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FINANCIAL STATEMENT INSURANCE: A NEW APPROACH TO INVESTOR PROTECTION

*Stephen Z. Surridge**

I. Introduction

The accounting profession rapidly is moving toward a crisis in liability. Members of the investing public are suing accountants with mounting frequency and success. This article will analyze briefly the origin and present dimensions of the crisis, and then propose a plan for replacing court-imposed liability with insured liability through the offering of financial statement insurance. The essentials of the plan can be simply stated. Insurance would be offered by accountants to investors on a voluntary basis in conjunction with purchases and sales of corporate stock and securities. Individual investors would be able to purchase from the auditors of a corporation assurance that the most recent, audited financial statements of that corporation in fact fairly represent its financial condition as of the date of the statements. All investors would be more confident of the independence of accountants, since a portion of the accountants' compensation no longer would come directly from their corporate clients. Amendments to the Securities Acts would insulate accountants from liability to uninsured investors except in instances of fraud or gross negligence constituting fraud.

II. Trend Toward Strict Liability

A. Recognition That Accountants Are Public Servants

The history of accountants' liability to the investing public for misleading opinions on corporate financial statements is fundamentally a story of changing attitudes toward the proper function of accountants in society. Prior to the 1933 and 1934 Securities Acts, courts viewed accountants' provision of audit opinions as a service

... primarily for the benefit of the [corporate client], a convenient instrumentality for use in the development of the business, and only incidentally or collaterally for the use of those to whom [the client] might exhibit it

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thereafter.¹ * * *

[P]ublic accountants [were considered] public only in the sense that their services are offered to any one who chooses to employ them. This is far from saying that those who do not employ them are in the same position as those who do.²

Accordingly although courts were willing to hold accountants liable to investors for fraud and for gross negligence constituting fraud in the conduct of an audit, they insisted upon privity of contract as a prerequisite to liability for simple negligence:

... [I]f there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract, and is to be enforced between the parties by whom the contract has been made.³

The Securities Acts brought with them an entirely different view of the accountants' function. Their purpose was "to protect the investor, maintain integrity and honesty in the securities market, and curb 'unnecessary, unwise, and destructive speculation.'"⁴ The 1933 Act dealt with original issues, the 1934 Act with securities trading. The general approach of the Acts was to provide investors with full disclosure of all relevant information about companies and their stock and security issues. One of the specific devices selected to ensure disclosure was the requirement that each registration statement, each prospectus issued pursuant thereto, and each corporate annual report contain statements of financial position and of income certified by an independent public accountant or a certified public accountant.⁵

Section 11 of the Securities Act of 1933 swept aside the requirement of privity between accountants and the investors, and imposed upon accountants liability to investors for simple negligence.⁶ "[N]ot only is it immaterial that privity is totally lacking between the accountant and the investor, but it is also of no consequence that the misrepresentation was neither addressed to him nor intended to influence him."⁷ For

¹ *Ultramares v. Touche*, 255 N.Y. 170, 183, 174 N.E. 441, 446 (1931).

² *Id.* at 188, 174 N.E. at 448.

³ *Id.* at 189, 174 N.E. at 448.

⁴ H. R. REP. No. 1383, 73rd Cong., 2d Sess. 2 (1934), *quoted in Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 102 (N.D. Ill. 1967).

⁵ Securities Act §10(a)(1), *as amended*, 15 U.S.C. §77j(a)(1), (1965); and Schedule A(25), (26), 15 U.S.C. §§77aa(25), (26), (1965); Securities Exchange Act §13(a)(2), *as amended*, 15 U.S.C. §78m(a)(2), (1965).

⁶ Securities Act §§11(a)(4) and 11(b)(3)(B)(i), *as amended*, 15 U.S.C. §§77k(a)(4) and 77k(b)(3)(B)(i), (1965).

⁷ Katsoris, *Accountants' Third Party Liability—How Far Do We Go?*, 36 *FORDHAM L. REV.* 191 (1967).

liability to be established it is unnecessary for the investor to prove that he relied on the accountants' certification. Once the investor establishes that the financial statements misstate or omit a material fact such as to render the statements misleading, section 11 places the burden upon the accountants to demonstrate that they were not negligent. As is true of any negative fact, proving the absence of negligence is not an easy task.

