

THE CASE FOR EDUCATING LEGALLY-AWARE ACCOUNTANTS

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Accounting is not a trade; it is a learned profession.¹ Its practitioners must have the attitude and perspective of educated people, rather than the limited skills of mere trained technicians.² The difference between a retired laborer who takes a tax preparation course from a tax-return preparation mill and a university-trained accountant lies largely (though not entirely) in courses taken outside the accounting department.³ Just as accountants need to know a little

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¹ A professional is one who possesses a "degree of responsibility, wisdom and concern for the public welfare, neither necessary nor commonly found in occupations not meriting the description 'profession.'" Robert K. Mautz, *Public Accounting: Which Kind of Professionalism?*, ACCT. HORIZONS, Sept. 1988, at 121.

² For example, a recent study indicated that general communication skills are more important to the decision of whom an accounting firm should admit to partnership than are matters of technical competence. Sak Bhamornsiri & Robert E. Guinn, *The Road to Partnership in the "Big Six" Firms: Implications for Accounting Education*, 6 ISSUES ACCT. EDUC. 9, 19 (1991).

³ For this reason, the technical nature and narrow scope of accounting education has been criticized for as long as accounting education has existed. See PATRICK J. KEATING & S. F. JABLONSKY, CHANGING ROLES OF FINANCIAL MANAGEMENT: GETTING CLOSE TO THE BUSINESS 62 (1990) (criticizing accounting education as being too narrow and technically

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geography—"The famous McKesson and Robbins case might never have happened if a junior member of an audit team had recognized that goods cannot be moved from Australia to San Francisco by lorry"⁴—they must know a lot of law. As Robert Mednick of Andersen Worldwide recently observed, while it is important that accountants master "the increasingly complex web of technical principles, rules, and interpretations governing the reporting of financial transactions ... another critical need, for practitioners as well as for students ... is [an] understanding [of] the ethical, legal, and institutional imperatives underlying the practice of [the accounting profession]."⁵

In this paper I discuss the importance of including basic legal education in a broad accounting curriculum and of including the subjects taught in the curriculum on the American Institute of Certified Public Accountant's (AICPA's) professional certification examination.⁶ I am prompted in part by the AICPA's current reexamination of the content of its Uniform Certified Public Accountant (CPA) exam. In 1993, the AICPA's Content Validity Task Force recommended a reevaluation of the examination and the Board of Examiners appointed a new task force, the Content Oversight Task Force.⁷ The Task Force is apparently considering reducing or

focused: "More and more it concentrates on formal accounting rules, with correspondingly less focus on essential business and social issues."); Irvin T. Nelson, *What's New About Accounting Education Change? An Historical Perspective on the Change Movement*, ACCT. HORIZONS, Dec. 1995, at 62, 63-64 (extensive discussion making similar points).

⁴ C.W. Nobes, in ACCOUNTANTS' LIABILITY IN THE 1980S: AN INTERNATIONAL VIEW 38 (E.P. Minnis & C. W. Nobes eds., 1985).

⁵ Robert Mednick, *Foreward* in HARRY T. MAGILL ET AL., THE CPA PROFESSION: OPPORTUNITIES, RESPONSIBILITIES, AND SERVICES (not paginated in original) (1998) [hereinafter MAGILL ET AL.]; see also Michael N. Chetkovich, *Introduction*, in FLOYD W. WINDAL & ROBERT N. CORLEY, THE ACCOUNTING PROFESSIONAL: ETHICS, RESPONSIBILITY, AND LIABILITY xi (1980) (noting that to be true professionals, accountants must be cognizant of "the moral and social as well as the *legal* and pragmatic" requirements of the profession) (emphasis added).

⁶ If important material is not covered on the CPA examination, accounting professors will be less likely to offer and students will be less likely to attempt to master that material. Nelson, *supra* note 3, at 64 (noting "the strong influence of the CPA exam on accounting curricula" in universities).

⁷ See generally Jacqueline Burke & Eugene T. Maccarrone, *Uniform CPA Examination: The Only Constant is Change*, CPAJ.ONLINE (2000), at <http://www.luca-online.com/cpajournal/2000/0300/f40300a.htm> (describing the process).

eliminating the business law portion of the CPA exam.⁸ The impetus for this proposal apparently stems from the responses to a small and decidedly unscientific survey that produced very mixed results.⁹

I am not dispassionate on this subject. I teach business law and strongly believe in the importance of law in a general business curriculum. I also teach accounting students specifically and submit that there is substantial evidence that no accountant is thoroughly educated absent substantial exposure to a wide range of substantive legal subjects, as well as to legal and ethical reasoning.¹⁰

⁸ *Id.* (noting that some respondents to the Task Force's survey suggested that the exam's attention to business law be "greatly reduced").

⁹ See American Institute of Certified Public Accountants Board of Examiners, Status Report: Updating the Uniform CPA Examination Content Specifications (1997). The survey simply invited responses from those who chose to respond. Seventy-four responses were received. Of those, ten indicated that business law should be deemphasized while two specifically indicated that it should be retained as is and four suggested that coverage of ethics be increased. *Id.* It is difficult to see in the results of this survey a mandate for removal of business law from the examination. Some of my students recently performed a similarly small and unscientific survey of practicing accountants and found resounding support for business law as essential for accountants in all fields of endeavor.

¹⁰ I certainly am not alone in this opinion. See, e.g., Raphael Boyd & Allen J. Rubenfield, *Learning the Law: What You Need to Know*, WWW.NEWACCOUNTANTUSA.COM, Vol. 16, No. 2, at 7 (arguing that the need to give undergraduate business students a firm grounding in the legal environment of business "is especially true of accounting majors, who will be dealing with a wide variety of legal issues when they start working ..."); RICHARD L. MILLER, JR. & GERALD P. BRADY, CPA LIABILITY: MEETING THE CHALLENGE I (1986) ("[A]ccountants are obligated to have at least a minimal understanding, or in some cases, a very high degree of understanding of the law."); Don M. Pallais, *What the Courts are Saying About Financial Forecast Engagements*, CPA J. ONLINE, June 1994, at <http://www.nysscpa.org/cpajournal/old/16097610.htm> ("The vital role played by the legal system in every aspect of American commercial life makes it necessary for accountants to know how their professional responsibilities are viewed by the courts."); ROBERT H. ROY & JAMES H. MACNEILL, HORIZONS OF A PROFESSION: THE COMMON BODY OF KNOWLEDGE FOR CERTIFIED PUBLIC ACCOUNTANTS 243 (1967) (study sponsored by the Carnegie Foundation and the AICPA concluding "[s]ince CPAs, because they are professionals, are responsible for their professional acts, it is our urgent recommendation that the beginning CPA have extensive knowledge of the law pertaining to his rights and duties."); DUKE N. STERN, *Preface in AN ACCOUNTANT'S GUIDE TO MALPRACTICE LIABILITY* (not paginated in original) (1979) ("Time must be taken to study those acts which have led to malpractice claims against other accountants, and procedures developed to prevent occurrence of similar results.").

I. LEGAL EDUCATION IS A CRITICAL COMPONENT OF A GENERAL BUSINESS EDUCATION.

If there were ever the slightest doubt, the internet revolution is making it clear beyond cavil that the law is an absolutely critical element of the business world and that most businesspersons should be familiar with its basic elements. The law has long played a critical role in the business world by creating social order, enforcing promises, punishing fraud, rewarding creativity, and deterring monopoly. Despite the numerous complaints about lawyers and frequent telling of lawyer jokes, legal regulation need not restrain business; rather, when done well legal regulation advances business.¹¹ It is becoming clear that without the necessary legal underpinnings, underdeveloped countries cannot create successful capitalist economies.¹²

¹¹ For example, several recent empirical studies have demonstrated that the more transparency that legal regimes require and the more legal protection nations provide for their investors, the cheaper and more efficient it is for their businesses to raise capital. See, e.g., LAURA N. BENY, A COMPARATIVE INVESTIGATION OF AGENCY AND MARKET THEORIES OF INSIDER TRADING 6 (Harvard Law School Discussion Paper No. 264, Sept. 1999) (finding that “weaker insider trading regimes have, on average, less liquid equity markets”); Alsi Demircuc-Kunt & Vojislav Maksimovic, *Law, Finance, and Growth*, 53 J. FIN. 2107, 2134 (1998) (“Firms in countries that have active stock markets and high ratings for compliance with legal norms are able to obtain external funds and grow faster.”); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131, 1131 (1997) (finding in a study of 49 countries “that countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets”); Ross Levin, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 33 (1999) (“[I]nformation disclosure matters for financial development. Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable.”); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading* 23 (Jan. 2000) (Working Paper on file with author) (finding that countries which enforced their insider-trading laws had a lower cost of equity); Simon Johnson & Andrei Shleifer, *Coase v. the Coasians* 1 (Nov. 1999) (Working Paper on file with author) (finding in a comparative study that “[I]n Poland, strict enforcement of the securities law by an independent Securities and Exchange Commission was associated with rapid development of the stock market [whereas in] the Czech Republic, hands-off regulation was associated with a near collapse of the stock market”); Rafael La Porta et al., *Investor Protection and Corporate Valuation* 1 (Oct. 1999) (Working Paper on file with author) (finding “evidence of higher valuation of firms in countries with better [legal] protection of minority shareholders”).

¹² See Keith Graham, *Asian Economic Crisis Not Yet Finished, Author Says*, ATLANTA J. & CONST., Jan. 28, 1999, at 8B (quoting N.Y.U. professor Ralph Buultjens); George Melloan, *Coase Was Clear: Law Can Cure or Kill*, WALL ST. J., Oct. 21, 1991, at A21 (“[I]n setting up

The law's role in creating a stable society and advancing economic development has often gone largely unnoticed, perhaps because the law is interwoven into the very foundation and fabric of most business transactions.¹³ The advent of the internet has made it clear, however, that:

- Absent proper legal rules, hackers can wreak havoc and yet go unpunished.¹⁴
- Legal rules will determine whether many new technologies, such as MP3 and Napster's peer-to-peer file sharing, revolutionize their industries or die aborning.¹⁵
- The winner in business competition is often not who has the best technology, but who has the best lawyers to negotiate the

'market systems' in former Communist lands, one thing should be kept in mind: It cannot be done without first creating a legal system that protects the right of all individuals to hold, buy or sell property and without corresponding legal protections for the contracts through which those transactions are conducted." Frederich Hayek is one of the most learned writers to expound on law's importance to the private enterprise economy. See generally FREDERICH A. HAYEK, *LAW, LEGISLATION, AND LIBERTY* 106-10 (1973) (noting law's importance to capitalism); FREDERICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* 22-53 (1960) (same).

¹³ Actually, this need not be qualified with the adjective "business," for it has been observed accurately that "[t]he law and human beings are inseparable." WILLIAM ZELERMYER, *LEGAL REASONING: THE EVOLUTIONARY PROCESS OF LAW* 165 (1960).

¹⁴ Wayne Arnold, *Filipinos, Now in Spotlight, Noted for Cyberskills*, *INT'L HERALD TRIB.*, May 20, 2000, at 15 (noting that the Love Bug hacker who disrupted computers worldwide could not be charged under Philippine law).

