AUDITOR LIABILITY IN CANADA: THE PAST, PRESENT and FUTURE

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Introduction

The liability of auditors to the readers of financial statements and the auditors' report thereon has recently garnered national attention in the financial press, within the accounting profession and from securities regulators. Much of this attention arose from the May 1997 decision of the Supreme Court of Canada in the case of *Hercules Managements Ltd.* v. *Ernst & Young*[1] and the refusal of the Supreme Court of Canada in November 1997 to hear an appeal from the B.C. Court of Appeal in *Kripps* v. *Touche Ross*.[2]

This paper is intended to provide an analysis of the relevant jurisprudence over the past 60 years, which culminated in *Hercules Managements* and *Kripps*. The analysis will examine the foundation and the development of the common law tort of negligent misrepresentation (or negligent misstatement), while attempting to provide insight into the rationale of the judiciary as it guided the development of the law underlying civil liability of auditors to third parties.

We will attempt to provide a tentative prediction of the future of auditor liability, particularly given the ever-growing need on the part of various users of financial information for new assurance services. Such a prediction can only be tentative, however, given the drastic changes taking place in the manner in which financial information is made available today to users and the role of auditors in providing assurance thereon.

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[1] [1997] 2 S.C.R. 165.

[2] [1997] 6 W.W.R. 421.

Auditors' Liability Generally

From a civil liability perspective, there are four principal sources of auditors' liability. First, certain statutes (notably securities legislation) impose liability on auditors and others who participate in the production of offering memoranda or prospectuses and in so doing, often set out specific rules that would govern that liability. Since these rules are statute-specific, we will not be dealing with them in this paper.

Second, an auditing engagement is a contract between the auditor and the company. Accordingly, the auditor will be liable to his client for breach of contract where he has failed to deliver the product or delivers something which is flawed. Although audit contracts tend to be fairly standard in practice across the country, it is possible for there to be specific differences from contract to contract which would have a bearing on liability issues. Moreover, certain concerns discussed by the Supreme Court of Canada in the *Hercules* decision regarding the spectre of indeterminate liability do not arise in a purely contractual setting, where there is only one professional and one client. Finally, the professional client relationship is a two-way street, with management being responsible for representing the truth to the auditor, which can give rise to fairly complex factual and legal questions on the issues of reliance and damages. For these reasons, contractual liability will not be a focus of this paper.

Third, the law of fiduciary duty is currently the subject of change and development in Canadian law. The Supreme Court of Canada decision in *Hodgkinson v. Simms*[3] made it apparent that the highest Court in Canada is prepared to find a fiduciary relationship more readily in a professional context than in an ordinary business context. The finding of a fiduciary relationship imposes serious additional obligations on the fiduciary and leaves her open to an assessment of damages which might be significantly greater than those damages which would normally be assessed at common law. Once again, we leave comment on that subject for others.

This brings us to the fourth principal source of auditors' liability, and the one on which we choose to focus, namely tort. Not too long ago (in the history of law), an action for damages arising out of negligently spoken words could not be sustained if the plaintiff merely suffered "pure economic loss". It was only mid-way through this century that U.K. Courts accepted that a plaintiff who had not suffered physical loss or damage to his person or property, could sue for negligent misrepresentation.[4]

Given the recent vintage of this tort of negligent misrepresentation, it is not surprising that the rules which govern it are not yet clear and that there are very few

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[3] [1994] 3 S.C.R. 377.

[4] *Hedley Byrne and Co. Ltd.* v. *Heller* [1964] A.C. 465 (H.L.).

cases in which the rules have actually been applied to specific fact situations. It is now relatively clear that there are five essential ingredients to the tort of negligent misrepresentation.[5] First, there must be a duty of care between the plaintiff and the defendant based on a "special relationship" between them which justifies judicial intervention in their dispute. Second, the statement or representation which was made must be false or misleading. Third, the person who made the statement or representation must have done so negligently. Fourth, the plaintiff must have relied reasonably on the representation. Fifth, the plaintiff must have suffered damages as a result of that reliance.

As indicated above, although each of these issues raises specific legal complexities which at times can be difficult to apply to specific fact patterns, we will be considering the duty of care issue (the first issue cited above) and the standard of care issue (the third element cited above). Further, in order to offer insights as to where auditors and the tort of negligent misrepresentation are likely heading, it is necessary to consider where the law in Canada currently stands on these issues. Moreover, in order to understand the law as it reads today, one must understand the legal rationale of yesterday as expressed by courts in Canada, Britain and the United States. Hence, it is necessary to examine the past as well as the present before considering the future.

The Duty of Care

The Early Years

It may surprise disciples of British jurisprudence to read that the Americans addressed the subject matter of auditor liability some sixty years ago, and that American legal rulings were the predominant guiding light on the subject matter of auditor liability for the following thirty years. The American courts did not have any particular concerns about creating a new basis for liability. Nor, it would appear, were the courts in the U.S. concerned with issues such as the standard of care which society believed should govern the conduct of auditors, or the particular circumstances in which the report of the auditors was issued. To the Americans, the most litigated issue was the scope of the duty of care owed by auditors to third parties. In other words, just how far would the parameters of auditor liability in the U.S. be extended?

The leading American cases which formed the basis for the subsequent development in British jurisprudence of the tort of negligent misrepresentation were *Ultramares Corporation* v. *Touche*[6] and *Glanzer* v. *Shephard.*[7] In *Ultramares* the

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[5] *Queen* v. *Cognos Inc.*, [1993] 1 S.C.R. 87.

[6] (1931) 174 N.E. 441.

[7] (1922) 233 N.Y. 236 [hereinafter *Glanzer*].

auditors were retained to express an opinion on the financial statements of a publicly traded corporation. In these circumstances, it was to be expected that the issue of the scope of liability of the auditors to third parties would be argued before the Court, given the expected and actual widespread distribution of the financial statements and the auditor's report attached thereto. The critical issue, as described by the Court, was not the purpose — intended or actual — of the auditor's report, but rather, the number of the actual users of the audit report. Given the widespread distribution of the audit report, the Court concluded that the risk of "liability in an indeterminate amount for an indeterminate time to an indeterminate class"[8] precluded the extension of the scope of the duty of care to the world at large. The U.S. Supreme Court ruled, in essence, that the auditors did not owe a duty of care to unforeseen or unintended users of their audit report, regardless of the particular use to which the report was actually put.

As circumstances might well dictate, the subsequent leading case from the U.S. — *Glanzer* — involved an auditor's report being used not only for the intended purposes, but, also, being used by the intended users of the report. In *Glanzer*, the Court focussed on the actual versus intended users of the audit report, and concluded that, since the actual users and the intended users were in fact one and the same, there was no concern regarding "liability in an indeterminate amount for an indeterminate time for an indeterminate class". The purpose of the audit report — a special purpose report intended to facilitate an investment decision as opposed to a traditional year-end audit report on the financial statements of the enterprise — drew no special consideration from the Court. As we shall point out later, such a distinction has gained paramount importance in British and Canadian jurisprudence.

Thus, the purpose underlying the audit report appears to have played no significant role in early American jurisprudence on auditor liability. The only element of significance appears to have been the identity of the "users" of the audit report, and their relation ship to the extent of the scope of the duty of care to be imposed upon the accounting profession. Different considerations may have played a more pivotal role if *Ultramares* had not involved a publicly traded company, thereby precluding concerns about indeterminate liability to an indeterminate class of users. Nevertheless, the concerns of the American courts in these early cases with respect to the scope of the duty of care were to shape the development of British and Canadian jurisprudence for many years to follow.

