

BE CAREFUL WHAT YOU WISH FOR: HOW ACCOUNTANTS AND CONGRESS CREATED THE PROBLEM OF AUDITOR INDEPENDENCE

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Abstract: Although corporate fraud is not held in check by our current audit process, in which auditors lack independence from the clients they inspect, numerous attempts to fix this problem have failed. This Article analyzes the history of auditing, which has been neglected in legal scholarship, to argue that the mandatory audit system created the problem of auditor independence. Accountants advocated for the system in order to gain the status of a learned profession; however, they received more than they bargained for. In particular, auditors incurred an obligation to the "investing public," but this undefined group does not actually control the auditors. Auditors answer to the companies being audited. The resulting conflict of interest has proven to be insurmountable. This Article argues that the problem will be resolved only by returning to its origins in the federal securities laws of the 1930s and by restructuring the relationships involved in public company audits.

INTRODUCTION

Anxious to respond quickly to the public outcry over the recent financial scandals that had rocked the national economy, the Senate Committee on Banking and Currency (the "Senate Committee") gathered in Room 301 of the Senate Office Building to hear testimony on a quickly drafted bill to regulate the securities industry. The bill required companies issuing securities to issue detailed financial statements that would be certified by company directors. In turn, these directors would

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then take on unlimited personal liability for the contents of the certified statements. The bill was quite controversial, yet the public demanded sweeping reform, and such reform could not be painless.

During the hearings, experts testified that the boardrooms of American companies would empty as even the most conscientious directors would refuse to take on the risk of such liability. Perhaps directors could be given a defense of good faith reliance on the opinions of certified public accountants or other qualified professionals. Who then would be on the hook for inaccuracies in the financial statements? The point was to have someone in control of the company take responsibility for the contents of the financial statements in order to counter the temptation for the company to spin the statements for its own ends.

Colonel Arthur H. Carter, President of the New York State Society of Certified Public Accountants, appeared before the Senate Committee and suggested that the bill be amended to require a company issuing stock to have its financial statements certified by an accountant, rather than simply to allow the government to call for an audit of a company after any suspicions arose.¹ After all, he testified, eighty-five percent of the companies listed on the New York Stock Exchange (the "NYSE") already voluntarily underwent outside audits.² The Senate Committee was skeptical and asked the following questions:

"How much more and additional employment would that give to certified accountants?"³

"Do you think it proper to insert in there that these independent public accountants should be privileged to state their opinion as to the value of securities or the condition of the company?"⁴

"Do you not think it is more in the interest of the public that is to buy these securities, if there is to be any check up or any guarantee as to the correctness, that it be done by some Government agency rather than by some private association of accountants?"⁵

¹ See *Securities Act of 1933: Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73rd Cong. (1933) [hereinafter *Hearings*] (statement of Col. Arthur H. Carter), reprinted in 2 *LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES ACT OF 1934*, at 56-62 (comp. by J.S. Ellenberger & Ellen P. Mahar, 1973) [hereinafter *LEGISLATIVE HISTORY*].

² See *id.* at 56, 60.

³ *Id.* at 56.

⁴ *Id.*

⁵ *Id.* at 57.

"Who audits you?"⁶

By the time the bill was enacted into law, however, Colonel Carter's suggestion was included—intentionally or otherwise—as part of Schedule A to the Securities Act of 1933 (the "'33 Act").⁷ Financial statements would have to be certified by an "independent public or certified accountant" prior to any public offering of securities.⁸ But there was a catch: section 11 of the '33 Act provides investors with a civil cause of action against most of the parties involved in preparing registration statements—expressly including accountants—with damages measured as the loss in value of the securities purchased.⁹

The certification requirement resulted in a windfall of business for the developing accounting profession, only somewhat tempered by the liability provisions. The accountants seemed happy; Congress seemed pleased with itself; and the public appeared mollified. After all, professional audits were already a part of the business landscape—especially after expanding in the mid-1800s in tandem with the spiraling complexity of businesses and financial markets touched off by the new factories and production methods of the Industrial Revolution.¹⁰ So why not just adopt the practice officially through federal legislation?

The problem was that by codifying a relatively new "best practice," which was employed by only a subset of stock-issuing companies, in a federal law that mandated this practice for all companies, Congress commodified and thus, destroyed the real premium-signaling value of the practice. Further, it froze in time an experiment in controlled public disclosure of what had been heretofore very much private audits commissioned by the company, its shareholders, or creditors for only their eyes.

Additionally, Congress seemed to have included some of the audit provisions from the various British Companies Acts without a full understanding of the long history and context in which those provisions developed. It is true that British companies at the time were required to have an auditor review the proposed financial statements and reports of the directors of the company before they became finalized. These audit reports then could be used in public of-

⁶ See *Hearings*, *supra* note 1, at 58 (statement of Col. Arthur H. Carter).

⁷ Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)) (also known as the "Fletcher-Rayburn Securities Act of 1933" and the "Truth in Securities Act").

⁸ 15 U.S.C. § 77aa, sched. A, ¶ 25.

⁹ See 15 U.S.C. § 77k. Some limitations on this liability are discussed *infra* notes 310-441.

¹⁰ See *infra* notes 22-238 and accompanying text.

ferings of stock. This "auditor," however, was an officer of the company, although only in the auditor capacity, and did not have to be an accountant. In fact, the company auditor officer position belonged to a well-established heritage that included trusted servants in English manorial households who were responsible for monitoring other servants' use of household assets. Auditors also might have been townspeople elected to monitor a government official's use of public assets.¹¹ The real requirements for an individual to be appointed a company auditor were that the individual could not also have been a director or officer of the company and that the individual must have been elected or appointed by the shareholders at the annual meeting.

Thus, in the British system, professional accountants were still working under private commission for parties who were investigating the accounting of others. Of particular note, accountants were hired by the "auditor" (shareholder) of a British company to help that auditor examine the directors' reports. Under the '33 Act, however, U.S. companies were only required to have an "independent public or certified accountant" review the financial statements for a registration statement. Because it was not specified otherwise, the job of commissioning the accountant fell to company management, even though they were part of the very group that the certification or audit process was supposed to monitor!

Finally, based on the stated investor focus of the '33 Act—emphasizing the principle of *caveat venditor* as much as the more traditional securities industry principle of *caveat emptor*—courts and commentators have maintained consistently that accountants certifying statements under the '33 Act¹² are acting as much on behalf of the public trust as they are for their paying client, the company.¹³ This bifurcated allegiance, however, was bound to promote conflict and controversy.¹⁴ Agents cannot successfully serve two principals with potentially adverse interests. The concept of "auditor independence" and the labyrinthian rules promulgated to try to define and enforce it

¹¹ See *infra* notes 22–238 and accompanying text.

¹² This claim also has been made under the similar annual certification required by rules promulgated under the later Securities Exchange Act of 1934. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78hh (2000)).

¹³ See *infra* notes 447–489 and accompanying text.

¹⁴ See generally Sean M. O'Connor, *The Inevitability of Enron and the Impossibility of "Auditor Independence" Under the Current Audit System* (2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181 (date posted Mar. 11, 2002).

have arisen as major issues, primarily because of this legally mandated divided allegiance of auditors.

Part I of this Article proceeds by clarifying the development of accounting into a profession through the dawn of the twentieth century.¹⁵ Part II looks at the profession in the early decades of that century and focuses on its quest for greater prestige and increased service engagements.¹⁶ This Part also describes the profession's move into the lobbying arena, culminating in its role in the passage of the Income Tax Act of 1913.¹⁷ Part III discusses the circumstances and debate surrounding the passage of the '33 Act.¹⁸ Finally, Part IV considers developments after the '33 Act, including passage of the Securities Exchange Act of 1934¹⁹ (the "'34 Act"), and rulemaking under both laws that followed the lead of the certification requirement of the '33 Act.²⁰ The Article concludes by arguing that Congress unwittingly created the problem of auditor independence when—at the accountants' own request—it included the financial statement certification requirement in the '33 Act.²¹

I. THE DEVELOPMENT OF ACCOUNTING INTO A PROFESSION

A. *Brief History of Accounting*

The beginning of modern accounting, in the form of double-entry bookkeeping, dates back to the end of the fifteenth century,²² but it was not until the nineteenth century that the true systems of accounting developed.²³ Further, prior to the mid-nineteenth century few individuals held themselves out as "public accountants," meaning that they practiced their craft through their own proprietary businesses.

¹⁵ See *infra* notes 22–238 and accompanying text.

¹⁶ See *infra* notes 239–285 and accompanying text.

¹⁷ See *infra* notes 286–310 and accompanying text.

¹⁸ See *infra* notes 311–446 and accompanying text.

¹⁹ 15 U.S.C. §§ 78a–78hh (2000).

²⁰ See *infra* notes 447–473 and accompanying text.

²¹ See *infra* notes 474–490 and accompanying text.

²² See A.C. LITTLETON, ACCOUNTING EVOLUTION TO 1900, at 12–21 (3rd ed., Garland Publ'g, Inc. 1988). In 1494, an Italian monk named Fra Luca Pacioli formalized and catalogued the then-current state of bookkeeping, including a description of early double-entry bookkeeping, in his book *Summa de Arithmetica Geometria, Proportioni et Proportionalita*. See Richard H. Macve, *Pacioli's Legacy*, in ACCOUNTING HISTORY FROM THE RENAISSANCE: A REMEMBRANCE OF LUCA PACIOLI 3–30 (T.A. Lee et al. eds., 1996) [hereinafter ACCOUNTING HISTORY].

²³ See LITTLETON, *supra* note 22, at 165; see also JOHN L. CAREY, THE RISE OF THE ACCOUNTING PROFESSION: FROM TECHNICIAN TO PROFESSIONAL, 1896–1936, at 17–19 (1969).

Even fewer individuals were able to have a public accounting practice as their only source of income.²⁴ Others who considered themselves accountants or bookkeepers were likely full-time employees of the sundry business enterprises of the day.²⁵ In fact, one major accounting historian has suggested that there were no real accountants before the nineteenth century, only bookkeepers.²⁶

With the advent of the Industrial Revolution and the concomitant shift from an agrarian to a capital intensive, industrial economy, business and financial structures became markedly more complicated. This required more rigorous theories and systems of bookkeeping, which, in turn, led to formal accounting.²⁷ The passage of early modern corporation law statutes in Great Britain and the United States came in tandem with this economic shift.²⁸ Some of the most salient features of these new statutes included the perpetual existence of a duly formed and maintained corporation, and an allowance for the entity to have a broadly stated business purpose.²⁹ The shift from limited term business partnerships that effected one specific venture—for instance, a single overseas trade expedition—to perpetual corporations with ongoing ventures, prompted the shift from so-called “agency bookkeeping” to “proprietorship bookkeeping.”³⁰ This shift, in turn, caused bookkeeping to evolve into accounting by “transforming a mere method of systematically recording exchanges into a means of giving business management an effective control over its affairs.”³¹

Of course, as the number and size of corporate industrial activities grew, the reach of their economic impact grew as well. As a result, corporate industries increasingly had a financial impact on a greater segment of the general public, including employees, managers,

²⁴ See CAREY, *supra* note 23, at 18–19; LITTLETON, *supra* note 22, at 265.

²⁵ Today one such position is that of the company “controller” or “comptroller.” See A HANDBOOK OF BUSINESS LAW TERMS 128–29, 145 (Bryan A. Garner ed., 1999).

²⁶ See LITTLETON, *supra* note 22, at 271–84, 361–68. In fact, the title of “accountant” for an independent professional does not seem to appear in directories in England until after 1766. See *id.* at 267.

²⁷ John Richard Edwards, *Financial Accounting Practice 1600–1970: Continuity and Change*, in ACCOUNTING HISTORY, *supra* note 22, at 31–45.

²⁸ See JOEL SELIGMAN, CORPORATIONS: CASES AND MATERIALS 3–18 (1995).

²⁹ See *id.*

³⁰ See LITTLETON, *supra* note 22, at 155–61. “Agency bookkeeping” developed from the “charge and discharge” records kept by servants for masters arising in the medieval feudal system and pertained simply to explaining the servant’s activities with the master’s goods and property. See *id.*; see also *infra* note 112 and accompanying text. “Proprietorship bookkeeping” focused instead on the “continuing investment of capital variously employed and periodically summarized.” See LITTLETON, *supra* note 22, at 156.

³¹ See LITTLETON, *supra* note 22, at 165.

shareholders, creditors, and debtors.³² At the same time, extensive formal capital markets were developing—notably in London³³—and stock exchanges were beginning to list substantial numbers of corporate securities over and above their early focus on government securities.³⁴ Within these markets, more investors from the general public began buying corporate securities (particularly railway company stock) and losing money through questionable circumstances that led to declines in share value. Industries either had to regulate themselves or suffer imminent government financial regulation.³⁵ A number of companies responded by issuing regular periodic financial statements to shareholders.³⁶ At the same time, new bankruptcy laws in England, premised on some disastrous failings of rail and other ventures, helped to create a new market for individuals skilled in bookkeeping and early accounting methods.³⁷ Nevertheless, the new corporate structure also was used to defraud investors outright through worthless or “watered” stock issued from sham corporations.³⁸

In England, one important response to the foregoing problems was the passage of an interrelated system of statutes, often referred to generally as the “Companies Acts,” beginning in the mid-1800s. The lineage of these statutes actually extends further back to the South Sea Bubble of the early 1700s. During the peak of this well-known example of early speculative frenzy in stock trading, Parliament passed a law reasserting the restriction of incorporation authority to the Crown and Parliament.³⁹ The Bubble Act expressly authorized King George

³² See SELIGMAN, *supra* note 28, at 3–18; see also LITTLETON, *supra* note 22, at 205–22.

³³ See CAREY, *supra* note 23, at 18; Edwards, *supra* note 27, at 36. Note that the Industrial Revolution commenced in England before it was brought to the United States. Thus, in many corporate and securities law advances, developments occurred in England before appearing in the United States.

³⁴ See Edwards, *supra* note 27, at 35–40.

³⁵ See *id.* The explosive growth of the rail system in England led to one of the earliest episodes when capital requirements were so great that investment by a significant portion of the general public was necessary. See *id.* It would appear that episodes such as this—despite the ensuing scandals—actually whetted the public's appetite for corporate securities investment, as some individuals watched others become fabulously rich off a few well-placed investments.

³⁶ See *id.*

³⁷ See LITTLETON, *supra* note 22, at 271–84.

³⁸ See SELIGMAN, *supra* note 28, at 11–16 (stating that the bubble was a result of a myriad of companies attempting to offer shares to the public in emulation of the success of the South Sea Company).

³⁹ See Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 806–07 (2002); Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. REV. 77, 94–96 (2003). Because European countries traditionally viewed incorporation as

to grant charters for two companies: the first company would be for the purpose of assuring ships and merchandise at sea, and the second company would be for the purpose of "lending money on bottomry."⁴⁰ In addition, the Bubble Act flatly extinguished virtually all other existing companies that were not created under a valid royal charter or parliamentary act. It also prohibited any new corporations from forming, or "presuming to act as corporate bodies," without enabling charters or statutes.⁴¹ The Bubble Act actually may have precipitated the disastrous bursting of the South Sea Bubble, or it simply may have been concomitant with it. One commentator, however, has suggested that it was the first example of a recurrent pattern of economic boom, bust, and over-reactive regulation.⁴²

It took more than a hundred years for Parliament to move past its concerns over unregulated "joint stock companies"⁴³ and repeal the Bubble Act via the Bubble Companies Act of 1825.⁴⁴ Parliament's reward for doing so was the unbridled "railway mania" speculation of the 1830s and 1840s alluded to above. Thus, Parliament yet again was prompted to pass legislation to restrict joint stock companies. This time, however, it responded with regulation rather than prohibition.

possible only by permission of the sovereign—the "concession" system—individuals in Great Britain simply had no rights to incorporate without such a concession prior to the 1800s. See Pistor et al, *supra*, at 806–07. They nonetheless found ways to skirt this general restriction, sometimes by buying charters from "moribund" companies. *Id.* at 806. The passage of the Bubble Act itself seemed to suggest that, at other times, enterprising individuals simply waffled on the form of their business venture, running the grey area between a large partnership and a true "corporation"—with or without "legal authority." See 6 Geo., c. 18 (1719) (Eng.). Thus, there was a need to "reassert" the exclusive authority of the sovereign.

⁴⁰ 6 Geo., c. 18. The first granting power clearly was directed to restrict the power to create any more overseas trading expeditions, such as the original South Sea Company, to the Crown. "Bottomry" is the maritime law term for secured lending transactions for use, equipment, or repair of a ship, using the ship itself (or its keel or "bottom") as security. BLACK'S LAW DICTIONARY 197 (8th ed. 2004). In the event that the ship was lost during a specified journey or time period, the lender lost his money. See *id.*

⁴¹ 6 Geo., c. 18. The captions of the relevant sections of the Bubble Act state, "After 24 June 1720, all undertakings tending to the prejudice of trade, and all subscriptions, &c. thereto, or presuming to act as corporate bodies without legal authority, and all acting under obsolete charters, &c. shall be deemed illegal and void." *Id.*

⁴² See Ribstein, *supra* note 39, at 96.

⁴³ "An unincorporated association of individuals possessing common capital, the capital being contributed by the members and divided into shares, of which each member possesses a number of shares proportionate to the member's investment." BLACK'S LAW DICTIONARY, *supra* note 40, at 298.

⁴⁴ 6 Geo. 4, c. 91 (Eng.).

In particular, the Joint Stock Companies Act of 1844⁴⁵ provided that companies could choose to incorporate without royal charter or parliamentary act ("free registration" or "free incorporation"), provided they registered with the Registry Office, an entity newly created by the Act, in compliance with a prescribed schedule of information.⁴⁶ Further, the Joint Stock Companies Act of 1844 required that registration occur before any "Prospectus, Handbill, or Advertisement" was distributed to the public.⁴⁷ Upon the filing of the registration form, a company would receive a provisional certificate of incorporation, but could not receive its "Certificate of complete registration" until certain other formalities were executed in writing by shareholders.⁴⁸ The Joint Stock Companies Act of 1844 contains an interesting combination of regulations anticipating, and influencing, U.S. federal securities laws, much of which is clearly directed toward protecting shareholders.⁴⁹ Of relevant note is a provision for audits and auditors to be elected by the shareholders, which will be discussed in Part I.B, together with the further evolution of this statute.⁵⁰

The Joint Stock Companies Act of 1844 expressly did *not* extend to either "charter" or "statutory" companies.⁵¹ Because Parliament was creating an increasing number of statutory companies, however, it apparently was tiring of repeating what was becoming a standard litany of provisions for governance of the companies. In response, it passed the Companies Clauses Consolidation Act in 1845 (the "1845 Companies Clauses Act").⁵² This legislation also sought to codify numerous provisions for the protection of shareholders, including requirements for audits and auditors.⁵³ Similarly, the Chartered Companies Act of 1837 allowed the Crown to create corporations by issu-

⁴⁵ 7 & 8 Vict., c. 110 (Eng.).

⁴⁶ See *id.* sched. C (setting forth prescribed information in Schedule C). This legislation moved England permanently away from the sole "concession" model of corporate bodies and into the modern era of "free registration." See Pistor, *supra* note 39, at 806-07.

⁴⁷ 7 & 8 Vict., c. 110. Clearly, the Joint Stock Companies Act of 1844 established a forerunner of the Securities and Exchange Commission (the "SEC") and anticipated modern securities regulation through registration and disclosure. See *id.* at § 4.

⁴⁸ See *id.* §§ 4, 7.

⁴⁹ At the same time, England was not the first to move to free registration; that honor fell to the State of New York in 1811. See Act of Mar. 22, 1811, ch. 67, 1811 N.Y. Laws 151-52.

⁵⁰ See *infra* notes 106-230 and accompanying text.

⁵¹ See 7 & 8 Vict., c. 110. That is, the Joint Stock Companies Act of 1844 did not extend to those companies created by royal charter or Parliamentary act, respectively. See *id.*

⁵² 8 & 9 Vict., c. 16 (Eng.); see also 8 HALSBURY'S STATUTES OF ENGLAND AND WALES 8 (Andrew Davies ed., 4th ed. 1999) [hereinafter HALSBURY'S STATUTES].

⁵³ See *infra* notes 106-238 and accompanying text.

ing letters patent, rather than solely through the lengthier process of granting a royal charter, so long as companies created by such letters patent adhered to the provisions of the Act.⁵⁴ No express provision for audits or auditors was included in this legislation, however.⁵⁵

Although the provisions for "auditors" in the Joint Stock Companies Act of 1844 and the 1845 Companies Clauses Act did not encompass accountants specifically, as will be discussed below, company-elected auditors increasingly hired and relied on public accountants to fulfill their duties under these statutes.⁵⁶ Thus, this evolution in corporate law in England provided still more work for accountants, and yet another impetus to develop a true profession. Over time, accountants—often "chartered accountants" as described below—were elected directly as company auditors.⁵⁷

At the same time, the growing awareness of, and focus on, the corporation as a distinct legal person led to a new perspective in accounting—the "entity theory." This approach viewed bookkeeping as "primarily concerned with accounting to 'outsiders' for all property entrusted from without to 'the business' and dedicated to its purposes."⁵⁸ Several scholars have noted that the "entity theory" was said to be "quite opposite to the proprietorship theory, in which bookkeeping is viewed as an accounting by the proprietor for his own property in detail and in total."⁵⁹ Ironically, this was also a shift away from the relatively new "proprietorship accounting" back to the older "agency accounting."⁶⁰

This new accounting perspective comported with the growing sense that some of the fundamental issues inherent in the new corporate forms were predicated on conflicted agency relationships.⁶¹

⁵⁴ 7 Will. 4 & 1 Vict., c. 73, §§ 2-32 (Eng.).

⁵⁵ Overall, governance of the corporation is not as detailed in the Chartered Companies Act of 1837 as it is under either the Joint Stock Companies Act of 1844 or the 1845 Companies Clauses Act. This is perhaps because fewer corporations were being formed by charter and/or because the Crown granted more deviation in governance structures among its chartered companies than Parliament was granting in its statute companies. See Companies Clauses Act, 1845, 8 & 9 Vict., c. 16; Chartered Companies Act, 1837, 7 Will. 4 & 1 Vict., c. 73.

⁵⁶ See *infra* notes 106-238 and accompanying text.

⁵⁷ See *infra* notes 106-238 and accompanying text.

⁵⁸ LITTLETON, *supra* note 22, at 191.

⁵⁹ *Id.*

⁶⁰ See *id.* at 193.

⁶¹ This view finds its greatest expression much later, of course, in the seminal work by Adolph A. Berle, Jr. and Gardiner C. Means on the agency implications of separated ownership and management. See generally A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 112-16 (rev. ed. 1968) (1932).

Whereas the earlier corporations had a relatively small number of shareholders, the new corporations drew increasingly on unprecedented numbers of shareholders.⁶² As the stock exchanges became more robust, allowing for a marvelous liquidity of many companies' shares, the now ever-changing "shareholder" often became as fungible as the shares he or she held.⁶³ Thus, the sense of the shareholder as an "owner" of the business in any meaningful sense was rapidly deteriorating. This alteration in the conception of shareholders was surprising given that one of the core purposes of the corporate model was separating management from ownership so that businesses could draw on a far larger and more stable pool of capital than would be available from even the largest viable partnership models of business. Nonetheless, the shift had some profound and unexpected consequences for the business and financial environment.

As discussed above, England embarked on a long and convoluted path of three distinct corporate law lineages largely intended to protect shareholders through *inter alia* audit and auditor requirements drawing upon the well-established British audit tradition.⁶⁴ In contrast, no requirements for—or protections by way of—auditors appeared to be available in the United States under either federal or state law before the enactment of the federal securities laws in the 1930s.⁶⁵ At the same time, the United States initially lagged behind Great Britain in industrialization and the development of sophisticated financial markets.⁶⁶ Further, the United States largely avoided some of the extreme stock speculative frenzies that roiled Great Britain and Europe,⁶⁷ which may have limited the interest in regulating corporations, securities, and accountants through legislation.

