CORPORATE COLLAPSE - Pitfalls for Directors, Auditors and Bankers:

A COMMENTARY FROM AN AUDITOR

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INTRODUCTION

This paper advances the case of auditors against the sometimes crippling liability they face in performing their duties. I am in favour of limiting liability. That does mean auditors will accept responsibility for their task, to a realistic extent, compensating those who have incurred loss as a consequence of negligent performance. This can be satisfied by a statutory cap and compulsory insurance up to that level. Above that cap the loss should be borne by the potential plaintiff who is best able to quantify the possible impact on him/herself of a proposed transaction going wrong.

SOME RECENT DEVELOPMENTS

There has been a rash of litigation in NZ following company collapses largely consequent on the October 1987 share market crash. Of the recent claims in NZ some have settled - eg Goldcorp; some decided - eg AIC; and some are still going - eg Cory Wright & Salmon. All the NZ major accounting firms have been troubled. These events clearly have an impact on the cost of the business and on whether anyone will want to remain auditing. Overseas, things are so bad one major accounting firm has sought a defensive merger - Spicer & Oppenheim, and another filed for Chapter 11 protection - Laventhol & Horwath [***The Economist*** 22 December 1990 p13 and ***NBR*** 3 December 1990 p10].

The major news is the decision of the House of Lords in ***Caparo*** (***Caparo Industries plc v Dickman and others*** [1990] 1 All ER 568). Caparo's argument was that Fidelity plc's reported profit of £1.3 million for the year ended 31 March 1984 was incorrect and that a loss of more than £400,000 should have been reported. Caparo argued that it placed reliance on these financial statements when it decided to acquire additional shares to take over Fidelity. Caparo said that had the true situation been known the bid would not have been made at the price paid, if at all.

Caparo claimed that the directors of Fidelity had made fraudulent misrepresentations and that the auditors were negligent in the performance of their duties. Subsequent to the decision of the House of Lords the background of the case has come to light with the hearing in the High Court of the action against the Fidelity directors. The directors decided to "improve" the financial statements by inflating the stock figure. This was done by reclassifying obsolete stock as good, altering stock sheets to invent stock, and documenting sales at year end of obsolete stock to business associates [***Financial Times*** 24/1/91 p15]. The directors' motive appears to have been to keep the major creditors from appointing a receiver. The company had been caught badly by the collapse of the consumer market for CB (Citizens' Band) radios. They had to stay in business long enough to ride the next boom in consumer electronics. The realisation that they were subject to an unfriendly takeover largely because of the altered accounts must have been a shock. As the inevitable approached, even they sold their shares to Caparo.

In the House of Lords decision in February 1990, the five Law Lords were unanimous in finding that the auditor, Touche Ross, did not owe a duty of care to Caparo as an investor or as an individual shareholder. (Touche Ross had issued an unqualified report on the financial statements for the year ended 31 March 1984.) This marks a significant reversal of the concept of foreseeability as set forth in ***Scott Group Ltd v McFarlane and Others*** ([1978] 1 NZLR 553), ***Jeb Fasteners v Marks, Bloom & Co*** ([1981] 3 All ER 289), and ***Twomax v Dickson, McFarlane & Robinson*** ((1982) SC 113). For cases of negligent misstatement to third parties, ***Caparo*** appears to have re-established the concept of "knowledge", previously expressed in the special relationship test from ***MLC v Evatt*** ([1971] AC 793) and the minority judgment in ***Scott Group***, as the basis under which the duty of care should be formulated. The Lords expressly approved another recent decision, ***Al Saudi Banque v Clark Pixely*** ([1989] 3 All ER 361), where the court held that the auditor of a company owed no duty of care to a bank lending money to that company, regardless of whether the bank was an existing or new creditor, as the relationship was not sufficiently proximate. Since then the Lords have gone further in ***Murphy v Brentwood District Council*** ([1990] 2 All ER 908) and actually overruled ***Anns*** case (***Anns v Merton LBC*** [1977] 2 All ER 492) upon which ***Scott Group*** was founded.

