

**Shoring up Investor Confidence:
Auditor Liability in an Era of Global Change in Accounting Practices**

**INSIGHT CONFERENCE
ACCOUNTING, AUDIT AND FINANCIAL REPORTING REFORMS IN CANADA
MAY 12-13, 2003**

**Joseph Groia
Kellie Seaman**

**Groia & Company
Lawyers
The Sterling Tower
372 Bay Street, Suite 1000
Toronto, Ontario
M5H 2W9**

**Phone: (416) 203-2115
Fax: (416) 203-9231**

‘Who the hell told you you could look at the corporate books?’

*Alleged Comment of HealthSouth Corp. CEO
Richard Scrushy to Auditor Neal Webster*

If any thing positive can be said about the collapse of Enron, and the upheaval it created in boardrooms and markets the world over, perhaps it is this: better late than never.

Without such an extraordinary corporate and financial collapse it is quite possible that questionable corporate governance practices and dubious accounting methods would have continued unabated forever. Instead, the name Enron, once reminiscent of all that was good in the trading of energy commodities, has come to be synonymous with all that is wrong with corporate Canada and America. In response, every possible market participant and every facet of the capital market has been closely scrutinized to ferret out their shortcomings and governments and regulators have been turning out new laws and rules hand over fist.

As the dust settles, one of the major recipients of much of this attention has been the accountant’s employed by a corporation to audit their financial statements. In particular, a perception has developed that pre-Enron auditors (or their colleagues, partners or consulting firms) too often enjoyed a major presence in too many facets of corporate affairs. This was due in large measure to the vast array of services on offer and the potential conflicts of interest that exist (at least in hindsight) as a result, which has

rendered the role of the auditor suspect. Yet, in many ways the burgeoning of this role was, if not encouraged, certainly condoned by the powers that be.¹

The purpose of this little paper is not so much to assess the appropriateness of the blame that has befallen the auditor. Rather, our purpose is to provide a summary of the many changes that have been or are about to be implemented, with a view to trying to sketch out an understanding of the boundaries for potential auditor liability in the post-Enron era. In particular, we will review the recent American developments including *Sarbanes-Oxley Act, 2002*² and their Canadian counterparts in the as yet unproclaimed *Bill 198*³ and the *Independence Standards – Exposure Draft* published by the Canadian Institute of Chartered Accountants. But first, we would like to step back and begin by considering the role of the auditor as the financial ‘dog’ of public company shareholders.

The Role of the Auditor: Guardian, Watchdog or Bloodhound?

Some of the earliest judicial attempts to define the role of the auditor were articulated by the English Court of Appeal in the late nineteenth century. In *Re London & General Bank (No. 2)*⁴ Lindley L.J. had this to say about the duty of an auditor:

It is no part of an auditor’s duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether the dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and

¹ An example of the willingness to extend the scope of services offered by accounting firms is provided by the 1991 decision of the American Institute of Certified Public Accountants to change the Code of Professional Conduct to allow accountants to charge performance-based contingency fees.

² Enacted July 30, 2002. Pub. L. 107-204, 116 Stat. 745 (2002).

³ *The Keeping the Promise for a Strong Economy (Budget Measures, 2002) Act*, S.O. 2002, c.22.

⁴ [1895] 2 Ch. 673 (C.A.).

state the true financial position of the company at the time of the audit, and his duty is confined to that.⁵

Just one year later the Court would again grapple with the role of the auditor. *In re Kingston Cotton Mill Company*⁶ Lopes L.J. made the following observation:

An auditor is not bound to be a detective or ... to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.⁷

Both of these statements warrant some consideration. The role of the auditor articulated in *London & General Bank* clearly distinguishes the traditional auditor role from the role that auditors were destined to play in the pre-Enron era. Many of the concerns that Lindley L.J. expressed about auditors would simply not hold true in an era of multi-service accounting firms. For example, firms clearly give advice in their capacity as tax specialists and so long as they make money by the provision of a myriad of services they clearly have an interest in the continued profitability of the corporation.

