The Modern Company Auditor: A Bloodhound without Teeth or a Watchdog without Eyes?

Robert Baxt

Follow this and additional works at: http://digitalcommons.osgoode.yorku.ca/ohlj

Citation Information
http://digitalcommons.osgoode.yorku.ca/ohlj/vol24/iss3/6
THE MODERN COMPANY AUDITOR:  
A BLOODHOUND WITHOUT TEETH  
OR A WATCHDOG WITHOUT EYES? 

BY ROBERT BAXT*

I. INTRODUCTION

Recent events in Australia and Canada, as well as some major judgements in the United States, have made company auditors a topic of considerable current interest. While the impetus for and major point of discussion of this paper is the Cambridge Credit litigation1 in Australia, the collapse of the Canadian Commercial Bank2 in 1985 has added considerable interest to the question of whether auditors can continue to be regarded as the watchdogs3 of the corporate world.

In the United States, courts have recently engaged in the apparent demolition of the famous dictum of Chief Justice Cardozo in the Ultramares case.4 The most important of these decisions was that of the

* Sir John Latham Professor of Law and Dean, Faculty of Law, Monash University, Victoria, Australia, Visiting Professor of Law, Osgoode Hall Law School, York University.

1 The Cambridge Credit litigation involved a number of decisions in the Supreme Court of New South Wales and in the New South Wales Court of Appeal. The first case, Cambridge Credit Corporation v. Hutcheson (1983), 8 A.C.L.R. 123 [hereinafter Cambridge Credit (1)], was a decision of Mr. Justice Rogers in 1983 involving the question of whether the accounts had made proper allowance for bad debts; it is discussed in this paper. The Court of Appeal referred the litigation back to Justice Rogers in (1983), 8 A.C.L.R. 526 [hereinafter Cambridge Credit (2)]. The matter was reheard by Justice Rogers in the context of other alleged breaches, and a major judgement was delivered in Cambridge Credit Corporation v. Hutcheson (1985), 9 A.C.L.R. 545 [hereinafter Cambridge Credit (3)]. See also Northumberland Insurance v. Alexander (1984), 8 A.C.L.R. 842. There were other decisions involving interlocutory and related matters that are not of consequence for this paper.

2 Hereinafter CCB.

3 The watchdog theme relating to auditors was first used by Lord Justice Lopes in In Re Kingston Cotton Mill Co. (No. 2) (1894), [1986] 2 Ch. 279 at 288-90. Lord Justice Lopes, not only referred to the auditor as a watchdog (not a bloodhound), but made other observations in relation to his role as a "detective." For interesting commentary on the watchdog theme and on whether the auditor could be likened to a watchdog, bloodhound, or other canine species, see R. Buchanan-Dunlop, "The Duty and Liability of an Auditor" The Accountant (19 November 1955) 572; see also R.W.V. Dickerson, Accountants and the Law of Negligence (Toronto: Canadian Institute of Chartered Accountants, 1966) at 14.

New Jersey Supreme Court in *Rosenblum Inc. v. Adler*. In holding the auditors liable to third parties, the court was echoing an approach already adopted in Australia, Canada, the United Kingdom, and New Zealand. But while the New Jersey and Wisconsin courts have followed developments in other common-law countries, the New York Court of Appeals has again called for caution.

The *Cambridge Credit* litigation began with a judgement in the New South Wales Supreme Court in which $145 million was awarded against the auditors of the company. But all three events (*Cambridge Credit, CCB collapse, and Rosenblum*) emphasize the important role played by the auditor of a corporation and the need to ensure that the shareholders of corporations (and indeed other investors to whom the auditor may owe some responsibility) are protected both by adequate legislation and by the administration of this legislation.

While Chief Justice McEachern may have had some doubts as late as 1984 that the standards expected of an auditor had kept pace with various developments, there have been other statements and events which suggest that his conservative analysis of the auditor's role in *Revelstoke Credit Union v. Miller* was not in keeping with views expressed elsewhere. That decision (or rather Chief Justice McEachern's evaluation) is almost an aberration in the context of the other developments discussed here.

---


8 The most recent English decision in which the *Hedley Byrne* principles were followed is *J.E.B. Fasteners Ltd. v. Marks, Bloom and Co.* (1980), [1981] 3 All E.R. 289 (QB.), aff'd 1982, [1983] 1 All E.R. 583 (C.A.). This case dealt with the liability of accountants and auditors to third parties, as did *Haig v. Bamford*, supra, note 7. The Australian cases do not deal specifically with accountants.


In this paper I will not deal in detail with the ramifications that arise from decisions such as *Rosenblum Inc. v. Adler* and its predecessors in other jurisdictions. Indeed this could (and perhaps should) be the focus of a separate paper.\(^{12}\)

### II. STATUS OF AUDITORS

It is interesting to note the comments made by the present Chief Justice of the Supreme Court of Canada in *Haig v. Bamford*, a case that dealt with the liability of auditors to third parties. His evaluation of the role of the accounting profession (to which auditors belong) is pertinent in the context of these recent events and cases:

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. 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 combined with the effect of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to changes in the role and the responsibilities of the accountant, and in the reliance which the public must place upon 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.

With the added prestige and value of his services has come, as the leaders of the profession have recognized, a concomitant and commensurately increased responsibility to the public.\(^{14}\)

These comments, issued in the context of an action by a third party against the auditor of the corporation in which an investment was being mooted, were endorsed and applied in rather spectacular fashion in May 1983 by the Alberta Securities Commission in its decision involving the audited accounts of Reed Communications Inc.\(^{15}\) The commission indicated that in its evaluation of the suitability of a public distribution it relied on the auditors who had prepared reports that would be part of the public offering documentation. The commission commented:

---

\(^{12}\) See Baxt, "Liability of Accountants," *supra*, note 6; and Ebke, *supra*, note 5, for a comprehensive list of articles published in the United States and other jurisdictions on this subject.

\(^{13}\) *Supra*, note 7; the judgement of Mr. Justice Dickson was in effect the judgement of the court.


An auditor should know that his work will be relied upon by a prospective investor. . . . The public perceives that an auditor will perform to a standard of professionalism [and will be] prepared to stand independent of the issues and will maintain and demonstrate objectivity in presentation of his material in pursuit of the statutory requirements of full free and plain disclosure. To this extent, the auditor carries a grave responsibility in the nature of a public trust.16

This is a rather dramatic extension of the role of the auditor. The commission felt that it was entitled to rely on the certified, or audited, financial accounts and related information in its evaluation of the prospectus and accompanying documents.

One can compare the remarks and evaluation of the role of the accountant/auditor in 1976 with more recent comments of Judge Shrieber in the Rosenblum litigation:

At one time the audit was made primarily to inform management of irregularities and inefficiencies in the business. . . . That function remains one of the principle reasons for the audit. Gradually a need for independent audits was generated by public ownership of business enterprises and by requirements of the stock exchanges and the Securities and Exchange Commission. . . . Institutional investors, investment specialists, stockholders, and lenders demanded more and reliable information. It is now well recognized that the audited statements are made for the use of third parties who have no contractual relationship with the auditor. Moreover, it is common knowledge that companies use audits for many proper business purposes, such as submission to banks and other lending institutions that might advance funds and to suppliers of services and goods that might advance credit. . . .

The auditor’s function has expanded from that of a watchdog for management to an independent evaluator of the adequacy and fairness of financial statements issued by management to stockholders, creditors, and others. . . .17

This view was endorsed and even enhanced by the U.S. Supreme Court in U.S. v. Arthur Young & Co.18 in 1984 when it suggested that the auditor

assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as the investing public. This public watch dog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant’s interpretations of the client’s financial statements would be to ignore the significance of the accountant’s role as a disinterested analyst charged with public obligations.19

---

16 Ibid. at 41; note also the additional comments at 42:

Whereas an accountant is customarily identified as a professional adviser to an issuer, upon assuming the mantle of an auditor, the accountant sheds the status of an adviser and assumes the status of a tester and reporter. To the extent that the audit is done for the benefit of the public, or potential investors, or in satisfaction of laws or regulations, then, to that extent, the auditor is responsible to the statutory or regulatory authority (the Commission) in assisting that body to carry out its mandate of public interest.


