STRANGE HAPPENINGS IN LAW AND AUDITING[1]

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The respondent auditors' purpose in preparing the reports was to assist the collectivity of shareholders of the audited companies in their task of overseeing management. The respondents did not prepare the audit reports in order to assist the appellants in making personal investment decisions or, indeed, for any purpose other than the standard statutory one. The only purpose for which the reports could have been used so as to give rise to a duty of care on the part of the respondents, therefore, is as a guide for the shareholders, as a group, in supervising or overseeing management.

Supreme Court of Canada, *Hercules Case,* 1997[2]

Never before has the public been so strongly involved in the capital markets. Never before has it been so critical that we ensure the public's confidence in those markets is maintained. So,
[Ontario Securities] Commission is troubled when we see an apparent erosion of confidence in audited financial statements.

David Brown, Chair, Ontario Securities Commission, June 1999[3]

Increasingly I have become concerned that the motivation to meet Wall Street earnings expectation may be overriding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earning estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

Arthur Levitt, Chair, Securities and Exchange Commission, September 1998[4]

It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first,

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2 Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16.

3 David A Brown, Q.C. Chair, Ontario Securities Commission, presentation to the Business Leaders' Luncheon, The Institute of Chartered Accountants of Ontario (June 8,1999).

4 Arthur Levitt, Chair, Securities and Exchange Commission, *The Numbers Game.* Remarks at the NYU Center for Law and Business (September 28, 1998) (transcript available at <http://www.nitgers.edu/Accounting/raw/aaa/newsarc/prl 01898.htm>).

> to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, second, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided ... I find it difficult to believe, however, that the legislature, in enacting provisions clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular.
>
> Lord Oliver of Aylmerton, *Caparo* Case, 1990[5]

> Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.
> Auditing should be done by a competent, independent person.
>
> Arens, Loebbecke, Lemon, Splettsoesser, Auditing. 1999 [6]

Readers:

It is a pleasure to welcome you to this dialogue between representatives of the legal and accounting professions. The introductory comments from experts in their respective disciplines highlight the need for this discussion. It is abundantly clear that the language each speaks is neither fully understood by the other, nor necessarily captures the other's expectations. As fundamental as the audit is to the effective continuance of capital markets, there is apparently little consensus even as to its intended purpose.

In a sense, the discussion of auditors' liability requires us to step into a world somewhere between that of law and accountancy.[7] Since neither profession is fully responsible for the governance of this world, it will offend no one to state that

[5] Caparo Industries pic v Dickman [1990] 2 AC. 605,630-632.

[6] A. J. ARENS, ET AL., AUDITINO AND OTHER ASSURANCE SERVICES, at 3 (Canadian 8th ed., Prentice Hall Canada 2000).

[7] *See,* Carl Pacini & David Sinason, *State Legislative Responses to the Call for Reform of Accountants' Liability to Nonclients for Negligence,* 6 J OF LEGAL STUD. IN Bus. 45, 47 (1998) (citing Thomas G. Mackey, *Accountants' Liability After* Bily v. Arthur Young & Co: *A More Equitable Proposal for Third Party Recovery,* 45 HASTINGS L. J. 160-162 (1993)). The expression "auditors' liability" is adopted throughout this paper in keeping with the relatively informal writing style. More correctly, it should be "auditors' liability for negligent misstatements." Even this description glosses over legal debate. Specifically, are there two torts, negligence and negligent misrepresentation, or merely one (negligence)? In Canada, for example, as recently as 1997, the Supreme Court of Canada has come close to adopting a one tort of negligence approach; see discussion, *infra.* In the United States, this debate turns upon the issue of "justifiable reliance" although, apparently, the judiciary and most commentators continue to interchange the terms negligence and negligent misrepresentation.

entering it is, at times, akin to Alice's journey through the Looking Glass. This realm is one where events become "curiouser and curiouser,"[8] the more we ponder its logic.

This presentation will proceed in the form of a dialogue and the expectation is not for each participant to seek victory through knock out blows to the other's position. Rather, it is intended that the statements of position will lead both to a better understanding of from whence the other comes, and to a better definition of where they should be heading.

The springboard for this discussion is the law of auditors' liability.[9] This field of law has been of great interest to scholars and practitioners since it first seriously developed in the 1960's.[10] It has been at the forefront of calls for the reform of tort law in most common law countries, both because of the uncertainty of its bounds and the potential enormity of the responsibilities imposed."

Ironically, while debates as to the appropriate scope of auditors' Lability have

[8] LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND, 10 (Macmillan Co. 1966) (1865).

[9] Note, the authors are not experts in U.S. law, and, as such, generally rely on secondary sources which will be cited from time to time. For example, Pacini, *supra* note 7; Susan Lorde Martin, *If Privily is Dead, Let's Resurrect It: Liability of Professionals to Third Parties for Economic Injury Caused by Negligent Misrepresentation*, 28 AM. BUS. L.J. 649 (1991); Jordan H. Leibman & Anne S. Kelly, *Accountants' Liability to Third Parties for Negligent Misrepresentation: The Search for a New Limiting Principle,* 30 AM. Bus. L.J. 347 (1992); Marianne M. Jennings, et al, *The Auditor's Dilemma: The Incongruous Judicial Notions of the Auditing Profession and Actual Auditor Practice,* 29 AM. Bus. L.J. 99 (1991); Carl Pacini & David Sinason, *Auditor Liability for Electronic Commerce Transactions Assurance: The CPAJCA Web Trust,* 36 AM. Bus. L.J. 479 (1999); Carl Pacini et al, *At the Interface of Law and Accounting: An Examination of a Trend toward a Reduction in the Scope ofAuditor Liability to Third Parties in the Common Law Countries*, 37 AM. Bus. L.J. 171 (2000).

[10] *See* Bruce Feldthusen, Economic Negligence (3d ed. 1994). Mr. Feldthusen describes the prior history of this tort: "until the 1960's the development of the law of negligent misrepresentation may be accurately described as a period during which the courts borrowed slightly from the principles of personal injury law in order to modify the law of contract when it was commercially expedient to do so." *Id.* At 24. In England, Canada, Australia and New Zealand, the triggering case was the House of Lords decision of Hedley-Byme & Co. Ltd. v. Heller & Partners Ltd. [1964] AC. 465, which, although not about auditors, created the tort of negligent misrepresentation causing economic loss, first in England and thereafter in the rest of the Commonwealth. In the United States, there were a number of early cases proceeding cautiously along the lines described by Feldthusen above, and beginning with Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1925) and Ultramares Corporation v. Touche, 255 NY. 170, 174 N.E. 441 (N.Y. 1931). Until the Rusch Factors, Inc. v. Levin, 284 F. Supp. 85 (D.R.I. 1968) decision, liability was also, in practice, so restricted as to be of little concern to auditors. Al most, the "near privity interpretation applied. *See* Pacini, *supra* note 7 at 49-50.