All of these factors arguably led to the development of an accounting profession in the United States later than in Great Britain, in terms of both numbers of accountants and formal organizations.⁶⁸ Of particular note, the precursor to the Institute of Chartered Ac-

⁶² See LITTLETON, *supra* note 22, at 205–06.

⁶³ See *id.* at 203.

⁶⁴ See *infra* notes 106–238 and accompanying text.

⁶⁵ See SELIGMAN, *supra* note 28, at 3–18.

⁶⁶ See, e.g., R.R. PALMER & JOEL COLTON, A HISTORY OF THE MODERN WORLD 435 (6th ed. 1984).

⁶⁷ See LITTLETON, *supra* note 22, at 255.

⁶⁸ See CAREY, *supra* note 23, at 18–22, 34 (noting, for example, 11 accountants listed in London in 1799, growing to 210 by 1850; compared with 14 accountants in New York in 1850, growing to 115 by 1886).

countants of Scotland (the "ICAS") received a royal charter in 1854.⁶⁹ The accounting societies in England formed around the same time, but did not receive their royal charter—as the unified Institute of Chartered Accountants in England and Wales (the "ICAEW")—until 1880.⁷⁰ In the United States, the first formal association for public accountants and precursor to the American Institute of Certified Public Accountants (the "AICPA") did not appear until 1887, and even then it had no authority other than itself.⁷¹

Similarly, although the ICAEW introduced mandatory qualifying examinations in 1882 to regulate who could adopt the title of Fellow Chartered Accountant,⁷² there was no examination requirement—private or public—in the United States until 1896. At that time, New York passed a law to regulate accountants who desired to practice under the new title of "certified public accountant" ("CPA").⁷³ Over the

⁶⁹ See *id.* at 19; see also INST. OF CHARTERED ACCOUNTANTS OF SCOT., *ICAS Celebrates 150 Years*, at http://www.icas.org.uk/site/cms/v4_newsArticleView.asp?article=2957 (last visited Oct. 1, 2004). The original charter was granted to the Society of Accountants in Edinburgh, while the Institute of Accountants and Actuaries in Glasgow received its royal charter in 1855, and the Society of Accountants in Aberdeen received its royal charter in 1867. See CAREY, *supra* note 23, at 19; see also INST. OF CHARTERED ACCOUNTANTS OF SCOT., *supra*. Collectively, the societies were known as the "Chartered Accountants of Scotland," and their members were the only individuals in the United Kingdom who could use the designation "Chartered Accountant" or "CA." See CAREY, *supra* note 23, at 19; see also INST. OF CHARTERED ACCOUNTANTS OF SCOT., *supra*. A Supplemental Charter in 1951 merged the three societies and gave rise to the current name. See CAREY, *supra* note 23, at 19; see also INST. OF CHARTERED ACCOUNTANTS OF SCOT., *supra*.

⁷⁰ See CAREY, *supra* note 23, at 19–20; see also INST. OF CHARTERED ACCOUNTANTS IN ENG. & WALES, *Governance and Structure: History and Overview*, at http://www.icaew.co.uk/index.cfm?AUB=TB2I_49070,MNXI_49070&route=11295,P,11388,11389,49070 (last visited Oct. 1, 2004). Local societies in London, Liverpool, Manchester, and Sheffield were merged to create the Institute of Chartered Accountants in England and Wales (the "ICAEW"). See CAREY, *supra* note 23, at 19; see also INST. OF CHARTERED ACCOUNTANTS IN ENG. & WALES, *supra*.

⁷¹ See CAREY, *supra* note 23, at 22; see also AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *Summary of AICPA Operations*, at <http://www.aicpa.org/about/summary.htm> (last visited Oct. 1, 2004).

⁷² See CAREY, *supra* note 23, at 20, 39. "Fellow Chartered Accountant" ("FCA") signified a partner or proprietor in practice, while "Associate Chartered Accountant" ("ACA") signified a qualified member of an FCA's staff, or a member of the ICAEW not in active practice. Both FCAs and ACAs might be referred to casually as "chartered accountants." See *id.* at 20; see also INST. OF CHARTERED ACCOUNTANTS IN ENG. & WALES, *supra* note 70.

⁷³ Act of Apr. 17, 1896, ch. 312, 1896 N.Y. Laws 263–64. The original law required those seeking the "certified public accountant" ("CPA") designation, including use of the abbreviation "C.P.A." or any similar "words, letters or figures" that would indicate the same (1) to be either U.S. citizens, or to have declared an intention to so become, (2) to reside or to have a place of regular business in New York, (3) to be over the age of twenty-one, and (4) to be of good moral character. *Id.* at § 1. Certification authority fell to the Regents

next decade, similar laws followed in Pennsylvania,⁷⁴ Maryland,⁷⁵ California,⁷⁶ Washington,⁷⁷ Illinois,⁷⁸ New Jersey,⁷⁹ Florida,⁸⁰ and Michigan.⁸¹ Of important note for later development, however, the U.S. state laws granted certification authority to certification boards not linked directly to either the accountant's local or national professional associations. This bifurcation of the certification process from the professional association arguably weakened the ability of either state or professional authorities to police issues such as auditor independence effectively. By comparison, the accounting professions in Scotland, on the one hand, and England and Wales, on the other, each have a unitary source of certification and association, as well as the express (and enforceable) public interest mandate of royal chartered organizations.⁸²

A major additional benefit of royal chartering to the U.K. accounting organizations was "the prestige attaching to [royal charters]." ⁸³Chartering further operated as a device to separate individuals with specific training and expertise in accounting from the increas-

of the University of the State of New York. *See id.* at §§ 1-2; *People v. Marlowe*, 203 N.Y.S. 474, 474 (Ct. Sp. Sess. 1923). The Regents were empowered to create a board of examiners, that would be comprised of three members, all of whom were to be CPAs beginning after 1897. *See Act of Apr. 17, 1896*, § 2. Certification could be revoked for cause after notice and a hearing. *See id.* The examination requirement could be waived only for public accountants in practice for at least one year before passage of the Act, provided that such accountant applied for waiver within one year after passage of the Act. *See id.* at § 3. Violations of the Act were made misdemeanors. *See id.* at § 4.

⁷⁴ *See Act of Mar. 29, 1899*, No. 17, 1899 Pa. Laws 21-22.

⁷⁵ *See Act of Apr. 10, 1900*, ch. 719, 1900 Md. Laws 1148-1149.

⁷⁶ *See Act of Mar. 23, 1901*, ch. 213, 1901 Cal. Stat. 645-646.

⁷⁷ *See Act of Mar. 12, 1903*, ch. 72, 1903 Wash. Laws 99-101.

⁷⁸ *See Act of May 15, 1903*, 1903 Ill. Laws 281-283.

⁷⁹ *See Act of Apr. 5, 1904*, ch. 230, 1904 N.J. Laws 400-404.

⁸⁰ *See Act of June 5, 1905*, 1905 Fla. Laws ch. 5425, §§ 106-108.

⁸¹ *See Act of May 4, 1905*, No. 92, 1905 Mich. Pub. Acts 130-132.

⁸² *See INST. OF CHARTERED ACCOUNTANTS IN ENG. & WALES*, *supra* note 70; *INST. OF CHARTERED ACCOUNTANTS OF SCOT.*, *supra* note 69; *see also INST. OF CHARTERED ACCOUNTANTS IN ENG. & WALES*, *Royal Charter of the 11th May 1880* [hereinafter *Royal Charter*], available at http://www.icnew.co.uk/index.cfm?AUB=TB2I_29914,MNXI_29914 (last visited Oct. 1, 2004). Of note, the ICAEW's 1880 Royal Charter also prohibits FCAs from splitting fees with persons in other professions, including fees in the form of commissions, which anticipates similar prohibitions coming into effect much later in the U.S. profession. *See Royal Charter*, *supra*.

⁸³ CAREY, *supra* note 23, at 20 (quoting SIR HAROLD HOWITT, *THE HISTORY OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES* (1966)). In fact, the ICAEW's Royal Charter was premised explicitly on the hope that such a charter would bring "public recognition of the importance of the profession and would tend to gradually raise its character." *Royal Charter*, *supra* note 82.

ing numbers of both well-intentioned, and not so well-intentioned, untrained persons who held themselves out as public accountants to satisfy the booming demand for accounting services.⁸⁴

As substantial amounts of British capital began to flow to the United States to finance the latter's industrialization, the now well-respected Scottish and British chartered accountants followed to monitor the capital owners' investments.⁸⁵ These British capital owners seemed reluctant to hire U.S. accountants⁸⁶—even though one would guess that travel expenses alone would have driven up the cost of British and Scottish accountants over their American counterparts. This was possibly a further demonstration of the power of the accreditation that came with royal charters.⁸⁷ A further insult to American accountants was that even American businesses favored British and Scottish accountants.⁸⁸ At the same time, a number of the chartered accountants from the United Kingdom wound up staying in the United States permanently and helped to establish some of the largest firms there, including some firms that continue to exist today.⁸⁹

The practice of most U.S.-trained public accountants towards the end of the nineteenth century was similar to that of U.K. accountants before industrialization, chartering, and the passage of the Joint Stock Companies Act of 1844. They helped businesses and individuals keep a proper set of books, generated financial statements for the client's internal use, and audited their books and inventories to guard against embezzling managers and subordinates.⁹⁰ This was pure "public accounting," in which services were provided solely for the benefit of paying clients.⁹¹ Duties and liabilities ran primarily to the client and consisted mainly of a duty to the client, and express third-party beneficiaries, to perform accounting services "with the care and cau-

⁸⁴ See LITTLETON, *supra* note 22, at 282–84.

⁸⁵ See CAREY, *supra* note 23, at 21–22, 27–28.

⁸⁶ See *id.* at 21–22, 27, 33–34.

⁸⁷ This reluctance to hire U.S. accountants was especially pronounced in the period before U.S. state CPA laws came into effect.

⁸⁸ See CAREY, *supra* note 23, at 26–28, 34.

⁸⁹ PricewaterhouseCoopers, LLP, for example, was established by British chartered accountants in the United States. See *id.* at 27–28.

⁹⁰ See *id.* at 25–26.

⁹¹ The discussion in these paragraphs does not encompass the imminent arrival of the expanded use of audited statements for the benefit of creditors and other third parties, which will be discussed below. See *infra* notes 326–338 and accompanying text.

tion proper to their calling."⁹² There was expressly *no* notion or duty pertaining to a "public calling" or obligations on behalf of the general public: "public accountants are 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."⁹³

Further, the new state CPA laws added no obligations to the general public.⁹⁴ Instead, state laws simply limited use of the designation "C.P.A." and similar "words, letters or figures" to individuals who met the state's professional criteria.⁹⁵ Nonetheless, the CPA laws generally were welcomed by the American profession.⁹⁶ In part, the laws seemed to be an acknowledgment of the "arrival" of accounting as an important profession, in the same league as law and medicine.⁹⁷ The accountant's embrace of state laws also was influenced partially by the profession's own initiatives to gain credibility and stature.⁹⁸ In New York, the State Legislature and the Regents of the University of the State of New York apparently did not think that the unregulated practice of public accounting was of itself as important or dangerous as, say, medicine. Indeed, they opted for a law that set out requirements only for those holding themselves out as "certified public accountants" (or other "expert" designations), instead of a law regulating all public accountants.⁹⁹ The other states who were early adopters of CPA laws also followed this model.¹⁰⁰ Of course, these states may simply have been following the chartered accountant model from Great Britain. In the U.K. system, there was no general regulation of "accountants," but instead only a royal charter that gave the chartered societies, such as the ICAEW, the sole power to grant specific titles variant on the theme of "chartered accountant."

⁹² See *Ultramares Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931). This case also contemplates a duty not to defraud any foreseeable users of the accountant's audit certificates, as will be discussed below. See *infra* notes 311-444 and accompanying text.

⁹³ See *Ultramares*, 174 N.E. at 448.

⁹⁴ See *supra* notes 73-81.

⁹⁵ See, e.g., *supra* note 73.

⁹⁶ See CAREY, *supra* note 23, at 43-45.

⁹⁷ See *Marlowe*, 203 N.Y.S. at 479.

⁹⁸ In fact, other accountants, along with the precursor of the American Institute of Certified Public Accountants (the "AICPA"), had pushed for legislation recognizing the profession as early as 1894. See CAREY, *supra* note 23, at 43-44. This is not surprising given the effect that chartering seems to have had on the prestige of their British and Scottish counterparts.

⁹⁹ *Marlowe*, 203 N.Y.S. at 477; CAREY, *supra* note 17, at 43-44.

¹⁰⁰ See *supra* notes 74-81.

The development of this sort of accredited profession-within-a-profession in the United States, however, led to challenges as to the authority of states to qualify CPAs—in particular, when the state rules conflicted with or overruled a “certification” granted by a non-governmental entity.¹⁰¹ These states ran up against private organizations purporting to grant the “degree” of certified public accountant, and the concomitant claim that successful candidates of these programs should be allowed to use the “CPA” designation regardless of state law on the matter.¹⁰² In 1923, in *People v. Marlowe*, a New York court rejected these claims as precluded by the state’s police and welfare powers.¹⁰³ Further, the court was quick to point out that the legislature was not regulating all of public accounting, but rather providing a particular way for highly qualified accountants to claim a measurable level of expertise.¹⁰⁴ The new accreditation also raised questions as to the various legislatures’ choice of the term “certified public accountant.” One noted accounting historian has suggested that a variation on “chartered accountant” was considered, but rejected on the grounds that it might conflict with the rights of the chartered accountants from the British Isles—who continued to have a strong presence in the United States. Additionally, the American accountants themselves did not want to seem to be aping their British and Scottish counterparts.¹⁰⁵

B. *Development of the Modern Corporate Audit in Britain*

The foregoing model of pure public accounting, of course, is oversimplified in one regard—it does not include the audit function that would become a cornerstone of the modern CPA practice.¹⁰⁶

¹⁰¹ In the United Kingdom, this problem likely was blunted or was eliminated simply because of the broader power of the Crown.

¹⁰² See, e.g., *Marlowe*, 203 N.Y.S. at 475–76.

¹⁰³ *Id.* at 476–77. Legislation was “in the public interest and for the general welfare” in order to “regulate the highly skilled and technical profession of public [accounting].” *Id.*

¹⁰⁴ See *id.* at 477. Perhaps this was yet another reason for adopting a limited accreditation model in the United States, rather than a strict regulation of all accountants.

¹⁰⁵ See CAREY, *supra* note 23, at 44–45. John L. Carey further notes that the title “public accountant” was so well established by individual accountants and in the names of professional associations, that “the simple addition of the prefix ‘certified’ seemed to meet with general approval.” *Id.* at 45. But perhaps state legislatures preferred it because it was more accurate; they were establishing criteria to certify accounting professionals much as they provided for certification of other professionals, such as doctors and lawyers. There was simply no “charter” or “chartering” involved.

¹⁰⁶ See LITTLETON, *supra* note 22, at 259 (stating that “[o]ne of the elements of accounting which definitely distinguishes it from bookkeeping is auditing”).

That is in part because the audit function that is now well established evolved through some unexpected twists and turns that will provide the narrative for the rest of this Article. The contemporary notion of an audit as an examination of financial books and records by a professional accountant is only one specific instance of the larger context in which the term and concept originated. In one limited and technical sense, "auditing"—as simply a process of checking financial records for errors—may be traced all the way back to Fra Luca Pacioli in the fifteenth century.¹⁰⁷ The tradition that leads to our contemporary audit, however, is not actually that of the accountant or bookkeeper *per se*. Instead, it dates back to the practice commencing in thirteenth century Great Britain wherein regular members of a community or enterprise were charged by their fellows to act as "awdytours" to "verify the honesty of persons charged with fiscal, rather than managerial, responsibilities."¹⁰⁸ Such persons to be audited included both government and private enterprise officials.¹⁰⁹

This audit process also found a natural home in the manors of England from the fourteenth century onward, where the auditor would have been the most trusted member of the household staff.¹¹⁰ The auditor would "hear the accounts" presented by all his or her fellow servants in the manor who were charged with control of money or property. Accordingly, the auditor had substantial power, including a role in legal proceedings brought against unfaithful servants.¹¹¹ All of

¹⁰⁷ See *id.* For background on Fra Luca Pacioli and his contributions, see *supra* note 16.

¹⁰⁸ See LITTLETON, *supra* note 22, at 260–61. For example, beginning in 1310, "six good men of the city, elected in the presence of the whole commonalty" were to audit the chamberlain of the City of London. *Id.*

¹⁰⁹ See *id.*

¹¹⁰ See *id.* at 261–62. The auditor's importance in the manor is reflected in the following statement:

"The auditor being the laste of all officers, is to bee judge betwixte the lorde and his accomptants, and to deale trulie for and beetween all parties, and upon the determination of his audite, to presente to his lorde by booke or breviat, all his receipts, expenses, imprestes; whatsoever, with the remaines of monye, if any bee."

Id. (quoting an unsigned statement written in 1605). Further, an early fourteenth century book on estate management advised that "[t]he auditors ought to be faithful and prudent." *Id.* at 262 (quoting Walter of Henley, HUSBANDRY).

¹¹¹ See *id.* at 262 ("[A] statute of Edward I in 1285 . . . provided that servants found 'in arrearages upon the account could be sent to prison by the testimony of the auditor.'). This early practice of literally "hearing the accounts" was based on the limited ability to read and write among the general population and led to the use of the term "auditor" in the first place. See *id.*

these early audits were premised on an earlier bookkeeping method of "charge and discharge," which simply tracked money and property "charged" to a servant as that servant "discharged" them through the intended disposition of the master.¹¹² The audits themselves were not necessarily viewed as accounting or bookkeeping exercises. Early examples of proto-audit certificates included statements in audit reports for the City of Aberdeen from 1586 through 1587, which noted that the accounts had been "'Heard, seen, considerit, calculat, and allowit by the auditors,' and 'futit, calculat and endit by Auditors.'"¹¹³

One noted accounting historian summed up these early audits as falling into two general categories: (1) "more or less public hearing[s] of the results of the fiscal activities of governmental officers by delegated representatives of the citizens[.]" and (2) "careful scrutiny by a trusted officer of the manor of the 'charge and discharge' accounts of those household officers who had fiscal responsibilities."¹¹⁴ The common theme, of course, was the delegated authority by those who had valuable interests in certain assets to a trusted agent, working solely on their behalf. This person was to check up on the use of those assets by other agents who had been charged with their disposition. In standard agency law terms, a principal would authorize one agent to investigate the activities of another agent. Under standard common law agency principles, both agents had clear, enforceable fiduciary duties running to the principal.¹¹⁵

Put into the foregoing context, then, it is not surprising that a "statutory audit" was included in both the Joint Stock Companies Act of 1844 and the 1845 Companies Clauses Act.¹¹⁶ Further, both statutes required that the shareholders appoint at least one of the auditors.¹¹⁷ There was also no requirement that auditors be accountants,¹¹⁸ again harkening back to the origins of the audit provision in the older Eng-

¹¹² See Edwards, *supra* note 27, at 32-33.

¹¹³ LITTLETON, *supra* note 22, at 263. "Futit" signified "footed," as in the modern practice of referring to tabulations as "footings."

¹¹⁴ *Id.* at 263-64.

¹¹⁵ See WILLIAM A. GREGORY, *THE LAW OF AGENCY AND PARTNERSHIP* §§ 65-74 (3d ed. 2001) (explaining the duties of agents).

¹¹⁶ This connection between feudal audits and the statutory audit provisions is suggested by A.C. Littleton. See LITTLETON, *supra* note 22, at 288-90.

¹¹⁷ The rule in the Joint Stock Companies Act of 1844. See 7 & 8 Vict., c. 110, § 38 (Eng.). The 1845 Companies Clauses Act further specifies that such auditors must hold at least one share in the company, but otherwise they must have no other interest in it (for example, as officers or directors). See 8 & 9 Vict., c. 16, § 102 (Eng.).

¹¹⁸ See Companies Clauses Act, 1845, 8 & 9 Vict., c. 16, § 102; Joint Stock Companies Act, 1844, 7 & 8 Vict., c. 110, § 38.

lish auditor custom of municipalities and manor houses. The 1845 Companies Clauses Act, however, specifically authorized the elected auditors to hire professional accountants, if they desired, and to charge the expense to the company.¹¹⁹

On this last point, some confusion enters the accounting history literature. A.C. Littleton, in his early seminal history of accounting, placed the two parliamentary acts in sequence, with one amending the other, rather than realizing that they represent two distinct lineages of legislation (and subject matter).¹²⁰ John L. Carey also committed and amplified this error in his later, and equally renowned, history of the American accounting profession, by collapsing the two statutes into one that he dated to 1845.¹²¹ A.C. Littleton also asserted an "evolution" of auditor qualifications in what he seemed to believe was a direct lineage of parliamentary acts even beyond the Joint Stock Companies Act of 1844 and 1845 Companies Clauses Act:

Under the act of 1845 every auditor "*shall have* at least one share" and may employ an accountant to assist (Sec. 102); under the act of 1862 the auditors "*may be* members of the company" and may employ accountants to assist (table A, Sec. 86); under the companies act of 1908 no qualification in regard to stock holding by the auditor was mentioned and the item about employing an accountant to assist was omitted. (Sec. 112).¹²²

It seems that A.C. Littleton is suggesting that the evolution was from traditional English "auditors," who might employ accountants, to professional accountants, who are directly appointed as the sort of auditors we think of today. There also seems to be an inference that the audit role was generalized and weakened over time. It changed from one that primarily empowered shareholders to examine management reports, to one that simply had professional accountant/auditors cer-

¹¹⁹ See 8 & 9 Vict., c. 16, § 108.

¹²⁰ LITTLETON, *supra* note 22, at 289 ("Within a few months [the Joint Stock Companies Act of 1844] was revised and repassed as 'the companies clauses consolidation act' of 1845.").

¹²¹ See CAREY, *supra* note 23, at 17. John L. Carey's debt to, and reliance on, A.C. Littleton is acknowledged clearly at the outset of the chapter in which the error occurs. *Id.* at 13.

¹²² LITTLETON, *supra* note 22, at 293 (alteration in original) (quoting in unnumbered footnote Company Clauses Act, 1845, 8 & 9 Vict., c. 16, § 102; The Companies Act, 1862, 25 & 26 Vict. c. 89, tbl.A, § 86 (Eng.); and The Companies Act, 1908, 8 Edw. 7, c. 12, § 112 (Eng.) respectively).

tifying company financial statements for the unfocused benefit of the entire investing public.¹²³

In fact, no such evolution occurred. Instead, the passage of the 1845 Companies Clauses Act had no effect on the Joint Stock Companies Act of 1844.¹²⁴ Thus, the free incorporation lineage of companies statutes began with no requirement for auditors to be shareholders, nor was there an explicit provision for auditors to hire accountants.¹²⁵ The only real requirement was that at least one auditor must be appointed by the shareholders directly.¹²⁶ Of note for later discussion, though, the Joint Stock Companies Act of 1844 also provided that a government agency, the Commissioners of the Treasury, was empowered to set the auditor's salary, as "appear[ed] suitable" to the Commissioners and that such salary was legally enforceable against the company.¹²⁷ Additionally, the auditor's report on management's mandatory half-yearly presentation of the company's accounts and balance sheet had to be sent with the latter materials to the government Registrar of Joint Stock Companies. The auditor's report also needed to be available for public inspection at the Registry Office.¹²⁸ Aside from the auditor's reports, however, which were made available either directly from the company or through the Registry Office, shareholders had only a qualified right to inspect the company's books. Further, the company had discretion to mandate the terms of any inspection.¹²⁹

The Joint Stock Companies Act of 1844 was amended and repealed¹³⁰ over time through different acts, some of which themselves

¹²³ This was more clearly the American system that was taking shape just as A.C. Littleton published his book in 1933, but it ignored the historical and cultural context of British audits that A.C. Littleton himself worked so hard to establish. *See generally* LITTLETON, *supra* note 22.

