IBIMA Publishing
Journal of Accounting and Auditing: Research & Practice
http://ibimapublishing.com/articles/JAARP/2018/722196/
Vol. 2018 (2018), Article ID 722196, 12 pages, ISSN : 2165-9532
DOI: 10.5171/2018.722196

Research Article

Auditors' Liability and Investors' Protection in Canada: The 'Leaky Umbrella'

Mark Lokanan

Faculty of Management Royal Roads University 2005 Sooke Road, Victoria, BC V9B 5Y2, Canada

Mark.Lokanan@royalroads.ca

Received date: 22 November 2017; Accepted date: 26 February 2018; Published date: 12 July 2018

Academic Editor: Husam Rjoub

Copyright © 2018. Mark Lokanan. Distributed under Creative Commons CC-BY 4.0

Abstract

In the spring of 1997, the Supreme Court of Canada ("Court") rendered a decision in *Hercules Managements Ltd. v. Ernst & Young* [1997] ("Hercules") that left shareholders out in the cold. Ever since the verdict in *Hercules* was released, the audit profession has been shielded from being held liable to third parties in cases of negligent misrepresentation. In *Hercules*, the Court ruled that audited reports are meant to inform management and creditors, but not for shareholders to make personal decisions. The *Hercules*' ruling was labelled a "national embarrassment" and exposes investors to even more aggressive accounting techniques. As is evident from the spate of corporate accounting frauds since the verdict in 1997, Canadian corporations and their auditors found it easier to sidestep accounting rules to produce financial statements that make their companies look healthier, when in actual fact they were downright toxic. Accordingly, the study of auditors' liability to third parties has a growing importance. In this paper, I argue that the Court's endorsement in *Hercules* has set a dangerous precedent to limit the liability owed by auditors towards shareholders in preparing financial reports. The paper shows how the discourse from *Hercules* has been disseminated and consumed by the audit profession and corporate enterprises to the detriment of shareholders. The paper emphasizes the residing significance of the auditors to use the discourse in *Hercules* to privilege their clients' interests and background the interests of non-contractual third parties.

Keywords: Hercules case; Auditors' liability; Fraud; Shareholders

Introduction

In 1997, the Supreme Court of Canada ("Court") issued its verdict in *Hercules Managements Ltd. v. Ernst & Young* ("Hercules"), which found that Canadian auditors do not owe a duty of care to third parties (including shareholders) in cases of negligent misrepresentation) (Brooks and Dunn, 2009; Parlow, 2012; Rosen and Rosen, 2010). The decision in *Hercules* was hailed as a landmark case in redefining the principles of negligence to limit auditors' liability from economic loss suffered by

____

Cite this Article as: Mark Lokanan (2018), " Auditors' Liability and Investors' Protection in Canada: The 'Leaky Umbrella'", Journal of Accounting and Auditing: Research & Practice, Vol. 2018 (2018)

non-contractual third parties in Canada (Smieliauskas and Bewley, 2012, p. 79). In *Hercules*, the plaintiffs were shareholders of Northguard Acceptance Ltd, which, together with Northguard Holdings Ltd. ("Northguard"), carried on business lending and investing money on the security of real property mortgages. The appellant, Hercules Managements Ltd., was among the shareholders who invested in Northguard. The respondent, Ernst & Young ("EY"), was initially hired by Northguard in 1971 to perform the Company's annual audits and provide audited reports to the Company's shareholders. In the early 1980s, things began to go downhill for Northguard and, in 1984, it went into receivership. The appellants and other investors in Northguard brought an action against EY in 1988 alleging that the audited financial reports from 1980 to 1981 were negligently prepared and, in reliance on these unqualified audit reports to make investment decisions, they suffered financial losses in their equity investment in excess of $850,000.

At issue in court was whether auditors (EY) owe shareholders a duty of care for negligently prepared audit reports. In a unanimous decision, the Supreme Court's justices held that auditors owed a *prima facie* duty of care to current shareholders. The Court took the view that there might be a duty of care between auditors and shareholders, but this duty was negated because the purpose for which shareholders used audited financial reports is not the purpose for which those reports were intended. The Court concluded that audited reports are prepared for current shareholders to evaluate management performance, not to guide investment decisions (Brooks and Dunn, 2009, p. 459). The Court's ruling, which remains controversial to this day, held that, if there is a duty of care owed to shareholders, it is negated by the fact that it will open the floodgates and expose auditing firms to "indeterminate liability" from a broad class of plaintiffs, for an indeterminate length of time (see Smieliauskas and Bewley, 2012, p. 80).

Immediately following the *Hercules'* verdict, there was a series of high profile accounting fraud cases involving some of Canada's largest corporations (Lokanan, 2014). The auditors of Nortel Networks, Eron Mortgage Corporation and Livent, among others, were all implicated in fraudulent misrepresentation (Rosen and Rosen, 2010, pp. 203-204). In these cases, the companies all received unqualified audit reports, which later proved to be highly deficient and lacked some of the most basic audit procedures (Rosen and Rosen, 2010). In more recent times, the issue of auditors' duty of care to independent third parties once again reared its ugly head in the Sino-Forest Corporation's ("Sino-Forest") (2012) scandal. As in previous cases, a similar pattern was repeated in Sino-Forest; the external auditors gave the Company a clean bill of health despite clear signs that it was falsifying its revenue (Kirby, 2014).