[11] *See* discussion of the report of the Committee to Review Accountants' Liability (CORAL), in Sally Gunz, *Is there no Justice?*, CA Mag. 38 (Dec. 1987). Because tort liability (and litigation in general) is greater in the United States than in most if not all other countries, accountants have been joined by many other interests in their call for reform. In countries such as Canada, where the approach to liability is generally more conservative, it is the auditors, joined at times by certain medical interest groups (in particular, obstetricians) who have been particularly vocal. For example, in Canada in 1987, the Canadian Institutes of Chartered Accountants formed a committee that recommended sweeping changes to auditors' liability.

absorbed much attention, the accounting profession itself has embarked upon a path of such fundamental change as to make a good deal of the discussion about legal responsibility, if not irrelevant, then certainly at times, anachronistic.[12] Likewise, regulators both within and outside the accounting profession have continued to follow traditional means of devising practice rules while the expanse between the formal profession to which these rules apply and the "in practice" profession grows ever wider.

It might be suggested, although to do so would be dangerously superficial, that those establishing legal and accounting principles are doing no more than engaging in elegant but less than relevant exercises. While they appear to count the numbers of angels on the heads of pins, the accounting profession itself moves in entirely new and uncharted directions. There is much with which to be frustrated when reviewing the confused and sometimes illogical definitions of the law, the pace of the accounting profession's devising of practice rules, and the ability of regulators to control or oversee the products of the accounting profession. It may well be the case, however, that in their own grinding way, all three entities, perhaps even inadvertently, are in fact preparing the anchor which will save the accounting profession from speeding uncontrolled into a future that has not only risks for the public, but inherent risks for itself. To return to our earlier analogy, the anchor comprises the mles and guidelines that will apply in the strange and sometimes dangerous netherworld in which the accounting profession now finds itself.

The dialogue between the lawyer and accountant begins:

The Accountant:

In order to ensure a clear understanding for the balance of the dialogue, and in recognition of the apparent confusion in the minds of the experts quoted above as to the definition of "auditing," I would like first to clarify some terminology. The primary role of auditors is to express an opinion on financial statements prepared by their client organization. The usual form of the opinion is that the statements "present fairly, in all material respects, the financial position of (client name)... and results ... in accordance with generally accepted accounting principles.... These financial statements are the responsibility of the company's management; our responsibility is to express an opinion...."[13] An alternative term for the audit process

[12] The nature and extent of these changes will be discussed *infra.*

[13] *See* auditing Standards Board, American Institute of Certified Public Accountants (AICPA), Statement on Auditing Standards No. 58, "Reports on Audited Financial Statements", (2000). The standard opinion used in Canada is virtually identical. The wording of the audit opinion in the United States changed in 1988 for the first time in 40 years. The new wording delineates the roles of the external auditors and of management who actually prepare the financial statements. The earlier version of the report did not address this issue. It is not unreasonable to assume that the changes were intended to limit the exposure of auditors to liability. The wording of the audit opinion is developed by the auditing profession - in the United States by the American Institute of Certified Public Accountants (AICPA) and in Canada, by the Canadian Institute of Chartered Accountants (CICA).

is the attest function. Today, those who attest are practitioners in what is generally known as the "assurance" service branch of accounting practice.[14] The words auditor and accountant are sometimes used interchangeably but more accurate usage is to reserve the word auditor to describe a person performing the attest function while accountants prepare and interpret accounting information.

Generally accepted accounting principles (GAAP) determine the form of financial reporting.[15] A set of financial statements includes an income statement, a balance sheet, a statement of changes in financial position, a statement of shareholders' equity, accompanying notes and management discussion and analysis.[16] A full financial report is required annually while public firms are required to issue interim financial reports on at least a quarterly basis. Interim statements are highly abbreviated in comparison to annual reports. This basic form of financial reporting has not changed for generations. It is a matter of conjecture whether this package is the most useful or primary information source for decision-makers when near unlimited information is available electronically or through other media sources and financial analysts.[17]

The Lawyer:

I, too, need to clarify some language. When we talk of "law" in terms of auditors and auditors' liability, it is primarily tort law that is the focus. Further, it is the responsibility to third parties that has been of paramount concern to the accounting profession.[1] It is useful to consider this liability in its historic context

To begin, it is necessary to understand that, until relatively recently in all common law countries, there was virtually no third party liability for torts to which auditors

[14] *See* Colin Boyd, The Transformation of the accounting Profession: The History Behind the Bio 5 Accounting Firms diversifying into Law 16 (1999). Accounting firms have undergone three profound changes in the past two decades. The first is the emergence, through mergers, of five huge global firms (Big Five) which dominate the audit market of large firms. The second change is the relative decline in importance of the audit function in large accounting firms with other services such as consulting and tax practice increasing in importance. One estimate showed audit revenue as a percentage of total Big Five revenue declining from 62 percent in 1980 to 38 percent in 2000. *See id.* The big firms themselves now use the expression "professional services organizations" rather than accounting firms to describe their activities. *Id.* The third change is that, for various reasons, auditing has become a low margin business. *See id.* A recurring concern is that economic pressures may cause auditors to reduce the quantity of resources used in audits. *See id.* at 10-12.

[15] Ultimately GAAP is determined by accounting standards setters. In the United States, this role is filled by an independent body, the Financial Accounting Standards Board, while in Canada, standards are set by the CIC A

[16] Some different terminology exists for the various financial statements as GAAP does not specify required nomenclature.

[17] See discussion *infra.*

[18] While liability to the "client" can be extensive, it has little of the boundless qualities of third party liability in tort. Further, since liability for negligent misrepresentation most often arises where there has been not only an audit failure but also a corporate failure, the auditor is very often able to raise a contributory negligence defence and/or join directors/officers/managers as co-defendants.

were exposed. Just as in the early part of the 20th centuiy, manufacturers had to come to terms with new responsibilities, so in the 1960's and beyond did public accountants.[19] For the latter, the adjustment has been particularly painful because the law itself has proved remarkably resistant to clear definition.

The difficulty with developing a consistent definition is a direct consequence of the broader policy concerns that underlie this field of liability. Liability here arises out of an audit failure. Arguably, there has been negligence in the conduct of the attest function. Yet failures in the attest function are unlikely to lead to litigation against the auditor unless there has been some more fundamental failure in the company itself. If there is no significant variation between actual value of the corporation and that presented in the financial statements and attested to by the auditor, any negligence on the part of the auditor is unlikely to be detected and, in any event, there is little incentive to pursue a claim.

Compare the context then of the typical audit failure and the typical manufacturer's liability claim. In the latter, the claim arises because the product the *manufacturer* created has, in some fashion, harmed the user. In the audit context, the real harm arises out of failures by the *company* itself. The auditor has "caused" harm to the plaintiff because there has been lack of appropriate notification of these failures. If the world were a perfect place, however, and if the corporation were a viable entity worth pursuing, it would be the corporation and its management, and not the auditor, that would be the obvious first target for the unhappy investor.[20]

This comparison, though crude, has had a profound impact upon the political debate surrounding the legal definition of auditors' liability. Imposing responsibility for the entirety of the loss, where the persons responsible for the unexpected and negative value of the corporation are other than those now called upon to pay, has an underlying taint of unfairness or, at the very least, inadequacy.[21] And there are other considerations that dampen enthusiasm for a broad imposition of liability. The sums plaintiffs claim in auditors' liability cases can be in the multi-million or even billion dollar range.[22] They arise also in an investment context. Again, crude comparisons

[19] *See generally* Donoghue v. Stevenson [1932] A.C. 562 (H.L.). This was the key case for England, Canada, Australia and New Zealand opening up the tort of negligence in general and manufacturers' liability in particular. In the United States the landmark case was MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050(1916).

