

auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

To assist practitioners, we are providing a sample auditor's report addressing scope limitation on cash revenue in the appendix of this newsletter. Note that the sample report makes the following assumptions and you should tailor the report to fit your clients' circumstances:

- the financial statements for the year ending 31 December 2011 are prepared in accordance with Part V of the CICA Handbook – Accounting;
- the auditor's report on the prior year, as previously issued, included a qualified opinion arising from a scope limitation;
- the matter giving rise to the modification is unresolved;
- the possible effects of the matter on the current year's figures are material and require a modification to the auditor's opinion regarding the current year figures;
- the audit is conducted in accordance with Canadian Auditing Standards; and
- the auditor for the current year was also the auditor for the prior year.

Entities Using Differential Reporting Options

When entities prepare their financial statements using differential reporting options, the auditor's report issued under the *Part II of the Assurance Handbook* Section 5400 refers to the financial statements being "prepared in accordance with Canadian general accepted accounting principles using differential reporting options available to non-publicly accountable entities". The CASs do not specifically address differential reporting options or whether auditor should refer to these options in the report.

As differential reporting options are accounting policies that have been selected by entities, and do not constitute a separate financial reporting

framework, the auditor's report should not refer to differential reporting. The differential reporting options elected would be included in the significant accounting policies note. If the financial statements are general purpose financial statements, the form of the report would follow CAS 700 and would refer to the financial reporting framework as "Canadian generally accepted accounting principles". For additional information, please refer to the CICA's *Reporting Implications of New Auditing and Accounting Standards* Issue No. 3, Question 1(e), page 11: <http://www.aasbcanada.ca/reference-material-for-practitioners/item42988.pdf>.

Additional resources

The CICA has set up a CAS Implementation Issues Advisory Group to help determine the issues that need immediate attention. CICA intends to publish a number of documents addressing the concerns during this year and some of the topics that might be covered include group audits, related parties, accounting estimates, going concern, and use of experts. Watch for these new resources to be posted on the CICA Standards in Transition website for CASs at: <http://www.cica.ca/cas/index.aspx>.

Professional Standards

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. Suggested wording for such limitations are included in the sample engagement letters provided by Mr. David Wende of Alexander Holburn Beaudin & Lang LLP, available on the ICABC website at: <http://www.ica.bc.ca/kb.php3?catid=969>.

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.

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Castor serves as a reminder to take steps to limit the class of people CAs owe a duty of care.
