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University of Toronto Law Journal, Volume 54, Number 1, Winter 2004, pp. 1-44 (Article)

Published by University of Toronto Press
DOI: *https://doi.org/10.1353/tlj.2004.0001*

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SHAREHOLDER ISOLATION AND THE REGULATION OF AUDITORS†

'The legal fiction that auditors are appointed by shareholders, not by corporate management, must become a reality.' – *Financial Times* 14 February 2002

I *Introduction*

In the post-Enron world,[1] debate and legislative initiatives[2] relating to public corporations have focused on the regulation of auditors.[3] The

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† I thank Jeff Merk, Kelly Muschett, and Dan Teguh for excellent research support and Virginia Haggerty, who tirelessly searched for material cited in this article. I thank Philip Anisman, Nick Bala, Kim Brooks, John Knowlton, Janet Salter, Steven Salterio, Lawrence Thacker, James C. Tory, Alan Brudner, and an anonymous reviewer for comments on earlier drafts. Research for this project was funded by the Social Sciences and Humanities Research Council of Canada. Prior to publication, this paper was presented at the Ontario Court of Appeal's Education Day, the University of Toronto's Law and Economics Workshop, the annual meeting of the Canadian Law and Economics Association, and the Queen's Annual Business Law Symposium. I thank participants of those sessions for their helpful comments.

1 While this article uses the fall of Enron and subsequent legislative initiatives as a reference point for examining existing regulation pertaining to auditors, conflicts of interest have plagued accounting firms, and undermined the integrity of the audits they perform, for the past several years in both Canada and the United States. For example, in the United States in 1999, Ernst & Young LLP agreed to a $335 million settlement with shareholders of Cendant Corp. arising from the company's alleged $500 million overstatement of revenues. In 2001, the US Securities and Exchange Commission (SEC) fined Arthur Andersen $7 million for its role in its client Waste Management Inc.'s $1.3 billion overstatement of revenues. Arthur Andersen also paid a portion of a $229 million settlement with Waste Management shareholders. Also in 2001, Arthur Andersen agreed to pay $110 million to shareholders of its client Sunbeam Corp. in connection with Sunbeam's alleged accounting fraud. These events, and their effect on the integrity and quality of the audit function, culminated in the indictment of Arthur Andersen in the Enron Corp. investigation. For a summary, see E.R. Greenstein & R.D. Bandman, 'Post Enron: Auditor Independence, Regulation and Disclosure' (2002) 1320 P.L.I./Corp. 217 at 222.

2 Following the collapse of Enron and other corporations, the US and Canadian governments issued legislation that addresses the role of auditors and the audit committee. The prime example is the *Sarbanes-Oxley Act,* Pub.L. No. 107-204, [session law citation] (2002). Regulatory bodies in both the United States and Canada (including the SEC, NYSE, NASDAQ, and the TSX and CICA) have also issued new rules. The Ontario government recently passed Bill 198, *An Act to implement Budget measures and other initiatives of the Government,* 3d. Sess., 37th Leg., Ontario, 2002, which contains additional enforcement provisions for the Ontario *Securities Act,* R.S.O. 1990, c. S.5. (proclaimed in force in part on 7 April 2003 [hereinafter Bill 198]. The Canadian Securities Administrators recently issued for comment 'Multilateral Instrument 52-110 and Companion Policy 52-110: Audit Committees' (2003) 26 O.S.C.B. 4997 [hereinafter CSA Rule].

3 For example, the Sarbanes-Oxley Act, ibid., contains pervasive reforms including disclosure controls and procedures; forfeitures of incentive-based compensation upon

underlying assumption is that heightened auditor independence and better financial reporting could have prevented investors' losses.[4] Frequently missing from the debate is an analysis of the role that shareholder empowerment, and not simply stricter rules governing the auditing profession, can play in achieving these goals. It is necessary to analyse shareholders' rights against the corporation's auditors because auditors are appointed by shareholders and are, in theory, accountable to them.

In this article, I posit the relative weakness of shareholders compared to other stakeholder groups (particularly management) in choosing and monitoring the corporation's auditor. Specifically, I argue that shareholders' right to appoint the corporation's auditors is of limited practical value, since management effectively controls the appointment process. I further claim that shareholders have few defined rights or remedies against auditors and that the duty owed by auditors to shareholders is unclear. Together, these factors render shareholders almost powerless in the corporation's relationship with its auditors.[5]

I maintain that shareholders should have an enhanced role in the selection, retention, and monitoring of a firm's auditor; that auditor changes should be initiated only by shareholders; and that periodic replacement of audit firms should be mandatory unless shareholders decide otherwise.[6] I argue that by creating a meaningful role for shareholders in the corporation's relationship with its auditors, greater auditor independence can be achieved. Thus conceived, greater shareholder voice is not an end in itself but a means to heightened corporate ac-

accounting restatement; pre-approval and disclosure of audit and non-audit services; criminal penalties; auditor oversight and independence requirements; retention of audit and review records; and audit committee composition and standards. See, *e.g.*, ss. 103, 302, and 906.

4 G. Quillen & A.G. June, 'Trends and Current Issues in Professional Standards, GAAS and GAAP' (2002) 1309 P.L.I./Corp. 65 at 71.

5 This article applies to outside auditors and will deal only peripherally with internal auditors.

6 In the accounting literature, there has been significant research relating to why auditor changes occur. For instance, M.L. DeFond & K.R. Subramanyam, 'Auditor Changes and Discretionary Accruals' (1998) 25 J. Acct. & Econ. 35 [hereinafter 'Auditor Changes'], point out that the SEC's view has been that firms will change auditors when opportunistic management wants to find an auditor willing to support a proposed accounting treatment. R. Dye, 'Informationally Motivated Auditor Replacement' (1991) 14 J. Acct. & Econ. 347 [hereinafter 'Replacement'], and R. Antle & B. Nalebuff, 'Conservatism and Auditor-Client Negotiations' (1991) 29 J. Acct. Res. 31 [hereinafter 'Conservatism'], argue that auditor changes can occur when managers and auditors hold legitimate but divergent beliefs regarding the appropriate application of GAAP. The issue of auditor change in Canada is informed by a less voluminous body of literature.

countability, which, in turn, is likely to have a positive effect on investor confidence and corporate performance.