[20] In many if not most cases where auditors' liability claims arise, the company itself has failed.

[21] The notion that the auditor is liable for the "entirety" of the loss flows from the principles of joint and several liability with joint tortfeasers. The plaintiff can claim recovery for the entire amount from any one of those found jointly negligent, even if that party is only responsible for a relatively small proportion of the loss. Obviously, if the corporation itself and its officers lack the resources, the accountant becomes the probable target; hence the description "deep pockets." It is this aspect of tort law that has often been proposed worthy of reform, and indeed has been reformed in some jurisdictions. *See, e.g.*, The Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(bX2).

[22] Note, there is inevitably a considerable difference between what is claimed and what is ultimately recovered after settlement or appeal. The latter sum is notoriously difficult to discover. For example, in one recent article the author describes the exposure in terms of "[ijt is claimed..." *See* C.

offer insight. The manufacturer of baby seats who introduces a poorly designed product that kills or seriously maims infants is responsible for injuries caused by its defective product. The attest by the negligent auditor allows the reader to form a false positive impression of the viability of the company, the company fails and the investor loses money. In life, you "win some, you lose some." Some investments work out, some do not. This is a far stretch in the public imagination from the grossly harmed infant. We can see that the infant will require large sums to maintain any quality of life. The argument is far less compelling for the out of pocket investor.[23]

The Accountant:

It is comforting to know that someone has concerns about imposing liability. It does raise the obvious question of why then is the exposure so great? Why should the auditor act as insurer for the company's negligence?[24]

The Lawyer:

And the quick retort is why should the auditors not be responsible for their errors? Every other profession has liability imposed.[25] The value of the audit comes only from the perceived reputation of the professional expressing an opinion."[6] If that same professional does not stand behind that opinion, why pay for it? Certainly liability for any profession or business producing a product with social merit must not be so great as to drive that profession or business out of existence. But as we look at the accounting profession today, there is little evidence it is doing anything other than thriving. Of course the size of claims against the large firms is enormous.[27] but the real growth in the firms is in areas other than the audit/accounting where liability is not of nearly such significance."[8] Let's not wheel

Richard Baker & R. Quick, *A Critical Comparison of Auditors Legal Liability in the United States and in Selected European Countries,* 96, 3 EUR. BUS. Rev. 36 (1996). Baker addresses another common assertion that is said to flow from this same exposure: "It has also been asserted, without evidence, that this increasing exposure to legal liability may reduce the availability of audit services because auditors are more cautious than formerly in undertaking audits of public companies.. ." *Id.* at 36. For example, [ijn the more standard statistics on exposure are cited: for example, "In 1993 the Big Six accounting firms expenditures for settling and defending lawsuits were $1.1 billion, or 11.9 percent of domestic auditing and accounting revenues," Pacini, *supra* note 7, at 45.

23 *See* FELDTHUSEN, *supra* note 10, at 9 - 16.

24 For a discussion of an insurance-like model for the audit, see S. Gunz & J. McCutcheon, *A New Perspective on the Role of the Audit,* J. L & Bus. (1996).

25 However, third party liability is seldom an issue, or at least not a serious issue for most professions, other than accounting, engineering and architecture. Third party liability in auditors liability cases offers the potential for huge awards of damages.

26 *See, e.g.* H.S. Becker, *The Nature of a Profession, in* EDUCATION FOR THE PROFESSIONS., ed. Nat. Soc. for the Study, of Educ. (1962); *See also* T. Johnson, Professions and power (1972).

27 *Supra* note 10.

28 In the areas of real growth, such as consultancy, the firm can shelter itself from liability through incorporation as well as standard exclusion clauses.

out the old Laventhal and Horvath example. Yes, that is one mid-sized, and well- respected, accounting firm that went bankrupt, but that was a long time ago now (1990). It is also interesting that bankrupty was declared *before* the infamous Praise the Lord Club litigation even went to trial.[29] I find it hard to extrapolate from this one, perhaps unique, example.

I suggest that if this discussion is to have value, it should be taken as given that liability should not be such as to drive the responsible auditor out of business. Further, auditors, as with any other service provider, should be able to hedge their risk through adequate insurance coverage if that is their desire.[30] Today there is little evidence of these conditions not being met. They always, however, are valid concerns.

The Accountant:

I accept these conditions. Let me remind you, however, that we must also recognize the different worlds that auditors occupy. The accounting firms best known to the public remain the "big five" multi-nationals. In practice, however, most accounting firms are relatively small and it is these with which the average individual or average business comes into contact

The Lawyer:

Yes. But it is important as well to remember the distinction between the accounting and the audit function. Accountants acting as accountants can restrict liability through standard exclusion clauses. This is a manageable risk exposure and has never been the subject of the current dialogue. Today, the "big five" accounting firms dominate the audit market.[31] In many respects this is a big firm problem. Of course it would be interesting to learn whether liability has hastened the trend towards concentration in the audit market although that is really the subject for another day.[32]

[29] *See* Gary Tidwell, Anatomy of a Fraud: Inside the Finances of the PTL Ministries 192-247(1993).

[30] In the mid-1980's in Canada, for example, the lack of availability of insurance coverage created a genuine crisis in the industry. While this was in part a quirk of the relatively small market being mis-evaluated by its primary underwriter, *see* Gunz, *supra* note 24, the consequence was nonetheless potentially catastrophic. A coming together of accounting firms and their professional organizations eventually ensured that adequate and affordable insurance was available.

[31] For example, one estimate had in 1995 the (then) big six firms auditing 73 percent of the world's companies when measured by number, or 83 percent of the world's companies when measured by a formula that combined sales and assets. *See*, CENTER FOR INTERNATIONAL FINANCIAL ANALYSIS AND Research (CIFAR), International Accounting and Auditing Trends Vol. II, 311 (4.h ed.). Another estimate had the (then) big six firms performing 94 percent (by revenue) and 93 percent (by assets) of US audits. This was said to be a steady number over the past five years. *See* STRAFFORD Publications, Auditor+Trac 5 (1996).

[32] *See* Colin Boyd, The Transformation of the Accounting Profession: The History Behind the Big 5 Accounting Firms diversifying into Law 16, at 9 (1999). Colin Boyd makes the

The Accountant:

Fine. I would like to turn now to the extraordinary divergence in definitions of the role of the audit expressed in the opening comments. I am looking at the two quotations from legal cases in particular, and am amazed at the narrow focus the judiciary is apparently giving to the role of the audit. If describing the role of an audit as being limited to that of providing information to shareholders to use in evaluating management is a method of limiting liability, I am obviously not protesting. However, I have a nagging concern that describing the audit in this fashion is not altogether good news for my profession. It seems a peculiarly narrow description and not one that jibes with my notion of why I do audits. Further, if that is really the reason why audits are performed, why place so much importance upon them? The Chairs of the security commissions (OSC and SEC) would appear to have far broader expectations of the audit, although clearly they are also concerned about the ability of the profession to deliver.