19 Ibid. at 1503.
These reflections on the role of auditors and the increased responsibilities they bear to the community and to corporations will be most severely tested and stretched, at least in Australia, if the second Cambridge Credit\textsuperscript{20} case stands. I make no apology for concentrating on decisions of my original home state. Some fourteen years ago another New South Wales judge handed down another landmark decision on auditors in the Pacific Acceptance litigation,\textsuperscript{21} which has had some impact in Canada and other jurisdictions.\textsuperscript{22}

III. THE WATCHDOG/BLOODHOUND SYNDROME

The dictum of Lord Justice Lopes in the late nineteenth century that an auditor was a watchdog and not a bloodhound\textsuperscript{23} has been the subject of comment by various writers elsewhere.\textsuperscript{24} It has also been the subject of a number of judicial comments and observations over the years.\textsuperscript{25} The ever-increasing number of actions being brought against auditors for breach of their duty bears testament to the fact that investors are concerned about the degree of protection they are receiving from the auditors.\textsuperscript{26} Whether the auditor can continue to be regarded as a watchdog or bloodhound seems almost irrelevant in the context of the quite astonishing story uncovered in Cambridge Credit Corporation v. Hutcheson in the New South Wales Supreme Court and in the spectacular events that have occurred in Canada involving banks. However, the story

\begin{itemize}
\item \textsuperscript{20} Cambridge Credit (3), supra, note 1.
\item \textsuperscript{21} Pacific Acceptance Corp. v. Forsyth (1970), 92 W.N. 29 (N.S.W. Sup. Ct.), Moffit J. [hereinafter Pacific Acceptance].
\item \textsuperscript{22} Professor Dickerson in particular has written on the impact of that decision for the Canadian Institute of Chartered Accountants. See R.W.V. Dickerson, Liability for Negligence: Pacific Acceptance Corporation Ltd. v. Forsyth et al. (Reprinted from the legal cases department of the Canadian Institute of Chartered Accountants) [hereinafter Liability for Negligence].
\item \textsuperscript{23} See In Re Kingston Cotton Mill Co. (No. 2), supra, note 3.
\item \textsuperscript{24} See R. Baxt, "The Modern Company Auditor — A Nineteenth Century Watchdog?" (1970) 33 Mod. L. Rev. 413; and Liability for Negligence, supra, note 22, especially at 6-12. The American literature on this subject is quite voluminous. See Ebke, supra, note 5; C.S. Hawkins, "Professional Negligence Liability for Public Accountants" (1959) 12 Vand. L. Rev. 797; and D.Y. Causey Jr., Duties and Liabilities of Public Accountants, rev. ed. (Homewood, Illinois: Dow Jones-Irwin, 1982) and references cited therein.
\item \textsuperscript{25} See Dickerson, supra, note 3, especially at 23, and note the comments of Moffit J. in Pacific Acceptance, supra, note 21 at 60, 73-74.
\item \textsuperscript{26} For a list of some of the more recent large claims, see "More Suits than Liberace" The Economist (29 June 1986) 78.
\end{itemize}
is only just unfolding, and there has been much disagreement on the role and importance of the auditor in the CCB collapse.\textsuperscript{27}

In this paper I will concentrate my comments on the obligations of auditors as assessed in the New South Wales decisions.\textsuperscript{28} These have some finality. My observations on the role of the auditors of the CCB depend to a large extent on the newspapers. One major parliamentary report is relevant, and there are ongoing senate hearings\textsuperscript{29} and a major judicial inquiry.\textsuperscript{30} As yet no litigation has arisen, but I am sure it will reveal even more interesting material.

IV. THE ROLE OF THE AUDITOR AND HIS INDEPENDENCE

The history of the auditor's role in Canadian corporate law is very similar to that in the United Kingdom and Australia. The general history is well documented elsewhere.\textsuperscript{31} Suffice it to say that while auditors were appointed in the nineteenth century by dint of private contract between enterprise and auditor, it was not until 1917 that it became obligatory for some corporations to appoint auditors under the Canadian statute.\textsuperscript{32} The auditor's role under Canadian federal and provincial statutes was (and still is) very similar to that in Australia with some variations.

The position in Canada insofar as business corporations are concerned is that corporations that distribute securities to the public or whose gross revenues exceed $10 million or whose gross assets exceed $5 million must appoint auditors.\textsuperscript{33} Other corporations may avoid the appointment

---

\textsuperscript{27} A disagreement as to the role of the auditors has come to a head in the hearings of the Commission of Inquiry into the Collapse of the Canadian Commercial Bank and the Northland Bank. See in particular the comments of Mr. Justice Estey, the Chair of the inquiry, as reported in A. Johnson, "CCB Long Entangled with Regulators", The [Toronto] Globe and Mail (22 November, 1985) B1; A. Johnson, "Estey Shows Impatience at Methods of Auditors", The [Toronto] Globe and Mail (23 November, 1985) B1.

\textsuperscript{28} While concentrating on Cambridge Credit (3), supra, note 1, I will also refer in some detail to the decision of Mr. Justice Moffitt in Pacific Acceptance, supra, note 21.

\textsuperscript{29} The hearings of the Finance, Trade and Economic Affairs Committee are not into the collapse of the bank but into proposed legislation to deregulate financial institutions. See in particular the comments by auditors on their role in the collapse of the CCB as reported in The [Toronto] Globe and Mail (22 October 1985) 1-2.


\textsuperscript{31} See W.K. Fraser and J.L. Stewart, Company Law of Canada, 5th ed. by J.L. Stewart and M.L. Palmer (Toronto: Carswell, 1962) at 690ff. See also H. Mann, Evolution of Accounting in Canada (Dissertation presented to Faculty of Business Administration of New York University in partial fulfillment of the requirements for the degree of Doctor of Philosophy, 1972) [unpublished].

\textsuperscript{32} See Mann, ibid.

\textsuperscript{33} Canada Business Corporations Act, S.C. 1974-75, c. 33 [hereinafter "CBCA"], s. 156 and note s. 154.
of an auditor if the shareholders resolve unanimously to dispense with the procedure.\textsuperscript{34}

The auditor appointed must be independent. Independence is a question of fact and is defined by reference to the business auditor’s relationships with, or shareholdings in, the relevant corporation or its affiliates.\textsuperscript{35} Questions of independence become relevant in the context of the obligations imposed on the auditors to report on the financial affairs of the corporation.

The auditor is appointed by ordinary resolution by the shareholders at the first annual general meeting of the corporation\textsuperscript{36} and holds office until the next annual general meeting.\textsuperscript{37} This limited tenure places considerable pressure on the auditor to either perform or lose his position, a view confirmed in Australia, at least, by \textit{Pacific Acceptance Corporation Ltd. v. Forsyth.}\textsuperscript{38}

This major case led to significant statutory reform in Australia. Mr. Justice Moffitt (as he then was) made a number of observations on the independence of auditors. He was concerned that an auditor was appointed for a period of only twelve months (or until the next annual general meeting, as is the position in Canada today). In his view, this meant there was a chance that the auditor might lose this position at the next annual general meeting if he or she did not “come up with the goods” and would lead to ambivalence in the way the auditor carried out his work. Justice Moffitt suggested that, the auditor should be appointed for a period longer than the statutory period of twelve months, as this might provide “some protection in appropriate cases for continuance in office . . . of an auditor who qualifies a report in defined material aspects.”\textsuperscript{39} He also commented that while the shareholders appointed the auditor (and would do so under an annual appointment), in many cases management was in a position to influence in a practical way the appointment and replacement of auditors. Qualification of a report placed the auditor “in a position where there must often be a real and practical conflict, or at least an apparent conflict, between the auditor’s

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{34} CBCA s. 157(1)(3).
\item \textsuperscript{35} CBCA s. 155(2) as am. S.C. 1978-79, c. 9, s. 47; the subsection contains both aspects of the definition of “independence.”
\item \textsuperscript{36} CBCA s. 156(1) as am. S.C. 1978-79, c. 9, s. 48; note that the directors may appoint the first auditor — see CBCA s. 99(1)(e).
\item \textsuperscript{37} See CBCA s. 156(1) as am. S.C. 1978-79, c. 9, s. 48; contrast this with the position in Australia, which is discussed below.
\item \textsuperscript{38} \textit{Pacific Acceptance, supra}, note 21.
\item \textsuperscript{39} \textit{Ibid.} at 126.
\end{enumerate}
\end{footnotesize}
duty to the shareholders and his interest not to take action which may prejudice his reappointment or relations with those whom he works.”

As a result of these remarks and of other situations showing the reluctance of auditors to qualify reports, the Australian legislation was amended in 1971 to its present regime. An auditor is now appointed, not for twelve months, but “until death.” The auditor may be removed by an ordinary resolution by the shareholders at a general meeting of which special notice is given but is given an opportunity to present his or her views at that meeting and to rally support in opposition to the resolution. A similar right allowing auditors to present their views exists in Canada if they are to be removed; but as they are appointed for only twelve months, it would seem that they could be easily replaced unless the shareholders chose not to follow management’s guidance.

