A Retrospective of Professional Liability of Auditors in Australia

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Abstract

Purpose: This paper reflects on the professional liability of auditors from perspective of Common Law and Statute Law in Australia.

Design/methodology/approach: The approach applied in this paper is analogous with a narrative investigation of the historical and legal precedence culminating in the ensuing legislative position.

Findings: As this is not an empirical study the analysis presented of the key legal developments pertaining to the professional liability of auditors.

Originality/value: This analysis provides the background to the development of professional liability and the impact upon the legal transition of professional liability in the context of the auditing profession.

Keywords: Auditor liability; professional liability; law of tort.

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Introduction

Professional occupations carry with them certain responsibilities that are above the normal duty of care required of someone who does not have or purport to hold a level of expertise, for example, solicitors, doctors and auditors. Thus, auditors as well as accountants are in the unenviable position of being estopped from denying their expertise and are further exposed to liability by virtue of the fact that their work is relied upon by a wide range of people not just their immediate clients (Kaur & van der Laan, 2013; Leung, Coram, Cooper & Richardson, 2015).

As McManamy (1984) so eloquently put it, while commenting on the Donoghue case “… the courts are now adding: ‘Oh, and by the way, Mrs Donoghue, why not sue your accountant while you’re at it. Or, better yet, sue someone else’s accountant.’…” This attitude has been reflected in the growth in litigation and subsequent legislation aimed at the accounting and auditing profession.

The ‘Big Four’ auditing firms have been subject to lawsuits emanating from their role in the credit crisis, although they have successfully defended some cases resulting in dismissal others they have had to settle. The major cases have occurred in the US legal jurisdiction the most notable of them include the following1:

Teachers’ Retirement System of Louisiana et al v. PricewaterhouseCoopers LLP, Delaware Court of Chancery, No. 454-2009. – PricewaterhouseCoopers in October 2010 won a key ruling in the New York Court of Appeals, which affirmed the auditor’s “in pari delicto,” or equal fault, defense against a lawsuit brought by the Teachers’ Retirement System of Louisiana. Citing the New York ruling, the Delaware Supreme Court dismissed the lawsuit against PwC on Jan. 3.

Mimms v. PricewaterhouseCoopers LLP et al, U.S. District Court, Southern District of New York, No 11-00030. The case was brought as a derivative action on behalf of the AIG Incentive Savings Plan.

Fannie Mae 2008 Securities Litigation, U.S. District Court, Southern District of New York, No. 09-md-02013. – Deloitte & Touche LLP in September 2010 won dismissal of a federal securities lawsuit brought by Fannie Mae stock investors alleging they were misled about the mortgage financier’s subprime mortgage risk. The judge ruled Fannie Mae had made many disclosures about its subprime risks and found no fraudulent intent by Deloitte.


Countrywide Financial Corp Securities Litigation, U.S. District Court, Central District of California, No. 07-05295. – KPMG in May 2010 agreed to pay $24 million to resolve class-action litigation brought by several pension funds, including the New York State Common Retirement Fund, for its audits of Countrywide Financial Corp, the troubled home lender that is now part of Bank of America Corp.

The number of high profile corporate failures and the negligence attributed to accountants and auditors alike has contributed to a view of scepticism in the public domain and inevitably the rise of legislative intervention (Gooley, Russell, Dicker & Zammit, 2011). In the global domain, corporate failures such as Enron and World.com revealed inherent problems in the auditing process that they lead to the demise of a large accounting and auditing firm in the United States (Arthur Andersons) and the introduction of legislation (Sarbanes Oxley Act). Australia was not immune to this form of large corporate failure and the FAI/HIH debacle, whilst not resulting in the demise of any accounting/auditing firm did have the same effect in leading to legislative changes such as the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP9). A notable impact of the global financial crisis, in the Australian sector, involves the Centro organisation. Although the company did not go into liquidation the subsequent legal cases are noteworthy for two reasons, first is the creation of new law directly affecting the liability of directors (Laing, Douglas & Watt, 2015); the second is a class action which resulted in Pricewaterhouse Coopers (PwC) having to pay approximately Au$66 million or one-third of the total settlement reached in private negotiation. In brief, PwC admitted negligence, acknowledging they should have considered more carefully the classification of debt between current and non-current obligations. However, they argued that Centro shared the blame for keeping for not being upfront in regards to their refinancing problems.