As most clearly evidenced by section 11 of the 1933 Act, the Securities Acts recast the role of the accountant into that of a truly *public* servant whose chief responsibility is to the investing public rather than to his client. When the laws were first passed, this role for the accountant was novel, and courts were slow to impose the liabilities that the laws sought to create. This lag is reflected in the first *Restatement of the Law of Torts*, adopted and promulgated by the American Law Institute in 1938, five years after passage of the 1933 Act. The 1938 *Restatement* recognised a duty on the part of

[o]ne who in the course of his business or profession supplies information for the guidance of others. . . [only toward]the person or one of the class of persons *for whose guidance the information was supplied* [Emphasis added].⁸

In contrast to this characterization of the accountants' duty, Tentative Draft #10 of the *Restatement (Second) of the Law of Torts*, published in 1964, added new language recognising that

The liability of one who is under a public duty to give information extends to loss suffered by any of the class of persons *for whose benefit the duty is created*, in any transactions in which it is intended to protect them. [Emphasis added].⁹

The 1938 wording indicates that the Institute—and likewise the courts—saw the accountants' duty of care as one growing out of the immediate transaction of performing an audit for a client. The 1964 wording indicates that at least the *Restatement* reporters have arrived at a view which is consistent with characterization of the accountants' duty of care as one which grows out of the statutes creating the public duty.

The Institute reporters' altered view also appears in the recent District Court case of *Fischer v. Kletz*¹⁰ wherein the court adopted as its

⁸ RESTATEMENT OF TORTS §552 (1938).

⁹ RESTATEMENT SECOND OF TORTS §552 (Tent. Draft No. 10, 1964). Comments to the draft clarify that persons other than public officials may be subject to such public duties. *Id.*, No. 5 at 179.

¹⁰ 266 F. Supp. 180 (S.D.N.Y. 1967).

own the language of the Securities and Exchange Commission to the effect that when an accountant performs services as a statutory "independent public accountant", his responsibility

... is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies. . . . The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. *His duty is to safeguard the public interest not that of his client.* [Emphasis added].¹¹

This language does not suggest that accountants owe equal duties to their clients and to the investing public, but rather that the duty to safeguard the public interest is *primary*.

In the recent and much-discussed case of *Escott v. BarChris Construction Corporation*,¹² purchasers of the debentures of BarChris brought an action against that corporation's auditors alleging that the certified financial statements published in the debenture registration statement contained material false statements and material omissions. As discussed earlier, section 11 of the 1933 Act places the burden on the defendant to demonstrate lack of negligence. In *BarChris*, the court concluded that the accountants had not carried that burden of proof. The court considered the audit program employed to have been adequate, but found that the accountants were negligent in applying the program. Judge McLean was careful to say that "[a]ccountants should not be held to a standard higher than that recognised in their profession,"¹³ but some of the particulars of his criticism indicate that he did not consider the accountants' approach to their review to be acceptable:

...[the accountant] read only what minutes [a company executive] gave him. . . . He did not read such minutes as there were of the executive committee. He did not know there was an executive committee. . . .

In substance. . . [h]e asked questions, he got answers which he considered satisfactory, and he did nothing to verify them.

. . . . He was content with. . . [a company executive's] assurance that no liability theretofore contingent had become direct.¹⁴

¹¹ *In re Touche, Niven, Baily & Smart*, 37 S.E.C. 629, 670-71 (1957), quoted in *Fisher v. Kletz*, 266 F. Supp. 180, 184 (S.D.N.Y. 1967). See also *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 104 (N.D.Ill. 1967).

¹² *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

¹³ *Id.* at 703.

¹⁴ *Id.* at 702.

The company executives with whom the accountant spoke purposely misled him, and purposely withheld information from him. The court's criticism of the accountant boils down to condemnation for failure to see through the *client's* deception—condemnation for believing what client executives told him.

