PROFESSIONAL LIABILITY OF ACCOUNTANTS AND AUDITORS

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Potential Sources of Liability: Causes of Action

- Breach of Contract
- Negligence- the failure to exercise that degree of professional skill and care appropriate to the circumstances which is expected of auditors or accountants.
- Gross negligence- failure to exercise a minimum level of care required without intent to harm or damage anyone
- Fraud- deliberate concealment or misrepresentation of material facts that causes damage to those deceived

Breach of Contract and Remedies for Breach of Contract

- A breach of contract occurs where an accountant/ auditor fails to perform his duties in accordance with the terms set out in the contract.
- Breach may take the form of :
    i. Failing to complete the engagement within the stipulated time
    ii. Withdrawing from the engagement without sufficient reasons/ justification
    iii. Violating client confidentiality
    iv. Failing to provide professional quality work
- Court remedies include:
    i. Order auditors to fulfil the contract (specific performance)
    ii. Issue injunction to prohibit the auditor from continuing the breach
    iii. Order auditor to pay damages

In what circumstances can an auditor or a reporting accountant be found legally liable for negligence?

- It must be shown that the accountant owed a duty of care to the claimant **(duty of care)**
- That the accountant was negligent in carrying out his professional responsibilities **(breach of duty)**
- The Claimant suffered loss or damage and the loss or damage suffered was caused by the accountant's negligence **(resultant damage)**

What is the standard of care expected of auditors?

- The general standard of care applicable to an auditor's work was described near the turn of the 19th century in ***In re Kingston Cotton Mill Co. (No. 2)*, [1896] 2 Ch. 279 (Eng. C.A.), at p. 288:**

"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

Work of a specialised nature

An accountant who undertakes work of an unusually specialised nature or work of a kind whose negligent performance is particularly liable to cause substantial loss, will be taken to have assumed a duty to exercise a higher degree of skill and care than would be appropriate to less unspecialised work. This will be especially where the accountant hold himself out as being experienced in the kind of work in question.

Accountant/Auditor Defences

In Contract:

- There was no breach of the contract
- Reliance on Indemnity clause*

In Tort:

- There has been no negligence
- Client was contributory negligent
- Client losses were not caused by the breach
- No financial loss has been suffered by the client

Indemnity Clauses/ Disclaimers

- The **Unfair Contract Terms Act Chap 82:37** recognises that exclusion of liability clauses may be included in contracts. However unless the person seeking to rely on the exclusion can show that its **reasonable** such terms would not be enforceable.
- There has been little case law which guides what exclusions of liability for negligence will be regarded as reasonable.

To whom are you liable?

- Auditors may be held liable in both contract and tort by clients and third parties who use audited financial statements or other documents prepared by them.

Who are those third parties?

- The courts have identified three groups of third parties :
  - Identified users or specific individual users who the auditors knows will use the statement to make specific decisions;
  - Foreseen users while not individuals known, belong to a specific group of users whom the auditor knows will use the statements;
  - Foreseeable users belong to a general class of users whose members may or may not use the financial statements.

How have the courts treated auditors/accountants?

> *Liability for economic loss due to negligent misstatement was confined to cases where the statement or advice had been given to a known recipient for a specific purpose of which the maker was aware and upon which the recipient had relied and acted to his detriment.*

The decision in ***Caparo Industries Plc v Dickman [1990] 2 AC 605*** and others has clarified the extent of auditors liability: three criteria must be met:

i. It must be reasonably foreseeable by the defendant that the statement would be relied on by the claimant;

ii. There has to be a relevant degree of proximity between the parties; and

iii. It must be just and reasonable to impose a duty of care on the part of the defendant to the claimant.

Customs and Excise Commissioners v Barclays Bank plc [2006] UKHL 28

Lord Bingham noted that three different tests had been approved for the imposition of duties of care in respect of economic loss where the fact that damage was reasonably foreseeable was not sufficient in itself to give rise to such a duty:

- i) The threefold test of foreseeability of damage, proximity of relationship and the question whether it is fair, just and reasonable to impose a duty. (The Caparo test)
- ii) Assumption of responsibility: did the Defendant, when looked at objectively, assume responsibility to the Claimant for a given task with a view to protecting the Claimant from the type of loss suffered?
- iii) The incremental approach: is the alleged duty consistent with other duties which have been accepted by the courts in previous cases and a logical extension of them?
- The tests should not, when applied, give rise to different results.

