The Auditor’s Legal Liability

The legal environment

• Litigation related to alleged audit failures have caused some concern in the profession
• The requirement to hold a practising certificate imposes an obligation on auditors to carry professional indemnity insurance for possible liability to their clients and members of the public

The legal environment

• This source of compensation (insurance) creates a perception that auditors have ‘deep pockets’ and, arguably, contributes to the extent of claims filed against them
• There have been major changes in the legal environment concerning auditor liability in the last few years
The litigation crisis

- KPMG paid $136 million in 1994 over its audit of the failed merchant bank Tricontinental
- KPMG and Price Waterhouse paid $120 million over the 1991 collapse of the State Bank of South Australia
- Litigation over the Adsteam collapse involved Deloitte Touche Tohmatsu in $20 million settlement
- It can be seen from the data that the litigation crisis may have reached its peak between 2002 and 2003. However, it is difficult to come to conclusions because of the lack of public information for the out-of-court settlement cases

The professional standards legislation

- The Treasury Legislation Amendment (Professional Standards) Bill 2003 was passed by the Commonwealth Government on 24 June 2004
- The Bill adapts the Professional Standards Legislation (PSL) at the State and Territory level to limit civil liability for misleading and deceptive conduct

- The bill does this through the Commonwealth’s Trade Practices Act 1974, the Australian Securities and Investments Commission Act 2001 and the Corporations Act 2001
- Replaces joint and several liability with a national model of proportionate liability
The professional standards legislation

- The following key points relate to subsequent state-based legislations to enact the Commonwealth based reforms:
  - Limitation caps are calculated with reference to a multiple of fees charged
  - The cap does not apply to liability arising from claims for death, personal injury or any conduct involving a breach of trust, fraud or dishonesty
  - A minimum cap of $500,000 applies but can vary within and between occupational groups

The impact of the CLERP 9 Act

- CLERP 9 allows companies to register as independent auditors provided they have adequate and appropriate professional indemnity insurance

Liability to shareholders and auditees

- In respect of the provision of auditing services, an auditor is liable to compensate a plaintiff if:
  - a duty of care is owed to the plaintiff and the audit is negligently performed
  - the plaintiff has suffered a loss as a result of the auditor's negligence (where the causal relationship is reasonably foreseeable)
- The loss must also be quantifiable
Liability to shareholders and auditees

The following issues, therefore, need to be considered and each is dealt with separately:
• Due care
• Negligence
• Privity of contract
• Causal relationship
• Contributory negligence
• Damages

The auditor’s duty of care

• The development of the concept of due care, as applied to the performance of an auditor’s duties, is considered by referring to cases decided in UK and Australian courts
• Consideration is also given to the relevance of the profession’s auditing and accounting standards

Kingston Cotton Mill Co. (1896)

Finding
• The Kingston Cotton Mill case laid down some fundamental auditing principles such as the ‘watchdog’ role and the notion of taking reasonable skill and care
London and General Bank (1895)

Finding
- The duty of an auditor is to convey information, not to arouse enquiry.
- Although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement.

Implications of the Kingston Cotton Mill and the London and General Bank cases
- These two cases have formed the basis for most subsequent decisions as to the determination of auditor negligence.
- The auditor is not necessarily answerable for an error of judgement, provided he or she exercises the skill and care of a reasonably competent and well-informed member of the profession.
- Nevertheless, a too-literal interpretation of the Kingston Cotton Mill Co. case has been criticised as retarding the development of improved auditing practices.

Implications of the Kingston Cotton Mill and the London and General Bank cases
- The narrow interpretation of the Kingston Cotton Mill Co. case concerning some audit practice was finally laid to rest by the Pacific Acceptance case.
- The Pacific Acceptance case showed the changing expectations in respect of the auditor’s responsibility, with the standards of reasonable care also being raised.
- The Pacific Acceptance case established some of the key features of professional due care now expected of an auditor.
Pacific Acceptance Corporation Ltd v. Forsyth (1970)

Findings

- ‘Reasonable skill and care’ calls for changed standards to meet changed conditions or changed understanding of dangers, and in this sense standards are more exacting today than in 1896 (Kingston Cotton Mill case)

The judgement was wide ranging and important points included:

- Closely must pay due regard to the possibility of material fraud or error in carrying out audit procedures
- Supervise and review the work of inexperienced staff
- Properly document audit procedures in a written audit program which is to be amended as necessary as the audit progresses
- Carry out proper objective auditing procedures

Due care further emphasised in:

- The Royal Commission into HIH Insurance
  - ‘… auditors have an obligation to ensure that they are, and are seen to be, maintaining high standards of honesty and probity, acting in the interests of the shareholders of the company … and exercising independence of mind …’
- Stanilite Pacific Ltd & Anor v. Seaton and Ors (2005) (trading as Price Waterhouse)
  - the judgement referred to ‘… an extension of the duty to exercise reasonable skill and care in giving consent for their report to be included in a prospectus …’
Negligence

- Negligence has been defined as any conduct that is careless or unintentional in nature and entails a breach of any contractual duty or duty of care in tort (that is, to those who the auditor could reasonably foresee would rely on the auditor’s report), owed to another person or persons.
- The auditor’s duty of care to a client thus arises either in contract or in the tort of negligence.