¹²⁴ *See* Companies Clauses Act, 1845, 8 & 9 Vict., c. 16 (lacking any mention of repeal or amendment of Joint Stock Companies Act of 1844, as was the custom of other repealing or amending acts in the same era).

¹²⁵ *See* Joint Stock Companies Act, 1844, 7 & 8 Vict., c. 110, § 38 (Eng.).

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* at § 43.

¹²⁹ *See id.* at § 37. The 1845 Companies Clauses Act has a similar limited right of inspection by shareholders, and further, does not provide for an outside government Registry Office. Of course, a Registry Office is less relevant for statutory companies: because they can only be created by a Parliamentary act, the government is already fully aware of each one that comes into existence. *See* 8 & 9 Vict., c. 16, §§ 117, 119.

¹³⁰ The amendment and repeal of the Joint Stock Companies Act of 1844 excepted existing companies registered under it, until they reregistered under the subsequent acts, as well as existing and to be formed insurance companies. *See infra* note 133.

were amended and repealed.¹³¹ First, it was amended in 1847,¹³² and then it was repealed by the Joint Stock Companies Act, 1856 (the "1856 Act").¹³³ The new law added a right for one-fifth of shareholders, in number and value, to request that the government Board of Trade appoint inspectors to examine the affairs of the company,¹³⁴ which seems to indicate a concern to give substantial, yet minority, subsets of shareholders another avenue to investigate the company beyond the existing audit rights. It also included, however, a provision for companies to appoint their own inspectors to investigate the company's affairs, in a manner similar to that used to request Board of Trade inspectors.¹³⁵ The resulting separate inspection performed by these inspectors seems to have replaced the limited direct shareholder inspection rights of the previous statute, because the only direct inspection right in the 1856 Act is one reasonably limited by the company and solely for purposes of inspecting the "Register of Shareholders"—not the general books of the company.¹³⁶ Both new inspector provisions, however, required management to produce all books and documents requested by the inspectors, as well as to answer any question, under oath, posed by the inspectors on pain of penalties and fines.¹³⁷

The 1856 Act also established default audit provisions that were strengthened in comparison to the original Joint Stock Companies Act of 1844. Auditors were not expressly required to be shareholders, but at the same time, auditors could not be interested in any transaction of the company in any manner *other* than as a shareholder.¹³⁸

¹³¹ Some amendments were directed only toward the winding-up provisions of the law and will not be recounted here.

¹³² Act to Amend [the Joint Stock Companies Act of 1844], 10 & 11 Vict., c. 78 (1847) (Eng.). This amending statute did not alter the audit provisions of the Joint Stock Companies Act of 1844.

¹³³ 19 & 20 Vict., c. 47 (Eng.). The Joint Stock Companies Act, 1856 also repealed the 1847 amendment. *See* Act to Amend the Joint Stock Companies Acts, 1856 and 1857, 21 & 22 Vict., c. 60 (1858) (Eng.); [Second] Act to Amend the Joint Stock Companies Act, 1856, 20 & 21 Vict., c. 80 (1857) (Eng.); Act to Amend the Joint Stock Companies Act, 1856, 20 & 21 Vict., c. 14 (1857) (Eng.).

¹³⁴ *See* Joint Stock Companies Act, 1856, 19 & 20 Vict., c. 47, § 48.

¹³⁵ *See id.* at § 51.

¹³⁶ *See id.* at § 23. Similarly, companies now were required only to register initially with the Registry Office and then to submit annual "Register of Shareholders," but not the balance sheets and reports of the company. *See id.* at § 17. This is possibly because the specific accounts and reports required in the body of the 1844 statute were now arguably "optional," depending simply on the regulations that the company had adopted, as discussed below. *See infra* notes 144–146 and accompanying text.

¹³⁷ *See id.* at §§ 49, 51.

¹³⁸ *See id.* at tbl.B, ¶ 76.

Officers and directors were ineligible to be auditors while they remained in those offices.¹³⁹ The company had first rights to set the compensation of the auditors.¹⁴⁰ Auditors explicitly were permitted to hire accountants at the expense of the company (in line with the 1845 Companies Clauses Act),¹⁴¹ and had express powers to "examine" officers and directors.¹⁴² Of particular note, the 1856 Act also specifically set forth what be thought of as the core definition of the modern professional audit:

The auditors shall make a Report to the Shareholders upon the Balance Sheet and Accounts, and in every such Report they shall state whether, in their Opinion, the Balance Sheet is a full and fair Balance Sheet, containing the Particulars required by these Regulations, and properly drawn up so as to exhibit a true and correct View of the State of the Company's Affairs, and in case they have called for Explanations or Information from the Directors, whether such Explanations or Information have been given by the Directors, and whether they have been satisfactory; and such Report shall be read, together with the Report of the Directors, at the Ordinary Meeting.¹⁴³

Companies were free, however, to adopt modified versions of any of the default "Regulations for Management of the Company" included as Table B of the 1856 Act.¹⁴⁴ If they adopted no regulations, then the default rules were considered binding on the company.¹⁴⁵ It is unclear whether a company could adopt regulations that completely ignored specific provisions of the default rules—for example, the audit provisions—or regulations that represented such watered-down provisions as to vitiate any practical import. Further, a company's regulations always could be modified by special resolution of the shareholders,¹⁴⁶ and the belief may have been that shareholders who wanted audit provisions in place would get them through a special resolution if they were not already part of the company's regulations.

¹³⁹ See Joint Stock Companies Act, 1856, 19 & 20 Vict., c. 47, tbl.B, ¶ 76.

¹⁴⁰ See *id.* at tbl.B, ¶¶ 78, 81.

¹⁴¹ See *id.* at tbl.B, ¶ 83.

¹⁴² See *id.*

¹⁴³ *Id.* at tbl.B, ¶ 84.

¹⁴⁴ See Joint Stock Companies Act, 1856, 19 & 20 Vict. c. 47, § 9.

¹⁴⁵ See *id.*

¹⁴⁶ See *id.* at §§ 33–36.

The following year, the 1856 Act was amended first by The Joint Stock Companies Act, 1857,¹⁴⁷ and then further by An Act to Amend "The Joint Stock Companies Act, 1856."¹⁴⁸ Neither one of these amendments modified the existing audit provisions.¹⁴⁹ The 1856 Act was later amended once more,¹⁵⁰ with no changes to the audit provisions, before itself being repealed in 1862.¹⁵¹

The Companies Act, 1862 (the "1862 Act") repealed the Joint Stock Companies Act, 1856, and its progeny.¹⁵² It also repealed or amended a number of other statutes, effectively bringing together all of the laws governing both regular "trading" joint stock companies and banking companies, the only exceptions being charter and statutory companies. In dropping the "joint" part of the previous statute names, it also signified a move towards the modern use of the unmodified term "company" to include joint, fixed stock firms. The statute preserved the right of shareholders to request an examination of the affairs of the company by inspectors from the Board of Trade, or by their own inspectors.¹⁵³ It also retained the provisions for a "Register of Members"¹⁵⁴ which had to be available to shareholders at the company's office and submitted to the government Registry Office for inspection by the general public.¹⁵⁵ Further, shareholders still could amend the regulations of the company by special resolution.¹⁵⁶

The default audit provisions of the Joint Stock Companies Act, 1856, persisted as well, with minor alterations. Auditors now were charged expressly with performing an audit once a year¹⁵⁷ and the company was to set compensation at-large in general meeting.¹⁵⁸ The 1862 Act also provided an interesting first suggestion of an "audit

¹⁴⁷ 20 & 21 Vict., c. 14 (Eng.).

¹⁴⁸ 20 & 21 Vict., c. 80 (1857) (Eng.).

¹⁴⁹ As a side note, the original Joint Stock Companies Act of 1844 remained in force throughout this period for companies that had been formed under it before repeal, as well as for insurance companies either existing or to be formed. *See id.* at § 1.

¹⁵⁰ *See* The Joint Stock Companies Amendment Act, 1858, 21 & 22 Vict., c. 60 (Eng.).

¹⁵¹ *See* The Companies Act, 1862, 25 & 26 Vict., c. 89 (Eng.).

¹⁵² *See id.* at § 4, sched. 3, pt. 1. This Schedule provides an excellent listing of the prior acts amended or repealed by The Companies Act, 1862. Insurance companies were also required to register under and in accordance with the provisions of this law. *See id.* at § 209.

¹⁵³ *See id.* at §§ 56-60.

¹⁵⁴ In the various companies acts, there is a certain interchangeability of the terms "member" and "shareholder."

¹⁵⁵ *See id.* at §§ 25-26, 32.

¹⁵⁶ *See id.* at §§ 50-51, 53-54.

¹⁵⁷ *See* The Companies Act, 1862, 25 & 26 Vict., c. 89, sched. 1, ¶¶ 83-94.

¹⁵⁸ *See id.*

committee"—although of course not composed of directors or officers, nor a committee of the board of directors—in a model "Memorandum of Association" given as an attachment to the statute.¹⁵⁹ This memorandum suggested that the audit committee normally would be nominated by the members—that is, shareholders—of the company at the annual meeting, and have all the powers of the auditors under the statute.¹⁶⁰

There followed a long succession of amending acts, few of which had a substantial effect on the audit provisions that were now well established for stock companies.¹⁶¹ Much of this amending history was based on attempts to limit the "illegitimate or fraudulent practices on the part of unscrupulous persons" who exploited the limited liability system introduced by the 1862 Act.¹⁶² At the same time, it was claimed to be "obvious to everyone of what value and importance the limited liability system has been and is to the commercial prosperity of the country."¹⁶³ Indeed, by 1907, there were 40,000 companies operating under the various free incorporation companies acts with a total of £2,000,000,000 invested in them.¹⁶⁴ Thus, the number of free incorporation companies already far outstripped the numbers of either charter companies or statute companies. Accordingly, the free incorporation system encompassed the lion's share of incorporated busi-

¹⁵⁹ See *id.* at § 29, sched. 2, form. B.

¹⁶⁰ See *id.* at §§ 29-34, sched. 2, form. B.

¹⁶¹ Other acts were passed to amend The Companies Act, 1862, directly, but they are of limited relevance here otherwise. See The Companies Act, 1908, 8 Edw. 7, c. 12 (Eng.) (permitting companies incorporated in British possessions to own land); The Companies Act, 1898, 61 & 62 Vict., c. 26 (Eng.) (empowering courts to enforce various provisions of the collected companies acts); The Companies (Winding up) Act, 1893, 56 & 57 Vict., c. 58 (Eng.) (amending further winding up procedures); The Companies (Winding up) Act, 1890, 53 & 54 Vict., c. 63 (Eng.) (specifying winding up procedures); The Companies (Memorandum of Association) Act, 1890, 53 & 54 Vict., c. 62 (Eng.) (allowing companies to modify their memorandum of association, or other incorporating document, by special resolution); The Companies Act, 1886, 49 Vict., c. 23 (Eng.) (providing for liquidation procedures for companies in Scotland); The Companies (Colonial Registers) Act, 1883, 46 & 47 Vict., c. 30 (Eng.) (permitting companies incorporated in British colonies to keep local registers of members); The Companies Act, 1880, 43 Vict., c. 19 (Eng.) (permitting distributions of accumulated capital to shareholders on certain conditions and establishing power of the Registrar of Companies to remove names of defunct companies from the Registry); The Companies Act, 1877, 40 & 41 Vict., c. 26 (Eng.) (clarifying that "capital" includes "paid up capital" and that companies can reduce the same); The Joint Stock Companies Arrangements Act, 1870, 33 & 34 Vict., c. 104 (Eng.) (specifying conditions on winding up arrangements between creditors and shareholders); An Act to Amend The Companies Act, 1862, 30 & 31 Vict., c. 47 (1867) (Eng.) (later known as "The Companies Act, 1867") (simplifying settlement of company debts to the Crown).

¹⁶² 2 CHITTY'S STATUTES OF PRACTICAL UTILITY 531 n.(q) (W.H. Aggs ed., 6th ed. 1911).

¹⁶³ *Id.*

¹⁶⁴ *Id.* (citing Lord Granard, House of Lords (Mar. 14, 1907)).

ness enterprise in England and could not be disassembled practically at that late date.

A few amendments of The Companies Act, 1862, are worth noting, however. The Companies Act, 1879,¹⁶⁵ removed any ambiguity about requirements for both auditors and an annual audit, at least for banking companies, by adopting the now standard audit provisions of the default regulations of previous acts.¹⁶⁶ The 1879 Act also instituted a new requirement—again only for banking companies—that the balance sheets submitted to shareholders as part of the annual, or other, meetings be signed by the auditors, as well as the directors of the company.¹⁶⁷

A clear precursor to the liabilities, and defenses, of company directors pursuant to untrue statements made in stock prospectuses that appear in the '33 Act was set out in the Directors Liability Act, 1890.¹⁶⁸ Of note here, is the provision that allowed directors to defend such claims based on good faith reliance on the expert reports of others, such as accountants.¹⁶⁹

The turn of the century brought a major change regarding audits and auditors to the Companies Acts, 1862 to 1898,¹⁷⁰ in the form of the Companies Act, 1900 (the "1900 Act").¹⁷¹ The new law removed the ambiguity about audits brought on by the placement of the rele-

¹⁶⁵ 42 & 43 Vict., c. 76 (Eng.).

¹⁶⁶ *See id.* at § 7.

¹⁶⁷ *See id.* at § 8. Note that this is different from requiring auditors to sign their *own* reports.

¹⁶⁸ 53 & 54 Vict., c. 64 (Eng.).

¹⁶⁹ *Id.* at § 3(1)(b). This prescient provision reads as follows:

With respect to every such untrue statement purporting to be a statement by or contained in what purports to be a copy of or extract from a report or valuation of an engineer, valuer, accountant, or other expert, that it fairly represented the statement made by such engineer, valuer, accountant, or other expert, or was a correct and fair copy of or extract from the report or valuation. Provided always, that notwithstanding that such untrue statement fairly represented the statement made by such an engineer, valuer, accountant, or other expert, or was a correct and fair copy of an extract from the report or valuation, such director, person named, promoter, or other person, who authorised the issue of the prospectus or notice as aforesaid, shall be liable to pay compensation as aforesaid if it be proved that he had no reasonable ground to believe that the person making the statement, report, or valuation was competent to make it . . .

Id.

¹⁷⁰ This is the convention set out in the various amending acts themselves. *See, e.g.*, Companies Act, 1900, 63 & 64 Vict., c. 48, § 36 (Eng.).

¹⁷¹ 63 & 64 Vict., c. 48.

vant provisions in the "optional" default regulations of Table B in the 1862 Act, by reinserting them in the body of the new statute.¹⁷² This development extended the trend of requiring audits, which started in the Companies Act, 1879, for banking companies, to all companies covered by the Companies Acts, 1862 to 1898.

Of note, these audit provisions continued the practice of the "optional" default audit provisions of earlier acts in which the only qualification for auditors was that they could not also serve as officers or directors of the company.¹⁷³ Remuneration and appointment of auditors remained generally the sole province of the company acting in general meeting—that is, full shareholder participation and voting.¹⁷⁴ The auditors continued to have rights of access at all times to the books, accounts, and vouchers of the company, as well as the right to require information and explanations from directors and officers.¹⁷⁵ Their mode of reporting was altered, however, because aside from the regular reports on the accounts examined, the auditors were to "sign a certificate at the foot of the balance sheet stating whether or not all their requirements as auditors have been complied with."¹⁷⁶ Finally, more references to auditors began appearing in other parts of the sections of the Companies Acts, 1862 to 1898, including those in the 1900 Act, suggesting an expanding formal role for auditors. In particular, the 1900 Act included a provision mandating that prospectuses include the names and addresses of the company's auditors,¹⁷⁷ and that the report from the initial "statutory meeting" of the company contain a capitalization section certified as correct by the auditors.¹⁷⁸

One final relevant amending act rounds out the history of the Companies Acts, 1862 to 1900—the Companies Act, 1907 (the "1907 Act").¹⁷⁹ The new law primarily concerned the issuances of prospectuses, and included a requirement that a prescribed "Statement in Lieu of Prospectus" be filed with the Registrar of Companies if no

¹⁷² See *id.* at §§ 21–23.

¹⁷³ See *id.* at § 21(3). That is, of course, auditors could only serve as officers of the company by virtue of being auditors; they could not occupy other officer positions.

¹⁷⁴ See *id.* at § 21. The directors can appoint the initial auditors and fill any casual vacancies. In addition, they can set remuneration in the foregoing situations.

¹⁷⁵ See *id.* at § 23.

¹⁷⁶ 63 & 64 Vict., c. 48, § 23.

¹⁷⁷ See *id.* at § 10(1)(i).

¹⁷⁸ See *id.* at § 12(3). The "statutory meeting" appears akin to the organizational meeting required of most new corporations in U.S. state corporation laws.

¹⁷⁹ 7 Edw. 7, c. 50, §§ 1–52 (Eng.).

prospectus was used in connection with the sale of stock.¹⁸⁰ The 1907 Act also included a revision of the now mandatory audit provisions of the 1900 Act. In particular, the audit section was revised to require that (1) either the auditor's report be directly attached to any balance sheet submitted to the shareholders in general meeting, or a reference to the report must be included at the foot of the balance sheet; (2) the auditor's report had to be read before the company in general meeting and to be open to inspection by any shareholder, including a right to copies for nominal charge; (3) anyone, other than a retiring auditor, who was to be nominated for appointment as auditor at the general meeting must be nominated by a shareholder who discloses such intention to nominate the individual a prescribed period before the meeting; and, (4) when any copies of balance sheets were issued, circulated, or published without being signed by the directors and including the auditor's report or reference thereto, the persons responsible for such act could be fined up to fifty pounds.¹⁸¹

The new law also required companies that had to submit annual reports to the Registry Office with summaries of financial activities under the Companies Acts, 1862 to 1900, to include a balance sheet audited by the company's auditors.¹⁸² This clearly anticipated the later annual statutory audit required under rules promulgated by the Securities and Exchange Commission (the "SEC") under the '34 Act. It also represented an interesting step forward in the British system for auditor's reports possibly to be used, and to be relied on, by persons other than management and shareholders of the company.

When the accretion of amending statute upon statute had become too labyrinthian, however, Parliament once again repealed the whole lot and replaced it with the Companies (Consolidation) Act, 1908.¹⁸³ This Act preserved the two important protections of inspection by the Board of Trade on request of a subset of shareholders¹⁸⁴ and annual audits by auditors who could not be officers or directors of the company, and who must be appointed by the company-at-large in the annual meeting.¹⁸⁵ Auditors retained their powers of access to

¹⁸⁰ See *id.* at §§ 1-3.

¹⁸¹ See *id.* at § 19.

¹⁸² See *id.* at § 21.

¹⁸³ 8 Edw. 7, c. 69, §§ 1-296 (Eng.).

¹⁸⁴ See *id.* at § 109.

¹⁸⁵ See *id.* at §§ 112-113.

documents and management and their rights to issue reports accessible to shareholders.¹⁸⁶

Further, the requirements to file an annual register of members, as well as an audited balance sheet, with the Registry Office continued in force.¹⁸⁷ The register also had to be kept at the registered office of the company and had to be made available for inspection by both shareholders (*gratis*) and the general public (for no more than one shilling).¹⁸⁸ Copies of the annual report and the register needed to be made available on request by either shareholders or members of the public for no more than sixpence per hundred words.¹⁸⁹

The company and its officers could incur liability for not making the register and annual report available pursuant to the foregoing requirements,¹⁹⁰ but it is not clear whether the audited balance sheet was "relied on" by members of the public enough to create any liability issues for the auditors. A provision of the Companies (Consolidation) Act, 1908, however, established liability in certain instances:

[When] any person in any return, report, certificate, balance sheet, or other document, required by or for the purpose of any of the provisions of this Act specified in the Fifth Schedule hereto, wilfully [*sic*] makes a statement false in any material particular, knowing it to be false, he shall be guilty of a misdemeanor ¹⁹¹

Finally, this lineage of companies acts metamorphosed through one more set of amendments before again being repealed and consolidated into the Companies Act, 1929, which would, in turn, be the direct template for the '33 Act in the United States.¹⁹² In particular, the Companies (Consolidation) Act, 1908, would be amended by the Companies Act, 1913;¹⁹³ the Companies (Particulars as to Directors) Act, 1917;¹⁹⁴ and the Companies Act, 1928 (the "1928 Act").¹⁹⁵ The last of these, however, would never become effective because the Companies Act, 1929, was passed before many of the 1928 Act's provisions

¹⁸⁶ *Id.* at § 113, ¶¶ 1-4.

¹⁸⁷ *See id.* at § 26, ¶ 3.

¹⁸⁸ *See* Companies (Consolidation) Act, 1908, 8 Edw. 7, c. 69, § 30, ¶ 1 (Eng.).

¹⁸⁹ *See id.* at § 30, ¶ 2.

¹⁹⁰ *See id.* at § 26, ¶ 5 & § 30, ¶ 3.

¹⁹¹ *Id.* at § 281.

¹⁹² *See infra* notes 311-444 and accompanying text.

¹⁹³ 3 & 4 Geo. 5, c. 25 (Eng.).

¹⁹⁴ 7 & 8 Geo. 5, c. 28 (Eng.).

¹⁹⁵ 18 & 19 Geo. 5, c. 45 (Eng.).

were implemented; therefore, much of 1928 Act was either repealed or restated in the Companies Act, 1929.¹⁹⁶

For the purposes of this Article, though, it is only the new material included in the final consolidation of the 1928 Act and the Companies Act, 1929, that advances the audit story in a curious way. Of central importance for this story, and with little explanation, the Companies Act, 1929, brought into force a new provision of the 1928 Act that required an auditor's report on the profits of the company for the preceding three years to be part of any prospectus used to sell stock.¹⁹⁷ This report also would set out the rates of dividends, if any, paid on each class of shares in each of the three years covered.¹⁹⁸ Additionally, where any proceeds of the securities offering would be used to purchase another business, a report by accountants—to be named in the prospectus—covering the profits of that business for the preceding three years also had to be included.¹⁹⁹ This unassuming change to a schedule to the 1928 Act furthered the new trend for British company audits to be used, and relied on, by others outside of the company's management and shareholders.

Aside from this new audit requirement for prospectuses, though, the Companies Act, 1929, did not add much to the story. Directors and other officers, in certain circumstances, could still rely on accountant's reports in liability actions based on untrue statements in prospectuses.²⁰⁰ The register of members was no longer required to be submitted annually to the Registry Office, but it had to be indexed and updated and available to a prescribed minimum extent to shareholders and members of the public at the company's registered office.²⁰¹ An annual return, however, was still required to be filed with the Registry Office, as well as made available by the company in the same manner as the register.²⁰² This return also had to include a list of shareholders as well as the last audited balance sheet, together with its auditor's re-

¹⁹⁶ See 26 CHITTY'S STATUTES OF PRACTICAL UTILITY 553 (Theodore John Sophian ed., 1929).

¹⁹⁷ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, sched. IV, pt. II (Eng.). This provision was derived from the Companies Act, 1928. See 18 & 19 Geo. 5, c. 45, § 33. The general provisions for the prospectuses themselves are set out at sections 34 through 38 of the Companies Act, 1928. *Id.* §§ 33–38.

