the qualification. In all probability, the portion reproduced was the explanatory paragraph in which case the A.I.C.P.A.'s requirements would now demand considerably more disclosures than those made. The reasons for the qualification should have been set forth more clearly, rather than merely stating: "[I]t is not within our province . . ."<sup>68</sup> The degree of reliance that the corporation placed on the valuation of the supporting collateral and its relationship to the ultimate collectability of the receivables should also have been disclosed.<sup>69</sup> Finally, the auditors should have noted the impact on the overall stability of the corporation if a considerable number of the receivables had proved uncollectible.<sup>70</sup>

In *Stephens Industries, Inc. v. Haskins & Sells*,<sup>71</sup> two car-rental companies retained the defendant-accountants to determine their net worth and to conduct an audit in anticipation of the sale of the two companies. The audit was initiated pursuant to the purchase agreement between plaintiff and the companies, the terms of which specifically provided that accounts receivable were not to be adjusted to reflect uncollectible accounts.<sup>72</sup> In reliance on the audited statements, plaintiff purchased a two-thirds interest in the two companies. After both companies failed, plaintiff filed suit against the accountants, claiming that the audited statements misrepresented the value of both companies' accounts receivable. The accountants disclosed the failure to adjust accounts receivable in a footnote to the balance sheet and qualified their opinion in this respect.<sup>73</sup>

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<sup>67</sup>*Id.*

<sup>68</sup>AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.35.

<sup>69</sup>*Id.* §§ 509.32-509.34.

<sup>70</sup>*Id.* § 509.33.

<sup>71</sup>438 F.2d 357 (10th Cir. 1971).

<sup>72</sup>The contract provided in part: "[A]ccounts receivable as shown by the records of such corporations, shall be used in determining net worth without adjustment to reflect the fact that the auditors may feel certain accounts are or may be uncollectible in whole or part." *Id.* at 358.

<sup>73</sup>The scope paragraph of their opinion read as follows:

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, excepting that in accordance with your instructions we

Plaintiff claimed that the auditors had failed to disclose the questionable nature of the accounts receivable and were therefore liable for misrepresenting the financial condition of the companies. The court rejected this argument, noting that both the auditors' opinion and the balance sheet footnote had adequately disclosed the failure to adjust accounts receivable for uncollectibles. Hence, the court found that the auditors had not consciously concealed crucial information and had exercised the required degree of care and competence demanded of the accounting profession in communicating the relevant information.<sup>74</sup>

The court's opinion can be read as holding that if an auditor's qualification is sufficiently clear and adequately discloses the nature of the problem, he will be absolved from liability. At the same time, it should be noted that the auditors' defense in *Stephens Industries* was considerably strengthened by a clause in the contract-to-sell that specifically excluded accounts receivable from the audit verification.

In *MacNerland v. Barnes*,<sup>75</sup> Airways Rent-A-Car retained defendant-accountant Barnes to prepare its financial statements prior to a sale of its stock. The financial statements overstated seller's accounts receivable by \$45,000. However, Barnes issued a disclaimer of opinion based on his lack of independence from the client.<sup>76</sup> The stock purchasers brought suit claiming, *inter alia*, that Barnes had been negligent in his preparation of the financial statements due to his failure to disclose known discrepancies in the client's accounts receivable.

The Georgia Court of Appeals reversed the trial court's summary judgment in favor of Barnes, but stated that an accountant would not be liable to third parties not in privity for mere negligence in preparing financial statements containing an express disclaimer, absent specific undertakings by the accountant that were inconsistent with the disclaimer. The court remanded the case for a

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did not request any of the customers to confirm their balances nor did we review the collectibility of any trade accounts receivable.

*Id.* at 360-61 n.1.

A note attached to the balance sheet under accounts receivable disclosed the following: "The balance shown on the balance sheets is the total of the daily accounts receivable records of the companies and has not been adjusted to reflect uncollectible accounts, the amount of which was not determined at December 31, 1964." *Id.*

<sup>74</sup>*Id.*

<sup>75</sup>129 Ga. App. 367, 199 S.E.2d 564 (1973).

<sup>76</sup>The disclaimer read: "Disclaimer of opinion. We are not independent with respect to Airway's Rent-A-Car of Atlanta, and the accompanying balance sheet as of March 31, 1970 and the related statement of income and accumulated deficit for the three months then ended were not audited by us; accordingly, we do not express an opinion on them." *Id.* at 370, 199 S.E.2d at 566.



jury determination of whether Barnes had agreed with plaintiff to verify certain major accounts in which case the disclaimer would presumably be ineffective, at least as to those accounts.<sup>77</sup>

The *Barnes* holding was explored in greater detail in *Ryan v. Kanne*,<sup>78</sup> which involved a suit by two accountants to collect their auditing fees and a counterclaim by the defendant-corporation against the auditors for negligent misrepresentation. James Kanne had retained the auditors to certify the financial statements of his lumber supply business, which he operated as a sole proprietorship. When the accountants were hired, Kanne specifically instructed them to pay particular attention to accounts payable-trade and to use every possible method to verify the balances. The auditors were also informed that the financial statements would be used to obtain financing or to incorporate. The auditors completed their audit and submitted to Kanne financial statements headed "Unaudited Statement."<sup>79</sup> The auditors' cover letter accompanying the statements read as follows:

Accounts Payable-Trade. Confirmations were used to arrive at the balance due at the date of the balance sheet. The payee of each check issued during 1965 and the latter part of calendar year 1964 was contracted [sic] to confirm if a balance was due at September 30, 1965. Also, a review of unpaid statements was made.<sup>80</sup>

The auditors also made oral representations that accounts payable-trade would be accurate to within \$5,000 of the balance sheet amount. In reliance on these statements, the proprietorship was incorporated and defendant Kanne Lumber Supply Company took over its assets and liabilities. A later audit of the corporation showed that the accounts payable-trade were understated by \$33,689.22. Furthermore, the auditors had failed to check a considerable number of unpaid invoices, contrary to the representations made in their cover letter.

