

Auditors and Accountants

For the convenience of readers interested only in issues relating to accountancy we provide this information about the duty and standard of care owed by auditors and accountants. For info about the duty and standard of care to be met by professionals generally, including auditors and accountants, click on "More" to the right or on the Professional Indemnity web page.

Professional Duty of Care

As with other professions, auditors and accountants almost always owe a duty of care to their clients. This duty arises from the law of negligence, contract, fiduciaries, or, in the case of auditors of corporate clients, from business corporations legislation. However, auditors and accountants have often also been held liable to third parties who have relied on their professional advice to a client.

When auditors or accountants provide an opinion on a client company's financial statements, they usually expect that the client will share the opinion with others who may rely on it, including bank creditors, suppliers, prospective investors and affiliated companies. The degree of reliance will generally increase when an audit opinion is given. In the case of large public companies, the audited financial statements can receive wide publication. As a result, under the traditional formulation of duty of care, accountants (and auditors in particular) could face liability in any amount to a virtually unlimited number of third parties.

The courts generally considered this to be an extreme and undesirable result. And so, over the past few decades, the law has evolved to limit the scope of the duty of care owed by auditors for financial statements which prove to be inaccurate. The limits which were developed address the question of who is owed a duty of care, as well as the question of what use is made of an auditor's or accountant's opinion.

Both of these issues were addressed in the 1997 Supreme Court of Canada decision in *Hercules Management Ltd. v. Ernst & Young*. The plaintiffs in that case lost on their investment as shareholders of the defendant auditor's client. This loss was foreseeable in that the defendant auditors could easily have anticipated that someone (including existing shareholders) might rely on their client's audited financial statements in making an investment in the client and could be harmed if the statements were wrong.

With respect to the "who?" question, the Supreme Court concluded that the auditors did not owe a duty to anyone and everyone who might be harmed by reliance on a negligent misstatement in the financial statements. An auditor will only owe a duty of care to someone who the professional actually knows might rely on the advice given. This would include a person who was a member of a specific class of persons that the professional knows about. In the *Hercules* case, the Court said that the existing shareholder plaintiffs did fall into this category.

Dealing with the second question, "for what use?", the Court went on to say that an auditor will only be liable to someone who used the advice for the specific purpose or transaction for which the advice was given. In the case of an audit opinion, the Supreme Court said that, ordinarily, that purpose is to assist shareholders in overseeing the management and affairs of the company, not to assist in making personal investment decisions. Therefore, the auditors were not liable to the plaintiff shareholders for their individual investment losses in this case. Auditors can be liable to their clients' shareholders if the shareholders as a group suffer a loss because inaccurate financial statements prevented them from holding management of the company to account for some problem.

The Hercules decision, even though it dealt with a claim by shareholders, also affects the duty of care that auditors owe to lenders and other creditors. Before Hercules, auditors were usually not found liable to creditors of whom they were not aware at the time of the audit. There were many cases though where the courts held auditors liable to their clients' creditors (often a client's bank) where the auditors knew that that creditor might rely on the audited financial statements. After the decision in Hercules, a creditor known to the auditor must also show that the financial statements were prepared for the purpose for which the creditor relied on them. In the case of a routine annual audit, this will ordinarily not be possible.

Audits are sometimes conducted for purposes other than overseeing management, such as inclusion in an investment prospectus. Nevertheless, even in the case where the auditor has performed an audit specifically for the client to provide to a particular group of lenders for their use, the auditor still might not owe a duty of care to those lenders. Following Hercules, a duty of care may not be owed, for example, where the financial statements are to be provided to a third party for the purpose of attracting a \$10,000 loan and the third party relies on those statements in making a \$1,000,000 loan.

In unusual cases, an auditor's actions can create a duty of care to a third party who could not meet the Hercules test at the time of the audit. In the case of ADT Ltd. v. Binder Hamblin, for example, the auditor met with a client's prospective investor and confirmed that the financial statements which were prepared for the company some time earlier, were accurate. The court found that the direct relationship formed with the investor at the meeting created a duty of care where none had existed before.

A claimant must prove not only the existence of a duty of care, but also the extent of the duty. The extent of the duty depends upon the nature of the engagement. In non-audit engagements, such as a review engagement, an auditor is not ordinarily required to consider factors like the client's own internal financial controls and procedures. If a review engagement client suffers a loss that could have been prevented had its accountant warned about problems with its internal controls, the accountant will usually not be liable unless the accountant actually noticed a significant problem resulting from poor controls, but failed to take appropriate action.

Professional Standard of Care

The standard of care that an auditor is required to meet depends to a large extent on the type of engagement entered into. Different engagements involve different degrees

of attestation by the accountant. The three most common types of engagement are audits, review engagements and compilation or non-review engagements conducted on a notice-to-reader basis. The highest degree of attestation, and consequently the highest standard of care, applies to an audit. Audits usually involve review of a client's financial statements, but may also relate to investigation of a specific aspect of the client's business. Audits can only be conducted by accountants who are qualified as Chartered Accountants.