The statutory obligations on the auditor in terms of the duty to report are surprisingly slight. Section 163 of the Canadian Business Corporations Act provides that an auditor of the corporation shall make such examination as in his or her opinion is necessary “to report in the prescribed manner on the financial statements required by this Act to be placed before the shareholders...” The regulations provide what must be included in the auditor’s statement. The auditor generally must comply with the rules or standards laid down by the Canadian Institute of Chartered Accountants as set out in the CICA Handbook. These requirements do not appear to be as extensive as in Australia. Audit

---

40 Ibid. at 131.
41 See the Companies Act 1981 (Australia), 1981, No. 89 [hereinafter Companies Act (Aust.) s. 280(4). (The legislation is uniform throughout Australia through a national system of co-operation.) The auditor may be removed but otherwise assumes office until death.
43 CBCA s. 162(1)(5)(6)(7)(8)(9). Note that the auditor only has a right to submit a written statement.
44 Canadian Business Corporations Regulations, SOR/79-316, s. 44.
45 Hereinafter CICA.
46 The Canadian Institute of Chartered Accountants, CICA Handbook. The handbook is updated with regular issues in which accounting principles and statements are revised from time to time. The CBCA does give to the institute’s pronouncements on accounting standards a force of law that does not exist in many other jurisdictions. See supra, note 42. There is much disagreement as to the utility of the pronouncements of the various accounting bodies in this area. On the concept of a true and fair set of accounts (or accounts that fairly represent the position of the company) see R. Baxt, “True and Fair? Accounts — A Legal Anachronism?” (1970) 44 Aust. L.J. 541 (and in particular the references to the work of Professor R. Chambers, a leading Australian academic accountant); see also A.J. Briloff, The Truth About Corporate Accounting (New York: Harper and Rowe, 1981).
47 See the provisions of the Companies Act (Aust.), Part VI, Division 2.
committees must be appointed by "public" corporations, a development that has not been replicated in Australia.

V. THE CAMBRIDGE CREDIT CASES

Cambridge Credit Corporation Limited had been incorporated in New South Wales on 8 March 1950. Its head office was in Newcastle, a city north of Sydney. Originally its principal activities were to conduct a hire-purchase business; later it engaged in land development and other business ventures. A substantial portion of the working capital of Cambridge Credit had been obtained from public borrowings through the issue of debentures and unsecured notes. Under the terms of the trust deed that governed this borrowing, certain limitations were placed on Cambridge Credit issuing stock beyond prescribed percentages. These percentages were similar to those operating for other companies that borrowed from the public. At the request of the company, the auditors were required to certify from time to time what further debenture stock could be issued under the terms of the deed. They were required to provide periodic certificates that set out information required by the legislation and the terms of the debenture trust deed. Following a number of successful years, the company suffered severe financial difficulties, and a receiver-manager was appointed on 30 September 1974.

By statements of claim filed on 20 May 1977, the company (through its liquidator) and the trustee for the debenture holders commenced three actions against the former auditors of the company. Later, five further actions were commenced against the auditors. The statements of claim alleged, among other things, a failure on the part of the auditors to carry out their obligations under the terms of the contract and claimed damages for negligence.

At first instance in 1983, Mr. Justice Rogers held that the auditors were in breach of their duty to act properly in relation to a number of matters. He concluded that the auditors should not have provided certain certificates without qualifying them. Further, he held that the auditors should have insisted that the directors of the company take certain action to ensure that the accounts were in fact properly drawn up in accordance with the statutory provisions. At a later hearing, however, Justice Rogers held that, in his view, the damages claimed by the plaintiffs were too remote to have been caused by the auditors' failure to fulfil

---

48 CBCA s. 165(1). Note possible exemptions under s. 165(2).
49 Hereinafter Cambridge Credit.
50 For the particular claims made against the auditors, see Cambridge Credit (1), supra, note 1.
their contract.\textsuperscript{51} The New South Wales Court of Appeal reversed that decision.\textsuperscript{52} It returned the matter to Justice Rogers for the purpose of making fresh orders based on the facts in the relevant decision. In a monumental judgement delivered on 25 March 1985,\textsuperscript{53} Justice Rogers reconsidered the question of negligence and causation. He held against the auditors and ordered that $145 million should be awarded in damages.

Not surprisingly, the defendant auditors appealed and obtained a stay of execution. In the most recent judgement,\textsuperscript{54} the New South Wales Court of Appeal dissolved an order that stayed execution and replaced it with a more flexible set of orders aimed at ensuring that the assets of the partners of the auditing firm were not dissipated.

The major appeal concentrated on the question of causation and the assessment of damages. In his judgement, Justice Rogers dealt with a number of issues (I have highlighted the obligations faced by auditors where financial difficulties confront the relevant company) and commented on the warnings that should have been given by the auditors. In his view, had these been given, a receiver-manager would have been appointed earlier than 1974.

In the first of the two judgements, Justice Rogers held that the auditors were liable.\textsuperscript{55} He ruled that when the auditors did not qualify the accounts by referring to the failure of the directors to write off the amount owed to Cambridge Credit by Hunter Purchases Pty. Ltd.\textsuperscript{56} as of 30 June 1971, they had failed to exercise due care. Hunter Purchases was a company owned by Hutcheson, the founder of Cambridge Credit. The plaintiffs contended that the whole or the major portion of the debt owed by Hunter Purchases to Cambridge Credit was irrecoverable. If the accounts had been qualified, then the amount of debenture stock that might have been issued by Cambridge following the presentation of these accounts and in accordance with the auditors’ certificate would have been considerably reduced. This in turn might have had a considerable impact in delaying or perhaps preventing Cambridge’s financial collapse.

The first of these judgements does not raise any major questions of law; indeed, no law was discussed in the judgement and none, it seemed, was argued. However, one aspect of the judgement is relevant to one

\begin{flushright}
\textsuperscript{51} Cambridge Credit Corporation v. Hutcheson (1983), 8 A.C.L.R. 513 (N.S.W. Sup. Ct.) [hereinafter Cambridge Credit (4)].
\textsuperscript{52} Cambridge Credit (2), supra, note 1.
\textsuperscript{53} Cambridge Credit (3), supra, note 1.
\textsuperscript{54} Alexander & Ors v. Cambridge Credit Corporation (1985), 10 A.C.L.R. 42 (C.A.). This decision was varied in (1985), 10 A.C.L.R. 327 (N.S.W.Sup.Ct.).
\textsuperscript{55} Cambridge Credit (1), supra, note 1.
\textsuperscript{56} Hereinafter Hunter Purchases.
\end{flushright}
of the themes of this paper — the question of the independence of the auditor.

Purcell, the relevant partner of the firm Fell and Starkey, was the resident partner in Newcastle. He had enjoyed a long and apparently satisfactory association with Hutcheson, the founder of Cambridge Credit. Purcell regarded Hutcheson as an excellent money manager. His failure to call into question the nature of the debt owed by Hunter Purchase to Cambridge Credit was explicable in part in light of

the difficult position in which [Purcell] was placed. [Cambridge Credit] and its associates were no doubt very important to Mr. Purcell's practice. The growth of the company was probably outstanding by any measuring stick, for [the city of] Newcastle it must have been unique. The loss of the company as a client, by too stringent an approach as auditor, would have been a heavy blow.57

This comment raised directly the problem faced by many auditors: qualify the accounts and run the risk of losing the audit contract.

The major issues in the later decision (the one that granted the $145 million award)58 were the failure of the auditors to comment on speculative and rash investment by Cambridge Credit in various companies, the inadequacy of the accounts to show the real value of these investments (a fairly common problem at the time and regrettably often overlooked by auditors), and the failure of the auditors to bring to the attention of the board of directors a potential breach of the law.

It is unnecessary to discuss the intricate factual details of the various investments that come under the first classification. Suffice it to say that Justice Rogers held that when Cambridge Credit invested in companies such as Kingscliff Forests Ltd.,59 Surfers Paradise Forests Ltd.,60 Carbeer Fishing Company Pty. Ltd.,61 and Northumberland Insurance Company Ltd.,62 the very fact of these investments should have raised some questions for the auditors. This was so because of the nature of the relationship between Cambridge Credit and Hutcheson and the relevant companies, because of the inadequacy of the capital bases of the relevant companies that were issuing the shares, and the arrangements whereby Cambridge Credit was to receive either a discount or some form of payment in respect of its subscription for the shares in these companies. Most of the investment procedures were highly artificial. Usually funds were

57 Cambridge Credit (1), supra, note 1 at 132.
58 Cambridge Credit (3), supra, note 1.
59 Hereinafter Kingscliff Forests.
60 Hereinafter Surfers Paradise.
61 Hereinafter Carbeer Fishing.
62 Hereinafter Northumberland Insurance.
advanced and rebates granted. Transactions intended to be at arms length were not treated as such. The comments of Justice Rogers in relation to the Kingscliff Forests investment are typical of the problems thrown up in these investment transactions:

On my understanding of the experts, once an auditor perceived the wholly artificial nature of the payment, the fact that it was made to a company owned and controlled by the managing director [of Cambridge Credit] and the size of the amount involved made it necessary to inquire further to see what in fact had happened to the money. On such enquiry it would have been readily seen that some of it came back to Cambridge [Credit] directly to its loan account with Northumberland [Insurance]. . . . That would then have excited a reasonable auditor to look to the fate of the balance of the [money]. . . . Accordingly, in so far as that may be necessary, I am of the view that the circular nature of the payment should have been discovered by [the auditor].