So after ***Caparo***, perhaps the appropriate practice for an English investor or lender who wishes to have possible recourse against an auditor is to obtain a letter of responsibility from the auditor [Cuthbert and Berg]. That is something which property valuers have long been doing when approached by a potential purchaser seeking to ensure that the valuer's duty of care for a valuation report extends to them. However, this does nothing to assist confidentiality of proposed commercial transactions.

There have been other cases after ***Caparo***. In one of the first in Canada (***Dixon v Price Waterhouse & Greenwood Cook and Co*** noted Beale (1990)), Price Waterhouse and Ontario-based Greenwood Cook & Co were absolved from liability following an action taken by an investor, Mr Ronald Dixon, who claimed that he suffered the loss of more than 75 percent of his investment of $1.2m in the shares of National Business Systems Inc, a credit card and peripherals manufacturer listed on the Toronto Stock Exchange. This was after it was revealed that the audited profit for the year ended 30 September 1987 of $14m should have been reported as a loss of $33m. Justice Huddart, citing ***Caparo's*** case in her decision, found that the plaintiff could not demonstrate sufficient proximity.

Professor Baxt notes in his paper at this conference that ***Caparo*** has not been followed in Australia by Justice Vincent in ***AGC (Advances) Ltd v R Lowe Lippman Figoor and Franck*** ((1991) Australian Torts Reports 81-072 - noted Baxt 1991).

In the English courts there have been several cases. In ***James McNaughton Paper Group Ltd v Hicks Anderson & Co*** (noted ***Accountancy*** January 1991 pp20-21) the Court of Appeal held that no duty of care was owed by the accountants to the purchasers in respect of draft financial statements they had prepared (despite the fact that direct oral representations had been made).

In ***Al-Nakib Investments (Jersey) Ltd v Longcroft*** (noted ***Accountancy*** January 1991 pp20-21 and ***The Examiner*** 28 February 1991 pp10-11) the court ruled that directors did not owe a duty to a shareholder using information from a rights issue prospectus (which allegedly contained untrue or misleading statements) to buy shares on the stockmarket as the prospectus was intended for the plaintiff to use only in relation to the rights issue.

In ***Morgan Crucible Company plc v Hill Samuel Bank Ltd*** (which went for trial in January this year) (noted ***Accountancy*** January 1991 pp20-21 and ***The Examiner*** 28 February 1991 pp10-11) the Court of Appeal permitted the claim to proceed on the basis that there is an arguable case that a duty of care existed in relation to each of the defendants (the bank, auditors, and directors of the target company First Castle Electronics). This was after the High Court had ruled there was no duty of care. Morgan Crucible (the bidder) argued that the target's financial statements before the battle, as well as a profit forecast and defence documents sent to shareholders, were negligently prepared and misleading. The Court of Appeal decided that the defence documents, which included parts of the financial statements, were intended to flush out a higher bid and a duty of care was owed to the bidder.

In New Zealand, ***Caparo*** was relied on by the defending auditors in ***Fletcher v National Mutual*** ((the AIC case) Henry J, High Court, Auckland, CL 51/87 and 7/88, 30 April 1990) where Thomas Fletcher, a representative of unsecured depositors in the collapsed AIC group sued National Mutual, trustee for the debenture holders, for breach of trust. National Mutual settled with the depositors for some $6 million, then sued the directors of AIC and AIC's auditors, Deloitte Haskins & Sells, to recover the amount. Mr Justice Henry ruled that the directors and auditors were jointly liable for $2.47 million of the depositors' loss plus interest. This was because the auditors should have advised National Mutual sooner of concerns about the financial position of AIC. However, the application of ***Caparo*** was not really in issue as in such a case, the parties were dealing with each other in a relationship well within any formulation of the duty of care - as the auditor was required to regularly report to the trustee.