The Lawyer:

You are certainly not alone in your unease with the *Hercules* and *Caparo* definitions.[33] In Canada, the accounting profession considered *Hercules* to be good law for their purposes, although I'm not entirely sure why.[34] As you noted, stating that the audit has such a limited purpose raises immediate questions as to its value. Not surprisingly, the financial press was highly critical of the *Hercules* decision. Indeed it was the position of the press that, if the common law could not provide adequate protection for investors, the regulators/legislators should step in.[35]

I think, however, before we become too critical of the judiciary, it is important to

argument that the move to concentration in the accounting profession encouraged audit clients to consider the audit as a commodity and this in turn led to the aggressive price competition in the audit market. "The sequences of successive mergers of accounting firms may have had an effect on client loyalties within the profession by revealing or reinforcing the notion that audit services are an undifferentiated product If the name of one's auditor changes every single year for 5 years in a row because of mergers, and a different group of personnel comes around each year to perform the audit, and yet the end result seems no different despite all these changes, then the impression can arise that an audit is a commodity which is the same no matter which firm does the work."

[33] *See, e.g.,* Caparo Industries pic v Dickman, [1990] 2 AC. 605. Soon after *Capro,* an editorial in a British professional journal questioned whether this development was good for the profession. *See* Brian Singleton-Green, *Caparo: The Cloud Behind the Silver Lining,* ACCOUNTANCY, Mar. 1990 at 1.

[34] *See* A. Davidson, *Spelling Out Legal Liability as Fraud Goes on to the Agenda,* THE Times, Jan. 14, 1993, as cited in Baker, *A Critical Comparison of Auditors Legal Liability in the United States and in Selected European Countries,* 3 EUR. Bus. Rev. 36, 96 (1996). In 1993, the Auditing Practice Board of the United Kingdom recommended that auditors' responsibilities actually should be increase rather than limited (although this was not widely accepted by the profession).

[35] See, *e.g.,* Philip Anisman, *Investors Need More Protection Against Negligent Auditing,* FIN. Post (Toronto), June 10,1997.

understand the difficulty of the task it has been given. Since the 1931 New York Court of Appeals decision in *Ultramares*,[36] courts in many countries have been concerned about finding the correct balance between the continued viability of the profession and the needs of the public users of the audit report. Indeed, it is safe to say that the *Ulltramares* exposition of the problem, the need to avoid liability "in an indeterminate amount for an indeterminate time to an indeterminate class" has been almost as widely cited in Canada, England, Australia and New Zealand, as it has been in the original jurisdiction of New York.[37]

The judiciary has had a major role in shaping this form of liability in good part because governments have themselves been reluctant to step in and legislate, at least until very recently. It is worth reminding ourselves what form statutory intervention could take. Statutes can allow for accountants to shield themselves from risk through practice management. The impact of risk exposure has traditionally arisen because accountants, like lawyers, but unlike a number of other professions, were not permitted to incorporate, and even where they were, incorporation did not extend to full limited liability.[38] Partnership law exposed accountants to full joint and several liability in most jurisdictions. Partners were responsible, not only for their own negligence, but for that of their partners and this exposure extended beyond partnership assets to personal assets. Introducing more choice in how accounting practices could be legally constructed and/or removing full joint and several liability would go a long way to removing the economic pain of negligence claims.

Another statutory approach would be to limit the tort exposure itself. At one extreme the tort could simply be denied legislatively, although I'm not aware of this ever being seriously proposed anywhere. Alternatively, caps can be put on liability or restrictions can be placed on the types of third parties eligible to make claims.

At various times and in all jurisdictions, the accounting profession has called for legislatures to implement most of these suggestions.[39] There were, however, also important countervailing pressures. It was not particularly clear that there was much political mileage to be made from implementing reforms, and there were obvious political risks. Most important was the spillover effect to other professions, in particular, medicine. While the public in general might be impacted little by limitations to the liability of auditors, the same could not be said for that of doctors. Underlying all of this has been the preponderance of lawyers as legislators. Limiting

[36] Ultramares Corporation v. Touche, 255 N.Y. 170,174 N.E. 441 (1931).

[37] *See, e.g.,* Haig v. Bamford [1976] 72 D.L.R. 68; Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16; Caparo Industries pic v Dickman [1990] 2 AC 605; Esanda Finance Corporation Ltd. v. Peat Marwick Hungerfords [1997] 142 A.L.R. 750; Scott Group Ltd. v. McFarlane [1978] 1 N.Z.L.R. 553.

[38] This denial flowed from the notion of the social contract the professional enters into. *See* Gunz *supra* note 24.

[39] For example, CORAL in Canada; *see* Gunz *supra* note 24. In the United States, *see* ARTHUR ANDERSON & CO ET. AL. THE LIABILITY CRISIS IN THE UNITED STATES: IMPACT ON THE ACCOUNTING PROFESSION (1992).

the liability of lawyers would likewise be a political hot potato, and while their risk exposure remained, there was little incentive to extend protection to auditors, however much greater was their exposure. Although it is hard to document this debate, the outcome is obvious: until relatively recently there were few effective legislative initiatives that would reduce liability.[40]

Today, you will be relieved to hear that many jurisdictions have enacted one of these legislative reforms,[41] although interestingly, sometimes these changes have occurred with remarkably little public notice.[42] Perhaps politicians still see this as something of a political minefield.

The Accountant:

I understand the legislative changes but I want to come back to my earlier concern because this ties in with some of what you have just described. You were right in noting my discomfort with the *Hercules*[43] pronouncement. In fact I have the same kind of concerns about the "near privity"[44] concept. I believe that professionals should stand behind their product and I am uneasy with any solution to the very real liability exposure accountants face that essentially removes the obligations I have to third parties. Levitt and Brown argue that the audit has a critical part to play in the capital markets.[45] I do not see how we as auditors can say this, command the respect we deserve and value, and, at the same time, claim that we have no direct responsibility to most of the people who might actually find our work useful. For these reasons, I am much more comfortable with the kind of protections that limited

[40] *See* Report to the Ministerial Council on the Civil Liability of Company Auditors (SepL 1986). Proposed legislation did no« often reach the stage of public debate and the reasons for the failure either to instigate the profession's proposals or to proceed with legislative initiatives were seldom disclosed. For example, in the mid-1980's a major proposal to cap liability of auditors in Australia following the unprecedented damages award in Cambridge Credit Corporation & Anor. v. Hutcheson & Ors. [1985] 9 A.C.L.R. 545, *overruled;* Alexander & Ors v. Cambridge Credit Corporation Ltd. & Anor [1987] 12 AC.L.R. 202, came close to implementation. Somewhat unexpectedly, the proposed reforms stopped, with the suggested motivation being a sudden lack of will on the part of certain State governments following reconsideration of the implications for medical liability. *See* Gunz, *supra* note 24 at 40.