In upholding a judgment for the defendant-corporation on its counterclaim, the Iowa Supreme Court discussed the effect of the disclaimer, noting that the auditors' "liability must be dependent upon their undertaking, not their rejection of dependability. They

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<sup>77</sup>*Id.* at 372, 199 S.E.2d at 567.

<sup>78</sup>170 N.W.2d 395 (Iowa 1969).

<sup>79</sup>The A.I.C.P.A. requires that a disclaimer of opinion must accompany all the unaudited financial statements. AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 516.04. For further discussion of unaudited financial statements, see notes 88-96 *infra* and accompanying text. The *Ryan* court indicated that a disclaimer was in fact issued; however, it was not reproduced in the court's opinion.

<sup>80</sup>170 N.W.2d at 398.

cannot escape liability for negligence by a general statement that they disclaim [the report's] reliability."<sup>81</sup>

These cases point out that auditors cannot insulate themselves from liability by a general disclaimer and at the same time make contrary representations as to specific items. If auditors have agreed to verify particular items or represent that they have done so, a general disclaimer of opinion will be no defense, at least as to errors in the specified items.<sup>82</sup> Care should also be taken in drafting cover letters to be attached to financial statements. If a cover letter contains ambiguous or inconsistent representations regarding the nature or scope of the examination, this could be construed to be inconsistent with the disclaimer, thereby negating the effect of the disclaimer as to the stated items. Finally, auditors should clearly spell out the nature of their engagement immediately after accepting the assignment in order to avoid later disagreements as to the scope of their undertaking.

Another recent case dealing with an attempted limitation of common law liability is *Rhode Island Hospital Trust National Bank v. Swartz, Bresenoff, Yavner & Jacobs*.<sup>83</sup> International Trading Corp. retained the defendant-auditors to audit its records and certify its financial statements, as required by the terms of a loan agreement with the plaintiff-bank. The financial statements prepared by the corporation reflected a capitalized expenditure of \$212,000 for leasehold improvements at various facilities in Florida, Georgia, and Rhode Island. In fact, no such improvements had been made, and the amount capitalized represented ordinary operating expenses, the effect of which was to overstate assets and net income. Had the expenses been properly recorded, the corporation would have reported a loss for the year rather than the reported gain. During the course of the audit, the auditors noticed considerable discrepancies between the alleged assets and the supporting cost records. In the explanatory paragraph preceding their disclaimer,<sup>84</sup> the auditors disclosed the problems encountered in auditing the cost records of the nonexistent leasehold improvements as follows:

*Additions to fixed assets in 1963 were found to include principally warehouse improvements and installation of*

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<sup>81</sup>*Id.* at 404.

<sup>82</sup>*Id.* (citing *C.I.T. Financial Corp. v. Glover*, 224 F.2d 44 (2d Cir. 1955)).

<sup>83</sup>455 F.2d 847 (4th Cir. 1972). See note 58 *supra*.

<sup>84</sup>Defendant's disclaimer read as follows: "Because of the limitations upon our examination expressed in the preceding paragraphs and the material nature of the items not confirmed directly by us, we are unable to express an opinion as to the fairness of the accompanying statements." 455 F.2d at 850.



machinery and equipment . . . . Practically all this work was done by company employees and materials and overhead was borne by International Trading Corporation and its affiliates. Unfortunately, fully complete detailed cost records were not kept of these capital improvements and no exact determination could be made as to the actual cost of said improvements.<sup>85</sup>

Plaintiff-bank, in reliance on the audited financial statements, extended additional money to the corporation, and subsequently initiated this suit against the auditors when the corporation became unable to repay.

The district court dismissed the complaint, ruling that the bank had failed to establish misrepresentation or negligence by the accountants in their audit. The Fourth Circuit Court of Appeals reversed as to the negligence issue and rejected the auditors' defense based upon the disclaimer. The court examined in detail the wording of the disclaimer and the explanatory paragraph, noting that the disclaimer followed other references that expressed the auditors' reservations as to the value of the leasehold improvements *but not* as to their existence. In addition, the auditors' cover letter stated, as a reason for the disclaimer, that adequate cost records had not been kept as to the leasehold improvements, when, in fact, no cost records ever existed. The court ruled that both these disclosures were inadequate to convey the required information and absolve defendant from liability.<sup>86</sup>

There were two principal flaws in the auditors' disclaimer. First, the explanatory paragraph did not adequately explain the reasons for issuing a disclaimer when it failed to disclose the total absence of cost records, thereby creating the impression some records were kept. Second, the explanatory paragraph, disclaimer paragraph, and the cover letter all conveyed the impression that the leasehold assets did exist and had *some* value when in reality they did not.<sup>87</sup> The *Rhode Island Trust* opinion again points out that extra care should be taken in drafting explanatory paragraphs and cover letters so as to maximize disclosure and minimize the chances of creating false impressions, since courts will carefully scrutinize the wording of these statements.

Even when an accountant is retained to conduct services other than an audit, he may be subject to liability for inaccuracies under special circumstances if he is deemed to be "associated with" the

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<sup>85</sup>*Id.* at 849 (emphasis added).

<sup>86</sup>*Id.* at 852.

<sup>87</sup>*Id.*

financial statements. This situation most commonly occurs when an accountant is retained to prepare unaudited financial statements.<sup>88</sup> The minimum A.I.C.P.A. standards require all unaudited financial statements that an accountant is "associated with" to carry a disclaimer clearly indicating that no audit has been conducted.<sup>89</sup>

*Stanley L. Bloch, Inc. v. Klein*<sup>90</sup> illustrates the effect of an accountant's failure to comply with these minimal requirements. In *Bloch*, the defendant-accountants prepared and issued financial statements on their stationery with no opinion attached. In a subsequent suit by the disappointed client, the court noted that A.I.C.P.A. standards minimally require an accountant to attach an opinion or disclaimer to a financial statement.<sup>91</sup> Because the accountants had failed to disclaim or qualify their nonexistent opinion, the court assumed that the accountants had intended to issue an unqualified opinion and imposed liability for the accountants' failure to physically verify the client's inventory as required by contemporary professional standards.<sup>92</sup> Accordingly, accountants should take care to append a disclaimer of opinion whenever there is a possibility of being "associated with" financial statements. As shown by *Bloch*, this is true even when statements are prepared only for internal use by the client.