In ***RJ Kelly Ltd v Hawkins and Others*** (Master Gambrill, HC Hamilton, CP 80/90; 28/3/91), a recent striking out application, Master Gambrill in refusing to strike out a claim for negligence noted that the High Court was bound by our Court of Appeal cases applying ***Anns***, and ***Caparo*** should not be followed.

There is debate about the extent to which ***Anns*** should remain good law in New Zealand, but I leave it to others, including Sir Robin Cooke, to advance that argument [Cooke, Smillie]. The ***Caparo*** decision gives some comfort to auditors. Though, with respect to the NZ Court of Appeal, rather less comfort in New Zealand than in the UK.

In the UK, the courts are getting very close to only admitting of a duty of care when the plaintiff is so proximate to the defendant as perhaps to have a contract. The latest development in the ***Caparo*** saga is the news that Caparo has, in the name of Fidelity, sued Touche Ross for breach of the contract of audit engagement [***Financial Times*** 21 March 1991]. Pending that battle I query why Scott Group did not proceed to sue the auditor in the name of the target company, Duthies? Perhaps that was because the potential damages were not seen as satisfactory.

Whether you approve of what ***Caparo*** and subsequent cases, such as ***Murphy v Brentwood***, do to Commonwealth tort law, they do provide some good news for auditors. That news might be welcome almost regardless of the mechanism for delivering it.

I suggest that the policy reasons driving the retreat from foreseeability as seen in ***Peabody Fund*** ([1984] 3 All ER 529), ***Sutherland Shire*** ((1985) 59 ALJR 564) and now ***Caparo***, also apply by extension to further limiting or even extinguishing the ***Hedley Byrne*** ([1964] AC 465) action. Given those policy reasons and the broader economic debate about the virtues of a return to a ***laissez-faire*** system, I look ahead and suggest (rather boldly) that one day the House of Lords may go that next step and overturn ***Hedley Byrne*** (or even ***Donoghue v Stevenson*** [1932] AC 562). On that day auditors will only applaud.

Auditors also face the rise of other causes of action such as the Fair Trading Act (recently applied by an accountant against a client in ***Hay v Chalmers*** - Fraser J, HC Timaru, CP 16/90; 20/3/91), but that could be a topic in itself.

WHY DO WE AUDIT?

In a presentation such as this there is not the scope to raise the fundamental questions of why do we audit and is it a valuable function? But we do need to bear these points in mind when looking at liability issues. Financial markets presumably want, and thus are prepared to pay for, the credibility the audit report gives to the financial information which influences those markets. Is this function required in today's markets? If small investors make their decisions on hunches and tips, and large investors on analysts' reports, to what extent is the auditors' work actually relied upon?

It is a policy decision to require audits by law. So NZ in effect exempts almost all private companies. Only the credit bureau may know anything about their standing. We require audited accounts from public companies though there may be a great deal of information in the market about these firms. This is expected of those raising funds from the public, as well as those not currently doing so. The latter may assist an orderly market in a company's securities and maintain its ability to raise capital. But it does amount to auditors being exposed to liability for an opinion they gave to one party - the company (in the meaning of the shareholders collectively) when the transaction in question is a sale between other parties - incoming and outgoing controlling shareholders.

If audits are legally required then the liability rules should allow, perhaps even encourage, someone to do the job. Companies legislation requires the report to the shareholders as a body. Where the law clearly envisages that report going to others for use in decision making - eg securities legislation, why of the possible experts in a prospectus is the auditor looked to as having unlimited liability?

AUDIT EXPECTATION GAP

There is an increasing amount written about an audit expectation gap [eg Brenda Porter]. This is the shortfall between society's expectations about what the audit function might be and the auditors' performance. Business, investors, regulators and politicians all have such expectations.

I suggest an expectation may be that auditors are "guarantors". That they warrant the state of health of a company and stand ready to reimburse investors if things go wrong.