Upon reflection it should be apparent that a significant proportion of the data and records examined by accountants during the conduct of an audit are, in one form or another, representations made to them by employees and officers of the client corporations. If accountants never can believe anything told to them by their clients, the conduct of audits, if possible at all, becomes tantamount to a police investigation of the clients. Under this characterization of the audit function, accountants' obligation to their nominal clients is virtually extinguished.

B. Disregard of Apparent Statutory Protections

Court decisions have moved progressively farther toward recognizing the full implications of the now-altered source and object of the accountants' primary duty, and, indeed, are on the brink of extending to investors rights and remedies significantly larger than those which one might have expected to grow out of the specific wording of the Securities Acts. Whereas section 11 of the 1933 Act holds accountants liable to investors for simple negligence in the rendering of certifications of financial statements for inclusion in securities registration statements, the only section of the 1934 Act which clearly imposes liability upon accountants, section 18, relieves them from liability in the rendering of certifications of financial statements for inclusion in corporate annual reports if any misrepresentations therein contained were unintentional. Also, under section 18, a plaintiff must prove damage caused by reliance upon the statements.

If section 18 remains the only basis for liability under the 1934 Act, then accountants will have a much easier time resisting claims brought by persons who buy or sell securities over the counter or through the national exchanges than they can hope to have resisting claims brought under section 11 of the 1933 Act by persons who purchase securities upon their original issuance. In the past few years, however, the case law has moved rapidly toward establishing a cause of action against accountants for negligence under section 10 (b) of the 1934 Act, and Rule 10b-5 promulgated thereunder.¹⁵

¹⁵ Rule 10b-5 states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange... or to make any untrue statement of a material fact or to omit to state a material

Whether negligence is sufficient under Rule 10b-5, or whether intent must be established, is a question which as yet remains unsettled. The growing weight of authority, however, is to the effect that negligence is sufficient. Two federal appellate courts have so held, and two others have expressed this view in dicta.¹⁶ Only the Court of Appeals for the Second Circuit has held that intent must be established.¹⁷ That court cited only two cases in support of the proposition, and the citations seem erroneous.¹⁸ When the question eventually is raised before the United States Supreme Court, accountants might hope that the Court will side with the second circuit. However, this writer expects that it will not.

fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security. 17 C.F.R. 240, 10b-5.

¹⁶ For holdings to the effect that negligence is sufficient, see *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961); and *Stevens v. Vowell*, 343 F.2d 374, 379 (10th Cir. 1965). For dicta to the same effect, see *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963), *aff'g* 208 F. Supp. 803 (E.D. Wis. 1962); and *Mysel v. Fields*, 386 F.2d 718, 734-35 (8th Cir. 1967), *cert. denied* 390 U.S. 951 (1968).

¹⁷ *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 786-87 (2d Cir. 1951).

¹⁸ The court cited *Norris & Hirschberg, Inc., v. SEC*, 177 F.2d 228, 230 (D.C. Cir. 1948); *Ward La France Truck Corp.*, 13 SEC 373, 381 (1943). Neither case supports the proposition that proof of fraud is required in suits under §10b of the 1934 Act, or Rule 10b-5.

Norris held that concealment of certain information by a brokerage firm constituted willful violation of the Securities Acts, and that the willful violation was a sufficient ground for revocation of petitioner's registration, adding the dictum that "a registration cannot be revoked *unless* there has been *willful violation* of statute." 177 F.2d at 233 [Emphasis added]. At the cited page, *Norris* indicates that the case was initiated, after an S.E.C. investigation, by an S.E.C. "order directing a private proceeding before a trial examiner in order to determine whether petitioner had violated any of the anti-fraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, or any of the Commission's rules promulgated thereunder," footnoting the statutes generally. Apparently the court in *Fischman* meant to infer—from this language and from the fact that the commission subsequently found petitioners in *Norris* to have violated Section 10b of the 1934 Act—that the *Norris* court had labeled Section 10b as an "anti-fraud provision." Even if this inference is correct, such a label would not preclude the possibility that Congress intended Section 10b to be applied where less than fraud was involved.