In relation to a second transaction, involving the investment in Surfers Paradise, Justice Rogers questioned whether the auditor knew or ought to have known of circumstances that would have indicated that the value of the investment shown in Cambridge Credit's books was too high. In view of the relationship between Purcell and Hutcheson and because the investment in Surfers Paradise involved another company in which Hutcheson was directly or indirectly involved, Purcell should have been particularly careful:

Purcell should have been conscious in 1971 of the need to scrutinise the transactions engaged in by Cambridge [Credit] with considerable care and to evaluate with a proper degree of skepticism the actions and promises of Cambridge [Credit] directors in general and Hutcheson in particular. In forming his opinions Purcell should have manifested a certain healthy curiosity as to the precise steps which Hutcheson was taking to honour his promises with respect to the apparently bad debts. In other words, however one defines the duties of an auditor in 1971, in relation to the accounts of a company the management of which has been found to be truthful and reliable, whose accounts aroused no particular comment and whose financial affairs passed scrutiny, here [the auditor] was dealing with a company which manifested none of these characteristics. It is the cumulative effect of the problems that confronted Cambridge [Credit] and the solutions found for them by management that should have driven [the auditor] to make inquiries. I am content to accept the defendants' submissions that [the auditor] did not in fact become aware of a number of matters in relation to the acquisition of shares in Surfers. That to my mind merely confirms the impression of lack of competence in the execution of his duties which I expressed in my earlier judgement. Had [the auditor] done the work called for by all the circumstances confronting him, I am satisfied that he would have become aware of all the matters which found the conclusion I arrived at concerning the true cost of the Surfers shares.

A final comment by Justice Rogers illustrates the burdens he suggested were imposed on an auditor, especially where a hint of

63 Cambridge Credit (3), supra, note 1.
64 Ibid. at 558-59.
uncertainty or difficulty faced a company. Dealing with a transaction involving Carbeer Fishing in which again he believed the value of the investment shown in the books of Cambridge Credit was too high, Justice Rogers noted the inability of Purcell to resist

the siren song of Hutcheson's assurance and his strange acceptance of the notion that, consistently with their fiduciary duties, the directors of Cambridge [Credit] may arrange affairs so that debts, which cannot presently be paid by debtors, will be paid out of the proceeds of transactions put their way and, in some instances, financed by the creditor.65

Justice Rogers continued:

By his actions and inactions Purcell demonstrated a concept of auditor's duties which requires mention and rejection. His basic philosophy appears to have been that a true and fair view of a company's affairs may be given by a balance sheet which shows an incorrect statement of the company's financial situation as at its date, but which may come true at some date in the future, provided that the directors are able to and do fulfill certain assurance of intention given to the auditor.66

The most interesting aspect of the case, however, turned on the question of whether the auditors had an obligation to report on the potential breach of law arising out of an investment decision of the company's directors. The company had advanced considerable sums of money to another company known as Wellington Court Holdings Pty. Ltd.67 to enable it, through an intermediary or a set of intermediaries, to purchase shares in Cambridge Credit. Such a purchase was in potential breach of what was section 67 of the relevant Companies Act,68 which prohibits a company from financing the purchase of shares in the company.69 At best, assuming that the particular transaction could have been saved by a more liberal interpretation of what it amounted to, the auditors (in the view of Justice Rogers)70, should have noted that the loan to Wellington Holdings was subject to possible legal challenge, which might have rendered the loan invalid and therefore made it impossible for the company to recover the monies lent. The evidence for the plaintiff in the case, led by one of the accounting experts, a Mr. Kirk, was that any auditor in this instance "should have sought legal advice in determining whether any part of the loan was made unenforceable by the section [s. 67]."71

65 Ibid. at 560.
66 Ibid.
67 Hereinafter Wellington Holdings.
68 Companies Act (N.S.W.), 1961, No. 71.
69 CBCA s. 42; there are equivalent provisions in provincial statutes.
70 Cambridge Credit (3), supra, note 1 at 564.
71 Ibid. at 562.
If so, the auditor would have been required to determine whether there was any chance of recovering the payment, presumably through severance of part of the agreement.\textsuperscript{72}

Justice Rogers was more adamant than Kirk (and the other expert who supported Kirk’s view) that Purcell should have sought legal advice. This advice, in the view of the judge, would have been unequivocal: that the relevant section had been or would have been breached.\textsuperscript{73} The auditor would have been obliged at that point to note the breach or potential breaches.

In defending his position, Purcell indicated that he had attended a seminar when this particular provision of the legislation was introduced. At this seminar eminent counsel had expressed the view that the section would not have been breached in the particular circumstances of the loan. Further, the leading textbook on the subject appeared to support this conclusion. These views were rejected by Justice Rogers: “The defect in [Purcell’s] approach is a failure to appreciate that the only knowledge required of the auditor was that which sufficed to send him off for legal advice.”\textsuperscript{74} The auditor argued that to require him to seek legal advice in such circumstances would be to impose a standard on auditors that would be quite beyond the ability of a competent auditor. It would in effect “require of an ordinary competent auditor a degree of knowledge and understanding of some esoteric branches of the law beyond that achieved by many of Her Majesty’s Counsel.”\textsuperscript{75}

Purcell appeared to have been the victim of a common failing: a lack of knowledge or sufficient understanding of the relevant legislation. This is not surprising in the context of the difficulties of the section under consideration and of the difficulties of the broader obligations of auditors.\textsuperscript{76} However, in some respects, and bearing in mind the rationale

\textsuperscript{72} Ibid at 563.
\textsuperscript{73} Ibid.
\textsuperscript{74} Ibid.
\textsuperscript{75} Ibid.

\textsuperscript{76} The auditor in the Australian context (and I have no doubt that similar arguments could be mounted in relation to the Canadian position) may have to consider a number of provisions in the legislation that would call for a similar preliminary assessment as to whether to seek legal advice. The \textit{Companies Act} (Aust.) for example, prohibits dividends being paid out unless they are paid out of profits (s. 565); companies may not make loans to officers (unless they are a special class of closely-held corporations — the exempt proprietary company) (s. 230); and there are numerous provisions dealing with registers to be kept (see, for example, ss 231 and 238). It is my view, a view that I believe would be supported by the judgement in the \textit{Cambridge Credit} litigation and by other judgements, that the auditor should ensure that the company complies with these provisions. Any cases of doubt should result in consultation with management and in seeking legal advice when management does not provide a satisfactory answer.
behind the appointment of an auditor, Purcell would always be "behind the eight ball" in trying to comply with his obligations in relation to each of the situations that Justice Rogers had to consider because of his domination by Hutcheson.

Had Purcell discovered that there was potential breach, what would his duties have been? In Australia the answer is fairly clear. Under the common law, the obligation of the auditor in such a case would be to confirm this with a lawyer and eventually to note the particular breach in the report by a qualification. However, the noting would occur only after the matter had been raised with the board of directors. Some explanation might have been given in advance, but, according to Justice Rogers, the position was such that no explanation would have waived Purcell's duty to seek legal advice. One would imagine that a similar procedure would apply in Canada. Under the CICA general auditing recommendations, the auditor might wish to discuss such a problem with the audit committee and with management; and seek legal advice if appropriate. However, these are not mandatory requirements.

Under the Australian statute the position would appear to be quite different from that at common law. The statute was amended in 1971 to impose a more onerous obligation on the auditor. Section 285(10) provides as follows:

[If an auditor, in the course of the performance of his duties as auditor of a company, is satisfied that
(a) there has been a contravention of, or failure to comply with, any of the provisions of this Act; and
(b) the circumstances are such that in his opinion the matter has not been or will not be adequately dealt with by comment in his report on the accounts . . . or by bringing the matter to the notice of the directors of the company . . . he shall forthwith report the matter to the Commission by notice in writing.

As can be seen from the terms of the section, the auditor has little choice in the obligations cast upon him. If on all the facts it was fairly clear that a mere reference of the matter to the board of directors would not have resulted in satisfactory steps being taken, the auditor would

---

77 Cambridge Credit (3), supra, note 1 at 563.
79 Ibid., para. 5300.54 and 5300.55.
80 Companies Act (N.S.W.), 1961, No. 71.
81 Companies (Amendment) Act (N.S.W.), 1971, No. 61, s. 6(1).
82 Companies Act (Aust.), s. 285(10).
have to turn to the Corporate Affairs Commission\textsuperscript{83} for assistance. This is an important obligation imposed on the auditor and, in turn, on the Corporate Affairs Commission. After all, the shareholders, by whom the auditor has been appointed and for whom the auditor is presumably acting, will have no opportunity to deal with the matters thrown up by the facts in such a case until the report of the auditors has been distributed by the directors. This will usually be too late. The ease with which the auditor, Purcell, was deflected in his apparent challenges to actions taken by the directors suggests that such a statutory provision may have been of some use. The legislation in Australia imposes this obligation on auditors to ensure that they have some backup in their disputes with the directors of corporations to whom they have no specific obligation.