The Developing Years

A number of early British cases witnessed a distinction by the courts between liability in negligence for physical loss or damage to one's person or property, and liability for economic loss. The distinction flowed, at least in part, from a concern that one should

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[8] *Supra*, note 6 at 444.

not be held liable for one's spoken or written word to a party whom one may not have ever met, and with whom one had no contractual or fiduciary relationship. A number of other British cases denied any basis for liability in such circumstances. Hence, the law in England was, to say the least, rather limited in its usefulness to investors.

It was left to Lord Denning, in a dissenting judgement in *Candler* v. *Crane Christmas & Co.*[9]) to truly lay the foundation in British law for the tort of negligent misrepresentation. According to Lord Denning, "those persons ... whose profession and occupation it is to examine books, accounts, and other things, and to make reports on which other people — other than their clients — rely in the ordinary course of business" are under a duty of care to these other people.[10] Secondly, this duty of care is owed by accountants to clients and employers, to those to whom the accountants show the accounts, as well as to those whom the accountant knows the accounts will be shown, so as to induce these others to invest money or take some other action on them. However, there was not, according to Lord Denning, a duty to the world at large, since, in his view, accountants should not be held liable, once they submitted their accounts to their employer, without their knowledge or consent regarding the subsequent use of the report.

It is interesting to note that Lord Denning expressly introduced a "purpose" element into his decision (e.g., so as to induce these others to invest money or take some other action on the report). He extended the legal considerations beyond simply the question of the actual versus intended users of the report to a consideration of the purpose of the report. As a third element of liability, Lord Denning wrote:

> [T]o what transactions does the duty of care extend? It extends, I think, only to those transactions for which the accountants knew their accounts were required ... the duty only extends to the very transactions in mind at the time. ... I have confined the duty to cases where the accountant prepares his accounts and makes his report for the guidance of the very person in the very transaction in question.[11]

In introducing a "purpose" element into the analysis, Lord Denning elaborated on the concerns of indeterminate liability introduced by Justice Cardozo in *Ultramares*. He did not restrict the particular purposes for which the audit report must have been used in order to impose liability on the auditor other than to say that the report and its use must have been central to the "very transaction in question" giving rise to the claim (i.e. the very person and the very transaction test). It was in this fashion that Lord Denning proposed to limit the scope of the duty of care owed by auditors, whilst opening the door to liability for pure economic loss.

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[9] [1951] 2 K.B. 164 (C.A.) [hereinafter Candler]

[10] *Ibid.* at 179.

[11] *Ibid.* at 182-183.

Lord Denning's dissent in *Candler* was approved by the House of Lords in *Hedley Byrne*. In that case, the Court ruled that the maker of the report in question was protected from liability by virtue of a disclaimer clause appended to his report. However, the Court took the opportunity to overrule the majority decision in *Candler*, and to approve Lord Denning's dissenting judgement therein.

The Supreme Court of Canada made the next significant contribution to the development of the tort of negligent misrepresentation with its decision in *Haig v. Bamford*.[12] This case involved an audit of a privately-held company. The audit report was to be used, with the knowledge and consent of the auditor, to induce a third party to invest in the company as a shareholder.

Dickson J.'s reasons in *Haig* are informative for a number of reasons. First, he acknowledged that a traditional year-end audit could be considered as a "special purpose" audit report in those circumstances where the auditor recognizes or should recognize that his report will be used for purposes beyond the traditional stewardship function of management. Mr. Justice Dickson wrote:

> The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry ... have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the public must place on his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.[13]

Second, while the Court was prepared to extend the scope of the duty of care of an auditor of a privately held corporation, it was clearly cognizant of earlier decisions, which warned of the risks of unlimited liability. The Court balanced the need to protect the public against the need to protect auditors from indeterminate liability, essentially by adopting the rationale of Lord Denning in *Candler*. The Supreme Court of Canada chose not to determine liability strictly upon the basis of a test of foreseeability — a foregone conclusion in this particular case. However, Dickson J. concluded that the report was prepared for the guidance of a specific class of persons (the very potential investors known to the accountants) and for a specific class of transactions (the investment of equity, as previously made known to the accountants). In *Haig*, the auditors had knowledge of the general class of investors and knowledge of the general nature of the transaction that gave rise to the claim for negligence. This was sufficient to bring the auditors within the parameters of Lord Denning's dissent in *Candler*. These factors, to Dickson J., were sufficient to negate any concerns about the extending the

[12] [1977] 1 S.C.R. 466.

[13] *Ibid.* at 475-476.

scope of the duty of care owed by auditors to potential investors.

The Formative Years

Twenty years would pass before the Supreme Court of Canada would once again have the opportunity to issue its opinion on the tort of negligent misrepresentation in the context of an audit report. During the interim, the law on the subject was further elaborated upon, and made somewhat more confusing, by seemingly contradictory decisions in the House of Lords.

The Law Lords, in *Anns v. Merton London Borough Council*,[14] formulated a two-part test for the purpose of finding liability. First, one must consider whether there existed such a relationship of "proximity" between wrongdoer and the plaintiff so as to impose a *prima facie* duty of care upon the former to the latter. Second, if such a relationship of "proximity" is found to exist, the court must then consider whether there are valid policy considerations that would negate such a *prima facie* duty of care. According to Lord Wilberforce,

> if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or to limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise.[15]

It is clear that the Court recognized that a reasonable foreseeability test alone might trigger an unlimited exposure of the maker of the statement to an extended class of recipients of the statement. Hence, consistent with previously expressed fears of indeterminate liability, the Law Lords formally expressed a "policy" consideration test in an attempt to protect auditors from unlimited liability.

Subsequent decisions of the House of Lords have cast doubt upon the continued acceptance in Britain of the two-part test enunciated by Lord Wilberforce in *Anns*. Hence, there is confusion in the British jurisprudence. In reality, these subsequent decisions appear to represent a refusal to accept the proposition that the complexities in the law regarding negligent misrepresentation can be reduced to a simple two-part test rather than an outright repudiation of the philosophy expressed by Lord Wilberforce.

A recent leading case from the House of Lords involving auditor liability is *Caparo Industries v. Dickman et al.*[16] The *Caparo* decision stands for several important postulates *vis-à-vis* auditor liability. In that case, the Plaintiffs were hostile takeover

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[14] [1978] A. C. 728, (H.L.).

[15] *Ibid*, at 751-752.

[16] [1990] 1 All E. R. 568, (H.L.).

bidders who allegedly relied on the statutory audit of the target company. The Defendants were the auditors of the target.

To some readers, including former Justice La Forest of the Supreme Court of Canada, the House of Lords' decision in *Caparo* represents an abandonment of the two-part test enunciated by Lord Wilberforce in *Anns*.[17] We share that assessment. The Law Lords believed that the *Anns* test represented an undue and unwelcome evolution of the law. Concerns about the scope of the duty of care caused the them to turn away from the "modern approach" in favor of "traditional categorization of distinct and recognizable situations" in attempting to assess such issues. Lord Bridge of Harwich, adopted the reasoning of Brenan J.of the High Court of Australia in *Sutherland Shire Council v. Heyman*:[18]

> It is preferable, in my view, that the law should develop novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a prima facie duty of care restrained only by indefinable "considerations which ought to negative, or reduce or limit the scope of the duty or the class of person to whom it is owed.[19]

In addition to an outright rejection of Lord Wilberforce's two-part test, the House of Lords in *Caparo* also expressed their views regarding the relationship between the auditors of a public company and the shareholders and potential shareholders of that company. The findings of the Court can be summarized as follows:

- No duty of care is owed to the world at large (i.e. potential investors who may rely upon the audited accounts and the audit report for investment purposes);

- The annual audit of a corporation — even that of a public company —is directed only towards assisting shareholders assess how well management has fulfilled their duty of stewardship of the assets of the corporation;

- While the statutory audit provisions found in companies legislation establishes a relationship between auditors and shareholders, such provisions do not necessarily establish a duty of care to existing or potential shareholders;

- Foreseeability of potential users of the report is not sufficient to establish liability on the part of the auditor; and

- A statutory audit is intended to protect primarily the company, not the interest

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[17] *Anns supra* note 14 at 498-499.