¹⁵ Technical innovations such as MP3 and peer-to-peer file sharing threaten to wreck the copyright system that has long fostered and encouraged creative efforts in literature, dance, music, and other creative fields. However, creative legal solutions may allow these new technologies to thrive and even to advance the purposes of copyright law. See Benny Evangelista, *Napster Talking Peace: Online Music Site Hoping to Settle Suit*, *S.F. CHRON.*, June 24, 2000, at D1 (explaining attempts of the music industry to reach creative solutions with Napster and MP3); Lee Gomes, *Napster Suffers a Rout in Appeals Court*, *WALL ST. J.*, Feb. 13, 2001, at A13, 16 (explaining latest developments in litigation between the music industry and Napster over alleged copyright infringement).

best deals and to draft the most favorable contracts¹⁶ and who has the best lobbyists to secure favorable legal treatment.¹⁷

- Absent proper regulation, the internet's enormous potential for transforming society and business will never be realized.¹⁸

Given the critical role of law in modern societies and economies, a basic legal education is important for all businesspersons to help them recognize and manage legal risks in business decisionmaking and to enhance their understanding of legal processes so that these processes can be used more efficiently and effectively in business strategy. After all, virtually every important decision made by any firm carries significant legal implications.¹⁹ Therefore, it is no surprise to most that "survey after survey shows business leaders believe lawyers are their most valued outside business advisers,

¹⁶ See Herb Greenberg, *Can Network Computing Catch a Big Wave Surfing the Net?*, S.F. CHRON., June 8, 1995 ("The best technology doesn't always win," says Paul Callahan, director of network strategies for Forrester Research in Cambridge, Mass. "What wins is making deals.").

¹⁷ See Peter Behr & Linton Weeks, *Dreams Give Rise to an Industry; Government Serves as Key Funding Link to Tech Firms*, WASH. POST, Dec. 7, 1998, at A1 (noting how effective lobbying allowed MCI to grow "from a gnat on the nose of AT&T to its most significant rival"); Paul Hansen, *Efficiency Trumps Nuclear Power*, CHRISTIAN SCI. MONITOR, May 23, 1990, at 18 (noting in a different context how in Washington the advantage is often "not to the most effective technology, but to the technology with the best lobbyists ..."); Arthur S. Hayes, *Broadband Battle Shifts to Beltway: Long-Awaited Court Ruling Provides More Grist for All Parties*, NAT'L L.J., July 11, 2000, at B1 (noting that broadband data transmission is the key to future success for ISPs and that who has access to high-speed internet access via cable will be determined by whom the FCC and Congress decide should regulate such service).

¹⁸ See Margaret Jane Radin & R. Polk Wagner, *The Myth of Private Ordering: Rediscovering Legal Realism in Cyberspace*, 73 CHI.-KENT L. REV. 1295, 1295 (1998) (noting the necessity of a proper legal system even in Cyberspace because "there can be no freestanding purely 'private' regime of property and contract."); Steven R. Salbu, *Who Should Govern the Internet: Monitoring and Supporting a New Frontier*, 11 HARV. J. L. & TECH. 429, 479-80 (1998) (noting the necessity of legal regulation of the internet and suggesting its proper mix).

¹⁹ See Constance E. Bagley, *Legal Problems Showing a Way to do Business*, FT.COM FINANCIAL TIMES, Nov. 24, 2000, available at <http://globalarchive.ft.com/globalarchive/articles.html?id=001124011499&query=bagley%2C+constance> ("Law has rarely been so important to managers ..."); Antonia H. Chayes et al., *Managing Your Lawyers*, 61 HARV. BUS. REV., Jan.-Feb. 1983, at 84 ("A decade of growth in the scope, nature, and complexity of government regulation has catapulted attorneys into daily business operations to an unprecedented degree. The equally rapid rise in consumer, shareholder, employee, and competitor litigation has forced prudent managers to include legal advice as an essential element of business planning and decision making.").



ranking them far above accountants and bankers."²⁰ Because of the intrinsic importance of law in the business world, businesspeople taking university-sponsored executive education programs recently rated law courses as among the most important they took,²¹ and firms such as Lucent Technologies, Inc., Allied Signal, Inc., Allegiance Healthcare Corp., Conoco, Inc., Johnson & Johnson, and others have founded their own in-house law schools to teach their employees how to be legally-aware.²²

II. LEGAL EDUCATION IS PARTICULARLY IMPORTANT TO THE ACCOUNTING PROFESSION.

Just as business law has been a critical part of a general business education since business education first began,²³ it has also been a mainstay of accounting education from the very beginning. Indeed, law has been a part of CPA exams since New York administered its very first CPA exam in 1896.²⁴ It remains an important component of CPA exams administered in other nations around the world.²⁵ Today, it is arguable that accountants, more than ever before and more than any others in business, need to be legally aware. This is true of company executives serving in the functional area of account-

²⁰ IOMA, *Competitive Pressure*, PARTNERS REPORT FOR LAW FIRM OWNERS, May 1999, at 3.

²¹ See George J. Siedel, *Six Forces and the Legal Environment of Business: The Relative Value of Business Law Among Business School Courses*, 37 AM. BUS. L.J. 717, 727 (2000) (reporting on survey of three executive education programs at the University of Michigan).

²² See Mark Voorhees, *Lucent's Law School Without Walls*, LEGAL TIMES, Nov. 29, 1999, at 23.

²³ Joseph Wharton's grant establishing the first American business school in 1881 stipulated business law as one of the five subjects that had to be included in the curriculum. See George Siedel et al., *An Executive Appraisal of the Importance of Business Law*, 22 AM. BUS. L. J. 249, 263 (1984).

²⁴ See 1996 is the One Hundredth Anniversary of the CPA Examination, <http://weatherhead.cwru.edu/accounting/cpaexam.html> (last modified Nov. 5, 1998) (reproducing the 1896 examination).

²⁵ For example, to be a chartered accountant in England, one must master the basics of commercial and company law. See <http://www.icaew.co.uk/thebigpicture/NewACA.htm>. Canada, Hong Kong, Singapore, India and other nations have similar requirements. *Id.*

ing (as they well recognize),²⁶ and it is certainly true of accountants working for accounting firms.

A. *The Ubiquity of Law for the Professional Accountant*

It is difficult to conjure up a profession that is more shaped and constrained by legal rules or faces more legal liability than the accounting profession. The influence of law is ubiquitous in the accounting world. Only law students enter the business world with a greater chance of coming face to face with the legal system than accounting students. Indeed, one must suspect that some senior partners in accounting firms have spent a lot more time in courtrooms during the past decade than some senior partners in law firms.

1. *Constraints*

Everywhere accountants are constrained by legal rules. Accountants doing tax work must know not only the tax rules of the rather substantial Internal Revenue Code (IRC) in order to properly give tax advice and prepare tax returns, they also must mind the many IRC provisions and Internal Revenue Service (IRS) rules that contain administrative, civil and even criminal sanctions against tax professionals who err. Under such provisions accountants may lose their privilege of doing federal income tax work,²⁷ face civil fines, or even suffer criminal punishments if (a) they do such minor things as failing to sign a return or to give a copy to a taxpayer client,²⁸ or (b) they commit such relatively more serious acts as disclosing client informa-

²⁶ In one survey of newly-promoted executives, seventy percent serving in a functional area designated as "Finance/Accounting" believed that business law is important for a career in general management. Although all other functional groups also deemed business law to be important, the "Finance/Accounting" response was higher than any of the others—higher than "General Management," "Production/Operations," "Research and Development," "Marketing/Sales," and "Personnel/Industrial Relations,"... higher even than the response for those working in the functional area denominated "Law." Siedel et al., *supra* note 23, at 252.

²⁷ Accountants, attorneys and others may have their right to practice before the IRS suspended or revoked under Circular 230, Rules for Practice Before the Internal Revenue Service, 31 C.F.R. §§10.100 – 10.97 (1999). See generally MARC J. EPSTEIN & ALBERT D. SPALDING, JR., *THE ACCOUNTANT'S GUIDE TO LEGAL LIABILITY AND ETHICS* 165-67 (1993)(explaining operation of Circular 230 for accountants).

²⁸ 26 U.S.C. § 6695 (2000) (civil penalty).

tion learned while preparing returns,²⁹ helping promote abusive tax shelters,³⁰ or attempting to evade or defeat a tax.³¹

An accountant doing audit work must be aware of a plethora of SEC rules that supplement the various securities statutes passed by Congress. This network of rules provides numerous methods of punishing auditors who misstep.³² Accountants can lose their privilege to audit public companies,³³ face civil fines,³⁴ and even suffer

²⁹ 26 U.S.C. §§ 6713 (civil), 7213 & 7216 (criminal).

³⁰ 26 U.S.C. §6700 (2000) (civil penalty).

³¹ 26 U.S.C. §7201 (2000) (criminal penalty).

³² One observer recently noted that:

The SEC's arsenal [against professionals such as auditors] includes the following: Rule 2(e) [now 102(e)] of the SEC's Rules of Practice and Procedure, 17 C.F.R. §Sec. 201.2(e) (1994); civil injunctive actions brought in federal district court under § 20(b) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77t (1988 & Supp. V 1993), and § 21(d) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78u (1988 & Supp. V 1993); administrative proceedings under Sec. 15(c)(4) of the Exchange Act, 15 U.S.C. § 78o (1988 & Supp. V 1993), stop order proceedings under § 8(d) of the Securities Act to suspend the effectiveness of a registration statement, 15 U.S.C. § 77h (1988); report of investigation disseminated publicly by the Commission under Sec. 21(a) of the Exchange Act, 15 U.S.C. § 78u (1988 & Supp. V 1993); and entry of an administrative order requiring any person to cease and desist from violation of the federal securities laws under the Securities Enforcement and Penny Stock Report Act of 1990, 15 U.S.C. §§ 77h-1, 78u-3 (Supp. V 1993).

Marie L. Coppolino, Note, Checkosky, *Rule 2(e) and the Auditor: How Should the Securities and Exchange Commission Define its Standard of Improper Professional Conduct?*, 63 FORDHAM L. REV. 2227, 2227 n.1 (1995).

³³ The SEC may discipline professionals practicing before it under Rule 102(e), 17 C.F.R. § 201.102(e) (1999). See generally Christine Neylon O'Brien, *SEC Regulation of the Accounting Profession: Rule 2(e)*, 21 GONZ. L. REV. 675 (1985/86) (describing the operation of the SEC disciplinary rule that has been renumbered to 102(e)); Task Force on Rule 102(e) Proceedings, *Report of the Task Force on Rule 102(e) Proceedings: Rule 102(e) Sanctions Against Accountants*, 52 BUS. LAW. 965 (1997) (describing a serious controversy about the level of scienter required for imposition of administrative sanctions under Rule 102(e)).

³⁴ See LOUIS LOSS & JOEL SELIGMAN, 10 SECURITIES REGULATION 4906-10 (1993) (explaining provisions).

criminal penalties³⁵ for violating a complex web of federal securities regulations.³⁶

An accounting professional doing consulting work must similarly be legally aware of the various theories—negligence, breach of contract, breach of fiduciary duty, deceptive trade practices, controlling person provisions,³⁷ etc.—that can be windows to liability should they err. Thus, accountants have been sued in all manner of consulting engagements, including litigation support,³⁸ software installation and other computer consulting,³⁹ business turnaround

³⁵ Any intentional or reckless violation of any provision of the 1933 or 1934 securities acts is a criminal act. See 15 U.S.C. § 77x (2000) (1933 Act), and 15 U.S.C. § 78ff (2000) (1934 Act). Accountants have been criminally convicted of violations of the federal securities laws even in cases where it was uncontested that GAAS and GAAP were complied with. See *United States v. Simon*, 425 F.2d 796, 812 (2d Cir. 1969).

³⁶ This is not to mention the fact that they must suffer the hectoring and moralizing by the SEC that seems to constantly occur. Former SEC Chair Arthur Levitt made repeated attacks upon the large audit firms in recent years. See Nanette Byrnes & Mike McNamee, *The SEC vs. CPAs: Suddenly It's Hardball*, BUS. WK., May 22, 2000, at 49 (describing repeated attacks by Levitt).

³⁷ See generally James K. Vines, Note, *CPAs Who Perform Management Consulting Services May Face Increased Exposure to Controlling Person Liability Under the Federal Securities Acts*, 44 WASH. & LEE L. REV. 1079, 1079-1102 (1987) (discussing this potential avenue of imposing liability on CPA consultants).