But this is a misconception of the task. The auditor does not issue a report on the state of health. The company itself does that. The auditor gives an opinion that the statement is fair. In forming this view, the auditor is entitled to rely on directors, unless put on notice (***Re Thomas Gerard & Son Ltd*** [1968] 2 Ch 455 and see also ***Re Kingston Cotton Mill Ltd*** [1896] 2 Ch D 279 and ***Re London & General Bank (No 2)*** [1895] 2 Ch 673; but note s50 Securities Act 1978 and s13 Companies (Special Investigations and Management) Act 1989 and also Securities Commission report ***Capital Structure and Financial Reporting in New Zealand*** on primary duty an auditor has to investigations). In the reality of business, sampling techniques must be used to test balances and transactions. The difficulties can be great - eg accounting for all liabilities including those contingent, and verifying the extent to which receivables are collectible. It is not the same as auditing a law firm to check misappropriation, or a government department to check that all monies expended were appropriated by Parliament.

Auditors are not in law guarantors. Whether in contract or tort, they are only liable when they have failed to perform to the standard required and have caused the loss. (Though the costs in defending a major case successfully are high.)

As an illustration consider the cases of ***Scott*** and ***Caparo***. ***Scott*** was an innocent mistake in consolidating a subsidiary. An auditor should have found it. But there is a view that the result of the mistake was not material on the financial position of the target company, Duthie, or for the motives of the raider. In ***Caparo*** the company fraudulently altered its financial position with a material result. This placed the auditor in a more difficult position. Fraud is harder to detect, though I do suggest this fraud, or at least part of it, should have been found. In both cases the auditor did not cause the original problem but failed to detect it. In both, of the potential defendants, the auditor was sued as having deep pockets. In coming to a decision in such cases our law must grapple with the concepts of duty of care, breach of the standard of care, and whether damage was caused. Putting these together it does not seem satisfactory, from the auditors' point of view, that our law may allow full recovery from one solvent defendant when others' conduct was more blameworthy. It is with some satisfaction that I read in January this year that the directors of Fidelity (the target in ***Caparo***) had judgment ordered against them for fraudulent misrepresentation. That is placing the blame where it should be (though it is not clear whether the Dickman brothers can pay the amount awarded).

PROPOSALS FOR LIMITS ON LIABILITY

There is ample precedent for some limitation on liability. Bar lawyers, the other professional advisors are now behind corporate veils. Insurance is getting more expensive and at the upper amounts of cover, increasingly hard to find.

RJ Beale in his 1990 literature survey canvasses the arguments for and against and I now summarise them. The professional accounting bodies consider that it is necessary to limit the liability of auditors in one form or another. They do not consider that accounting firms should have unlimited liability when companies and their directors can enjoy the protection of limited liability. The reasons in support of limiting the liability of auditors include the large increase in recent years in the number and value of claims made against auditors, the difficulty in obtaining adequate insurance cover and its mounting cost, the inequity of the law of joint and several liability as it affects auditors, and the difficulties in taking action against the directors, who often do not have the financial resources to meet a major claim. For these reasons, accounting bodies throughout the world have made strong submissions demanding reforms.

Statutory Cap

I suggest (not for the first time) a statutory cap. Above the cap the loss and thus any applicable insurance should be borne by the party best able to identify the nature and extent of the loss from a particular transaction going wrong. That is not something that is possible for the auditor if there is no actual knowledge of the potential plaintiff or of the transaction.

As a counter for the cap, insurance below that level would be compulsory. Multiple claims would be reinsured. Such insurance stops any problem of a successful claim not being paid as might be so if all the auditors' assets have been sheltered.

The ***advantages*** of a statutory cap include:

1. A statutory cap provides a relatively simple means of limiting the auditor's liability which can easily be understood by the users of financial statements.

2. It would reduce the levels of professional indemnity insurance required, increase its availability, and reduce its cost. At present, the large auditing firms find it difficult to purchase all the cover they require, and the cost of professional indemnity insurance has increased substantially.