[18] (1985) 60 A.L.R. 1 at pages 43 – 44.

[19] *Caparo supra* note 16 at 574.

of individual shareholders or the interest of the public at large.

The Court in *Caparo* were determined to limit the expansion of the tort of negligent misrepresentation, particularly in relation to the auditing profession. Any consideration of establishing "rules of thumb" governing auditor liability, such as a *prima facie* duty of care owed by auditors to shareholders negated, in certain circumstances by policy considerations, was strongly rejected by the Lords. Lord Oliver of Aylmerton aptly summarizes the position of the Lords:

> [I]it has to be recognized that to search for any single formula which will serve as a general test of liability is to pursue a will-o'-wisp ... the attempt to state some general principle which will determine liability in an indefinite variety of circumstances serves not to clarify the law but merely to bedevil its development in a way which corresponds with practicality and common sense.[20]

It should come as no surprise that *Caparo* decided that the auditors were not liable for the economic loss of the investors on the basis that the auditors owed them no duty of care. In reaching this decision, the House of Lords determined that there existed no relationship of "proximity" between the auditors and the investors, notwithstanding that the use of the audit report by investors might be reasonably foreseeable to the auditors. Oddly enough, and despite their rejection of policy considerations underlying the *Anns* decision, the Lords in *Caparo* concluded, by necessary implication if not expressly, that there existed insufficient policy considerations to justify the extension of an auditor's duty of care beyond the bounds of the statutory stewardship purpose as contemplated in companies' legislation. In the final analysis, the Lords concluded that such an extension of liability was not in keeping with a "traditional categorization" philosophy, and would require, in the words of Lord Bridge of Harwich, "a legislative step which it would be for Parliament, not the courts, to take."[21]

The Early Years and the Formative Years: an Overview

Throughout the fifty-year period from the early 1930s to the 1980s, courts in the U.S., Britain and Canada accepted the premise that auditors should be held accountable for negligent misrepresentations made in audit reports. However, a competing underlying concern has been a fear that the scope of the duty of care owed to third parties may be extended too far and that the tort of negligent misrepresentation might evolve too quickly and too broadly. The consequences of such an evolution would likely be the opening of the floodgates of civil liability against those professionals involved with the preparation of reports which may be used by people, and in circumstances, which were

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[20] *Ibid* at 585-586.

[21] *Ibid* at 578.

not contemplated by the maker of the report.

In order to counter this concern, the courts adopted a variety of mechanisms. In the final analysis, these mechanisms can be described as a means of prescribing the scope of the duty of care to those "very persons" and to those "very transactions" which were actually known to the auditors at the time of making the report. And, from a Canadian standpoint, the only leading case to come before the Supreme Court of Canada during these years, *Haig,* did not offer the Court, because of the particular facts of that case, an opportunity to elaborate and to clarify such jurisprudence. It is against this backdrop of fifty years that the accounting profession, the users of financial statements, securities regulators and the Supreme Court of Canada found themselves when faced with the *Hercules Managements* and the *Kripps* decisions.

Recent History: *Hercules & Kripps*

Hercules Managements — Back To The Future

In considering the various legal issues before them in *Hercules*, the Supreme Court of Canada established several fundamental principles distinct from those pertaining to negligent misrepresentation. The Court established that an engagement letter between an auditor and a corporation does not establish a contractual right of action in favor of individual shareholders. The Court also ruled that an alleged breach by an auditor of a statutory obligation to remain independent from the company being audited does not give rise to a right of action or a duty of care to shareholders. These principles are an important indication of the Court's thinking as it considered the wider issues associated with auditor liability.

In summary, the Supreme Court ruled that the purpose of a statutory audit report was to enable shareholders as a group to assess management's stewardship of the assets of a corporation. The report was not intended to facilitate or promote investment decisions by current or prospective shareholders. In this sense, the decision of the Supreme Court is entirely consistent with that of the House of Lords in *Caparo*.

The Supreme Court of Canada also recognized that it would likely always be reasonably foreseeable to an auditor that a third party — such as a shareholder — would rely upon the audit report in making investment decisions. However, the Supreme Court of Canada, in recognition of the concerns of indeterminate liability which had traditionally guided previous decisions in various courts, also held that there were many policy considerations to justify a limitation on the scope of the duty of care to the immediate corporation and for the very purposes for which the audit report was given. In other words, liability is to be founded on the basis of "proximity of relationship" between the preparers and the users of the audit report, subject to policy considerations that might negate a duty of care.

In considering whether a duty of care existed between the maker and the recipient of a statement, the Supreme Court considered reasonable foreeability as well as reasonable reliance in determining whether there existed a *prima facie* "special relationship" between the maker and the recipient, a relationship described as a "relationship of proximity". The Court concluded that such a relationship could not be established without reliance by the recipient upon the maker's words. Justice La Forest wrote:

> To my mind, proximity can be seen to inhere ... when ... (a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation; and (b) reliance by the plaintiff would, in the particular circumstances of the case, be reasonable.[22]

In order to establish liability, the plaintiff-representee must demonstrate these factors in order to prove its proximity to the auditor. Then, even if such a relationship can be established, the Court must then consider whether the scope of the duty of care should be negated by policy considerations. The Supreme Court concluded that such a relationship of proximity between the auditor and shareholders — current and prospective — would almost always be established. Hence, in Canada today, one can say with a great deal of confidence that there is a *prima facie* duty of care between an auditor and the shareholders of a corporation. However, in a case involving the traditional year–end audit of a privately held corporation, policy considerations directed towards precluding "liability in an indeterminate amount for an indeterminate time to an indeterminate class" mean that auditors owe no duty of care to individual shareholders for the results of their investment decisions.

In the first instance, La Forest J's decision in *Hercules* may appear to some to be a regressive statement of the law as it pertains to auditors. Clearly, the Court in *Hercules* did not consider itself bound by Dickson J's view, as expressed in *Haig*, of the importance of the audit report to capital markets. Dickson J. identified the stewardship function as merely one element of the wider purposes of an audit report, even for private, closely held corporations. The Court's decision in *Haig* can be reconciled to the decision in *Hercules* by virtue of the principle that, on the basis of the facts in *Haig*, there was no risk of indeterminate liability.

In our opinion, the decision in *Hercules* is an acknowledgement that the law pertaining to auditor liability — or any other instance of the law of negligence — must and will continue to evolve as the Courts assess the ever-changing needs of Canada's business community. Furthermore, there are ample grounds for the belief that such change will occur much more quickly in Canada than in other common law jurisdictions, such as Britain. How can such a view be supported, especially in light of the Court's decision in *Hercules*?

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[22] *Hercules supra* note 1 at 188.

It must be recognized that the Supreme Court in *Hercules* enunciated its unequivocal support for Lord Wilberforce's decision in *Anns*. Furthermore, theCourt refused to sanction a view that such two-part test should be restricted to the tort of negligent misrepresentation or claims involving economic loss. As Justice La Forest stated:

> [T]his two-stage approach has been applied by this Court in the context of various types of negligence actions, including actions involving claims for different forms of economic loss ... to create a "pocket" of negligent misrepresentation cases ... in which the existence of a duty of care is determined differently from other negligence cases would, in our view, be incorrect.[23]

Finally, it must also be recognized that this affirmation of the two-part test of *Anns* stands in marked contrast to the rejection of it by the House of Lords in *Caparo*. Hence, the Supreme Court of Canada in *Hercules* has demonstrated a "modern approach", rather than a desire to cling to "traditional categories" of precedents, in considering the development of the law of negligence.