The reference to the *La France* case is to a footnote which reads:

The standards adopted by the Commission in its rule [Rule 10b-5], it will be noted, make applicable to the purchase of securities, the same *broad antifraud provisions* which the Congress has imposed in Section 17(a) of the Securities Act of 1933, in connection with the sale of securities. [Emphasis added].

Again, the *Fischman* court's reference is to a label of uncertain application, and not to a holding which requires proof of fraud. In *La France* the Commission held that purchase of stock by insiders without disclosure of material information to the sellers constituted a violation of Rule 10b-5; the Commission nowhere asserted—even as dictum—that fraud was essential to a violation of that rule.

Accountants, in appraising the situation, might consider that none of the comforting defenses available under section 18 are to be found under section 10b. Indeed, if the Supreme Court holds that Rule 10b-5 can be applied in instances of negligence, nothing will remain of the wording of that rule to preclude its application to impose strict liability.

The imposition upon accountants of strict liability under the Securities Acts could come about even if the current trend of expanding liability and diminishing defenses is not carried that far via statutory interpretation. Negligence is a highly subjective concept, and it is always possible for a judge to conclude that an auditor should have done more than he did. In the *BarChris* case, Judge McLean could not resist observing in his opinion that "As far as results were concerned, his [the accountant's]. . . review was useless."¹⁹ The more sympathetic a judge is to a plaintiff's case, the greater the likelihood that he will give weight to results in evaluating the defendant's performance. Widespread recognition of accountants' statutory duty will increase the probability that judges will be sympathetic toward complaining investors. Under such circumstances, the line between liability for negligence and strict liability could become very blurred indeed.

III. Response of Accountants

A. Present: Resistance to Liability

The potential for further expansion of accountants' liability to third party investors is too great to be ignored. So far the accounting profession has reacted to this situation by resisting and defending against liability with all possible zeal. Very early in the game the accountants retreated from "certifying" financial statements, and instead undertook only to render "opinions" with respect to them. This ploy was intended to avoid the danger that if financial statements are certified as fact, and if those statements are false, the accountants may be held liable at common law for deceit.²⁰ Accountants also assert that their audit procedures "cannot be relied upon, to disclose defalcations and other similar irregularities. . ."²¹ Try saying that to a man on the street who has just invested heavily in some corporation, having based his decision to do so partly upon the corporation's most recent audited financial statements, and see how he reacts!

The Accounting Principles Board of the American Institute of Certified Public Accountants has noticeably increased the frequency and

¹⁹ *Escott v. BarChris Constr. Corp.*, 283 F. Supp. at 702.

²⁰ A. HOLMES, *AUDITING PRINCIPLES AND PROCEDURE* 28 (6th ed. 1964).

²¹ American Institute of Certified Public Accountants, *Auditing Standards and Procedures (Statements on Auditing Procedure No. 33)* 11 (1963).

specificity of its pronouncements of late, clearly with the intent of more explicitly defining audit procedures and narrowing statement presentation alternatives.²² The accountants apparently believe that if they can clarify and render more uniform the standards of their own profession and then follow those standards closely, they can avoid liability. This belief very possibly is correct to the extent that liability may be founded upon certified financial statements deemed misleading because of their manner of presentation, or because information known to the accountants is omitted by an exercise of judgement with which a court disagrees. To the extent that liability may be founded upon certified financial statements deemed misleading because the accountant failed to discover or accurately to record pertinent information, however, an assertion of compliance with professional standards inevitably will carry the implication that those professional standards, and perhaps even the professionals themselves, are inadequate to their task. Accountants will lose the war if they win too many battles against this type of liability.

If accountants continue their zealous resistance to liability, they are likely to experience two disastrous results: (1) The public will cease to look to the auditor's opinion as an assurance that it is receiving adequate information upon which to base investment decisions, and (2) the Securities and Exchange Commission will begin to look elsewhere for ways to accomplish the purposes of the Securities Acts. Conceivably, Congress might even go to the extent of writing independent public accountants out of the Securities Acts and replacing them with government inspectors. No certified public accountant would welcome that result.

