Is the Present State of Law Relating to the
Liability of Accountants in the Public Interest?

by

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I'm glad to have the opportunity to debate the extent to which there should be limited liability on accountants, the main reason being because this has caused me to focus on these issues in a way in which I otherwise would not have and because it gives me the opportunity to provide comment in this auspicious gathering of high intellects. By putting it that way I have not only ingratiated myself to you but also ensured that we will agree on at least one point during the day. By way of maintaining my reputation let me say that what I intend to comment on is the specious nonsense which, apparently at the present time, informs the judicial practice with regard to the liability of accountants.

So that you will know the departure point for my comments, I want to briefly outline a few of the premises that I carry about with me as part of my analytical toolbox and which tend to influence my thinking on issues of this kind.

The first, and most important observation, is my conception of the history of human progress (following Sir Henry Maine) as one in which mankind has struggled in a stumbling, bumbling fashion from a societal norm in which status was a determining factor for almost every aspect of human affairs, toward a society in which relations between people are based primarily on contracts of one sort or another. Now, of course, I don't mean to imply that this has been a monotonic process or even a universal process, in fact, as we look about us in the world today, we can find ample evidence of societies based still on the concept of status rather than contract.

The reason for regarding this evolution as positive is not because there is anything inherently good or bad about relationships based on status or contract but because for a variety of reasons, relationships based on contract tend to be more freedom-enhancing than the other kind.

The practical significance of this from an economic and social point of view is that a society based on contract rather than status offers the maximum degree of possibility to move away from a
world based on initial endowments. That is true whether those endowments are of a physical, intellectual or financial kind.

In more prosaic terms, the kind of world that contractual relationships lead to is one where anybody can grow up to be prime minister. While we all probably subscribe to the idealism of such a society, seldom is it that we recognize that the source of such potential is the fact that relationships are based on contract rather than on status.

The second premise that guides my thinking on these issues is that I am basically a utilitarian in an evolutionary sense. That is to say, I tend to examine policy matters from the point of view of what will be the evolutionary consequences of adopting a particular set of institutions and I am particularly interested to maximize the human benefit and to minimize the human costs of particular policies.

In considering the particular issue at hand I must say I had some great difficulty sorting out the various lines of duty and agency which ought to be considered if one is to come to a correct understanding of the relationships.

In order to get my own thinking straight on the issues, I have contrived to start my analysis with a simpler transaction involving the purchase of an automobile. We have in this transaction the automobile producer and the automobile buyer together with a number of intermediaries who may represent the buyer or the producer. Under ordinary circumstances, the producer has a sales agent from whom the buyer buys the automobile although the buyer may also engage the services of a mechanic or others to advise on the quality or other characteristics of the automobile. The most usual other party hired by automobile buyers is the organization that produces the publication called "Consumer Reports" which is a source of advice for people contemplating the purchase of an automobile or other durable product.

Now, there may be a number of contractual arrangements in the transaction between the producer and the buyer of the automobile. The producer normally has a contractual relationship with a sales agent; the sales agent will normally enter a contract with the purchaser of the
automobile, which contract is often conditioned by subsidiary agreements between the purchaser of the automobile and the producer, particularly as regards the extent of the automobile services package being acquired under the terms of the contract.

The liabilities in the case of an automobile are strictly limited to the parties having a contractual relationship to each other. While under the unwholesome influence of the judiciary of the State of California and its Rose Birdian eclecticism the notion of product liability has been extended, the traditional attitude of the judiciary as I understand it and certainly of the legislative framework, was caveat emptor. While this doctrine has been transformed into a malicious après moi la deluge posture by those wishing to demonstrate the inequities of capitalist-inspired legislation, it is, in fact, a doctrine basically in the interests of consumers.

The reason, quite simply, is because it maximizes the amount of choice that consumers will have in any particular range of products or in any particular sphere of activity. That is true because the doctrine of caveat emptor very strictly confines the product or service which is being transacted and, therefore, creates optimum conditions of supply.

Let me be more precise. In the case of the automobile, the doctrine of caveat emptor says that what the buyer and the seller have mutually agreed on in the contract for sale is the product that is being transacted and no other. Under these circumstances, the supplier of automobiles is in a position to know precisely within a reasonable range of error what the costs are of providing the automobile and is therefore in a position to create a supply to satisfy the needs of the consumer.