³⁸ See *Mattco Forge v. Arthur Young*, 60 Cal. Rptr. 2d 780 (1997) (reversing and remanding for new trial a \$42 million judgment against accounting firm in a litigation support case). The case was later settled out of court. See generally Barbara J. Duganier & Everett P. Harry, *Surviving the Litigation Services Jungle*, TODAY'S CPA, Sept./Oct. 1996, at 34, 37 (discussing cases and noting the "eroding barriers of liability for experts" in litigation support); Michael A. Crain et al., *Expert Witnesses—In Jeopardy?*, J. ACCTCY., Dec. 1994, at 42, 42 (noting potential liability of accountants serving as expert witnesses).

³⁹ See *Diversified Graphics, Ltd. v. Groves*, 868 F.2d 293 (8th Cir. 1989) (holding Ernst & Whinney potentially liable for failing to help plaintiff obtain an appropriate computer system for its data processing needs); *Figgie Sues Deloitte*, WALL ST. J., Oct. 12, 1994, at B3 (reporting on filing of suit over breach of promise to help plaintiff develop a "world-class" manufacturing program); Elizabeth MacDonald, *Maker of Gore-Tex Sues PeopleSoft and Deloitte*, WALL ST. J., Nov. 2, 1999, at B14 (reporting on the filing of a multi-million dollar lawsuit arising from an allegedly botched software installation); Elizabeth MacDonald, *E-Mail Trail Could Haunt Consultant in Court*, WALL ST. J., June 19, 1997, at B1 (noting UOP lawsuit against Andersen Consulting over project to develop a new computer system).

consulting,⁴⁰ personnel consulting,⁴¹ feasibility consulting,⁴² and other types of consulting activities.⁴³

In addition, accountants whose clients are investigated by the IRS or SEC or the Department of Justice had best have familiarity with their ethical responsibilities of client confidentiality,⁴⁴ as well as basic concepts of the Fifth Amendment's privilege against self-incrimination⁴⁵ and the limited existence of an accountant-client testimonial privilege.⁴⁶ Observers have predicted that accountants' (and clients') lack of familiarity with the complexities of the IRS Restructuring and Reform Act of 1998's privilege provisions may well lead to serious difficulties.⁴⁷

⁴⁰ See Matt Fleischer & Karen Donovan, *Merry-Go-Round, Indeed*, NAT'L L.J., Mar. 26, 2000, at A6 (noting \$185 million settlement paid by Ernst & Young arising from a business-turnaround engagement).

⁴¹ See *Greenstein, Logan & Co. v. Burgess Marketing, Inc.*, 744 S.W.2d 170 (Tex. App. 1987) (accountant held liable for bad advice given to client regarding whom client should hire as comptroller).

⁴² See *Palmer v. Woods*, No. 83-1388 Civ-T-10, 1998 U.S. Dist. LEXIS 15840 (M.D.Fla. 1988) (accountant held liable for hotel feasibility study).

⁴³ See *Union Planters v. Peat, Marwick, Mitchell & Co.*, 733 S.W.2d 509 (Tenn. App. 1987) (holding accounting firm potentially liable for failure to properly evaluate and control plaintiff bank's lending practices).

⁴⁴ AICPA, CODE OF PROFESSIONAL CONDUCT, ET Sec. 301 (1996).

⁴⁵ See, e.g., *Couch v. United States*, 409 U.S. 322 (1973) (client's privilege against self-incrimination did not prevent government from forcing accountant to disclose client's records); *In re Frank P. Hyde*, No. 98-Civ-5691 (BDP), 1999 U.S. Dist. LEXIS 9892 (S.D.N.Y. June 25, 1999) (holding that accountant did not have to turn his own records over pursuant to a subpoena in a bankruptcy proceeding because they were potentially incriminating).

⁴⁶ Until passage of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (codified as amended throughout 26 U.S.C.), an accountant-client privilege did not exist at the federal level. See generally *United States v. Arthur Young & Co.*, 465 U.S. 805, 821 (1984). Rather, it existed in only twenty or so states that had accountant-client privilege statutes. See Denzil Causey & Frances McNair, *An Analysis of State Accountant-Client Privilege Statutes and Public Policy Implications for the Accountant-Client Relationship*, 27 AM. BUS. L.J. 535, 540 (1990) (analyzing these statutes).

⁴⁷ See Alyson Petroni, *Unpacking the Accountant-Client Privilege Under I.R.C. Section 7525*, 18 VA. TAX. REV. 843, 873 (1999) (urging practitioners to proceed with caution in light of potential confusion about scope of the privilege under the new law); Therese LeBlanc, Note, *Accountant-Client Privilege: The Effect of the IRS Restructuring and Reform Act of 1998*, 67 U.M.K.C. L. REV. 583, 596 (1999) (voicing similar concerns).

Accountants in every field face common law liability for breach of contract,⁴⁸ defamation,⁴⁹ breach of fiduciary duty,⁵⁰ fraud,⁵¹ and negligence.⁵² Numerous state law causes of action are brought against accountants under these theories, and others of statutory creation, such as deceptive trade practice statutes.⁵³ Accountants can minimize liability, for example, by knowing how to ensure that

⁴⁸ See, e.g., *Jewish Hosp. v. Boatmen's Nat'l Bank*, 633 N.E.2d 1267, 1279 (Ill. 1994) (accountant held potentially liable to intended beneficiaries of a trust when bad tax advice reduced their inheritance); *CAE Indus. Ltd. v. KPMG Peat Marwick*, 597 N.Y.S.2d 402, 403 (N.Y. App. Div. 1993) (accountant held potentially liable for failing to complete an audit by the promised time).

⁴⁹ See, e.g., *Abella v. Barringer Res., Inc.*, 615 A.2d 288, 289 (N.J. Super. Ct. Ch. Div. 1992) (independent auditor sued for defamation over information contained in footnote in a corporation's financial report); *Burke v. Deiner*, 463 A.2d 963, 969 (N.J. Super. Ct. App. Div. 1983) (accountants held potentially liable for allegedly defamatory statements contained in audit report); *Williams v. Hobbs*, 131 N.W.2d 85, 87 (S.D. 1964) (accountant sued for statements in audit report); *Bailey v. Rogers*, 631 S.W.2d 784, 786 (Tex. 1982) (accountant sued for defamation over statements made in a special report of partnership accounts).

⁵⁰ See, e.g., *Baldwin v. Kulch Assoc., Inc.*, 39 F. Supp. 2d 111, 119-20 (D.N.H. 1998) (accountant sued for breach of fiduciary duty); *Elm City Cheese Co. v. Federico*, 752 A.2d 1037, 1052 (Conn. 1999) (accountant held liable for breach of fiduciary duty to former client); *Stewart & Co. v. KPMG Peat Marwick LLP*, No. 602493/96 (N.Y. Sup. Ct. July 15, 1997) (accounting firm held to have breached fiduciary duty to former client).

⁵¹ See, e.g., *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D.Mass. 1997) (holding auditors potentially liable for fraud to investors in two corporations involved in a stock swap); *Joel v. Webber*, 569 N.Y.S.2d 955, 959-61 (App. Div. 1991) (holding accountant potentially liable to singer Billy Joel on fraud claim); *Barger v. McCoy, Hillard & Parks*, 462 S.E.2d 252 (N.C. 1995) (accounting firm held potentially liable for constructive fraud). Fraud is, of course, often a criminal matter as well as grounds for civil suits. See, e.g., *United States v. Autuori*, 212 F.3d 105, 121 (2d Cir. 2000) (reversing in part former Arthur Andersen partner's conviction on 12 counts of fraud and conspiracy arising out of Colonial Realty debacle); *United States v. White*, 98-1424, 1999 U.S. App. LEXIS 4235 (2d Cir. Mar. 5, 1999) (affirming in part and reversing in part criminal fraud conviction of former Deloitte & Touche partner involved in Chris Bagdasarian scandal).

⁵² There are literally hundreds if not thousands of accountant negligence cases. See generally DAN L. GOLDWASSER & THOMAS ARNOLD, *ACCOUNTANTS' LIABILITY* 4-1 to 4-89 (1999) (discussing legal standards).

⁵³ See, e.g., *Lyne v. Arthur Andersen & Co.*, 772 F.Supp. 1064, 1068 (N.D. Ill.) (holding accounting firm potentially liable under Illinois consumer fraud statute); *In re Prof. Fin. Mgmt. Ltd.*, 703 F.Supp. 1388, 1397-98 (D.Minn. 1989) (holding accountants to be within the coverage of the Minnesota consumer fraud statute); *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 815 (Tex. 1997) (holding that user of an audit report was a "consumer" with standing to sue accounting firm under state deceptive trade practices statute).

engagement letters do not provide an opening for third-party contract or tort liability.⁵⁴ They must know what steps to take to avoid third-party negligence liability in their jurisdiction.⁵⁵ They must know how to draft engagement letters to minimize liability via disclaimers,⁵⁶ and how to evaluate liability insurance policies.⁵⁷

In addition to federal and state causes of action, accountants are constrained by the rules of their state licensing boards, their national society (the AICPA), as well as state professional societies. The AICPA's Code of Conduct is a particularly daunting set of rules, but its importance cannot be gainsaid as it is often imported wholesale

⁵⁴ Many courts hold that if the engagement letter does not *on its face* indicate that the parties intend to benefit a third party, then there will be no accountant liability to that third party even if there is substantial other evidence that the accountant knew the third party was relying on the accountant's work. *See, e.g., Fireman's Fund Ins. Co. v. Glass*, No. 94-civ-7375 (WK), 1997 U.S. Dist. LEXIS 7518 (S.D.N.Y., May 30, 1997) (holding that although the name of a specific intended beneficiary need not be included in an engagement letter before third-party beneficiary status is found, the parties' intent to benefit a third party such as plaintiff must be shown on the face of the contract); *Mariani v. Price Waterhouse*, 82 Cal. Rptr. 2d 671, 697-702 (Cal.App. 1999) (taking similarly restrictive view of accountant liability to intended third-party beneficiaries).

⁵⁵ For example, in states such as Illinois and Arkansas that have passed special statutes limiting accountant liability to third parties, accountants should assiduously resist putting anything in writing that would indicate their knowledge that a third party is relying on their work. Absent such a writing, third-party liability will be extremely difficult for plaintiffs to establish. *See, e.g., Dougherty v. Zimble*, 922 F. Supp. 110, 115-19 (N.D.Ill. 1996); *Endo v. Albertine*, 812 F. Supp. 1479, 1495-96 (N.D.Ill. 1993); *Robin v. Falbo*, No. 91 C 2894, 1992 WL 188429 (N.D.Ill. 1992). *But see Chestnut Corp. v. Pestine, Brinati, Gamer Ltd.*, 667 N.E.2d 543, 547 (Ill. App. 1996) (seeming to ignore the statute's legislative history in holding accountants potentially liable absent such a writing).

⁵⁶ It is clear that a disclaimer that clearly indicates that a particular engagement is not an audit but only, say, a review, will generally be respected and recognized by a court of law. *See, e.g., William Iselin & Corp. v. Landau*, 513 N.Y.S.2d 3 (N.Y. App. Div. 1987). On the other hand, a disclaimer along the lines of "the firm will not be liable for its negligence" is traditionally against public policy. However, a few recent cases recognize the validity of such disclaimers, making them worth inserting in accountant engagement letters. *See, e.g., Metro. Life Ins. v. Noble Lowndes Int'l*, 643 N.E.2d 504, 509 (1994) (enforcing limitation of liability clause in contract licensing software); *Estey v. MacKenzie Eng'g., Inc.*, 902 P.2d 1220, 1223 (Or. App. 1995) (enforcing limitation of liability provision in an engineer's service contract).