Although the role of the auditor has received much attention in the financial press, the legal academic literature has not focused in a significant way on the relationship between auditors and the corporation's shareholders.[7] In this article, I argue that the legal regime does not provide shareholders with sufficient ability to control the process of choosing auditors. The article fills a gap in the legal literature by examining reasons why shareholders are disempowered when it comes to monitoring auditors and by providing concrete suggestions to ameliorate this problem and thereby improve corporate governance.

The discussion is divided into three parts. Part II underlines the auditor's significance in acting as a check on the corporation's financial disclosure. Part III presents three arguments that emphasize shareholders' powerlessness in their relationship with the corporation's auditors. Part IV outlines proposals for regulatory amendments to address the problem of shareholder isolation in their relationship with the corporation's auditors.

II *The auditor as gatekeeper*

Under corporate law, the board of directors has the authority to delegate to officers of the corporation the responsibility to manage the business and affairs of the corporation.[8] Typically, one of these responsibilities is to prepare and provide to shareholders the corporation's financial statements.[9] Management, particularly the chief executive officer and the chief financial officer, exerts strong influence over the formulation and

7 I note that academic literature in other disciplines has addressed this issue and related topics. See, *e.g.*, issues 21.2, 22.2 and 22.5 *Journal of Accounting and Public Policy*. See particularly A. Rashad Abdel-Khalik, 'Reforming Corporate Governance Post Enron: Shareholders' Board of Trustees and the Auditor' (2001) 21 J. Acct. & Pub. Policy 97 [hereinafter 'Reforming'].

8 *Canada Business Corporations Act,* R.S.C. 1985, c. C-44 [hereinafter CBCA], ss. 102(1), 121. See also corresponding sections of the Ontario *Business Corporations Act,* R.S.O. 1990, c. B.16 [hereinafter OBCA], ss. 115(1), 133; *British Columbia Company Act,* R.S.B.C. 1996, c.62 [hereinafter BCCA], and *Quebec Companies Act,* R.S.Q., c. C-38 [hereinafter QCA].

9 Annual financial statements must be placed before shareholders at every annual meeting. See *CBCA,* ibid. at s. 155(1). See also corresponding sections of the OBCA, ibid. at s. 154(1). Under securities legislation, interim financial statements must also be circulated to shareholders on a quarterly basis. See *Securities Act,* R.S.O. 1990, c. S.5, ss. 77–79. See also Ontario Securities Commission [OSC] Rule 51–501, 'AIF and MD&A' (2000) 23 O.S.C.B 7289 at 8311.

content of financial disclosure.[10] While the audit committee facilitates the board's approval of management-prepared financial information, this process does not alter the fact that, traditionally, management presents this information and the board approves it.[11]

If financial information is negative, shareholders can become dissatisfied with management. This dissatisfaction can result in a divestiture of their corporate holdings and a corresponding decrease in the value of the corporation's stock. As a result, management has an incentive – and feels pressure – to do whatever it can in preparing financial statements to meet earnings projections set by analysts[12] and to affirm that it, the management of the corporation, has been performing well.[13]

10 The Canadian Institute of Chartered Accountants, *Report of the Commission to Study the Public's Expectations of Audits* (Toronto: June 1988) [hereinafter *CICA Report*] at 21.

11 Ibid. at 21. The process in the United States is somewhat different from the traditional practice described here. See Sarbanes-Oxley Act, supra note 2 at s. 301(3)(A)(B)(ii), which states that each member of the audit committee must be a member of the board and shall otherwise be independent. No member of the audit committee can be an affiliated person of the issuer or any subsidiary of the corporation. Furthermore, in January 2003, the SEC issued a proposed rule titled 'Standards Relating to Listed Company Audit Committees,' and it is presently considering comments relating to this rule. See also CSA Rule, supra note 2, which proposes to implement similar requirements. These pieces of legislation are discussed in Part IV infra.

12 The desire of management to meet earnings projections is referred to as 'earnings management.' In particular, the term refers to management's ability and willingness to manage earnings to avoid a loss, to avoid an earnings decline, or to avoid falling below analysts' forecasts. For discussion, see A. Levitt, 'The Numbers Game' (Remarks at NYU Centre for Law and Business, New York, 28 September 1998), online: American Accounting Association <http://accounting.rutgers.edu/raw/aaa/newsarc/pr101898.htm> (date accessed: 6 November 2003) [hereinafter 'Numbers']. Levitt explains,

> While the problem of earnings management is not new, it has swelled in a market that is unforgiving of companies that miss their estimate ... This is the pattern earnings management creates: companies try to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. Their ability to do this depends on achieving the earnings expectations....

See also W.H. Beaver, 'What Have We Learned from the Recent Corporate Scandals That We Did Not Already Know?' (2002) 8 Stan.J.L.Bus.& Fin. 155 at 159 [hereinafter 'Scandals'], and S. Richardson, I. Tuna, & M. Wu, 'Predicting Earnings Management: The Case of Earnings Restatements' (2002) [unpublished, archived at The Wharton School, University of Pennsylvania) at 8.

13 See Beaver, 'Scandals,' ibid., where the author states, 'Management can improve or impair the quality of financial statements through the exercise of discretionary behavior over accounting numbers. Discretionary behavior includes voluntary earnings forecasting, voluntary disclosure, choice of accounting methods, and estimation of accruals.' In making this statement, Beaver cites M.F. McNichols, 'Research Design Issues in Earnings Management Studies' (2000) 19 J.Acct.& Pub.Policy 313, who reviews research in earnings management and discretion with respect to accounting data. See also W.H. Beaver, 'Perspectives on Recent Capital Market Research' (2002) 77 Acct.Rev. 453.