Essentially, the notion of liability emanates from the common law area referred to as the law of tort (Bagaric, Carter & Faris, 2011). For most of the court actions regarding the breach of some duty can be traced back to the leading case in this area Donoghue v Stevenson (1932) and the various types of legal actions can be considered as branches growing from the seed into a rather large and overwhelming tree in the legal forest (Arens, Best, Shailer, Fiedler, Elder & Beasley, 2013).

**Liability under Law of Tort**

The liability to third parties arises from the legal essence of negligence, being viewed as a tort which is actionable by the injured party for a breach of duty of care whether a contract exists or not (Clarke, Devereux, Werren & O’Reilly, 2014). The Common Law principles concerning liability to third parties for negligence resulting in economic loss outside the confines of a contractual relationship follow a specific set of court cases. In order to establish negligence, it is necessary to there are four main elements that the courts will require the plaintiff (the person or business bring the action) to show as being in existence.

To start there must be a duty of care owed by the defendant to the plaintiff, there must be a breach of the duty of care, damages must be sustained as a result of the breach of duty of care, and there must be a causal link involved with foreseeability or remoteness of the outcome.

The leading case is Donoghue v Stevenson (1932) this case established that a duty of care is owed to third parties for physical harm or loss but did not extend to advice given by professionals. In Candler v Crane, Christmas & Co. (1951) the court held that there was no liability for financial loss from negligence without a contractual relationship regardless of whether it was foreseeable. The next case however, made an amendment to this principle. Hedley Byrne & Co. Ltd. V Heller & Partners Ltd. (1963) established that there was liability for negligent misstatement resulting in economic loss where no contractual relationship existed, however, this applied only to those experts or persons of special skill and when it was foreseeable that the injured party might reasonably rely on the advice of such an expert. This principle was applied in the Mutual Life and Citizens Assurance Co. Ltd. V Evatt (1968) by both the New South Wales Court of Appeal and the High Court of Australia.
The principle was extended in Scott Group Ltd. v McFarland & Others (1978) in which the auditors were found to owe a duty of care to users who rely on audited public financial statements. Then in JEB Fastners Ltd. v Marks Bloom & Co. (1981) this widened the concept of foreseeability to the extent that an auditor could owe a duty of care to a specific third party unknown to the auditor but who belonged to a special class of persons that the auditor should be generally aware of. There was a caveat to the extent a substantial burden of proof was placed on the injured third party. In deed this aspect was addressed in Twomax Ltd. v Dickson McFarland & Robinson (1983) while the case supported the test of reasonable foreseeability it introduced a new criterion in that the longer the gap between the audit of accounts and the injury the more difficult it would be to establish a breach of duty. Subsequently, no damages were awarded due to the plaintiff’s failure to show a causal link between the decision to invest and the loss/injury. The test of reasonable proximity which effectively narrows the scope of the auditors’ liability to third parties was reaffirmed by the courts in the United Kingdom in Caparo Industries Pty. Ltd. v Dickman & Other (1987).

Legal Causation is usually expressed as a question of ‘foreseeability’. An individual is liable for the foreseeable, but not the unforeseeable, consequences of his or her act. This type of causal foreseeability is to be distinguished from foreseeability of extent or kind of injury, which is a question of remoteness of damage, not causation. For example, novus actus interveniens. However, a person may not be held liable if that damage is not of a type foreseeable as arising from that persons’ negligence: The Wagon Mound (No 1) [1961] AC 388 (Privy Council). That is a question of public policy, and not one of causation!

The principle of causation has been the subject of legislative review in most States in Australia. As part of the torts reform packages legislation has now set out prescribed test for establishing causation. For example, the Civil Liability Act 2002 (NSW) in Section 5D sets out a general two step approach to test for causation with an allowance for what it refers to as exceptional cases.