On the other hand, the statement of Lopes L.J. in *Kingston Cotton*, to the effect that an auditor need not look for trouble, still holds true today. As Mindy Paskell-Mede commented in her article ‘Audit in the Courtroom’, the traditional principle, and one that is unchanged by the new standards, is “that the statutory auditor – unlike the forensic auditor – does not carry out his engagement on the assumption that he is being deceived.”⁸

⁵ Ibid.

⁶ [1896] 2 Ch. 279.

⁷ Ibid.

⁸ Mindy Paskell-Mede, ‘Audit in the Courtroom’, CA Magazine online at camagazine.com, August 2002.

Armed with these traditional definitions of the role of the auditor we move, then, to a review of the new regime of accounting practices.

U.S. Reform of Accounting Practices: ‘A Generosity of Spirit’

Given the magnitude of the recent American effort to curb corporate dishonesty, it is not surprising that an understanding of post-Enron accounting practices should begin with the revolutionary American changes embodied in the *Sarbanes-Oxley Act of 2002*. This is no doubt encouraged by the pre-eminence of the U.S. in the world’s capital markets: approximately 56% of the world’s market capitalization is invested in their markets but more importantly, it is also due to the extra-territorial nature of the reforms themselves. When asked to comment on the U.S. initiative in *Sarbanes-Oxley*, Howard Davies, the Chairman of the Financial Services Authority in the UK, said “with their usual generosity of spirit the Americans have ensured that a number of its provisions apply to overseas companies as well as to their own.”

For our purposes, the significant changes brought about by *Sarbanes-Oxley* are those contained in the U.S. Securities and Exchange Commission’s *Final Rule: Strengthening the Commission’s Requirements Regarding Auditor Independence*.⁹ Title II of the Act entitled ‘Auditor Independence’ requires the Commission to adopt final rules addressing, among other things, which non-audit services will be prohibited, auditor partner rotation and the relationship between the independent auditor and the audit committee.¹⁰ Each of these has been addressed in the Canadian context and so we will review each one in turn.

⁹ Effective May 6, 2003 with various transition dates. See the full text of the *Final Rule* at <http://www.sec.gov/rules/final/33-8183.htm>.

¹⁰ *Sarbanes-Oxley Act of 2002*, s.201. *Final Rule*, Introduction and Background.

Non-Audit Services

Non-audit services offered by accounting firms have borne the brunt of the blame for hindering auditor independence. The reasons put forth in support of this argument are twofold: Firstly, the more an auditor has at stake in its dealings with an audit client, the greater the cost to the auditor should the client be displeased. Secondly, some non-audit services create inherent conflicts of interest that are prima facie incompatible with objectivity.

The non-audit services provision is structured as a blanket prohibition on any of the specified services with a catch all provision requiring all those services not described as ‘prohibited services’ to be pre-approved by the issuer’s audit committee.¹¹ Accordingly, the newly added sub-section 10A(g) of the *Securities and Exchange Act of 1934* prohibits the following categories of non-audit services:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the Public Company Accounting Oversight Board (PCAOB) determines, by regulation, is impermissible.

Notably, tax services are not prohibited. In fact, the SEC goes so far as to reiterate “its long-standing position that an accounting firm can provide tax services to its audit clients

¹¹ Section 201 of *Sarbanes-Oxley* adds sub-section (h) to Section 10A of the *Securities Exchange Act of 1934* (SEA), requiring pre-approval of non-audit services that are not prohibited under the new sub-section (g) of 10A.

without impairing the firm's independence."¹² This is undoubtedly the result of a very forceful, and successful, lobby effort by the accounting firms.

We will address the issue of tax services in more detail in the Canadian context.