Let me illustrate the operation of a section such as this in the context of the specific provisions of the CBCA (with cross-reference to the Australian provision). Section 117 of the Act\textsuperscript{84} imposes a number of statutory duties on directors. Assume that the auditor, in reviewing the books of the company for the year, discovers that a corporate asset has been sold by the corporation to directors of an affiliated corporation and that the price appears to be quite low when compared to its book value. How does the auditor deal with this particular matter? There is potentially a breach of the statute,\textsuperscript{85} and the auditor could, after discussing

\textsuperscript{83} The Corporate Affairs Commission would be the equivalent of the Director of the Canadian Business Corporations Act and similar officers in the provinces. However, it should be noted that companies legislation in Australia is administered at two levels. At the national level there is a National Companies and Securities Commission primarily charged with determining policy for the administration of both the companies legislation and other legislation dealing with takeovers and securities, with State Officers, known as Corporate Affairs Commissioner Corporate Affairs Commissions, charged with the day-to-day administration of the legislation. The provision in the statute dealing with reference to the commission is to State Corporate Affairs Commissions and Commissioners.

For a description of the Australian scheme of administration see R. Baxt, \textit{An Introduction to the Securities Industry Codes}, 2d ed. (Australia: Butterworths, 1982).

\textsuperscript{84} This section requires directors and officers to exercise powers and discharge duties "honestly and in good faith with a view to the best interests of the corporation; and . . . exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." This statutory duty is similar to the statutory duty imposed on Australian directors and officers under s. 229 of the \textit{Companies Act (Aust.).} While no Canadian or Australian cases have analyzed the statutory provision in fine detail, there have been references to them from time to time indicating that the statutory provisions would be interpreted in line with the developments of the common-law obligations on directors and officers. See T. Hadden, R.E. Forbes & R.L. Simmonds, \textit{Canadian Business Organizations Law} (Toronto: Butterworths, 1984) at 214ff.

\textsuperscript{85} In my view, where there is a sale of a corporate asset to a director or a company associated with the director without there being full disclosure to shareholders so that they might affirm the particular contract, there would be a breach, not only of s. 117 of the CBCA, but also a potential breach of s. 115; (Disclosure of interested director contract). The common law duties will also be breached in this situation — for a recent example of a potential common law breach see Daniels v. Daniels, [1978] Ch. 406, [1978] 2 All E.R. 89, Templeman J. It is doubtful that the shareholders could successfully ratify the transaction if a statutory breach is involved — see CBCA s. 117(3).
the matter with the board, qualify the accounts or provide some explanation. Alternatively, the auditor might seek legal advice and then, if appropriate, pursue the course of action provided by section 285(10). Reference to the relevant official would probably result in some action being taken. Often the result of qualifications made to the accounts are not seen until much later, when the corporation is already in liquidation or under receivership. Often the actions taken by the auditors do not receive sufficient publicity until the shareholders’ interests (financial and other) in the corporation are already seriously at risk.

While it could be argued that the auditor has no specific statutory duty to the creditors and other persons who may be interested in the welfare of the corporation,\(^{86}\) the ramifications of the auditor’s failure to identify a particular deficiency or breach and to satisfy him or herself as indicated by Justice Rogers could dramatically affect their interests. That they may stand in a preferred position to shareholders will be little consolation to them in the kind of collapse that occurred in *Cambridge Credit*.

The Cohen Commission of Inquiry into the American auditing profession\(^{87}\) recognized the difficulties that arise from the demands made on auditors in situations such as that confronting Justice Rogers in *Cambridge Credit*. It recognized that the views of society on this score were unclear. The reliance placed on auditors in special positions — for example, where securities are to be issued to the public — has imposed an ever-increasing burden on the profession. While the commission recognized that the auditor has some obligations in detecting illegal acts, breaches of statutes, and related legal matters, it also wished to draw some parameters on these obligations:

Several fundamental considerations suggest limits on the extent of the auditor’s responsibility for detection and disclosure of the illegal acts of clients. Auditors cannot reasonably be expected to assume responsibilities for detection or disclosure of a client’s violations of law in general. Auditors are primarily accountants, trained and experienced in activities that are basically financial. They are not lawyers nor are they criminal investigators, and they do not possess the training or skills of either group.

Society has developed an elaborate enforcement system to help assure compliance with its laws, including regulatory agencies, police, lawyers, courts, and prisons. Independent auditors — by tradition, training, and experience — have played a minor role in this system. Nevertheless, with the current increased concern

\(^{86}\) Traditionally the auditor has a duty only to the shareholders of the company; this is clearly the statutory provision. However, there have been many cases in which the auditor has been stated as owing a duty to interests. See text accompanying notes 14-16. Note in particular the remarks of the Alberta Securities Commission in the *Reed Inquiry*, *supra*, note 15 at 41.

OSGOODE HALL LAW JOURNAL

with white collar crime, some parties view independent auditors as public agents to be used to improve the functioning of the enforcement system as it relates to the conduct of business.

The public accounting profession must be responsive to society's needs for evolution of the scope of the services it provides. ... However, the Commission believes that it would be inefficient and impractical for auditors to undertake responsibilities that would require the knowledge, skills, and experience of members of another profession, namely, law. Thus, the resolution of the issue should be within the framework of the conventional skills attributed to accountants and auditors.88

It is interesting to compare these remarks with those made at about the same time by the Adams Committee, appointed by the Board of Governors of the Canadian Institute of Chartered Accountants.89 Its remarks relate to illegal acts at large, not only to the breaches of the corporations statutes, which is the thrust of the Australian provision. It will be interesting to see how soon these recommendations are incorporated into the CICA Handbook or into law:

E.15. An audit cannot be expected to provide assurance that illegal acts will be detected. Determination of whether an act is illegal is usually beyond the competence of auditors, though their training and experience provide a basis for realizing that some acts that come to their attention may be illegal. Generally, the further removed an act is from the transactions reflected in financial statements, the less likely it is to come to the auditors' attention or that auditors will recognize its possible illegality. For example, because of their training, auditors would normally be expected to recognize a breach of tax laws, while on the other hand they would not normally be expected to recognize a breach of pollution control laws....

E.16. When, during their examination of the financial statements, the auditors encounter an act of a serious nature which is or may be illegal, which breaches the enterprise's code of conduct, or which casts doubt on the integrity of management of the directors, they should report it to the enterprise's audit committee (regardless of whether the act requires financial statement disclosure). ... The auditor may also have a responsibility to report the matter outside the enterprise, depending on the action and/or disclosures made by the enterprise itself....

E.17. Considerable judgement will be necessary to determine whether a particular act casts doubt on the integrity of management or the directors. An isolated inadvertent act, however serious, clearly would not; nor would the intentional recurrence of minor breaches of the law such as parking violations. Doubt is cast on their integrity, however, where there is a deliberate and serious breach of the law, where management or the directors are the beneficiaries of an illegal or questionable act (for example, acceptance of bribes), or where their actions call into question the credibility of the financial reporting process. Examples of these last-mentioned actions include falsification of accounting records, overriding of control systems, deception of auditors, and misrepresentations as to the enterprise's compliance with its code of conduct or by-laws generally.

88 Ibid. at 44-45.
E.18. Auditors should inform the audit committee promptly when they encounter an illegal or questionable act that gives rise to a material contingent liability or casts doubt on the integrity of management or the directors. As prompt corrective action may be necessary, the auditors may need to requisition a meeting of the audit committee to bring such an act to its attention.

E.19. The directors may have an obligation under the securities laws to make timely disclosure of illegal or questionable acts brought to their attention by the auditors. If the directors fail to discharge such an obligation, we believe that the auditors cannot wait until their next report on the financial statements to discharge their own reporting responsibility. Instead, they should resign, deliver a statement to the company secretary setting out the reasons for their resignation . . . and lodge a copy with the Securities Commission. The company secretary should be obliged to distribute this statement to the shareholders without delay. Both this statement and responses to related questions from the Securities Commission should be covered by qualified privilege. While it may be a new step for auditors to report such matters to a regulatory agency, it is an effective step and is consistent with their evolving function as agents of social control. Auditors have a responsibility toward the shareholders, which they may find difficult to discharge in the special circumstances under discussion; the Securities Commission is uniquely qualified to assist auditors in discharging their responsibility because it can effectively protect investors by issuing a "cease-trading" order in the company's securities. . . .

The recommendation contained in paragraph E19 would not impose very different obligations from those imposed under section 285(10) of the Australian Companies Act, discussed above.

VI. THE CANADIAN COMMERCE BANK COLLAPSE

At the time I chose my topic for the Lewtas Lecture which formed the basis of this paper, I had no forewarning that momentous events were to occur in Canada that would have a direct bearing on my main area of interest. I have concentrated, in following up these events, on the Canadian Commercial Bank collapse and the reports of that event. I have had to rely in part on newspaper accounts. I have also found

90 Ibid. at 50-51.
92 My reliance on newspaper accounts has been limited to The [Toronto] Globe and Mail. In October and November 1985 the Globe and Mail carried fairly detailed reports of the hearings of the Standing Committee of Finance, Trade and Economic Affairs on the deregulation of Canadian financial institutions, as well as reports of the Estey Commission of Inquiry into the collapse of the Canadian Commercial Bank and the Northland Bank. However, the most interesting statements appeared after the Lewtas Lecture was delivered, on 21 and 22 November, when Mr. Justice Estey strongly criticized certain procedures adopted by the auditors. The newspaper reports of many other features of the collapse, the role of the office of the Inspector-General of Banks, the various officials of the Canadian Commercial Bank and other persons, are also of particular interest.
a report of the Standing Committee on Finance, Trade and Economic Affairs\textsuperscript{93} of major interest.