Soon after the Sino-Forest scandal was exposed, the audit profession in Canada again came under increased scrutiny from commentators and regulators alike for being reckless in failing to spot red flags of fraud and wilfully neglecting their duties as gatekeeper of corporate financial reports (Anand, 2004; Khoury, 2001; Lokanan, 2014; McFarland, Hoffman, and Gray, 2012; Parlow, 2012; Rosen and Rosen, 2010). In the Sino-Forest inquiry, the *Hercules'* ruling was invoked by the Ontario Securities Commission ("OSC") (Barber, 2013) to highlight the weak position of investors and shareholders vis-à-vis auditors. Hence, since *Hercules,* the question of auditors' liability towards third parties other than their clients has drawn a sharp reaction from commentators and has subsequently assumed great practical importance in Canada (Anand, 2004; Karan, 2004; Khoury, 2001; Livesey, 2012; McFarland *et al*., 2012).

It is now an opportune time to revisit the interpretation of the *Hercules* ruling in connection with audits of financial statements of reporting issuers (see also Dummett, 2014, par. 7). Reflecting on the issue of third party liability, the analysis presented here hopes to elucidate the

Mark Lokanan (2018), Journal of Accounting and Auditing: Research & Practice,
DOI: 10.5171/2018.722196

significance of *Hercules* for the auditing profession and its impact on contemporary auditing practices in Canada. My thesis is simple: I argue that the endorsement in *Hercules,* of not holding auditors liable to non-contractual independent third parties, has set a dangerous precedent that only works to absolve auditors of their duty of care and fiduciary responsibility to shareholders and potential investors. In exploring this argument, the paper addresses three overarching questions: What are the implications of *Hercules* for Canadian auditors? In the light of *Hercules*, what then is the purpose of an audit? Who do auditors really work for: the investors or the companies who employ them?

Literature Review

Auditors' Liability in Context

The term "auditors' liability" is not easily defined in a uniform and consistent manner (Arel, 2012; Gist *et al*., 2004; Porter, Simon, and Hatherly, 2008; Power, 1998; Samsonova-Taddei and Humphrey, 2015). The issues that constitute auditors' liability are largely dependent on the operative context and jurisdiction in which the audit is performed (Chung, Farrar, Puri, and Thorne *et al*., 2010). Notwithstanding the broader discursive conditions and contextual issues associated with audit engagements, the elements that constitute auditors' liability are relative and revolve around questions of to whom auditors should be liable and, if they are to be held liable, who should bear the consequences of the liability claim (Samsonova-Taddei and Humphrey, 2015, p. 56).

Generally speaking, auditors' liability for independent non-contractual third party losses occurs when auditors fail to perform an audit that meets minimum audit and accounting quality standards (Arel, 2012, p. 202). Beyond this basic premise that auditors should be held liable for producing sub-standard financial statements, is that the legal arrangements of such claims comprise multiple dimensions, which vary significantly in range and scope of regulatory actions (Samsonova-Taddei and Humphrey, 2015, p. 56). With investors bearing the primary burden of distorted financial statements, there have been very few issues in accounting that have generated as much controversy and debate than litigation against auditors for misstatements in financial reports (Chung, *et al*., 2010; Lokanan, 2015; Samsonova-Taddei and Humphrey, 2015; Sikka, 2009; Sikka andWillmott, 1995). This debate, for the most part, deals with the balance between the liabilities auditors are willing to assume and third parties' expectations of the audited financial statements that they produce (Lin and Chen, 2004; see also Clikeman, 2013; Porter *et al*., 2008; Sikka, 2008; 2009; Sikka and Wilmott, 1995).

The 1970s and 1980s saw a substantial extension of liability claims against auditors, to the point where virtually any third party who relied on audited financial reports to make decisions could claim damages against auditors for negligent misstatements (Samsonova-Taddei and Humphrey, 2015, p. 56). The intractable problems that give rise to these claims saw accounting standards being manipulated to permit companies to conceal their losses and disguise their true financial position (Williams, 2008, p. 491). The rendering of financial statements as distorted is further circumscribed by the view that accounting standards and directors' profit projections are virtually immiscible and that regulation must meet a very high standard of proof by focusing on avoiding collateral damage to the profession rather than effecting positive change (Lokanan, 2015; Williams, 2008, p. 491; Sikka, 2015). To reproduce a more general faith in the regulatability and governability of the audit profession, legal codes were mobilised by attorneys representing the interests of investors as the appropriate mode of action to hold auditors accountable to law and ethical standards. These codes were deployed to assess and respond to calls for fair treatment to investors and, more generally, third parties who relied on audited financial reports to make informed decisions (Samsonova-Taddei and Humphrey, 2015, p 56; also see Chung *et al*., 2004; Lokanan, 2017; Pacini *et al*., 2000a; Sikka 2009). Non-contractual third

Mark Lokanan (2018), Journal of Accounting and Auditing: Research & Practice,
DOI: 10.5171/2018.722196

parties who used the audited financial statements to inform their decisions were obliged to plead facts, which gave rise to an inference that fraud had been committed (Anand, 2004, p. 30).