[41] In Canada the changes have primarily addressed practice management issues. For example, some provinces now allow limited liability partnerships which address concerns for joint and several liability, in Ontario, Partnerships Act, R.S.O. ch. P-5, § 10(2) (1990) (Ont.). Only the partner responsible for the negligent work (and potentially any other member of that audit team) is responsible for the loss, although in practice, such risk is usually spread across the partnership in general through partnership indemnification agreements. Should the partnership itself fail, individual partners are now no longer held personally responsible for damages arising out of the work of other partners. Contrast this with the approaches that limit liability itself. In the United States, several states have introduced a near privity regime that effectively eliminates third party liability for auditors. *See*, Carl Pacini & David Sinason, *Slate Legislative Responses to the Call for Reform of Accountants'Liability to Nonclients for Negligence*, 6 J OF
Legal stud. IN Bus. 45,47, 53 - 66 (1998). *See* discussion at *supra* note 7.

[42] *See, e.g.,* Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4(bX2).

[43] Hercules Managements Ltd. v. Ernst & Young, [1997] 2 S.C.R. 16.

[44] Pacini, *supra* note 7.

[45] *See Corporate Earning: Who Can You Trust?* BUS. WEEK, Oct 5,1998 at 133-162.

liability partnerships and their equivalent provide, though I recognize that in jurisdictions where verdicts are enormous, this might still not provide adequate protection.

Before we move to what I consider to be at the heart of the dilemma we as accountants face, I am still curious about how the court in, say, the *Hercules* decision, managed to come up with what I consider to be such a patently absurd description of the purpose of the audit?

The Lawyer:

This decision came out of the difficulty courts left without legislative guidance have had in defining to whom the accountant is responsible. In pure negligence, responsibility is owed to "reasonably foreseeable" persons.[46] If that were the case with auditors, clearly most investors relying for their investment decisions on the audited financial statements would be able to establish liability if the auditor were negligent and as a result the investment went sour.[47] In other words, this is precisely the kind of unreasonable and even catastrophic exposure that everyone has feared since Judge Cardozo first addressed the issue in *Ultramares*,[48]

In order to avoid just this scenario, judges in many jurisdictions came up with a test that said auditors can be responsible where they have "actual knowledge of the limited class that will use and rely on the statement."[49] While this test was reasonably effective, it still left open obvious questions such as how many persons comprise a limited class.

The Supreme Court of Canada in *Hercules*[50] was trying to end the debate about how to define duty of care. It said there is only one tort of negligence and it applied another English case of *Anns* v. *Merton*.[51] This case provided a two step test, the first being the longstanding one of foreseeabiity and the second requiring an

[46] *See* Donoghue v. Stevenson [1932] AC. 562 (H.L.). The classic statement by Lord Atkin of the duty of care was, '*[y]ou must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be -- persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called in question." *Id.* at 580.

[47] This was the test introduced in New Jersey in Rosenblum v. Adler, 461 A2d 138 (N.J. 1983), and likely was the impetus for the near privity legislation now in place in that state. The test applies still in Mississippi and Wisconsin. *See* Pacini & Sinason, *supra* note 41 at 52-53, 58.

48 Ultramares Corporation v. Touche, 255 N.Y. 170, 174 N.E.441 (1931).

49. Haig v. Bamford [1976] 72 D.L.R (3d) 68. This is a very similar test to that in the RESTATEMENT (Second) OF Torts § 522 (1977) and presently used in 18 states of the United States. *See* Carl Pacini & David Sinason, *State Legislative Responses to the Call for Reform ofAccountants' Liability to Nonclients for Negligence, 6* J OF Leo STUD. IN Bus. 45, 50-52 (1998).

50 Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16.

51 Anns v. Merton London Borough Council [1978] AC. 728; *see also* City of Kamloops v. Nielsen [1984] 2 S.C.R. 2.

examination of whether there are any policy reasons for placing tighter bounds than foreseeability. It was in the course of this exercise that the court turned to the corporations legislation that creates the statutorily mandated audit[52] As with the House of Lords in *Caparo,*[53] the court interpreted the legislated purpose of that audit as being solely for existing shareholders in order to evaluate the performance of management on an annual basis. If any other investors wished to bring themselves within the scope of audit responsibility, they would be obliged to establish a relationship of privity, presumably by written exchange between the auditor and themselves prior to the conduct of the audit.[54]

Accountant:

So, in principle, if the legislators wished, they could always change the various corporations legislation in Canada and expand the purpose of the audit.

Lawyer:

Yes.

Accountant:

Underlying all this dialogue is something else that has always troubled me. It seems to me that if I drive over your toe, and you sue me for damages alleging that my negligence broke that toe, you would still have to prove that my actions actually caused both the fracture and any subsequent damages you now suffer. To take it to the absurd, if your livelihood and quality of life have always depended on your ability to balance on the other foot at all times, you are unlikely to receive much in the way of damages.

Using this analogy, I am confused as to why there is not an obligation to prove in an auditors' liability claim that the investor plaintiff actually used and relied on the audited financial statements and that reliance caused the loss. I am not even sure that the average investor can understand financial statements.[55]

[52] The audit in Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R 16 was prescribed under the Corporations Act, R.S.M. 1987, c C225, ss. 149 (1), 163 (1).

53 Caparo Industries pic v Dickman [1990] 2 AC 605.

54 See, Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16 and Caparo Industries pic v Dickman [1990] 2 AC 605. In Canada, and particularly in Quebec, some major institutions such as banks have been requesting privity letters since the Hercules decision. The Assurances Standards Board of the Canadian Institute of Chartered Accountants is now examining the issue. To the best knowledge of the authors, privity letters are not being supplied at present in Canada, and there will be obvious reluctance to change this practice because of the potential risk exposure. The privity letter approach would be similar to that suggested under some of the statutory regimes introduced in the United States.

[55] Standard setters recognize that financial statements are complex and users require a certain background in order to be able to understand accounting information. "Users are assumed to have a

We know that the public is often mistaken as to what an audit does,[56] and that few auditors and managers understand what information is relevant to, or used by, investors as they make investment decisions.[57] In the case of publicly traded corporations, there are innumerable sources of information above and beyond audited financial statements.[58] In many auditor liability cases, it is unclear whether the plaintiff actually ever read the audited financial statements. If this is the case, how has liability ever been imposed (at least with public companies)?

Lawyer:

You are quite right. Indeed, the SEC perceived this to be such a burden that it actually imposed a "deemed reliance" regime.[59] Certainly all jurisdictions have incorporated the notion of reliance as with negligence in general, but it is my suspicion that the inability of accountants and lawyers ever to truly understand wh& each other does, led to the reliance aspect of proof being mishandled or given short

reasonable understanding of business and economic activities and accounting, together with a willingness to study the information with reasonable diligence." *See* CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS, CICA handbook, § 1000.19 (2000). It is open to question whether all, or even most, users have such a background. Marianne M. Jennings, et al, *The Auditor's Dilemma: The Incongruous Judicial Notions of the Auditing Profession and Actual Auditor Practice*, 29 Am. Bus. L.J. 99 (1991) described the general state of understanding on the part of non-accountants thus: "The perception of the public and many lawyers and judges is that accounting is a precise science akin to math and that when financial statements are contained in mandated securities filings, those statements are accurate with very little error in the numbers that appear. However, not knowing the accounting rules for 'booking' an item or understanding their flexibility and the fact accounting is as much an art as a science can prove costly to an investor. Given the same set of financial data, different auditors could produce different results and yet all results could be consistent with the rules...." *Id.* at 99-100. *See also,* D. Jordan Lowe, *The Expectations Gap in the Legal System: Perception Differences Between Auditors and Judges,* 10 J. APP. Bus. RES. 39 (1994).