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<sup>88</sup> The A.I.C.P.A. deems an accountant to be "associated with" unaudited financial statements

when he has consented to the use of his name in a report, document, or written communication setting forth or containing the statements. Further, when a certified public accountant submits to his client or others, with or without a covering letter, unaudited financial statements which he has prepared or assisted in preparing, he is deemed to be associated with such statements. This association is deemed to exist even though the certified public accountant does not append his name to the financial statements or uses "plain paper" rather than his own stationery.

AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 516.03. An auditor is deemed not to be "associated with" the financial statements *only* when he was not involved in their preparation, reproduces them on "plain paper," and only submits the statements to his client. *Id.* § 516.03.

<sup>89</sup>*Id.* § 516.04. It follows from the nature of the financial statements that the auditor probably will not be in a position to express an opinion as to their conformity with GAAP. However, if the accountant is aware of nonconforming items, he must insist that his client make the required changes, or, if the client refuses, the accountant should clearly note the departures from GAAP in his disclaimer. *Id.* §§ 516.06-516.07. See also 1136 *Tenants Corp. v. Max Rothenberg & Co.*, 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971) (accountant hired only to do write-up work had a duty to report material irregularities discovered during the course of preparing the statements).

<sup>90</sup>45 Misc. 2d 1054, 258 N.Y.S.2d 501 (Sup. Ct. 1965).

<sup>91</sup>*Id.* at 1058, 258 N.Y.S.2d at 506.

<sup>92</sup>*Id.* at 1058, 258 N.Y.S.2d at 506-07. However, the court went on to hold the accountants liable only for auditing fees, ruling that the client failed to establish that further damages were proximately caused by the accountants' negligence. *Id.* at 1060, 258 N.Y.S.2d at 508.



In *Coleco Industries, Inc. v. Berman*,<sup>93</sup> the court discussed the extent of an accountant's responsibilities when associated with unaudited reports. In *Coleco*, the defendant-accountants were retained to prepare unaudited financial statements prior to plaintiff's purchase of a business. The accountants made several errors of varying significance in the preparation of the statements. In the suit that followed, the accountants raised the defense that there could be no liability imposed for errors contained in unaudited financial statements, but the court rejected this argument and held them liable for negligent preparation of the financial statements.<sup>94</sup> Of particular significance was the court's finding that the mistakes were only simple mathematical errors. In a footnote, the court stated that when mechanical errors are made, no differing standard should be applied to audited and unaudited financial statements, since in both cases, parties can reasonably assume that accountants will correctly perform simple mathematical functions.<sup>95</sup> A moderately liberal reading of *Coleco* could lead to the conclusion that an accountant cannot escape liability for unaudited financial statements containing erroneous items that would be discoverable or correctable without an audit.<sup>96</sup>

3. *Conclusion: Common Law Liability.*—Taking the above cases together, some general conclusions can be drawn regarding the effects of qualifications and disclaimers at common law. There is a noticeable trend in recent cases to examine in detail the specific working of the disclaimer or qualification and to judge the adequacy of the disclosure in light of the situation in its fully developed form, rather than in the position of the auditor at the time the opinion was issued. This puts considerably more pressure on the auditor to closely examine the situation in determining what to disclose and how to disclose it.

Auditors should not rely solely upon their opinions or disclaimers to reveal potential problem areas but should attempt to disclose the required information in as many places as possible—in footnotes, cover letters, and explanatory paragraphs to the auditors' opinion. Auditors must, however, avoid equivocal or contradictory representations in cover letters, explanatory paragraphs, and

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<sup>93</sup>423 F. Supp. 275 (E.D. Pa. 1976).

<sup>94</sup>*Id.* at 310.

<sup>95</sup>*Id.* nn.59 & 60. The court stated: "[W]e believe even the most restricted undertaking would impose on [the accountant] a duty to multiply correctly and to make overhead deductions from inventory that can be simply computed." *Id.* n.59.

<sup>96</sup>An interesting case involving "associated with" liability that defies categorization is *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976). In *Bonhiver*, liability was imposed upon accountants for negligence when third parties relied upon erroneous items in the accountants' *working papers*.

disclaimer paragraphs, as well as in oral statements that tend to negate or overshadow the qualification or disclaimer. In addition, auditors should take care to clearly spell out the nature and extent of their engagement to the client as soon as possible after acceptance of the assignment.

When drafting reports, auditors would be wise to note specific departures from GAAS, rather than enumerating procedures actually performed and leaving to inference procedures not followed. *Rhode Island Trust* illustrates the dangers created by the latter when courts scrutinize the auditor's opinion in light of the fully developed circumstances.

### *B. Treatment of Qualifications and Disclaimers Under the Securities Laws*

1. *Introduction.*—Auditors are brought under the purview of the Securities and Exchange Commission through the disclosure requirements of the Securities Acts of 1933 and 1934.<sup>97</sup> The 1933 Act requires initial public offerings of securities to be accompanied by certified financial statements both in the registration statement filed with the SEC<sup>98</sup> and in the prospectus sent with the stock.<sup>99</sup> The 1934 Act provides for initial registration and continuous filing of reports that generally must contain certified financial statements.<sup>100</sup>

The threshold question involving qualifications and disclaimers under the securities laws is not whether they serve as a basis for insulating the auditor from liability but whether the reporting requirements of the Acts are satisfied when such limitations are present. Accordingly, the bulk of this discussion distinguishes the types of qualifications that are acceptable and the types that fail to satisfy the reporting requirements of the 1933 and 1934 Securities Acts.