Partner Rotation

The notion of partner rotation at accounting firms is not novel. Historically, many accounting firms have voluntarily participated in a rotation process in an attempt to maintain a 'fresh look'. In addition, one of the member requirements of the American Institute of Certified Public Accountants is that the lead partner rotate off the audit engagement of SEC registrants after seven years with a two year time out.¹³ However, the requirements of *Sarbanes-Oxley* are more stringent. Section 203 of the *Sarbanes-Oxley Act* specifies that:

It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

The adoption of this provision has not been without controversy. In essence, the source of the angst is the need to balance "the need for a fresh look with concerns about the loss of continuity and competence."¹⁴ The SEC has decided to weigh in favour of a fresh look: lead and concurring partners will be required to rotate after five years and, upon rotation,

¹² *Final Rule*, Commentary B (11).

¹³ AICPA, SEC Practice Section, Requirements of Members, item 'e'. Access it online at www.aicpa.org/members/div/secps/require.htm.

¹⁴ *Final Rule*, Commentary, p. 24.

will be subject to a five year time out while the remaining partners will be subject to a seven year rotation requirement with a two year time out.

This has sparked much debate about audit quality and the inability of any one auditor to achieve an adequate comfort and knowledge level with a client before being rotated out of the picture. In addition, concerns have arisen in respect of the potential impact such a policy may have on medium-sized accounting firms.¹⁵

Audit Committee

When asked to describe the role and responsibilities of an audit committee, Berkshire Hathaway CEO Warren Buffett quipped: “Their function ... is to hold the auditor’s feet to the fire.” *Sarbanes-Oxley* defines the audit committee in slightly more sombre terms as:

A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.¹⁶

The Act provides that where no such committee exists, the board as a whole will perform this task. In respect of the matters to be addressed by the Committee, the Act directs the

¹⁵ The SEC has made special provision for small accounting firms: audit firms with fewer than 5 audit clients that are issuers and fewer than 10 partners that qualify for the exemption from partner rotation, will be subject to review by the PCAOB at least once every 3 years. See *Final Rule*, p. 27-28. This will not alleviate the strain on the medium-sized firms that do not qualify for the exemption and yet will be required to rotate auditors in excess of their employment capacity.

¹⁶ Section 205.

Commission to issue rules requiring timely reporting of specific information by accountants to audit committees.¹⁷

While certainly not the most controversial of the *Sarbanes-Oxley* reforms, the reporting requirements vis-à-vis the audit committee have not gone unnoticed. The issue here is that the information contained in the financial statements is the responsibility of management. The role of the accountant is to ensure the accuracy of the statements and thus, the audit committee provisions, so the argument goes, extend the role of the auditor beyond its traditional confines.

International Impact

We have already made reference to the extra-territoriality of the U.S. provisions and the controversy that has arisen as a result. The International Federation of Accountants (IFAC) articulated these concerns and their suggested remedy in their comment to the Secretary of the SEC:

The general application of the Act to all companies having registered equity or debt securities with the SEC and to all accounting firms that furnish audit reports with respect to issuers on US markets has an impact on national sovereignty. If no exemption or consideration is provided for companies and firms in other countries that already have a legal or regulatory framework to deal with these same issues the proposal will create conflict with the laws of those countries and unnecessary duplication of compliance with multiple regulatory approaches designed to achieve the same safeguarding objectives. Since so many jurisdictions are adopting the IFAC Code of Ethics, we

¹⁷ Section 204 *Sarbanes-Oxley* adds subsection 10A(k) to SEA. Each public accounting firm registered with the Board that audits an issuer's financial statements must report, prior to the filing of such a report with the Commission, to the issuer's audit committee: all critical accounting policies and practices used by the issuer, all alternative accounting treatments of financial information within GAAP that have been discussed with management, and other material written communications between the accounting firm and management of the issuer. In addition, as we noted earlier, the auditing committee must pre-approve any non-audit services, not prohibited by the Act that the accounting firm wishes to perform for the issuer.