[56] The standard definition of the "expectations gap" can be found in ARENS, *supra* note 6 at 94: "[The] conflict between statement users and auditors often arises because of what is referred to as the *expectation gap between users and auditors.* Most auditors believe that conducting an audit in accordance with generally accepted auditing standards is all that can be expected of auditors. Many users believe auditors guarantee the accuracy of financial statements, and some users even believe the auditor guarantees the financial viability of the business." *Id.*

[57] Surprisingly, little is known about how economic decisions are made. *See, e.g.* TORONTO CICA Corporate Reporting: Its Future Evolution: a Research Study, 48-49 (1988).

58 Sources include print and electronic media, financial analysts and company press releases.

[59] By "deemed reliance" is meant that there is no onus upon the plaintiff to prove reliance upon the audited financial statements. *See* Securities Exchange Act of 1933 §§ 11, 12(aX2) (relating to misstatements made during public offerings, whether in audited financial statements or not). The onus then shifts and the defendant must prove that the plaintiff lacked reliance (an "affirmative defense"). *See* Securities Exchange Act of 1934 § 10(b). Rule 10b-5, has a reliance requirement for plaintiffs, but if the plaintiff s main claim is that a fact was omitted by the defendant's disclosure, proof of reliance is excused (how can you prove you relied on something that was hidden from you?). If the main claim is that there was a misstatement, then the plaintiff must prove reliance. If the stock involved is that of a widely traded company, the 'fraud on the market' theory can be used by the plaintiff. Under this theory, the plaintiffs must prove that, although they did not see the misstatement with their own eyes or rely on it directly, institutional investors, market analysts and others whose actions set the market price did see it and were misled.

shrift in all but the most obvious eases.[60] That and the preoccupation of the courts with attempting to define "duty of care" as a means of curtailing unlimited liability.

Accountant:

This leads to another issue. The moderator of this session referred to the extraordinary changes in the accounting profession in her opening remarks. Indeed today, the big firms don't even call themselves accounting firms any more, but rather professional service providers.[61] The five multi-nationals are getting larger and larger but the audit today accounts for less and less of their revenue.[62] This troubles many of us who are more traditional accounting professionals. In most of the big five firms today the non-audit work contributes the majority of revenue.[63] This leads us to question whether the standards that make this profession unique, and have earned it the public respect that allows it to expand into other fields will prevail within the firm.[64] We are left to wonder whether, even in the relatively short term, there will be little left to distinguish, at least the major accounting firms, from service providers in general.[65] When I add to this mix a legal regime that tells users of audited financial statements that either there is no responsibility assumed by the accountant for negligence whatsoever, or, if there is, it is limited to those who used the audited statements for a purpose that is so narrow as to be virtually irrelevant in practice, I become deeply concerned.

Lawyer:

[60] An example of where the lack of reliance was argued fully and successfully was Toromont Industrial Holdings Ltd. v. Thome, Gunn, Helliwell & Christensen [1976] 62 D.L.R. 225, 234-36.

[61] For example, the Ernst & Young home page describes the firm as being "one of the leading professional services organizations..." and makes no mention of the audit/assurance function on its home page under "We're Here to Help". *See* http://www.ev.com/global/gcr.nsf7Intemational/Welconie - About Us, (visited Sept 19, 2000). The PricewaterhouseCoopers home page provides the following information under "About Us": "A1 PricewaterhouseCoopers, we measure our success by yours. Everyday, our 150,000 people in more than 150 countries go to work to help our clients succeed. From Dublin to Durban, from Minneapolis to Manila, our job is channeling knowledge and value through six lines of service and 22 industry-specialized practices. We are global, and because we are global, we are local — there to serve you wherever you are." It is only two clicks from the home page that the reader finds the first mention of "audit, assurance and business advisory services" as one of the six lines of service, http://www.pwcglobal.com/gx/eng/main/home/index.html (visited Sept. 19,2000).

[62] *See* BOYD *supra* note 32.

[63] *See id.* There are even suggestions that the majority of new "partners are no longer accountants, although the true figure is very hard to uncover, as legal restrictions in some jurisdictions prevent or discourage non-accountants from being in a partnership position in the firms.

[64] As auditing forms a declining portion of the Big Five firms' business, it follows that the influence of the auditing area on the culture of the firm will also decline. Certainly the declining fortunes of auditing have promoted political strife within firms.

[65] The issue is whether the accounting firms will retain the essential elements of a profession.

[66] In practice, the consequence of a *Hercules* or *Caparo* type claim would most obviously be a derivative action on behalf of the company; the shareholders would claim that the company was harme because they were mislead as to the quality of the management (a derivative action was, in fact, suggeste by the court in Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16). It is almost impossi e to envisage any successful direct claim on behalf of the shareholders themselves.

I understand. But now I want to ask you something that I don't understand. The audit we are describing is of the financial statements. These financial statements are an historic picture of the company's performance for a period; they also describe the financial position as of a certain date. Some of the information relates to events which may have occurred some months prior to actual publication.[67] If I were a defence attorney in a claim brought where reliance is a required element, I would argue that this historic information is in fact a poor substitute for all the other much more useful sources of information available to me about the company. Indeed, the very fact that a company can petition itself into bankruptcy the day after an auditor has provided a clean audit opinion, and yet it be the case that the auditor acted properly and in accordance with Generally Accepted Auditing Standards (GAAS),[68] suggests to me that there is something fundamentally wrong with this "product" today.

The Accountant:

Ah, the expectations gap. The interesting thing is that we, the accountants, so often say we should bridge this gap by educating the public so that it sees the world as we do,[69] yet maybe we simply have our heads in the sand. I accept that my thoughts on this issue are not those of many of my colleagues, and certainly not our professional associations, but I wonder if it is not time for us to consider a radical change in how and what we attest to.

The attentions of accounting standard setters seem to be directed to endless attempts at further refining the existing reporting model. I am starting to doubt whether the standard setting process can possibly deliver what is required. Perhaps an example would help. There is little doubt that in many organizations and industries, intellectual property and innovation are the key elements of value. However, due to accounting measurement conventions, these items rarely appear on balance sheets. This creates the odd situation that high technology firms typically have balance sheets consisting of all sorts of elements but not those that created value.[70] I wonder

[67] Annual financial reports for public firms under the SEC jurisdiction must be filed within 90 days of the end of the reporting period. Rule 3-01 of SEC Regulation S-X. In practice, most are released within six weeks of the end of the reporting period. The income statement will contain information that is up to 13.5 months old. It is important to note, however, that this information has already been issued, albeit in highly abbreviated form, in interim financial statements.