Section 11<sup>101</sup> of the 1933 Act, sections 18<sup>102</sup> and 10(b)<sup>103</sup> of the 1934 Act and rule 10b-5<sup>104</sup> provide methods by which third-party suitors and the SEC may proceed against accountants for their part in filing false or misleading financial statements with the Commission. In addition, if an auditor certifies financial statements and the report fails to satisfy the disclosure requirements of the 1933 or 1934 Acts, the SEC has the power to initiate disciplinary proceedings against

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<sup>97</sup>15 U.S.C. §§ 77(a)-(aa), 78(a)-(jj) (1976).

<sup>98</sup>*Id.* § 77(g).

<sup>99</sup>*Id.* § 77(j).

<sup>100</sup>*Id.* § 78(m)(a)(2).

<sup>101</sup>*Id.* § 77k(a).

<sup>102</sup>*Id.* § 78(r).

<sup>103</sup>*Id.* § 78(j).

<sup>104</sup>17 C.F.R. § 240.10b-5 (1977).



the auditor that could result in temporary or permanent denial of the privilege to practice before the Commission.<sup>105</sup>

In general, the SEC has not promulgated specific auditing standards or procedures to be followed by auditors certifying financial statements under the securities laws, but it has left the development of standards and procedures to the accounting profession.<sup>106</sup> Consequently, A.I.C.P.A. standards play a major role in determining the adequacy of the financial statements and supporting opinions filed with the Commission. However, the SEC does require certain items to appear in all auditor's reports filed with the Commission.<sup>107</sup>

2. *SEC Treatment of Qualifications and Disclaimers.*—The effect of a disclaimer under the securities laws is fairly easy to determine. Both the 1933 and 1934 Acts require financial statements filed with the SEC to be certified.<sup>108</sup> "Certified," in the context of financial statements, is defined as "examined and reported upon with an opinion expressed by an independent public or certified public accountant."<sup>109</sup> In addition, the S-X regulations contain an implicit assumption that an opinion will be expressed.<sup>110</sup> Since the securities laws

<sup>105</sup>*Id.* § 201.2(e).

<sup>106</sup>This policy was first announced in McKesson & Robbins, Inc., Accounting Series Release No. 19, 5 FED. SEC. L. REP. (CCH) ¶ 72,020 (1940).

<sup>107</sup>17 C.F.R. § 210 (1977). The required contents of an auditor's report (opinion) are:

(a) *Technical requirements.* The accountant's report (1) shall be dated; (2) shall be signed manually; (3) shall indicate the city and State where issued; and (4) shall identify without detailed enumeration the financial statements covered by the report.

(b) *Representations as to the audit.* The accountant's report (1) shall state whether the audit was made in accordance with generally accepted auditing standards; and (2) shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission. Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this section.

(c) *Opinion to be expressed.* The accountant's report shall state clearly: (1) The opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and (2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(d) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

*Id.* § 210.2-02.

<sup>108</sup>15 U.S.C. §§ 77(g), (j) (1976).

<sup>109</sup>17 C.F.R. § 210.1-02(f) (1977).

<sup>110</sup>*Id.* § 210.2-02(c).

require an opinion to be expressed, a disclaimer of opinion is unacceptable, because such a disclaimer states that the auditor does not express an opinion on the financial statements.<sup>111</sup>

The effects of qualifications and footnote disclosures are considerably more complicated and can be broken down into a number of areas. The SEC dealt with qualifications and footnote disclosures due to departures from GAAP as early as 1938.<sup>112</sup> The SEC stated that financial statements that are prepared using accounting principles for which there is "no substantial authoritative support"<sup>113</sup> will be presumed to be misleading or inaccurate, notwithstanding full disclosure in the auditor's opinion or in the footnotes of the financial statements. Clearly, departures from GAAP should be avoided or, if the client refuses to comply, the auditor should disassociate himself from the financial statements.

A qualification arising due to limitations on the scope of an audit is a bit more involved. The SEC addressed this question in Accounting Series Release No. 90.<sup>114</sup> The question arose in the context of a "first time" audit exception taken by auditors.<sup>115</sup> The Commission noted that since it was impossible to physically verify beginning inventories in the first-time audit situation, GAAS do not require such verification. However, the Commission stated that alternative means should be employed to determine the accuracy of the inventories. If such alternative procedures are applied and the auditor is in a position to express an affirmative opinion, an exception due to a failure to physically verify beginning inventories should be unnecessary.<sup>116</sup> The principal restriction imposed by Accounting Series Release No. 90 is that qualifications due to material scope limitations on the audit are unacceptable in reports filed with the Commission.

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<sup>111</sup>See note 37 *supra*. See also *SEC v. Beisinger Indus. Corp.*, 421 F. Supp. 691, 695 n.11 (D. Mass. 1976).

<sup>112</sup>Accounting Series Release No. 4, 5 FED. SEC. L. REP. (CCH) ¶ 72,005 (1938).

<sup>113</sup>"Substantial authoritative support" is the SEC's definition of GAAP. The SEC has traditionally left the promulgation of GAAP to the accounting profession. See Accounting Series Release No. 150, 5 FED. SEC. L. REP. (CCH) ¶ 72,172 (1973).

<sup>114</sup>Accounting Series Release No. 90, 5 FED. SEC. L. REP. (CCH) ¶ 72,112 (1962).

<sup>115</sup>GAAS require physical observation of inventories. A problem arises during a first-time audit because verification of beginning inventories is impossible when the auditor is not retained until year-end. See *McKesson & Robbins, Inc.*, Accounting Series Release No. 19, 5 FED. SEC. L. REP. (CCH) ¶ 72,020 (1940).