⁵⁷ EPSTEIN & SPALDING, *supra* note 27, at 219-26 (instructing accountants regarding insurance options).

into state licensing rules, and violations are often the basis for license forfeiture.⁵⁸

The very evolution of the structure of the accounting profession in this country is channeled by legal constraints. A decade ago virtually every accounting firm in the country was a sole proprietorship or a general partnership, yet today most are limited liability partnerships or limited liability companies. Why? Liability considerations drove the change.⁵⁹ In Europe, the Big Five have acquired many of the largest law firms and now widely offer multidisciplinary practice (MDP).⁶⁰ In the United States, the Big Five have made only the most tentative steps in that direction.⁶¹ Why? Legal constraints and SEC concern⁶² have made MDP a more problematic venture here than

⁵⁸ See, e.g., *Boever v. S. D. Bd. of Accountancy*, 561 N.W.2d 309 (S. D. 1997) (upholding state board's revocation of accountant's license caused by his failure to comply with GAAS and GAAP); *Ray v. Tex. State Bd. of Pub. Accountancy*, 4 S.W.3d 429, 431-33 (Tex. App. 1999) (similar).

⁵⁹ See generally, William D. Bagley, *Unlimited Options*, TODAY'S CPA, May/June 1995, at 21 (discussing advantages for firms of reforming as LLCs); Lee Berton & Joann S. Lublin, *Partnership Structure Is Called in Question as Liability Risk Rises*, WALL ST. J., June 10, 1992, at A1 (noting how law and accounting firms were moving away from the traditional general partnership structure in order to minimize liability); Edgardo E. Colon, *Business Law Update*, TEX. B.J., Oct. 1993, at 908, 913 (noting that every attorney should consider recommending to its clients facing significant liability lawsuits that they consider the LLP form of organization).

⁶⁰ See NEW YORK STATE BAR ASSOCIATION, REPORT OF SPECIAL COMMITTEE ON MULTI-DISCIPLINARY PRACTICE AND THE LEGAL PROFESSION 36 (1999) (noting that Arthur Andersen had the goal of becoming the largest law firm in the world by the year 2000 and that in Europe the Big Five have acquired or created their own law firms in most major markets, including France where KPMG Fidal Pet International is the largest law firm); Jonathan Ames, *Partners Who Sleep with the Enemy*, INDEPENDENT (London), June 1, 1999, at 12 (noting general acceptance of multidisciplinary practice in Europe, Australia, and Canada); Rocco Cammarere, *Invasion of the MDPs*, N.J. LAW., May 24, 1999, at 1 (noting similar acceptance in South America);

⁶¹ Ernst & Young has raided the Atlanta law firm of King & Spalding for lawyers to form its Washington D.C.-based firm McKee Nelson, Ernst & Young. See Geanne Rosenberg, *Will Others Follow Ernst & Young On Its Forays Into Legal Services?*, NAT'L L.J., Sept. 25, 2000, at B7. Arthur Andersen has also forged a strategic alliance between Andersen Legal in Singapore and the prominent New York law firm Weil, Gotshal & Manges. See Geanne Rosenberg, *Andersen Legal Breaks New Ground with Weil Gotshal Deal*, NAT'L L.J., Aug. 14, 2000, at B8.

⁶² See John Gibeaut, *MDP in SEC Crosshairs: Accountants May Cool Their Urge to Merge*, A. B. A. J., Apr. 2000, at 16 (noting that SEC opposition is the major current deterrent to MDP).

across the pond.⁶³ Accounting firms have (Arthur Andersen⁶⁴ and Ernst & Young⁶⁵) or are considering (PricewaterhouseCoopers⁶⁶) splitting into separate units in order to separate audit and consulting operations. Why? Legal considerations, especially in the form of SEC pressure,⁶⁷ again are responsible.

2. *Magnitude of Liability Exposure*

The availability of all the liability theories noted in the previous sections led to what was legitimately termed a “liability crisis.” Particularly in the early 1990s, there was reason to wonder whether the accounting profession could survive in any semblance of its then-existing form. In the early 1990s, the Big Six accounting firms claimed that they faced as much as \$40 billion in unresolved claims.⁶⁸ In 1993, accountants’ legal costs exceeded one billion dollars.⁶⁹ Indeed, litigation caused the demise of some firms, including Laventhol & Horwath.⁷⁰ For a time, insurance rates skyrocketed out

⁶³ In addition to SEC opposition on grounds that there is a potential conflict of interest between the audit function and the legal function, MDP arguably places accountants in a position where they are illicitly engaged in the practice of law. For general discussions of the MDP debate, especially within the legal community, see Lawrence J. Fox, *New Firm: Wolf in Sheep's Clothing?*, NAT'L L.J., Jan. 24, 2000, at A23; Geoffrey C. Hazard, *The Ethical Traps of Accounting Firm Lawyers*, NAT'L L.J., Oct. 19, 1998, at A27; Randy Myers, *Lawyers and CPAs: How the Landscape Is Changing*, J. ACCT., Feb. 2000, at 73.

⁶⁴ See Securities Act of 1933—Rule Regulation S-X, 1990 SEC No-Act. LEXIS 943 (SEC July 9, 1990) (gaining SEC approval of new structure).

⁶⁵ Ernst & Young sold its consulting arm to Cap Gemini in 2000 for \$11 billion. Louis Lavelle, *Professional Services*, BUS. WK., Jan. 8, 2001, at 134.

⁶⁶ *Id.* (noting that PwC will probably sell its consulting branch in 2001).

⁶⁷ *Cap Shareholders Agree to E&Y Deal*, MGMT. CONSULTANT INT'L, June 16, 2000, at 1 (noting that E&Y's sale of its consulting unit to Cap Gemini was “prompted” by regulatory pressure from the SEC); Adrian Michaels & Lina Saigol, *PwC May Consider Sale of Corporate Finance Unit*, FIN. TIMES (London), June 24, 2000, at 10 (noting that PwC's spin-off of its consulting unit was partly driven by regulatory scrutiny).

⁶⁸ See David Hellier & Roger Trapp, *Accountants Shiver as Cover Slips Away; A Legal Onslaught is Scaring Off Insurers*, INDEPENDENT (London), Aug. 1, 1993, at 8.

⁶⁹ Donna H. K. Walters, *Accounting Firms Must Watch Their Ps and Qs*, L.A. TIMES, June 4, 1994, at D2.

⁷⁰ See Lorana Sullivan, *Laventhol and Horwath Collapse—Who Accounts for Accountants?*, OBSERVER, Nov. 25, 1990, at 29.

of sight for small and medium-sized firms,⁷¹ and coverage largely disappeared altogether for the then-Big Six firms.⁷² *Caveat emptor* was replaced by *caveat auditore*.⁷³

Although the liability crisis itself and accompanying insurance problems declined during the second half of the 1990s, the litigation crisis is far from over for accounting firms. As evidence, note the recent gigantic settlements such as Ernst & Young's \$355 million settlement in the Cendant audit case⁷⁴ and its \$185 million settlement in the Merry-Go-Round consulting case.⁷⁵ Several other ongoing cases appear to carry the potential for similar large outcomes.⁷⁶

In the midst of the liability crisis of the early 1990s, auditors particularly decried the existence of an "expectations gap," arising because judges and jurors supposedly were unable to grasp the true purposes of an audit.⁷⁷ In that time frame, it was reasonably observed that "[accounting schools] need to have courses in the potential liabilities of accountants in concrete situations—not to moan about what happened, but to illustrate that this is the standard the rest of society is going to hold them to."⁷⁸ To put it another way, Epstein and Spalding asked: "How can accountants be made aware that their

⁷¹ See *Big Six Firms Launch Legal Attack*, NAT'L L.J., Sept. 14, 1992, at 12 (quoting position paper by Big Six firms).

⁷² See Michael Schachner, *Big Six Losses Don't Add up to Cover Crisis for Small Firms*, BUS. INS., Nov. 22, 1993, at 3 (noting that insurance "capacity has all but evaporated for Big Six firms, causing several to entirely self-insure.").

⁷³ Richard Murray, *A View from the USA*, in ACCOUNTANTS' LIABILITY IN THE 1980S: AN INTERNATIONAL VIEW 71, 74 (E.P. Mimmis & C. W. Nobes eds. 1985).

⁷⁴ See Shannon P. Duffy, *Ernst & Young Reaches \$335 Mil. Settlement in Cendant Corp. Case*, LEGAL INTELLIGENCER, Dec. 21, 1999.

⁷⁵ See Matt Fleischer & Karen Donovan, *Merry-Go-Round, Indeed*, NAT'L L.J., Mar. 26, 2000, at A6 (noting settlement).

⁷⁶ See, e.g., *Ernst & Young Again Has JWP Lawsuit to Contest*, WALL ST. J., Mar. 20, 2000, at B2 (noting reinstatement of federal securities case involving claims of \$100 million); Elizabeth MacDonald, *How a Ballpark Tip Evolved Into a Burden For One of the Big Five*, WALL ST. J., Feb. 18, 2000, at A1 (describing racketeering lawsuit by Emcore against its former auditor, Coopers & Lybrand (now PwC)); Debra Sparks, *Asleep at the Audit?*, BUS. WK., Mar. 6, 2000, at 150 (describing massive fraud involving a hedge fund that went undetected for a substantial period of time).

⁷⁷ For brief explanations of the expectations gap, see THOMAS J. SHROYER, ACCOUNTANT LIABILITY 8-9 (1991); Bala V. Balachandran, *Introduction: Auditors' Legal Liability in the United States*, 2 J. ECON. & MGMT. STRATEGY 333, 334 (1993).

⁷⁸ John Cushman, *Failures Raise a Question: Who Does the Final Audit?*, N.Y. TIMES, Dec. 6, 1992, § 4, p. 6 (quoting Susan N. Koniak).

own (often self-serving) pronouncements and rules are quite properly viewed with a healthy cynicism by the courts, and are sometimes rightly overridden by judicially imposed standards?"⁷⁹ Absent an infusion of legal education, accountants who have mastered the technical standards of their craft are unlikely to be made aware that courts and juries can and sometimes do require them to do more.⁸⁰

Given omnipresent legal constraints and potential liabilities for the professional accountant, reducing the amount of law that these professionals know cannot be a good idea. "Practitioners who ignore the possibility of legal involvement, or who fail to understand the legal duties that they owe to the users of their work product, will soon find themselves unable to conduct their professional practices in a profitable manner."⁸¹ Today's litigious environment means that accountants must practice defensively and it goes without saying that "[t]o practice defensively, it's good to have an idea of the current legal landscape."⁸²

B. *Legal Knowledge Helps Accountants Do Their Job*

Additional knowledge of legal rules can help accountants in a number of ways in addition to those already noted. "The nature of an accountant's work necessarily brings him in touch with areas of law that he must comprehend in order to produce accurate computations and conclusions."⁸³ Does anyone believe that an accountant can competently prepare an account for a trust estate without being familiar with the provisions of the Uniform Principal and Income Act?⁸⁴ Or that an accountant can competently prepare an account

⁷⁹ EPSTEIN & SPALDING, *supra* note 27, at 7.

⁸⁰ See Pallais, *supra* note 10 ("[I]n some cases, courts using 20/20 hindsight have required more [than compliance with professional standards and] it's helpful to know what else the courts think should be done.").

⁸¹ JONATHAN J. DAVIES, CPA LIABILITY: A MANUAL FOR PRACTITIONERS v (1983).

⁸² Pallais, *supra* note 10.

⁸³ Susan Schwab, Note, *Bringing Down the Bar: Accountants Challenge the Meaning of Unauthorized Practice*, 21 CARDOZO L. REV. 1425, 1442 (2000).

⁸⁴ The matter is further complicated, of course, by the various versions of the act that have been promulgated and adopted in the various states. The latest version was promulgated in 1997. See UNIF. PRINCIPAL AND INCOME ACT, 7B U.L.A. 3 (1997). However, the states have been slow to adopt the new version. See Patricia R. Beauregard & Jessie A. Gilbert, *The New Environment in Connecticut for the Investment and Management of Trust Assets*, 14 QUINNIPIAC PROB. L.J. 419, 420-21 (2000).

for a partnership without knowing the basics of partnership law?⁸⁵ Is it unimportant for accountants to know whether promissory notes their clients hold or liens they have filed are enforceable?⁸⁶ Is it irrelevant to accountants that their clients' titles to real estate or to personal property may be invalid?