In theory, the auditor is an arm's-length third party who is not subject to management pressures. Auditors have little to gain (and much to lose) from misrepresenting financial information provided to shareholders.[14] The law mandates that auditors audit and certify financial statements to ensure that they comply with established legal requirements.[15] Because their potential liability is great and they have a reputation to protect, auditors are deterred, in theory, from cooperating with management in providing requested certification where such certification should not be made.[16] Auditors thus act as a check on management.[17]

The certification process can be complex. In auditing the financial statements, auditors must attest to management's appropriate application of Generally Accepted Accounting Principles (GAAP).[18] However, the

14 J.C. Coffee, Jr., 'The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting' (May 2001) [unpublished, Working Paper No. 191, Columbia Law School Centre for Law and Economic Studies], online: Social Science Research Network [SSRN] <http://papers.ssrn.com/paper.taf?abstract_id=270944> (date accessed: 7 November 2003) [hereinafter 'Acquiescent']. See also J.C. Coffee, Jr., 'Understanding Enron: It's About the Gatekeepers, Stupid' (30 July 2002) [unpublished, Working Paper No. 207, Columbia Law School Centre for Law and Economic Studies, 2002), online: SSRN <http://ssrn.com/abstract_id=325240> (date accessed: 7 November 2003). Coffee cites and relies on foundational academic writing relating to gatekeepers, including R. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy' (1986) 2 J.L.Econ.& Org. 53 [hereinafter 'Gatekeepers']; S. Choi, 'Market Lessons for Gatekeepers' (1998) 92 N.W.U.L.Rev. 116. See also R.J. Gilson & R.H. Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Va.L.Rev. 549.

15 These rules are set forth in the CBCA, supra note 8, and *The Handbook of the Canadian Institute of Chartered Accountants*, looseleaf (Toronto: Canadian Institute of Chartered Accountants, 1983). [hereinafter *CICA Handbook*] . See J. Ronen, 'Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited' (2002) 8 Stan.J.L.Bus.& Fin. 39 at 46 [hereinafter 'Post-Enron']:

> For their attestation to be credible, the auditors must be perceived as 'objective' and 'neutral' qualified outsiders. They need to exert effort in detecting potential misrepresentation and to convince investors that they have done so. Potential penalties must face auditors who do not conduct their job appropriately. Without such penalties, auditors' pursuit of their own self-interest may induce them to collaborate with the 'poor quality' managers, diminishing the credibility of the financial reports.

16 Coffee, 'Acquiescent,' supra note 14, citing Kraakman, 'Gatekeepers,' supra note 14. Note that the provision of non-audit services (to the extent that those services generate significantly greater fees than the audit itself) in practice undermines this theoretical position.

17 See *Hercules Management Ltd.* v. *Ernst & Young,* [1997] 2 S.C.R. 165 at 171 [hereinafter *Hercules*], where the Supreme Court of Canada stated, 'The auditors' purpose in preparing the reports was to assist the collectivity of shareholders of the audited companies in their task of overseeing management.'

18 The requirement regarding preparing financial statements in accordance with GAAP is found in s. 78(1) of Ontario's *Securities Act,* R.S.O. 1990, c. S.5 s.130.1 [hereinafter OSA]. See also DeFond & Subramanyam, 'Auditor Changes,' supra note 6 at 40.

interpretation of GAAP requires professional judgement and management, and auditors can hold legitimate conflicting views regarding its application.[19] If the auditors are not satisfied with management's interpretation of GAAP and the presentation of the financial information, they must then decide whether the disagreement is sufficiently serious to warrant a qualification of the audit opinion.[20] From a practical point of view, therefore, audited financial statements are often the outcome of negotiations between management and the incumbent auditor.[21] Auditors are intermediaries standing between corporate management and shareholders. Auditors give credibility to financial statements that might be treated with suspicion if they originated from management alone, with no third-party verification.[22] The auditor is often a 'repeat player' that pledges its reputational capital in faithfully performing its responsibilities.[23]

Auditors are intermediaries not only for shareholders but also for creditors, lenders, and the public at large. If a corporation fails to provide meaningful financial disclosure to investors, the consequences can be disastrous. Arthur Levitt, past Chair of the SEC, prophetically explained such consequences in 1998: 'The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate for no discernible reasons; and the trust that is the bedrock of our capital markets is severely tested.'[24] The fall of Enron exemplified this domino effect as well as the important role that auditors play as a public 'watchdog.'[25] If auditors perform their functions effectively, they can provide

19 See M. Gibbins & A.K. Mason, *Professional Judgment in Financial Reporting* (Toronto: Canadian Institute of Chartered Accountants, 1988); R. Magee & M. Tseng, 'Audit Pricing and Independence' (1990) 65 Acct.Rev. 315.

20 *CICA Handbook,* supra note 15 at para. 5100. See also *CICA Report,* supra note 10 at 23.

21 Antle & Nalebuff, 'Conservatism,' supra note 6. See also Dye, 'Replacement,' supra note 6.

22 See *Re City Equitable Fire Insurance Company Ltd.,* [1925] 1 Ch. 407, [1924] All E.R. Rep. 485 (Ch. Div.), aff'd [1925] 1 Ch. 500 (C.A.) [hereinafter *Re City*], which stands for the principle that the duty of the auditor is verification, not detection. The 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. See also W. Gray, ed., *The 1999 Annotated Canada Business Corporations Act* (Scarborough, ON: Carswell, 1999) at 235 [hereinafter *Annotated*].