Kripps v. Touche Ross — Confusion Abounds

In *Kripps*, the auditors were engaged for the sole purpose of satisfying the regulatory requirements with respect to the annual prospectus that a publicly traded company had to submit to the provincial Superintendent of Brokers. Hence, the audit report in issue was never intended to serve only the stewardship function traditionally associated with year-end audit reports submitted to shareholders in accordance with companies legislation. Furthermore, the audit report was included in the prospectus pursuant to section 46(3) of the BC *Securities Act*[24], which required, amongst other things, that the auditor provide the Superintendent with,

> a statement that he has read the prospectus and that the information contained in it, which is derived from the financial statements contained in the prospectus or which is within his knowledge, is, in his opinion, *presented fairly and is not misleading.* [emphasis added]

Kripps involved an action on the basis of the common law tort of negligent misrepresentation. The case did not involve statutory civil liability under the *Securities Act*, since no such provisions existed at the time in question so as to establish a statutory cause of action. In arriving at its decision, the B.C. Court of Appeal appears to have "blurred" the distinction between a regular year-end audit report and the particular obligations imposed upon auditors pursuant to securities legislation. For example, the Court held that "the aim of an auditor's report is to allow auditors to provide their

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[23] *Ibid.* at 185-186.

[24] R.S.B.C. 1979, c.380.

professional opinion which may be relied upon as a guide to business planning and investment."[25] This view of the purpose of an auditor's report goes well beyond the view later expressed by the Supreme Court in *Hercules* and that of the House of Lords in *Caparo*. Even if this view were intended to apply only to a publicly traded company, it would, nevertheless, still represent an extension beyond the view expressed in *Ultramares* with respect to the scope of the duty of care owed to readers of the report.

In reality, the B.C. Court of Appeal in *Kripps* never expressly contemplated the very issue which had consumed the attention of every court which had previously addressed the matter of auditor liability — that is, the scope of the duty of care. Rather, perhaps due to the fact that the inclusion of the audit opinion in a prospectus gave rise to a presumption that the auditors agreed to be answerable to those who would rely on that prospectus to invest, the Court shifted its attention to a consideration of what the appropriate standards were.

In fact, the only express comment made in *Kripps* with respect to the scope of the duty of care is to be found where the Court refers to the auditor's "specific knowledge of the defendant in this case."[26] Hence, one can only conclude that the BC Court of Appeal, and by necessary implication the Supreme Court of Canada, did not have fears of "liability in an indeterminate amount for an indeterminate time to an indeterminate class", given the relationship of proximity between the defendant/ auditors and the investor/plaintiffs.

On one issue that touches on the duty of care, although not with respect to the problem of indeterminacy of exposure, the British Columbia Courts took a view which opens a new indeterminacy: on which representations will the duty be owed? Perhaps one of the most difficult questions raised by the *Kripps* decision arises from the fact that the financial statements had been altered by the client after the audit opinion was issued and before the financial statements with the opinion were included in the prospectus. The alteration was with respect to a note disclosure regarding the very loans in dispute.

Initially, the auditor had suggested to his client that some disclosure be made with respect to the loans in arrears and he drafted a note which was fairly alarming. The client balked. After discussion, a revised note was agreed upon which talked about "non-performing loans". The Court referred to expert evidence to the effect that "non-performing loans" was not a term of art and did not have, at the time, a recognized meaning. As a result, the Court of Appeal held that the note as agreed by the auditor, and as inserted in the original financial statements on which the audit opinion was expressed, was not sufficiently informative and therefore was in itself misleading.

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[25] *Kripps supra* note 2 at 439.

[26] *Ibid.* at 442.

Nevertheless, the client removed the note from the financial statements and inserted another paragraph, elsewhere in the prospectus, which according to the trial judge, was even less alarming than the agreed note about its loan portfolio. The Defendants, of course, argued that regardless of all the other issues raised, the financial statements in the prospectus were not the ones on which they had given an opinion and therefore, no duty of care could arise towards users of those other altered financial statements.

Since the Court of Appeal had come to the conclusion that the note which had been in the financial statements on which the auditors opined was inadequate, it ruled that the financial statements as published in the prospectus were "materially the same". The minor alternations did not negate the duty of the care.

In our view, this conclusion was surprising. The note had been fought over and then deliberately deleted by the client, facts which might have led one to the conclusion that at least the client believed that the deletion of the note from the financial statements and moving it, in a water-downed form, to another place in the prospectus, would in fact enhance its ability to raise capital. The Court of Appeal does not refer to specific evidence given by the Plaintiff as to his view of the difference nor to any expert evidence led by the Plaintiff as to a reasonable investor's interpretation of the two different disclosures. However, even this debate might miss a more important point: whether or not the alteration was material in the sense of having caused that particular Plaintiff to change his mind, there is a more significant policy issue as to whether the integrity of the financial statements on which an auditor gives his opinion must be protected by the Courts. What degree of alteration will be condoned as acceptable? In our view, the capital markets must respond "none". Although this might leave otherwise deserving Plaintiffs without a deep pocket for compensation, it is our view that the imposition of liability on auditors in circumstances where the financial statements have been altered gives the wrong message as to the degree to which a Court will condone, directly or indirectly, alterations of a professional's opinion.

The Standard of Care: The *Kripps* Issue

As indicated in our introduction, the third element in the tort of negligent misrepresentation is that the statement, which was false, was made negligently. At first glance, the principle seems to be fairly simple: there is no strict liability for making false or misleading statements. The Courts will only award compensation to the Plaintiff if the Defendant did not take adequate care to ensure that the representation was free from error and not misleading (obviously, if the person making the statement deliberately misled the Plaintiff, the situation is one of fraud which is governed by its own set of rules).

Where the representation is with respect to a complex technical subject matter or is given in the form of an opinion (*i.e.* the assertion is couched in terms which imply

that there is a significant degree of judgment involved), the question of negligence, or standard of care, is often difficult to apply in practice. Generally speaking, the standard would be the standard of the representor's peers. Courts have stated that one compares the professional to reasonably competent professionals in similar circumstances. This would lead to fairly obvious corollaries, such as the rule that one must not judge the professional with hindsight and that, in the absence of any specific representation as to special skill, one does not judge a general practitioner against the standard of the specialist. It also leads to the principle that not every error made by a professional is culpable. Professional peers, in similar circumstances, can easily have differing views and as long as the view arrived at was not perverse and in fact took into consideration relevant factors which would be recognized as such by the professional's peers at the time, the fact that the professional "got it wrong" ought not to matter. Lord Denning, whilst sitting in judgment in the Court of Appeal in the case of an action against an obstetrician, pointed out that his judgments were frequently overturned by the House of Lords. He recognized that whilst this means that his judgment was later proved to be wrong, he observed that this was not tantamount to admitting that he had been negligent in arriving at those decisions.[27]

By what standard, then, should a Court assess the opinion of a professional? From a practical viewpoint, the answer is often expert evidence. Both sides to the dispute will find experts in the field who will, under oath, inform the Court as to their view of what the Defendant's peers would have done in similar circumstances. The Court will assess the credibility of the expert witnesses, the thoroughness with which they reviewed the file, whether or not the assumptions they made were ultimately proven as facts to the satisfaction of the Court and the logic and persuasiveness of their conclusions. From time to time, however, the Courts will be dissatisfied with all the expert evidence put before them or will have significant difficulty accepting that the standard of care thus presented is appropriate. Within the last decade, the Supreme Court of Canada has dealt with this issue twice. The *Kripps* judgment was the first case of auditors' liability subsequent to these two Supreme Court decisions to look at this issue in the context of an audit opinion.