suggest that an undertaking that the foreign audit firms are complying with this Code should meet your needs.¹⁸

The potential impact of the new rules on foreign accounting firms has not gone unnoticed by the SEC: “The Commission has historically addressed conflicts between US and foreign requirements regarding non-audit services on an *ad hoc* basis ... the Commission will continue to take this *ad hoc* approach, and will continue to consider requests for exemptive relief from foreign auditors.”¹⁹

The Canadian Response: *Keeping the Promise to Incorporate SEC Regulations*

Not surprisingly, the initial Canadian response to Enron has been very much in step with that of the US. Whether this is both purposive and desirable remains to be seen. It is, however, exemplified by the extent of Canada’s willingness to adopt an American-style approach to auditor independence. This is clearly apparent in the CICA Public Interest and Integrity Committee’s response to the SEC’s *Final Rules*:

The PIIC concluded that, with minor modifications to transitional and other provisions, to reflect Canadian circumstances, it would be desirable to incorporate the revised SEC regulations to protect the public interest in Canada and achieve convergence with the U.S. requirements for listed entities.²⁰

Bill 198²¹, which received royal assent on December 9, 2002, but is not as yet proclaimed into force, is the Canadian complement to *Sarbanes-Oxley*. For our purposes, the significance of Bill 198 is twofold: firstly, for the secondary market right of action it

¹⁸ Letter dated January 10, 2003 from Marilyn A. Pendergast, Chair IFAC Ethics Committee, to Jonathan G. Katz, Secretary, US Securities and Exchange Commission.

¹⁹ *Final Rules*, p. 51.

²⁰ CICA ‘Independence Standards *Status Update*’, March 18, 2003

²¹ *The Keeping the Promise for a Strong Economy Act (Budget Measures) 2002*.

might one day import into the Canadian securities markets, and secondly, for the new rule-making power it bestows upon the Ontario Securities Commission (OSC).

Civil Liability for Secondary Market Disclosure: Overruling Hercules?

Bill 198's introduction of a civil right of action for purchasers of securities on the secondary market (that is, purchases from other purchasers as opposed to purchases from the issuer on the primary market), and the deemed reliance long sought after by Canadian plaintiffs, is a first for Canadian securities law. It has, however, been a long-standing component of the US regulatory regime.

The right of action created by section 185²² is for those purchasers who acquire securities of an issuer during the period between the time a misrepresentation has been made and the time it is publicly corrected. The misrepresentation can be in a document, or in a public oral statement, and the right of action exists against the issuer, directors and officers of the issuer, influential persons and experts.²³ The new provision defines 'expert' as 'a person or company whose profession gives authority to a statement made in a professional capacity by the person or company including ... an accountant [or an] auditor.'²⁴

²² Section 185 of Bill 198 creates section 138.3 'Liability for secondary market disclosure', Part XXIII of the Ontario *Securities Act*.

²³ Section 138.3 provides that a right of action for damages will lie against an expert where, (i) the misrepresentation is also contained in a report, statement or opinion made by the expert; (ii) the document includes, summarizes or quotes from the report, statement or opinion of the expert; and, (iii) if the document was released by a person or company other than the expert, the expert consented in writing to the use of the report, statement or opinion in the document.

²⁴ Section 138.1, Part XXIII.1, *OSA*.

On its face, the statutory enactment of auditor liability for misrepresentation in a corporate document appears to replace the narrow limits on auditor liability simpliciter contained in the leading decision of the Supreme Court of Canada in *Hercules Management Ltd. v. Ernst & Young*²⁵; albeit in the secondary market context. In *Hercules*, the Supreme Court was asked to determine the boundaries of auditor liability. They approached the question as a two-step process. Firstly, they sought to determine whether or not there was a prima facie duty of care and they determined that there clearly was. Secondly, they sought to determine if the duty was negated or limited by policy considerations. The Supreme Court held that the “possibility that the defendant might be exposed to ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’”²⁶ was a sufficient policy consideration to negate the duty.