Law Society v KPMG (Peat Marwick) 2000 ALL ER 540

- The defendant accountants were retained by DF, a firm of solicitors, to prepare the annual reports which DF was required to deliver to the Law Society under s 34[a] of the Solicitors Act 1974.
- Such reports, which had to indicate whether a solicitors' practice had complied with the rules on the handling of client funds, were intended to alert the Society to any dishonesty, enabling it to exercise its statutory powers of intervention and thereby protect the compensation fund.
- In 1992 the Society discovered that two DF partners had defrauded a number of the firm's clients. Several hundred of them made claims on the compensation fund, and payments totalling some £8·435m were eventually paid out of the fund. In its capacity as trustee of the fund, the Society subsequently brought proceedings for negligence against the accountants in respect of the preparation of the 1989, 1990 and 1991 reports, seeking damages to compensate for the payments made from the fund.
- On the hearing of a preliminary issue, the accountants contended that they had not owed the Society a duty of care in preparing those reports.

“The Court held that:

An accountant owed a duty of care to the Law Society, in its capacity as trustee of the compensation fund, when preparing a report for the purposes of s 34 of the 1974 Act. The intervention by the Society which an adverse report could trigger protected both the public and the fund, and the information available to accountants made it clear that the reports were required so that protective steps could be taken. It was obvious that there could be adverse consequences to the fund if protective steps were not taken because a report failed to draw attention to non-compliance with the account rules.”

-Law Society v KPMG (Peat Marwick) 2000 ALL ER 540

You are not liable to every third party!

- **Swynson v Lowick Rose UK HC 2014-** A director behind a company which sought due diligence services in relation to an acquisition alleged that the accountants owed him a duty of care personally in addition to the duty owed to the company.
- The Court found that it was necessary to establish whether the accountant had assumed responsibility for the advice given to the director. The advisor's knowledge that the director might have relied on his advice was not an adequate basis for demonstrating an assumption of duty. This decision is helpful in upholding the corporate veil and reducing the ability for third parties such as companies director to initiate claims against accountants.

Barclays Bank v Grant Thornton UK HC 2015

The key issue relates to the effectiveness of a disclaimer of responsibility in an auditors' report.

The underlying claim concerns audit services provided by Grant Thornton to the Von Essen Hotels Ltd Group in non-statutory audit reports.

Barclays, contended that Grant Thornton owed it a duty of care in tort in relation to the contents of those reports and that it was negligent in their production because of their failure to uncover the fraud of two employees of Von Essen Hotels Ltd ("VEH") who had deliberately caused Grant Thornton to be misled about (inter alia) the true sales and expenses position.

One of the two admitted that he "encouraged a culture of obfuscation and diversion amongst hotel accounts staff in their dealings with Grant Thornton" and acted in concert with the other to "provide misleading explanations to Grant Thornton".

- The Disclaimer:

"In accordance with the engagement letter dated 18 December 2006, and in order to assist you to fulfil your duties under the terms of your loan facility, we have audited the non-statutory group financial statements (the 'financial statements') of Von Essen Hotels Ltd which comprise the group profit and loss account, the group balance sheet and the related notes. These financial statements have been prepared under the accounting policies set out therein and do not contain comparative information.

This report is made solely to the company's director. Our audit work has been undertaken so that we might state to the company's director those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's director as a body, for our audit work, for this report, or for the opinion we have formed."

Barclays Bank v Grant Thornton UK HC 2015

The Court held that it was self-evident that when the assumption of responsibility test was applied to determine the existence of a duty of care, a person could not be taken to have assumed responsibility in circumstances where it was specifically negatived by him, e.g. **if the maker of a representation told the recipient that if he chose to rely upon the representation the maker would not accept responsibility for the accuracy of it.** Moreover, if a disclaimer was reasonable and effective it would self-evidently not be fair, just and reasonable to impose the very duty it purported to negative.