Tax practice is law, and rather complex and confusing law at that.⁸⁷ There can be no doubt that knowledge of important legal concepts, such as rules of statutory construction⁸⁸ and the role of precedent in our court system,⁸⁹ are vital matters for all tax professionals to know. Inaccurate legal research is often the basis for accountant malpractice liability.⁹⁰ Indeed, given the intertwining of accountants' tax work and law, accountants also must know enough law to avoid illicitly engaging in its practice.⁹¹ And, given the CPA

⁸⁵ See *Silverman v. Sydeman*, 25 N.E.2d 215, 220 (Mass. 1940) (accountant's failure to understand partnership law contributed to his client's inability to gain compensation for his work for the partnership).

⁸⁶ See Schwab, *supra* note 83, at 1443 (“[A]n accountant must understand negotiable instruments, patent rights, corporate stocks and bonds, insurance policies, and other contracts.”).

⁸⁷ See James W. Colliton, *Standards, Rules, and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265, 265 (1995) (“The tax law is the most complex body of statutory law that exists in our legal system.”).

⁸⁸ Nicole D. Stanger, Note, *Carroll v. Commissioner: Narrow Judicial Interpretations of Internal Revenue Code §7502 May Cause Increased Burden on Taxpayers*, 30 AKRON L. REV. 581, 581 (1997) (“Although most of the tax law is enacted and amended by Congress, significant tax law has developed through judicial interpretation of ambiguously-worded statutes.”).

⁸⁹ Because different courts have different views not only as to what particular tax statutes mean but also as to the importance of precedent in making such determinations, grasping such subtleties is of extreme importance to tax professionals of all stripes. See Michael S. Smith, *Third Party Assignment, Statutes of Limitations, and the Tax Refund Offset Act: Breathe a Little Easier Student Deadbeats, the Fifth Circuit is on Your Side*, 46 VAND. L. REV. 443, 444 (1993) (noting situation where disagreements as to meanings and value of precedent existed).

⁹⁰ See GEORGE SPELLMIRE ET AL., ACCOUNTANTS' LEGAL LIABILITY: PREVENTION AND DEFENSE 5.55 – 5.57 (1993) (giving case examples).

⁹¹ A CPA's tax practice typically involves preparation of Federal and state income tax returns, research to determine the appropriate treatment of prospective and completed transactions, and representations of a taxpayer in administrative proceedings. Each of these may require an analysis of how statutory law, regulations, judicial decisions, and administrative decisions and pronouncements may affect a taxpayer's particular fact pattern, and this analysis will often involve what is accepted as the practice of law . . . [so] the need to understand the boundaries established for unauthorized practice of law will increase.

James R. Hamill, *There is a Penalty for Encroachment: CPAs and the Unauthorized Practice of Law*, CPA J., Aug. 1998, at 32, 33.

firms' continuing invasion into the field of estate planning,⁹² can it be plausibly maintained that they need no familiarity with the law of trusts and estates?⁹³

Auditors also need a broad base of legal knowledge for their work. They interact with Securities and Exchange Commission rules and guidelines every day. The numerous problems with revenue recognition that the SEC has noted in recent years⁹⁴ are clearly indicative that auditors need to know more about contract law. Agreements that give the buyer total discretion to return the product and consignment arrangements do not produce binding contracts. In many recent cases,⁹⁵ auditors allowed revenue recognition in such situations, making it appear either that they did not know what it takes to have a binding contract so that revenue might be properly recognized, or worse, that they didn't care.

In doing their work, auditors must evaluate sales contracts, leases, and other transactions, claims of title to property (real and personal), the enforceability and priority of secured interests held by lenders, the rights and obligations of parties to commercial instruments, the validity of claims to insurance proceeds, and on and on. As the general counsel to a major accounting firm observed not too long

⁹² See Associated Press, *CPAs Lay Siege to Law Firms*, Newswire, Nov. 25, 1998, at http://www.electronicaccountant.com/news/112598_4.htm (noting that "CPA firms are grabbing lucrative new areas of business from the bar, especially in rich niches like taxes and estate planning").

⁹³ See *Jewish Hosp. v. Boatmen's Nat'l Bank*, 633 N.E.2d 1267, 1278-79 (Ill. App. 1994) (accounting firm held potentially liable in estate planning malpractice case).

⁹⁴ See Carol J. Loomis, *Lies, Damned Lies, and Managed Earnings: The Crackdown is Here*, FORTUNE, Aug. 2, 1999, at 74 (describing problem of managed earnings); Reva Steinberg & Roy Van Brunt, *1999 AICPA National Conference on SEC Developments*, CPAJ., Mar. 1, 2000, at 32 (noting SEC concern with earnings management and financial fraud, especially that involving revenue recognition practices).

⁹⁵ See Arthur Levitt Addresses "Illusions"; *SEC Official's Concern Over Integrity of Financial Statements*, J. ACCT., Dec. 1998, at 12 (quoting SEC Chair Arthur Levitt as saying that one wouldn't pop the cork on a bottle of wine before it was ready but that companies and their auditors were doing that by recognizing revenue on contracts where customers still had the option to void or delay the sale); *Taking Sides: Fudge Has No Place in Financial Reports*, INVESTMENT NEWS, Apr. 3, 2000, at 16 (SEC criticizing auditors for game of "nods and winks" with clients wherein clients are allowed to recognize revenue in sales that are not complete).

ago, "A basic understanding of business law is essential to the auditor in his task of categorizing transactions for accounting purposes."⁹⁶

A classic illustration of the need for this basic understanding of legal principles occurred in *Herzfeld v. Laventhol*,⁹⁷ where the court admonished the accountants' actions in considerable detail, noting error after error that defendants had made by failing to appreciate essential legal principles.⁹⁸ Red lights were flashing everywhere in the audit that gave rise to the *Herzfeld* litigation, but the auditors' failure to understand and/or appreciate some relatively basic legal concepts

⁹⁶ Harris J. Amowitz, *The Accounting Profession and the Law: The Misunderstood Victim*, J. ACCT., May 1987, at 356. Amowitz was General Counsel of Coopers & Lybrand.

⁹⁷ 540 F.2d 27 (2d Cir. 1976)

⁹⁸ The judge noted, in part:

The November 22 and 26 contracts came to Laventhol's attention on or about December 1st through its partners, Chazen and Lipkin, and Schwabb, the audit manager. Schwabb sought Lipkin's advice about the proper way to report the transactions in the audit. Lipkin sought to gather the pertinent information by meeting with Scott, a FGL vice-president, and Firestone. Scott told him that FGL was busy acquiring the necessary documentation. Firestone said that the agreements were legitimate and described Continental's principal, Max Ruderian, as an experienced real estate operator and a wealthy individual. Laventhol learned that Continental had a net worth of \$100,000 and that its assets consisted of "miniature golf courses plus other assets." Ruderian's business practice was to "buy and resell prior to final payment on his sales contracts."

Lipkin also examined the sales contracts. He was an attorney but had only practiced one year. He concluded that the contracts were legally enforceable. He consulted another Laventhol partner who assured him that there need be no concern about Ruderian. Ruderian's references concurred in the appraisal.

Lipkin also consulted over the telephone with a Los Angeles attorney. The attorney did not see the contracts, nor were the contracts in their entirety read to him, despite the fact that his offices were only one-half hour away by cab. Nevertheless, the attorney gave a telephone opinion that they were valid and enforceable.

The first tangible results of Laventhol's accounting efforts appear in its audit enclosed in its letter to FGL, dated December 6, 1969. In the consolidated balance sheet as of November 30, 1969, the amount of \$1,795,500 was recorded "as unrealized gross profit". The same characterization was given to this assumed profit in the income statement with a reference to an explanatory Note 4. This Note only explained the \$1,795,500 by stating that "because of the circumstances and nature of the transactions, \$1,795,500 of the gross profit thereon will be considered realized when the January 30, 1970 payment is received."

Id. at 30-31. See generally Randall S. Rapp, *Accountants—Herzfeld v. Laventhol, Krekstein, Horwath & Horwath—The Variety of Actions Available to Investors*, 1 J. CORP. L. 395 (1976) (analyzing the case in detail).

led to a finding of liability. As Miller and Brady have noted, *Herzfeld* illustrates

that the CPA should have some understanding of at least the following areas of law: contracts, real property, suretyship, and corporations. It further admonishes the accountant to seek a legal opinion where there is doubt about the law in question. Finally, the court indicates that halfhearted attempts will undoubtedly be to no avail. The point is that the CPA must have sufficient knowledge of various areas of law in order to perform the audit. Adequate understanding is necessary both to recognize the legal problem and to realize that some help is probably needed.⁹⁹

While many aspects of the audit task are becoming increasingly computerized (such as sampling and calculating),¹⁰⁰ judgments regarding legal matters will continue to resist mechanization. The individual auditor's knowledge of and appreciation for legal implications and other aspects of transactions will continue to be of critical importance in the future. Audit failures do not typically arise because samples were not drawn properly or numbers were not calculated accurately. Rather, a recent "study by the California Society of Certified Public Accountants found that . . . CPAs lose liability lawsuits because of errors in judgment or mistakes committed due to lack of understanding of a transaction."¹⁰¹ Can there be any doubt that a legally-aware auditor will be more effective than a legally-naïve auditor?

Similar conclusions can be drawn regarding consulting activity. Can an accountant truly serve the "trusted business adviser" role to which the profession aspires with no working knowledge of bankruptcy law? With no background in business organizations? With no knowledge of employment law or of potential environmental liabilities? If these matters are not tested on the CPA exam, they will not be taught in schools and accountants will go into the real world with next to no appreciation of these important concepts.

Or consider the accountant as expert witness. Unless accountant experts can take relevant accounting expertise and meld it with

⁹⁹ RICHARD L. MILLER, JR. & GERALD P. BRADY, CPA LIABILITY: MEETING THE CHALLENGE 2 (1986).

¹⁰⁰ See David Coderre, *Computer-Assisted Techniques for Fraud Detection*, CPAJ., Aug. 1, 1999, at 57 (noting the increased use of computerized techniques to detect fraud); Peter Williams, *IT and Audit: Leaving Paper Behind*, ACCT. AGE, Mar. 2, 2000, at 22 (noting computerized revolution that is coming to audit field).

¹⁰¹ *Analysts Corner*, THOMSON'S INT'L BANK ACCT., June 22, 1992, at 4.

“accepted legal theories,” their testimony will be rejected by the courts and serve no purpose.¹⁰² This, in turn, can feed the trend toward more malpractice suits against accountants serving as expert witnesses.¹⁰³

C. *The Law Helps Accountants Shape Their Environment.*

It would be a slight exaggeration, but no more, to state that the accounting profession owes its very survival to its realization in the early 1990s that it functioned within a framework of legal constraints that (a) threatened its existence, and (b) could be affected by lobbying activity. Rather than hide its collective head in the sand and ignore the legal system, the accounting profession proactively addressed the system in a very successful attempt to improve its business environment.¹⁰⁴ By 1993, the accounting profession had formed a lobbying group described as “one of the best financed and most powerful in Washington.”¹⁰⁵

At the federal level, this proactive lobbying effort has produced impressive results for accountants. Due primarily to the political pressure exerted by the accounting profession and Silicon Valley firms, Congress in 1995 overrode President Clinton’s veto to pass the Private Securities Litigation Reform Act (PSLRA).¹⁰⁶ This law contained a number of provisions favorable to defendants in securities class action lawsuits, including provisions that (a) made it harder for

¹⁰² See Joseph T. Gardemall III, *As Investigator and Expert Witness, an Experienced CPA Will Calculate and Prove Damages in All Sorts of Cases*, LEGAL TIMES, Mar. 27, 2000, at 29 (noting the necessity for a CPA expert to have “knowledge of the law”).

¹⁰³ See Mark Hansen, *Experts Are Liable, Too*, A.B.A.J., Nov. 2000, at 17 (noting that lawsuits against expert witnesses “while still relatively rare, are multiplying”). Although accountants hired as arbitrators or appointed by courts as experts have often tried to claim judicial or quasi-judicial immunity for their mistakes, several courts have rejected this defense. See, e.g., *Gammel v. Ernst & Ernst*, 72 N.W.2d 364, 368-69 (Minn. 1955); *Levine v. Wiss & Co.*, 478 A.2d 397, 402-03 (N.J. 1984).