The other side of the debate argues that auditors' liability should be limited to the corporate body being audited (Chung *et al*., 2010; Lokanan, 2017; Pacini *et al*., 2000a; Pacini *et al*., 2000b; Porter *et al*., 2008; Samsonova-Taddei and Humphrey, 2015). The typical starting point of this argument is that auditors' liability to third parties is unnecessary because shareholders and creditors can purchase assurance from the companies by conducting their due diligence if they so wish to protect themselves (Goldberg, 1988, p. 295). Implicit in this argument is that investors should conduct their due diligence before investing or risk investing in risky products because less diligence is needed (Lokanan, 2014; Tarr and Mack, 2013). This narrow conception of stewardship returns stricter conditions under which a duty of care is owed by auditors to third parties (Peecher *et al*., 2013; Power, 1998; Samsonova-Taddei and Humphrey, 2015). The auditors' job is to conduct their audit to alleviate the information asymmetry between investors and firms.

Canadian Precedents

There has been considerable litigation in recent years concerning auditors' liability in Canada. To fully appreciate the Hercules decision, a brief review of the cases regarding auditors' liability in tort is necessary. Most claims against auditors in Canada come under the tort of negligence. To succeed in a claim of auditors' negligence, the plaintiff (i.e., non-contractual third parties) must show that they were owed a duty of care, there was a breach of the duty of care (e.g., failure to follow GAAS and/or GAAP), and there was factual causation, which resulted in damages to the plaintiffs (Smieliauskas and Bewley, 2012, pp. 77-80). For years, the landmark case in Canada regarding auditors' liability was Haig v. Bamford [1976]. In Haig, the Court ruled that there were three tests that needed to be established to determine an auditors' duty of care to third parties: foreseeability of the use of the financial statements by the third parties; actual knowledge of the limited class that will use and rely on the financial statements; and actual knowledge of the specific plaintiff who will use and rely on the financial statements (Chung et al., 2010, p. 69; see also Khoury, 2001). Kripps v. Touche Ross & Co (now Deloitte Touche LLP) [1994] adjusted the ruling in Haig. The upshot of Kripps was that the British Columbia Court of Appeal held that auditors should not "hide behind GAAP" if they are aware that the financial statements are misleading.

Hercules modified the broad bounds of expansion to auditors' liability (McFarland, 2014, par. 6). In Hercules, the Court ruled that third parties (and most notably investors) do not have the "right to sue auditors for misstatements in financial statements because a duty of care does not exist between auditors and shareholders unless there are special circumstances within the facts of the case" (Chung et al., 2010, p. 69). The Court went on to reason that, even if auditors can foresee that shareholders and prospective investors will rely on their audited financial statements, auditors will not have a legal obligation (i.e., a duty of care) to them besides alleviating the information asymmetry gap (Smieliauskas and Bewley, 2012).

In Waxman v. Waxman [2004], the Ontario Court of Appeal reaffirmed the ruling in Hercules that auditors will not be held responsible to third parties of their corporate clients. The upshot of Waxman is that the plaintiff must demonstrate, on reasonable grounds, that (i) the auditors knew that shareholders would rely on the audited financial statements to make financial decisions other than the customary audit retainer; and (ii) that the auditors agreed to such an expansion of their mandate (Law Commission of Ontario, 2009, par. 18). The Waxman decision represents a significant development in the continuum of auditors' liability jurisprudence in Canada in that auditors only owe a "duty of care" to their

DOI: 10.5171/2018.722196

client to reduce information asymmetry on material information (McFarland, 2014).

The latest development in this area is explained in Widdrington v. Wightman et al. [2013] also known as Castor Holdings Inc. ("Castor"). In Castor, the Quebec Appeal Court largely upheld the Quebec Superior Court's decision that auditors Coopers & Lybrand (now PricewaterhouseCoopers) was negligent in the financial affairs of Castor. The case, which lasted some twelve years ears (it started in 1998) is noted as the longest auditor liability case in Canadian history. In the ruling, Justice Marie St-Pierre of the Quebec Superior Court said that Coopers & Lybrand failed to perform their duties as auditors in accordance with auditing and accounting standards (The Canadian Press, 2013, par. 6). Justice Marie St-Pierre also went on to reason that Coopers & Lybrand, one of the more senior auditing firms in Canada, issued "faulty opinion" about Castor's true financial position that prevented investors from evaluating its financial health (The Canadian Press, 2013, para. 7). The Honourable Marie St-Pierre, renowned for her conservative approach, reasoned that there was an exception to Hercules based on the specific factual situation presented in the case. She found that "the typical concerns surrounding 'indeterminate liability' do not arise" as they did in Hercules, for two key reasons: (1) Castor's financial statements were prepared for a broader purpose; and (2) the class of potential investors was identifiable to the auditors (Stock, 2011, p. 3).

This brief review reveals that, in the area of auditors' liability, the courts have been faced with the struggle to balance two fundamental, but equally important, conflicting interests: the public interest to rely on accurate and reliable financial statements and the interest of the auditing profession not to be burdened with potentially overwhelming liabilities from non-contractual third parties (Khoury, 2001, p. 471; Smieliauskas and Bewley, 2012, pp. 80-82). Invariably, the legal principle developed over time indicates that third-party recovery of economic loss from negligent auditing is limited and is only allowed in certain circumstances (Khoury, 2001, p. 471).