It is imperative that accountants see beyond their immediate danger of financial loss to their ultimate danger of extinction as a profession. If the general public is to place confidence in audited financial statements, it must believe that the auditors stand behind their work. Accountants can be stubborn, and fight liability in the courts, but success in such efforts would lead to destruction of their professional stature.

B. Proposed: Financial Statement Insurance

If accountants would recognise *now* the inevitability of expanded liability, perhaps they might stop working so hard to defend against it and instead direct their efforts toward providing an alternative solution to the underlying problem which, after all, is that of finding a means of compensating investors who rely upon financial statements which turn out to have been in error. A little positive thinking should reveal that the accountants' supposed plight is actually a tremendous opportunity. Instead of shrinking from liability, accountants should seek it—for a price.

²² During the decade 1950-59, the Committee on Auditing Procedure of the American Institute of Certified Public Accountants issued only five new "Statements on Auditing Procedure." During the period 1960 through January 1969, ten such statements were issued, doubling the number of the previous decade.

Potential liability toward investors would not be so burdensome if the accountants regularly received all or a portion of their compensation from those same investors.

As the role of accountants has moved away from serving their clients and toward serving the public, retention of the old scheme of compensation has become an anomaly. The accountants are compensated by those whom they are to scrutinize, and the public—the primary beneficiary of their services—pays not at all. But for the threat of liability imposed by a court of law, there is very little financial motivation of accountants toward doing a good job. The Securities Acts guarantee that corporations will employ their services, and the corporations pay their accountants' fees regardless of the degree of care with which they perform their audit. The public might speculate that the only basis upon which a corporation selects one accounting firm over another is the relative congeniality and cooperativeness of that firm's personnel. Seemingly, the public would be more confident of the accountants' independence from corporate management if someone other than management were paying the bills, and the public would be more confident of the accountants' professional competence if their remuneration were directly dependent upon that competence.

Many have suggested that accountants can meet the cost of expanded liability by passing that cost on to their clients. To do so would amount to funding the risk of liability by charges to clients, which charges would be well in excess of the actual costs of performing the audits themselves. Advocates of this solution would have the accountants seek to exact larger fees from their clients at the very time when pressure is on the accountants to scrutinize their clients more thoroughly. This is hardly a proposal that would foster independence on the part of the auditor.

The advocates of increased direct charges argue that a charge exacted from the client is actually a charge exacted indirectly from investors, since the assets of a corporation are owed to its creditors, or belong to its stockholders. This indirect incidence of such a charge, however, would not parallel the incidence of potential damage through reliance on audited financial statements. The investors who *should* bear the brunt of corporate financial reverses, or who *should* enjoy the fruits of corporate successes, are the investors who hold stock or securities in the corporation at the time such reverses or successes occur. If the same persons hold the stock or securities at the time such reverses or successes eventually are discovered and reported, then those persons have not been damaged by an accountant's failure to have discovered and reported the change of circumstances at the earliest opportunity. Only those persons who change their positions by buying or selling stock between the time of occurrence of a reverse or success and the time of its eventual reporting will have been damaged by a delay in its reporting. Those who may have been damaged by inaccurate financial statements will be contained in the list of those who have *bought* or *sold* stock or

securities, but *not* necessarily in the list of those who *held* stock or securities at the time the accountant conducted his audit and assessed his charges against the corporation. Yet the *latter* group would be the one to bear the indirect burden of increased charges assessed against the corporation. Thus, increasing client charges would merely perpetuate the anomaly of charging one group for services actually provided to another group.

An alternative more desirable than increased direct charges would be for accountants to receive all or a portion of their total compensation in the form of payments from investors incident to each individual purchase or sale of their client corporation's stock and securities. Then those persons who could be damaged by inaccurate financial statements — those who buy or sell in reliance upon the statements — would be actual purchasers of the accountants' services.

Accountants could offer insurance somewhat analogous to title insurance, the insurance to be purchased by investors incident to their purchase or sale of corporate stock or securities. It would be offered by the accounting firm that had audited and rendered an opinion on the most recent financial statements of the corporation, and would insure against the possibility that those financial statements did not fairly present the financial condition of the corporation as of the date of the statements. The insurance would relate only to the transaction incident to which it was purchased, and thus would not be transferable between successive investors in the same stock or security. The insurance would be purchased directly from the appropriate accounting firm upon submission of a document provided by the investor's broker, which document would verify the fact and amount of a purchase or sale.