The *Hercules* decision distinguishes the potential liability of an auditor on the basis of the use for which the audit was performed and/or the document was produced. In the case of a statutory audit the purpose is clearly not with a view to individual investment and thus the auditor will not, at least according to *Hercules*, ordinarily be liable. On the other hand, if the purpose is for inclusion in a prospectus, or some other ‘public’ purpose, the auditor clearly runs the risk of liability to shareholders and potential investors. In other words, if the reliance by the plaintiff is reasonable, given the use for which the document was intended, the policy consideration will not be met and liability will probably follow. Given the role of reliance in the assessment undertaken by the Court it is difficult to see how the *Hercules* requirement for reasonable reliance by the plaintiff can be maintained

²⁵ [1997] 2 S.C.R. 165.

²⁶ *Ibid.*, quoting Cardoza C.J. in *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y.C.A. 1931).

for primary market purchasers when secondary market purchasers can avail themselves of the new deemed reliance care of Bill 198.

New Corporate Governance Role for the OSC: the Rule-Maker

The proposed ability of the Ontario Securities Commission to make rules ‘defining auditing standards for attesting to and reporting on a reporting issuer’s internal controls’²⁷ is akin to the provision in *Sarbanes-Oxley* mandating the creation of the SEC’s *Final Rules* that we looked at earlier. This provision will enable the Commission to determine the appropriate standards to be maintained by the public companies over which they exert regulatory control. It will also keep the OSC in step with the powers exercised by their American counterpart. Any increase in rule-making by the OSC will not, however, be without controversy, especially in light of the recent debate surrounding the CSA and BCSC blueprint proposals on securities regulation.

In January 2003 the Canadian Securities Administrators released its Blueprint for Uniform Securities Laws for Canada. This concept proposal sets out a four-tiered system of securities regulation: the Uniform Act as the platform legislation setting out the fundamental rights, powers and obligations; the Uniform Rules which would include the detailed requirements; the Administration Acts (one for each province and territory) which would contain the procedural and administrative provisions that currently exist in the various Securities Acts; and, finally, the Local Rules, which would exist in each jurisdiction, setting out the local differences where a harmonized approach is not appropriate.

²⁷ Section 187(1) adds sub-paragraph vi. To section 143(1) of the Ontario *Securities Act*.

In April 2003 the British Columbia Securities Commission presented its blueprint for securities regulation (the ‘BC Model’). The approach advocated in the BC Model is based on the fundamental principles of securities regulation and the conviction that what needs to happen is a reduction in the rules, not an increase. The model is a “radically stripped down version of the province’s existing legislation, aimed at decreasing the burden on issuers while hiking the penalties.”²⁸

The fundamental difference in approach advocated by each of these proposals means that any attempt by the OSC, or any other Canadian regulator, to create additional rules, will necessarily be subject to the debate that is currently raging about the direction Canadian securities regulation should be taking. An in-depth consideration of these concerns is clearly beyond the scope of this paper, however, it is enough that we appreciate the potential difficulties that are sure to arise once the Bill 198 rule-making powers are in force.

Independence Standards: The New Accounting Rules, A Canadian approach?

In theory, one of the unique features of the new Canadian approach to accounting practices is a self-professed principle-based approach, as opposed to the rule-based approach boasted by the US.²⁹ Indeed, as proposed, the draft standards appear to take such an approach. However, in practice, it is questionable whether such an approach can

²⁸ John Greenwood & Peter Fitzpatrick, ‘BCSC Outlines New Blueprint for Regulation’, The Financial Post, April 16, 2003.