23 Coffee, 'Acquiescent,' supra note 14 at 9.

24 Levitt, 'Numbers,' supra note 12.

25 See *United States* v. *Arthur Young & Co.,* 465 U.S. 805 at 817–8 (1984), in which the US Supreme Court stated,

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This 'public watchdog' function demands that the

the public with confidence in the market, which, in turn, contributes to both market integrity and efficiency.[26]

III *Shareholder isolation*

We will now turn to exploring the notion that shareholders are isolated in terms of their relationship with the corporation's auditors. The concept of shareholder isolation is founded on a number of claims, developed below, which are as follows: shareholders have weak statutory rights; they suffer from lack of auditor accountability and few remedies; financial disclosure is not meaningful; and, as a result of these factors, shareholders have little power to elect and monitor the corporation's auditors. We begin by addressing (and dismissing) an important criticism of this thesis.

Shareholder isolation is not a particularly novel idea for law and economics scholars. Drawing on Adolf Berle and Gardiner Means's thesis that the modern public corporation is typified by shareholders who are detached from and merely rubber-stamp choices made by management,[27] law and economics scholars argue that shareholder isolation is inevitable. Because the costs of becoming informed are greater than the benefits of simply 'voting with management,' shareholders choose not to participate in corporate affairs and simply abide by management's decisions or exit the company altogether. In this way, shareholders are 'rationally apathetic.' [28]

accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

See also Levitt, ibid.

26 See 'Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges' (October 2002), online: United States General Accounting Office <http://www.gao.gov/new.items/d03138.pdf> (date accessed: 7 November 2003) [hereinafter General Accounting Report]. This report is a General Accounting Office Report to the Committee on Banking, Housing, and Urban Affairs, US Senate.

27 A.A. Berle & G.C. Means, *The Modern Corporation and Private Property,* rev. ed. (New York: Harcourt, Brace & World, 1968) at viii [hereinafter *Modern*]. Berle and Means document 'the growing dominance of the corporate form, the increasing decision-making power of corporate management, the increasingly passive position of shareholders, and the increasing inapplicability of the ethical and economic justifications given ... by classic economics.' See also B.S. Black, 'Shareholder Passivity Reexamined' (1990) 89 Mich.L.Rev. 520 at 567–70 [hereinafter 'Passivity'].

28 See F.H. Easterbrook & D.R. Fischel, 'Voting in Corporate Law' (1983) 26 J.L.& Econ. 395 at 402; M. Lipton, 'Corporate Governance in the Age of Finance Corporatism' (1987) 136 U.Pa.L.Rev. 1 at 66–7; G.W. Dent, Jr., 'Toward Unifying Ownership and Control in the Public Corporation' (1989) Wis.L.Rev. 881; Black, 'Passivity,' supra note 27 at 567–70; S.M. Bainbridge, 'Independence Directors and the ALI Corporate Governance Project' (1993) 61 G.W.L.R. 1034 at 1055.

Yet shareholder apathy is an incomplete account of shareholder behaviour. To begin with, apathy will decrease as shareholdings increase.[29] As Bernard Black states, 'increased stake in the outcome, increased probability that their vote will affect the outcome, increased ease of coordinated voting among institutions, and scale economies combine to create substantial incentives for institutions to become informed voters.'[30] Thus, controlling and other bloc shareholders generally take an active interest in the corporation, its earnings, and its projected performance. Institutional holders, in particular, tend to be considerably more active than their retail counterparts[31] and view their role as including a monitoring function on which retail shareholders can free ride.[32] Even retail shareholders are becoming less passive, as shareholder activists Yves Michaud and Bob Verdun have demonstrated.[33] In short, the rational apathy theory describes the behaviour of some, but not all, investors.

Rational apathy theory is too broad in another respect, failing to draw distinctions between the various types of issues that confront shareholders. There are indeed some issues about which shareholders are apathetic, including whether to recapitalize, whether to borrow funds or sell stock to fund a new venture, and whether to embark on a particular acquisition or divestiture.[34] However, there are other issues in which shareholders will take an active interest.[35] For example, as Black points out,

29 Black, 'Passivity,' supra note 27 at 524.

30 Ibid.

31 J.G. MacIntosh, 'The Role of Institutional and Retail Investors in Canadian Capital Markets' 31 Osgoode Hall L.J. 371 at 380–3. MacIntosh states, 'While most institutional investors would once have sold their investments as a matter of course when dissatisfied with management ... institutions are increasingly retaining their investments and attempting to influence management's course of action.' MacIntosh argues that increasing shareholder activism in Canada can be traced to enhanced shareholder rights accorded in corporate and securities legislation and to an illiquid Canadian market with a lack of available investment options for institutional holders.

32 Ibid. Note also the advent of the Canadian Coalition for Good Governance (CCGG), which was formed in 2002 to fight for improved governance in Canadian corporations. Members of the CCGG hold in aggregate $135 billion in assets of Canadian corporations. The Members of the CCGG include the Ontario Teachers Pension Plan Board (OTPPB), the Ontario Municipal Employees Retirement System (OMERS), Manulife Financial, Burgundy Asset Management, and Jarislowsky Fraser. See CCGG, 'Institutional investors form coalition to fight for improved corporate governance' (press release, 27 June 2002), online: <http://www.ccgg.ca/web/website.nsf/web/ccggrelease1> (date accessed: 12 November 2003) [hereinafter CCGG].

33 J. Taber, 'Hard-Liner Fought Banks and Won: Bouchard's Nemesis Called "Robin Hood" for Court Battle for Shareholders' Rights' *National Post* (13 January 2001) A6; S. Scott, 'Corporate Crusader and Gadfly: Bob Verdun Jumps at Every Chance to Show CEOs the Error of Their Ways' *National Post* (31 August 2002) B8; T. Corcoran, 'Vote the Banks Out of Politics' *National Post* (14 January 1999) C7.