Analysis

Proposition 1: Effects of Increased Liability on New Investment: As auditor liability for audit failures increases, new investment decreases

One of the first problematised and attributional texts to have emerged from the *Hercules* ruling surrounds two key legal principles: "duty of care" and "indeterminate liability". These principles represent the basic frames in which discourses are deployed and aligned with accounting standards (i.e., CICA Handbook rules) and audit functions (also, see Williams, 2008). The *Hercules* ruling made it clear that, only in cases where the auditors prepare financial statements, expressly for the purpose to aid shareholders in making informed investment decisions, do they owe a duty of care to those shareholders (Rosen and Rosen, 2010, p. 9).

Up until *Hercules*, the natural response from the auditing profession in preparing audits has been risk avoidance (O'Connell, 2004; Peecher and Piercey, 2010; Power, 2007; Samsonova-Taddei and Humphrey, 2015; Sikka, 2009). The Court's ruling, however, has changed the way auditors work. Armed with the confidence of being protected within reasonable limits of liability claims, there has been a renaissance of sorts in an auditor's focus on more pressing and critical matters that are integral to the sustenance of the profession (Chung *et al*., 2010; King, 2002; Peecher *et al*., 2013). Now, more than ever, auditors are "required not only to be on the lookout for [red flags] and to report them if stumbled upon, but actually to provide reasonable assurance that material fraud would be discovered if present" (Clikeman, 2013, p. 146). Of course, as the Court opined, auditors should not be held liable if they fail to detect fraud in their engagements (also see Cooper, Dacin and Palmer, 2013; Donegan and Ganon, 2008; Humphrey *et al*., 2009).

DOI: 10.5171/2018.722196

These developments create a space for a critical analysis of the features of the *Hercules* ruling. The contradictory and heterogeneous nature of the Court's ruling in *Hercules* shapes regulation as a dialogue, which shows auditors as gatekeepers of financial statements (Cooper *et al*., 2013; Dorminey, Fleming, Kranacher, and Riley, 2012; Free and Murphy, 2013; Morales Gendron, and Guénin-Paracini, 2014; Power, 2013). While this discursive representation is, no doubt, valuable in revealing the complexity of external auditors' role in preparing financial statements, the recent accounting scandals in Canada have forced the audit profession to reopen the issues that were previously silenced in the Court's centred attributional frame of the *Hercules* decision. As part of an effort to make explicit the apparent contradictions between systemic manipulation of financial statements and legality of accounting standards, a critical view of the ideological underpinning of *Hercules* triggered an interpretative crisis that exposed the immunity conferred to auditors by the Court. Shareholders, who for years have depended on audited financial reports to guide them in their investment decisions, have, since *Hercules*, discovered that the reports are no longer reliable (Rosen and Rosen, 2010, p. 8). Suspicion has come to replace adulation (Williams, 2008, p. 483). Due to the reasonability limits to any liability claim, auditors now have minimum responsibility to investors, except in situations where an auditor(s) had specific knowledge of particular investors or class of investors and whether the statement would be used for the specific purpose for which they were prepared (see Sikka, 2015, p. 2).

Proposition 2: Effects of Increased Liability on Audit Failures: As auditor liability for audit failures increases, the audit failure rate decreases.

Given that the Court ruled that auditors do not owe a duty of care to "indeterminate classes" of people, what then is the purpose of an audit? The Court, in its ruling, placed a narrow view on limiting or negating the *prima facie* duty of care that auditors owed to shareholders. By ascribing only stewardship use of audited financial statements, the Court, in effect, is diminishing the value of audits to other stakeholders (see also Chung *et al*., 2010; Karen, 2004). On this basis, it may be said that auditors' purpose in preparing financial reports is, precisely, to assist the collective shareholders of companies in their tasks of overseeing management and not for other stakeholders (Rosen and Rosen, 2010, p. 8).

This is not a tenable argument and coalesces around a discursive trend of dominance and control manifested by the auditors when preparing financial statements (Sikka, 2009; Power, 2013). Historically, a wide range of non-contractual third parties, ranging from individual investors to creditors, have relied on audited financial reports to make informed decisions as to whether to buy, sell, or hold stocks or finance the company through loans. Of these, investors can be classified as the most vulnerable (see Clikeman, 2013; Livesey, 2012; Sikka, 2015). *Hercules* has increased this vulnerability by advocating a discourse which asserts "that investors who trade in securities of public corporations on a stock exchange or other secondary market have no remedy if they suffer loss as a result of negligent misrepresentation" (Anisman, 1997, p. 13). From a prospective shareholders' perspective, *Hercules* has effectively rendered the audit function meaningless by privileging the interest of corporations over the interests of investors (Anand, 2004, p. 17). The ruling in *Hercules* acts as a catalyst to show how the problem of auditors' liability has been subverted to the point where audited financial statements are viewed as discursive objects with identifiable properties (Morales, *et al*., 2014; Peecher and Piercey, 2010; Peecher *et al*., 2013; Sikka, 2008; 2009; Williams, 2008). The Court's decision in *Hercules,* as a sense-making device and vector of dominant discourse, has found its way into audit standards (CICA Handbook Section 5135 and 5136) that reproduce a distorted and narrowly hegemonic view that the auditor's responsibility is to conduct the audit in accordance with Generally