Applying the test of whether, viewed objectively, the defendants had assumed responsibility to the bank, a reasonable person in the position of the bank would not properly have considered that there had been any such assumption of responsibility either in respect of the duty of care owed to a third party, such as the bank, which relied on the audit or in respect of the type of loss actually suffered by that third party, because:

- (i) the disclaimer was clear and obvious on the face of the 2006 and 2007 reports,
- (ii) the bank was a sophisticated commercial party which could be expected to be familiar with notices of disclaimer in auditors' reports,
- (iii) the bank was aware that auditors did not like undertaking responsibility to persons other than their clients and was well aware from previous dealings with the defendants that they always sought to negate or restrict their liability for their reports,
- (iv) the bank had not engaged or paid the defendants for the reports and ought not to be placed in a better position than if it had paid for reports in which the defendants' liability was limited, and
- (v) the defendants could not have been expected to do anything more than they had done to bring the disclaimer to the bank's attention. The bank's claim therefore had no reasonable prospects of success and the defendants were entitled to summary judgment.

LIVENT Inc. (RECEIVER of) v DELOITTE & TOUCHE [2016] ONCA 11

- Garth Drabinsky and Myron Gottlieb were flamboyant entertainment impresarios who, in the 1990s, created and developed a live entertainment empire known as Live Entertainment Corporation of Canada Inc., or Livent. The developer of high-profile stage productions such as *The Phantom of the Opera, Show Boat, Kiss of the Spider Woman, Music of the Night,* and *Sunset Boulevard*, Livent had every appearance of a healthy, dynamic, and successful business enterprise.
- Canadian IPO in May 1993 and American IPO in 1995 with securities listed on Toronto Stock Exchange and NASDAQ.
- Between 1993 and 1998 massive fraud was orchestrated by senior management. Livent was hiding its unprofitability through accounting manipulations assisted by computer software it had designed to carry out these manipulations without a trace.
- After a change in management, Livent's accounting staff confessed and the fraud was discovered.
- Restated financial statement were released in November 1998 and Livent voluntarily made a petition for bankruptcy protection in the US and files for protection under the CCAA in Canada.
- The Receiver of Livent (Ernst & Young) brought a claim against Deloitte for failure to discover a fraud being perpetrated at the direction of Livent former CEO and CFO, with the assistance of its accounting and IT departments and to the knowledge of most of Livent audit committee.

LIVENT Inc (RECEIVER of) v DELOITTE & TOUCHE [2016] ONCA 11

- Action against Deloitte alleged various categories of fraudulent activities that Deloitte ought to have detected.
- Although the court acknowledged that there had been an a concerted effort to conceal the fraud from the auditors, it was held that Deloitte owed a duty of care to the company for the benefit of the corporate collective and was negligent in preparing clean audit opinions in 1997 and 1998 and but for Deloitte's negligence, Livent would have been forced into bankruptcy sooner.
- Damages awarded were substantial - $84,750,000 and interest thereon bringing the total to **$118,035,770.00.**
- The Appeal Court agreed with the trial judge's finding that Deloitte owed a duty of care to the company for the benefit of shareholders.
- Ample evidence was shown that Deloitte had breached the standard care for an auditor
- Deloitte's negligence permitted Livent to continue in operation.

Some criticisms of Deloitte's interaction with Livent

- Improperly dealt with such audit items
- Failed to put a proper audit plan and the necessary auditing procedures in place to detect possible misstatements or irregularities, when it knew that Livent was a "high risk" client whose principals pushed the envelope (and, in fact, characterized the 1996 audit as such);
- Deloitte became too close to the client and lost its required level of "professional scepticism";
- Succumbed to the demands of Gottlieb to change the audit team to one more open to Livent's approach and, having done so, failed to put a team in place that had sufficient knowledge of the Livent audit history and the aggressive characteristics of its two flamboyant principals
- Failed to respond with the appropriate professional scepticism following Gottlieb's incurably deceitful presentation to the Livent audit committee;
- Failed to resign in such circumstances; and
- Allowed its name be associated with the announced "settlement" of auditing differences in September 1997, when it knew that the press release announcing the resolution was misleading.

Caribbean Steel Company Limited v Price Waterhouse 1998/C0166 SC (Jam)

Price Waterhouse were engaged as the auditors and accountants for CSC and for Caribbean Cable Company and were requested to conduct a valuation of the shares of Carib Cable which CSC intended to acquire.