Consider, on the other hand, the consequence of pursuing exactly the opposite doctrine, namely caveat venditor. In this case, the automobile manufacturer is providing a number of goods or services to the consumer which has basically an unknown cost. If the automobile manufacturer is to be held liable, for example, for perceived defects in an automobile which become evident long after the automobile's manufacture and which are due to an advance in the state of knowledge then the producer of the automobile is in a position of being unable to determine with any reasonable degree of precision the costs of producing the automobile product. The reason is because the
extent of the warranty, the extent of the total package being provided to the purchaser, is not
determined in advance.

Assuming for the moment that *caveat emptor* is the prevailing doctrine with regard to the
actual purchase of the automobile, it is interesting to investigate the other potential contractual
arrangements which may emerge in the course of the process of the sale of the automobile. The
consumer of the automobile may, either on a contractual or other basis, go to a third party to
acquire information about the automobile whether, for example, it is likely to be unsafe at any
speed, whether it burns too much gasoline, requires repair more frequently than other automobiles
or whatever. By acquiring this information the consumer is acting on the responsibility which the
doctrine of *caveat emptor* imposes, namely, to assure him or herself that the automobile is what it
appears.

The automobile company, for its part, may invest in the production of a magazine or
magazines which extol the virtues and merits of their product untrammeled by any second thought
or subsidiary considerations. Both of these activities, of course, are legitimate and an essential
part of a marketplace in which the institutions encourage freedom of choice and freedom of action
of the part of all participants. Now, the possibility of multiple suppliers of automobiles, of course,
would ensure a competition for the sympathies of the consumer from an intellectual point of view
(in the brochures published) and for the consumers' dollars in the purchase of the actual automobile
itself. Similar competition for the consumers' dollars on the side of advice about the product will
ensure the emergence of automobile associations, consumer magazines and other associations
designed to provide information about the extent to which the product being offered is faithful to
the descriptions of it provided by the manufacturer, both directly and in the form of magazines and
other media.

Within the arrangements which evolve in these marketplaces for automobiles and ideas about
automobiles, the lines of interest are clearly drawn. The consumer of the automobile relies on the
consumer association for unbiased, objective assessments about the automobiles which are offered
for sale by the automobile producer. The consumer pays for this information and pays for the support of the automobile association or the consumer association in order to ensure a steady supply of information which is, to the degree possible, untainted by the interest of the automobile producer.

No thoughtful consumer would think to rely exclusively upon information provided by the automobile manufacturer through the agency of a magazine or brochure which it had paid to have produced even if this magazine or brochure were produced by an independent agency in the sense that its personnel were not direct employees of the automobile company.

It is equally difficult, Rose Bird aside, to imagine a court taking seriously the claim of a consumer claiming he or she had just cause for compensation from automobile company X because, in spite of the fact that the person had purchased company X's automobile, they were unable nevertheless to acquire a beautiful companion of the kind shown riding in the automobile in the company's brochures! Or, more seriously, that the automobile turned out not to be the quietest riding, most economical under some condition as indicated in Motor Trend Magazine which was supported by the advertising dollars of the automobile company.

It is even more difficulty to imagine any court taking seriously the claim of a member of the Consumers' Association of Canada to the effect that while the Consumer Report Magazine had clearly indicated that such and such an automobile had the lowest frequency of repair record that, nevertheless, their automobile was in the shop on a frequent basis and that, therefore, the Consumer Report owed a compensation to the magazine reader to redress the cost of the highly frequent repairs.

Undoubtedly, in each of these cases, the reason the court would take such an attitude would be because no contract was deemed to exist between the member of the consumers' association and the magazine nor was a contract in existence between the consumer and the Motor Trend magazine extolling the virtues of company X's automobile.
From the point of view of the paper which has been provided by Mr. Giles for your consideration, it is very clear that many of the characteristics of the transactions that he mentions as potential guides for the court are clearly present in these transactions. The Consumer Reports, for example, has knowledge of particular individuals who will use and rely on their information. They have information from the point of view of their subscribers of the limited class which will rely on the statements and certainly foresee the use to which the information will be put by subscribers and that they will, hopefully, rely on that information in their decision to purchase. Fortunately, however, in the case of automobile purchase there has been no interpretation to the effect that Consumer Reports has any liability whatsoever if the consumer purchased an automobile which failed in some way or other to live up to the expectations which the information provided by Consumer Reports may have encouraged.