Mark Lokanan (2018), Journal of Accounting and Auditing: Research & Practice,
DOI: 10.5171/2018.722196

Accepted Auditing Standards (GAAS) to detect fraud and error. However, this could imply that the auditor is responsible for material misstatements, regardless of source, and, conversely, could also imply that the auditor is not responsible for detecting material misstatement regardless of source (Messier, Glover and Prawitt, 2012, p. 45; see also CICA Handbook Sections 5135 and 5136)

Known as the expectation gap, Canadian auditors have, for years, struggled with the dilemma of balancing the responsibility to serve the public and the need to serve their clients who pay their fees (i.e., what they are responsible for) (Smieliauskas and Bewley, 2012, p. 75). If, as the Court ruled, the auditor's job is to prepare financial statements so that current shareholders can assess management's performance, it may be appropriate to ask who do auditors work for: the corporations that employ them or the broader public? Using the recent accounting scandals (not only in Canada, but around the world) as evidence of auditors' allegiance, it becomes evident that they have a common ground with their corporate clients, i.e., to prepare financial statements that will maximize the audited companies' financial performance. Instead of being "watchdogs", the auditors are subordinate to corporate elites who influence their selection, retention and compensation to produce misleading financial reports (Chen *et al*., 2012; Clinkeman, 2013; Sikka, 2009).

These rationalities are a unique form of discursive complementarities that legitimize the dominant role of auditors through claims about their independence and ethical conduct. Beneath these claims are individuals whose "veneer of respectability is routinely punctured by silence, collusion and revelations of involvement in questionable practices" (Sikka, 2015, p. 9). Due to the discursive investment of company directors, corporations are able to function as the primary definers of the auditors' role, which enables them to influence the accounting treatment for dubious transactions (Sikka, 2009). It then becomes evident that the discursive nuances accompanying the *Hercules* ruling give rise to practical regularities (of accounting maneuvers) that have become commonplace in preparing audited financial reports (see also Galbraith, 2004). Audit engagements have now become a meaningless normal functional exercise under conditions of "irrational exuberance" (Shiller, 2001, p. xii) between talented clients (the corporate directors) and obedient experts (the auditors).

Proposition 3: Effects of Increased Liability on Cost of Capital: Increasing auditor liability for audit failures

The manner in which the *Hercules* ruling has been conveyed and consumed hinges on the duty of care issue. The ruling in *Hercules* "reaffirmed that auditors generally do not owe a duty of care to an indeterminate class such as potential investors" (Stock, 2011, p. 4). However, the Court "explicitly stated that there may be an exception depending on the factual situation" of the case (Stock, 2011, p. 4). The elements of what constitutes factual situations are open to discretion and interpretation. It is fair to say, however, that *Hercules* did not nullify auditors' duty of care to shareholders in Canada. Instead, the analysis so far reveals that the Court sets out the conditions in which a duty of care is owned to corporate clients, who are required to present the audited reports to shareholders for performance assessments and not for investment purposes (Anand, 2004, pp.16-17; Anisman, 1997). Therein lies the danger for auditors in preparing financial reports. On the one hand, the CICA is asserting that auditors have a duty of care to their clients and, at the same time, must work to protect the public interest. The two ultimately cannot be reconciled and, thus, implode, thereby exposing the organized hypocrisy of the CICA.

A special feature so far in this case analysis is the link between auditors' moral responsibility of being mindful of their clients who pay their fees and as useful servants to society (see Carey, 1946). No doubt there are auditors who want to perform their jobs to the best of their abilities and serve the public interest.

DOI: 10.5171/2018.722196

These are the auditors that "honour the public trust, and demonstrate commitment to professionalism" by adhering to the professional standards governing their professions (Baker, 2005, p. 693). They are the most fortunate auditors who are hardworking, are driven by core ethical values, are seen as stewards of the auditing professions and ensure that the information from the audits is fairly presented (Gray and Collison, 2002; Lokanan, 2017). In return for the exclusive franchise to sign off on audit report, these auditors work to protect the public interest from erroneous reporting and are motivated by the pursuit of sustainability in the best way possible (Clinkeman, 2013, p. 11).

Then there are those auditors who operate within the narrow discursive hegemony of the *Hercules* ruling and use it to legitimize and rationalize their practices. These are auditors who have disavowed themselves of their moral responsibility to serve the public interest (Rosen and Rosen, 2010). They ebb and flow throughout their professional careers, either because of their lack of understanding of the rules and ethical guidelines that guide the profession, or they understand the rules and ethical guidelines, but choose to follow a discursive practice for personal gain (Lokanan, 2017; Sikka, 2015). The language used in *Hercules* has convinced these recalcitrant auditors that they can produce erroneous financial statements with impunity. There is no incentive to curb their predatory practices while attending to the needs of their clients. These auditors are bound to a narrow mode and creatively portray themselves as the "shareholders' auditors", while' at the same time, produce audit reports to maintain their history of silence and collusion with corporate elites (Humphrey *et al*., 2009; Sikka. 2015). The latter is indicative of those auditors who want to satisfy their clients so badly that they have to put on their masks and give off the appearance that they are serving the public interest. It is in this respect that the discourse of the *Hercules* ruling is invoked, framed, gauged and, subsequently, rationalised and legitimized in practice.