[68] GAAS are generally accepted auditing standards developed by the profession - in Canada by the CICA and in the United States by the AICPA.

[69] "Fortunately for the profession, the courts continue to support the auditor's view. Unfortunately, the expectation gap often results in unwarranted lawsuits. Perhaps the profession has a responsibility to educate financial statement users about the role of auditors and the difference between buiness failure, audit failure, and audit risk. Realistically, however, auditors must recognize that, in part, the claims of audit failure may also result from the hope of those who suffer a business loss to recover damages from any source, regardless of who is at fault." Arens, *supra* note 6, at 94.

[70] The assets in the Balance Sheet in the Microsoft 1999 annual report totaled $31.156 billion but did not include any assets developed through research and development efforts. The notes to the

about the relevance of such a balance sheet and certainly would not be surprised if decision makers seek out alternate information sources.[71]

I sometimes wonder if the conventional reporting process will continue to move towards irrelevance at least in the case of public firms. Certainly the status quo does not appear viable. A number of influences are converging to make it essential we rethink our financial reporting processes. Specifically, the vast expanse of information available to users electronically and the speed with which information can be processed and reported suggests to me that a form of continuous reporting is in fact today the norm, whether or not it is in fact recognized. The issue is that there is no assurance given to its quality. Perhaps this is to be expected given the hodgepodge of sources - everything from company pronouncements to rumors. I appreciate that there is little that can be done about information from non company sources but I wonder if we cannot formalize some sort of continuous reporting. I have no doubt that users increasingly expect continuous information about firms. It will become increasingly difficult to defend a regime where "official" information is normally only issued quarterly and annually.

The accounting profession is aware of the limitations of the current reporting system. A recent CICA report noted that the emphasis of periodicity of reporting must shift to a more continuous stream of information, and standard setters should be pro-active in establishing a disclosure framework.[72] The report predicts a diminishing role for traditional financial statements as alternate reporting becomes more important. I believe it remains to be seen whether standard setters can move quickly enough to prevent the usurpation of accounting as the prime source of information concerning public companies. To make things even more complicated, although the forces of change relate to public firms, standard setters have taken the stance that accounting rules should be basically the same for all sizes of firms.

It is important to appreciate the linkage between financial statements and audits. The current financial reporting system is not a precondition to an audit. Auditors can and do perform attests on all sorts of different information and there is certainly no reason why audits could not be conducted on continuous or other forms of disclosures.

The Lawyer:

financial statements state that research and development expenditures are charged to income as incurred in accordance with Statement of Financial Accounting Standard 86.

[71] The current accounting model fails to account for about 60 percent of the assets valued in the marketplace by investors. *See, e.g.,* David L. Landsittel, *Auditing: Some Current Challenges.* Speech to the American Accounting Association 2000 Auditing Section Midyear Conference, (Jan. 14, 2000), at 10 httD://raw.rutgers.edu/raw/aaa/audit/midvear/OOmidvear/speech.htm. Mr. Landsittel is a former partner, Arthur Anderson and past Chair of the A1CPA Auditing Standards Board and Chair, Auditing Standards Board Fraud Task Force.

[72] GERALD TRITES, IMPACT OF TECHNOLOGY ON FINANCIAL AND BUSINESS REPORTING, CICA (1999).

Following that train of thought, where does that lead the audit function? Put another way, what, under a new regime, would be the value an audit adds to the existing information? Why would an independent professional even be necessary?

The Accountant:

That comes back to what the capital markets need. They need assurance that the information they rely upon, is, indeed, reliable. There can be little doubt that investors value audited information. Even a small deviation in reported (audited) earnings compared to analyst and investor expectations is likely to trigger an investor response that will have a major impact on the firm's market capitalization.[73] We should be looking at how to enhance the quality of disclosure to users by expanding the base of disclosures that are subject to an attest.

The Lawyer:

So the auditor would become, in a sense, the whistle blower. If the auditor, reviewing information emanating from the company, discovers that it is less than accurate, there could be no equivalent of a "clean" audit report attached to that information. I realize that there are still many other sources of information put out by others, but, presumably, they could only receive the stamp of approval from the auditor if that auditor were hired specifically to review them. [4]

The Accountant:

The whistle blowing analogy is troubling. We know auditors today are not responsible for uncovering fraud; they only react to "red flags" that should be obvious to them if they undertake a prudent audit.[75] Auditors do not investigate or review every transaction but instead utilize statistical sampling and audit software. Increased levels of assurance could be achieved by larger sample sizes and other tests but at a significant cost. Companies are not willing to pay for higher levels of assurance although it is possible that users of financial statements (who do not pay for audits) would appreciate a higher level of assurance. Information still comes from management whether on an historic or continuous basis, and, as such the depth to which the auditor can go is purely a function of balancing risk and the probable

[73] *See id.; see also* Landsittel, *supra* note 71 at 2. Landsittell states that the aggregate reduction in the cost of capital that results from audits far exceeds the total cost of those audits.

[74] Note, this would be very much like the attest process developed for e-commerce sites by the AICPA and CICA. *See* Carl Pacini & David Sinason, *Auditor Liability for Electronic Commerce Transactions Assurance: The CPA/CA Web Trust*, 36 AM. BUS. L.J. 479 (1999). Other industries, for example investment counselors, might find value in providing similar assurance to users.

[75] *See, e.g.*, J.E. Boritz, *Positive Accounting Theory, Management Fraud and the Auditor* in Gordon D. Richardson & Patricia L. O'Malley, Ethics and Positive Accounting Theory 149
(1995).

economic benefits from expanding the scope of the audit. As an aside, it is interesting to note that there are signs of a renewed interest amongst auditing firms and others, in the prevention and deterrence of fraudulent financial reporting.

The Lawyer:

I would like to ask you another question. The quotes from Levitt and Brown came from very controversial speeches in which they were highly critical of the auditors' ability to audit effectively given the pressures from companies wishing to apply aggressive accounting practices. As I read these speeches and many others in the press,[77] it seems to me that there are real concerns about present auditing practices. How fair are these criticisms and is it possible for auditors to do what regulators want?

The Accountant:

These observations are certainly not new. Present aggressive accounting practices are very much a function of the markets' interest in short term performance. Managements are also not necessarily effective in communicating with the marketplace to assure that analysts' and investors' expectations are aligned with likely results.[78] The absence of an attest on non-financial statement communications may also create an environment where management is less cautious or forthright than should ideally be the case. The aggressive accounting practices undoubtedly reflect what we were talking about before. The accounting information that is now provided and to which the auditor attests is not as useful as it could be.

Can regulators impose their expectations upon auditors? They can and will certainly try to enforce them. Indeed, the SEC has been signaling its unhappiness with accounting excesses and the efficacy of the audit process.[79] A cynical view of the public utterances from Levitt and Brown is that they are part of a response to criticisms leveled at them for their organization's recent performance.[80] While their comments have real value, the fundamental flaws in the system remain unaddressed.

And we haven't even begun to consider the roles of the profession's standard setters. They are fixated with improving the current model. What is required instead is a sort of paradigm shift to match reporting with information technology.

76 *See* Landsittel, *supra* note 71 at 6.