**CIVIL LIABILITY ACT 2002 - SECTION 5D**

**General principles**

**5D General principles**

(1) A determination that negligence caused particular harm comprises the following elements:

(a) that the negligence was a necessary condition of the occurrence of the harm ("factual causation"), and

(b) that it is appropriate for the scope of the negligent person’s liability to extend to the harm so caused ("scope of liability").

(2) In determining in an exceptional case, in accordance with established principles, whether negligence that cannot be established as a necessary condition of the occurrence of harm should be accepted as establishing factual causation, the court is to consider (amongst other relevant things) whether or not and why responsibility for the harm should be imposed on the negligent party.

(3) If it is relevant to the determination of factual causation to determine what the person who suffered harm would have done if the negligent person had not been negligent:

(a) the matter is to be determined subjectively in the light of all relevant circumstances, subject to paragraph (b), and
(b) any statement made by the person after suffering the harm about what he or she would have done is inadmissible except to the extent (if any) that the statement is against his or her interest.

(4) For the purpose of determining the scope of liability, the court is to consider (amongst other relevant things) whether or not and why responsibility for the harm should be imposed on the negligent party.

The general overview of the law of tort, pertaining to the act of negligence, as it has developed in Common Law may best be summarised by the following diagram (Figure 1).

**Figure 1:**
*General Overview of the Law of Tort*

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**Auditor’s Liability to Clients**

The liability of auditors to clients arises from the failure to perform auditing functions with due care and diligence that would be expected of a person acting under the auspices of professional auditing standards or as specified by legislation. Has developed along similar lines to that of general negligence under the law of tort.
From the aspect of negligence courts would be likely to consider certain criteria as pertinent (McManamy, 1984; Goldberg & Kelly, 1967). Firstly, the duty of care, which requires that the plaintiff prove that a duty of care was owed. Secondly the standard of care and skill, which requires sufficient reasonable care and skill be exercised. Thirdly, actual damage, which requires that the plaintiff must have suffered damage or injury as a result of the breach of such duty.

At Common Law there have been a number of key cases in which the courts have examined the area of contractual relationship between auditors and their clients and these provide a foundation for the understanding of the direction that auditor liability has taken (Goldberg & Kelly, 1967; Davies, 1991).

There are two important early cases starting with Re London & General Bank Ltd (1895) this case clearly identified that an auditor’s duty was to report to shareholders and that the shareholders not the company directors were the clients of the auditor. The next development was in the Re Kingston Cotton Mill Co. (No.2) (1896) case in which Lopes LJ at 289 “An auditor is a watch dog, but not a bloodhound.”. This was to become a key statement upon which future court arguments would rely. What it basically meant was that the auditor would not be liable for failure to detect fraud unless there was negligence on the part of the auditor, and once fraud had been detected then it would have to be reported.

The next two cases proved to be important in the evolution of auditor liability specifically in the Australian context begins with Pacific Acceptance Corp. Ltd. V Forsyth & Others (1970). In this case Moffitt J found that in addition to the duty to make the statutory auditor’s report there was duty to audit, for the possibility of error or fraud, and to warn the client accordingly. There were seven key points made by Moffitt J in regards to the determination of this position:

1. Scope of audit can be restricted by reliance on internal control but only for satisfactory and appropriate areas;
2. Duty to use reasonable care must be reinforced;
3. Auditors have a duty to warn and inform;
4. Where the auditor’s suspicion is aroused, the auditor is expected to take further action;
5. The auditor’s plans and procedures should be structured to detect material error or fraud if it exists;
6. The auditor has a duty to check and see personally;
7. Professional standards are a guide only the law decides what is reasonable care and skill.

The second case is Cambridge Credit Ltd. & Anor. v Hutchenson & Ors (1985) this case is noteworthy for the amount of damages that was awarded at that time, in effect it was a brutal awakening for the profession that liability was not limited. Rather than look for ways to address the problems that led to this case the profession attempted to have a limit placed upon the level of liability. One cannot help but wonder if this action on the part of the profession was an acceptance that negligence was unavoidable in the realm of auditing work. Additional points that emanated from this case were that an auditor may be liable for breach of contract if he/she:

1. Issues a standard audit report when he/she has not made an examination in accordance with the Australian Auditing Standards;
2. Does not deliver the audit report by the date agreed upon;
3. Violates the confidentiality of the relationship with the client.
Figure 2:
Auditors’ Liability under Common Law

Auditor’s Liability under Statute Law

The Corporations Act (2001) imposes responsibilities on auditors under section 285 which deals with the powers and duties of auditors. There are a number of sections under the Corporations Act that relate to offences s.107 and s.108 refer to untrue statements or non-disclosure in a prospectus while s.554, s.555 and s.556 deal with the signing of false reports or conspiracy (Gooley, Russell, Dicker & Zammit, 2011).