At some point in this wider sociocultural practice, auditors who are complicit in compromising auditing standards will have to remove their masks. This will be the point at which they realize that the audited financial reports they are producing are to the detriment of both their clients and third parties. For some of these auditors, it may be that they are unmasked because regulatory agencies detect their misconduct. For others, it may be that they are unmasked because of the pressure from clients to meet the numbers, and, when they failed to do so, they were lost and unable to cope with what is real against what was hidden behind the mask. No one is arguing that auditing is meant to stop companies from using professional judgements in their financial statements – just to make sure that, when judgements are used, they are properly disclosed (Rapoport, 2010, par. 3; also see Chen *et al*., 2012; Healey and Palepu, 2003). Under either scenario, the issue which remains "misrecognized" is the possibility that manipulation and deception are *normal* features of preparing financial reports (Williams, 2008, p. 480 emphasis added; see also Sikka, 2015).

Conclusion

The present paper took a critical stance and exposed the connection between the overlapping interests of auditors with corporate elites and the discursive formation of precedents from the *Hercules* ruling. The institutional and wider social domains in which discursive hegemony occurs reveal that auditors were non-coercive and willing carriers of the discourse in *Hercules* to sustain a particular practice. The corporate elites have not been rolled back either; instead, they were willing participants in the dissemination of a discourse that advances their agenda of markets and private profits (Sikka, 2015, p. 13). In an environment of light touch regulation and commercialization of the audit profession, interpreting the ruling in *Hercules* for personal gain has been the order of the day. By linking the texts and the discourse on auditors' liability, I was able to disentangle and uncover the opaque

Mark Lokanan (2018), Journal of Accounting and Auditing: Research & Practice,
DOI: 10.5171/2018.722196

relationship that allowed auditors to maintain their oligopolistic position and seek jurisdictional protection in audit engagements.

Contextually, the paper illustrates how the audit profession was able to attach meaning to the controversial *Hercules* ruling. The "interactive process of meaning-making" exposed the dominant ideology used to chart a course of action that saw auditors being absolved from any duty and standard of care in signing off on financial statements. Minimizing audit risk and the prospect of seemingly unlimited liability has allowed Canadian auditors to background their duties to investors and become advocates for their corporate clients (Rosen and Rosen, 2010) without the fear of being accused of negligent misrepresentation for failing to detect and report on accounting inaccuracies (Parlow, 2012, p. 1). Misleading financial statements seem to have become acceptable, once they lead to personal enrichment for the audit firms (see also Sikka, 2015). Contrary to the claim of the audit profession, the normalcy of this discourse, as it is played out in practice, advocates that the auditor's job is to ensure the needs of financial enterprises are met, not to protect ordinary investors who are fleeced out of their life savings and pensions (Levitt, 2002; Parlow, 2012; Sikka, 2015). By according a privileged place for the information that is disclosed, audited financial statements can be said to offer as much support to investors "as a leaky umbrella from a thunderstorm" (Rosen and Rosen, 2010, p. 15).

References

1. Anand, A. (2004) 'Shareholder Isolation and the Regulation of Auditors,' *University of Toronto Law Journal*, 54 (1), 1-44.

2. Anisman, P. (1997) 'Investors Need More Protection Against Negligent Auditing', *Financial Post.* Toronto, ON.

3. Arel, B. (2012) 'The influence of judges' attitudes on liability assessments related to failed audits exhibiting significant audit team over-time or significant use of off-shore auditors', *Advances in Accounting, incorporating Advances in International Accounting*, 28(2), 201-208.

4. Baker, C. (2005) 'What is the meaning of 'the public interest'? Examining the ideology of the American public accounting profession', Accounting, *Auditing & Accountability Journal*, 18(5), 690-703.

5. Barber, P. (2013) 'Bull in the China Market: The Gap Between Investor Expectations and Auditor Liability for Chinese Financial Statement Frauds', *Duke Journal of Comparative & International Law*, 24, 349-402.

6. Brooks, L. and Dunn, P. (2009) *Business and Professional Ethics for Directors, Executives, and Accountants,* Cengage Learning, Mason, OH.

7. Carey, J. (1946) *Professional Ethics of Public Accounting*. American Institute of Accountants, New York.

8. Chung, J., Farrar, J., Puri, P. and Thorne, L. (2010) 'Auditor liability to third parties after Sarbanes-Oxley: An international comparison of regulatory and legal reforms', *Journal of International Accounting, Auditing and Taxation*, 19(1), 66–78.

9. Clikeman, M. (2013) *Called to account: Fourteen financial frauds that shaped the American accounting profession* (2nd ed), Routledge, New York.

10. Cooper, D., Dacin., T. and Palmer, D. (2013) 'Fraud in accounting, organizations and society: Extending the boundaries of research', *Accounting, Organization, and Society*, 38(6-7), 440–457.

11. Donegan, J. and Ganon, M. (2008) 'Strain, differential association, and coercion: Insights from the criminology literature on causes of accountant's misconduct', *Advances in Public Interest Accounting*, 8(1), 1–20.