34 Black, 'Passivity,' supra note 27 at 580.

35 Black, ibid. at 524, makes a similar point, stating that 'shareholder voice holds more promise for process and structural issues than for company-specific concerns.'

shareholders are likely to be active in issues relating to process and structure, including instances in which they are entitled to vote, capital structure, and the form of management compensation.[36]

To Black's list we must add the fact that in the post-Enron era, shareholders seem to have a heightened concern about the corporation's relationship with its auditors. One reason for this concern may be that the corporation's auditors are not obliged to demonstrate to shareholders that they are performing their duties in a conflict-free manner. By contrast, management must constantly reassure shareholders through required disclosures (*e.g.*, insider trading reports) that they are acting in the corporation's best interests and not their own. The stakes are higher for shareholders in the corporation's relationship with the auditors, and they have become less apathetic about this relationship.

Given that rational apathy theory may not fully describe shareholder behaviour, it makes sense to probe the nature of shareholder isolation in the law relating to the corporation's auditors. Once we understand the extent of shareholders' isolation, we can more easily contemplate whether regulatory changes are necessary or desirable. We begin by analysing the rights accorded to shareholders under corporate statute.

A SHAREHOLDERS HAVE WEAK STATUTORY RIGHTS

The conspicuous conflict of interest confronting auditors is that they are in theory appointed by shareholders and responsible to them, but they are effectively hired and paid by management.[37] As a result, auditors are vulnerable to bias in the performance of their duties, a bias that could lead them to interpret GAAP and its application to the company's financial statements in a way that favours management.[38] For this reason, the corporate statute sets forth a regime that attempts to ensure shareholders a voice in the selection of auditors.

Under corporate law, shareholders' rights relating to auditors are largely ineffective. Their most basic right is the ability to appoint auditors at the annual general meeting.[39] In practice, management selects the

36 Ibid. at 580.

37 This is not the case in the United States since the passage of the Sarbanes-Oxley Act, supra note 2. If the CSA Rule, supra note 2, is implemented, this practice will presumably change. Under both of these pieces of legislation, an audit committee composed of independent members of the board has the responsibility to retain the corporation's auditor. These regulatory developments are discussed in Part IV infra.

38 See M.H. Bazerman, K.P. Morgan, & G. Loewenstein, 'The Impossibility of Auditor Independence' (1997) Sloan Mgmt.Rev. 89 at 90 [hereinafter 'Impossibility']: '[i]t is psychologically impossible for auditors to maintain their objectivity; cases of audit failures are inevitable.' See also D.A. Moore, G. Lowenstein, & M.H. Bazerman, 'Auditor Independence, Conflict of Interest and the Unconscious Intrusion of Bias' (GSIA Working Paper 2002-19) [hereinafter 'Auditor Independence'].

39 CBCA, supra note 8 at s. 162(1). See also corresponding sections of the OBCA, supra note 8 at s. 149(1); QCA, supra note 8 at s. 113(1); and BCCA, supra note 8 at s. 178(2),

auditor and places its name on the proxy or meeting agenda for shareholders to appoint. Shareholders are simply presented with the name of an audit firm, and they confirm or reject (by withholding their votes) a decision that has been made by management.[40] The proxy process whereby shareholders cede their vote to management (or refrain from voting altogether) serves to heighten management's influence over the choice of auditor.[41] Thus, in terms of their relationship with auditors and the input they have into decisions relating to auditors, shareholders' rights are limited.[42]

Furthermore, the right to appoint the auditor seems weaker than many other rights that shareholders have under statute. Shareholders can solicit proxies,[43] requisition meetings,[44] submit shareholder proposals,[45] bring derivative actions,[46] and launch oppression claims.[47] Together, this collection of rights underpins a principle of shareholder democracy in the corporation.[48] The right to appoint auditors appears much weaker than these other rights, since, in practice, the choice of auditor is already

(3). If an auditor is not appointed at a meeting of shareholders, the incumbent auditor continues in office until a successor is appointed: CBCA, ibid. at s. 162(3). See also corresponding sections of the OBCA, ibid. at s. 149(2); QCA, ibid. at s.113(4); BCCA, ibid. at s. 178(3). The remuneration of an auditor may be fixed by ordinary resolution of the shareholders or, if not fixed in this way, may be fixed by the directors: CBCA, ibid. at s. 162(4). See also corresponding sections of the OBCA, ibid. at s. 149(7); QCA, ibid. at s. 113(2); BCCA, ibid. at s. 184.

40 *CICA Report,* supra note 10 at 25, states that 'the audit appointment is so subject to the influence of management ...' See also Ronen, 'Post-Enron,' supra note 15 at 48: 'Shareholders admittedly vote on management's recommendation of which auditor's services to hire, but the decision is effectively handed over to management.'

41 Ronen, ibid.

42 Shareholders' right to elect directors is also weak. The right to elect directors is in reality a right to elect a slate of directors (in the absence of cumulative voting). If shareholders do not wish to vote in favour of one of the directors, they are given the option of withholding their vote altogether. This is similar to the 'appointment' process in the case of auditors, since, typically, shareholders are voting in favour of a slate put forth by management or have the option to withhold their vote. See A. Anand, 'Shareholders Deserve More' *Financial Post* (20 May 2003) FP13.

43 CBCA, supra note 8 at s. 150. See also corresponding sections of the OBCA, supra note 8 at ss. 112, 258(1)(d); and BCCA, supra note 8 at s. 154.

44 CBCA, ibid. at s. 143 (ability to requisition meetings if hold not less than 5% of the corporation's shares). See also corresponding sections of the OBCA, ibid. at s. 105; QCA, supra note 8 at s. 99; and BCCA, ibid. at s. 147. See also CBCA, ibid. at s. 144 (shareholder can apply to the court to call a meeting), and corresponding sections of the OBCA, ibid. at s. 106, BCCA, ibid. at s. 149.

45 CBCA, ibid. at s. 137. See also corresponding sections of the OBCA, ibid. at ss. 99; QCA, ibid. at ss. 99, 49; and BCCA, ibid. at s. 147.

46 CBCA, ibid. at s. 239. See also, corresponding sections of the OBCA, ibid. at s. 246; QCA, ibid. at s. 123; and BCCA, ibid. at s. 201(1)–201(3).