Most lawsuits against accountants arise from the audit function. Typically, such suits are based on allegations of negligent misstatement regarding the financial position of an audit client as reflected in the client's audited financial statements. One recurring complaint arising from audits relates to the auditor's failure to detect fraud by employees or by management of the audit client. Audits are not designed to detect fraud, but that does not prevent claimants from arguing that they should. As a result, complicated issues often arise regarding whether an auditor should have detected a fraud and whether a failure to do so resulted from the auditor's failure to comply with proper auditing procedures.

Auditors are required to comply with the extensive, detailed standards set out in the Handbook of the Canadian Institute of Chartered Accountants (CICA). The Generally Accepting Accounting Standards (GAAS) and Generally Accepting Accounting Practices (GAAP) set out in the CICA Handbook provide evidence, although not necessarily conclusive evidence, of the standard of care that auditors are required to meet by law.

The general standard contained in the CICA Handbook applicable to auditors states that an auditor "performs the audit with an attitude of professional scepticism, and seeks reasonable assurance whether the financial statements are free of material misstatement." There are many practical limitations inherent in the audit process. The auditor is expected to exercise professional judgement regarding the sort of testing to be conducted and other audit procedures to follow on a given audit. Judgement is also required to evaluate the results of whatever procedures are conducted. When approaching an audit, the auditor must assume that the client's management is acting in good faith unless there is reason to believe otherwise. The CICA Handbook observes that "much of the evidence available to the auditor is persuasive rather than conclusive in nature". Therefore, an auditor cannot be expected to obtain "absolute assurance" in the course of an audit review.

Before 1997, the most authoritative pronouncement in Canada on the degree to which the courts should accept the CICA Handbook as determining the standard of care to be met by accountants was the Supreme Court of Canada's decision in *Hodgkinson v. Simms*. That decision stated that professional standards are of guiding importance in determining the nature of the duty owed by a member of the profession. However, in 1997, the B.C. Court of Appeal held in *Kripps v. Touche Ross* that the court was not bound to conclude that the CICA Handbook was determinative. Despite the existence in that case of a retainer letter stating that the audit opinion was given in accordance with GAAP, the court stated that the adherence to GAAP was not a defence where the GAAP standard fails to adopt obvious and reasonable precautions which are readily apparent to the judge. As a result of this decision, accountants in Canada cannot

assume that adherence to the provisions of the CICA Handbook will necessarily protect them from liability.

Notwithstanding this uncertainty, the CICA's detailed codification of standards and its structural process for the review of those standards remains highly relevant for the determination of liability. In most cases where accountants' work meets those standards they will not be found liable.

Cases involving sophisticated commercial fraud present an interesting opportunity to see how a Canadian court will typically establish a standard of care to govern liability in a particular case. As previously noted, auditors are normally entitled to assume the honesty and good faith of management. However, one of the most commonly encountered phrases in negligence case law is "knew or ought to have known." Many a standard of care dispute will focus on what the professional "ought to have known".

Among the questions which are likely to arise are:

1. Did the auditors obtain sufficient knowledge of the client's affairs to plan the audit?
2. Was the audit plan adequate?
3. If the auditors relied upon internal controls and limited their substantive testing, did they have appropriate evidence of the proper functioning of those controls?
4. Were all relevant audit assertions tested?
5. Was the intensity of inquiry adequate and were questions directed to appropriate individuals?
6. Are analytical procedures properly documented and were the results of those procedures given appropriate consideration?

It is because questions of this nature regularly arise that audit cases are often complicated and expensive to pursue.

It is also important to consider the flip side of the coin. What care does management owe and what are the legal consequences of management's failure to meet an appropriate standard of care? An issue commonly arises where both the auditor and the management of an audit client are at fault to some degree for failure to detect the existence of a problem. Under the legislation enacted in most provinces dealing with negligence, where two parties are at fault for a loss, the courts will apportion a degree of fault to each. If one of the parties is the plaintiff in the action, the liability of the other party as defendant will be reduced to the extent of the plaintiff's contributory negligence. If the fault is divided between two defendants, the plaintiff is entitled to recover its losses on a joint and several basis, meaning that the plaintiff can recover part or all of the loss from either defendant. This situation sometimes creates serious problems for auditors in circumstances where, for example, an auditor is found to be 5% at fault for a loss, but the party that is 95% at fault is insolvent. The auditor must then answer for the whole of the plaintiff's loss.

There is disagreement in the case law regarding how the law of contributory negligence should be applied to an action by an audit client against its auditor, where both the auditor and the client's management are at fault for failure to detect a problem. Canadian courts have generally concluded that an audit client cannot recover from its auditor to the extent that the client's own management is at fault for the loss. A few

decisions though have held that the client has retained the auditor to provide a check on management and, consequently, the auditor cannot defend itself by pointing to errors or wrongdoing by management of the sort that the auditor was paid to detect.

December 28, 2004