CHAPTER 2M--Financial reports and audit
Division 3—Audit and auditor’s report

307. Audit
307A. Audit to be conducted in accordance with auditing standards
307B. Audit working papers to be retained for 7 years
307C. Auditor’s independence declaration
308. Auditor’s report on annual financial report
309. Auditor’s report on half-year financial report
310. Auditor’s power to obtain information
311. Reporting to ASIC
312. Assisting auditor
313. Special provisions on audit of debenture issuers and guarantors
The stipulation under s.307A of the Corporations Act (2001) is that the audit is to be conducted in accordance with auditing standards. The auditing standards are given the force of law under s.336 which refers to the Auditing and Assurance Standards Board (AUASB) and its power to make auditing standards.

(1) The AUASB may, by legislative instrument, make auditing standards for the purposes of this Act. The standards must not be inconsistent with this Act or the regulations.

(3) An auditing standard applies to financial reports in relation to:

(a) periods ending after the commencement of the standard; or

(b) periods ending, or starting, on or after a later date specified in the standard.

(4) If:

(a) the AUASB makes an auditing standard; and

(b) the standard applies to financial reports in relation to particular periods under subsection (3); and

(c) an auditor is conducting an audit of a financial report in relation to a period that occurs before the start of the earliest of those periods;

the auditor may elect to apply the auditing standard to that audit unless the standard says otherwise. The election must be recorded in the audit report.

Division 2--Registration requirements

324BA. Registration requirements for appointment of individual as auditor
324BB. Registration requirements for appointment of firm as auditor
324BC. Registration requirements for appointment of company as auditor
324BD. Exception from registration requirement for proprietary company
324BE. Exception from registration requirement--reviewing financial reports of companies limited by guarantee

CORPORATIONS ACT 2001 - SECTION 311
Reporting to ASIC
Contravention by individual auditor

(1) An individual auditor conducting an audit contravenes this subsection if:

(a) the auditor is aware of circumstances that:

(i) the auditor has reasonable grounds to suspect amount to a contravention of this Act; or

(ii) amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (6)); or

(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit; and
(b) if subparagraph (a)(i) applies:

(i) the contravention is a significant one; or

(ii) the contravention is not a significant one and the auditor believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors; and

(c) the auditor does not notify ASIC in writing of those circumstances as soon as practicable, and in any case within 28 days, after the auditor becomes aware of those circumstances.

Contravention by audit company

(2) An audit company conducting an audit contravenes this subsection if:

(a) the lead auditor for the audit is aware of circumstances that:

(i) the lead auditor has reasonable grounds to suspect amount to a contravention of this Act; or

(ii) amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (6)); or

(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit; and

(b) if subparagraph (a)(i) applies:

(i) the contravention is a significant one; or

(ii) the contravention is not a significant one and the lead auditor believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors; and

(c) the lead auditor does not notify ASIC in writing of those circumstances as soon as practicable, and in any case within 28 days, after the lead auditor becomes aware of those circumstances.

Contravention by lead auditor

(3) A person contravenes this subsection if:

(a) the person is the lead auditor for an audit; and

(b) the person is aware of circumstances that:

(i) the person has reasonable grounds to suspect amount to a contravention of this Act; or

(ii) amount to an attempt, in relation to the audit, by any person to unduly influence, coerce, manipulate or mislead a person involved in the conduct of the audit (see subsection (6)); or

(iii) amount to an attempt, by any person, to otherwise interfere with the proper conduct of the audit; and
(c) if subparagraph (b)(i) applies:

(i) the contravention is a significant one; or

(ii) the contravention is not a significant one and the person believes that the contravention has not been or will not be adequately dealt with by commenting on it in the auditor's report or bringing it to the attention of the directors; and

(d) the person does not notify ASIC in writing of those circumstances as soon as practicable, and in any case within 28 days, after the person becomes aware of those circumstances.