In reviewing the cases which preceded the British Columbia Court of Appeal decision in *Kripps*, and comparing those cases with *Kripps*, we will be proposing that *Kripps* must be read on the very narrow basis of its own facts, for two reasons. First, we are of the view that a wide reading of the *Kripps* decision would lead to a proposition of law which is significantly different from the cases which preceded it. Given that two of those cases are Supreme Court of Canada judgments, this is a result to be avoided. Second, unlike the two Supreme Court of Canada cases which preceded it, *Kripps* was dealing the case of an audit opinion and, in our view, failed to consider certain implications which arise out of the fact that the auditor's choices are limited with

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[27] *Whitehouse* v *Jordan*, [1980] 1 All E.R. 650 (C.A.).

respect to the form and content of the opinion that he can render. Finally, we consider the impact of the *Kripps* judgment with respect to forged financial statements. We believe that if the *Kripps* decision is generally followed in this respect, it will create serious difficulty for auditing and other professions, as well as for the stability of Canada's capital markets.

Expert Evidence

As indicated above, Canadian courts have grappled with the issue of the weight of expert evidence in numerous cases over the last number of years. In *Roberge v. Bolduc*,[28] the Supreme Court of Canada was called upon to render judgment in a case involving an opinion on title given by a notary in Quebec. Although Quebec rules of civil liability differ somewhat from common law rules, and although different terminology is used, the general rule that a professional will not be held liable if he acts in a manner consistent with that of the reasonable professional in similar circumstances, is basically the same. The Supreme Court had made the determination that the notary had in fact committed an error when he gave his opinion as to the title. In order to demonstrate, however, that the error was not negligent, the Defendant notary had introduced expert testimony. Much to the chagrin of the Court, the experts advised the Court that the opinion rendered by the notary in question was indeed similar to other opinions rendered generally by notaries in Quebec. In other words, the experts appear to have told the Court that everyone was making the same mistake. The Court quickly came to the conclusion that as a final arbiter on legal issues, it did not require (or appreciate) expert evidence, the purpose of which would be to advise the Court on the basic issue as to whether the opinion was right or wrong. However, the expert evidence was admissible with respect to common practice.

The Supreme Court held, however, that the judge is not bound by the expert evidence, even if, as in this case, such evidence was unanimous as to the current practice. In part, the Court's comfort in dismissing the unanimous expert evidence was based on the fact that in the field of law, unlike other cases of alleged professional negligence, it is not the case that the expert is the specialist and the judge is the layman: the judges of the Supreme Court of Canada are the supreme experts. The language of the judgment, however, is not restricted to cases of liability for legal malpractice. The Court held that it is entitled not only to assess the practitioner against the practice of his peers, but also to assess the reasonableness of that practice:

> that the appellant notary acted in accordance with the then general notarial practice does not seem to be contested. Neither the trial judge nor the respondents suggest otherwise. It is not sufficient, however, in my view that

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[28] [1991] 1 S.C.R. 374.

> the common professional practice be followed in order to avoid liability. The practice has to *be demonstrably reasonable.* [emphasis added][29]

In short, the Court held that following the practice of one's peers is strong evidence of appropriate conduct, but is not determinative:

> [I]f the practice is not in accordance with the general standards of liability, i.e., that one must act in a reasonable manner, then the professional who adheres to such a practice can be found liable, depending on the facts of each case.[30]

In other words, even if the majority of professionals behave in a certain fashion, if that fashion is in and of itself unreasonable, the Court will still find the individual professional negligent.

As indicated above, the Court no doubt felt fairly comfortable with assessing the reasonableness of notarial practice where that practice routinely (according to the experts) overlooked a fundamental legal concept which ought to have impacted significantly on the opinion of title. How does the Court, however, make this assessment when the professional activity at issue is one in which the Court is truly a layman, and the experts are the only specialists?

The Supreme Court of Canada answered this question in the more recent case of *ter Neuzen v. Korn*,[31] a case concerning medical malpractice. In this case, the Defendant doctor had failed to advise his patient that she could contract HIV from artificial insemination. The patient underwent the artificial insemination procedure in January 1985, at a time when, according to the evidence, knowledge about HIV was rapidly growing, but was still in its infancy and fairly confusing. Although the Defendant doctor knew that it was transmissible by heterosexual sex and blood transfusions, he did not know that it could be transmitted through artificial insemination and argued that this knowledge was not disseminated at conferences he attended nor in the medical journals he read. Expert evidence was to the effect that the artificial insemination practice of the Defendant doctor was in keeping with general practice across Canada.

After agreeing that the starting point for a determination of negligence was the practice of similar professionals in similar circumstances, to be judged without the benefit of hindsight, the Court held that following general practice is not necessarily enough. In discussing the difficult issue as to when the Court can substitute its view of what ought to be general practice for what the experts say was in fact general practice, the Supreme Court stated that:

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[29] *Ibid.* at 434.

[30] *Ibid.* at 437.

[31] [1995] 3 S.C.R. 674. [hereinafter *ter Neuzen*].

> It is generally accepted that when a doctor acts in accordance with a recognized and respectable practice of the profession, he or she will not be found to be negligent. This is because Courts do not ordinarily have the expertise to tell professionals that they are not behaving appropriately in their field. In a sense, the medical professional as a whole is assumed to have adopted procedures which are in the best interests of patients and are not inherently negligent.[32]

Referring to the *Roberge v. Bolduc*[33], however, the Court affirmed that where the custom of an entire profession "ignores the elementary dictates of caution"[34], following the general custom will not insulate the practitioner from a finding of negligence. After reviewing other cases, Mr. Justice Sopinka articulated a proposition which helps to identify when such a substitution of view can legitimately be made:

> I conclude from the foregoing that, as a general rule, where a procedure involves difficult or uncertain questions of medical treatment or complex, scientific or highly technical matters that are beyond the ordinary experience and understanding of a judge or jury, it will not be open to find a standard medical practice negligent. On the other hand, as an exception to the general rule, if a standard practice fails to adopt obvious and reasonable precautions which are readily apparent to the ordinary finder of fact, then it is no excuse for a practitioner to claim that he or she was merely conforming to such a negligent common practice.[35]

The Audit Opinion

So how does this apply to auditors, and more particularly, to the judgment in *Kripps*? In our view, the Court of Appeal in the *Kripps* decision was really saying two things. First, the Court of Appeal held that the auditor in question knew the precise purpose to which the financial statements would be put, namely, to induce the Plaintiff to buy debentures in the company being audited. The Court also held that the auditor knew that there was information not disclosed in the financial statements which would be material to that decision. Although the expert opinions given were unanimous, that GAAP (Generally Accepted Accounting Principles) did not require the disclosure of that specific information (and it is described at some portions in the judgment as being the disclosure of the amount of loans in arrears and in other places in the judgment as the disclosure of the amount of capitalized interest), in light of the auditor's specific knowledge, he had acted negligently. Although there is clearly room for debate as to whether this is a correct interpretation of the judgment and if so, whether the judgment was a correct interpretation of professional standards, we are of the view that a narrow

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[32] *Ibid.* at 695.

[33] *Supra*, note 19.

[34] *Supra*, note 31 at 697.

[35] *Ibid.* at 701.

interpretation of the case such as this, which ties the result to the specific finding of facts, is the only one which might not present irreconcilable conflict with the Supreme Court of Canada cases cited above.