3. If the statutory cap is set at a high enough level, it would provide adequate compensation in most cases.

The ***disadvantages*** of a statutory cap include:

1. Because the method may, in some instances, result in a plaintiff not being able to receive full compensation for a loss suffered as a result of negligence, it is regarded as a fundamental change in one of the basic principles of common law.

2. There are difficulties in deciding on the most appropriate way of establishing the amount of the statutory cap. For example it could be -

    (a) A percentage of the actual financial loss attributed to the auditor's negligence;

    (b) Some multiple of the audit fee for the particular audit (this is the most usual suggestion);

    (c) A percentage of a firm's total gross annual auditing fees;

    (d) A percentage of the size of the client company, based on its total gross income and assets.

Of course, whether the law works in a given case assumes the defendant is solvent to pay the damages. I also note that the ***Scott Group*** action never extended to all innocent third parties. It was limited to the new controller of the company taken over, (or some similar party with a transaction in the target company's shares which was significant from the target's perspective). I ask whether it is better to have some damages paid to a plaintiff up to a cap; or to allow the courts to respond to the policy tensions and case by case remove the cause of action (as they have done in ***Caparo***)?

The New Zealand Law Commission [1987] in its ***Preliminary Paper No 5 Company law - a discussion paper*** [Paragraph 320] invited comments on the duties and liabilities of auditors. In response, the New Zealand Society of Accountants [1988 / 2] made a submission on the case for a statutory limitation on auditors' liability, summarising its submission as follows:

1. That there be a specified limit on the amount of damages that can be awarded against an auditor, once negligence is established. The limitation or cap should apply to each instance of a single loss.

   This "statutory cap" could, for example, be based on a multiple of the audit fees for the task in question.

2. That auditors be required to carry a minimum prescribed level of professional indemnity cover, being at least the amount of the statutory cap.

   In conclusion, the New Zealand Society of Accountants believes these measures are required to protect and improve existing standards of service to the business community in New Zealand by the chartered accounting profession [p31].

The New Zealand Law Commission [1989] ***Report No 9 Company law reform and restatement*** did not address the problem but the Law Commission indicated that it would deal with the matter in its project on contribution in civil cases [para 609] which is still pending.

In February 1986, the Councils of the Institutes of Chartered Accountants in England and Wales, Scotland, and Ireland submitted a memorandum to the Secretary for Trade and Industry recommending that an inquiry should be set up without delay to review the issue of limiting claims of negligence. Because of problems with the capacity of the professional indemnity insurance market, the memorandum recommended that a limit should be placed on the amount that may be claimed by way of damages for professional negligence [para 5.7.2]. It was also recommended that a statutory limit should be supported by compulsory indemnity insurance [para 5.7.3].

Subsequently, the UK Corporate and Consumer Affairs Minister, Michael Howard, rejected the plea for a limit to be placed on liability. However, he did recommend a review of the law of negligence, with particular emphasis on the concept of joint and several liability.

In May 1988, the Secretary of State and Industry announced that three study teams had been appointed "in the light of current concern about the cost and availability of professional indemnity insurance and the extent of professional civil liability for negligence". The three selected professions were auditing, surveying, and construction engineering. A steering group was appointed, chaired by Professor Andrew Likierman of the London Business School.

The Likierman Report [1989 Report of the Steering Group, para 4.2] rejected the introduction of a statutory cap and recommended:

1. The Law Commission should be asked to examine the possibility of change in the law of joint and several liability.

2. The use of directors and officers insurance should be encouraged.

3. The Law Reform (Contributory Negligence) Act 1945 should be amended so as to make clear that negligence by a plaintiff is relevant to awards in cases involving breach of contract as well as in tort.

4. The Companies Act 1985 should be amended so as to allow each company and its auditor to agree on a reasonable limit of liability, which is currently prevented by s310 of that Act. This would put the audit contract on the same footing as other contracts [p10].