77 *See, e.g.. Corporate Earnings: Who Can You Trust?* Bus. WEEK Oct 5. 1998 at 133-162, Holman W. Jenkins, Jr., *Abused Accountants Say 'Take this Job and... '* The WALL STREET JOURNAL, Jan. 19, 2000, at A23.

78 *See* Landsittel, *supra* note 71 at 2.

79 *See Fighting Accounting "Hocus-Pocus,"* PricewaterhouseCoopers Solutions Securities Litigation Newsletter (1999) at 6. The Chairman of the SEC has also gone on record as being strongly supportive of high quality accounting standards. Arthur Levitt, *The Importance of High Qua ity Accounting Standards*, Accounting Horizons, Mar. 1998 at 80.

80 *See, e.g., Corporate Earnings: Who Can You Trust? " supra* note 77, at 133-162.

Moderator:

I like the way you two are heading. Is it possible now to get some consensus on your respective positions?

The Lawyer:

Let me begin with my own profession. I have been far from happy with the direction both the judiciary and legislators have been taking us in restricting the liability of auditors. While I understand perfectly well that some of the excesses of litigation,[81] particularly in the United States, had to be addressed if the accounting profession is to remain viable, I do not agree with the extent to which these decisions have, in so many cases, virtually ruled out the possibility of a successful third party action

At the same time, maybe the pronouncements in cases such as *Hercules*[82] and *Caparo*[83] are not so far off the mark after all. What the judges are doing in their interpretation of the purpose of an audit is identifying the fundamental flaws in the exercise.[84] If what is audited is historic financial statements, no prudent investor should completely depend upon the opinion for a future investment decision. Rather, investors should be doing what they are undoubtedly already doing, and relying on other, more current, sources.

The Accountant:

And the regulators are fulfilling a similar role. In questioning the ability of the auditor to withstand the pressure from the client to implement aggressive accounting practices, for example, they question the heart of what it is to do an audit; namely, to maintain independence.[85] Yet, why is this independence threatened? Because what

[81] An example of this excess relates to law firms who track stock performance, contacting shareholders when there is a drop of more than a certain percent in share price. The intent is to gather a critical mass of plaintiffs to ensure a class action of sufficient size in order to act as incentive for the auditor to settle. Even a relatively low settlement is adequate on a cost/benefit basis for plaintiffs and their lawyers. Under these scenarios, the existence of negligence or otherwise on the part of the auditor is virtually irrelevant

[82] Hercules Managements Ltd. v. Ernst & Young [1997] 2 S.C.R. 16.

[83] Caparo Industries pic v Dickman [1990] 2 AC 605.

[84] This is, of course, a two-step process. The judges are interpreting what the legislature has said is the purpose of the audit.

[85] The issue of independence is at the forefront of much of the debate about multi-disciplinary practices ("MDP"s). It has been argued that this trend, and the constant push in general to extend the range of services provided by accounting firms, threatens independence. *See, e.g.,* Roy Suddaby & Royston Greenwood, *Multidisciplinary Practices Catch Regulator's Eye,* GLOBE & MAIL, Jan. 31, 2000, at Ml. Also, the House of Lords expressed concerns about the ability of the firms to maintain "Chinese walls" and maintain client confidentiality with MDP's (in this case, litigation support services); Prince Jefri Bolkiah v KPMG [1999] 2 AC 222. In the U.S., the investigation of conflict of interest violations at PricewaterhouseCoopers ordered by the SEC resulted in a highly publicized report of numerous violations

is being audited has in fact limited relevance given the plethora of information available. What users need is continuous information in order to make informed investment decisions. The auditors' independence in evaluating the reliability of this corporate generated information is critical. Of course the auditor will continue to be under pressure from management wishing to present information in the most favourable manner. Withstanding that pressure goes to the heart of what it is to be a professional. This will always be made easier, however, when the activity itself is worthwhile.

The Lawyer:

Returning to the issue of legal liability: if what is now to be audited (presumably because of changes to the relevant legislation/regulations) is of direct relevance to the investment decision, the very limited perspective of liability we see now, at least in Canada and the United Kingdom, should change. The proviso would remain, however, that claimants must prove causality and reliance. Of course, whether or not the judiciary makes the appropriate shift would be open to question. This would certainly be an interesting test of how well it understands the purpose of the audit and its role in capital markets.

The Moderator:

Can we agree on a series of statements/propositions that describe where we are now and where we believe we should be heading?

Both:

Yes

Final Statement presented jointly by Accountant and Lawyer:

by the firm. *See*, Lankier Siffert & Wohl LLP, *"Report of the Internal Investigation of Independence Issues at Pricewaterhousecoopers LLP,"* SEC, AP File No. 3-9809 (Jan. 6, 2000). The fact that most violations were minor was of little relevance. Note; it has been suggested in The Economist February 26 - Mar. 3, 2000, that this report is a cause of the recent announced division of the PricewaterhouseCoopers firm into three — accountancy, consultancy, and other services — although it is difficult to see how such a major change could have come about so rapidly. Indeed it is far more likely that the change was planned over a far longer term and had similar motivations to that which took place at Arthur Andersen. *See, Lawyers Go Global: The Battle of the Atlantic*, 454; *see also* 8159 THE ECONOMIST 79-81 Feb. 26, 2000. They highlighted the difficulty (impracticality) of implementing current policies in the enormous, and diverse firms. It has been concluded that "The recent cases are effectively rejecting the trust-us stature. MDP's are being pushed to provide more compelling and visible assurances that conflicts of interest and independence are being successfully managed. How MDP's will convince external agencies that they are acting professionally is neither clear nor easy. One problem is that no matter how professional they are, public perception of the MDP's is easily affected by isolated blemishes. There is, however, at least one answer to the problem of auditor independence, which would be a partial answer to the risk of conflicts of interest: Divest the audit function." Suddaby at Ml.

Proposition One: Proper functioning of capital markets will continue to require a prominent role for the audit or attest. The role of the profession that conducts the audit/attest will be to ensure organizations report financial statements to investors and creditors with a high degree of integrity.

Proposition Two: The difficulty today that the judiciary and regulators have in defining the scope of auditors' responsibilities is an inevitable consequence of the dated reporting model presently utilized by the accounting profession.

Proposition Three: In a world of a constant and rapidly changing flow of information, the presentation of historic financial data on a periodic basis is not competitive with other information sources. This "dated reporting model" does not satisfy the audit/attest function dictated by Proposition 1.

Proposition Four: The law and regulators are reasonably well prepared for a new reporting and, therefore, new attest fimction. If the accounting profession fails to change its product, the modem accounting firm may continue to thrive, but the audit as it currently exists will be rendered obsolete. This consequence will place at risk the continued status of accounting as a profession. Other products and other professions will fill the vacuum.

Proposition Five: Under a new audit model, auditors must be prepared to assume responsibility for their own work. They should be held liable if the user relied upon the information in the intended manner and that reliance caused their loss. The auditor will continue not to be responsible for management fraud, other than that which a reasonably responsible auditor would have identified.

Moderator:

Thank you for participating in this dialogue and for your propositions to increase the usefulness of the attest function.