47 CBCA, ibid. at s. 241. See also corresponding sections of the OBCA, ibid. at s. 248; QCA, ibid. at s. 123; and BCCA, ibid. at s. 200.

48 See B. Welling et al., *Corporate Law and Cases, Notes and Material* (Toronto: Butterworths, 2001) at 50, who discuss the concept of majority rule as a fundamental tenet of corporate law.

made for shareholders prior to the meeting in which *de facto* appointment occurs.[49]

One might argue that since shareholders hold the right to remove auditors,[50] they have a significant degree of control.[51] However, shareholders rarely exercise their right to remove the auditors of a corporation.[52] They must either requisition a special meeting of shareholders to do so or to wait until the next annual meeting of shareholders. Most shareholders would likely divest from a corporation if dissatisfied with the performance of the firm's auditors. Further, if shareholders do exercise their right, but do not appoint a new auditor, the directors are responsible for filling the vacancy if the corporation's auditor resigns.[53] The corporation makes a statement regarding the proposed replacement, but the proposed outgoing or incoming auditor is not obliged to do so.[54] Thus, auditors may resign without ever providing an explanation of reasons for their resignation to shareholders.

49 Proposed reforms under the CSA Rule, supra note 2, relating to the function and structure of audit committees provide an alternative process to the traditional practice described here. See discussion at Part IV infra.

50 CBCA, supra note 8 at s. 165(1), states, 'The shareholders of a corporation may by ordinary resolution at a special meeting remove from office the auditor ...' See also corresponding sections of the OBCA, supra note 8 at s. 149(4); BCCA, supra note 8 at s. 185(1).

51 See Gray, *Annotated*, supra note 21 at 231.

52 The collective action necessary to do so would likely occur only in rare circumstances. For example, if auditors fail to detect inconsistencies with GAAP and are not otherwise removed or replaced, shareholders would need to requisition a special meeting of shareholders or wait until the next annual general meeting to replace the auditor. US academic literature reveals that auditor changes are generally rare and also reveals several competing reasons for auditor changes, including the following: current auditors' fees become too high; the firm is distressed; the client needs a higher-quality audit or a better location; the auditor offered a qualified opinion in the year preceding the switch; opportunistic management seeks an auditor willing to support a proposed accounting treatment; managers and auditors hold legitimate divergent beliefs regarding the appropriate application of GAAP; clients' financing and operating characteristics shift. See J.S. Whisenant & S. Sankaraguruswamy, *Evidence on the Auditor and Client Relationship: What Can Be Learned from Reasons Reported by Managers for Changing Auditors?* (January 2000) [unpublished] at 4; K.B. Schwartz & B.S. Soo, 'The Association between Auditor Changes and Reporting Lags' (1996) 13 Contemp.Acct.Research 353 at 361, citing K. Schwartz & K. Menon, 'Auditor Switches by Failing Firms' (1985) 60 Acct.Rev. 248; J. Krishnan, 'Auditor Switching and Conservatism' (1994) 69 Acct.Rev. 200; and DeFond & Subramanyam, 'Auditor Changes,' supra note 6. The author is currently collecting data relating to the frequency of auditor change in Canada.

53 CBCA, supra note 8 at ss. 165(2) and 166(1). See also, corresponding sections of the OBCA, supra note 8 at s. 149(4); QCA, supra note 8 at s. 113(4); and BCCA, supra note 8 at s. 185(1). That auditor holds office for the unexpired term of the predecessor: CBCA, ibid. at s. 166(4). See also corresponding sections of the OBCA, ibid. at s. 149(4); BCCA, ibid. at s. 185(1).

54 CBCA, ibid. at s. 168(5), 168(5.1). See also, corresponding sections of the OBCA, ibid. at s. 149(6); BCCA, ibid. at s. 185(3).

There are other factors that highlight the weak position of shareholders *vis-à-vis* auditors. For example, auditors have a statutory duty to make examinations as necessary for them to report on the corporation's financial statements,[55] in accordance with standards set forth in the *Handbook* of the Canadian Institute of Chartered Accountants.[56] However, the average shareholder has very little understanding of these standards and whether they necessitate disclosure that makes financial statement analysis meaningful. This issue is discussed in more detail below.

B. SHAREHOLDERS SUFFER FROM LACK OF AUDITOR ACCOUNTABILITY AND FEW REMEDIES

One of the issues plaguing the modern public corporation is that shareholders suffer from a lack of accountability on the part of directors and senior officers.[57] These individuals are required to act in the interests of the corporation and of its shareholders, but managers' self-interest can be a barrier to the fulfilment of this obligation. Similarly, shareholders suffer because auditors are not accountable to them. Under statute, auditors are not directly accountable to shareholders for negligently performing their audit function, with the exception of any misrepresentation contained in an expertised portion of a prospectus.[58] Further, the scope of shareholders' common law right against auditors is unclear.

The lack of auditor accountability has come to the fore recently because the number and frequency of financial restatements[59] have been increasing in recent years.[60] The increase in the number of restatements

55 The financial statements upon which the auditor is required to report include the balance sheet, statement of retained earnings, income statement, and statement of changes in financial position.

56 CBCA, supra note 8 at s. 169(1). See also corresponding sections of the OBCA, supra note 8 at s. 153(1); QCA, supra note 8 at s. 114(1); BCCA, supra note 8 at s. 188(1). *CICA Handbook,* supra note 15.

57 See, *e.g.*, issues that arose in *Aberdeen Railway Co.* v. *Blaikie,* H.L. 1854, 1 Macq. 461, and *Beatty* v. *Northwest Transportation Co.,* 5 Can.L.T. 277, regarding the validity of contracts in which directors had an interest. See also Berle & Means, *Modern,* supra note 27.