More recently many of the arguments associated with this issue have been discussed in Australia, where the recommendation by the Companies and Securities Law Reform Committee that there should be a statutory cap on liability has effectively been shelved for the present [Gwilliam 1988 / 1].

In Canada, the Committee to Review Accountants' Liability (CORAL) in 1987 [Gunz 1987] recommended a cap on liability, reform of the law on joint and several liability, incorporating accounting firms, and alterations to the current limitation period for bringing claims.

The results of a recent survey of the views of Australian audit practitioners conducted by Adams and Kimber [1990] showed that there is "overwhelming support" in the profession for a statutory cap on liability. Nonetheless, auditors must acknowledge that there are both philosophical and pragmatic arguments for maintenance of unlimited liability (and the Australian Companies and Securities Law Review Committee Report 1986 recites these).

Of course, some will argue that a statutory cap is not acceptable in a free market environment [eg Pratt 1991] but they must admit that the market for statutory audit services is not free. The requirement for audit is imposed by law, and the qualifications of the providers are also prescribed. The vigorous competition for audit work is bounded by this, and by the legal requirements as to change of auditor, as well as by possible financial markets reaction to such a change. In such an environment, it may not be that higher costs, eg insurance premiums, can always be passed on to clients, or that the best quality auditor will eventually be the price leader.

The Principle of Joint and Several Liability

In its submission to the Law Commission, the New Zealand Society of Accountants [1988 / 3] stated that:

> The Society believes that the problem is exacerbated by the fact that under the principle of joint and several liability auditors are potentially liable for the full amount of a multi-million dollar breach of contract or negligence claims notwithstanding the fact that responsibility for the loss giving rise to the claim is or could be apportioned between a number of parties ... [p4, para 1.5].
>
> From the point of view of defendants, particularly those such as auditors whose responsibility for major losses may be minor, there are good policy grounds for arguing that liability as between defendants should be several and not joint -
>
> (a) The severing of liability accords with notions of justice, fairness and equity between those responsible for a claimant suffering loss. It is difficult to justify a multi-million dollar award of damages against a firm of

chartered accountants when their error was only one of a number of factors leading to the loss suffered by the claimant, particularly when the claimant is not a client but a third party.

(b) It is not a proposal which seeks to avoid liability totally. It recognises that professional persons should bear responsibility for their acts and omissions, but that responsibility should be limited to what is reasonable in the circumstances of the case [pp10-11, para 3.3].

This recognises that although the law in New Zealand [eg s17 of the Law Reform Act 1936] provides for proceedings against, and contribution between, joint and several tortfeasors, in practice actions by auditors against the directors are only practicable if directors have the resources to make a significant contribution to a large award of damages.

At present, the New Zealand Law Commission is still researching the topic of shared liability and proposes to issue a discussion paper on the topic.

Audit Quality

It might be suggested that a limitation of liability could lead to reduced standards of professional work. The New Zealand Society of Accountants [1988 / 2] considered that several factors should ensure that firms have the incentive to maintain consistently high standards of professional work. These are that auditors compete with other firms in the marketplace, that they will need to meet a very substantial insurance deductible, and increased premiums will result if a firm has an unsatisfactory claims record.

Looking at it the other way I also argue that the scope of the ***Scott Group*** duty of care, the size of potential damages, and the costs in even a successful defence mean that mere reliance on improving audit performance will not suffice to solve the liability problem.

Contributory Negligence

In an action against an auditor in tort, the auditor has the option to seek apportionment of the loss with the plaintiff under the terms of the Contributory Negligence Act 1947. However until ***Day v Mead*** ([1987] 2 NZLR 443 and note ***New Plymouth Borough v R*** [1951] NZLR 49 and ***Nelson Guarantee Corporation v Hodgson*** [1958] NZLR 609 on the point) it was accepted that this was not a defence in contract. In several Canadian cases, eg ***HE Kane v Coopers & Lybrand*** ([1983] 44 NBR 2d 374, (1985) 17 DLR 695), a court has been prepared to apportion loss under contributory negligence rules in a contract action. ***HE Kane Agencies*** was approved by our Court of Appeal in ***Day v Mead***. The latter was a case involving fiduciary obligations and perhaps could be distinguished on that ground, so the position in New Zealand is still somewhat uncertain.