¹⁰⁴ In so doing, the accounting firms are following the lead of high-tech firms, which have recently realized how they can improve the legal environment for their businesses by lobbying for favorable legal treatment. See Liz Alvarez, *China Vote in Congress is Test for High-Tech Lobby*, INT’L HERALD TRIB., May 19, 2000, at 14 (noting that technology firms are playing a leading role in lobbying Congress in the geopolitical debate over trade with China).

¹⁰⁵ Ed Roberts, *Big Six Firms Branch Out to Create Lobby, Making Liability Reform Top 1993 Priority*, THOMSON’S INT’L BANK ACCT., May 10, 1993, at 5.

¹⁰⁶ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

plaintiffs' attorneys to control litigation and less profitable to do so, (b) erected barriers to discovery, making it harder for plaintiffs to find the evidence to prove their cases, (c) raised the pleading requirements for plaintiffs, especially regarding matters of scienter (intent), (d) provided a "safe harbor" from litigation for various kinds of disclosures, mostly those containing "soft" information, (e) eliminated Racketeer Influenced Corrupt Organizations Act (RICO) liability for most securities-related claims, and (f) largely eliminated accountants' joint and several liability in securities cases.¹⁰⁷

The PSLRA's effects were generally salutary for accountants and other defendants.¹⁰⁸ Indeed, its provisions were so burdensome for plaintiffs that their attorneys began an "end-around" by filing parallel lawsuits in state courts with the hope that they could do discovery in those proceedings to use in their federal class actions.¹⁰⁹ Again the accountants mounted a successful lobbying campaign, producing the Securities Litigation Uniform Standards Act (SLUSA) of 1998,¹¹⁰ which required that the vast majority of securities class actions be filed in federal court where they will be subject to the pro-defendant provisions of the PSLRA.¹¹¹

¹⁰⁷ See generally PRACTISING LAW INSTITUTE, *SWEEPING REFORM: LITIGATING AND BESPEAKING CAUTION UNDER THE NEW SECURITIES LAW* (1996) (discussing law's provisions generally).

Even as this article was in press, the accounting profession's lobbying forces won another major victory by moderating substantially SEC proposals for new independence rules that would have required a significant restructuring of Big Five firms. See *Highlights*, J. ACCT., Jan. 2001, at 8 (describing the new auditor independence rules as "more moderate" than the original proposals); Michael Schroeder, *SEC May Drop Plan to Limit Auditors' Work*, WALL ST. J., Oct. 25, 2000, at C1 ("Fearing the SEC would unilaterally approve the [new] rule, accounting firms enlisted the support of key lawmakers on Capitol Hill to rein in the agency.").

¹⁰⁸ See William R. Maguire, *Securities Litigation Reform Marks Its Second Anniversary*, N.Y. L.J., Dec. 4, 1997, at § Outside Counsel, p. 1 (concluding that the PSLRA is "changing the securities landscape" and noting that "the number of cases filed against secondary actors, outside accountants, bankers and lawyers, is falling") (emphasis added).

¹⁰⁹ See Michael A. Lynn, *Defending Securities Fraud Class Actions in State Courts Raises Many Procedural and Substantive Issues Different from Those Being Litigated in Federal Court*, NAT'L L.J., Nov. 10, 1997, at B5 ("[T]he initial decline in the number of federal securities class actions in 1996 was met by a significant increase in state court filings.").

¹¹⁰ Pub. L. No. 105-353, 112 Stat. 3227 (codified in scattered sections of 15 U.S.C.).

¹¹¹ See generally Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 98 (1998) (describing law and questioning whether it was truly justified). However, the benefits of the PSLRA to the

Similarly ardent lobbying at the state level has produced other beneficial results for auditors. The profession, by itself or in conjunction with other tort reform advocates, has induced the vast majority of states to reform or eliminate altogether joint and several liability,¹¹² and has persuaded some states to pass statutes severely restricting accountants' negligence liability to nonclients¹¹³ and statutes amending deceptive trade practice laws to largely eliminate their applicability to accountants.¹¹⁴ Legally-aware accountants are in a position to use the law proactively as well as reactively; they can shape their business environment to facilitate success rather than have all their interactions with their regulatory environment be in the form of staving off disaster.¹¹⁵

D. *Ethical Concerns*

The business world has high expectations for the ethical standards of the accounting profession, and accountants have similar high

accounting profession can be overstated. Although there is no doubt that the PSLRA and SLUSA dramatically improved defendants' lot, plaintiffs' attorneys are a persistent breed and the number of audit failures and financial restatements that have occurred in recent years have provided fodder for many class action securities suits. See Todd S. Foster et al., *Trends in Securities Litigation and the Impact of PSLRA* (NERA Working Paper 1999) (noting that settlements are down and dismissals are up [the good news] but that large numbers of securities class actions continue to be filed against accountants).

¹¹² See Christopher T. Stidvent, Note, *Tort Reform in Alaska: Much Ado About Nothing?*, 16 ALASKA L. REV. 61, 65-71 (1999) (describing state legislative tort law reforms). Under joint and several liability, a defendant accountant whose negligence made defendant one percent responsible for a financial injury could be held one hundred percent financially responsible if other codefendants lacked the resources to pay the plaintiff's judgment or were otherwise unavailable to satisfy it. See Jonathan Cardi, Note, *Apportioning Responsibility to Immune Nonparties: An Argument Based on Comparative Responsibility and the Proposed Restatement (Third) of Torts*, 82 IOWA L. REV. 1293, 1300 (1997) (noting a case in which a party one percent at fault paid eighty-six percent of the victim's damages).

¹¹³ Such laws have been passed in Arkansas, Illinois, Kansas, Michigan, New Jersey, and Utah. See generally H. Keith Morrison & Robert W. George, *Arkansas's Privity Requirement for Attorney and Accountant Liability*, 51 ARK. L. REV. 697, 705-11 (1998) (discussing these laws).

¹¹⁴ See, e.g., Tex. Bus. & Com. Code Ann. § 17.49(c) (Vernon 1995) (largely exempting services performed by professionals such as accountants from coverage of the Texas Deceptive Trade Practices Act).

¹¹⁵ Accounting firms have become so adept at lobbying on their own behalf that they are now opening up their own lobbying services. See Ron Eckstein, *Big 5 Accounting Firms Learning to Lobby*, RECORDER, July 1, 1999, at 3 (noting that PwC earned nearly \$6 million in lobbying revenue in 1998).

expectations for themselves.¹¹⁶ Absent a reputation for honesty, auditors especially are unlikely to be able to profit from the reputational capital that has served them so well in the past.¹¹⁷

It seems an odd time for the accounting profession to consider reducing the exposure of accounting students and accounting professionals to legal and ethical requirements of the profession. Indeed, at this particular time, matters of ethics should be of heightened concern to the profession. The most salient reminder of a “crisis” in accounting ethics is the recent PricewaterhouseCoopers scandal. Certainly current rules regarding independence are burdensome, overly picky, and in substantial need of revision.¹¹⁸ However, these problems scarcely excuse the numerous and blatant violations of those rules by the Big Five accounting firms. PricewaterhouseCoopers was caught first, and although it initially attempted to pin the blame on a few “rogue individuals,”¹¹⁹ a subsequent study ordered by the SEC found over 8,000 violations of the independence rules regarding stock ownership in clients, with many of the violations occurring at the highest levels of the firm.¹²⁰ When the SEC is concerned with which company employs an

¹¹⁶ See *NASBA Speakers Focus on Ethics*, J. ACCT., Jan. 1999, at 14.

¹¹⁷ See, e.g., Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 111-12 (1993) (“Accountants, lawyers and investment bankers, in particular, have strong reasons to put their reputational capital to profitable use.”).

¹¹⁸ In November 2000, the SEC issued new independence rules addressing such matters as investments by family members and employment relationships between auditors or their family members and audit clients. Other difficult independence issues are currently being tackled by the Independence Standards Board (ISB). See Susan McGrath et al., *A Framework for Auditor Independence*, J. ACCT., Jan. 2001, at 39 (noting new SEC rules and summarizing ISB plans).

¹¹⁹ Dan Atkinson, *Accountants Pay \$2.5m Settlement*, THE GUARDIAN (London), Jan. 15, 1999, at 23, available at LEXIS/NEXIS, NEWS Library, ALLNWS File.

¹²⁰ The study found that violations were rife throughout PwC (8,064 violations), especially at the partner level; almost half of all partners ultimately reported potential independence problems due to stock holdings. See JESS FARDELLA ET AL., REPORT OF THE INTERNAL INVESTIGATION OF INDEPENDENCE ISSUES AT PRICEWATERHOUSECOOPERS LLP 20, 21 (Jan. 6, 2000). After partners were given repeated opportunities to self-report their violations to PwC, 77.5% of 200 randomly selected partners whose records were audited had at least one unreported violation. *Id.* at 58. After performing a statistical analysis, the law firm hired to do the report concluded “at a 90% confidence level, [that] between 81.9% and 90.3% of PwC’s partners as a whole—or approximately between 2,210 and 2,436 individuals—had at least one reported or unreported violation during the relevant time period.” *Id.* at 69.

auditor's spouse, where that spouse's mutual funds are invested, and even whether an auditor has a live-in lover, legal and ethical rules would seem to be more, not less, important.¹²¹

Another sign for concern regarding the ethics of the profession is the number of insider trading charges¹²² and employment discrimination suits¹²³ that have been filed against accountants and their firms recently. In addition to providing substantial evidence that accountants are receiving too little rather than too much legal

¹²¹ See *Auditor Independence: Cohabitation Arrangements Could Impair Independence*, SEC, ISB Staff's *Wam*, BNA SECURITIES LAW DAILY, July 2, 1999 (noting that the SEC staff believed that spousal independence rules should apply to live-in lovers as well).

¹²² See, e.g., *United States v. Ruggiero*, 56 F.3d 647 (5th Cir. 1995); *SEC v. Stephen V. Humphries*, SEC Litig. Rel. No. 16361, 1999 SEC LEXIS 2452 (D.D.C. Nov. 18, 1999); *SEC v. Heden*, Civil Action No. 99 Civ. 1418 (SAS) (S.D.N.Y., filed June 15, 1999); *SEC v. Drabinsky*, SEC Litig. Rel. No. 16033, 1999 SEC LEXIS 238 (S.D.N.Y. Jan. 21, 1999); *SEC v. Beers*, SEC Litig. Rel. No. 15823, 1998 SEC LEXIS 1604 (D.D.C. July 30, 1998); *SEC v. Lane*, SEC Litig. Rel. No. 15801, 1998 SEC LEXIS 1377 (S.D.N.Y. July 7, 1998); *SEC v. Kotecha*, SEC Litig. Rel. No. 15765, 1998 SEC LEXIS 1064 (N.D. Ga. June 3, 1998); *SEC v. Hirsch*, SEC Litig. Rel. No. 15607, 1998 SEC LEXIS 13 (S.D. Ga. Jan. 6, 1998); *SEC v. Sargent*, SEC Litig. Rel. No. 14854, 1996 SEC LEXIS 804 (D. Mass. Mar. 25, 1996); *SEC v. Evans*, SEC Litig. Rel. No. 14767, 1995 SEC LEXIS 3459 (C.D. Cal. Dec. 27, 1995); *SEC v. Blair*, SEC Litig. Rel. No. 13956, 1994 SEC LEXIS 324 (W.D.N.C. Feb. 3, 1994); *SEC v. Weinstein*, SEC Lit. Rel. No. 13336, 1992 SEC LEXIS 1917 (D.N.J. Aug. 11, 1992); *SEC v. Adams*, SEC Litig. Rel. No. 11439, 1987 SEC LEXIS 4654 (C.D. Cal. 1987); *SEC v. Drew Nat'l Corp.*, SEC Lit. Rel. No. 6995, 1975 SEC LEXIS 1187 (D.D.C. July 18, 1975); *In re Mark S. Tague*, CPA, Accounting and Enforcement Release No. 788, 1996 SEC LEXIS 1539 (SEC June 3, 1996); *In re William P. Lorea*, CPA, SEC Accounting and Auditing Rel. No. 30323, 1992 SEC LEXIS 313 (SEC 1992).