58 OSA, supra note 18 at section 130(d) and applicable defences 130(3)(d).

59 A financial restatement occurs when a company revises previously reported public financial information pertaining to the corporation. Restatements can be issued either voluntarily or at the request of regulators. Restatements often occur because a corporation's financial statements were not fairly presented in accordance with GAAP or because GAAP has changed and is applied retroactively. This type of 'accounting irregularity' can include material errors and fraud. See General Accounting Report, supra note 26 at 2.

60 In the United States, the number of restatements owing to accounting irregularities increased to 145 from January 1997 to June 2002 and was expected to reach 170 by the end of 2002. The number of restatements rose from 92 in 1997 to 225 in 2001. See General Accounting Report, supra note 26. See also L.E. Turner, 'Speech by SEC Staff: The State of Financial Reporting Today: An Unfinished Chapter II' (Third Annual SEC Disclosure and Accounting Conference, New York, 7 June 2001): 'The auditors say

has occasioned investor losses of massive proportions.[61] The statutory and common law regimes provide investors with remarkably limited recourse against their auditors when the audited financial statements are restated.[62]

1. Whither the duty?

A preliminary issue is how to define the duty, if one exists, of auditors toward shareholders. Auditors have a contractual relationship with the corporation but, in theory, report to shareholders. Yet there is no explicit or precise duty (statutory or otherwise) owed by auditors to shareholders,[63] and, indeed, the nature of the relationship between these parties is unclear.

It has been argued that the relationship between auditors and shareholders is contractual.[64] Yet courts generally refuse to recognize that the contract between the corporation and auditors extends to shareholders, holding that shareholders have statutory rights *vis-à-vis* the corporation's

management fraud is the reason the errors were not detected during the audit ... But I must ask you, "How can an auditor miss a billion dollars?"'

61 Restatements cost investors an average of 10% in the short term (from the day before to the day after the restatement) and 18% in the medium term (from sixty days before to sixty days after the restatement). See General Accounting Report, ibid. Examples of corporations that have experienced large negative market reactions to their earnings restatements include US corporations MicroStrategy, Cendant, and Sunbeam. Turner et al., 'Accounting Restatements' (2002) [unpublished, Working Paper, SEC and Ohio State University] report that in the seven-day period around the announcement of the restatement, these three firms lost more than $23 billion combined in market value. Other companies that have restated their financials in recent years include Adelphia, Aurora Foods, Critical Path, Enron, Hayes Lemmerz International, JDS Uniphase, MicroStrategy, Orbital Sciences, Rite Aid, Safety-Kleen, SeaView Video Technology, Shurgard Storage Centers, Sunbeam, Thomas & Betts, Waste Management, and Xerox. For a summary of the restatement data for each of these corporations, see General Accounting Report, ibid.

62 For comment see A. Rosen, 'The Safety Net Myth' 75:7 *Canadian Business* 27 (14 April 2003), online: Accountability Research <http://www.accountabilityresearch.com/documents/media/Apr_14_03_safety_Net_Myth.pdf> (date accessed: 12 November 2003) [hereinafter 'Safety Net'].

63 See *Haig* v. *Bamford et al.* (1976), 72 D.L.R. (3d) 68. See also J.E. Sexton & J.W. Stevens, 'Accountants' Legal Responsibilities and Liabilities' in *Meredith Memorial Lectures: Professional Responsibility in Civil Law and Common Law, Faculty of Law, McGill University, 1983–84* (Don Mills, ON: Richard De Boo, 1985) 88; I.F. Ivankovich, 'Accountants and Third-Party Liability: Back to the Future' (1991) 23 Ottawa L.Rev. 505. Regarding American law, see *Glanzer et al.* v. *Shepherd,* 233 N.Y. 236 (1922); *Ultramares Corporation* v. *Touche,* 174 N.E. 441 (1931); *Rusch Factors* v. *Levin,* 284 F. Supp. 85 (1968); *Citizens State Bank* v. *Timm, Schmidt & Co.* 335 N.W. 2d 361 (1983); and *H. Rosenblum, Inc.* v. *Adler,* 461 A.R. 2d 138 (1983).

64 *Hercules*, supra note 17; *Roman Corporation Ltd. et al.* v. *Peat Marwick Thorne et al.* (1992), 11 O.R. (3d) 248 [hereinafter *Roman*].

auditors but that these do not create a contractual relationship.[65] The finding that no duty under contract exists raises the question of whether shareholders are indeed the intended beneficiaries of the audit process. If auditors owe no contractual duty to shareholders, what is their duty?[66]

The corporate statute does not set forth auditors' duty to shareholders. The CICA *Handbook* is more helpful, stating that '[t]he auditor performs the audit with an attitude of professional skepticism, and seeks reasonable assurance whether the financial statements are free of material mis-statements.... The general practice ... is some evidence of reasonable care and skill to be expected of a profession ...'[67] Yet these obligations are expressed not as a duty of auditors to shareholders but as a duty of auditors to the profession generally. It is doubtful that shareholders would have any enforceable rights against auditors for breach of a standard articulated in a professional handbook.[68] It seems that a more logical and appropriate place for the expression of the duty would be in the corporate statute itself.[69] But with no duty explicitly stated, the question is left open as to whether a duty exists and, if it does, what its scope and nature might be.

2. Common law

The issue of how to define the duty of auditors has long been litigated at common law. The main recourse for shareholders against auditors is at

65 *Hercules,* ibid.; *Roman,* ibid.

66 This question was addressed by the Ontario Court (General Division) in *Roman,* supra note 64.

67 *CICA Handbook*, supra note 15 at 8-6 and 8-7, continues as follows:

> The auditors normally design auditing procedures on the assumption of management's good faith, and exercise professional judgment in determining the nature, extent, and timing of these procedures, in evaluating the results and in assessing determinations made by management. Absolute assurance in auditing is not attainable as a result of such factors as the use of judgment, the use of testing, the inherent limitations of internal control, and the fact that much of the evidence available to the auditors is persuasive rather than conclusive in nature.

See also *Revelstoke Credit Union* v. *Miller,* [1984] 2 W.W.R. 297 at 303–4.