¹⁹⁸ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, sched. IV, pt. II.

¹⁹⁹ See *id.*

²⁰⁰ See *id.* § 37(1)(d). Accountants are "experts" per section 37(4). *Id.* § 37(4).

²⁰¹ See *id.* §§ 97–98.

²⁰² See *id.* §§ 108–111.

port.²⁰³ Newly formed companies still had to hold a "statutory meeting" and issue a "statutory report," certified by the company's auditors to members, as well as file a copy of the report with the Registry Office.²⁰⁴

Likewise, the standard auditor provisions were fully retained,²⁰⁵ except that the disqualifications as to eligibility to act as an auditor were extended beyond officers and directors of the company to encompass (1) persons who are partners or employees of an officer of the company and (2) any corporation.²⁰⁶ There were also extra calls for use of auditors' reports, such as in the case of holding and subsidiary companies,²⁰⁷ and a requirement that auditors must disclose the particulars of any case in which the accounts they had been examining were not kept in accordance with the provisions of the Act.²⁰⁸ In a new development, however, auditors were included expressly in a provision limiting so-called "willful default" clauses that indemnify or exempt directors and officers from liability that might otherwise attach under the law—regardless of whether the auditors were considered officers of the company by virtue of their positions.²⁰⁹

Additionally, in the now well established manner, balance sheets presented by management had to have auditor's reports attached, and the auditor's reports needed to be read at the general meeting and made available for inspection by shareholders.²¹⁰ Improperly executed balance sheets, or balance sheets without auditor's reports, that were distributed, continued to lead to liability for the knowing distributors.²¹¹ The rights of members to receive balance sheets, and auditor's reports attached thereto, however, were extended. For example, the Act required auditors to send these materials to shareholders in advance of meetings and to furnish the same upon demand, even to shareholders who might not otherwise have a right to them.²¹²

The provisions for inspectors from the Board of Trade were retained, but were strengthened, including subsequent court actions that may be premised on their findings. The provisions also were bal-

²⁰³ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, §§ 108, 110.

²⁰⁴ See *id.* § 113.

²⁰⁵ See *id.* §§ 132-134.

²⁰⁶ See *id.* § 133.

²⁰⁷ See *id.* § 126(2).

²⁰⁸ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 128(4).

²⁰⁹ See *id.* § 152. The auditor, as an officer, also might be subjected to the extra penalties for officers acting in default of provisions of the Act. See *id.* § 365.

²¹⁰ See *id.* § 129.

²¹¹ See *id.*

²¹² See *id.* § 130.

anced by inquiry and security requirements of those calling for such inspection to minimize bad faith requests.²¹³ Similarly, companies retained the ability to appoint their own inspectors by special resolution, with similar rights and obligations of those appointed by the Board of Trade.²¹⁴

In sum, the Companies Act, 1929, continued the established framework for the audit and auditor requirements, while consolidating a trend of gradual, incremental expansion of audit report use. The primary thrust of the system, however, was still to provide shareholders an organized mechanism that they could control to monitor directors' and officers' management of the company. Before turning to summarize the overall state and context of auditors and audits in the British system—up to that system's pronounced influence on the drafting and passage of the '33 Act in the United States—it is important to tie up some loose ends. This will be done by briefly tracing the less convoluted paths of audit provisions in the lineages of acts governing statutory companies and charter companies.²¹⁵

To begin, the Companies Clauses Act, 1845 (the "1845 Act"), governing statutory companies, is still valid law.²¹⁶ It has been amended, but not fully repealed. The Companies Clauses Act, 1863, was the first amendment, but it mainly concerns modifications of the capitalization provisions.²¹⁷ Next, the Companies Clauses Act, 1869, modified provisions regarding debentures.²¹⁸ The amending acts were consolidated in the Companies Clauses Consolidation Act, 1888 (the "1888 Act"),²¹⁹ which led to the full law as to statutory companies distributed between the original 1845 Act and the 1888 Act, all of which is cited as the Companies Clauses Consolidation Acts, 1845 and 1888.²²⁰ The 1888 Act itself only modifies provisions regarding proxy voting. Finally, the Statutory Companies (Redeemable Stock) Act, 1915, permitted statutory companies to authorize and to issue redeemable preference and debenture stock.²²¹ Accordingly, essentially all of the law regarding statutory companies was set out among the Companies Clauses Act, 1845, the Companies Clauses Consolidation Act, 1888, and the Statutory

²¹³ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, §§ 135–136.

²¹⁴ See *id.* § 137.

²¹⁵ See *infra* notes 216–236 and accompanying text.

²¹⁶ See 8 & 9 Vict., c. 16 (Eng.); see also 8 HALSBURY'S STATUTES, *supra* note 52, at 8.

²¹⁷ 26 & 27 Vict., c. 118 (Eng.).

²¹⁸ 32 & 33 Vict., c. 48 (Eng.).

²¹⁹ 51 & 52 Vict., c. 48 (Eng.).

²²⁰ See *id.* § 1.

²²¹ 5 & 6 Geo. 5, c. 44 (Eng.).

Companies (Redeemable Stock) Act, 1915—especially when considering it at the time of passage of the '33 Act in the United States.

The audit and auditor provisions in this lineage were contained in the 1845 Act, as discussed briefly above. These provisions may be amended or disregarded, however, when the specific parliamentary act that created the company did so expressly. Thus, to some extent, all of the Companies Clauses Consolidated Acts, 1845 and 1888, are default rules.²²² To expand on the brief sketch of audit provisions above, the following are the "default" requirements for statutory companies: auditors must be elected by the shareholders in the same manner as directors;²²³ there must be two auditors unless the shareholders vote otherwise;²²⁴ auditors must hold at least one share in the company, but they may not hold any other office in the company, nor have any other interest in the company other than as a shareholder;²²⁵ one auditor in any given year must rotate out of office, but can be re-elected as a "new" auditor immediately;²²⁶ auditors must receive and examine the half-yearly reports of the directors;²²⁷ auditors may employ accountants at the expense of the company;²²⁸ and auditors can either make a special report on their examination of the half-yearly directors' reports, or simply confirm the directors' reports, with such report or confirmation to be read at the general meeting.²²⁹

Other important provisions not related specifically to audits or auditors include the following: a "Shareholder Address Book" must be kept and made available to shareholders, but not the general public, in the same manner as the Register of Members for joint stock companies;²³⁰ general meetings must be held half-yearly;²³¹ officers are specifically liable to account for their use of company monies, with specific penalties, including possible criminal charges, for non-

²²² See 51 & 52 Vict., c. 48, § 1.

²²³ See Companies Clauses Act, 1845, 8 & 9 Vict., c. 16, § 101 (Eng.). This is more specific than the "appointment of auditors" by "general meeting" in the Companies Acts.

²²⁴ See *id.*

²²⁵ See *id.* § 102.

²²⁶ See *id.* § 103. Of course, this seems a little formalistic, with little practical safeguarding benefit.

²²⁷ See *id.* § 107. And, the directors are obliged to deliver the same to them. See *id.* at § 106.

²²⁸ See 8 & 9 Vict., c. 16, § 108.

²²⁹ See *id.*

²³⁰ See *id.* This is in addition to a Registry of Shareholders, but that registry is not required to be available to shareholders in the same manner. See *id.* at § 9.

²³¹ See *id.* § 66.

compliance;²³² and accounts must be kept, and books balanced, with shareholders given limited rights to see evidence of the same.²³³

For chartered companies, the lineage of statutes is even briefer. The original Chartered Companies Act, 1837,²³⁴ was amended only by the Chartered Companies Act, 1884,²³⁵ before both were repealed by the Statute Law (Repeals) Act, 1993.²³⁶ At the time of the '33 Act, however, both were still in force. For our purposes, neither act is particularly instructive, as they say little about audits or auditors as discussed above.

* * *

It is clear that the audit custom and office in British companies and law developed largely without formal reference to accountants, chartered or otherwise. Instead, they were rooted in a centuries old tradition of directly delegated agency to trusted individuals who would look after their principals' interests as against other agents of those principals. As explained below, the entire Companies Acts system was admired enough by Congress and the drafters of the '33 Act (and '34 Act) to be followed closely. Much of what was good in the Companies Acts, however, may well have stemmed from a top-down coherency allowed by the aggregation in one place of the law relating to corporations, securities regulation, and bankruptcy (insofar as related to rules governing the winding up of companies). Further, to the extent that accountants were employed—directly or indirectly—as auditors, they were also likely to be chartered accountants, who were themselves licensed, regulated, and associated professionally under one authority.

The real beauty of the British audit system, however, is that it existed as a stand alone office of the company, beholden only to shareholders as a watchdog for their interests. Audits were not done by a company's auditors for the use of third parties, such as creditors. Instead, as outlined above, British creditors tended to employ their own

²³² See *id.* §§ 109–114. This sounds like the old “charge and discharge” system, but with the directors acting as “auditors.”

²³³ See 8 & 9 Vict., c. 16, §§ 115–119.

²³⁴ 7 Will. 4 & 1 Vict., c. 73 (Eng.).

²³⁵ 47 & 48 Vict., c. 56 (Eng.) (granting power to Crown to renew terms of chartered companies).

²³⁶ Statute Law (Repeals) Act, 1993, c. 50 (Eng.), available at http://www.hmso.gov.uk/acts/acts1993/Ukpga_19930050_en_1.htm (last visited Oct. 1, 2004); see also 8 HALSBURY'S STATUTES, *supra* note 52, at 8. Even after the repeal of the Chartered Companies Act, 1837, and the Chartered Companies Act, 1884, however, the Queen still retained the power to grant charters of incorporation of limited duration and to extend or renew such charters, or the privileges granted by such, a charter. Statute Law (Repeals) Act, 1993, c. 50, § 11, sched. 2.

auditors to check up on their investments at home or abroad. When a company was being liquidated, the Board of Trade also could call for an audit of the accounts of the liquidator, but there is no indication that such audit would be done by the company's auditor, nor that any reliance would be given on the company's auditors' reports or certificates.²³⁷ Most important, there was no sense that a company's auditors were acting on behalf of the general public, or even on behalf of that subset which might be deemed the "investing public." This was because of the formal disconnect between the company office of "auditor" and the separate profession of accountants, chartered or otherwise. Thus, in the British system in place at the time of the passage of the '33 Act, auditors occupied a unique position as quasi-insiders—technically officers of the company—but also as elected agents or watchdogs for the existing shareholders. The auditor's role was essentially a "private" one, in that it was exclusively on behalf of the hiring party, the shareholders.

Chartered accountants, however, who performed audit services directly or indirectly as a company's auditors, might have felt a professional sense of duty to the general public in providing their services. Their primary duty, however, was still to their client—whether that client was the elected auditor of the company, or the shareholders of the company (in the case where the chartered accountant was directly elected as auditor). For that matter, chartered accountants were often hired to play other roles such as liquidator or receiver in the British system, but again, their role in those cases was not as a chartered accountant *per se*, but instead as that officer and in accordance with that officer's rights and obligations as set out in the various Companies Acts.²³⁸

In this regulatory environment, then, a true reputation marketplace for accounting and audit services could flourish. Chartered accountants picked up engagements as auditors, liquidators, or receivers for companies, creditors, or government agencies—or as professional "subcontractors" for others who filled those roles—based on their reputations as trustworthy and competent agents for their hiring principals, including, obviously, their facility with accounting. They were not conflicted in these engagements by being required to act for two or more principals on the same matter. Thus, no "auditor independence"

²³⁷ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23, § 195 (Eng.).

²³⁸ See LITTLETON, *supra* note 22, at 279–80.

rules developed or were needed in the British system existing at the time of passage of the '33 Act (or '34 Act) in the United States.

II. THE QUEST FOR PROFESSIONAL RECOGNITION

Across the Atlantic, however, both auditing and accounting were proceeding quite differently. The United States appears to have had fewer worries about "free incorporation," so state statutes allowing the formation of corporations simply upon registration cropped up earlier than the Joint Stock Companies Act of 1844 in Great Britain.²³⁹ The result, however, was numerous different corporation laws with little uniformity across the United States.²⁴⁰ Further, these were relatively bare bones laws that centered on registration requirements and formalities.²⁴¹ There were no audit provisions, nor for that matter, very many provisions for the protection of shareholders generally.²⁴²

Of relevance here, too, may be the timing of the development of corporations law in the United States. The American Revolution occurred during the period that the Bubble Act was in effect throughout the British Empire. Thus, the fledgling United States grew out of a background in which virtually no companies were allowed.²⁴³ At the same time, there was no longer any Crown to charter companies—the only way to establish companies under the Bubble Act. Thus, the only other logical counterpart to a British authority with the power to create companies would have been Congress. The history of the states as separate colonies, however, perhaps originally linked more tightly to Parliament and the Crown than to each other, coupled with the subsequent chaotic period of the Revolution and the hesitant steps from loose federation to republic through the War of 1812, may have further entrenched the development of corporations law as a state, rather than a federal matter. Additionally, the notion of central control of a basic, usually locally operating, commercial vehicle such as the corporation may have been exactly the sort of thing that smacked of the overbearing control of Parliament and the Crown, which the

²³⁹ See, e.g., *supra* note 44 (describing New York state statute).

²⁴⁰ See, e.g., BUREAU OF CORPS., U.S. DEP'T OF COMMERCE & LABOR, REPORT OF THE COMMISSIONER OF CORPORATIONS 39-40 (1904).

²⁴¹ See *infra* notes 311-347 and accompanying text.

²⁴² See *infra* notes 311-347 and accompanying text.

²⁴³ See *supra* notes 22-42 and accompanying text.

new United States had revolted against, and so instead properly fell to the powers reserved to the states under the U.S. Constitution.²⁴⁴

At the same time, the widely distributed wealth of the new country—largely spread out among the small family farms that accounted for ninety-five percent of the population²⁴⁵—likely reduced the need for an audit tradition similar to that of the great English manors. Similarly, the direct democracies of small town governments in the colonies, later states, and their relatively uncomplicated financial record keeping,²⁴⁶ may also have reduced the demand for audits of local government officials.

The foregoing, compounded with the later development of industrialization in the United States than in Great Britain, resulted in a slower development of the accounting profession and a largely absent tradition of auditing up until the mid-1800s.²⁴⁷ Thus, when industrialization was well underway in the United States by the mid-1800s, the nascent accounting profession was as decentralized and variable as the corporations laws.²⁴⁸ With no real professional body, and no licensing requirements to attest to competency, the profession likely was perceived as composed of "mere" bookkeepers of limited usefulness. Yet, as they had done in England, the developing industrial businesses and railroads necessitated accounting and audit services, as much as the ensuing speculative booms and busts did.²⁴⁹

Even in the late 1800s, however, as the transformation of the United States from an agrarian economy to an industrial one was nearing completion, the disaggregated profession was unable to achieve the same level of stature as its chartered counterparts in England and Scotland—whose members indeed were even then "invad-

²⁴⁴ See, e.g., INDUS. COMM'N, FINAL REPORT 645 (1902). In 1902, the federal Industrial Commission stated the following:

It has long been considered a fundamental principle of our Government that the States should retain a considerable proportion of the legal supervision of business. In the main, at the present time, the various civil rights of our citizens, including those rights which come under the law of contracts, are in the hands of the separate States. [A change in this status quo], while it may eventually be necessary, would prove centralizing to a degree to most people unthought of, in connection with our form of government.

Id.

²⁴⁵ See GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING 33-34 (1998).

²⁴⁶ See *id.* at 60.

²⁴⁷ See *supra* notes 22-105 and accompanying text.

²⁴⁸ See *supra* notes 22-105 and accompanying text.

²⁴⁹ See PREVITS & MERINO, *supra* note 245, at 66-73, 81-91.

ing" the United States to monitor substantial investments by British syndicates.²⁵⁰ Thus, from the long-awaited creation of the first American accountants' society in 1887, through the passage of the first CPA law in 1896, to the passage of the '33 Act, a defining goal of accountants was arguably their status as members of a true profession.²⁵¹ Nevertheless, the vagaries and inconsistencies of different state CPA laws worked against any sort of national reliance on accountants based on uniform minimum standards, such as existed for the English and Scottish chartered accountants. Additionally, few if any laws, state or federal, enshrined a role that seemed as custom built for accountants as the British Companies Acts did, at least indirectly.

The only element that American accountants could control was their association as a profession—and this they did by creating a "national" organization called the American Association of Public Accountants in 1887.²⁵² The organization grew slowly, however, and was comprised primarily of New York accountants through its first years.²⁵³ By 1904, accountants seemed as likely to be members of local societies as members of the "national" organization. Many of these local societies grew up as associations for newly minted CPAs under recent CPA laws.²⁵⁴ In fact, these local societies were numerous and substantial enough to create their own "Federation of Societies of Public Accountants in the United States of America."²⁵⁵ As the confusion reached a peak over the primacy of these accounting organizations, as well as membership requirements—for example, could all accountants or only CPAs join?—the first International Congress of Accountants was held that year in St. Louis.²⁵⁶ The International Congress provided a "rallying point" for American accountants, who then managed to merge or disperse their various professional associations such that the American Association of Public Accountants could lay claim as "the" association of the profession.²⁵⁷

The profession, however, still sought to burnish its image to the general public, to elevate itself above "mere bookkeepers," and to

²⁵⁰ See *supra* notes 85–88 and accompanying text.

²⁵¹ See CAREY, *supra* note 23, at 45–46.

²⁵² See *id.* at 36–38. This group is one of the precursors to the AICPA. Ironically, it was largely started by a transplanted English chartered accountant. See *id.*; see also AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 71.

²⁵³ See CAREY, *supra* note 23, at 39–40, 49.

²⁵⁴ See *id.* at 49–52; see also *supra* notes 73–81.

²⁵⁵ See CAREY, *supra* note 23, at 49.

²⁵⁶ See *id.* at 49–52.

²⁵⁷ See *id.*

take on weightier public service roles.²⁵⁸ In short, it wanted to be viewed as a prestigious learned profession such as law or medicine. The seeming attainment of this status by the English and Scottish chartered accountants made this goal all the more tantalizing.²⁵⁹

Opportunities to achieve this goal finally arose in the first two decades of the twentieth century. First, some major companies, such as the U.S. Steel Corporation and the American Tobacco Company, began experimenting with public disclosure of audits that they already were having done for other internal or shareholder purposes. Such public disclosure led to an increase in auditing work, generally in the guise of a new "best practice" for major companies.²⁶⁰ Second, auditors increasingly found their work commissioned by corporate clients, or others, in connection with credit facilities, investments, or investigations that involved a corporation.²⁶¹ Third, and most substantially, the passage of the Sixteenth Amendment to the U.S. Constitution²⁶² expressly permitted Congress to institute an income tax—which it did²⁶³—and dramatically increased the need for the services of accountants, as many of them had accurately predicted.²⁶⁴

Public disclosure of corporate finances and governance also may have been a preemptive response to increased calls for such disclosure—termed "publicity" in the jargon of the time²⁶⁵—regarding the inner workings of the powerful trusts that had come to dominate the economic landscape. At the height of the "trust busting" era at the turn of the century, the Final Report of the federal Industrial Commission called for *inter alia* (1) disclosure and anti-fraud measures related to the offering or sale of stock to the public; (2) disclosure of the nature of the business, and the powers and limitations of the directors and officers, of the publicly traded company in its certificate of incorporation, which must then be available for public inspection; (3) annual detailed financial reports to members or shareholders,

²⁵⁸ See *id.* at 45–46. One leading accountant from the time is quoted as frequently quipping that "[t]he public thinks a public accountant is a bookkeeper out of a job—who drinks." *Id.* at 46.

²⁵⁹ See *supra* notes 68–70 and accompanying text.

²⁶⁰ See CAREY, *supra* note 23, at 57–58, 83–84.

²⁶¹ See *id.* at 77; LITTLETON, *supra* note 22, at 298. In contrast, British audits rarely were relied upon by third parties as discussed above. See *supra* notes 106–237 and accompanying text.

²⁶² U.S. CONST. amend. XVI.

²⁶³ Tariff of 1913 (Underwood Tariff Act), Pub. L. No. 63-16, 38 Stat. 114 (codified as amended in scattered sections of 26 U.S.C.).

²⁶⁴ See CAREY, *supra* note 23, at 67–71.

²⁶⁵ See *infra* note 316 and accompanying text.

"verified by a competent auditor"; and (4) publication of annual, detailed financial reports, "properly audited" under oath and subject to government inspection.²⁶⁶

One member of the Industrial Commission, Thomas W. Phillips, was allowed to append a statement that went even further in its recommendations. His proposal would have pushed states to adopt uniform state corporation laws that *inter alia* would establish "a rigid system of public accounting"²⁶⁷ that would operate in two complementary ways:

First, each corporation should be required to make periodical reports of its business, supplemented by other reports upon official demand, all verified by oaths of certain of its officers. Second, official examiners should also be maintained, who should, at irregular periods and without notice, appear at the offices of each corporation and make rigid examination of its affairs, using its books in the first instance, but verifying the correctness thereof by every practicable method. The reports of this official should be made to a supervising official, and by him duly made public.²⁶⁸

Phillips pointed out that similar systems were already put in place by the federal government for banking concerns and manufactures of certain items on which the government levied internal taxes.²⁶⁹

Under his proposal, the annual reports would be made to an officer designated as the auditor and would contain information largely in accordance with that required under various reporting provisions of the British Companies Acts as discussed above.²⁷⁰ The auditor would prescribe the form of the reports and could call for additional reports. As to the level of scrutiny authorized, "No detail of the business of the corporation shall be considered private so as to be ex-

²⁶⁶ INDUS. COMM'N, *supra* note 244, at 649-650 (including recommendations from preliminary report in final report).

²⁶⁷ By "public accounting" Thomas W. Phillips appears simply to mean an "accounting to the public" on the part of the company, not the practice of being a public accountant as described *supra* notes 91-94 and accompanying text.

²⁶⁸ INDUS. COMM'N, *supra* note 244, at 669.

²⁶⁹ See *id.*

²⁷⁰ See *id.* at 670. Thomas W. Phillips does not state explicitly whether these provisions intentionally followed many of the British precedents, nor whether the "auditor" should be an accountant. See *id.* Likely, he deems this a permissive, rather than mandatory, aspect of the system, as he also provides for "expert accountants" to act as examiners subordinate to the auditor. See *id.* At the same time, however, the auditor can also play the role of an examiner at the auditor's own discretion, as discussed below. *Id.* at 671.

empt from the examination of the auditor, whenever he may demand report thereon."²⁷¹ Most important, the auditor would make such reports public, including a requirement that the final auditor approved version would be published by the company in a newspaper in accordance with regular custom for publication of corporate notices.²⁷² Appropriate penalties for corporations who attempted to evade or frustrate this reporting system also would be included.²⁷³

For "surprise" examinations, "expert accountants"²⁷⁴ would be provided for and, under the direction of the auditor, appear without notice and examine the books, property, records, and papers of the corporation.²⁷⁵ These examiners also would "have the power to examine under oath all officers or employees of the corporation, or any other person having any knowledge of its affairs"—all enforceable by appropriate court action.²⁷⁶ Auditors themselves could also act as examiners at their sole discretion.²⁷⁷ But examiners could not inspect any business if they were "interested in the business thereof, or of any competing concern, or [if they had] relatives who are so interested."²⁷⁸

It is not clear whether these auditors and examiners would be government employees, or even contractors, or whether they would instead be separate individuals or firms that then would be hired by stock companies to satisfy legal requirements (analogous to the contemporary statutory audit system). Further, the remuneration mechanism is not clearly specified.

Nonetheless, these proposals must have been terrifying to corporations big and small. Thus, in accordance with a well-worn pattern, the biggest, most notorious companies and trusts likely felt it was in their best interest to begin disclosing information on their own terms, rather than wait for state or federal regulation. Accordingly, whether evidencing a causal relationship or not, a number of these companies, including those mentioned above, began commissioning audits by external CPAs with the results made publicly available.²⁷⁹

²⁷¹ *Id.* at 671.