Negligence

- If the auditor has been negligent, then the client may sue the auditor for breach of an implicit term of the contract to exercise reasonable care and skill, so as to recover any consequential loss suffered.
- The client may also sue the auditor in the tort of negligence to obtain damages sufficient to restore the client to its original position.

Negligence

- Subsequent to the Pacific Acceptance case, the Australian accounting bodies issued more comprehensive and specific auditing standards and practice statements concerning the conduct of the audit.
- Disputes may still arise as to whether, in a specific engagement, an auditor has complied with the standards and thus has a good defence against an action for damages on the grounds of negligence.
**Privity of contract**

- The term privity of contract refers to the contractual relationship that exists between two or more contracting parties.
- An audit is assumed to be performed in accordance with professional standards unless the contract (engagement letter) contains specific wording to the contrary.

**Privity of contract**

- Under contract, only the directors (on behalf of the company) or, more commonly, the liquidator or receiver, may sue the auditor in respect of losses incurred by the company arising from the auditor’s negligence.
- *Individual shareholders, creditors, employees etc. have no claim against the auditor under contract.*

**Privity of Contract**

Liability of auditors at one and two stages removed.
Causal relationship

- A causal relationship exists between the breach of duty by the defendant and the loss or harm suffered by the plaintiff.
- This relationship must have been reasonably foreseeable and it must be proven that the loss suffered is attributable to the negligent conduct of the auditor in a negligence case.

Privity of contract

- Segenhoe Ltd v. Akins & Ors (1990)
  - Court held that where an auditor has been negligent and the company has been induced to pay a dividend out of capital — relying on an incorrectly audited profit and loss account — the auditor is liable for the loss incurred.
  - Reaffirmed the causation relationship requirement to establish the liability of the auditor.

Contributory negligence

- Contributory negligence relates to the failure of the plaintiff to meet certain required standards of care.
- Together with the defendant’s negligence, it contributes to bringing about the loss in question.
- The judgement in the AWA case is the landmark decision on contributory negligence in an auditor–client relationship.
Damages

- Where auditors fail in their duty to act with reasonable care and skill, whether under contract or in tort, a plaintiff is entitled to recover any economic loss arising out of such a breach of duty.
- Two issues need to be considered
  - Firstly, what is the purpose of statements that may give rise to reliance reasonably being placed on them?
  - Secondly, to what extent may responsibility for any loss be assigned on the one hand to the auditor’s negligence and, on the other, to other causes and other parties?

Proximity and third party liability

- As a result of the reluctance of professional indemnity insurers to allow cases to come to court there are very few decided Australian (or overseas) cases of significance involving claims by third parties against auditors.
- Most of these cases involve action being brought by companies relying on audited accounts in making a takeover bid for another company.
- Proximity is held to arise through the fact that where a company’s financial condition is such that it is a likely takeover target, auditors should be aware that potential suitors will rely on the accounts and that a duty of care thus arises.

Proximity and third party liability

- The House of Lords in the Caparo case argued that the purpose of the financial statement on which auditors express an opinion is to assist the shareholders in their collective function of scrutinising the company’s affairs.
- It would be unreasonable, therefore, to hold the auditors responsible for their use, by shareholders or others, for any other purpose.
- However, the general view of the legal profession is that the Caparo verdict appears to treat auditors more favourably than it treats other experts on whom third parties place reliance.
Proximity and third party liability

- In Australia, the common law concerning the nature and extent of an auditor’s duty of care to third parties remains complex because judgements contain differences of judicial opinion and interpretation
- However, the judgement in the Esanda case was a positive development for auditors because the Court rejected the contention that liability could be based on foreseeability of reliance alone

Proximity and third party liability

- The High Court found that there had to be circumstances establishing a relationship of proximity between the auditor and the third party before a duty of care could be said to exist
- In respect of auditor liability for negligent misstatements, the current position and court expectations are changing as a result of a continual struggle to balance the respective rights and interests of auditors, investors and the wider community

Third party liability

The essential elements in negligence actions
Avoidance of litigation

The following precautions may be taken by auditors wishing to avoid or minimise the consequences of litigation:
- Use engagement letters
- Investigate prospective clients thoroughly
- Comply fully with professional pronouncements
- Recognise limitations of professional pronouncements
- Establish and maintain high standards of quality control
- Maintain adequate professional indemnity cover
- Be prepared to issue a privity letter on request

Trade Practices Legislation

- Rights for individual investors
- S.52 prohibits misleading and deceptive conduct and has been used as a basis for successful actions by investors