Auditor's Exposure Expanded to Potential Investors? Case comment on the *Castor* decision

By Emily Stock, LL.B., M.B.A.

Editor's note: The ICABC encourages members to consider Ms. Stock's argument that practitioners need to better protect themselves by using specific language in their engagement letters, but also reminds members of their professional obligations to consider clients' interests, recognizing that this is a delicate balance.

After 16 years of active litigation, the Superior Court of Quebec has found the auditors of the former firm Coopers & Lybrand liable for material misstatements in the audited financial statements of Castor Holdings Ltd. in *Widdrington* (2011 QCCS 1788) (*Castor*).

Castor Holdings Ltd. was a real estate investment company that collapsed into bankruptcy in 1992. Coopers & Lybrand issued auditors' reports for Castor's consolidated financial statements for the years 1988, 1989, and 1990.

The Plaintiff alleged that the auditors failed to perform their professional services in accordance with GAAP and GAAS and that the financial statements accompanying the auditors' reports were materially misstated and misleading. The Defendants took the position that if the financial statements were incorrect; it was because of the fraud by senior management of Castor which was so pervasive that the auditors could not be liable for failing to uncover the true nature of the business.

The Court did not accept the position that the auditors were not responsible for Castor's fraud, but instead found that the auditors should have seen a "screaming contradiction" between the financial statements and notes prepared by management versus the accounting records and loan files available to the auditors. Among other issues, the Court found that the financial statements failed to disclose that many of the loans were not producing income and should have been recorded as a loss. This failure to comply with GAAP meant that the auditors should not have been able to issue a clean opinion.

Indeterminate Liability

The 752 page decision in *Castor* includes discussion of many issues of interest to the accounting profession. Perhaps one of the more significant issues is that the auditors were found liable to an arguably "indeterminate" class: the investors and potential investors of Castor.

The issue of indeterminate liability was addressed by the Supreme Court of Canada in *Hercules Managements Ltd.* [1997] 2 S.C.R. 165 (*Hercules*). In *Hercules*, the Plaintiffs were investors that had relied on financial statements that had been negligently opined on by the auditors.

The Court found that while a prima facie duty of care was owed by the Defendant auditors to the Plaintiff investors, that duty was negated by policy concerns surrounding indeterminate liability. The Court refused to impose a duty of care upon an auditor whose Auditor's Report was not prepared for the actual purpose upon which it was relied.

Hercules reaffirmed that auditors generally do not owe a duty of care to an indeterminate class such as potential investors. However, the Supreme Court of Canada explicitly stated that there may be an exception depending on the factual situation.

This issue had not been reconsidered until last year in British Columbia in *International Culinary Institute of Canada* (2010 BCSC 541) (*ICIC).* In *ICIC,* the Plaintiff used financial statements and a review engagement report from the Defendant accounting firm when purchasing the Dubrulle French Culinary School Ltd. The accounting firm was not made aware of this possible purpose. The Honourable Mr. Justice Goepel found that this was not an exception to the principle enunciated in *Hercules* and so the Plaintiff was not owed a duty of care.

In *Castor,* the Honourable Marie St-Pierre found that there was an exception based on the specific factual situation. She found that "*the typical concerns surrounding indeterminate liability do not arise*" as they did in *Hercules* for two key reasons:

1. The Castor financial statements were prepared for a broader purpose.

In *Hercules* the auditors persuaded the Court that they were not aware of broader purposes beyond the statutory purpose. While the auditors knew the identity of the investors, and presumably knew that the investors would be interested in the financial statements, the Court was persuaded that the audited financial statements were not prepared for the purpose of providing them to the investors.

In *Castor*, an Audit Planning Memo that was prepared at the commencement of the engagement indicated that the audit team knew that the statements would be distributed to shareholders, investors, and lenders for various financing purposes. The Court, therefore, found that the auditors knew that Castor's financial statements were being used for a broader purpose.

The Court further distinguished *Hercules* on the basis that the purpose of the audit was not a statutory audit since Castor was not obliged by statute to produce audited financial statements.

2. The class of potential investors was identifiable to the auditors.

The Court found that the Defendants knew that Castor was marketing to an "investment club" (as defined by the Court) of closely connected high net worth shareholders, lenders, and potential shareholders and lenders.

It was significant in the Court's reasoning that the engagement audit partner, Mr. Wightman, had met the members of the "investment club" at receptions and dinners organized in conjunction with the shareholders' and directors' meeting.

It was also significant that Mr. Wightman kept brochures that included the five year summary of the audited financial statements for Castor in his office and had distributed them to third parties contemplating doing business with Castor.

On these facts, the Court decided that the "investment club" was a definable class of potential investors and so reasoned that the issue of indeterminate liability did not arise.

It is difficult to reconcile the reasoning on this issue in *Castor* with that in *Hercules.* In both, the auditors knew the identity of the investors.

Limiting Duty of Care

The *Castor* case serves as a reminder to Chartered Accountants to consider what steps they should take in an assurance engagement to limit the class of people to whom they owe a duty of care. Chartered Accountants seeking to ensure that their duty of care is limited to specific intended users of the financial statements should consider the following three strategies in each assurance engagement:

1. Identify the intended users in the engagement letter. Tell your client that you do not accept any responsibility for use of the assurance report by a third party who relies on your report without your written consent.

2. Ensure that the end users are noted in the working papers, including your planning memo. Ask your client to identify the end users with specificity, and document this in your working papers. If the auditor's report is intended to be distributed to a large group or class, ensure that the level of engagement and professional fees reflect this risk of exposure.

3. Include a "restriction on distribution or use" paragraph in the auditor's report when appropriate and in accordance with CAS 706. Any restriction on distribution or use should also be addressed in your working papers and the engagement letter. CAS 706 permits the assurance report to include an "other matter paragraph" that states that "the auditor's report is intended solely for [the intended users], and should not be distributed to or used by other parties."

It will be interesting to follow the next stage of the *Castor* case. An appeal is anticipated and hopefully the Court on appeal will reconsider whether *Castor* is properly an exception to the law that auditors do not owe a duty of care to an indeterminate class such as potential investors.

Guest contributor Emily Stock, LL.B., M.B.A., is a lawyer at Alexander Holburn Beaudin & Lang LLP in Vancouver. She defends financial professionals and assists them in managing their legal issues.