²⁷² *See id.*

²⁷³ *See* INDUS. COMM'N, *supra* note 244, at 671.

²⁷⁴ Interestingly, "certified public accountants" were not included—likely because not all states had passed CPA laws by this time.

²⁷⁵ *Id.*

²⁷⁶ *Id.* at 672.

²⁷⁷ *See id.*

²⁷⁸ *Id.*

²⁷⁹ *See* CAREY, *supra* note 23, at 57–58.

At the same time, the Industrial Commission's Final Report underscored the problems of a system in which the states exclusively had the power to create corporations:

It is important to observe that whenever any State has put conservative restrictions upon corporations, either as to their formation or their management, other States have taken advantage of the situation and enacted such liberal laws that corporations have removed to them from other States. Two or three States have apparently, for the sake of securing a certain revenue easily collected, bid against each other by offering more liberal inducements to corporations.²⁸⁰

So went an early formulation of the "race to the bottom" feared as a consequence of corporate "charter-mongering" among the states.²⁸¹ For this Article's purposes, though, it underscores the very different starting points that the United States and Great Britain were operating from in matters of corporations and audits: the former had no centralization of corporate laws, accountant certification, or securities regulation, while the latter had all three. As explained below, these crucial differences should have counseled against any easy adoption by the United States of specific solutions, taken out of context, that seemed to work in Great Britain.²⁸²

Fundamentally then, the development of accounting and auditing—especially regarding provision of certified audits to clients for "comfort" of interested third parties—was different in the United States. The banking community may have agreed as one banker "asserted that the accountants' clients were both the stockholders or owners of a business, and the investing public and their agent, the banker."²⁸³ Coupled with the needs of the fledgling American profession for expanded work engagements and enhanced prestige, this unique trajectory soon led the profession to offer its audit certification services to clients on behalf of broader and broader classes of third party beneficiaries. Additionally, unpopular corporate empires were apparently only too eager to bring on other parties such as accountants to deflect liability for financial misreporting.

²⁸⁰ INDUS. COMM'N, *supra* note 244, at 642–43.

²⁸¹ For a more contemporary account, see JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 42 (3d ed., Aspen Publishers 2003) (1982).

²⁸² See *infra* notes 464–481 and accompanying text.

²⁸³ CAREY, *supra* note 23, at 78.

As early as 1910, the profession seemed to acknowledge this different trajectory, and in particular, appeared to disapprove of the limited nature of the British auditor's job:

"[The president of the ICAEW] believes that the auditor is not "concerned in the volume of business a company does, whether it is overtrading, whether its working capital is sufficient, whether it is carrying on operations on too extensive a scale in countries where credit is bad and economic conditions are unfavorable"—nor should an auditor act or appear to act as a valuer. However, if assets appear to him to have been overvalued, he should say so.

In the United States it is generally recognized that the duties of an auditor depend very much upon circumstances. An auditor may certify merely to the correctness of the account-keeping, if that is all the directors of the company desire. Frequently, however, audits are made on behalf, not of directors, but of banks or intending investors or dissatisfied stockholders, and in such cases it will not be generally admitted in this country that an accountant has done his full duty if he has discovered merely that the accounts and financial statements are technically correct. The accountant's work under such circumstances combines that of the investigator and of the auditor."²⁸⁴

The author of the foregoing quotation seems to misunderstand the metes and bounds of the British statutory auditor's role. As previously explained, the latter simply is elected by the shareholders to verify, on their behalf, that the reports presented by company management fairly reflect the company's state of affairs.²⁸⁵ There is no provision for the British auditor to advance his opinions as to whether the company is being correctly or well managed. So long as the reports presented give shareholders an accurate view of the company, then the shareholders can decide whether the company is being properly run. If they believe that it is not, then they can bring about a change in management through total or partial ouster of the current board of directors.

Further, although British directors could hire or provide for their own internal audit of the company—and one would imagine that

²⁸⁴ *Id.* at 77 (quoting Editorial, *J. ACCOUNTANCY*, Nov. 1910).

²⁸⁵ See *supra* notes 223–229 and accompanying text.

some did simply as part of good governance and internal controls of the organization—they were not “masters” of the statutory audit and auditors. Additionally, as to other sorts of non-statutory audits, such as those commissioned by prospective creditors, it is not clear that the British chartered accountant felt any more constrained as to the scope of services than did an American counterpart. Even if the British chartered accountant did feel more constrained, this just further underscored the different context of “auditors” in the British tradition—the auditor and audit are merely instruments for principals to make sure that their agents are doing what they say they are doing, not to cast judgment on the overall wisdom of the enterprise. There is no doubt, however, that, upon proper engagement orders described as an “audit” or otherwise, British chartered accountants could accomplish an equally penetrating investigation as their American counterparts.

Of course, just as the respectable segment of the American accounting profession was trying to use these expanded new types of engagements to burnish the image of the profession,²⁸⁶ some other members, of questionable motive and qualifications, used the mounting lucrative demand for such services to their own ends, offsetting whatever salutary effects the former had.²⁸⁷ A major window of opportunity for the profession both to expand its services and reputation as a public service minded, learned profession, however, was perceived in the passage of the new income tax law of 1913.²⁸⁸ Often excluded, for one reason or another, in much of the previous federal legislation or rulemaking relevant to the profession, the American Association of Public Accountants, was now ready to become an active player in shaping both the passage and implementation of the new income tax law.²⁸⁹ Through a personal representative and a committee formed specifically for issues of federal legislation, the American Association was able to have mean-

²⁸⁶ See *id.* at 54–55. An editorial in 1907 stated the following:

“Publicity is a safe and conservative remedy for most corporate abuses. The certified public accountant is the authorized agent of publicity. Let popular discussion of this subject proceed until the people shall demand that the affairs of every public-service corporation, of every bank and of every insurance company shall be regularly examined by certified public accountants who are independent of the directors, if not also of the stockholders.”

Id. (quoting Editorial, J. ACCOUNTANCY, Nov. 1907).

²⁸⁷ See *id.* at 83–84.

²⁸⁸ Tariff of 1913 (Underwood Tariff Act), Pub. L. No. 63-16, § 2, 38 Stat. 114, 166–81 (codified as amended in scattered sections of 26 U.S.C.).

²⁸⁹ See CAREY, *supra* note 23, at 67–71.

ingful participation in the drafting and passage of the law, securing modified provisions of importance to the profession.²⁹⁰

The real payoff of the income tax law, of course, was the increased business that it brought to CPAs by those trying to make sense of, and get the best possible results under, the new tax system.²⁹¹ The profession was well primed for the latter as well, based on its experience with corporate clients under the Corporation Tax Act of 1909.²⁹² Arguably, these sorts of engagements began aligning CPAs with their corporate clients as advocates for the latter against the revenue seeking goals of the government. If so, then tax services represented an early form of "non-audit service" that potentially compromised the accountants' perceived objective and independent status as to third parties, in this case the government.

Even in the absence of any requirements for formal, public audits, one might question the alignment of accountants and their clients in efforts to minimize each client's tax burden while accountants were promoting their value as "independent" auditors and investigators. In fact, one member of the profession later proposed that the American Association of Public Accountants formally petition the Treasury Department to require attestation of income tax returns by accountants on behalf of filers.²⁹³ The American Association chose not to act on this proposal, apparently fearing that it would spur renewed government interest in registering accountants, such as had been proposed by the Federal Trade Commission (the "FTC") a year earlier in 1916.²⁹⁴ There was also some belief that "under Civil Service Commission rules it would be impossible to appoint practicing accountants as employees of the government."²⁹⁵ Over time, similar proposals would surface, but they always were rejected overwhelmingly as contrary to most accountants' views of themselves as "advocates" of their tax clients who engaged in "adversary proceedings" against the Internal Revenue Service on behalf of those clients.²⁹⁶ To the extent that tax clients were also audit clients, it is not clear how

²⁹⁰ See *id.*

²⁹¹ See *id.* at 146.

²⁹² Payne-Aldrich Tariff Act of 1909 (Corporation Tax Act), ch. 6, § 38, 36 Stat. 11, 112-17; see CAREY, *supra* note 23, at 64-67.

²⁹³ See CAREY, *supra* note 23, at 215-16.

²⁹⁴ See *id.* at 216.

²⁹⁵ *Id.*

²⁹⁶ *Id.*

the accountant could be both an "advocate" on the tax side, while "independent" on the audit side.

As accountants spread their services across larger swaths of the economy, and provided an increasing array of accounting, audit, and tax services with demonstrable effects on broader classes of third parties, the question of legal liability was bound to arise. Further, as mentioned above, some accountants seemed to be not taking their role as seriously as the leaders of the profession would like.²⁹⁷ The following two measures were suggested: first, import the English practice established by the Companies Acts and have shareholders elect auditors, rather than letting boards appoint them; second, and somewhat counter intuitively, encourage litigation against accountants so as to establish the legal duties of auditors through the courts.²⁹⁸ In particular, the leaders of the accounting professions were relatively less concerned with determining the liability of auditors who failed to catch evidence of embezzlement within a corporate client, than with establishing clear legal duties when investors suffer losses based on their misplaced reliance on a defective auditor's certificate. Perhaps this lack of concern was because the former seemed already a clearer case to make, assuming some defect, or willful ignorance, in the audit process. The profession worried, correctly, that it was less clear whether auditors had any duty, and hence liability, to third parties, such as investors.

Pursuant to the foregoing debate, an editorial in the profession's *Journal of Accountancy* practically begged the courts and legislatures to step in and to provide guidance:

"It would therefore seem to follow, if an auditor has failed to exercise reasonable care . . . that he should be held in some measure at least, responsible for losses sustained by investors. . . . One of the strongest inducements to this exercise of conservatism in certification . . . would be the possibility of fixing upon the auditor legal liability for statements made. . . .

In order to protect the public against inefficiency . . . and in order to protect the profession against the inclusion of undesirable members we strongly advocate the theory that if the laws today do not fix legal liability upon the auditor they

²⁹⁷ See *supra* note 287 and accompanying text.

²⁹⁸ See CAREY, *supra* note 23, at 80-81.

should be so amended as to bring about that condition of affairs."²⁹⁹

The editorial board of the *Journal of Accountancy* would have done well to remember the old adage, "be careful what you wish for." This plea for legal regulation was ironically prescient.

Instead of requesting legal guidance, however, the profession might have done better by simply considering the increasingly muddled allegiances of the American accountant/auditor to his client. Not the least of these problems was the difficulty of performing objective audits that led to qualified certificates because the client company's management was not fully cooperating with the auditor's request for documentation. In the British system under the Companies Act, 1929, the auditor would have to report whether management had cooperated with the audit.³⁰⁰ The American auditor, however, was in a bind: should the auditor give an unqualified certificate that was now misleading and a dereliction of duty, or instead issue a qualified certificate that would surely reflect unfavorably on company management, who would likely then fire that auditor? An editorial in the *Journal of Accountancy* is quoted as musing that:

"Looking at the matter from the highest ethical viewpoint, . . . [i]t must be admitted that the proper course for the accountant to pursue would be to refuse to conduct an audit unless opportunity were given for verifying inventories and accounts receivable and all other things having a bearing on the accounts.

But here the difficulty arises that many clients would be estranged thereby, and unfortunately some accountants are not yet in a position to ignore the financial consideration. . . . The average accountant is not sufficiently independent to be able to dictate in this respect."³⁰¹

Although it is likely that the editorial board did not mean "independent" in the sense that term has taken on under the '33 Act and '34 Act, it is again oddly appropriate that they chose the phrase "not sufficiently independent" to present the glaring reality that many accountants would not be affluent enough to avoid being beholden to

²⁹⁹ *Id.* at 81-82 (quoting Editorial, J. ACCOUNTANCY, May 1912).

³⁰⁰ See Companies Act, 1929, 19 & 20 Geo. 5, c. 23; *supra* notes 176, 208 and accompanying text.

³⁰¹ CAREY, *supra* note 23, at 82-83 (quoting Editorial, J. ACCOUNTANCY, n.d.).

their paying clients. This should not have been a surprise. How many accountants *were* affluent enough not to have to worry about retaining clients and getting paid? Of course, the accountants themselves already had the answer—switch to the British system and have auditors elected by the shareholders, which included allowing those shareholders to set auditor remuneration. Regardless, neither the profession as a whole, nor external lawmaking bodies, apparently were willing to effectuate this change. Alternatively, it may simply have been one of those things that fell through the cracks between different systems of regulation for and among accountants, corporations, and the financial services industry.

At any rate, much of this hand wringing by accountants, and Progressive Era reform rhetoric by government officials and commissions, seems to have been drowned out by the economic boom of the Roaring Twenties. Few people are interested in reform when everyone is making money—the overriding concern is instead to get in on the action before it is too late. In tandem with the economy, then, the accounting practice boomed from 1916 to 1930.³⁰² Concurrently, although companies were not required by state or federal law to do so, many increasingly came to disclose audited financial statements in connection with issuances of new securities.³⁰³ The optimist might say these companies did this because they believed it was the right thing to do; the cynic might say that this was really just a marketing ploy to attract attention in an increasingly crowded field of issuances. Whatever the real motive, the trend played into the desires of accountants to grow their practices, and what could have been more alluring than the high profile “public” engagement of certifying a hot new stock issuance?

Arguably, the bigger, more respected accounting firms—many of which ironically were originally started by transplanted English and Scottish chartered accountants³⁰⁴—were worth a premium through the quality signaling function they could perform for corporate issuers, especially new or unknown ones. This phenomenon certainly exists today, when new or untested companies piggyback on the “legitimacy” of brand name accounting firms, law firms, or investment banks to assure prospective investors. Even established companies will use the reputation of these professional service providers to gain extra valuation in a deal, or to coax uneasy parties into an unorthodox deal structure.

³⁰² See *id.* at 144.

³⁰³ See *id.*

³⁰⁴ See *id.* at 22, 27–30, 33–35.

This theory of "reputational intermediaries" who rent their reputation to others who currently lack such a reputation in the marketplace has been well documented in the literature.³⁰⁵ It also has attracted some serious criticism, including perhaps the most important rejoinder that it does not comport well with the way the history of the marketplace has actually played out.³⁰⁶ It is also unlikely that an efficient market for reputational intermediaries—necessary to induce them to maintain their reputation through demonstrated integrity and objectivity—can exist in today's highly concentrated market dominated by the Big Four accounting firms.³⁰⁷ Such an efficient market, however, could exist in a world of "pure play" accounting/audit firms, with appropriate distribution of market share among a number of competitive players.³⁰⁸ In fact, the accounting/audit marketplace of the early decades of the twentieth century was a more compelling environment for the reputational intermediary system to flourish. Indeed, it may have been that this environment was precisely what created the signaling practices of accounting and other professional services firms in the real world that endured and led to the suggestion of the theory decades later. If so, then the question to be addressed below is whether the audit requirements of the '33 Act, and rules promulgated under the '34 Act, shored up a budding, constructive practice, or whether instead they froze in time an experiment that may have died out on its own through "natural" market forces.

In the meantime, accountants simply rode the boom, with only minor trepidations as they saw instances of shoddy audits, and improper usage of respected firms' names, certificates, or misleading snippets of reports by companies eager to gain the quality signaling

³⁰⁵ The literature provides a more detailed discussion of reputational intermediaries. See Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 888–98 (1984); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 491 (2001). See generally Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998); JOHN C. COFFEE, *THE ACQUIESCENT GATEKEEPER: REPUTATIONAL INTERMEDIARIES, AUDITOR INDEPENDENCE AND THE GOVERNANCE OF ACCOUNTING* (Ctr. for Law & Econ. Studies, Columbia Law Sch., Working Paper No. 191, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=270944 (date posted May 25, 2001); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984); Reinier Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986).

³⁰⁶ See B.W. Mayhew et al., *The Effect of Accounting Uncertainty and Auditor Reputation on Auditor Objectivity*, AUDITING: J. PRAC. & THEORY, Sept. 2001, at 49–70 (documenting that reputational intermediaries act in reputation depleting ways to a degree not predicted by the theory).

³⁰⁷ See Partnoy, *supra* note 305, at 491.

³⁰⁸ See O'Connor, *supra* note 14, at 68–69.

function of a prestigious firm's "endorsement" of their issuances.³⁰⁹ Considering the boom in stock issuance certification work, tax engagements with all the newly wealthy individuals and companies seeking to reduce their tax burdens, accounting system consulting work generated from tax clients who wished to do better on their taxes next year, and audits pursuant to commercial bankers' increased demands for them from the accountants' clients, the profession found its services almost inexhaustibly in demand.³¹⁰ Also, a rising demand curve usually leads to higher valuations of the underlying goods or services, which in turn often leads to greater perceived prestige of them. Not bad for a bunch of "bookkeepers" who had a hard time getting organized and recognized only a few decades before.

III. THE SECURITIES ACT OF 1933

Of course, all good things must end. With what now might seem a depressingly predictable pattern, another great speculative boom collapsed and took down many paper fortunes. In the first aftermath of the 1929 crash, "populist scapegoats" were rounded up and prosecuted.³¹¹ Poster boys for 1920s material success were quickly transformed into poster boys for everything that was greedy and evil.³¹² Additionally, true to the pattern, even before the finger-pointing subsided, reformist legislation was in the offing in the form of the '33 Act. One commentator has suggested that regulation following in the wake of a collapsed bubble is "the mirror image of the bubble—a kind of speculative frenzy in regulation."³¹³

Stoked by the harshness of the 1929 crash, the self-righteous indignation growing from the daily doses of outrageous abuses disclosed from the Senate chamber, where the Pecora Investigation was taking place, and the reformist allies of President Franklin D. Roosevelt, who were hammering away at the evils that may have been prevented by proper regulation of business and the financial community, the public essentially demanded congressional action.³¹⁴ Thus, when

³⁰⁹ See CAREY, *supra* note 23, at 145. One respected firm was forced to place a warning note regarding improper use on its reports. See *id.*

³¹⁰ See *id.* at 145–48.

³¹¹ See Ribstein, *supra* note 39, at 91–92.

³¹² See *id.*

³¹³ *Id.* at 78.

³¹⁴ See SELIGMAN, *supra* note 281, at 39. Dean Joel Seligman provides a more detailed background on the immediate responses to the 1929 crash, such as the Pecora Investiga-

President Roosevelt signed the '33 Act into law in May of 1933, it seemed perhaps a hasty response to public outcry. In fact, though, President Roosevelt's own frequent invocation of Louis D. Brandeis's famous study, *Other People's Money*, published in 1914,³¹⁵ belies the roots of the '33 Act, and subsequent '34 Act, in the earlier Progressive Era that had been eclipsed by the Roaring Twenties. Thus, one historian of federal securities regulation pinpointed President Roosevelt's comments as "paraphras[ing the famous quote from "*Other People's Money*"]: 'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.'"³¹⁶

This could not have been better news for the accounting profession—the self-proclaimed "authorized agents of publicity."³¹⁷ Further, only a year earlier the NYSE adopted rules, in consultation with the Institute of Accountants in the United States of America (the "Institute"),³¹⁸ to require that all listed companies have their financial statements certified by accountants "qualified under the laws of some state or country."³¹⁹

In fact, the Institute had earlier approached the NYSE in 1927 to suggest requirements for better financial disclosure from listed companies, but while the boom continued apace, there seems to have been little incentive for the NYSE to tinker with success.³²⁰ Ironically, only five years earlier it was the NYSE itself that was musing about better financial disclosure "in line with the English practice."³²¹ The *Journal of Accountancy* is quoted as concurring with the position: "What can and should be done by legislation and effective public administration is to throw a light of publicity upon the issuance of securities that

tion. See *id.* at 18–38; see also CAREY, *supra* note 23, at 167–69 (discussing the Pecora Investigation).

³¹⁵ See SELIGMAN, *supra* note 281, at 41. See generally LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (Bedford Books of St. Martin's Press 1933) (1914).

³¹⁶ *Id.* at 41–42 (quoting BRANDEIS, *supra* note 315, at 89). It is ironic that Louis D. Brandeis is also the author of the seminal work that is commonly acknowledged as the beginnings of the legal right to privacy. See generally Samuel D. Warren & Louis D. Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193 (1890).

³¹⁷ See *supra* note 286 and accompanying text.

³¹⁸ The Institute of Accountants in the United States of America is another forerunner of the AICPA.

³¹⁹ CAREY, *supra* note 23, at 169.

³²⁰ See *id.* at 163–64.

³²¹ *Id.* at 160. Notably, the *Journal of Accountancy* is quoted as calling for audits in conjunction with securities offerings still earlier, in 1919. See *id.* at 145 (citing J. ACCOUNTANCY, Jan. 1919).

will enable investors to judge for themselves whether a given security is sound and to what extent it is speculative."³²² Apparently the *Journal of Accountancy* also expressly advocated for adoption of provisions from the British Companies Acts, including "independent audits."³²³ A noted accounting historian has suggested that if action along these lines had been taken—"if the business and financial community had disciplined itself in time"—then the '33 Act might not have been needed. Of course, the community did not discipline itself adequately because "[t]he stock market was zooming, corporations were merging, and holding companies in the utility field were developing vast empires, financed by issue after issue of common stock."³²⁴

Nevertheless, by the early 1930s, the accounting profession began getting the kind of legal guidance it had been clamoring for since the turn of the century. In 1931, the New York Court of Appeal decided the landmark appeal of *Ultramares Corp. v. Touche*.³²⁵ Judge Benjamin N. Cardozo, writing for the court, was willing to find that accountants certifying financial statements had to make the certificate without fraud. This duty ran to third-party creditors and investors as well, because the accountants knew that these parties might also rely on the certification.³²⁶ Further, Judge Cardozo cautioned that "[f]raud includes the pretense of knowledge when knowledge there is none."³²⁷ Judge Cardozo was unwilling, however, to extend liability to such "indeterminate" third parties for actions based on mere negligence, because then a "thoughtless slip or blunder," including the "failure to detect a theft or forgery beneath the cover of deceptive entries," could "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class."³²⁸ Thus, accountants who performed their audits in good faith, and who did not attest to transactions for which they had seen no documentary evidence, should not have any liability to third parties not included ex-

³²² *Id.* at 161 (quoting J. ACCOUNTANCY, n.d.).

³²³ *Id.* (citing J. ACCOUNTANCY, n.d.). In truth, the Companies Acts do not call for "independent audits," but rather simply audits done by auditors elected by the shareholders, who may employ professional accountants. A professional accountant could be elected directly as an auditor, and he might have no other interest in the company other than this engagement. But, there was no requirement for this, the only real hallmark of "independence" as we consider it today.

³²⁴ CAREY, *supra* note 23, at 161.

³²⁵ 174 N.E. 441, 442 (N.Y. 1931).

³²⁶ *See id.* at 444.

³²⁷ *Id.*

³²⁸ *Id.*

pressly as formal beneficiaries of the engagement contract—even if it was foreseeable that the client might use the certificate in the future with as yet unnamed parties.