<sup>116</sup>The SEC reasoned that the certificate must state whether the audit complied with GAAS and whether it included the necessary tests of accounting records. Accounting Series Release No. 90, 5 FED. SEC. L. REP. (CCH) ¶ 72,112 (1962) (construing 17 C.F.R. § 210.2-02(b)(1) (1961)). If the certificate contains this statement, a qualification due to failure to observe physical inventories is unacceptable and contradictory, since the auditor must have satisfied himself as to the accuracy of the inventories by some other means before he can certify that he complied with GAAS. *Id.*

For further treatment of scope limitations, see Accounting Series Release No. 62,



Uncertainties that cannot be resolved as of the statement date present another area where qualifications can arise. Uncertainties arising due to a need for additional financing were addressed in Accounting Series Release No. 115.<sup>117</sup> The auditor's report disclosed that, due to prior years' losses, continued operation of the business was in jeopardy unless additional financing could be obtained. A qualified opinion was issued, due to the need for additional funds to finance current operations.<sup>118</sup> The Commission found the financial statements defective, reasoning that rule 2-02<sup>119</sup> requirements regarding auditor's opinions are not satisfied where financial statements are prepared on a "going concern" basis and the auditor's opinion is so qualified as to indicate serious doubt as to whether such an assumption of "going concern" status is appropriate. Presumably, a qualification would be acceptable if the immediate threat to "going concern" status has been removed by a firm commitment of funds from such sources as banks or public offerings (if adequate funds are anticipated); however, this information should be disclosed in a separate explanatory paragraph. Accounting Series Release No. 115 renders "open ended" qualifications, such as "subject to obtaining additional financing," unacceptable to the SEC, at least if there is an immediate threat to continued operations without a commitment for such funds.<sup>120</sup>

*Resource Corp. International*<sup>121</sup> addressed a more generalized question regarding qualifications, namely, how extensive a qualification may be and still satisfy the requirements of the 1933 and 1934 Acts. Resource Corp. International was organized to acquire financing for the purchase of Mexican timberlands. The accountants who

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5 FED. SEC. L. REP. (CCH) ¶ 72,081 (1947); Barrow, Wade, Guthrie & Co., Accounting Series Release No. 67, 5 FED. SEC. L. REP. (CCH) ¶ 72,086 (1949) (SEC disciplinary proceeding pursuant to 17 C.F.R. § 201.2(e) (1977) initiated against auditors issuing a qualified opinion for failure to verify working process).

<sup>117</sup>Accounting Series Release No. 115, 5 FED. SEC. L. REP. (CCH) ¶ 72,137 (1970). For additional discussion regarding treatment of uncertainties arising in financial statements filed with the Commission, see Accounting Series Release No. 166, 5 FED. SEC. L. REP. (CCH) ¶ 72,188 (1974); Accounting Series Release Interpretations, Topic 6(E), 5 FED. SEC. L. REP. (CCH) ¶ 74,151 at 62,843 (1974).

<sup>118</sup>See AICPA PROFESSIONAL STANDARDS, *supra* note 3, §§ 509.21-509.26, for the A.I.C.P.A. form and opinion content requirements.

<sup>119</sup>17 C.F.R. § 210.2-02 (1977), reprinted in note 107 *supra*.

<sup>120</sup>For a case dealing with uncertainties due to management's use of sales and cost reduction estimates in financial statements, see Accounting Series Release No. 173, 5 FED. SEC. L. REP. (CCH) ¶ 72,195 (1975). The case notes that the issuance of a qualified opinion due to uncertainties does not absolve the auditor from responsibility for performing adequate audit tests and obtaining documentation of management's assessment of the outcome of the uncertainty—at least in cases where the uncertainty is such that a reasonable assessment can be made.

<sup>121</sup>7 S.E.C. 689 (1940).

were retained to audit the corporation and prepare its SEC filing papers qualified their certificate extensively.<sup>122</sup> The SEC ruled that the auditor's certificate failed to satisfy the rule 2-02 requirements of a "certified" report<sup>123</sup> because the effect of the extensive qualification was that the accountants expressed an affirmative opinion as to only \$35,000 of over \$9,000,000 in total assets.<sup>124</sup> This ruling indicates that when a qualification is so pervasive as to effectively negate the overall affirmative opinion, the Commission will consider the financial statements to be uncertified and thus defective.

In *Associated Gas & Electric Co.*,<sup>125</sup> the SEC was called upon to determine the adequacy of financial statements and supporting auditor's opinions filed over a period of several years. The auditors' opinions contained incredibly complicated and verbose qualifications and footnote disclosures regarding the treatment of various items by Associated Gas.<sup>126</sup> In determining the adequacy of the disclosures,

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<sup>122</sup>The auditor's opinion was as follows:

Investments in capital stocks of subsidiary companies and in Mexican timber tracts were recorded by the issuer on the basis of the liability (\$1,650,000) which it agreed to assume and the value assigned by the board of directors (\$7,350,000) to 735,000 shares of its capital stock issued in connection with the acquisition of these assets October 15, 1931. Mr. H.S. Hoover has represented that the cost to him of his equity in these assets for which he received 735,000 shares of capital stock was approximately \$359,154. Subsequent to October 15, 1931, Mr. H.S. Hoover secured a reduction of \$487,860, without cost to him, in the amount of the liabilities assumed by the issuer at that date and 52,536 additional shares of capital stock of the issuer were issued to him in connection therewith. The issuer in 1937 issued 68,542 shares of its capital stock to Mr. B.L. Hoover or his nominee at a declared value of \$10 per share in settlement of \$685,420 principal amount of purchase contract obligations acquired by him from vendors for a cash consideration of \$217,700, which cash was advanced to him by Mr. H.S. Hoover. The issuer represents that Mr. B.L. Hoover is not an affiliated interest.

The investments of the issuer in Mexican timber tracts, including those owned by subsidiaries, represent practically its sole assets. As auditors, it is not possible for us to make any determination of the value of such assets. Consequently we are not in a position to express an opinion with respect to the accompanying balance sheet that embraces the matter of value assigned therein to those assets and to the stated capital or the accounting principles followed in connection therewith. The remaining items on the issuer's balance sheet at November 30, 1937, together with supporting schedules referred to in connection therewith are, in our opinion, fairly stated thereon in accordance with accepted principles of accounting.

*Id.* at 739.

<sup>123</sup>17 C.F.R. § 210.2-02 (1977), *reprinted in* note 107 *supra*.

<sup>124</sup>7 S.E.C. at 739.