¹²³ In recent years accounting firms have lost high profile sex discrimination cases. See *Price Waterhouse v. Hopkins*, 490 U.S. 228, 231-58 (1989) (case which went to the Supreme Court disclosing clear use of gender stereotypes in firm's making of employment decisions). They have settled embarrassing age discrimination cases. See L.M. Sixel, *Peat Marwick Settles Age-Bias Lawsuit*, HOUSTON CHRON., Nov. 28, 1996, § Bus. at 1 (reporting \$600,000 settlement to 24 job applicants in ADEA case brought by the EEOC and \$278,000 settlement by Arthur Andersen & Co.). Surveys have demonstrated that accounting firms have "a significant problem" with sexual harassment. See Brian B. Stanko & Charles A. Werner, *Sexual Harassment: What is it? How to Prevent it*, NAT'L PUB. ACCT., June 1995, at 14 (reporting results of survey in which 37% of accounting firm female employees self-reported suffering sexual harassment on the job).

training, these suits serve as a clear signal that the ethical standards of the accounting profession are not where they should be.¹²⁴

A third sign of concern is the generally depressing findings derived by recent studies of the ethical development of accountants. Most importantly, a recent study found a *negative* association between level of moral development and employee advancement within audit firms.¹²⁵ Something is seriously askew in a profession where ethical development seems to be a hindrance rather than a help to one's career. The results of several other studies of auditor moral development are no more comforting.¹²⁶ Furthermore, a case can be made that both accounting firms and individual accountants tend to act in a relentlessly self-serving manner.¹²⁷

Despite evidence that improved ethical training can affect accountant performance,¹²⁸ critics justly complain that accounting

¹²⁴ See WINDAL & CORLEY, *supra* note 5, at xiii-xiv ("Too often, accountants in industry and public practice are guilty of *not* seeing the obvious wrongs, are *not* aware of an accepted standard of practice, and are *not* living up to the moral code expected of professionals.") (emphasis in original).

¹²⁵ See Lawrence A. Ponemon, *Ethical Judgments in Accounting: A Cognitive Development Perspective*, 1 CRITICAL PERSP. ACCT. 191 (1990).

¹²⁶ See, e.g., Richard A. Bernardi & Donald F. Arnold, Sr., *An Examination of Moral Development within Public Accounting by Gender, Staff Level, and Firm*, 14 CONTEMP. ACCT. RES. 652, 663 (1997) (finding that the average moral development scores for male managers of the Big Five fell between those expected for senior high school and colleges students, although female accountants scored somewhat higher); Jeffrey R. Cohen, *An Exploratory Examination of International Differences in Auditors' Ethical Perceptions*, 7 BEHAV. RES. ACCT. 37, 57 (1995) (finding in a cross-cultural study that U.S. auditors were much more likely to perform questionable acts than Latin American or Japanese auditors if the action would either maintain or expand their client base). Another study was slightly more comforting, although it also found that CPAs tended to see conflicts of interest as unimportant (a constant SEC worry) and discovered evidence that (unsurprisingly) "the education of CPAs does not enhance their overall ethical development to the same extent as the education provided theologians." G.A. Claypool et al., *Reactions to Ethical Dilemmas: A Study Pertaining to Certified Public Accountants*, 9 J. BUS. ETHICS 699, 705 (1990).

¹²⁷ See Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597 (2000) (making this case).

¹²⁸ See Judy S.L. Tsui & Ferdinand A. Gul, *Auditors' Behaviour in an Audit Conflict Situation: A Research Note on the Role of Locus of Control and Ethical Reasoning*, 21 ACCT. ORGS. & SOC'Y 41, 47 (1996) (finding that both levels of ethical reasoning and personality type affected auditor responsiveness to client pressure for improper accounting treatment).

students' educations are insufficient in the area of ethics.¹²⁹ Technical skills are well and good, but as Magill and his co-authors have pointed out:

Inability to acquire higher technical skills is and should be a limiting factor in a career. On the other hand, moral "errors," violation of written or implicit canons of behavior, are more serious since they are an indication of inability to establish proper priorities—to the ultimate degradation of the fiduciary relationship between professional and client or professional and employer. A concealment of a technical error, an inability to work through ambiguities in relationships and duties, or a refusal on the part of an aspirant to acknowledge written or unwritten codes of behavior, are fatal to a professional career and should be treated as such.¹³⁰

The profession itself has formally recognized the critical need for improvements in ethical education.¹³¹ But actions speak louder than words, and this recognition means little when the profession's actions reduce rather than increase ethical training. After all, a significant proportion of ethics teaching in business schools is done by business law professors.¹³² I have heard it said, and believe it to be true, that

¹²⁹ Robert Mautz has observed: "My experience has been that accounting education tends to emphasize technical skill and understanding with little attention to social responsibility...." See MAGILL ET AL., *supra* note 5, at 8 (quoting Mautz); see also Peter Arlow & Thomas A. Ulrich, *Can Ethics Be Taught to Business Students?*, COLLEGIATE FORUM, Spring 1983, at 17, 17 (finding that while other business majors' ethical thinking improved while taking a business and society course, accounting students seemed to regress and surmising that the result might be caused by the fact that in accounting courses students are "trained in 'hard and fast' rules").

¹³⁰ MAGILL ET AL., *supra* note 5, at 108.

¹³¹ See Arthur Andersen & Co. et al., *Perspectives on Education: Capabilities for Success in the Accounting Profession 6* (1989) ("Practitioners must also be able to identify ethical issues and apply a value-based reasoning system to ethical questions.") quoted in MAGILL ET AL., *supra* note 5, at 8; STEVEN P. MINTZ, *CASES IN ACCOUNTING ETHICS AND PROFESSIONALISM I* (2d ed. 1992) (quoting an American Accounting Association Committee (the Bedford Committee) as concluding that "[p]rofessional accounting education must not only emphasize the needed skills and knowledge, it must also instill the ethical standards and the commitment of a professional," and the Treadway Commission's conclusion that "[t]he business and accounting curriculum should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting").

¹³² See Jerry L. Furniss et al., *Integrating an Ethics Component into Legal Studies in Business Schools—Survey and Findings*, 9 J. LEG. STUD. EDUC. 192, 202 (1991) (finding that full-time business law faculty do a very good job of integrating ethics into law courses, although part-

when the question is "What is ethical?" the answer ninety percent of the time is "What is legal."¹³³ This is true in business generally, and it is especially true in accounting.¹³⁴ Accountants need more, not less training in what is legal because this training gives them direct guidance as to what is ethical as well.¹³⁵

time lecturers do not do as well); O. Lee Reed et al., *The Status of Law in Academic Business Study: 1998 Report of the President's Task Force 5* (1998) (unpublished manuscript on file with author) ("A study in the *Journal of Business Ethics* found that 22.9% of business ethics classes were being taught by legal scholars . . . a higher percentage than were being taught by faculty holding doctorates in management.").

How to better teach ethics is a constant theme in the business law discipline's teaching journal. See, e.g., Catharyn Baird, *Finding the Highest Common Ground: Strategies for Teaching Ethical Decisionmaking*, 14 J. LEG. STUD. EDUC. 133 (1996); John Collins, *Resolving Difficult Ethics Problems*, 14 J. LEG. STUD. EDUC. 155 (1996); John Collins, *An Introduction to Ethical Theory*, 13 J. LEG. STUD. EDUC. 163 (1995); Beverly Earle, *Integrating Ethics into an International Business Law Course*, 12 J. LEG. STUD. EDUC. 43 (1994); Beverly Earle, *Human Rights and Trade Policy: What Should the Connection Be? A Classroom Exercise*, 16 J. LEG. STUD. EDUC. 331 (1998); Gerald Ferrara, *Ethics in the Legal Environment: An Augmentation of Legal Realism*, 9 J. LEG. STUD. EDUC. 161 (1991); Marc Lampe & Craig B. Barkacs, *Adding an Ethical Dimension to the Teaching of Contract Law*, 11 J. LEG. STUD. EDUC. 227 (1993); M. Francis Reeves, *Bloom's Global Pedagogical Goals, Business Ethics, and the Legal Environment of Business*, 9 J. LEG. STUD. EDUC. 175 (1991); Lynn Sharp Paine, *Law, Ethics, and Managerial Judgment*, 12 J. LEG. STUD. EDUC. 153 (1994); Scott Sibary, *Question-Centered Ethical Analysis*, 11 J. LEG. STUD. EDUC. 241 (1993); Leonard Weber et al., *Who Sets the Agenda? Integrating Ethics into Functional Business Courses*, 9 J. LEG. STUD. EDUC. 215 (1991); Art Wolfe, *Business Education, The Rule of Law and Ethics*, 9 J. LEG. STUD. EDUC. 97 (1990).

¹³³ Certainly this is only a rough estimation, but I believe it is clear that although law and ethics are not coextensive, "[l]aw enshrines many of the ethical judgments of a society." THOMAS M. GARRETT & RICHARD J. KLONOSKI, *BUSINESS ETHICS* 1 (2d ed. 1986). Law not only reflects the ethical views of society, it shapes them. See THOMAS DONALDSON & THOMAS W. DUNFEE, *TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS* 95-96 (1999) ("Law, particularly when it is perceived as legitimate by members of a community, may have a major impact on what is considered to be correct behavior.").

¹³⁴ Accountants operate in a very rule-oriented environment. Although they constantly face ethical issues, those issues are often resolvable by reference to the appropriate legal rules or professional guidelines.

¹³⁵ A recent report sponsored by the accounting industry surveyed both accounting professors and accounting practitioners. They rated ethics as relatively low on their list of topics of importance for education of accountants. W. STEVE ALBRECHT & ROBERT J. SACK, *ACCOUNTING EDUCATION: CHARTING THE COURSE THROUGH A PERILOUS FUTURE* 52 (Accounting Educ. Series Vol. 16, Aug. 2000). The evidence in this section indicates that accountants must be in deep denial if they believe that ethics education is unimportant. Business law was rated as more important than ethics, but understandably lower than core topics such as financial accounting, information systems, taxes, managerial

E. Reasoning and Critical Thinking Skills

Legally-aware accountants are better prepared to do their jobs, to cope with the litigious environment in which they work, to shape that environment, and to reach ethical decisions within it. An additional reason to increase rather than decrease legal training for accountants deals with reasoning and critical thinking skills. The quantitative and technical skills that accounting students gain in their accounting courses are, of course, indispensable. But taking only accounting courses leaves accountants' thinking skills incomplete:

If by education we mean the cramming of a pupil's mind with facts or rules, without any real conception of their meaning or of the relations in which they stand to each other, it is perfectly safe to say that it is a waste of time. This kind of education fits a man for a certain groove, in which he moves in a routine way, a mere piece of mechanical machinery, incapable of independent thought or action. If confronted with a new condition, to which his rules do not apply, he is helpless, and is liable to make mistakes that are disastrous, because his action is based on insufficient knowledge of the foundation principles¹³⁶

This criticism was first voiced in 1917, but it has been often repeated¹³⁷ and many believe that accounting education is now more than ever before inappropriately tilted toward memorization of technical rules rather than development of analytical skills.¹³⁸

accounting, auditing, statistics, and business strategies. *Id.*

¹³⁶ S. Walton, *Practical Application of Theoretical Knowledge*, J. ACCT., Oct. 1917, at 276; *see also* ALFRED NORTH WHITEHEAD, *THE AIMS OF EDUCATION* 37 (1929):

Whatever be the detail with which you cram your student, the chance of his meeting in after-life exactly that detail is almost infinitesimal; and if he does meet it, he will probably have forgotten what you taught him about it. The really useful training yields a comprehension of a few general principles with a thorough grounding in the way they apply to a variety of concrete details

The function of a University is to enable you to shed details in favor of principles.