One might question why the court was willing to find liability to third parties for fraudulent misrepresentation, but not for negligence—was it just because fraud is more serious in some way? Perhaps, but the court also was concerned that the extension of liability to third parties for negligence would render fraud and negligence nearly coterminous.³²⁹ The court also may have been considering that fraud in this case sounded in tort, but negligence in performing the audit was actually a breach of the contract between the accountant and client. Thus, even though one generally might owe a duty of care to the whole world that one can breach through negligent behavior, here the specific shortcoming was not a negligent breach of that garden variety duty of care, but rather it was the negligent breach of a specific implied duty arising only under the contractual relationship of the parties. That is, accountants must provide audits “with the care and caution proper to their calling.”³³⁰ As a result, to extend this contractual duty to others outside the chain of privity was both unwarranted and would result in a situation in which “[t]he hazards of a business conducted on these terms [would be] so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.”³³¹

Ultramares provides an additional fascinating insight into the changing environment for accountants acting as auditors. The plaintiff was asked to rebut the claim that allowing liability to third parties for negligence would make negligence nearly indistinguishable from fraud. The plaintiff responded by arguing, “first, that the duty to speak with care does not arise unless the words are the culmination of a service, and, second, that it does not arise unless the service is rendered in the pursuit of an independent calling, characterized as public.”³³² This suggests the development of the mistaken notion that “public accountants” are called that because they owe some extra duty

³²⁹ See *id.* at 447.

³³⁰ *Ultramares*, 174 N.E. at 444.

³³¹ *Id.* The court is not strictly limiting liability for negligence to parties in privity, but rather it is limiting such liability to parties in privity *or* when a specified third party is so clearly an intended third party beneficiary of the contract, so as to make him essentially a party thereto.

³³² *Id.* at 448.

to the public at large that private citizens do not.³³³ As discussed above, however, this simply was not the origin of the name, nor the intent of the early accountants using it.³³⁴ Judge Cardozo catches this error and corrects it, as quoted earlier in this Article.³³⁵

Clearly, *Ultramares* is a mixed bag for accountants. On the one hand, the case establishes that negligence in the audit engagement and resultant certificate does not open accountants to liability to third parties—even for liabilities that were foreseeable. On the other hand, liability for fraud attaches on behalf of third parties just as much as it does for the paying client. On one level, the result makes perfect sense because service providers are primarily responsible to their contractual, paying clients, but they are not allowed to mislead others intentionally along the way, especially if reliance is foreseeable.³³⁶ On another level, however, the result makes no sense at all, because the accountants then must be acting, to varying degrees, on behalf of at least three distinct groups, whose interests may not completely overlap—management, shareholders, and creditors. Thus, an unintentional message of *Ultramares* may be that accountants simply should not act as auditors on behalf of multiple parties in the same matter, explicitly or implicitly. Of note, all of the foregoing is simply in general accordance with the British audit system under the Companies Act, 1929.³³⁷

Although *Ultramares* clarified the common law governing audit services, a new federal legislative plan for regulating corporations and their securities that would completely transform the legal landscape for audits was being formulated as part of Franklin D. Roosevelt's presidential campaign. The first and perhaps most crucial component of this plan was set forth in President Roosevelt's nomination acceptance speech. Beyond the famous promise of a "New Deal" for America, he proposed to undertake:

"[A] comprehensive planning for the reconstruction of the great credit groups . . . I list an important place for that prize statement of principle in the platform here adopted calling for the letting in of the light of day on issues of securities,

³³³ See *infra* notes 464–489 and accompanying text (repeating theme).

³³⁴ See *supra* notes 91–95 and accompanying text.

³³⁵ See *supra* note 93 and accompanying text.

³³⁶ Note that in *Ultramares* it is management of the client company itself that does much of the fraud and deceit that leads to the defective certificate. 174 N.E. at 442. Thus, the real question that the court is grappling with is to what degree the accountants were complicit in this fraud.

³³⁷ See *supra* notes 106–238 and accompanying text.

foreign and domestic, which are offered for sale to the investing public."³³⁸

In particular, President Roosevelt wanted to federalize corporation laws so as to reinstate the sorts of shareholders' protections that had eroded in the wake of excessive charter-mongering among the states.³³⁹ Taken together, the changes in state corporation laws allowed corporate managers to gain entrenched control of a company in a manner that proved exceedingly difficult for increasingly disaggregated general shareholders to counter.³⁴⁰ To this end, the meteoric growth of businesses in numbers and size, the ascendancy of a class of professional managers, and the expansion of shareholder ranks for large companies to transnational levels, worked together with changes in the state corporation laws to create the serious agency problems of the modern corporation set out so well by Adolph A. Berle, Jr. and Gardiner C. Means in 1932.³⁴¹

States had attempted to ameliorate these problems, at least with regard to sales of corporate securities, by enacting "Blue Sky" laws as early as 1911.³⁴² Kansas began the trend—and gave the similar statutes that were adopted in other states their name³⁴³—with a law that required companies who wished to sell stock in the state to file a description of operations with the bank commissioner. The commissioner could refuse to give the requisite sales permit when:

[H]e found any aspect of the company's business to be "unfair, unjust, inequitable, or oppressive to any class of contributors, or if he decides from his examination of its affairs that said investment company is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds or other securities by it offered for sale."³⁴⁴

As such, this law, and similar laws that followed, permitted so-called "merits review" by the state authorities, which was markedly different

³³⁸ SELIGMAN, *supra* note 281, at 19 (quoting Speech of Franklin D. Roosevelt, 1 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT 653 (1938)).

³³⁹ *See id.* at 42–44.

³⁴⁰ *See id.*

³⁴¹ *See generally* BERLE & MEANS, *supra* note 61.

³⁴² *See* SELIGMAN, *supra* note 281, at 44–46.

³⁴³ Such a law was "popularly known as a 'blue sky' law, since it was intended to check stock swindlers so barefaced they 'would sell building lots in the blue sky.'" *Id.* at 44.

³⁴⁴ *Id.*

from the British system under the Companies Acts, which instead merely mandated truthful disclosure of relevant information.

Despite initial success stories that prompted nearly identical statutes in seventeen states, and other securities regulation statutes in six others, the statutes were, in fact, not particularly effective.³⁴⁵ Nonetheless, after Kansas's law was upheld by the U.S. Supreme Court in 1917, even more states signed on with their own laws so that by 1933, every state save Nevada had one.³⁴⁶ After the 1929 crash, however, it became readily apparent that these trumpeted laws had not really worked: most could be evaded through stock offerings by mail that crossed state lines and many laws were amended so often as to render them impotent.³⁴⁷

Ironically, one noted historian of the securities laws has suggested that the NYSE listing requirements established during the 1920s were, relatively speaking, the most effective securities regulation of the era.³⁴⁸ After quoting William Z. Ripley's statement that "[b]eyond peradventure of doubt the New York Stock Exchange is today the leading influence in the promotion of adequate disclosure[,]'" and Adolph A. Berle, Jr.'s statement that "the most forward-looking steps in finance taken during the 1925-1929 boom were not taken by government, but by that much maligned institution, the New York Stock Exchange[,]'" Dean Joel Seligman nonetheless noted that the NYSE requirements were not much more effective than Blue Sky laws.³⁴⁹ Other American stock exchanges fared even worse, especially when they permitted extensive trading in unlisted securities.³⁵⁰

Dean Seligman also pointed to the "primitiveness of accounting standards" as a fatal flaw for fair and effective securities markets.³⁵¹ At the same time, at the beginning of the boom, less than seventy percent of NYSE listed firms were bound by agreements to provide shareholders with annual or quarterly statements, and only 242 out of 957 listed firms provided both annual and quarterly statements to shareholders.³⁵² By 1933, however, all of the 1157 listed firms provided annual reports; sixty percent also provided quarterly reports; and eighty-five

³⁴⁵ See *id.* at 45.

³⁴⁶ See *id.*

³⁴⁷ SELIGMAN, *supra* note 281, at 45-46.

³⁴⁸ See *id.* at 46-47.

³⁴⁹ *Id.* (quoting WILLIAM Z. RIPLEY, MAIN STREET AND WALL STREET (Harper Bros. 1939) (1927) and statement of Adolph A. Berle, in RUDOLPH WEISSMAN, THE NEW WALL STREET (1939)).

³⁵⁰ See *id.* at 47.

³⁵¹ *Id.* at 48.

³⁵² SELIGMAN, *supra* note 281, at 48.

percent underwent annual audits by CPAs with the results made publicly available.³⁵³ Dean Seligman also noted that "[t]he rapidity with which periodic audited financial statements became commonplace masked the continued unreliability of financial reporting" because "no government or private agency effectively defined generally accepted accounting principles."³⁵⁴ Beyond this, however, as argued above, the rapid rise in the use of audited statements may have been mainly a marketing ploy, or, more generously, a quality signaling best practice, to attract investors in a quickly crowding field of issuances.

The only congressional precedent for federal regulation of securities was a limited six-month episode in 1918 during World War I.³⁵⁵ The Capital Issues Committee, authorized by Congress, may have been simply a wartime expediency. Yet, in final reports, it urged continuing federal supervision of securities—especially as the patriotism-driven success of the government's Liberty Bonds seemed to have whetted the appetite of a whole new segment of the general population for even more speculative investments.³⁵⁶ Although President Woodrow Wilson argued for permanent federal securities regulation, and numerous bills were introduced in Congress over the years, no other formal regulation was initiated until passage of the '33 Act.³⁵⁷

When Franklin D. Roosevelt was elected President on his New Deal platform, however, forces finally aligned to prioritize and to realize the goal of federal securities regulation earlier articulated by both Louis Brandeis and Woodrow Wilson.³⁵⁸ The Pecora Investigation had whipped up such sentiment against Wall Street and the securities industry among members of Congress and the public, that the former essentially were forced to act.³⁵⁹ After some false starts, an initial draft by Huston Thompson, a former member of the FTC, (the "Thompson draft") was introduced in both houses in March of 1933, along with a preliminary message from President Roosevelt.³⁶⁰

³⁵³ See *id.*

³⁵⁴ *Id.*

³⁵⁵ See *id.* at 49. This, of course, is in addition to the earlier Progressive Era calls for corporate and securities regulations discussed above, but none of those materialized into concrete bills or actions. See *supra* notes 260–279 and accompanying text.

³⁵⁶ See SELIGMAN, *supra* note 281, at 48.

³⁵⁷ *Id.* at 49.

³⁵⁸ See *id.* at 50–51.

³⁵⁹ See James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

³⁶⁰ See *id.* at 30–31.

To the Congress:

I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce.

In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus back to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.

This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.

What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.

—Franklin D. Roosevelt
The White House, *March 29, 1933*.³⁶¹

³⁶¹ 73 CONG. REC. 937 (1933), reprinted in 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 20 (comp. by Sec. Law Comm., Fed. Bar Ass'n, 1983).

President Roosevelt seemed concerned that the legislation should neither authorize merits review of securities by the federal government nor appear to attach liability to the federal government for securities that appeared to have its imprimatur (like Treasury bonds). Apparently, however, Huston Thompson "didn't get the memo" on this because his draft explicitly permitted the FTC to revoke the registration of any offeror whose "affairs are in unsound condition or insolvent" or when "the enterprise or business of the issuer, or person, or the security is not based upon sound principles, and . . . revocation is in the interest of the public welfare."³⁶² Beyond these undesirable merits review provisions, however, the Thompson draft was deemed unsatisfactory in many other ways as well by the Committee on Interstate and Foreign Commerce (the "Commerce Committee") of the House of Representatives to whom it had been referred.³⁶³ It did not fare as poorly in the Senate, where it was initially referred to the Committee on the Judiciary.³⁶⁴ Despite the drubbing the Thompson draft took both from the House committee members and later historians, it is actually not that crazy, nor does it represent a radical departure from the major outlines of either the British Companies Act, 1929, or the final version of the '33 Act. In fact, the introduction, *inter alia*, of a waiting period after filing and before the stock can be sold arguably made the '33 Act more of a departure from the Companies Act, 1929, than the Thompson draft was.

For this Article's purposes, the most important provisions of the Thompson draft exist in this same section 6 which contained the controversial powers of the FTC to revoke registrations. Most of the triggers for this power were probably uncontroversial: violation of the act or orders of the FTC; fraudulent activities of the issuer; dishonesty or fraudulent representations by the issuer, especially in prospectuses or similar documents; and illegal activities of the issuer's business.³⁶⁵ It was only the two last specific triggers of the section, cited in the discussion above, that were based on the controversial merits review the-

³⁶² See H.R. 4314, § 6 (1933), reprinted in 3 LEGISLATIVE HISTORY OF SECURITIES ACTS, *supra* note 1, at 13; see also Landis, *supra* note 359, at 30-31.

³⁶³ See SELIGMAN, *supra* note 281, at 51-57; Landis, *supra* note 359, at 31-33. For political reasons, the draft was originally subjected merely to "perfecting amendments" by the new drafting team led by Felix Frankfurter, but ultimately even those portions of Huston Thompson's draft that were originally retained were "happily discarded." Landis, *supra* note 359, at 34.

³⁶⁴ See SELIGMAN, *supra* note 281, at 67-68; Landis, *supra* note 359, at 41-42.

³⁶⁵ See H.R. 4314, § 6, reprinted in 3 LEGISLATIVE HISTORY OF SECURITIES ACTS, *supra* note 1, at 12-15.

ory. Beyond these specific triggers, however, section 6 also sets out the rights of the FTC as to how it would conduct an examination to determine whether any of the triggers have occurred:

In making such examination the [FTC] or other officer or officers designated by it shall have access to and may compel the production of all the books and papers of such issuer, representatives, or underwriters, and may administer oaths to and examine the officers of such issuers, representatives, underwriters, or other entities or other person connected therewith as to its business and affairs and may, in its discretion, require the production of a balance sheet exhibiting the assets and liabilities of any issuer, representative, or underwriter, or his income statement, or both, to be certified by a public accountant approved by the [FTC].³⁶⁶

This was, of course, no general requirement for an audit, but rather only a targeted provision of audited financial statements in furtherance of a government investigation. From the auditor's perspective, he would be retained for a specific limited engagement with a specific third party beneficiary—and thus, under the reasoning of *Ultramares*, he would have full liability under both fraud and negligence theories to that beneficiary. There likely would be little incentive for collusion with management in this matter, however, even though the audited company would technically be the paying party in this transaction.

The Institute, in the meantime, had been made aware that such a bill was in the offing, but chose not to appear formally during any hearings for fear of hostile questioning and further bad public relations.³⁶⁷ When Thompson's draft came out, however, the Institute's members quickly noticed the FTC examination audit provision and sent a letter to the Commerce Committee suggesting that this audit provision should be extended to all registration statements.³⁶⁸ The letter was possibly followed up with personal lobbying by the Institute's Washington legal counsel, J. Harry Covington.³⁶⁹ One accounting historian has asserted that the foregoing "apparently made an impression on the

³⁶⁶ *Id.* at 5.

³⁶⁷ See CAREY, *supra* note 23, at 183. The profession itself often had been lumped in with all of the other purported bad actors when the entire financial services industry came under fire in the wake of the 1929 crash.

³⁶⁸ See *id.* at 184.

³⁶⁹ See *id.*

House Committee on Interstate Commerce, since its bill was amended to include the audit provisions which finally became the law.³⁷⁰

At the same time, and quite uncoordinated with the Institute and J. Harry Covington, the then president of the New York State Society of Certified Public Accountants, Colonel Arthur H. Carter, took it upon himself to contact the Senate's Committee on Banking and Currency (the "Banking Committee"), to which the Thompson bill had been redirected from the Committee on the Judiciary.³⁷¹ Colonel Carter "was a West Point graduate, a man of action and of military mien," as well as a senior partner at Haskins and Sells.³⁷² Not part of the current governing council of the Institute, he instead sent his telegram on behalf of the New York Society. In it, he too suggested an audit by "accountants qualified under the laws of some state" of financial statements to be used in prospectuses.³⁷³ The communication won him a place at the Banking Committee's upcoming hearings on the Thompson draft. The full transcript provides many fascinating exchanges, relevant not only to the profession's desire to win the audit provision, but also for many issues of auditor independence to come. Accordingly, much of the record is transcribed below, with appropriate commentary:

Mr. CARTER. At the outset I wish to state that my sympathies are with the general principles of the proposed bill known as the Federal Securities Act. I also wish to have it understood that I would advocate that, if possible, the proposed bill be changed so as to afford even greater protection to the investor than it now contemplates. . . .

. . . .
. . . I would suggest that the following be added after the words "actual business":

The accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent public accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet date and also the income statement for the period indicated.

³⁷⁰ *Id.*

³⁷¹ See *id.* at 184-85; Landis, *supra* note 359, at 31.

³⁷² CAREY, *supra* note 23, at 184-85.

³⁷³ *Id.* (quoting Letter from Col. Arthur H. Carter (Mar. 30, 1933)).

....

Senator BARKLEY. How much more and additional employment would that give to certified accountants?

Mr. CARTER. Eighty-five percent of the companies that are listed on the exchanges in New York today are examined.

Senator REYNOLDS. Do you think it proper to insert there that these independent public accountants should be privileged to state their opinion as to the value of securities or the condition of the company?

Mr. CARTER. We are unable to express an opinion as to the value of securities ³⁷⁴

Colonel Carter appears to have misunderstood Senator Reynolds's line of questioning; Senator Reynolds clearly seems to be asking why accountants should get such a valuable government-mandated franchise.

Senator REYNOLDS. Do you think they should be permitted to express their opinions about [the accounting records]?

Mr. CARTER. Yes.

Senator REYNOLDS. Will not the figures themselves show?

Mr. CARTER. The figures will not necessarily show. . . .

Senator BARKLEY. Do you think that the Federal Trade Commission's records or these reports ought to be encumbered by the bookkeeping processes by which accountants would arrive at an opinion as to the value of a stock?

Mr. CARTER. I do not see how the Federal Trade Commission can properly discharge its duty by merely accepting a statement that has not been independently examined and certified to by an accountant.

Senator BARKLEY. In other words, after the statement has been filed by the officers of the company you want an independent organization to go over it and then report to the Federal Trade Commission whether this is correct or not?

Mr. CARTER. I mean that that statement itself should have been the subject of an examination and audit by an independent accountant.

Senator GORE. Before filing?

Mr. CARTER. Before filing.

³⁷⁴ *Hearings, supra* note 1, at 56-62 (statement of Col. Arthur H. Carter).

Senator GORE. Is that patterned after the English system?

Mr. CARTER. Yes, sir.³⁷⁵

This was not exactly true. The Companies Act, 1929, merely provides that the company's auditor must certify the company's profit and loss statements—not balance sheets—for the last three years, as applicable, for inclusion in any prospectus to be used for offering to sell stock to the public.³⁷⁶

Senator WAGNER. Well, basically, are not these facts that have got to be alleged rather than an opinion?

Mr. CARTER. Under the terms of the bill it has to be given under oath. I do not see that anyone can certify under oath that a balance sheet giving many millions of dollars of assets is as a matter of fact correct. He can state his opinion based upon a thorough investigation.

Senator BARKLEY. In other words, before the officers of the company that is issuing stock shall file that statement that is contained in this bill with the Federal Trade Commission the company must call in outside independent accountants and give them the job of going over it and passing on whether they have told the truth or not. Well, I am not for your amendment, I will say that now.

Mr. CARTER. Later on in the act it provides that the Commission may call for such a statement. The only point I am trying to make is this, that I think the such an examination should be a part of the application rather than after the application has been filed.

Senator ADAMS. The law does not require any examination, as I read it.

Mr. CARTER. No.

Senator ADAMS. That is, it merely requires the filing of this statement.

Mr. CARTER. That is right.

Senator ADAMS. Then by the fact of filing this statement they in substance get the right to go into interstate commerce and sell securities. There is no such requirement for examination to be included in the application.³⁷⁷

³⁷⁵ *Id.* at 56-57 (statement of Col. Arthur H. Carter).

³⁷⁶ See *supra* note 197 and accompanying text.

³⁷⁷ *Hearings, supra* note 1, at 57 (statement of Col. Arthur H. Carter).

Colonel Carter seems to be unaware of the larger context behind this line of questioning. As discussed above, one of the major sore points for the Thompson draft was its inclusion of merits review powers for the FTC.³⁷⁸ At the same time, the Banking Committee members seem to be concerned that "opinions" will not be of much help to investors, either when deciding to invest in a company, or in bringing a lawsuit for fraud or negligence later.

Mr. CARTER. Not in the application. But there is in the bill a provision which gives the Commission a right to demand such an investigation and demand such a report as a result of such investigation. My point is to put that in the application in the beginning.

Senator BARKLEY. Do you think it is more in the interest of the public that is to buy these securities, if there is to be any check up or any guarantee as to the correctness, that it be done by some Government agency rather than by some private association of accountants?

Mr. CARTER. I think it is an impractical thing for the Government agency to do it effectively.

Senator REYNOLDS. Why?

Mr. CARTER. Because it involves such a large force. It involves the question of time.

Senator REYNOLDS. Well, it would not require any more time on the part of government officials to make a check up and audit than it would by private individuals, would it?

Mr. CARTER. I think the public accountant is better equipped to do that than the average government agency would be able to do that.

Senator GORE. How many public accountants do you think would be available for this service?

Mr. CARTER. There are approximately 15,000 certified public accountants in the United States today qualified under the laws of the various States.

Senator BARKLEY. How many in your organization?

Mr. CARTER. Two thousand.

Senator BARKLEY. Is there any relationship between your organization with 2,000 members and the organization of controllers represented here yesterday with 2,000 members?

³⁷⁸ See *supra* note 362 and accompanying text.

Mr. CARTER. None at all. We audit the controllers.

Senator BARKLEY. You audit the controllers?

Mr. CARTER. Yes; the public accountant audits the controller's account.

Senator BARKLEY. Who audits you?

Mr. CARTER. Our conscience.

Senator BARKLEY. I am wondering whether after all a controller is not for all practical purposes the same as an auditor, and must he not know something about auditing?

Mr. CARTER. He is in the employ of the company. He is subject to the orders of his superiors.

Senator BARKLEY. I understand. But he has got to know something about auditing?

Mr. CARTER. Yes.

Senator BARKLEY. He has got to know something about bookkeeping?

Mr. CARTER. But he is not independent.

Senator REYNOLDS. Let me ask you this question, Colonel. These companies are going to arrive at these figures through their special auditors. All right. Now you want the members of your organization to check up on their figures?

Mr. CARTER. As we do in many cases of industrial companies every year.

Senator REYNOLDS. All right. Then it goes to the Commission, does it not?

Mr. CARTER. Yes.

Senator REYNOLDS. Have they got to check their accounts and your account?

Mr. CARTER. I do not think so. I do not think they would have to go to that.

Senator REYNOLDS. Why should your members ask that they be permitted and empowered to check these accounts?

Mr. CARTER. Because it is generally regarded that an independent audit of any business is a good thing.

Senator REYNOLDS. All right. Then after it goes to the Commission they have to check up to see who is right; they have to go through and audit again. There has to be a Government audit, as suggested by Senator Barkley. Would it not be creating more difficulty and more expense and more time for the Government if auditing organizations interest themselves in these various and sundry corporations?

Mr. CARTER. I do not think so. I think if a corporation wished to issue some securities and had been employing independent public accountants for 20 years those accountants should be able to make this examination more economically and quickly than the Government.

Senator REYNOLDS. Could they do it more economically than the Government?

Mr. CARTER. I think so.

Senator GORE. There would not be any doubt about that.

Senator REYNOLDS. Why?

Mr. CARTER. We know the conditions of the accounts; we know the ramifications of the business; we know the pitfalls of the accounting structure that the company maintains. You have got every kind of business to deal with.³⁷⁹

This same argument resurfaces numerous times all the way to the present, when it has been used to justify the provision of non-audit services to audit clients—the familiarity that auditors have with their clients' enterprises puts them in the best position to provide the myriad non-audit services; at the same time, the provision of non-audit services is claimed to help the efficiency of the annual audit too. Of course, this argument proves too much, as there then seems to be few limits to what services auditors should be allowed to provide to their clients.³⁸⁰

Senator REYNOLDS. Suppose that we decide in the final passage of this bill here to employ five or six hundred auditors from your organization, that would be all right, then, would it not?

Mr. CARTER. I do not think the Government could employ five or six hundred independent accountants.

Senator REYNOLDS. Why could they not?