Elsewhere, the UK Law Commission [Lawrence 1990] has recently published a consultation paper which concludes that the principle of contributory negligence should be extended into the law of contract.

Other Proposals

Incorporate audit firms: I do not favour incorporating audit firms for just liability reasons though other reasons are advanced why auditors should be permitted to incorporate. The idea of audit firms necessarily being unlimited partnerships is peculiar to the Anglo

Saxon or common law accounting jurisdictions. In many others including Germany, Switzerland and France incorporation is the norm. The USA professional body, AICPA, is considering changes to allow CPAs to incorporate which is currently prohibited in 46 of the 50 states [*Accountants' Journal* March 1991 p15].

Limit the life of an audit: by reducing the limitation period for civil actions against auditors.

Sue other parties first: so a plaintiff should exhaust all remedies against the defaulting directors or other parties before having recourse to the auditor. This was considered but not favoured by the Australian Companies and Securities Law Review Committee [1986, para 209].

Permit auditors and clients to agree to a limit on liability: by amending s204 of the Companies Act.

Special legislation: eg that auditors should be liable only for the amount by which the financial statements were misstated and not for any consequential loss arising from the misstatement. However, the Australian Companies and Securities Law Review Committee [1986, para 213] rejected this option because "it would constitute a substantial departure from the common law principles of causation and remoteness of damages ...". Though at this point I note there is an Occupational Liability Bill presently before the NSW Parliament which seeks to allow accountants and lawyers limited liability on condition they carry indemnity insurance.

Amended reporting requirements: to make it clear whether auditors are required to report to parties with whom they are not in a contractual relationship. Pratt [1989] concluded that:

> A usual argument against the extension of liability to third parties is that company law requires the auditor to report to the existing shareholders, for the purposes of stewardship only. Further, that the accounts have not necessarily been prepared with others in mind ...
>
> ... it can be strongly argued that if company law wants auditors to report to creditors and others, it should clearly say so. Tort should not be used as a backdoor approach for creating such a liability. On grounds of equity one can question whether the auditor should in fact be held responsible for the financial loss of every potential investor and every creditor who seeks to rely on the audit report.

It may be that this matter necessarily gets interwoven with the revision of statutory requirements as to financial reporting as are currently under consideration in New Zealand. We could consider the England experience following changes to their companies legislation in the 1980s [J Horsfall Turner].

Compulsory professional indemnity insurance: this is an integral part of the proposals for the introduction of a statutory cap.

CONCLUSION

As the debate goes on there come calls for change from outside the profession. The British MP Austin Mitchell has called for auditors to be more independent - by being auditors only, rather than one stop shops. That is something that ***The Economist*** has picked up [22 December 1990 p13]. The argument is also made that audits should rotate [*Bulletin* 3 April 1990 pp126-128]. This does not do justice to the efforts firms make to maintain independence, but that in itself does not explain away the criticisms. Much of the problem has to do with "creative accounting" and the pressures on companies and thus their auditors to produce particular financial results, but that is another topic.

This paper advances the case for greater protection of auditors against a sometimes crippling liability. It is in favour of limiting liability. That still means auditors will accept responsibility for their task, including to a realistic extent, compensating those who have incurred loss as a consequence of negligent performance. But this can be satisfied by a statutory cap and compulsory insurance up to that level. While in England it is possible that Parliament and the provisions of the EC Fifth Company law Directive will determine where an auditor's liability will lie, in New Zealand we will not have that outcome. Meanwhile any doubt in NZ as to the application of *Caparo* does not assist auditors.

Finally I should like to acknowledge my indebtedness to Leslie Brown of the Commercial Law Group of my Faculty for his assistance in the preparation of this paper.

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