The British Columbia Court of Appeal, however, went much further. The Court of Appeal also questioned the validity of GAAP as the standard against which misrepresentations ought to be judged. It held that in fact the standards of GAAP were under discussion at the time and that they subsequently required explicit disclosure of unpaid interest. (It is interesting that the Court never identified the new section of the Handbook to which it was referring.) The Court of Appeal of British Columbia rejected the argument that was made to the effect that if the statements were in accordance with GAAP (and the expert evidence was to the effect that GAAP did not require the disclosure which the judge and the Plaintiff would have wished), then the representation made by the auditor, embodied in the standard form audit opinion, was not misleading. The Court of Appeal seems to have rejected this argument on two grounds.

We will deal with the second ground first because we believe that it is in direct contradiction to the judgment in *Hercules* and therefore must be seen as having been supplanted by *Hercules*. The majority of the Court described the aim of the audit report as a guide to business planning and investment. The Court then went on to state as follows:

> GAAP may be their guide to forming this opinion, but auditors are retained to form an opinion on the fairness of the financial statements, not merely on their conformity to GAAP ... auditors cannot hide behind the qualification to their reports ("according to GAAP") where the financial statements nevertheless misrepresent the financial position of the company.[36]

The Supreme Court of Canada, just one month later, pointed out that although it is certainly foreseeable that various uses will be made of the audit report, the Court will not come to the assistance of those who so use the report unless a special relationship, premised on the auditor's actual knowledge of that use, has been proven. In other words, on the facts as found in this case (the Court of Appeal held that the auditor in question knew the specific use in question), the conclusion might be consistent with the *Hercules* decision, but the statement that the aim of the audit report is to guide business planning and investment is not the law in Canada with respect to statutory annual audit opinions.

The second branch of this part of the judgment is even more difficult. As evidenced from the quote above, the British Columbia Court of Appeal is dissatisfied with the language of the standard form audit opinion. In fact, at paragraph 62 of the judgment,

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[36] *Kripp supra* note 2 at 439.

the Court of Appeal rejected the notion that GAAP must be referred to as the "*lingua franca*" of capital markets because, in the Court's view, the standard opinion to the effect that the financial statements present fairly the financial position of the company in accordance with generally accepted accounting principles, is ambiguous: it does not state either that there is fair presentation nor that the financial statements are in accordance with the GAAP. It is possible that the Court merely intended to hold the auditor to the statutory opinion found in section 46(3) of the B.C. *Securities Act* as it then existed, rather than allowing the auditor to use the standard form opinion (the difference is between simply "presenting fairly" and "presenting fairly in accordance with GAAP").

If, however, the Court intended this statement to apply to all standard form audit opinions, including those issued within a statutory framework which calls for an opinion on "fairness in accordance with GAAP", then in our view, it cannot be reconciled with the Supreme Court of Canada decisions of the same decade. Unless the Court of Appeal was of the view that the debate in the profession which allegedly brought about changes in 1985 to presentation requirements under GAAP was devoid of any serious meaning because it was obvious, even to a layman, that the failure to require disclosure of the amount of loans in arrears or of the amount of interest being capitalized was demonstrably unreasonable (an assertion which the Court of Appeal did not make), then according to the test to set out by the Supreme Court of Canada, the finder of fact has no choice but to compare the behaviour of the individual professional against the standard of the time. In our view, this contradiction is to be avoided if possible, and therefore the best interpretation of the *Kripps* case would be as a fact-specific case.

This brings us to a consideration as to whether the law should be different for auditors and for other professionals. In our view, an argument for this proposition is available, but the argument ought to have led the British Columbia Court of Appeal to the opposite conclusion.

Unlike the opinion rendered by the notary in *Roberge* v. *Bolduc* or the warning (or failure to give warning) in *ter Neuzen*, when an auditor is appointed under statute, she often has very little choice as to the content or form of the opinion which she gives. The Court of Appeal recognized this at the outset of the majority judgment in *Kripps* (which did not faithfully reflect the *Securities Act*) where it was indicated that under the *Securities Act*, the financial statements and an auditor's report are required to form part of the prospectus and there is a further requirement that "this auditor's report states that the financial statements presented the financial position of the company fairly according to GAAP, and that otherwise the report be unqualified."[37]

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[37] *Kripps supra* note 2 at 426.

In other words, it would seem apparent from this passage of the Court of Appeal judgment that the auditor had no choice in using the language proposed by the CICA Handbook for a clean opinion whether or not that language is, in the British Columbia Court of Appeal's view, ambiguous. Moreover, this is not merely the standard of the profession, but is in most cases, a legislative requirement. Although the point made by the British Columbia Court of Appeal to the effect that the law cannot allow a profession to insulate its members from the consequences of head-in-the-sand tactics is well taken, we would argue that this concern is misplaced where the legislature has, by statute, directed the form and content of the opinion which is to be rendered. The auditor is then left with no choice but to issue a clean opinion or not. He is not left with the choice to amend the client's representation, namely, the financial statements. Moreover, unlike the case in *ter Neuzen*, there was no direct communication between the Plaintiff and the auditor and therefore the representation is no more or less than the standard form audit opinion. If the Court of Appeal is correct that the opinion is ambiguous, it is difficult to see how reliance thereon is reasonable. Presumably, it is reasonable because it is a standard form opinion and has come to take on a specific meaning within that community which prepares, audits and uses financial statements. We are then thrown back to the proposition that if that community, as evidenced by expert testimony, understands what the opinion means and agrees that GAAP does not require the disclosure in question, the ultimate finding is difficult to reconcile with this portion of the judgment.

The Court of Appeal also made reference to an earlier British Columbia judgment which at first glance might support the conclusion that despite the high degree of technical difficulty, the Court is entitled to substitute its opinion for the standard of the auditing profession. That case was *Revelstoke Credit Union v. Miller*,[38] in which the debate arose over the application of GAAS (Generally Accepted Accounting Standards). In short, in that case, the auditors had failed to detect fraud committed by the Credit Union's manager. In defending themselves, the auditors asserted that they had in fact carried out standard tests as called for by generally accepted auditing standards. The Court found that this was insufficient. At first glance, it therefore appears that this case stands for the proposition that the Court can substitute its judgment for what would be appropriate audit tests. However, we are of the view that a closer reading of the *Revelstoke* decision leads to a different conclusion. The Court in *Revelstoke* was simply saying, in our view, that the application of GAAS should be something other than mechanical. It is not enough to do the tests: one must interpret and analyze the results. The Court in *Revelstoke* held that if that had been done by the auditors, they would have recognized a series of red flags which by themselves should have obliged them to undertake further tests which might well have led to the discovery of the fraud. In other words, in our view, the *Revelstoke* decision did not question GAAS as fundamentally as certain passages of the *Kripps* decision question GAAP and

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[38] [1984] 2 W.W.R. 297 (B.C.S.C.) [hereinafter *Revelstoke*].

the standard form audit opinion; it merely stated that a professional is not only obliged to carry out the same steps that a reasonable professional in similar circumstances would have carried out, but also to pay attention to what he is doing and draw appropriate professional conclusions therefrom.

The Dissenting View

A very strong dissenting opinion was written in the *Kripps* case on many of the points outlined above. It remains to be seen whether this dissenting opinion will attract the attention of future Courts. One is reminded of the fact that the law of negligent misstatement involving auditors began as a result of a dissenting opinion by Lord Denning in a judgment rendered in an era when no action lay for pure economic loss.

The dissenting judge pointed out that the auditors were required, both by the engagement and statute, to give an opinion on whether the financial statements presented fairly in accordance with GAAP. Relying on GAAP, therefore, in her view, was not "hiding behind" anything, but was merely answering the question as it had been posed. The dissenting judge was of the view that failing to answer a different question that was never asked (is there any additional information which I, as an investor, would find material, even if that information is not required to be disclosed to me by virtue of GAAP in financial statements?) cannot be the basis for a finding of negligence of the company's auditors.