It is reasonably clear from the report of George C. Hitchman (for the Inspector General of Banking)\textsuperscript{94} that the procedure adopted by the CCB in relation to loans made by it was unsatisfactory in many respects. Hitchman’s report was the subject of criticism at the Estey Inquiry into the collapse, and there appeared to be “buck passing” on where the ultimate responsibility lay for blowing the whistle. It will be some time before a full picture can be painted, but what is very clear is that there were many doubtful stages in the scenario, which suggested some positive action could (and many would say should) have been taken by the auditors.\textsuperscript{95}

The Standing Committee on Finance, Trade and Economic Affairs, in its eighth report, looked closely at some of these issues. It categorized the activities of the CCB as having been “marked by a series of imprudent lending practices, questionable accounting policies, inadequate information disclosure and lack of supervisory enforcement.”\textsuperscript{96} According to the committee, the imprudent lending policies, dating back to the late 1970s, were responsible for much of the bank’s problems. Despite these difficulties, the committee found little warning contained in the accounts or in the auditors’ reports.

In this climate, the external auditors of the bank “appearing before the Committee acknowledged that they would have liked to [have seen] a greater provision for loan losses” but qualified this by doubting whether the bank could in fact have made such a provision.\textsuperscript{97} Surely that was a matter for specific comment.

Only a passing reference to these problems was made in the Annual Report for 1984. Furthermore,

\textsuperscript{93} The report on the Canadian Commercial Bank was the eighth report of the Standing Committee of the Finance, Trade and Economic Affairs Committee and was presented to the House on 23 June 1985. The committee was given its order of reference on 18 April and 28 May 1985. These were to consider “the circumstances leading up to the support package offered to the Canadian Commercial Bank as approved in Bill C-37.” For the full report, see Minutes of Proceedings and Evidenced of the Standing Committee on Finance, Trade and Economic Affairs, Issue No. 41, 1985 [hereinafter Standing Committee Report].

\textsuperscript{94} This report dated 12 August 1985, was presented in evidence to the Estey Royal Commission into the collapse of the Canadian Commercial Bank and Northland Bank. It was the subject of heavy criticism by the banks auditors and was also criticized in evidence in the Estey Inquiry; see The [Toronto] Globe and Mail, (24 October 1985). The criticism concerned \textit{inter alia} the method chosen by Mr. Hitchman to value the assets of the bank, and the disagreement related to acceptable accounting techniques and methods.

\textsuperscript{95} See the remarks of His Honour Mr. Justice Estey as reported in The [Toronto] Globe and Mail (22 November 1985) B1 and (23 November 1985) B1.

\textsuperscript{96} Standing Committee Report, \textit{supra}, note 93 at 5.

\textsuperscript{97} \textit{Ibid.} at 8.
In the opinion of the Committee, the amount of information and the manner in which information was disclosed were neither adequate nor satisfactory. More stunning however was the discrepancy between publicly disclosed information and information reported to the OIGB.\textsuperscript{98} The tremendous discrepancy between what is publicly disclosed and reported to the supervisory authority is not only unacceptable to shareholders of the Bank, but also to the public at large who entrust funds to financial institutions.\textsuperscript{99}

The auditors alerted the audit committee to some of the problems being encountered in October 1983. They stressed the need for greater conservatism in dealing with loan losses. Despite this warning, the auditors did no more than echo their concerns in a report at end of 1984 to the audit committee: “[T]he Bank continues to be less conservative than we would like with respect to loan loss provisions, accrual and capitalization of fee income on re-structures, limited recourse work-outs... the Bank is somewhat more aggressive in its accrual and capitalization of uncollected interest than we would prefer.”\textsuperscript{100}

Again, with these comments ringing in their ears, management made no specific statement and did not react positively to the problems posed. They queried what accounting responses may have been made by them. It was not surprising that problems continued to occur. The auditors continued to make suggestions for improvements in the accounting procedures; indeed, the bank was advised it would stand or fall by these doubtful strategies. Little reaction was obtained from management. The audit committee obviously had little influence.

In its conclusions the committee was predictably scathing in its comments on management’s performance:

Where CCB failed in the Committee’s view is that management was less prudent than can be reasonably expected in its manner of dealing with these accounts. In fact, its accounting practices overstated income and understated loan losses because of its interest capitalization policy, overvaluation of the security value in real estate loans, equity participation in the refinancing of problem accounts and accrual of interest income where the loan balance exceeded the value of the underlying security. CCB’s difficulty was further exacerbated by its overexposure in the energy and real estate sectors. Management must have been fully aware that the Bank would stand or fall by its strategy. And whether the Bank would be able to ride out of its difficulty would depend on economic events. Hence, the Bank’s expression of surprise following the events early this year which necessitated financial assistance is not a credible one.\textsuperscript{101}

\textsuperscript{98} The Office of the Inspector-General of Banking. It should be noted that the committee was also critical of some of the actions taken by this regulatory agency.

\textsuperscript{99} Standing Committee Report, supra, note 93 at 9-10.

\textsuperscript{100} Ibid. at 11.

\textsuperscript{101} Ibid. at 16-17.
But the committee was also highly critical of the auditors:

The fact that CCB had to be rescued five and a half months after its 1984 financial statements had been approved by the shareholders' auditors with an unqualified opinion raises questions about their role in the entire affair. Did the annual report of CCB for 1984 represent a fair and accurate view of the Bank's financial position at the time? In forming their opinion, the auditors evaluated the Bank's internal control and inspection systems which were material to its accounts, examined transactions by sampling and reviewed management decisions regarding loan loss provisions and income recognition. . . .

The committee admitted it could not obtain detailed information about the management of the “questionable practices” and how these might have affected the accounts. The chronology of events as well as the size of the Bank's marginal loans, however, “constitute sufficient evidence for the Committee to question the auditors' decision to issue an unqualified opinion.” In other words, the committee was questioning why the auditors had not instead chosen to issue a qualified opinion.

While recognizing the fact that the auditors had advised both the audit committee of the CCB and the president of the bank and may not therefore have been directly responsible for its collapse, the committee indicated that some more positive steps might have been taken. It added that “the auditors also knew that the financial statements approved by them would be used not only by CCB's existing shareholders, but also potential shareholders, creditors and potential creditors.” Indeed their statement was used in a prospectus issued in February 1985, and the OIGB relied heavily on the auditors as well.

The committee recognized that an unqualified report was highly misleading to the supervisory authority about the affairs of the bank. It concluded:

To ensure that shareholders' auditors exercise their responsibility vis-à-vis the general public and effectively discharge their duty as agents of the OIGB in this supervision, it is therefore recommended that the Government consider the advisability of adopting a dual audit system similar to that in Belgium where one of the two external auditors would be nominated by the appropriate supervisory authority and that the auditor so appointed be accountable to that supervisory authority.

Such an approach is not dissimilar to the positive obligation cast on the auditor under the Australian legislation to report to the commission under the terms of section 285(10).

102 Ibid. at 17.
103 Ibid.
104 Ibid.
105 Ibid. at 18.
VII. THE QUESTION OF INDEPENDENCE

Earlier I noted the legislative response in Australia to the issues of independence canvassed by Justice Moffitt in the Pacific Acceptance litigation, problems again highlighted by the Cambridge Credit litigation. Those issues are of course only one small part of the independence issue, an issue that has concerned the American and Canadian professions in recent times.

The Canadian statute requires the auditor to be independent; independence is described as a question of fact. This difficult question is discussed by Justice Moffitt in Pacific Acceptance:

The task of being independent in any field is always a difficult one, and any steps which can reasonably be taken to remove matters which consciously or unconsciously tend to undermine independence or appear to do so obviously ought to be taken. The question of a qualified report raises problems of which the auditing profession themselves are well aware and in respect of which I would expect they would welcome some aid and protection. Although the shareholders appoint the auditor, a right which in some cases of conflict may be real and of considerable importance, in many cases management is in a position in a practical way to influence the appointment and replacement of auditors. . . .[T]he persons in true communication with the auditor are management and the directors and not the shareholders. . . .[I]t was and is usual to warn management of a proposal to qualify the audit opinion so as to give management the opportunity of persuading the auditor he is wrong and, in default, the opportunity of altering the accounts to overcome the qualification. In this situation the auditor, unfortunately for him and no doubt much to his concern, is put in a position where there must often be a real and practical conflict, or at least an apparent conflict, between his duty to the shareholders and his interest not to take action which may prejudice his reappointment or his relations with those with whom he works. Only the auditing profession and the business world can know how real this conflict is.\(^6\)

Justice Moffitt was considering the issue in its very narrowest sense — that of independence vis-à-vis management. As I have noted, the Canadian statute states that the auditor must be independent and that this is a question of fact.\(^7\) Some guidance is given (as in the Australian statutes) by reference to the allowed association between the auditor and the corporation and its officers; but of course no mention is made of the fact that the auditors' firm may also often be handling tax work, management services, and professional services for the corporation. Mark Stevens, in his very readable critique of the accounting establishment in the United States, commented at some length on this issue:

That aggressive, profit-minded firms like The Big Eight can remain independent and objective with audit clients who also enrich them with multimillion-dollar fees for tax, MAS, and the like is a hard notion to swallow. The instincts of a well-paid professional are, after all, to bend over backwards to satisfy clients,

\(^6\) Pacific Acceptance, supra, note 21 at 131.