12. Dorminey, J. W., Fleming, A. S., Kranacher, M.J. and Riley, R. A. Jr. (2010)

'Beyond the fraud triangle', CPA *Journal*, 80(7), 16–23.

13. Dummett, B. (2014). Ernst & Young Settles Over Audits of Sino-Forest and Chinese Company. *Wall Street Journal,* [online] Available at: http://www.wsj.com/articles/ernst-young-settles-over-audits-of-sino-forest-another-company-1412101002 (accessed 12 April, 2017).

14. Free, C. and Murphy, P. (2013). 'The Ties that Bind: The Decision to Co-offend in Fraud', *Contemporary Accounting Research*: doi: 10.1111/1911-3846.12063

15. Galbraith, J. (2004). *The Economics of Innocent Fraud: Truth for Our Time,* Houghton Mifflin Harcourt, New York.

16. Gist, W., McClain, G. and Shastri, T. (2004) 'User versus auditor perceptions of the auditor's report on internal control: Readability, reliability and auditor legal liability', *American Business Review*, 22(2), 117–130.

17. Goldberg, V. (1988) 'Accountable Accountants: Is Third-Party Liability Necessary?', *Journal of Legal Studies*, 17(2), 301-307.

18. Gray, R. and Collison, D. (2002) 'Can't see the wood for the trees, can't see the trees for the numbers? Accounting education, sustainability and the Public Interest', Critical *Perspectives on Accounting,* 13(5-6), 797–836.

19. Healey, P. and Palepu, K. (2003) 'The Fall or Enron. *Journal of Economic Perspectives*, 17 (2), 3-26.

20. Karan, R. (2004) 'Implications for third party actions against auditors of recently failed US companies and decision-usefulness objective under the New York Rule', *Critical Perspectives on Accounting*, 15(6-7), 927-941.

21. Khoury, L. (2001) 'The liability of auditors beyond their clients: A comparative study', *McGill Law Journal*, 46, 443-471.

22. King, R. (2002) 'An experimental investigation of self-serving biases in an auditing trust game: the effect of group affiliation' The *Accounting Review*, 77(2), 265–284.

23. Kirby, J. (2014). The red flags raised by the Sino-Forest case, *Macleans*, [online] Available at: http://www.macleans.ca/economy/economicanalysis/the-red-flags-raised-by-the-sino-forest-case/ (accessed 18 June 2017).

24. Law Commission of Ontario. (2009) 'Legislative and other developments', available at: http://www.lco-cdo.org/en/joint-several-liability-consultation-paper-sectionIII> (accessed 04 July 2017).

25. Lin, Z. and Chen, F. (2004) 'An Empirical Study of Audit 'Expectation Gap' in The People's Republic of China', *International Journal of Auditing*, 8(2), 93-115.

26. Livesey, B. (2012). *Thieves of Bay Street: How Banks, Brokerages and the Wealthy Steal Billions from Canadians*, Random House, Toronto, ON.

27. Lokanan, M.E. (2014) 'How Senior Managers Perpetuate Accounting Fraud? Lessons for Fraud Examiners from an Instructional Case', The *Journal of Financial Crime*, 21(4), 411-423.

28. Lokanan, M.E. (2015) 'Challenges to the fraud triangle: questions on its usefulness', *Accounting Forum*, 39(3), 201-224.

29. Lokanan, M. E. (2017). Theorizing Financial Crimes as Moral Actions, *European Accounting Review*, DOI: 10.1080/09638180.2017.1417144

30. Lynch, M., McGurrin, D. and Fenwick, M. (2004) 'Disappearing act: The representation of corporate crime research in criminological literature', *Journal of Criminal Justice*, 32, 389-398.

31. McFarland, J. (2014) 'Livent decision could pave way for new suits against

auditors', *The Globe and Mail* [online] Available at: http://www.theglobeandmail.com/report-on-business/industry-news/the-law-page/livent-decision-could-pave-way-for-new-suits-against-auditors/article17863142/ (accessed 10 March 2017).

32. McFarland, J., Hoffman, A. and Gray, J. (2012) ,OSC cracks down on Sino-Forest auditors', *The Globe and Mail* [online] available at: http://www.theglobeandmail.com/globe-investor/osc-cracks-down-on-sino-forest-auditors/article5913025/ (accessed 13 May2017).

33. Messier, W., Glover, S. and Prawitt, D. (2012) *Auditing and Assurance Services: A Systematic Approach* (8th ed), McGraw-Hill, Toronto, ON.

34. Morales, J., Gendron, Y. and Guénin-Paracini, H. (2014) 'The construction of the risky individual and vigilant organization: A genealogy of the fraud triangle', Accounting, *Organizations and Society*. http://dx.doi.org/10.1016/j.aos.2014.01.006

35. O'Connell, B. (2004) 'Enron. Con: He that filches from me my good name … makes me poor indeed', Critical *Perspectives on Accounting*, 15(6-7), 733-749.

36. Pacini, C., Hillison, W. and Sinason, D. (2000a) 'Auditor liability to third parties: An international focus', Managerial *Auditing Journal*, 15(8), 394–406.

37. Pacini, C., Martin, M. J. and Hamilton, L. (2000b) 'At the interface of law and accounting: An examination of a trend toward a reduction in the scope of auditor liability to third parties in common law countries', *American Business Law Journal*, 37(2), 171–235.