Mr. CARTER. I do not think the type of men that are in the public practice of accountancy would leave their present practice to go in the Government employ.

Senator REYNOLDS. Well, if it were sufficiently remunerative they would?

Mr. CARTER. Yes; if the Government made their time worth while.

³⁷⁹ *Hearings*, *supra* note 1, at 57–59 (statement of Col. Arthur H. Carter).

³⁸⁰ *See* O'Connor, *supra* note 14, at 64.

Senator REYNOLDS. The bill here provides for taking care of the expenses incident thereto by way of registration.

Mr. CARTER. Well, you will have to build some more buildings in Washington to house them if you are going to do that.

Senator REYNOLDS. Then we had better not pass this bill at all.³⁸¹

This last exchange evidences contemplation of simply having the federal government perform the general audits, if any are to be done. Such proposals seem to have surfaced at least occasionally as the statutory audit system developed under both the '33 Act and the '34 Act, but they are always deemed politically impossible.³⁸²

Senator ADAMS. How much of a burden is this going to put on a relatively small company? You were speaking a while back of the companies whose stocks are listed being independently audited. Now coming under the control of this bill are going to be thousands of small companies putting out an issue for their original financing. How much of a burden and cost is that going to put on them?

Mr. CARTER. Very little measured in value to the investor and to them.³⁸³

This was a nice rhetorical flourish, but the senators do not appear to be amused.

Senator GORE. What would be the range?

Mr. CARTER. My experience would be that the average company pays around \$500 or \$600 or \$700 for its auditing, that is, taking the large and the small together.

Senator GORE. How often do they resort to that?

Mr. CARTER. Every year. And the largest organizations of our country do it and have been doing it for the last 15 years.

....

Senator GORE. But they have not been available for any public authority to examine and afford no safeguards?

Mr. CARTER. They have been published in their annual reports and distributed to all of their stockholders, to the newspapers and anyone who calls for them.

³⁸¹ *Hearings, supra* note 1, at 59 (statement of Col. Arthur H. Carter).

³⁸² *See* O'Connor, *supra* note 14, at 47, 72-73.

³⁸³ *Hearings, supra* note 1, at 57 (statement of Col. Arthur H. Carter).

Senator GORE. And have not done any good?

Mr. CARTER. Yes, sir; I think they have.

Senator GORE. We have had all this debacle here in spite of that.

Mr. CARTER. You still have some very sound companies and industries in this country.³⁸⁴

You have to admire Colonel Carter's tenacity on this one.

The CHAIRMAN. Most of these people applying to be registered already have an independent audit. It is not necessary to put them in the law. That is their practice now; that is, they are supposed to have already.

Mr. CARTER. I think the trend has been decidedly in that direction in the past five years, and especially in the last three years, and I certainly think it is a safeguard that should not be discouraged.³⁸⁵

The Chairman, Senator Duncan Fletcher, makes an excellent point. Colonel Carter rebuts it only by saying the trend "should not be discouraged," but there is a wide gulf between "not discouraging" and congressionally mandating something. Publicly disclosed audits already were being employed by eighty-five percent of companies listed on the NYSE, yet, as Senator Gore points out, this did not seem to do much in terms of preventing, or even minimizing, the colossal failures of the 1929 crash. At the same time, the Thompson draft, even amended as Colonel Carter was requesting, would not have required those companies already employing public audits to have done anything differently. Given the widespread failures and stock price decline of even surviving companies, this problem cannot be resolved then by assuming that the audited companies all survived, and are in better shape, than the non-audited companies.

This observation—together with the apparent fact that all of the tweaking of auditor independence rules formulated by the SEC up until Enron and other scandals did not prevent the myriad of audit failures linked to compromised independence—provides grist for anyone who wants to argue that mandatory disclosure and/or statutory audits under the securities laws are unnecessary. Perhaps the system simply helps keep people honest. Given the expense of compliance, however, some might argue that from a cost-benefit perspective,

³⁸⁴ *Id.* at 59–60 (statement of Col. Arthur H. Carter).

³⁸⁵ *Id.* at 60 (statement of Col. Arthur H. Carter).

mandatory disclosure and/or statutory audits are a failure and should be substantially modified or completely eliminated.³⁸⁶ Additionally, for all the hype surrounding it, at least one commentator has argued that the Sarbanes-Oxley Act of 2002,³⁸⁷ did not really change the disclosure system radically.³⁸⁸

Further, the combination of mandatory disclosure and statutory audits should not necessarily be seen as a package deal. The '34 Act simply authorized the SEC to determine whether the statutory mandatory disclosures of issuers should also be certified by independent auditors. A more robust reputational intermediary market may have developed where audits were simply permissive and could serve as a quality signaling best practice, rather than as the commodified loss leader they appear to have become.³⁸⁹

Senator GORE. Is this mandatory in England, the requirement that an independent accountant shall check up?

Mr. CARTER. All companies in England are required to be audited by an independent accountant, who is present at the stockholders' meeting and is available to answer any questions the stockholders wish to put to him.

Senator GORE. And they list the accountants that will be acceptable?

Mr. CARTER. That is right.³⁹⁰

³⁸⁶ In the 1980s, there was a serious debate over the value of mandatory disclosure, but the general consensus appears to have been that, on balance, it enhanced the functioning of capital markets. For a synopsis of this debate, see MARC I. STEINBERG, *SECURITIES REGULATION* 297-306 (4th ed. 2004). Recently, a modified form of this debate has arisen with arguments for "issuer choice," in which companies need only comply with some disclosure system somewhere in the world, not necessarily the U.S. system, even if the company's stock is sold and/or traded in U.S. capital markets. See generally Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207 (1996); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1 (1999); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

³⁸⁷ Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2004)).

³⁸⁸ See generally Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Just Might Work)*, 35 CONN. L. REV. 915 (2003).

³⁸⁹ See O'Connor, *supra* note 14, at 72 n.498.

³⁹⁰ Hearings, *supra* note 1, at 61-62 (statement of Col. Arthur H. Carter).

This, of course, is simply wrong. The Companies Act, 1929, did not require that accountants provide audits, much less "independent" accountants—a notion that did not even seem to exist at the time in either the Companies Acts generally or the ICAEW and ICAS as the regulators of chartered accountants.³⁹¹ Colonel Carter's comments further obscure the facts that the shareholders themselves elect the auditor in the first place and that the auditor's report must be read aloud at the annual meeting. Senator Gore, however, did seem to understand that the shareholders at least have some type of right to select auditors. Finally, this exchange conflates the Companies Act, 1929's annual audit process with the separate, and different, requirement for certified profit and loss statements in prospectuses.

The remainder of Colonel Carter's testimony that concerned the request for a general audit requirement covers the Banking Committee's continuing interrogation as to whether such a requirement will add to the merits review slant of the Thompson draft or even provide a government-mandated tool that could be used to a filing company's distinct disadvantage at the hands of competitors.³⁹² Overall, Colonel Carter's session clearly did not go swimmingly well, and in fact, his efforts may have backfired. The Senate not only neglected to add his hoped for general audit provision, although perhaps not due to his statements, but also removed the existing FTC audit provision!³⁹³

Further, other than the original FTC audit provision, the Thompson draft and its immediate revisions were silent as to accountants, auditors, and audits. A later Senate report analyzing the bill expressly mentions that parts of it, especially the information to be disclosed on a registration statement, "follow[] to some extent that required in the British act."³⁹⁴ Huston Thompson himself credits the Companies Act, 1929, among other laws, as a model in his testimony in the Banking Committee hearings.³⁹⁵ At this point, however, other than in the House version of the bill, there were no audit provisions in the proposed securities law. The bill, however, was very much alive in all other respects in the Banking Committee.

As discussed above, however, for all intents and purposes the Thompson draft was dead in the House, even as it still contained at

³⁹¹ See *supra* notes 200–214 and accompanying text.

³⁹² See *Hearings*, *supra* note 1, at 62 (statement of Col. Arthur H. Carter).

³⁹³ See S. REP. NO. 73-47 (1933) (text of reported bill), reprinted in 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY, *supra* note 361, at 13–14, 43–44.

³⁹⁴ See *id.* at 3 (text of accompanying report).

³⁹⁵ See *Hearings*, *supra* note 1, at 56–62 (statement of Hon. Huston Thompson).

least the FTC examination audit provision. President Roosevelt quickly turned to his close and trusted friend Felix Frankfurter to take over production of a new draft to be introduced in the House.³⁹⁶ Felix Frankfurter, in turn, enlisted the help of James Landis, Benjamin Cohen, and Thomas Corcoran as a drafting team under his oversight (the "Landis-Cohen team").³⁹⁷ After obtaining the consent of Sam Rayburn, the Chair of the Commerce Committee, the Landis-Cohen team went to work and drafted the core of the '33 Act in only a few days.³⁹⁸

This core also was based expressly on the British Companies Act, 1929.³⁹⁹ As such, and more in line with President Roosevelt's intentions, it was centered solely on the goal of "full and fair disclosure" rather than the more controversial merits based review contained in the Thompson draft.⁴⁰⁰ But whereas the Thompson draft was consistent with the Companies Act, 1929's allowance of sales of securities simply upon adequate registration with the Registry Office (U.S. offerors would file with the FTC), the Landis-Cohen team added the requirement for the so-called "waiting period." This allowed the FTC to examine the registration statement and conduct examinations of the issuer's records, if necessary, before the issuer could proceed to actually sell the registered stock.⁴⁰¹ This was quite a departure from both the Companies Acts, 1929, and the Thompson draft, and created many secondary effects upon the financial markets, including the use of so-called "red herring" prospectuses during the waiting period.⁴⁰²

The Landis-Cohen team also amended the provisions to require specific information in the registration statement so that they were "both tightened and expanded."⁴⁰³ Additionally, the Landis-Cohen

³⁹⁶ See SELIGMAN, *supra* note 281, at 57-58; Landis, *supra* note 359, at 33.

³⁹⁷ See SELIGMAN, *supra* note 281, at 61; Landis, *supra* note 359, at 33-34. Dean Seligman suggests that Thomas Corcoran was not brought in so much to draft the legislation, but rather to help lobby it through Congress. See SELIGMAN, *supra* note 281, at 63. James Landis gives no such indication, although he does mention that the group often met with Thomas Corcoran only at night because "his duties prevented him from giving his full time to this project." Landis, *supra* note 359, at 37. Nonetheless, this Article adopts the convention of Dean Seligman to call the group the "Landis-Cohen team." See SELIGMAN, *supra* note 281, at 61.

³⁹⁸ See SELIGMAN, *supra* note 281, at 63; Landis, *supra* note 359, at 34.

³⁹⁹ Landis, *supra* note 359, at 34.

⁴⁰⁰ See SELIGMAN, *supra* note 281, at 63; Landis, *supra* note 359, at 34-35. This Article does not purport to give a detailed history of all the provisions of what would become the '33 Act, but rather mainly focuses on the development of its audit provisions.

⁴⁰¹ See Landis, *supra* note 359, at 34-35.

⁴⁰² See *id.* at 34-35 n.11.

⁴⁰³ See *id.* at 35.

team "was particularly anxious through the imposition of adequate civil liabilities to assure the performance by corporate directors and officers of their fiduciary obligations and to impress upon accountants the necessity for independence and a thorough professional approach."⁴⁰⁴ In his later recollection of the legislative history of the '33 Act, James Landis noted that:

Despite the fact now generally recognized that the registration requirements of the Securities Act have introduced into the accounting profession ethical and professional standards comparable to those of other recognized professions, the then dean of the accounting profession, George O. May, of Price, Waterhouse & Co. was strangely opposed to our proposed requirements for independent accountants.⁴⁰⁵

"Strangely opposed" indeed! George May would have been incensed on two fronts: first, because the Landis-Cohen bill allowed the FTC to set accounting standards and rules—a long-standing goal of the profession itself generally, and George May in particular;⁴⁰⁶ second, because accountants now were enumerated specifically as those with joint liability for nearly any defect in a registration statement that led to an investor's lawsuit.⁴⁰⁷

It is unclear whether the actual general audit provisions entered the draft at this point as well. Regardless, the Landis-Cohen team draft was presented to Sam Rayburn and the Commerce Committee on April 10, 1933, as "perfecting amendments" to the Thompson draft, so as to not offend Huston Thompson.⁴⁰⁸ After approval, the team set to work with Middleton Beaman, the House's chief draftsman, "to hone the bill."⁴⁰⁹

Dean Seligman asserted that at this point Benjamin Cohen suggested that the bill include a detailed schedule of data to be included in the registration statement. If so, then the general audit provisions would likely have been introduced at this time as well.⁴¹⁰ In Dean Seligman's account, James Landis vehemently countered this suggestion by arguing that it was better to give the FTC general power to is-

⁴⁰⁴ *Id.*

⁴⁰⁵ *Id.* at 35 n.12.

⁴⁰⁶ See CAREY, *supra* note 23, at 182, 191-92.

⁴⁰⁷ See *id.* at 192.

⁴⁰⁸ See SELIGMAN, *supra* note 281, at 64; Landis, *supra* note 359, at 36.

⁴⁰⁹ See SELIGMAN, *supra* note 281, at 64; Landis, *supra* note 359, at 37-38.

⁴¹⁰ See SELIGMAN, *supra* note 281, at 64.

sue regulations in this regard.⁴¹¹ Benjamin Cohen pushed back by arguing that James Landis's plan would risk ineffectual regulation.⁴¹² Middleton Beaman allegedly gave the first resolution by "overruling Cohen" on the grounds that it was best "to eliminate from the draft any material not essential to the bill's structure."⁴¹³ At this point, Benjamin Cohen is alleged to have brought Felix Frankfurter into the fray, and threatened to quit.⁴¹⁴

Unfortunately, Dean Seligman cites no clear support for the reported exchange to this point.⁴¹⁵ He does, however, next cite a telegram from Felix Frankfurter to President Roosevelt which appears to support the contention that there was some important debate over including such a schedule. The Frankfurter telegram of April 14, 1933, is cited as arguing that:

"[T]he omission of specific data to be disclosed would 'raise needless questions of constitutionality as to delegation of legislative power,' invite frustration of the bill's purposes by hostile judicial interpretation, and 'jeopardize effective enforcement because of the enormous discretion it leaves to the [FTC] . . . thereby inviting laxity, favoritism, and indifference.'"⁴¹⁶

Dean Seligman cited a subsequent telegram from Felix Frankfurter of April 17, 1933, which thanked President Roosevelt for intervening with Sam Rayburn on the bill.⁴¹⁷ Felix Frankfurter also telegraphed Benjamin Cohen around the same time, coaxing him to stay on the project, and contacted Raymond Moley, a member of President Roosevelt's administration and a supporter of the project, to help mend fences between James Landis and Benjamin Cohen.⁴¹⁸

In contrast, James Landis, in his own account, professed not only not to recall this heated dispute, but also not to recall exactly how the crucial schedule came to be.⁴¹⁹ He stated, "[The new draft] also contains the device of schedules setting forth in detail the items of information to be presented in the registration statement. I have no dis-

⁴¹¹ *See id.*

⁴¹² *See id.*

⁴¹³ *Id.*

⁴¹⁴ *See id.*

⁴¹⁵ *See* SELIGMAN, *supra* note 281, at 64.

⁴¹⁶ *Id.* at 64-65.

⁴¹⁷ *See id.* at 65.

⁴¹⁸ *See id.*

⁴¹⁹ Landis, *supra* note 359, at 38.

ting memory of the origins of that device."⁴²⁰ His next comments, however, suggest what might have happened:

I believe that [the device] was probably due to Beaman's desire to eliminate from the draft material not essential to its main structure. I do recall his comment that, handled as a schedule, it would probably be glossed over by the committee after that committee had exhausted its patience on the bill itself. In this he proved to be right. I believe, however, that he knew as well as we that the core of the registration requirements lay in those schedules.⁴²¹

This hardly sounds as if James Landis had opposed the inclusion of a specific schedule of requirements generally—in fact, he clearly seems to support it as a crucial part of the bill. Of course, James Landis's memory could have been failing him on this matter. The more plausible story is that the debate was perhaps only partly over whether to include the requirements at all, and partly over whether to include such requirements, if included at all, within the body of the bill, or instead to attach them as a schedule after the body of the bill as a separate item.

The Landis-Cohen team members had already deferred once to political expediency when they called their first draft "perfecting amendments" to the Thompson draft. Perhaps now too, whether at Middleton Beaman's direct or indirect suggestion, or their own intuition, they decided that the list of disclosure items for registration statements would be too distracting or controversial if placed in the main text. Alternatively, perhaps, there really was a struggle between James Landis and Benjamin Cohen as to the policy implications of placing firm requirements in this bill, instead of including only enabling language that delegated the specifics to the FTC. Either way, pushing the requirements into a separate schedule might have been seen as a nice compromise: the Commerce Committee and/or James Landis could be appeased partly that the requirements were not technically part of the bill text. Benjamin Cohen, and maybe James Landis, could feel comfortable that the requirements had nonetheless been laid out as part of a congressional action, and not "merely" by delegated action by the FTC.

⁴²⁰ *Id.*

⁴²¹ *Id.*

At the same time, use of the separate schedule "device" was hardly unprecedented. In fact, arguably the schedule and much of its contents had simply been lifted, with or without credit, directly from the Companies Acts, where a forerunner had been introduced as early as the Joint Stock Companies Act, 1856.⁴²² Originally, the removal of this earlier version from the body of the prior Joint Stock Companies Act of 1844, as amended, into a separate table/schedule seemed to have been part of the shift to establish these requirements as default provisions that could be expressly modified by the company, either at its inception or by special resolution later.⁴²³ The Companies Act, 1879, however, brought many of these provisions, in particular the audit provisions, back into the body of the text, presumably to emphasize that they were binding again and not merely default rules.⁴²⁴

Further, the Companies Act, 1928, as consolidated by the Companies Act, 1929—which served as the acknowledged model for the Landis-Cohen bill—included a Schedule IV that set out all the requirements for information to be contained in any prospectus used by a company to sell stock, including the new audit provision.⁴²⁵ The requirements of this Schedule IV, however, were no less mandatory than other provisions included in the text of the statute. The eventual Schedule A of the '33 Act bears some resemblance to Schedule IV, and so, in some ways, it is not clear what all the preceding fuss was about—no new conceptual ground was being broken by the "device" of a schedule, nor for that matter, a specific set of requirements for prospectuses (including some select audited financial statements). Instead, at most, this may have been an argument over *diverging* from the Companies Act, 1929 model/precedent either as to removing the requirements altogether, or pushing them back into the body of the bill, perhaps to give them even more force.

Regardless of how the schedule came to be included, the subsequent development of the Landis-Cohen draft is fairly well documented. The House Commerce Committee had created a subcommittee under Sam Rayburn to bring the draft along in confidence until it was suitable for "prime time."⁴²⁶ An April 21, 1933, draft included the delegation of power to the FTC to define accounting terms.⁴²⁷ James

⁴²² See *supra* notes 138–143 and accompanying text.

⁴²³ See *supra* notes 144–146 and accompanying text.

⁴²⁴ See *supra* note 166 and accompanying text.

⁴²⁵ See *supra* note 197.

⁴²⁶ See SELIGMAN, *supra* note 281, at 65; Landis, *supra* note 359, at 38–39.

⁴²⁷ See SELIGMAN, *supra*, note 281, at 65.

Landis reported that they went through four more drafts, with limited input of individual subcommittee members, and then two subcommittee meetings, before anyone outside of the subcommittee was allowed to meet with them to discuss the draft.⁴²⁸ James Landis noted that neither of the subcommittee meetings led to any substantial changes.⁴²⁹ As the draft was ready to go to the full Commerce Committee, Sam Rayburn acquiesced to letting a select group of top securities lawyers review and comment on it in a closed door meeting.⁴³⁰ This meeting did not go particularly well, but appeared to result in only "a number of technical changes particularly in the schedules to the bill that had not had a thorough going over by the subcommittee."⁴³¹

From here, the bill went to the full Commerce Committee in a public meeting on May 3, 1933.⁴³² Few changes were requested by that group, except for the addition of a couple of additional exemptions from registration.⁴³³ The bill was then reported out to the House on May 4, 1933, and the next day, with relatively little debate, the bill was unanimously adopted by that chamber.⁴³⁴ The House Report of May 4, 1933, sets out the full text of this bill and shows inclusion of the full Schedule A with registration statement requirements for a balance sheet and a profit and loss statement, both to be certified by an independent public or certified accountant.⁴³⁵ Whether any of these inclusions were the result, even in part, of the Institute's lobbying seems unknowable on the existing record. Nonetheless, the accounting profession had indeed received what it had requested.

Ironically, this bill also reinstated the original Thompson draft provision for the FTC to require that financial statements given to it pursuant to an examination during the waiting period be certified by a public or certified public accountant approved by the FTC.⁴³⁶ Given the registration statement requirements under Schedule A, however, this may seem redundant. The Schedule A provisions, however, do not

⁴²⁸ See Landis, *supra* note 359, at 39.

⁴²⁹ See *id.*

⁴³⁰ SELIGMAN, *supra* note 281, at 65-66; Landis, *supra* note 359, at 39-40.

⁴³¹ Landis, *supra* note 359, at 40-41.

⁴³² See SELIGMAN, *supra* note 281, at 66; Landis, *supra* note 359, at 41.

⁴³³ Landis, *supra* note 359, at 41.

⁴³⁴ *Id.*

⁴³⁵ H.R. REP. NO. 73-85 (1933) (text of reported bill, H.R. 5480), reprinted in 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, *supra* note 361, at 36-37. Of course, this went further than the Companies Act, 1929 in two regards: (1) it required both certified balance sheets and profit and loss statements, and (2) it required that those certified statements be filed with the FTC, rather than simply be included in the prospectus. See *id.*

⁴³⁶ See *id.* at 16.

require the accountant to be approved by the FTC. Thus, this may indicate a continuing skepticism as to the reliability of company chosen auditors. Such auditors might be acceptable for the routine registration statement filing, but where the suspicion of the FTC is aroused about the verity of that filing, it may initiate an investigation that, *inter alia*, requires a new audit to be conducted by an FTC approved auditor. This concept of routine filings coupled with adversarial, or what might be deemed "forensic," audits may well suggest a better model for the use of auditors in securities regulation in the future.

As to the scope of the provisions of Schedule A, there is no doubt that it is more extensive than its counterpart, Part II of Schedule IV, of the Companies Act, 1929. At the same time, not too much should be made of this expansion because, as discussed above,⁴³⁷ the Companies Act, 1929, brings together all of the major legislative areas regarding corporations and their securities, and thus requires other sorts of information in other schedules, forms, and provisions of that act. In total, these arguably cover the same ground as the single Schedule A, which at the time was to be the only chance that federal authorities would get to compel companies to disclose information.

Meanwhile, in the Senate, the revised Thompson bill was still percolating along in the Banking Committee.⁴³⁸ During April, it had been amended substantially to withdraw many of the most nettlesome provisions such that the Banking Committee's chairman would proclaim it to be quite similar to the Landis-Cohen bill.⁴³⁹ Felix Frankfurter attempted to have the Senate bill withdrawn in late April, but to no avail—it was reported out to the Senate on April 27, 1933. Despite further efforts by Felix Frankfurter, with the assistance of Raymond Moley on approval from President Roosevelt, passage of the Thompson bill in the Senate was merely delayed, but ultimately achieved on May 8, 1933.⁴⁴⁰ Somewhat out of the blue, however, an entire second part purporting to form a federal Corporation of Foreign Security Holders was tacked on just before passage.⁴⁴¹

All of these events presented a bit of a sticky wicket for the promoters of the House's Landis-Cohen bill, including President Roosevelt himself.⁴⁴² Nonetheless, as the two chambers prepared to send

⁴³⁷ See *supra* notes 106–238 and accompanying text.