The dissenting judge concluded that her colleagues on the Court of Appeal had simply come to the conclusion that GAAP themselves were inadequate. In her view, whether or not that was true, it does not assist the investors in their action against the auditors. The auditors were asked to determine what GAAP then was and then to state whether the financial statements were prepared in accordance with them. She was of the view the auditors successfully completed that engagement. As she put it:

> [T]hey are not accused of negligently determining the proper generally accepted accounting principles, they are accused of failing to state that the prevailing principles were inadequate. In my view they were under no obligation to offer such an opinion.[39]

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[39] *Kripps supra* note 2 at 456.

In some sense, the dissenting view might be seen as going beyond the degree of deference which the Supreme Court of Canada has told us that, in the case of other professionals, must be shown to the profession. It is unclear whether her determination that a finding that GAAP were themselves inadequate is insufficient to assist the plaintiffs because the plaintiffs did not show that GAAP were so inadequate as to be "demonstrably unreasonable" or whether she was of the view that, in the circumstances, even that would not have been enough. In our view, either one of these two rationales would be sufficient for the decision.

Clearly, there is nothing in the majority opinion which indicates that in the Court of Appeal's decision the lack of disclosure requirements at the time in question was "demonstrably unreasonable". The best spin one can put on the judgment is that the Court of Appeal felt that the failure to require disclosure was "demonstrably wrong", given the judge's statement that the standard setters themselves modified the CICA Handbook in this regard the following year. Presumably, the mere fact that a profession's standards evolve with the times does not by itself indicate that at any point in the process the previous set of rules was "demonstrably unreasonable" in the sense we believe was required by the Supreme Court of Canada.

As indicated above, the dissenting judge might even have adopted a stronger view point, namely, that in light of the actual words of the opinion given by the auditors, the general rule articulated by the Supreme Court of Canada to the effect that a lay bench can come to the conclusion that a professional was negligent despite having followed the standards of his profession at the relevant time, would not apply in the case of the standard form audit opinion. By referring back to the words of the opinion, she is indicating that the professional has properly qualified his opinion as being in accordance with GAAP and therefore, if the recipient is not satisfied with the level of information that GAAP requires, it is up to him to ask for a special report or further information. Such a strong view might be fairly controversial. It might be analogous, for example, in the case of medical negligence to defend a doctor who had rendered a diagnosis after warning his patient that he had only considered some, but not all possibilities or having performed some but not all diagnostic tests. Would we be content with a system which allowed the doctor to escape liability because, given the tests he did perform, the diagnosis was not unreasonable, or would we want to know whether it was reasonable for him to have performed only those tests? Would we demand that the patient seek another opinion from a doctor who was willing to perform those additional tests? In actual practice, however, doctors do not regularly limit their medical opinions in the way that the standard form audit opinion does. Therefore, it can

be said that, as a society, we do accept such qualified opinions from auditors in a way we do not normally accept from doctors. Following this line of argument, one could argue that the exception to the rule that expert evidence ought to prevail found in the Supreme Court of Canada in the cases decided above should not be applied to the standard of GAAP in the case of a standard form audit opinion.

Implication of *Hercules Managements & Kripps*

The decisions in the *Hercules* and *Kripps* cases have brought to the surface a number of issues pertaining to auditor liability in Canada. It would be naïve to believe that the legal wrangling is over. Indeed, in the opinion of some commentators, the courts have failed to provide any definitive principles, which would have resolved the issue once and for all.

Whatever one's opinion of the decision in *Hercules*, that case has allowed the Supreme Court to express very forcefully its views regarding auditor liability. There are some that would believe that the decision has caused, or at least has hastened, the demise of the annual statutory audit. Professor Al Rosen of York University in Toronto was quoted as follows:

> The annual financial statement is now a joke. Public accountants may think this is a wonderful win for them. But in the long run I see this as a disaster. Who really needs an audit of financial statements that are not useful for investor decision-making?[40]

While we would agree that traditional historic cost financial statements cannot be the sole basis of investment decisions, we disagree with the premise that the Supreme Court decision in *Hercules* has caused their demise. First of all, the vast majority of the audits of public and private corporations are conducted and the financial statements thereof are prepared in accordance with proper auditing and accounting standards. Secondly, to the extent that historic cost financial statements have many inherent limitations from an investment perspective, this was true for many years prior to the *Hercules* decision. Finally, generally speaking, these limitations are or should be well recognized by investors, with the result that sound investment decisions are guided by information from a variety of sources rather than simply the information contained in the audit report and a corporation's financial statements.

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[40] "Auditors not legally liable to investors, top court rules" *The Financial Post* (24 May 1997) at 3.

There are also those who believe that governments must legislate a cause of action in order to give investors an avenue of relief against the "narrow" scope of liability imposed as a result of *Hercules*. The Editorial in the *Financial Post* read:

> Provincial governments should quickly establish new securities law that makes a negligent auditor liable when investors lose money after relying on a company's audited financial statements to buy or sell shares.[41]

Such views appear to completely ignore the principle of causation, and would treat auditors as guarantors of a safe return on investment. In addition, such views ignore the statutory causes of action which already exist in securities legislation when audit reports and financial statements are included in a prospectus. Finally, the editors appear not to have recognized that the ultimate responsibility for the accuracy of the financial information upon which investors make decisions rests with the management of the corporation rather than the auditor.

And, what of the *Kripps* decision? The decision of the Supreme Court to dismiss the application for leave to appeal without commenting on the merits of the case has thrown the law surrounding auditor liability into a state of confusion and uncertainty. The confusion and uncertainty does not stem from concerns surrounding the scope of the duty of care, since, in *Kripps*, the auditors were certainly aware that their audit report would be used for investment purposes. They were also aware of the general class of users of the report. Hence, akin to Lord Denning's conclusion in *Candler* and that of Justice Cardozo in *Glanzer* and that of Justice Dickson in *Haig*, the auditors in *Kripps* did not attempt to defend the action on the basis of potential "indeterminate liability". Rather, the confusion and uncertainty arises from concerns regarding the appropriate standard of care against which the conduct of auditors should be measured.

There are those who will look to the decision in *Kripps* as evidence to support their view that GAAP and GAAS, as found principally in the CICA Handbook, may sometimes be deficient, with the result that financial reporting standards and auditing standards are below the needs of the financial and business communities. Those who might take this view would do well to consider the words of the Court of Appeal, whereby the Court acknowledged that

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[41] "Editorial Opinion" *The Financial Post* (27 May 1997) at 18.

> the amount of arrears was not disclosed. This was ... the universal practice of financial companies like VMCL. It was the considered approach of the Chartered Accountants as a profession, and thus a practice not to be lightly disturbed. [42]

In our view, the significance of *Kripps* should be measured against the backdrop of a discrete form of statutory liability, which, we submit, may have pervaded the entire case. While the case was framed on the basis of the common law tort of negligent misrepresentation, it must be recognized that section 46(3) of the then B.C. *Securities Act* contained no qualifier to the phrase "presented fairly". That is, there was no criterion in section 46(3) by which the "fairness" of presentation was to be measured. In reality, in reporting to the Superintendent, the auditor was expected to state, without any reservation and as a matter of fact, that the information contained in the prospectus "is presented fairly and is not misleading".

It is submitted that the level of assurance required for giving an opinion on "fairness" without tying that to a defined standard, if possible at all, approximates that of a guarantee of accuracy, and is founded on a fundamental disagreement with the principle that the fairness of presentation must be measured, and can only be measured, against the criteria of a recognized framework, such as Generally Accepted Accounting Principles (GAAP). Fairness of presentation cannot exist in a vacuum, despite the wording of any legislation.