¹³⁷ In 2000, a study sponsored by the American Accounting Association, the AICPA and other prominent accounting industry entities again concluded that traditional accounting education contained too much memorization and not enough development of critical thinking. ALBRECHT & SACK, *supra* note 135, at 55, 64.

¹³⁸ *See* Nelson, *supra* note 3, at 69 (“[I]t would be fair to say that the length, breadth, and depth of the education required for CPA certification have been issues of great concern to professional accountants since the inception of accounting programs and that existing programs have consistently failed to meet their expectations of imparting to individuals the

When a similar criticism was made regarding business education in general,¹³⁹ one of the most significant studies ever done on the contents of business school curricula suggested that “[the study of business law at the undergraduate level] would be particularly useful in developing a student’s capacity for analytical investigation and for responsible action in a social setting.”¹⁴⁰ Studying law is certainly a desirable route for teaching accounting students the higher cognitive skills they need in today’s modern business world. Indeed, more recently it has been noted:

Development of critical thinking skills, which include the ability to question, evaluate, reevaluate, reason in graduated terms, defend positions, and decide in the midst of uncertainty, should be one of the objectives of all higher education experiences. Business law courses provide students with ample opportunity to develop these skills.¹⁴¹

Whereas developing critical thinking skills is a particular focus of many business law courses,¹⁴² accounting education has been repeatedly criticized as not going far enough toward development of

required capabilities before professional entry.”)

¹³⁹ In the late 1950s, two studies were done that concluded that business students needed less concentration in specialized subjects and more exposure to broader liberal arts and sciences concepts. One of the studies was funded by the Carnegie Foundation. FRANK C. PIERSON ET AL., *THE EDUCATION OF AMERICAN BUSINESSMEN* (1959). The other was funded by the Ford Foundation. ROBERT A. GORDON, *HIGHER EDUCATION FOR BUSINESS* (1959).

¹⁴⁰ PIERSON ET AL., *supra* note 139, at 213.

¹⁴¹ John R. Allison, *The Role of Law in the Business School Curriculum*, 9 J. LEG. STUD. EDUC. 239, 245 (1991); *see also* ELLIOT I. KLAYMAN ET AL., *IRWIN’S BUSINESS LAW 1* (1994) (“Business law study is an ideal context in which to build critical thinking skills [because t]raditional law study and pedagogy naturally use critical thinking approaches and the critical thinking inquiries fundamental to legal analysis.”).

¹⁴² *See, e.g.*, Susan M. Denbo, *Employee v. Employer: Integrating Employment Law Issues and Critical Thinking Skills Into the Undergraduate Business Law Curriculum*, 15 J. LEG. STUD. EDUC. 107 (1997); Andrea Giampetro-Meyer & Nancy Kubasek, *The Research Paper: A Tool for Developing Thinking Skills in the Legal Environment of Business Classroom*, 9 J. LEG. STUD. EDUC. 317 (1991); Andrea Giampetro-Meyer & Nancy Kubasek, *A Test of Critical Thinking Skills for Business Law and Legal Environment Studies*, 9 J. LEG. STUD. EDUC. 501 (1991); Nancy Kubasek & M. Neil Browne, *Integrating Critical Thinking into the Legal Environment of Business Classroom*, 14 J. LEG. STUD. EDUC. 35 (1996); J. David Reitzel, *Critical Thinking and the Business Law Curriculum*, 9 J. LEG. STUD. EDUC. 471 (1991).

such skills.¹⁴³ Accounting professors have faced the unenviable task of teaching material that has become more and more technically complex every year. Teaching the necessary substance in core accounting courses is extremely challenging. Believing that accounting courses too often focus on problem materials of the “cookbook” variety, Subotnik has written that “[a]s a consequence, students can’t and don’t develop the requisite skills for dealing with situations involving any uncertainty, and the stage is set for an endless succession of cases like [*United States v.*] *Stirling* and [*United States v.*] *Simon*,”¹⁴⁴ cases where accountants made poor judgments in areas in which there was no clear guidance from accounting rules. Other accounting professionals have agreed.¹⁴⁵

Therefore, Subotnik argues, “accounting education, considered both as a self-contained discipline and as a means of preparing practitioners, could benefit from a dose of the methodology that underlies legal education.”¹⁴⁶ The law is awash with subtleties, and a study of the law teaches students to reason beyond the black-and-white, a useful skill for accountants in a variety of settings.¹⁴⁷

¹⁴³ See Dan Subotnik, *What Accounting Can Learn From Legal Education*, 2 ISSUES ACCT. EDUC. 313, 313-14 (1987).

¹⁴⁴ *Id.* at 315-16. *United States v. Stirling*, 571 F.2d 708, 713-14 (2d Cir. 1969) involved, among other deceptions, “land transactions that were not what they were claimed to be ... [and] contracts for module sales based upon guile and trickery rather than agreement.” *United States v. Simon*, 425 F.2d 796, 805-13 (2d Cir. 1969) involved auditors who knew that financial statements were misleading but certified them anyway, comforting themselves with the notion that they had complied with GAAP and GAAS. The judge and jury took a dim view of the auditors’ “form over substance” approach.

¹⁴⁵ See Nelson, *supra* note 3, at 65 (noting that the trend in accounting courses is to focus on numbers and rules and to “reinforce students’ perceptions that ‘accountants work with numbers, not people,’ and there is ‘one right answer’ to every accounting question”).

¹⁴⁶ Subotnik, *supra* note 143, at 318; see also Dale Bandy, *Accounting Education at the Crossroads*, CPA J. ONLINE, Aug. 1990, <http://www.nyscpa.org/cpajournal/old/08766796.htm> (similarly lauding the study of cases and especially of law cases as a valuable tool for teaching accountants how to think critically and to solve problems).

¹⁴⁷ See Subotnik, *supra* note 143, at 322-23 (“Unlike the typical accounting student, the practitioner of accounting knows full well that the rules do not cover all circumstances. The problem is that he or she has not developed methods for dealing with subtlety. Hence, some shocking errors in judgment by accountants have occurred ...”).

As the accounting profession encourages accounting professors to make use of the case method in accounting courses,¹⁴⁸ it is well to remember that the case method of study was invented by lawyers¹⁴⁹ and is still widely used in business law classes.¹⁵⁰ Surveys of business executives find that they recognize the value of the problem-solving techniques they were taught in business law classes.¹⁵¹ Indeed, accounting firms often like to hire lawyers because of their superior analytical skills gained during legal training.¹⁵² While many individual accounting teachers have done an improved job of injecting qualitative reasoning skills into their courses, accounting students clearly profit from receiving that exposure in university business law courses, which tend to be of high quality.¹⁵³

¹⁴⁸ See American Institute of Certified Public Accountants, *Core Competency Framework for Entry into the Accounting Profession*, <http://www.aicpa.org.edu/overview.htm> (last modified December 14, 1999).

¹⁴⁹ Actually, Dean Langdell of the Harvard Law School invented the case method of study. See Mary Brigid Macmanamon, *Felix Frankfurter: The Architect of "Our Federalism,"* 27 GA. L. REV. 697, 739 n.250 (1993).

¹⁵⁰ Cases are the quintessential method of studying the law, and the business law discipline's teaching journal often contains articles to assist professors in honing their skill at teaching the case method of study. See, e.g., Debra Dobray & David Steinman, *The Application of Case Method Teaching to Graduate Business Law Courses*, 11 J. LEG. STUD. EDUC. 81 (1993); Jordan H. Liebman, *In Defense of the Legal Case Method and the Use of Integrative Multi-Issue Cases in Graduate Business Law Courses*, 12 J. LEG. STUD. EDUC. 171 (1994); Diane B. MacDonald, *Turning War Stories into Case Studies*, 9 J. LEG. STUD. EDUC. 437 (1991).

¹⁵¹ See Michael W. Little & William H. Daughtrey, Jr., *Survey of Virginia Corporate Executives on the Role of Law in Business Curricula*, 13 J. LEG. STUD. EDUC. 147, 160 (1995) (reporting this survey result).

¹⁵² See Claudia MacLachlan, *Counting on Counsel: KPMG Finds Northern Va. A Hot Spot for Its Growing Litigation Support and Tax Work*, LEGAL TIMES, June 5, 2000, at 40 (noting that Earl Hannum, partner in charge of tax for KPMG's Washington region, says that he "likes hiring lawyers because of their analytical skills and because they can write").

¹⁵³ As a broad generalization, law courses taught in business schools tend to be of high quality. In a 1998 AACSB/EBI comprehensive survey of undergraduate student satisfaction (copy on file with author), Business Law/LEB Courses rated #1 of 12 disciplines studied (accounting, business policy/strategy, business economics, finance, human resource management, information systems, international business, management/organizational behavior, marketing, operations, statistics) in terms of teaching quality.

III. CONCLUSION

For many years the accounting profession has complained that “accounting students have become ever-more narrowly-educated.”¹⁵⁴ Any change in the CPA examination that reduces the focus on relevant legal subjects is likely to accelerate rather than reverse this unfortunate trend. Legally-aware accountants will be better at their jobs—tax, audit, consulting, etc.—than legally-naïve accountants. Legally-aware accountants will also tend to act more ethically and to be better problem-solvers. Legally-aware accountants can better shape their business environment in an advantageous manner.

A facile response to the evidence presented in this article is that accountants can just call a lawyer when they need one. Unfortunately, absent a modicum of legal knowledge, the accountants will not know that they need a lawyer until it is too late. That modicum of knowledge is often the difference between a smooth transaction and years of litigation. Furthermore, accountants in small firms will seldom be able to afford all the phone calls to lawyers (the meter will be running) that they will need to make to properly minimize mistakes and the attendant liability exposure.

As noted earlier, law has been a critical part of the CPA exam since its inception in 1896. In 1896, the accounting profession was not regulated, had no code of ethics, and was virtually never a target of litigation. How can law suddenly be *less* important to a profession that today is heavily regulated by government, operates under a detailed code of ethics, and faces the omnipresent threat of litigation?

Indeed, a strong argument can be made that accountants need to know more law, not less.¹⁵⁵ Consider that the current version of the CPA exam contains no section on cyberlaw. If accountants in the 21st century do not recognize the absolute centrality of cyberlaw to

¹⁵⁴ Nelson, *supra* note 3, at 65.

¹⁵⁵ Not that long ago it was urgently argued that undergraduate business education was severely underserving accounting students. Following a comprehensive survey, it was concluded that undergraduate business law courses had been reduced in number and scope and therefore “clearly fail[ed] to meet the functional need of accountants to understand the substantive legal basis of business transactions, and to conduct professional practice in a way that is careful and ethical, and avoids legal liability.” Eugene T. Maccarrone, *Do College Law Curriculums Meet the Needs of Accounting Majors?*, CPAJ. ONLINE, Apr. 1990, at <http://www.nysspca.org/cpajournal/old/08415654.htm>.

strategic e-business decisionmaking,¹⁵⁶ they will have difficulty fulfilling their traditional role as key general business advisers.

Certainly every day sees new developments in *all* areas of business and technology that accountants could profitably learn about. Therefore, curricular change in university accounting programs and content evolution in the AICPA's professional certification examination must ever and always occur. However, before the role of law is minimized in either, those seeking to make the change face a substantial burden of justification. After all, the purpose of accounting education "is not to teach accounting, but rather to teach students to be accountants."¹⁵⁷ To become effective accountants, students must have a strong background in the legal rules that so influentially shape both the business environment in general and the specific professional realm in which accountants practice their craft.

¹⁵⁶ See HENRY H. PERRITT, JR., LAW AND THE INFORMATION SUPERHIGHWAY 2-3 (1996) (noting the many roles law is playing in shaping the information age).

¹⁵⁷ Bandy, *supra* note 147.