⁴³⁸ See SELIGMAN, *supra* note 281, at 67.

⁴³⁹ See *id.*

⁴⁴⁰ See *id.* at 67–68.

⁴⁴¹ See *id.* at 68–69; Landis, *supra* note 359, at 43.

⁴⁴² Landis, *supra* note 359, at 43.

their delegates to meet in Conference Committee to hammer out the final version of the bill, enough politicking was achieved in the background so that the delegates could have a "free hand" in fashioning the final version, all under the chairmanship of Sam Rayburn, and at the concession of Senator Fletcher.⁴⁴³ In the proceedings of the Conference Committee, the Thompson draft part of the Senate bill was quickly dropped, while the House's Landis-Cohen bill was adopted as the basic working draft.⁴⁴⁴ Somewhat oddly, although likely another political expediency, the tacked on amendment to the Senate bill was retained.⁴⁴⁵ After four more drafts containing amendments that weakened some of the regulatory provisions a bit, but with Schedule A intact, the final bill came out of Conference Committee, passed both houses of Congress, and was signed into law on May 27, 1933.⁴⁴⁶

IV. AFTERMATH

A. The '34 Act and the SEC

A little more than a year after passage of the '33 Act, President Roosevelt was also able to get Congress to pass a second component of his ambitious reform plan in the form of the '34 Act.⁴⁴⁷ This latter legislation was intended to regulate the stock exchanges, and many of their key players like brokers and dealers.⁴⁴⁸ It also regulated the so-called secondary market in which issuer stock was traded amongst members of the public after it initially was purchased directly from the issuer, often via underwriters, in a public offering.⁴⁴⁹

The '33 Act itself was also amended, largely to cut back on what were perceived to be excessive liabilities imposed on company management and the directors they relied on, such as accountants.⁴⁵⁰ In a nutshell, the legitimate concern of those facing the prospective liabilities under the original '33 Act was that the liability seemed limited neither to the harmed party's reliance on the defective statements

⁴⁴³ See SELIGMAN, *supra* note 281, at 69; Landis, *supra* note 359, at 43-45.

⁴⁴⁴ Landis, *supra* note 359, at 43-45.

⁴⁴⁵ *Id.* Although a provision was added to stay the effectiveness of the amendment's provisions unless and until there was a presidential proclamation doing so, this apparently never happened. See SELIGMAN, *supra* note 281, at 70; Landis, *supra* note 359, at 48-49.

⁴⁴⁶ See SELIGMAN, *supra* note 281, at 69-70; Landis, *supra* note 359, at 45-48, 49.

⁴⁴⁷ See SELIGMAN, *supra* note 281, at 73-100; see also Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78hh (2000)).

⁴⁴⁸ See 15 U.S.C. §§ 78a-78hh.

⁴⁴⁹ See *id.*

⁴⁵⁰ See SELIGMAN, *supra* note 281, at 94-100.

and certifications in the prospectus nor to the direct causal role that such statements and certifications may have played in the actual harm alleged.⁴⁵¹ Adding to the pain, the liability provisions provided no cap to damages other than the price at which the security was offered to the public.⁴⁵² George May expressed the indignation of the accounting profession:

"I cannot believe that a law is just or can be long maintained in effect which deliberately contemplates the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not to be measured by injury resulting from falsity in such statement. Yet, under the Securities Act as it stands, once a material misstatement or omission is proved, it is no defense to show that the plaintiff had no knowledge of the statement in question or of the document in which it was contained, or that the fall in the value of the security which he has purchased is due, not to the misstatement or omission complained of, but to quite different causes, such as the natural progress of invention, or even fire or earthquake. The Securities Act not only abandons the old rule that the burden of proof is on the plaintiff, but the doctrine of contributory negligence and the seemingly sound theory that there should be some relation between the injury caused and the sum to be received."⁴⁵³

James Landis, however, is quoted with a specific response to accountants regarding their new liability under the '33 Act at a meeting of the New York State Society of Certified Public Accountants:

"It has been said, and very rightly in my humble opinion, that accounting is after all a matter of opinion rather than anything else. But though this may be true I have still to see the case of a prospective investor being offered a balance sheet and having it carefully explained to him that this or that item is merely an opinion or deduction from a series of other opinions mixed in with a few acknowledged facts. But the fact is that accountancy has paraded too largely as an exact science.

⁴⁵¹ CAREY, *supra* note 23, at 192; SELIGMAN, *supra* note 281, at 94-100.

⁴⁵² 15 U.S.C. § 77(g).

⁴⁵³ CAREY, *supra* note 23, at 192 (quoting comments of George May).

Accountancy, as distinguished from law, has generally been portrayed as an exact science, and its representations have been proffered to the unlearned as representations of fact and not of opinion. If it insists upon such fact representations, it is, of course, fair that it should be burdened with the responsibility attendant upon such a portrayal of its results."⁴⁵⁴

These are tough statements to make to a room full of CPAs, but James Landis apparently did not have a reputation for being particularly warm and fuzzy.⁴⁵⁵ Nonetheless, the edges of the perceived excesses of the '33 Act were softened by amendments introduced as part of the '34 Act.⁴⁵⁶ In part, these amendments were due to a return of the public sentiment pendulum closer to the center and away from the extremes it reached while the glaring spotlights of the Pecora Investigation highlighted every last peccadillo of members of the financial services industry.⁴⁵⁷ This allowed members of that industry to regroup and mount a responsive campaign against what they perceived to be the tougher provisions of the '33 Act and proposed follow-on legislation, such as the '34 Act.⁴⁵⁸ Thus, the '34 Act itself has been described as much more the result of compromise among the affected parties than was the originally enacted version of the '33 Act.⁴⁵⁹

Perhaps owing to this compromising nature of the '34 Act, or even perhaps to the delegation theory allegedly espoused by James Landis in the drafting of the '33 Act, the '34 Act sets out less detail and gives the new SEC more power to engage in rulemaking to flesh out specifics than its predecessor did.⁴⁶⁰ In particular, the '34 Act requires annual financial reporting, and allows for additional or more frequent reporting, of publicly traded companies under implementing rules to be promulgated by the SEC.⁴⁶¹ Interestingly, these reports are not required to be certified or audited under the provisions of the '34 Act itself, but

⁴⁵⁴ *Id.* at 193 (quoting James M. Landis, Speech to the New York State Society of Certified Public Accountants (1933)).

⁴⁵⁵ See SELIGMAN, *supra* note 281, at 63-65.

⁴⁵⁶ 15 U.S.C. §§ 77k, 77m, 77o.

⁴⁵⁷ See SELIGMAN, *supra* note 281, at 20-38.

⁴⁵⁸ See *id.* at 76-77, 89-93.

⁴⁵⁹ See *id.* at 99-100.

⁴⁶⁰ See generally 15 U.S.C. §§ 78a-78l (covering Securities Exchanges, SEC Rules of Practice, and Investor Protection). The '34 Act also created the SEC, which then is to oversee and to enforce both the '33 Act and the '34 Act in place of the FTC. *Id.*

⁴⁶¹ See *id.* §§ 78j-78n. Section 78m of the '34 Act deals especially with financial reporting. *Id.* § 78m.

rather the decision to require certification is left to the SEC.⁴⁶² The SEC, of course, did choose to promulgate rules requiring annual, quarterly, and "material event" reporting, with annual reports to be certified by an independent public or certified accountant.⁴⁶³

B. *The Problem of Auditor Independence*

With the passage of both the '33 Act and '34 Act, however, accountants reached another major milestone and achieved a much desired goal—they could now argue that their's was a prestigious profession recognized by Congress as playing an important public role in the fair administration of the vast financial services sector. In fact, Chief Justice Warren Burger would sum up this role for them decades later in the landmark 1904 U.S. Supreme Court case of *United States v. Arthur Young & Co.*:

By certifying the public reports that collectively depict a corporation's financial status, the independent accountant assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.⁴⁶⁴

Between enactment of the '34 Act and the *Young* case, however, the SEC would wield its exclusive power to define who qualifies as an "independent public or certified accountant" to achieve virtual regulation of CPAs—at least those who wanted to perform the initially stable and lucrative statutory audits for publicly traded corporate clients.⁴⁶⁵ Nevertheless, as accountants' engagements with audit clients became multi-faceted—including tax work, consulting, and an ever-increasing array of other non-audit services—the SEC's job making sure the accountant-as-auditor was "independent" of the client, so as to be able to render an objective and accurate opinion, became ever more

⁴⁶² See *id.* § 78m(a)(2) (stating that "such annual reports . . . , certified if required by the rules and regulations of the [SEC] by independent public accountants" (emphasis added)).

⁴⁶³ Regulation 13A, 17 C.F.R. §§ 240.13a-1, -13 (2004).

⁴⁶⁴ 465 U.S. 805, 817-18 (1984).

⁴⁶⁵ See O'Connor, *supra* note 14, at 8-10.

difficult.⁴⁶⁶ The result was a labyrinthian compendium of principle, rules, interpretations, and no-action letters whose sole constant feature seemed to be change.⁴⁶⁷ The most recent revision to this bramble bush is the auditor independence provisions of the Sarbanes-Oxley Act of 2002.⁴⁶⁸ Now, any such certification or audit required by the SEC must be performed by a "registered public accounting firm" who must register with a new quasi-public body, the Public Company Accounting Oversight Board (the "PCAOB"), and comply with a new set of independence rules that overlap with the existing SEC rules.⁴⁶⁹

Adding to this confusion, the accounting profession has long had its own independence rules as established by the AICPA in its Code of Professional Conduct.⁴⁷⁰ Yet, in the wake of Enron and other scandals, none of these myriad sources and details of independence regulation appear to have been fully effective.⁴⁷¹ Of course, it may be too soon to tell whether the "new" independence regime under Sarbanes-Oxley will prove more effective than its predecessors. This is unlikely, however, as the "new" regime largely seems simply to import the existing SEC independence rules into the statutory codification of the '34 Act.⁴⁷² While this "promotion" from "mere" rules to statutory language may have some enforcement value, it may not be enough to overcome the widely acknowledged problems and failures of the existing auditor independence regulatory mechanism.⁴⁷³

⁴⁶⁶ See *id.* at 53–70.

⁴⁶⁷ See *id.* at 10–23. The codification of these rules is at (1) Regulation S-X, 17 C.F.R. §§ 210.2-01(b)–(c) (2004), and (2) Codification of Financial Reporting Policies §§ 601–602, reprinted in SEC Accounting Rules (CCH) ¶3872, at 3796. The Codification of Financial Reporting Policies is not intended to supplant the rules set forth in Regulation S-X, but is intended instead only to supplement those rules.

⁴⁶⁸ Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2004)).

⁴⁶⁹ See 15 U.S.C.A. §§ 78j–78n. Note that section 78m(a)(2) still refers to "independent public accountants." See *id.* § 78m(a)(2).

⁴⁷⁰ AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODE OF PROFESSIONAL CONDUCT, <http://www.aicpa.org/about/code/index.htm> (last visited Oct. 1, 2004); see also O'Connor, *supra* note 14, at 24–37.

⁴⁷¹ See O'Connor, *supra* note 14, at 1–3. See generally William W. Bratton, *Enron, Sarbanes-Oxley, and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002); Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421 (2002).

⁴⁷² Cunningham, *supra* note 388, at 918–19, 943–54; see also Bratton, *supra* note 471, at 1031–32.

⁴⁷³ Lawrence A. Cunningham also suggests that Sarbanes-Oxley was really a way for Congress to appear to be doing something profound in rapid response to the corporate and financial services meltdown after Enron and other scandals, while in fact doing nothing.

Accordingly, there is little reason to believe that the critical problems of auditor independence will be remedied by "tweaking" the current system. If this cannot be done, however, then what might be done instead?

C. *Be Careful What You Wish For*

In short, the problem of auditor independence was created by the federal securities laws: initially, through the statutory audit provision for prospectuses in the '33 Act, and then exacerbated by the de facto extension of this audit to an annual requirement under the '34 Act. In particular, the small change from the Companies Acts precedents of shareholder election of "auditors"—as that term was understood in the British tradition—to the unspecified method of retaining "independent public or certified accountants" in the '33 Act and '34 Act (together, the "Securities Laws"), set off a cascade of negative effects that leveraged off the broad cultural differences in accounting and auditing on different sides of the Atlantic.

To recap, the British tradition of audits is based on a principal's employ of a trusted agent to check up on the disposition of the principal's assets and affairs.⁴⁷⁴ This is a straight agency relationship that has loose connections with agency accounting theories—although the concept of "auditor" is not coextensive with that of "accountant." In some cases the auditor was working for a single principal, in other cases the auditor might have been working on behalf of a class of persons, but in all cases the auditor's services were provided towards what should be a unitary set of interests.⁴⁷⁵ Later, even as business accounting theories such as proprietorship and entity accounting developed, the role of the auditor did not necessarily follow. Rather, the auditor continued to work on behalf of individuals or classes with a unitary set of interests, such as shareholders.⁴⁷⁶

In the later developing American tradition, however, "auditors" were nearly always accountants and their audits often were used by

ing and preserving the status quo until either the crisis subsided or it could figure out the "right" thing to do. Cunningham, *supra* note 388, at 979–80.

⁴⁷⁴ See *supra* notes 22–230 and accompanying text.

⁴⁷⁵ See *supra* notes 106–230 and accompanying text. An example is the townspeople checking up on their local municipal treasurer. See *supra* notes 106–230 and accompanying text.

⁴⁷⁶ Cf. William W. Bratton, *Shareholder Value, Financial Conservatism, and Auditor Independence*, 53 DUKE L.J. 439, 446–62 (2003) (arguing that even subsets of current shareholders may have different needs and goals regarding audits and financial statement disclosure).

multiple parties with clearly distinct interests.⁴⁷⁷ Thus, the theories of proprietorship and entity accounting may have had more impact on American auditors. In the former, the accountant/auditor was to distinguish between all of a natural person's financial affairs—business and personal—taken together, and those specific assets implicated directly in a defined, ongoing proprietary enterprise.⁴⁷⁸ In the latter, the accountant/auditor distinguished between an agency relationship with one or more natural persons, and one with a corporation or other legal, but non-natural person.⁴⁷⁹

Further, whereas the British system has unitary sources of regulation for both corporations and chartered accountants, the American system consists of a confusing, and sometimes conflicting, pastiche of varying state laws concerning corporations and CPAs, partially preempted by federal laws in limited domains such as securities regulation. This likely made it difficult for any cultural tradition regarding audits and auditors to develop and may be yet another reason why American accountants and lawmakers continually looked to the British Companies Acts for guidance.

As one might expect, however, problems arise when specific provisions are lifted—and modified—from their place in a coherent and comprehensive whole. To be fair, President Roosevelt and his New Dealers appeared to want to move all corporate and accounting regulation to the federal level, but they were unable to do so. Their failure perhaps led to a worst of both worlds situation in which rules for accountants were removed partially from their existing location in state law and placed in a federal system without the necessary surrounding provisions that provided such critical context as they did for the British audit system.

Paramount in this surrounding context was the conceptual separation of the auditor and accounting roles, and the allegiance of the auditor to the owners (shareholders) of the company. The centuries-old British audit tradition, combined with the placement of hiring and compensation power in the hands of the principal(s) under the Companies Acts, created an environment in which it was clear what the auditor's role was and for whom the auditor was working. When the Securities Laws left it open as to who would hire and set compensation for the auditors, this responsibility fell to management and/or

⁴⁷⁷ See *supra* notes 239–310 and accompanying text.

⁴⁷⁸ See *supra* note 30.

⁴⁷⁹ See *supra* notes 58–60 and accompanying text.

the board of directors—the very parties upon whom the auditors were supposed to be checking up on! Further, the statutory language simply directing companies to have certain financial statements certified by an independent public or certified accountant minimized the richer tradition of the British auditor as an officer of the company, working on behalf of shareholders.

Not surprisingly, the audit system established under the Securities Laws instead created a culture in which outside accountants are hired merely to perform a professional service to certify financial statements on behalf of the “company,” with a host of implied duties to creditors, directors, and the “investing public,” not to mention a duty to shareholders and possibly even employees. Of course, all of these groups of beneficiaries have markedly different interests. Thus, the American accountant/auditor is placed in the untenable position of the agent serving many masters with conflicting interests. In such an imbroglio, is it any wonder that the group who hires, fires, and sets compensation for the auditor becomes the *de facto* client? Over time, laudable efforts to establish protections such as audit committees of company boards that would insulate auditors from the direct influence of management have been instituted. These still fail, however, to take the simple step of pushing control of the audit relationship back to shareholders where it belongs.

It is not clear why the Landis-Cohen team chose to include an audit provision for prospectuses that clearly was derived from the Companies Act, 1929, yet was altered in such crucial ways. Perhaps they felt that the very lack of a comprehensive federal corporation regulating mechanism such as the Companies Act, 1929, would create problems for a more closely followed audit provision because the '33 Act was not broad enough in scope to dictate a general auditor for stock issuing companies. Alternatively, perhaps the team felt it would be more palatable to modify the British audit to more closely track the developing American corporate practice of publicly disclosed audits (such as Colonel Carter argued, albeit unpersuasively, to the Banking Committee).

Regardless of how it came to be, the form of the audit provision set out in the enacted '33 Act was then picked up by the '34 Act and the SEC rules promulgated thereunder. This set in place the American form, which has subsequently proved to be extremely difficult to dislodge. Further, by mandating what was arguably a useful quality signaling best practice, the Securities Laws turned it into a mere commodity—a cost of doing business that should be dispensed with as cheaply

as possible.⁴⁸⁰ Over time, as one would predict, the profit margins for statutory audits became razor thin as the service was transformed from a premium into a commodity—in some accounts, it has actually been run as a loss leader simply to give accountants access to corporate decisionmakers in the quest for premium consulting engagements.⁴⁸¹

At the same time, while it has been endlessly “tweaked,” the core structure of the American audit, replete with all the independence issues it creates, remains firmly in place. Beyond suggesting to replace it with one more closely modeled after the British system—in particular, placing control of the audit relationship in the hands of the shareholders—this Article does not examine whether the British system is in fact demonstrably better than the American system. Rather, it simply starts from the premise that the American system has not worked particularly well and argues that this failure is due to the misapplication of the British precedent. Accordingly, any true solution for the problem of auditor independence must start from when and how it was created—a story that this Article does explore in detail.

Ironically, the American system has not worked out that well for the accountants either. To be sure, they received a government-mandated windfall concession, and this concession may well have led to the phenomenal growth and consolidation of the major accounting firms.⁴⁸² Although perhaps not as an intentional quid pro quo, however, the Landis-Cohen team also saddled the accountants with substantial liabilities for their choice role in the securities issuing process. Additionally, perhaps more importantly, the profession has been hobbled ever since by the fast-growing complexities and limitations involved in maintaining auditor independence—even as the largest firms transformed themselves into international professional services behemoths. Currently, the Big Four firms continue to wrestle with what to do with their lucrative consulting divisions—the very divisions that also create the most visible independence challenges through provision of non-audit services to audit clients.

⁴⁸⁰ See O'Connor, *supra* note 14, at 62–63.

⁴⁸¹ See Revision of the Commission's Auditor Independence Requirements, 17 CFR pts. 210, 240, § III(C)(2)(a)(i) (2001) (codifying Exchange Act Release Nos. 33–7919, 34–43602, 35–27279, IC-24744, IA-1911, and FR-56 (Nov. 21, 2000)), available at <http://www.sec.gov/rules/final/33-7919.htm> (last modified Oct. 12, 2001); Arthur Levitt, Renewing the Covenant with Investors, Speech at New York University Center for Law and Business (May 10, 2000), at <http://www.sec.gov/news/speech/spch370.htm> (last modified May 26, 2000).

⁴⁸² See O'Connor, *supra* note 14, at 68–69.

Ask members of the former Arthur Andersen about the problems of audits and independence. Even before the Enron debacle that resulted in its criminal conviction and implosion, the firm had suffered through a nasty divorce from its consulting arm, Andersen Consulting (now Accenture).⁴⁸³ This divorce, however, was arguably the culmination of the growth of the audit and tax services under the substantial business generated by both the income tax law of 1913 and the Securities Laws, which in turn led to the firm's ability to create and grow the consulting practices.⁴⁸⁴ Yet, hemmed in by independence rules, the consulting services could not fully prosper until the firm secured a unique no-action letter from the SEC blessing a novel separation of the firm into two distinct legal entities—one for tax and audit and one for consulting.⁴⁸⁵ Neither controlled the other, but both were "coordinated," along with the firm's overseas legal entities, through contracts established with yet another entity, the Swiss-based Andersen Worldwide.⁴⁸⁶

Over time, the partners at Andersen Consulting came to resent the obligations they had to the Arthur Andersen member firms through the Andersen Worldwide Organization. In particular, the Andersen Consulting partners felt that their earnings were being unfairly targeted by the profit-sharing provisions of the inter-firm agreements (even though the net flow of money had been reversed earlier in the organization's history). They also felt that the Arthur Andersen member firms were creating harmful competition within the Andersen Worldwide Organization by allegedly developing new consulting divisions.⁴⁸⁷ Eventually, they sought and received an arbitration award that allowed them simply to walk away from the worldwide Andersen family of firms.⁴⁸⁸ This was a major blow to the U.S.

⁴⁸³ See *id.* at 57–58.

⁴⁸⁴ See *Final Award, Andersen Consulting Bus. Unit Member Firms v. Arthur Andersen Bus. Unit Member Firms & Andersen Worldwide Societe Coop.*, Int'l Comm. Arb. 4–25 (2000) (No. 9797/CK/AER/ACS) [hereinafter *Final Award*]; see also ARTHUR ANDERSEN & CO., A VISION OF GRANDEUR 84, 92–93 (giving a history of Arthur Andersen & Co., published by the firm for its seventy-fifth anniversary).

⁴⁸⁵ See Arthur Andersen & Co., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,484, at 77,457 (June 20, 1990).

⁴⁸⁶ See *Final Award*, *supra* note 484, at 10–14; ARTHUR ANDERSEN & CO., *supra* note 484, at 84, 92–93. Of historical note, Harvey Pitt, then of Fried Frank, and later SEC Chairman, signed the no-action letter request for allowance of this convoluted structure—although it is unclear what role he played in creation of the structure. See Arthur Andersen & Co., *supra* note 485, at 77,457.

⁴⁸⁷ See *Final Award* at 4–25, 116–18.

⁴⁸⁸ See *id.*

Arthur Andersen entity and arguably played some role in the subsequent downward spiral of the firm. Even as it then attempted to grow a sort of replacement consulting division, Arthur Andersen Business Consulting, within the Arthur Andersen entity, the firm became increasingly mired in independence issues. It also faced the same apparent general decline in profitability of the once dependable cash cow statutory audit that the other members of the then-Big Five faced.⁴⁸⁹ It is difficult to tell what proportional role all of these factors played in the demise of Arthur Andersen, but in the end they collectively killed the firm.

Thus, the very thing the accounting profession so desired at the dawn of the twentieth century—to be acknowledged as a “true” profession and entrusted with an important and respected role in society—may well have led it to accept, and even advocate for, its Achilles’ heel of auditor independence. To be held to the higher standard that arguably separates a “profession” from a mere business enterprise, however, one must then live up to that standard, perhaps even when it means declining lucrative engagements and diminishing the bottom line. Or, maybe it is just another *Great Gatsby*-type story, in which an all-consuming desire to “better one’s position” in life blinds the protagonist to the reality of life beyond the dock with the green light.⁴⁹⁰

At any rate, in postscript then, be careful what you wish for—you might actually get it.

⁴⁸⁹ See *supra* note 479.

⁴⁹⁰ See generally F. SCOTT FITZGERALD, *THE GREAT GATSBY* (Chelsea House Publishers 1986) (1925).