At this point I feel obliged to remind you that the reason for venturing into the swamp of automobile liability and the lines of contracts and interests which are there, is because, in my view, it would help elucidate the process which is ongoing in the case of accounting services. Those of you who became mired in the quicksand and crocodiles of the automobile swamp may find that diversion to have been completely unhelpful. In any event, let us now turn to consider the case of the accountants.

First of all, corresponding to the lines of interest and contact which we established in the case of automobiles, let us establish the typical pattern in the case of accounting services. Consider, for example, the management of the Acey-deucey Mining Corporation which is on the verge of making a public offering of its shares through the auspices of the Vancouver Stock Exchange. The management of Acey-Deucey, wishing to present the best possible face on their financial activities, acquire the services of an chartered accountant to do financial analysis and financial statements for inclusion in the prospectus describing the company for prospective shareholders. Of course, it is in the interests of the Acey-deucey management that the accountant be appropriately flattering about the activities of the company and it will, therefore, not exert
effort on its behalf to raise the spectre of business transactions which may tend to show the company in a bad light. In fact, the motto of Acey-deucey is "Let sleeping dogs lie" a fact which is, of course, communicated directly and indirectly to the accountant in the process of their arriving at a contract for the preparation of the financial accounts.

Now the prospectus is prepared and is circulated to potential shareholders who know that the accounts have been prepared by an individual employed by Acey-deucey Mining Corporation. This is similar in our automobile analogy, to the magazine or brochure which is prepared at the request of, or under the support of, the automobile company. For some reason, however, there is a different attitude about the tactics employed by Acey-deucey than there is toward the public relations flacks who are hired by the automobile company. The reasons for this will be evident in a moment.

Corresponding to the automobile case, there are also potential sources of information available to investors in the form of stock market analysts, analysts of stock market analysts, accountants hired by groups of investors to perform audits of financial statements, and the like. The attitude of the court and the traditions which have developed with regard to the liability attaching to these various pieces of information vary considerably according to the nature of the relationship between the investor and the supplier of the information. For example, stock market analysts provide information on a disclaimed basis and are, therefore, not held liable for the comments which they make which are meant only as an additional source of potential information to the investor. The reliability of this information and advice is maintained by a cadre of individuals who, in their turn, assess the advice of stock market advisers. And, in the same way that investors can buy information or advice about which stocks to buy, they can also buy an assessment of the accuracy of advisers.

In other words, the market for securities and information about securities tends to function very much like the market for information about automobiles except that in the securities markets, for some reason there has evolved a judicial tradition of holding public relations flacks liable for
the descriptions they produce for the management of mining corporations but not the public relations flacks who prepare information for automobile companies.

Now, of course, I know that this kind of analogy will cause the hackles of many to rise—they will say that chartered accountants, sir, are not public relations hacks but are rather professionals in whom the public have lodged a measure of trust. And, it is because of this trust that accountants must be held to be liable for the financial attestations they make, not only to the people with whom they contract but also to the broader public.

In my view, the only difference between the PR flack and the accountant is that the accountant has been given a measure of legislative status. We do not question the data provided by the accountant because it is given the implicit blessing of legislation. Public companies must use Chartered Accountants to give their affairs a financial imprimatur and the Chartered Accountants are given the power to control who may join their cadre.

In other words, the implicit judgement in the assessment of broader liability to the chartered accountant is that in failing to give the correct information, chartered accountant violate a kind of public trust.

The problem is, that the premise upon which the whole edifice is based, namely special status for accountants, is not in the public interest and any decisions of the court which confirm this are also not in the public interest. As the auditing according to standard principles of the CCB and the Northland Bank should show, the conferring of status does not ensure the procurement of useful and accurate information. The only process which will is one of skepticism and competition between alternative suppliers.