²⁹ In their letter to Jonathan Katz, IFAC advocates the principle-based approach as ‘establishing the principles of independence and providing a conceptual framework for applying those principles.’ See footnote 18, *supra*. The CICA is also of the opinion that a ‘conceptual approach’ is best: ‘Public Interest and Integrity Committee opts for a conceptual framework approach to modernization of Canadian independence requirements’, CICA Forum, August 2001.

be ultimately sustained given the pressure on Canadian regulators to be in step with the US. Nevertheless, it is within this context that the CICA has released its *Independence Standards – Exposure Draft*.

Like its American counterpart (SEC *Final Rules*) the *Independence Standards* address the prohibition of non-audit services and partner rotation. The Standards do not address audit committee requirements because pursuant to s.187(1) of Bill 198, the authority here lies with the Ontario Securities Commission. It is important to keep in mind that the proposed rules are likely to change in light of the SEC *Final Rules*. This is made clear in the proposal:

...the committee will review the revised SEC regulations when they are issued and promptly modify the Canadian proposals, as necessary to protect the public interest in Canada.

Non-Audit Services

The list of services proposed to be prohibited by the *Independence Standards* is so much in keeping with those of the SEC in the *Final Rules* that it is not even necessary to repeat them here. However, there is one similarity that requires special attention and that is the absence of a prohibition on the provision of tax services. In addition, there are two substantial differences that deserve mentioning here. The first is the absence, in the Canadian context, of a provision allowing additional services to be prohibited. The second is the absence, again in the Canadian context, of a pre-approval regime similar to that fashioned by the SEC.

Auditing and Tax Services: Giving with one hand what we take with the other?

In keeping with the SEC's decision to allow auditors to perform tax services for audit clients, the *Independence Standards* makes special allowance for the provision of tax services by auditors.³⁰ However, it will be interesting to see how the court (or the Institute) assesses the potential for a conflict of interest that arises when an auditor gives tax planning advice to the company for which they will subsequently perform an audit. This is a particularly important consideration given the Supreme Court of Canada decision in *Hodgkinson v. Simms*.³¹ In this case a chartered accountant advised his client to invest in a specific real estate tax shelter without disclosing his position as advisor for the developers of the tax shelter. In finding the accountant liable the Court looked to the industry standards for guidance:

With respect to the accounting profession, the relevant rules and standards evidenced a clear instruction that all the real and apparent conflicts of interest be fully disclosed to the clients.

This decision suggests that, at the very least, there may be an obligation for auditors to make a special point of disclosing their interest as a tax advisor to the company.

Non-Audit Services & Canada's Response to the PCAOB

If we take a moment to look back to the non-audit services prohibited by the SEC *Final Rules*, the last of these is 'any other service that the Public Company Accounting Oversight Board (PCAOB) determines, by regulation is impermissible.' The PCAOB was created by *Sarbanes-Oxley* and will be overseen by the SEC. The role of this new entity

³⁰ Proposed in section 98 of the *Independence Standards*.

³¹ [1994] 3 S.C.R. 377.

is to oversee and investigate audits and auditors of public companies. It is worth noting that the powers of this entity are not disclosed by its name: it is empowered to do a lot more than oversee. The powers of the PCAOB include not only inspection and sanctioning abilities but also a direct referral mechanism to the SEC and, in certain circumstances, even to the Department of Justice. In particular, the Board can require testimonial and documentary production from the firm and may even request such information from ‘relevant persons outside the firm.’³² In respect of sanctions, the Board can sanction both firms and individuals for ‘non-cooperation, violations or failing to supervise a partner or employee in a registered accounting firm.’³³

Unlike the SEC’s *Final Rules*, the Canadian Standards do not propose to allow the Canadian Public Accountability Board (CPAB – Canada’s answer to the PCAOB) to prohibit additional non-audit services.³⁴

Pre-Approval of Non-Audit Services

The second notable absence from the *Independence Standards* is a requirement for pre-approval by the audit committee for any non-audit services that are not specifically prohibited. This is due, however, to the power to provide direction to the audit committee resting with the Ontario Securities Commission. It is anticipated that the OSC may

³² ‘*How the Sarbanes-Oxley Act of 2002 Impacts the Accounting Profession*’, American Institute of Certified Public Accountants. See it at <http://www.aicpa.org/info/Sarbanes-Oxley2002.asp>.