\(^7\) See CBCA s. 155(2).
to be responsive to their needs, and to keep them happy and loyal customers. Is The Big Eight auditor likely to blow the whistle on a plum account in the name of independence, knowing full well that this action may sever the client relationship? Are the firms so steeped in principles that they will hold their ground while a treasured client walks across the street to a competitor, taking $5 million or more in annual fees with it?[108]

The U.S. Senate Committee of Enquiry into the profession (The Metcalf Committee) was equally skeptical:

The major responsibility of independent auditors is to perform their services while maintaining strict independence from the clients, both in fact and appearance. Public confidence in the accuracy and usefulness of corporate financial information depends upon a firm belief that such information has been checked and certified by qualified auditors who are truly independent. Confidence in the independence of auditors requires that they have no direct or indirect interests in the affairs of their clients.[109]

The problem, however, is a very difficult one to overcome as was noted by the Metcalf Committee:

The Big Eight firms have seriously impaired their independence by becoming involved in the business affairs of their corporate clients and by advocating their clients' interests on controversial issues. . . . It appears that The Big Eight firms are more concerned with serving the interests of corporate managements who select them and authorize their fees than with protecting the interests of the public for whose benefit Congress established the position of independent auditor.

The management advisory services provided by Big Eight firms are intended to aid corporate managements in operating their businesses and necessarily involve Big Eight firms in the business affairs of their clients. Such involvement creates a professional and financial interest by the independent auditor in a client's affairs which is inconsistent with the auditor's responsibility to remain independent in fact and in appearance.

When a Big Eight firm recruits executives for a corporate client, shareholders and the public may wonder if the firm is retained as the client's independent auditor primarily because of the relationship existing between the firm and the influential executives it recruited. Similarly, the public may reasonably question the ability of a Big Eight firm to act as independent auditor for a corporate client which has also retained the firm to provide marketing analysis, financial management services, actuarial services, or other management advisory services. In such cases, an independent auditor not only becomes involved in the business affairs of its clients, but may be placed in the position of auditing its own work.[110]

Both the Cohen Report[111] and the Adams Report[112] recognized the problems and encouraged the respective professional bodies to work

---

[110] Ibid.
[111] Cohen Commission, supra, note 87 at 1, and in particular at 93ff.
[112] Supra, note 89, especially section G.
towards a solution. These suggestions have yet to be implemented in the Canadian rules as far as I can tell.

Following the Metcalf Report, two important directives were issued by the Securities Exchange Commission\(^{113}\) in the United States to assist in dealing with the problems exposed by that report: Accounting Series Release 250 (1978) and Accounting Series Release 264 (1978). Professor Briloff, in a stinging attack on the SEC and the American accounting profession, alleged that these directives were withdrawn in 1981 probably due to pressure from the accounting profession.\(^{114}\)

In Australia one response to the failure of auditors to qualify the report (as illustrated by the Cambridge Credit litigation) was to appoint auditors "for life," placing the onus on management, in effect, to bring about a change in auditors.\(^{115}\) Knowledge that one could not be replaced at the whim of management in the case of disagreement with it was seen as an important change. But as Stevens so graphically illustrated (and, indeed, this is seen in the Metcalf Report as well), the Big Eight control a significant section of the market. Giving one of these firms a life-long audit contract, without curtailing these rights to win other contracts (such as tax or management services), would place even greater strains on the notion of independence.

The problem offers no easy solution. Certainly the profession itself will not quickly be able to find one; perhaps the creation of stronger audit committees and the establishment of some reporting rules that indicate the fees the relevant firm of auditors is receiving from non audit work will assist in solving the problem.\(^{116}\) The Australian statutory provision discussed above, a variation of which is seen as viable in the Adams Report, is another possible partial solution.

VIII. AUDIT COMMITTEES

As I have noted above, certain corporations under the Canadian legislation must appoint audit committees.\(^{117}\) The work of the audit committee was seen as enhancing and easing the task of the board of

\(^{113}\) Hereinafter SEC.


\(^{115}\) Companies Act (Aust), s. 280, and see also s. 282.


\(^{117}\) See CA CA s. 165.
The committee, under the Canadian statute, consists of representatives of the board, but the majority of its members must not be officers or employees of the corporation.\textsuperscript{118} Some work has been done by the CICA on the operation of audit committees.\textsuperscript{119}

The existence of an audit committee was seen as a major improvement in enhancing the independence of auditors in the United States. The American Law Institute,\textsuperscript{120} in its corporate governance study noted:

Such a committee reinforces the independence of the corporation's outside auditor, and thereby helps assure that the auditor will have free rein in the audit process. . . . [S]uch a committee provides tangible embodiment of the concept that, within the framework of corporate relationships, the independent auditor is responsible to the board and to the shareholders. Finally, such a committee provides a forum for regular, informal, and private discussion between the independent auditor and directors who have no significant relationships with management. In the absence of such a forum, an independent auditor would often be reluctant to call for a meeting at the board level unless a problem of great magnitude had arisen.\textsuperscript{121}

Of course in the United States the auditor is appointed by and is primarily responsible to management, in contrast to the position in Canada and Australia, at least in theory. The fact that the Canadian audit committee does have a majority that is independent of management supports the flavour of the ALI's comments. In the context of the American practice, Eisenberg\textsuperscript{122} and the ALI\textsuperscript{123} have both argued strenuously for the introduction of legislation to require the appointment of such committees. The tasks undertaken by audit committees are helpful in providing a continuing review and detailed discussion of financial data and related information. But would it in fact pick up the "breaches" of duty that the court expected the auditor to recognize in \textit{Cambridge Credit}? What role can such a committee play in collapse of a major financial institution when things move swiftly? Will the board listen more attentively to the audit committee than to the auditor? What assistance does this committee provide to shareholders or investors at large?

The committee under the Canadian provision serves the management or the board, although it has a direct relationship with the auditor. The directors are required to act pursuant to information that comes to them.

\textsuperscript{118} CBCA s. 165(1).

\textsuperscript{119} See Canadian Institute of Chartered Accountants, \textit{Audit Committees: A Research Study} (Toronto: CICA, 1981).

\textsuperscript{120} Hereinafter ALI.

\textsuperscript{121} American Law Institute, \textit{Principles of Corporate Governance and Structure: Restatement and Recommendations, Tentative Draft No. 1} (Philadelphia: ALI, 1982) at 88.

\textsuperscript{122} M.A. Eisenberg, \textit{The Structure of the Corporation: A Legal Analysis} (Toronto: Little, Brown, 1976) c. 12.

\textsuperscript{123} Supra, note 121.
under section 165(8) of the CBCA and that relates to reports on which the auditor has commented before these reports are approved. The auditor does have the power to attend the meetings of the committee (and must do so if requested), so that in theory the committee could be responsible for picking up the errors or omissions in the financial statement — but that is as far as the audit committee can go. Just how ineffective a committee can be was illustrated in the CCB Report discussed above.

Proposals under the American Law Institute Tentative Draft go part of the way to remedying the deficiencies in the Canadian situation as well as the American. It proposed that the Audit Committee should:

(C) Review, in consultation with the independent auditor:
   (i) The results of each external audit of the corporation, the report of the audit, any related management letter, and management’s responses to any suggestions made by the independent auditor in connection with the audit;
   and
   (ii) The scope and plan of forthcoming external audits.

(D) Consider, in consultation with the independent auditor and the chief internal auditor, if any, the adequacy of the corporation’s internal accounting controls.

(E) Review, in consultation with the independent auditor and management:
   (i) The corporation’s annual and quarterly financial statements;
   (ii) Any certification, report, opinion, or review rendered by the independent auditor in connection with those financial statements; and
   (iii) Any disputes between management and the independent auditor that arose in connection with the preparation of those financial statements.

(F) Consider, when presented by the independent auditor or otherwise, material questions of choice with respect to the appropriate accounting principles and practices to be used in the preparation of the corporation’s financial statements.

(G) Perform such other functions as may be assigned to it by law.

These suggestions should enhance the work of the auditor, but only if the auditor in fact uses the committee as it should be used. Time will tell how successful the ALI will be in its moves for reform.