All purchases of the insurance would be voluntary.²³ If an investor chose not to buy the insurance, he would be evidencing his intent not to

²³ Accountants are in no position to *demand* payments directly from investors, because the Securities Acts require the *corporations* to secure certification of their financial statements. Demanding that accountants' corporate clients collect such payments from purchasers of their stocks and securities would be feasible only with respect to original issues, because corporations have no control over who buys or sells their stocks and securities on the exchanges or over the counter. Imposition of such demands upon corporations might subject both the accountants and their clients to prosecution under the antitrust laws anyway. The types of antitrust obstacles that this approach might encounter only will be suggested here, and will not be analyzed in detail. If all accountants explicitly agree to refuse to provide audit services except on condition that the corporations to be audited require persons purchasing original issues of stock and securities to make payments to the accountants, the agreement might be condemned under §1 of the Sherman Act as a concerted refusal to deal. *See* *Paramount Famous Lasky Corp. v. United States*, 282 U.S. 30 (1930). If accountants uniformly refuse to provide audit services except upon the same condition, but there is no express agreement, then a conspiracy to refuse to deal nevertheless would be present if a tacit agreement in fact did exist. This again might be condemned under §1 of the Sherman Act. *See* *Theatre Enterprises, Inc. v. Paramount Film Distrib. Corp.*,

rely upon the financial statements, and consequently should have no cause of action against the accountants for loss growing out of his transaction. If an investor did buy the insurance and suffered loss, he only would have to establish the inaccuracy of the financial statements in order to recover from the accountants. This is the same minimal burden of proof that would be enjoyed by *all* investors if the courts advance their current trend of decisions to the point of holding accountants strictly liable to investors.

The risks against which insurance is to be provided must be limited and measurable at the time the risks are incurred, or else premium rates cannot be established on a rational basis. In the situation of an error which results in an *overstatement* of a corporation's financial condition, the risk would be limited and measurable. Clearly the maximum injury which could occur would be the amount of the overstatement, and that maximum injury would be inflicted *only* in the event that all stock and securities were traded at least once before the error was discovered. Since the overstatement could be no larger than the value of the entire corporation which could be deduced fairly from the financial statements, that value would be the theoretical maximum injury that could be inflicted by an overstatement. That some securities or shares of stock might be traded more than once during the period between the date of the statements and the date of discovery of the error would not alter this result; only those holding the stock and securities when the error was discovered could have lost from the delay. Suppose

346 U.S. 537 (1954). If a corporation did predicate issuance of its stock and securities upon such a condition, then that corporation might be vulnerable to suit under §1 of the Sherman Act for an offense analogous to an illegal tying arrangement. The corporation would be using whatever economic power it could muster to coerce purchase of insurance by investors from the corporation's accountants. To the extent this effort was successful, other insurers that might be willing to offer comparable insurance would be excluded. This situation is similar to that in *Atlantic Ref. Co. v. FTC*, 381 U.S. 357 (1965), wherein Atlantic was enjoined from further coercing its wholesalers and retail outlets to carry Goodyear products. While §3 of the Clayton Act, the statutory section specifically addressed to the tying problem, does not apply to this situation because that section, by its terms, only concerns "goods, wares, merchandise, machinery, supplies, or other commodities," tying arrangements involving other marketable items have been held unlawful under §1 of the Sherman Act. That neither the tying nor the tied items fall within the language of Clayton Act §3 does not preclude application of Sherman Act §1. The same situation existed in *Northern Pac. Ry. v. United States* 356 U.S. 1 (1958), wherein agreements to use Northern Pacific's rail routes exclusively were tied to sales and leases of land; the agreements were held to be violations of Sherman Act §1.