CSC claim damages for breach of contract and breach of duty of care in tort.

PW argued that they did not owe a duty of care to CSC as their contract was with Carib Cable.

The court distinguished Caparo, highlighting that in this case PW was the advisor and auditor of both CSC and Carib Cable. They were aware of the terms of the share agreement and the importance and reliance placed on the information in the audit report by CSC. The problems arose regarding the pension fund surplus and whether that item should have been treated as an asset.

The Court found that PW should have informed CSC that the trustees of the pension fund had made loans to the company and of the possible conflict of interest and found that PW breached its duty in both contract and tort.

Other instances of professional negligence claims:

- 2015 PwC and financial services group Cattles settled £1.6Billion dollar professional negligence claim where it was alleged by the creditors that PwC was negligent in its audit of one of Cattles subsidiaries for financial years ending 2006 and 2007.
- 2015 PwC required to pay $65M USD to settle a class action litigation with MF Global Holdings customers who accused PwC of negligently failing to identify the bankrupt brokerage alleged scheme to deceive investors about its financial stability
- 2014 Class action brought against Ernst & Young accused of helping Lehman Brothers Holdings Inc. deceive investors in the years leading up to its collapse. Settlement payment $10M USD.
- 2015 KPMG $88M accounting blunder of Singing Health System's receivables. KPMG is accused of breach of contract, negligence, and professional malpractice. The lawsuit calls KPMG's mistake "one of the largest reported adjustments in history."

Under the Securities Act 2012 (as amended)

Section 165

- 165(1) A person who-

(a)Knowingly or recklessly makes a misrepresentation in contravention of or otherwise in relation to this Act;

(b) Knowingly or recklessly makes a misrepresentation to any person appointed to conduct and investigation, review or an examination under section 150 or 151

(c)Contravenes section 36 or 73

- **<u>Commits an offence and is liable on summary conviction to a fine of two million dollars and to imprisonment for five years.</u>**

Section 165

- 165(4) A auditor who knowingly or recklessly provides a false or misleading audit report in respect of financial statements which are required to be filed under this Act commits an offence and is liable on summary conviction to a fine of

five million dollars and to imprisonment for five years

- 164 (5) where an auditor is convicted of an offence under subsection (4) the Commission may order, under section 155. and in addition to any other order that the Commission may make, that

the auditor be prohibited from being an auditor of a market actor for a period not exceeding five years.

Section 166- (implications for internal accountants/ auditors)

- 166 (1) Notwithstanding any other provision of this Act, where a company has been convicted of an offence under this Act, then any senior officer who knowingly or recklessly authorised, permitted or acquiesced in the offence is also guilty of an offence and liable to the penalty specified for it.

- 166 (2) Notwithstanding any other provision of this Act, where a person has been convicted of an offence under this Act, then any supervisor of the individual who knowingly or recklessly authorised, permitted or acquiesced in the offence is also guilty of an offence and liable to the penalty specified for it.

Auditors and AML/CFT Obligations- Proceeds of Crime Act and the Financial Obligations Regulations

- Financial Obligations Regulations (FOR) 4(2) requires that registrants have Compliance Officers that have been approved by their relevant Supervisory Authority.
- External Auditors are not verifying that the Compliance Officers have been approved as required. In order to do so they would need to see the approval letter instead of simply relying on the word of the registrant.
- External Auditors should not demand that registrants make available to them Suspicious Activity/Transaction Reports filed by registrants.
- External Auditors should also focus on the training requirement outlined in FOR 6. Part of their audit should be to ensure that all of a registrant's staff and its directors have received the training outlined in the relevant legislation and not just general training on ML/FT. This would entail actually looking at the training materials to determine whether it fulfils the requirements of the FOR in addition to verifying that the staff and directors have signed of in the training registers.

THANK YOU

QUESTIONS/COMMENTS?

TRINIDAD AND TOBAGO SECURITIES AND EXCHANGE COMMISSION

57-59 DUNDONALD STREET, PORT OF SPAIN, TRINIDAD, W.I.
Phone: (868) 624-2991
Fax: (868) 624-2995

Corporate Website:
www.ttsec.org.tt

Investor Education Website:
www.investucatett.com