<sup>125</sup>11 S.E.C. 975 (1942).

<sup>126</sup>The opinions issued for a single year were too long to reproduce in a footnote; however, for those readers possessed of strong eyes or a magnifying glass, the opinions can be found in an appendix to the case. *Id.* at 1063 app.



the SEC examined each qualification and disclosure from two viewpoints: First, it examined each disclosure in detail for clarity, compliance with GAAP, and adequacy in relation to its purpose; and second, the Commission examined the financial statements as a whole to determine in light of all circumstances whether the statements conveyed all the required information in an understandable manner.<sup>127</sup> The Commission ultimately ruled that the financial statements did not meet the certification requirements and accordingly were defective. The most important point to be drawn from the case is the SEC's view that compliance with GAAP and A.I.C.P.A. disclosure requirements is not enough; rather, the information must also adequately inform the average investor.<sup>128</sup> The SEC noted that too many qualifications in the auditor's opinion may in some cases indicate that the scope of the audit was inadequate, thereby prohibiting the expression of an opinion or alternatively, as in *Resource Corp. International*, negating the overall opinion expressed.<sup>129</sup> In either case, the rule 2-02 requirements will not be satisfied.

The Commission, in *Thomascolor Inc.*,<sup>130</sup> elaborated on the requirements for adequate disclosures in financial statements. Thomascolor's business consisted of processing color films, and its principal assets were patents on a "new" color process (which was in fact old and filled with technical flaws). The central dispute in the SEC proceeding involved the valuation method applied to the patents and the adequacy of the disclosure of the patents' cost basis. Footnotes to the financial statements only partially disclosed the

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<sup>127</sup>"We believe that, in addition to the question whether the individual items of financial statements are stated in accordance with accounting principles, practices, and conventions, there must be considered the further question whether, on an overall basis, the statements are informative." *Id.* at 1059.

<sup>128</sup>*Id.* at 1058-59. A number of decisions have adopted this position in civil suits, as well as criminal prosecutions. *See, e.g.,* United States v. Simon, 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970); Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968) (use of traditional installment method misleading); Herzfeld v. Laventhal, Krekstein, Horwath, & Horwath, 378 F. Supp. 112, 121 (S.D.N.Y. 1974), *aff'd*, 540 F.2d 27 (2d Cir. 1976) ("Our inquiry is properly focused not on whether [defendants'] report satisfies esoteric accounting norms, comprehensible only to the initiate, but whether the report fairly presents the true financial position of Firestone . . . to the untutored eye of an ordinary investor."). *See also* Touche, Niven, Bailey, & Smart, Accounting Series Release No. 78, 5 FED. SEC. L. REP. (CCH) ¶ 72,100, at 62,220 (1957) ("[A] public accountant whose duty it is to convey full information does not fulfill his obligation by simply giving so much as is calculated to induce requests for more.").

<sup>129</sup>11 S.E.C. at 1062.

<sup>130</sup>27 S.E.C. 151 (1947). *See also* Accounting Series Release No. 73, 5 FED. SEC. L. REP. (CCH) ¶ 72,092, at 62,184 (1952) (SEC disciplinary proceeding against auditors of Thomascolor arising out of the above activities).

cost basis for valuing the patents. However, the SEC ruled that the disclosures were inadequate and that the patents were overvalued, due to inclusion of promotional costs in the cost basis of the patents.<sup>131</sup> Of significance is the SEC's view of footnote disclosures in the financial statements:

It is not enough to say that here perhaps much (but by no means all) of the factual background forming the basis of the original patent and patent application account was given in footnote data. Significant data were not provided; but even if these had been given there is an obligation to present material in a way in which it will be useful to the informed but less sophisticated readers.<sup>132</sup>

It is by now apparent that the SEC not only requires qualifications to be understandable to the average reader, as was illustrated in *Associated Gas*, but also applies the same requirement to footnote disclosures.

Footnotes are also occasionally used to make certain types of disclosures where a qualification is deemed to be unwarranted, but some explanation is still needed.<sup>133</sup> In *F.G. Masquelette & Co.*,<sup>134</sup> an extreme example of this alternative use, the Commission brought a disciplinary proceeding<sup>135</sup> against Masquelette & Co. resulting from their audit of Health Institute, Inc., a corporation organized to erect and operate a hotel in Hot Springs, New Mexico. The corporation's principal asset, as of the filing date, was a leasehold (the site of the proposed hotel), which was valued at \$100,000 on a completely arbitrary basis with no consideration of its market value. The auditors issued an unqualified opinion on the financial statements. The only disclosure regarding the leasehold was made in a note attached to the balance sheet in which the auditors disclosed that the leasehold value was arbitrary and based on the amount of stock issued in exchange for the leasehold.

The Commission ruled that the balance sheet did not present fairly the corporation's financial position in conformity with GAAP, since valuation of an asset based upon the par value of its stock does not comply with GAAP.<sup>136</sup> The Commission further stated that

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<sup>131</sup>27 S.E.C. at 169.

<sup>132</sup>*Id.* at 170 n.17.

<sup>133</sup>Occasionally the SEC requires the use of footnote disclosures. *See, e.g.*, Accounting Series Release No. 62, 5 FED. SEC. L. REP. (CCH) ¶ 72,081 (1947) (footnote explanations required under certain circumstances in summary earnings tables).

<sup>134</sup>Accounting Series Release No. 68, 5 FED. SEC. L. REP. (CCH) ¶ 72,087 (1949).

<sup>135</sup>17 C.F.R. § 201.2(e) (1977).