The *Kripps* judgment raises numerous issues, and it is difficult to predict what impact the decision will have on future cases. On the issue of the circumstances under which a judge should substitute his opinion for those of experts and declare that if generally accepted accounting principles do not call for a certain disclosure, then those principles can be deemed deficient, there will be little change. As explained, the principle that judges can, in exceptional circumstances, substitute their judgments for those of experts, is well enshrined in our law. Although we have quarreled with the application of this principle to the facts in the *Kripps*' case, it remains just that: an application of a principle to a set of facts, and therefore is unlikely to be relevant to a different set of facts.

However, on two other issues, one might expect more reaction. First, the British Columbia Court of Appeal has told us that it finds the standard audit opinion to be

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[42] *Kripps supra* note 2 at 442-443.

misleading. However, there are no current plans afoot from within the profession to change the standard form wording nor have the legislatures across the country who have endorsed the standard form wording either directly (by reiterating the standard formula in the statute) or indirectly (by identifying the CICA Handbook as the principal source of GAAP which they have required companies to use) made any announcements that they will be revisiting this endorsement. The standard form opinion remains alive and well and in use; thousands of such opinions have no doubt been signed across Canada since the *Kripps* ruling. Either the vast majority of users understand what the standard form opinion means, or we are all operating in a communication gap which is larger than any of us dare think.

Second, the issue of forged or altered financial statements is one which should receive attention. Recent proposals published by the Ontario Securities Commission in its May 29, 1998 bulletin[43] would deal with this issue head on. For example, amendments to the Ontario *Securities Act* are proposed which would impose statutory liability for continuous disclosure. In those sections dealing with an expert's opinion, the proposed statutory language would specifically relieve experts of liability where they prove that written consent to the use of their report or opinion had not been obtained or where a reference to or a guide from a report did not fairly represent the report's contents. In the latter case, the expert would have an obligation to inform the Commission that his report had been misconstrued or misinterpreted as soon as practicable after learning that such misuse of his opinion had been made. Whether or not these specific amendments are ever adopted as law, it is hoped that all professionals can look forward to such an attitude towards forgery and alteration being adopted by the courts and by Canadian legislatures.

The Future of Assurance Services and Auditor Liability

The development of accounting principles and auditing standards in Canada have a pervasive effect on Canadian business and the capital markets. Hence, a consideration of the current status of the law of auditor liability and its application to the future evolution of the auditing profession is more than simply an academic exercise. These issues do have and will continue to have a dramatic effect on individual Canadians, the business community and society.

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[43] (1988) 21 O.S.C.B. 3367.

The annual audit of historic cost financial statements, for both private and public corporations, arguably cannot and should not be the only information source used by investors and lenders who are looking for assurances when advancing loans. The capital markets desire real-time "current" financial results of operations in order to meet the needs of investors. As the courts accept this reality, investors will lose the ability to sue auditors for failing to tell them everything they needed to know.

Simultaneously, auditors are also being called upon to provide new assurance services demanded by sophisticated investors. To an ever-increasing degree, this will mean providing assurance services — lending credibility to financial information — in an electronic environment. It will also likely mean providing assurance via the use of performance measurement criteria other than dollars and cents.

It is against this backdrop that the jurisprudence on auditor liability should be assessed, and the implication of the law on the tort of negligent misrepresentation measured in terms of its effect on the auditing profession. In our opinion, the decision of the B.C. Court of Appeal in *Kripps* should pose no great risk or hurdle to auditors as they deliver new assurance services in the context of a global economy. Stated simply, if a new brand of reporting principles becomes "generally accepted" by the preparers and the users of the financial information, whatever the form of such information, and if "new" generally auditing standards are adopted under which auditors will conduct audits of the financial information, these new reporting standards will become the criteria by which the "fairness of presentation" of the financial information will be measured.

As we said earlier, the fairness of presentation cannot exist in a vacuum. We expect the reporting standards to continue to evolve to meet the needs of the new world economy. However, we remain of the opinion that government, the business community as well as the courts will recognize that some criteria will be necessary by which "fairness" must be measured if the financial information is to have any utility and if auditors are expected to fulfill their role in providing assurance thereon. Hence, the reasoning of the court in *Kripps* should not, in our opinion, be adopted in future cases and should not cause undue concern to auditors as assurance services evolve.

The greatest risk to auditors in providing these new services will continue to be the scope of the duty of care owed by auditors to third parties. For private, closely held corporations, it will be difficult for auditors to overcome the argument that they owe a *prima facie* duty of care to the existing and prospective shareholders. In the context of

publicly traded companies, auditors will be called upon to provide assurance on financial information beyond that of the year-end financial statements. Hence, auditors might no longer be able to rely upon the premise that the audit report was prepared simply to allow shareholders to assess management's stewardship of the company's assets.

It is possible, for example, that new "special purpose" assurance reports will be issued periodically, and not in lieu of the statutory audit report. Furthermore, given the needs of the capital markets, the assurance reports will be intended for wide distribution. The auditors, in advance of the preparation and distribution of the reports, will know, at least in a very broad sense, the intended users and the intended use of the reports and can take appropriate steps to manage the associated risk, or decline the engagement if they cannot do so. In such circumstances, how will the duty of care concept evolve outside the statutory audit, where there is no legislative "purpose" to define the limited class to whom the duty is owed?

In our opinion, the risk of "liability in an indeterminate amount for an indeterminate time to an indeterminate class" will shift focus as auditors choose to deliberately take up the challenge (as well as the financial rewards) of providing assurance services for the benefit of individuals whose interest in the subject matter is not defined by existing legislation. To the extent that auditors provide more than historic cost financial information and statutory audits, new difficulties will arise in applying the policy considerations set out by the Supreme Court of Canada to palliate the concerns associated with expanding the scope of the duty of care owed by auditors to the readers of these new assurance reports. The equity of the *Hercules* decision lies in its granting of permission to auditors to choose whether to take on, decline, or negotiate a fair contract when the potential exposure associated with a proposed engagement is "indeterminate". The challenge is to apply the test to new situations that have not yet been considered by any court of law.

There are a number of factors in support of this proposition. First, securities regulators will continue to press for legislation to establish a statutory cause of action in favor of investors, although as we have seen, not without limitations. Second, in order to appease the concerns of investors, the management of a publicly traded company may demand and obtain a written confirmation from the auditors regarding the intended use and the intended users of the assurance reports, thereby establishing a "relationship of proximity" between the auditors and the investors. Finally, other legislative changes, for example, proposed amendments at the federal level so as to

institute a form of modified proportionate liability in place of joint and several liability in conjunction with the audit of federally regulated financial institutions, and the creation in some provinces of Limited Liability Partnerships so as to afford a measure of protection for the personal assets of non-negligent partners, can give professionals some comfort and some degree of flexibility when undertaking new engagements in what is now unchartered territory.

What, then, should be the response of the auditing profession? Should the profession choose not to venture down the road of providing new assurance services for fear of attracting an unwelcome extension of the scope of their duty of care? Can the profession, regardless of the legal risks, afford to stand still?

In our view, there can be no turning back. Market demands are driving a need for new assurance services. It is inevitable that providers of these services will face uncertainty in the application of the "purpose" test as set out in *Hercules* to evolving fact patterns. The words of Mr. Justice Dickson in *Haig* of twenty years ago about the compexities of modern society changing the role and responsibilities of accountants might be even truer today.

The auditing profession will be obliged to continue to develop its own standards, but given that reality necessarily moves faster than standard setters and that standard setters move faster than the law, there will continue to be frontiers where professionals will act with little guidance. Despite *Kripps*, we believe that courts should and will continue to judge professionals in the context of the authoritative guidance that in fact existed at the time the services were performed, and not on a subsequent view of what they should have been. Obviously, the challenge is for the profession to continue vigilantly to update its standards and for practitioners to practice good risk management as the process of providing new and broader assurance services evolves.