Of course, it would be possible to coerce payments from investors by force of federal statute. A statute merely requiring that investors pay to accountants whatever fees the accountants demand would go against the main thrust of the Securities Acts, which is to protect investors. Thus any coercive statute necessarily would provide for government establishment of rates. At best, such a statute would make the government a conduit of all accountants' remuneration, and at worst it would make all accountants government employees.

that as to a given share of stock the amount of the overstatement were \$10, and the true value of the share at the time of the financial statements were X. Anyone purchasing the share on that day would pay $\$(X + 10)$. If that person sold the share before discovery of the error, then he would sell it for whatever its true value might then happen to be, Y, plus the same \$10 overstatement. The overstatement would have had precisely the same effect on the share's buying and selling prices, and thus the person both buying and selling while the error remained undiscovered would suffer no injury.

On the other hand, in the situation of an *understatement* of a corporation's financial position, the risk would not be limited and measurable. The aggregate value of items omitted from financial statements cannot be known until the omissions are discovered. Thus the accountants could not know their maximum potential liability. To state an extreme example, it is conceivable that an audit might fail to reveal that the client corporation had recently discovered valuable oil reserves not reflected on its books. The potential resultant injury to investors who sell before the omission from the financial statements is reported would be limited to the value of the oil reserves, but that value neither would have been known nor foreseeable at the time of the original omission. The value could be larger than all other assets of the corporation, and an unforeseen liability of such magnitude might financially ruin the accountants.²⁴ Even though the potential liability for an understatement of financial position is unlimited, the proposed insurance plan provides accountants with an opportunity to place a *contractual* upper limit on that liability, thus permitting premium rates to be established rationally.

Obviously, the proposed insurance would be of no value to investors if the courts reach the point of holding accountants strictly liable toward all investors regardless of whether they had purchased it. In that event there would be no way to induce investors to make any voluntary payments to accountants. Such an insurance plan, therefore, ought only be undertaken in conjunction with securing amendments to the Securities Acts to guarantee that investors who do not establish privity of contract with the accountants by purchasing the insurance will be able to recover from the accountants *only* in instances of fraud or gross negligence constituting fraud. As already pointed out, the need which underlies the current judicial trend toward strict liability is that of compensating investors who rely upon financial statements which turn out to have been in error. Surely both the Securities and Exchange Commis-

²⁴ In such a situation there would be a high probability that failure of the audit to reveal the discovery of the oil reserves would be the direct result of intentional non-disclosure by executives of the corporation so that the accountants would have an action over against those executives. Nevertheless, if the executives are judgement proof, the accountants conceivably could find themselves stuck with liability to injured investors for the full value of the oil reserves.

sion and Congress would be receptive to a plan which offers to provide that compensation in a manner both economical and equitable in that it (1) restricts recovery to investors clearly identified as having relied upon the statements, and (2) minimizes the litigation burden upon those who so rely.

The proposed insurance plan also would cause accountants' financial rewards to vary directly with their own professional competence. The more diligent their audit examinations, the fewer the instances of error resulting in liability, and the more premiums the accountants will be able to keep for themselves. The reader might observe that if accountants are to provide insurance, there must be some mechanism to hold down the magnitude of the premiums charged, lest accountants simply insure against the risk that *unaudited* financial statements might be in error and retire from their original profession. The proposed plan, however, does not contemplate relief from liability toward uninsured investors for fraud or gross negligence constituting fraud, so the necessity of conducting an audit would remain. Furthermore, the offering of insurance would introduce an opportunity for price competition not heretofore existent in the market for auditing services. In the past, stockholders have had little or no basis upon which to evaluate corporate management's choice of auditors prior to voting to approve or disapprove that choice. With an insurance plan in effect, stockholders could vote against accounting firms which charge particularly high premiums. As a final check against excessive premium charges, the charges could be subject to S.E.C. scrutiny.

IV. Conclusion

Accountants eventually will become strictly liable to the investing public for all material errors in, and omissions from, audited financial statements—one way or another. Surely accountants, as professional men, would prefer to arrive at that position voluntarily, rather than by force of court decisions. A significant advantage to voluntary assumption of liability would be the added financial benefit to be derived. The accounting profession must decide soon, for if it does not, the opportunity to decide could be foreclosed.