IX. A POSTSCRIPT — CONTRIBUTORY NEGLIGENCE AS A DEFENCE

Before concluding, I wish to return briefly to the question of auditor’s liability to third parties. At a time when the courts seem set to recognize that civilization will not cease if they extend the potential liability of auditors to third parties, it has been particularly interesting (and

---

124 Supra, note 121 at 83-84.
125 As yet there are no moves to reform the role of audit committees in Canada as far as the writer is aware, but it is interesting to note that, in contrast to the position in Canada and the United States, there is no requirement at all for audit committees in Australia.
126 Despite protestations by accountants, there is no firm evidence that accountants are refusing to accept audit work. See Ebke, supra, note 5 at 689ff, and note the study by H.R. Jaenicke, The Effect of Litigation on Independent Auditors (Comm. Print, 1977).
disappointing) to read two Canadian decisions in which the courts have accepted arguments based on contributory negligence in limiting such liability. The first case, *Revelstoke Credit Union v. Miller*,\(^{127}\) turned in part on a statute allowing apportionment between negligent parties to litigation. Chief Justice McEachern held that contributory negligence could be a defence in an action based on breach of contract by the auditor. In the second case, *Coopers & Lybrand v. H.E. Kane Agencies*,\(^{128}\) a similar result followed but on different grounds. The Court of Appeal dealt at length with the issue of whether contributory negligence could be argued in a case based on contract. Neither case referred to an earlier Australian authority\(^ {129}\) in which auditors tried to shift total responsibility for their alleged negligence to the internal accountants or directors whose negligence it was alleged was responsible for the “failure” on the part of auditors.

In each Canadian case, counsel for the plaintiffs argued, on the basis of earlier New South Wales decisions, that contributory negligence was an inappropriate defence in cases involving a corporate audit. They were unsuccessful. Justice Moffitt in *Pacific Acceptance Ltd. v. Forsyth*\(^ {130}\) summed up the arguments that I believe should have been applied by the court as a matter of principle in dealing with this issue:

> Having in mind the function of the auditor and his relation to the shareholders, and in particular his duty to them in relation to the directors, I do not find merit in a submission which in effect is that although the auditors were negligent they should be excused because the directors also were negligent. To excuse an auditor because the directors or management were also at fault, and in particular to excuse him when he failed to perform his duty with independence and to check on management and the board, would be to . . . to negate a fundamental reason for the appointment of the auditor. If there is a complaint that other officers of the company also failed in their duty and contributed thereby to the loss, then the proper course is to take such action, if any, as in the circumstances is open to the auditor, for contribution from the officers at fault so that the company's loss can be shared between those proved at fault after precise allegations and proper investigation, rather than being cut down or excused to the detriment of the company because others as well as the auditor were at fault.\(^ {131}\)

These views were echoed by the same judge sitting later on the New South Wales Court of Appeal in *Simonius Vischer & Co. v. Holt & Thompson*\(^ {132}\) where he noted:

---


\(^{129}\) See *Dominion Freeholders Ltd. v. Aird*, [1966] 2 N.S.W.R. 293 (N.S.W. Sup. Ct.); and *Employers Corporate Investments Pty. Ltd. v. Cameron* (1977), 3 A.C.L.R. 120 (N.S.W. Sup. Ct.).

\(^{130}\) *Pacific Acceptance, supra*, note 21.


\(^{132}\) [1979] 2 N.S.W.L.R. 322 (N.S.W. Sup. Ct.).
I prefer to express no opinion upon the questions debated before us at length . . . in relation to whether a cause of action in tort lies for professional negligence, whether any such action should be treated as an action in tort and, accordingly, whether the defence of contributory negligence is available. There is, however, one comment that I do make. Where the action for professional negligence is against an auditor, it is difficult to see how a finding of contributory negligence, according to usual concepts, could be made. If, as where the audit is of a public company, the audit contract or the undertaking of an audit is found to impose a duty to be exercised so as to safeguard the interests of shareholders, it is difficult to see how the conduct of any servant or director could constitute the relevant negligence, so as to defeat the claim against the auditor, whose duty is to check the conduct of such persons and, where appropriate, report it to the shareholders.

Neither Canadian court was willing to face head-on the arguments proposed by Justice Moffitt. There seems little point in heralding the auditor as the champion of the shareholders if the onus to seek recovery of damages could be so easily diverted by the auditor to the shareholders by a separate action against the directors. Let the auditors seek recovery from the directors in a separate action! In my view, Justice Moffitt was right in denying apportionment in a number of cases.

In Coopers v. Lybrand the court was dealing with a closely held corporation in which the directors were basically the proprietors as well. In Revelstoke the court was reviewing the actions of an auditor of a credit union that had many members. In neither case was it appropriate for the auditor to shift liability in an action by the client because of the negligence of one or more of the officers of the client. The audit serves a number of purposes. Although it is arguable that the decision may have been justified on a strict application of the facts in Coopers v. Lybrand, it is very disappointing that the courts were not prepared to accept the policy underlying the judgements of Justice Moffitt.

X. CONCLUSION

What conclusions can be drawn from these momentous decisions and events? After the second Cambridge Credit decision was handed down, the insurance premiums on professional liability policies jumped considerably. This, together with a series of decisions on liability for economic loss in third-party situations, has caused more nervousness in the Australian accounting profession than since the aftermath of the Hedley Byrne decision. But I for one do not subscribe to the floodgates theory of Chief Justice Cardozo in Ultramares. And indeed Lord Denning, who in many ways was responsible for opening up the potential liability of

133 Ibid. at 322.
auditors and accountants in his decision in *Candler v. Crane, Christmas*\(^\text{135}\) and in *Selsdon Fountain Pen*\(^\text{136}\) (which in my view brought this area of the law into the twentieth century), himself became nervous when doctors were being successfully sued in England. While his decision in *Whitehouse v. Jordan*\(^\text{137}\) concerned errors of judgement, the theme of his remarks seeking to cut back on potential negligence actions will no doubt be taken up by others. He was nervous about the failure to recognize errors of judgement as an “exception”:

Else there would be a danger, in all cases of professional men, of their being made liable whenever something happens to go wrong. Whenever I give a judgement, and it is afterwards reversed by the House of Lords, is it to be said that I was negligent? That I did not pay enough attention to a previous binding authority or the like? Every one of us every day gives a judgement which is afterwards found to be wrong. It may be an error of judgement but it is not negligent. So also with a barrister who advises that there is a good cause of action and it afterwards fails. Is it to be said on that account that he was negligent? Likewise with medical men. If they are to be found liable whenever they do not effect a cure, or whenever anything untoward happens, it would do a great disservice to the profession itself. Not only to the profession but to society at large. Take heed of what has happened in the United States. Medical malpractice cases there are very worrying, especially as they are tried by juries who have sympathy for the patient and none for the doctor, who is insured. The damages are colossal. The doctors insure but the premiums become very high: and these have to be passed on in fees to the patients. Experienced practitioners are known to have refused to treat patients for fear of being accused of negligence. Young men are even deterred from entering the profession because of the risks involved. In the interests of all, we must avoid such consequences in England. Not only must we avoid excessive damages. We must say, and say firmly, that, in a professional man, an error of judgement is not negligent. . . . Perhaps I may remind you of the saying of John Bradford over 450 years ago. On seeing some criminal taken to execution he exclaimed: ‘But for the Grace of God, there goes John Bradford.’ So now if this judgement against Mr. Jordan stands, all the doctors in England will say: ‘But for the Grace of God, there go I.’\(^\text{138}\)

Such an approach is alarmist and unlikely to eventuate when one reminds oneself of the legal-costs rules that should apply in England, Australia, and Canada.

The accounting profession receives some wonderful plums by virtue of its special position. Accountants must pursue their obligations as auditors with great vigour and more professionalism than appears to have been done in the cases I have discussed. Certainly they must remain


independent in theory and in fact. Mark Stevens has the second last word:

The problem is, most of the users of financial statements — the investing public — have been led to believe that the auditor's signature on an annual report means the books are a totally accurate reflection of the corporation's financial status. At the very least, they are confident that a Big Eight stamp of approval means the company has been investigated for fraud and that it has been found free of any trace of wrongdoing. How shocked the "little old widow" would be to find that auditors point to fraud as one of the factors they provide little insurance against. Insisting that they are not policemen, auditors state that they are, instead, management's partners in the audit process and not their overseers. They do not set out to catch management with its hand in the till but look to management to cooperate with the audit team.¹³⁹

The last word belongs to Mr. Justice Moffitt. In evaluating the role of the auditor he remarked on the use of metaphors about the "standards" expected of the auditor. He added:

I apprehend that too great a use of [metaphors] of the type quoted in substitution for the legal duty has tended perhaps at times to be adopted by the audit profession . . . so that it . . . lead[s] to the idea that if the facts just fall within the supposed rule a great degree of investigation must be done, whereas if in a case perhaps only slightly different it can be said that an auditor could possibly consider the facts just outside it, nothing further need be done.

I point out these matters because the over-use of some dicta has tended to confuse rather than aid this [case].¹⁴⁰

A basic problem facing the profession in the context of the cases discussed here is to ensure that the responsibilities and "rights" given to it are fully appreciated. It should not shirk from imposing appropriate standards, where relevant, on its members. Failure to do so may well result in regulatory watchdogs being appointed to oversee the corporate watchdogs!

¹³⁹ The Big Eight, supra, note 108 at 98.
¹⁴⁰ Pacific Acceptance, supra, note 21 at 62.