<sup>136</sup>Accounting Series Release No. 68, 5 FED. SEC. L. REP. (CCH) ¶ 72,087, at 62,181 & 62,183 n.4 (1949).



the footnote disclosure did not cure this deficiency and noted: "[E]ven were the footnote to state with complete frankness the true fact that the assets were over-valued, this would not mitigate the effect of the valuation figure itself. A balance sheet item which is flatly untrue will not be rendered true merely by admission of untruth."<sup>137</sup> Thus, auditors should not rely on footnote disclosures in place of a clear qualification and explanation as to the departure from recognized standards, particularly where the item is material and the departure is extreme.<sup>138</sup>

3. *Judicial Treatment of Attempts at Limiting Liability Under Securities Laws.*—Judicial response to auditors' attempts at limiting liability under the securities laws by qualification has been minimal.<sup>139</sup> The very limited number of reported cases tend, in general, to follow the common law treatment. *Herzfeld v. Laventhol, Kreskstein, Horwath & Horwath*<sup>140</sup> is illustrative of the current judicial attitude toward qualifications and supporting footnote disclosures in the rule 10b-5<sup>141</sup> actions. Plaintiff Herzfeld was approached by representatives of Firestone Group Ltd., a California corporation primarily engaged in the purchase and resale of real estate, regarding a private placement of Firestone's securities. The focus of this suit (and the basis of plaintiff's allegations of materially misleading financial statements) was the accounting treatment given to two real estate transactions in the audited financial statements that were subsequently delivered to the plaintiff-purchaser. The transactions in question involved Firestone's purchase of twenty-three nursing homes for \$13,362,000, with \$5,000 payable during the statement year, and Firestone's contract to sell the same property to Continental Recreation Co. for \$15,393,000, with \$25,000 payable during the statement year. This purchase and resale represented the largest transaction ever entered into by Firestone.<sup>142</sup> Firestone wanted to recognize the entire profits of this proposed resale in the statement year so as to convert a \$772,108 loss into a \$1,257,892 gain with the obvious result of making their securities offering con-

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<sup>137</sup>*Id.* at 62,180 (quoting *Mining & Development Corp.*, 1 S.E.C. 786, 799 (1936)).

<sup>138</sup>The facts of this case clearly presented a situation requiring at least a qualified opinion. See AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.29.

<sup>139</sup>A number of cases have dealt with the quality of footnote disclosures in financial statements. See, e.g., *Republic Technology Fund, Inc. v. Lionel Corp.*, 483 F.2d 540, 547 (2d Cir. 1973) (footnote disclosing overall interim profit picture should have been appended to financial statements); *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838, 843 (2d Cir. 1952) (footnote should have disclosed that material increase in earnings was due to inventory adjustment during prior quarters); *SEC v. Geotek*, 426 F. Supp. 715 (N.D. Calif. 1976); *Green v. Jonhop, Inc.*, 358 F. Supp. 413 (D. Ore. 1973).

<sup>140</sup>540 F.2d 27 (2d Cir. 1976).

<sup>141</sup>17 C.F.R. § 240.10b-5 (1977).

<sup>142</sup>Sales for 1969 including this transaction would have been \$22,132,607, as opposed to \$6,739,607 without its inclusion.

siderably more attractive. However, the defendant-accountants were hesitant to recognize the total gain on the resale agreement in the 1969 statement year primarily because of its questionable compliance with GAAP.<sup>143</sup> Accordingly, defendants reported \$235,000<sup>144</sup> as gross profit and the balance of the "gain" as "deferred gross profit."<sup>145</sup> The income statement contained the following note regarding "deferred gross profit": "Of the total gross profit of \$2,030,500, \$235,000 is included in the Consolidated Income Statement and the balance, \$1,795,500, will be considered realized when the January 30, 1970 payment is received. The latter amount is included in the deferred income in the consolidated balance sheet."<sup>146</sup> The auditors'

<sup>143</sup> *APB Statement No. 4*, *supra* note 4, ¶ 150, provides in part that revenues should not be recognized until the "earnings process is complete or virtually complete" and "an exchange has taken place." Firestone had paid \$5,000 on a \$13,200,000 purchase and had received \$25,000 on a sales contract of \$15,000,000. In addition, as of the statement date, the accountants were unsure as to whether certain conditions in both sales contracts had been satisfied.

<sup>144</sup>This figure was apparently arrived at by adding the \$25,000 deposit, a \$25,000 payment due in January 1970, and \$185,000 liquidated damages for nonperformance.

<sup>145</sup>The term "deferred gross profit" is typically used in installment sales of realty to indicate the postponement of income recognition until installments are received. See D. KIESO, R. MOUTZ, & C. MOYER, *INTERMEDIATE PRINCIPLES OF ACCOUNTING* (1969); R. WIXON, W. KELL, & N. BEDFORD, *ACCOUNTANTS' HANDBOOK* (5th ed. 1970).

<sup>146</sup>540 F.2d at 31. The full text of the note read as follows:

The Firestone Group, Ltd. acquired by contract of sale a group of convalescent hospitals containing approximately 1,900 beds. The properties were leased back to the former owners. In November, 1969 the Company sold the properties by means of a contract of sale.

The terms of the contract by which The Firestone Group, Ltd. purchased the properties provide for the following:

Assumptions of existing first trust deed liens	\$ 5,822,283
Note payable, secured by second trust deed, requiring monthly amortization of principal and interest at 9¼% for 25 years	3,540,217
Cash:	
Upon contract execution	5,000
On December 20, 1969	25,000
On January 30, 1970	3,970,000
	\$ 13,362,500

The contract of sale provided for the following:

Assumption of existing trust deed liens	\$ 9,362,500
Cash:	
Upon contract execution	25,000
On January 2, 1970	25,000
On January 30, 1970	4,965,250
Note secured by trust deed in favor of The Firestone Group, Ltd. requiring monthly amortization based on twenty-five years with interest of 8½%; final payment due in 120th month	1,015,250
	\$ 15,393,000



opinion also contained the following qualification: "In our opinion, subject to collectibility of the balance receivable on the contract of sale (see note 4 of Notes to Financial Statements) the accompanying consolidated balance sheet and related consolidated statements of income and retained earnings present fairly the financial position of [Firestone] . . . ." <sup>147</sup>

A cover letter, <sup>148</sup> written by Firestone and attached to the financial statements sent to plaintiff, attempted to explain the breakdown of profit and deferred gross profit and offered any securities purchasers the right to rescind the sale if the audited financial statements caused a change in the decision to purchase. Plaintiff read the cover letter but did not read defendant's opinion or notes and decided not to exercise the right of rescission. Neither the purchase nor the sale of the nursing homes were completed, and one year later Firestone filed a petition for reorganization under the Bankruptcy Act.