Significant contraventions

(4) In determining for the purposes of this section whether a contravention of this Act is a significant one, have regard to:

(a) the level of penalty provided for in relation to the contravention; and

(b) the effect that the contravention has, or may have, on:

(i) the overall financial position of the company, registered scheme or disclosing entity; or

(ii) the adequacy of the information available about the overall financial position of the company, registered scheme or disclosing entity; and

(c) any other relevant matter.

(5) Without limiting paragraph (4)(a), a penalty provided for in relation to a contravention of a provision of Part 2M.2 or 2M.3, or section 324DAA, 324DAB or 324DAC, includes a penalty imposed on a director, because of the operation of section 344, for failing to take reasonable steps to comply with, or to secure compliance with, that provision.

Person involved in an audit

(6) In this section:

"person involved in the conduct of an audit " means:

(a) the auditor; or

(b) the lead auditor for the audit; or

(c) the review auditor for the audit; or

(d) a professional member of the audit team for the audit; or

(e) any other person involved in the conduct of the audit.
Schemes to Limit Auditor Liability

The concept that joint and several liability imposes an obligation on a defendant that is not proportionate with the defendant’s actual level of responsibility has been viewed as being arguably unjust (Free, 1999). Consequently, States and Territories in Australia have introduced legislation that addresses proportionate liability relating to economic loss under contract, tort and statute intended to limit the extent of contribution. The approach adopted in Australia involves focusing on the pertinent professional association and thereby covering its members. Thus, the Professional Standards Legislation (PSL) allows the registration of professional standard schemes by professional associations which have the effect of limiting the civil liability of participants in the scheme. The schemes are approved and monitored by the Professional Standards Councils (PSC), in consultation with the relevant professional association. The Professional Standards Scheme limits the civil liability of professionals who take part in them by capping the amount of damages that a court can award to a client if they succeed in certain claims against a professional. These limits vary from scheme to scheme, and the associations need to demonstrate that these limits are high enough to cover losses any person and most companies would suffer if they needed to make a claim.

There are circumstances under which the limiting of liabilities under a Professional Standards Scheme may not apply. However, whilst these may vary between states and territories the most common that need to be considered are:

- Whether the professional is a member of an association that has a Professional Standards Scheme
- Whether the claim concerns something the professional has or hasn’t done in providing services related to his or her job
- What’s specified in the Professional Standards Scheme
- Whether the Professional Standards Scheme applied when the relevant act or omission occurred
- Where the relevant services were provided
- Whether the claim arises from death or personal injury, dishonesty or fraud, or breach of trust, which are generally excluded from limited liability.

For example, the CPA Australia Professional Standards scheme does not cover:

- services provided by members who do not hold a Public Practice Certificate (PPC) or Limited Public Practice Certificate (LPC) issued by CPA Australia
- services provided by members who directly hold a (full) Australian Financial Services licence (AFSL) in accordance with section 913B of the Corporations Act 2001 (Cth), not being a Limited Licence (including Authorised Representatives of an AFSL)
- Representatives of licensees under section 913B of the Corporations Act 2001 (Cth), not being a Limited Licence
- In practical terms, the Scheme will not apply to members who either themselves hold a (full) AFSL, (this was also the case with the previous Scheme) or are “Representatives” or “Authorised Representatives” of a person or company which does.

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2 https://www.psc.gov.au/consumer-information/limited-liability-explained

Summary

The skills, knowledgeable and care of an ordinarily prudent and knowledgeable auditor are to be found in the auditing standards promulgated by the AUASB in conjunction with the legislative requirements within the Corporations Act (2001). In essence, an auditor must possess the skills that an ordinarily prudent and knowledgeable auditor would have and exercise the degree of care that an ordinarily prudent and knowledgeable auditor would exercise.

Whether an auditor is likely to have limited liability will very much depend upon the Professional Association he or she is a member of and the Professional Standards Scheme of the State or Territory in which they operate.

References