38. Parlow, D. (2012) 'The Prospect of a Successful Claim against Auditors in Fraud', Available at: http://www.kornfeldllp.com/wp-content/uploads/2012/05/Propsects-of-a-Successful-Claim-Against-Auditors.pdf (accessed 22 June 2016).

39. Peecher, M. and Piercey, M. (2010) 'Judging Audit Quality in Light of Adverse Outcomes: Evidence of Outcome Bias and Reverse Outcome Bias', *Contemporary Accounting Research*, 25 (1), 243-274.

40. Peecher, M., Solomon, I. and Trotman, K. (2013) 'An accountability framework for financial statement auditors and related research questions', *Accounting, Organizations and Society*, 38(8), 596-620.

41. Porter, B., Simon, J. and Hatherly, D. (2008) Principles *of external auditing* (3rd ed.) Chichester, England: John Wiley & Sons Ltd.

42. Power, M. (1998) 'Auditor Liability in Context', *Accounting, Organizations and Society*, 23(1), pp. 77–79.

43. Power, M. (2007) 'Business risk auditing – Debating the history of its present', Accounting, *Organizations and Society*, 32(4-5), 379–382.

44. Power, M. (2013) 'The apparatus of fraud risk', Accounting, *Organizations and Society*, 38(6-7), 535-543.

45. Rapoport, M. (2010) 'Role of Auditors in Crisis Gets Look', *The Wall Street Journal*, Available at: http://www.wsj.com/articles/SB10001424052748703814804576036094165907626 (accessed 12 May 2017).

46. Rosen, A. and Rosen, M. (2010) Swindlers*: Cons & Cheats and How to Protect Your Investments from Them.* Toronto, ON: Madison Press Limited.

47. Samsonova-Taddei, A. and Humphrey, C. (2015) 'Risk and the construction of a European audit policy agenda: The case of auditor liability', *Accounting, Organizations and Society*, 45(1), 55–72.

48. Shiller, R. (2001) Irrational *Exuberance*, Broadway Books, New York.

49. Sikka, P. (2008) 'Globalization and its discontents: Accounting firms buy limited

liability partnership legislation in Jersey', Accounting, *Auditing and Accountability Journal*, 21(3), 398–426.

50. Sikka, P. (2009) 'Financial crisis and the silence of the auditors', *Accounting, Organizations and Society*, 34(6-7), 868-873.

51. Sikka, P. (2015) 'The corrosive effects of neoliberalism on the UK financial crises and auditing practices: A dead-end for reforms', Accounting *Forum*, 39(1), 1-18.

52. Sikka, P. and Willmott, H. (1995) 'The power of 'independence': Defending and extending the jurisdiction of accounting in the UK', Accounting*, Organizations and Society*, 20(6), 547–581.

53. Smieliauskas, W. and Bewley, K. (2012) *Auditing: an International Approach* (6th ed), McGraw-Hill Ryerson, Toronto, ON.

54. Stock, E. (2011) 'Auditor's Exposure Expanded to Potential Investors? Case comment on the Castor decision', Published by the Institute of Chartered Accountants of British Columbia (Now CPA BC) [online] Available at: http://www.cica.ca/cas//index.aspx (access 05 June 2017).

55. Tarr, J. and Mack, J. (2013) 'Auditor obligations in an evolving legal landscape', *Accounting, Auditing & Accountability Journal*, 26(6), pp. 1009 – 1026.

56. The Canadian Press. (2013), Castor Holdings auditor held liable in its 1992 failure. Canadian Broadcasting Corporation"[online] available at: http://www.cbc.ca/news/business/castor-holdings-auditor-held-liable-in-its-1992-failure-1.1383297 (accessed 18February 2017).

57. Williams, J. (2008) 'The lessons of 'Enron': Media accounts, corporate crimes, and financial markets', *Theoretical Criminology*, 12(4), 471-499.

Cases Cited

Haig v. Bamford [1976] 1 S.C.R. 466.

Hercules Managements Ltd. v. Ernst & Young, [1997] 2 S.C.R. 1652.

Kripps v. Touche Ross & Co. [1994] 22 B.L.R. (2d) 86 (BSCS), aff'd [1997] BCJ No. 968 (BCCA).

Notes

Including shareholders: The terms "investors" and "shareholders" are used interchangeably throughout this paper as they broadly refer to independent third parties

Fraud cases: Corporate accounting fraud", "corporate fraud" and "fraud" will be used interchangeably throughout the paper. Given the nature of the paper, it was not necessary to disentangle the terms since all three were central components of the research methodology undertaken (also see Lynch, McGurrin & Fenwick, 2004, p. 397).

Independent Third Parties: The reference to independent third parties refers to someone who relies on audited financial reports to make informed financial investments (see also Chung et al., 2010).

Sino-Forest: In the Sino-Forest case, Canadian shareholders recorded a record settlement of $117 million against Ernst & Young for negligent misrepresentation (Barber, 2013).

Auditors: In relations to the Court's ruling in *Hercules*, new securities legislations have been passed in some provinces to hold auditors liable for negligence in financial statement audits (Smieliauskas and Bewley, 2012, p. 724).