In upholding a trial court verdict for plaintiff, the Second Circuit Court of Appeals ruled that the auditors' report was materially misleading. The report included the purchase-resale transaction without adequate disclosure of all material facts of the transaction, and the financial statements had been drafted to improperly recognize certain forms of income. <sup>149</sup> The court ruled that the

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The sales agreement also provides for liquidated damages of \$185,000 if the buyer fails to perform.

Of the total gross profit of \$2,030,500, \$235,000 is included in the consolidated income statement and the balance, \$1,795,500, will be considered realized when the January 30, 1970 payment is received. The latter amount is included in deferred income in the consolidated balance sheet.

378 F. Supp. 112, 124 (S.D.N.Y. 1974).

<sup>147</sup>540 F.2d at 31.

<sup>148</sup>The cover letter attached to the audited financial statement read as follows: One transaction which is reflected in the November 30 audited financial statements has been treated as producing deferred gross profit rather than current gross profit. While the combination of current and deferred income is actually higher than projected (\$1,411,557 as compared with \$1,360,000 projected) the shift of \$1,795,500 of gross profit on this transaction from a current basis to deferred basis by the auditors has reduced current net income below that originally projected. . . .

Deferred income shown on the audited balance sheet has been increased to \$2,834,133 as against \$1,421,000 projected. A breakdown of the components of the deferred income account is shown in the audited financial statements. . . . If for any reason you find that the changes reflected in the audited financial statements are of a nature which would have resulted in a change in your investment decision, we will arrange to promptly refund to you your subscription payment.

*Id.* at 32.

<sup>149</sup>*Id.* at 35.

auditors' qualification was defective, due to a failure to include the true nature and circumstances of the purchase-resale transaction, failure to explain the basis for determining the \$235,000 gain, and failure to adequately disclose the reasons for the qualification.<sup>150</sup> The court also noted that plaintiff's failure to read the notes or opinion was irrelevant because of their inadequate and deceptive character.<sup>151</sup> It is clear from *Herzfeld* that in an action arising under the securities laws the courts will demand a high degree of disclosure in qualifications and will closely scrutinize the opinion in light of surrounding transactions to determine if this standard has been met. In addition, although the *Herzfeld* court referred to A.I.C.P.A. standards on disclosure, the court judged the adequacy of the contested disclosure on its understandability to the average reader.<sup>152</sup>

4. *Conclusion: Securities Laws.*—Some general conclusions can be drawn regarding qualifications and disclaimers under the securities laws. It is fairly clear that the presence of a disclaimer of opinion in an auditor's report will render the filing defective under the securities laws. In general, qualifications and footnote disclosures arising from departures from GAAP are unacceptable, as are qualifications due to scope limitations and "open ended" qualifications due to need for additional financing. In any case, where extensive qualifications are present there is always a chance the SEC will treat the pervasiveness of the qualification as negating the overall affirmative opinion or will possibly raise questions as to the adequacy of the audit. Qualifications and footnote disclosures should not be relied upon to rectify clearly inadequate or misleading

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<sup>150</sup>The district court listed ten items which, in its opinion, should have been disclosed in order to eliminate the misleading nature of the statements. 378 F. Supp. at 125-26. The court of appeals disagreed, ruling that the principal flaw in the financial statements was the recordation of the purchase-resale transaction as complete during fiscal year 1969. 540 F.2d at 37. The court also noted that the explanatory paragraph of the auditors' opinion failed to meet minimum A.I.C.P.A. standards. The court cited A.I.C.P.A., STATEMENTS ON AUDITING PROCEDURE, *AICPA Statement No. 33*, at 16 (1963), reprinted in AICPA PROFESSIONAL STANDARDS, *supra* note 3, § 509.32, as requiring complete disclosure of the reasons for the qualification. The court noted that this requirement could have been easily satisfied and suggested that the following disclosure would have been sufficient: "Agreements for the purchase of Monterey Nursing Inns, Inc. for \$13,362,500 and the sale thereof to Continental Recreation, Inc. for \$15,393,000, have been executed. When, as and if these transactions are consummated, FGL expects to realize a profit of \$2,030,500." 540 F.2d at 36.

<sup>151</sup>540 F.2d at 37.

<sup>152</sup>"[I]nvestors [should] be provided 'with all the facts needed to make intelligent investment decisions [which] can only be accomplished if financial statements fully and fairly portray the actual financial condition of the company.'" *Id.* at 32-33 (quoting the district court).



disclosures made in the financial statements. When evaluating qualifications and footnote disclosures, both the SEC and the courts will consider not only whether the minimum standards of the accounting profession have been met, but also whether the financial statements as a whole are useful to the average reader. Thus, auditors should attempt to draft clear opinions and footnotes in order to avoid ambiguous or inconsistent statements. If any general formulation can be made regarding the required contents of a qualification in an auditor's report filed with the SEC, such a check list would require the qualification to be specific and readily understandable, presenting every reason for the qualification as accurately and completely as circumstances permit.

### III. CONCLUSION

As the foregoing materials indicate, it is possible for an auditor to limit his liability. It should also be clear that the auditor must walk a tightrope of adequate disclosure. He must balance the reader's interests in fair disclosure and understandability against his client's interests in showing results of operation and changes in financial position in the most favorable light possible. The guiding factor in striking this balance is the auditor's evaluation of the ultimate impact of each problem area on the client's financial condition. This standard necessarily involves judgment calls, and errors do occur. Additionally, the auditor should be aware that courts will closely scrutinize attempted limitations on liability. They will evaluate the adequacy of disclosures with the benefit of hindsight, looking for not only technical compliance with professional standards, but also compliance with the more practical standards of usefulness and understandability to the average reader.

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