³³ Ibid.

³⁴ However, it is anticipated that the OSC may do so under its rule-making ability. The CPAB is only one of the bodies that will perform PCAOB-type tasks. The Auditing and Assurance Standards Oversight Council (AASOC) has been established by the CICA to oversee the Assurance Standards Board. This is a national body responsible for setting auditing and assurance standards for both the public and private sectors.

introduce requirements relating to pre-approval by an audit committee of non-audit services to be performed by auditors for clients that are also audit clients.

Partner Rotation

The *Independence Standards* propose that the lead engagement partner be rotated after five years with a two year time out. However, the proposal admits that this term was selected on the basis that it was the rotation recommended by *Sarbanes-Oxley*. As we have seen, the SEC rules have implemented a more stringent rotation requirement. It is anticipated that we can expect the Canadian standards to be pumped-up accordingly.

Audit Committee

As we have already mentioned, the *Independence Standards* do not address the issue of audit committees. Pursuant to the changes proposed in Bill 198, the Ontario *Securities Act* will require ‘reporting issuers to appoint audit committees and prescribe requirements relating to the functioning and responsibilities of audit committees.’³⁵ In addition, the CICA issued new standards for reporting to audit committees in their Handbook in early 2002³⁶ and the Toronto Stock Exchange has made numerous proposals in respect of audit committees in their proposed revisions to its TSX Company Manual.

CONCLUSION

Following the Rules: Calming the Upheaval

³⁵ Section 187(1) Bill 198 proposes the addition of paragraph 57 to section 143(1) of the *OSA*.

³⁶ *CICA Handbook*, Section 5751, ‘Communications with those having Oversight Responsibility for the Financial Reporting Process.’

Given that many of the changes in the Canadian accounting practices regime are currently at the proposal stage, it is difficult, going forward, to make authoritative suggestions as to the limits of auditor liability. However, given the fervour with which the Canadian regime has attempted to mirror that of the US, we can make some assumptions about where the lines are going to be drawn and we have attempted to do so. Unfortunately, the sheer magnitude of organizations (committees, boards, and councils alike) that have been created or brought on board to bring salvation to accounting practices post-Enron, further complicates the proposals and the new regime. More importantly, the ability of market participants to follow the proliferation of rules that are likely to exist at the end of the day will be seriously impeded by their ability to know what the rules are. In Canada alone (and remember the extra-territorial nature of the US regime means that the majority of accounting firms and corporations can not safely view their accounting practices in isolation) the OSC, the BCSC, the CVMQ, the ASC, and possibly even the CSA, the AASOC, the CICA, the ASB, the PIIC, the IAASB (International Auditing and Assurance Standards Board, and IFAC (International Federation of Accountants), each has their hand in the pot, so to speak.

One of the ironies of such a daunting system of accounting supervision is the way in which this approach is in such contrast to that principle-based approach, trumpeted by many, as the only approach suitable in the Canadian context. It remains to be seen if we can sustain the ideal. Do not underestimate, however, the long, drawn-out, path that lies ahead. Bill 198 has not yet been enacted. When and if it is enacted the Ontario Securities Commission will have the power to make a variety of rules that will, no doubt, have a

profound impact upon the accounting practices regime. In addition, the TSX proposals are still on the table as are the CICA *Independence Standards*.

More importantly, however, the US response to Enron is not over. We would suggest that the reaction thus far indicates that so long as there is life in the American desire to stamp out shoddy corporate governance (and it will probably have nine lives), the limits of auditor liability will remain indefinite. In the meantime, there is little more for us to do than to sit tight and, if you're a litigator, get ready for the interesting cases that lie ahead.