68 As Finch J.A. of the British Columbia Court of Appeal stated *obiter* in *Kripps* v. *Touche Ross,* [1997] 6 W.W.R. 421, 33 B.C.L.R. (3d) 254 (C.A.) (leave to appeal refused (1997), 225 N.R. 236n (S.C.C.)) [hereinafter *Kripps* cited to W.W.R.], 'While professional standards would normally be a persuasive guide as to what constitutes reasonable care, those standards cannot be taken to supplant or to replace the degree of care called for by law. A professional body cannot bind the rest of the community by the standard it sets for its members. Otherwise, all professionals could immunize their members from claims of negligence.'

69 One barrier to expressing the duty in statute was stated in *Tannereye Ltd.* v. *Hansen,* [2001] P.E.I.J. No. 58 (22 May 2001): 'The standard of skill and care required of auditors and other professionals is difficult to define with precision. It is, by necessity, a general standard which can be applied to every possible task performed by a professional in the fulfillment of his or her professional obligations.'

common law in tort. Specifically, shareholders would argue that auditors made either negligent or fraudulent misrepresentations in the audit report delivered to shareholders. In either case, the plaintiff must prove each of the constituent elements of the tort.

In cases of negligent misrepresentation, shareholders typically claim that auditors owe them a duty of care that can result in negligent conduct if breached.[70] A broad duty of care is favoured by those who believe that the prospect of tort liability will be a strong incentive for auditors to improve their auditing standards.[71] The subsequent economic gains would include more effective monitoring of managers (and the financial information they prepare) by auditors. Others argue that a widely cast duty of care would lead to more negligence suits, imposing costs on auditors, who ultimately pass them on to the investing public.[72] The total fees paid to defence lawyers would be higher, since auditors would have to hire them more frequently. The higher costs imposed on auditors would be borne by the clients (corporations) that use the auditors. The clients would in turn pass on the higher costs to their shareholders or consumers.[73]

This more conservative, anti-remedial view has generally been adopted in the jurisprudence. As a result, shareholders' ability to succeed in claims of negligence against auditors has been limited.[74] For instance, in *Caparo Industries plc* v. *Dickman,* the House of Lords held that when a corporation hires an accountant to audit its financial statements, the auditors owe no duty of care to shareholders of a corporation. The House

70 See *Caparo Industries plc.* v. *Dickman,* [1990] 1 All E.R. 568 (H.L. (E.)); *Hercules,* supra note 17.

71 H.B. Wiener, 'Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation' (1983) 20 San Diego L.Rev. 233.

72 B.R. Cheffins, 'Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow' (1991) 18 C.B.L.J. 118 at 126 [hereinafter 'Liability'].

73 W.F. Ebke, 'In Search of Alternatives: Comparative Reflections on Corporate Governance and the Independent Auditor's Responsibilities' (1984) 79 N.W.U.L.Rev. 663 at 682, 684; T.E. Bilek, 'Accountants' Liability to the Third Party and Public Policy: A Calabresi Approach' (1985) 39 S.W.L.J. 689 at 704; Cheffins, 'Liability,' supra note 72 at 126–7. See also R. Baxt, 'The Modern Company Auditor: A Bloodhound Without Teeth or a Watchdog Without Eyes?' (1986) 42 Osgoode Hall L.J. 667 at 695. Baxt questions the rationale behind imposing contributory negligence on the corporation in a claim of auditor negligence: 'There seems to be little point in heralding the auditor as the champion of the shareholders if the onus to seek recovery of damages could be so easily diverted by the auditor to the shareholders by a separate action against the directors.'

74 See the House of Lords' decision in *Caparo,* supra note 70. In *Caparo,* the House of Lords held that when a corporation hires an accountant to audit its financial statements, the auditors do not owe a duty of care to shareholders of a corporation. See also Cheffins, 'Liability,' supra note 72.

of Lords refused to follow established authority,[75] stating that previous law reflected a bias in favour of imposing liability. The Law Lords held that auditors' professional advice is tendered with a specific purpose in mind and that liability must be restricted to losses incurred in transactions related to that purpose.[76]

In Canada, the leading negligence case is *Hercules Management* v. *Ernst & Young*.[77] In this case, two companies that carried on business lending and investing money on the security of real property mortgages went into receivership. Shareholders and investors brought an action against the auditor, alleging that audit reports for three years preceding the receivership were negligently prepared and that as a consequence of relying on these reports, they suffered various financial losses. The auditors successfully brought a motion to have the plaintiffs' claims dismissed on the basis that they raised no genuine issues for trial. The Manitoba Court of Appeal unanimously dismissed the appeal of that decision with costs.[78]

On appeal, the Supreme Court of Canada held that a two-step test must be applied in deciding whether auditors owe shareholders a duty of care for negligently prepared audit reports. These steps include (1) whether the auditors owe a *prima facie* duty of care; and, if so, (2) whether the duty is negated or limited by policy considerations. The court held that the auditors owed a *prima facie* duty of care to shareholders of the corporation.[79] However, this duty was negated because the purpose for which the shareholders used the auditors' report was not the purpose for which it was intended. The court concluded that auditors' purpose in preparing the reports was to assist the collectivity of shareholders in their task of overseeing management and not to assist in investment decisions.[80] The court further held that to hold auditors liable would be to expose the profession to the possibility of indeterminate liability to a broad class of potential plaintiffs. Thus, the *prima facie* duty of care owed by the auditors was overridden by policy considerations.

75 The leading English case is *Anns* v. *London Borough of Merton,* [1977] 2 All E.R. 492 (see especially 498).

76 Ibid. See especially judgment of Lord Liver of Aylmerton citing dissenting judgment of Denning L.J. in *Candler* v. *Crane, Christmas & Co.,* [1951] 2 K.B. 164 at 181, who expressed the test of proximity as follows: 'Did the accountants know that the accounts were required for submission to the plaintiff and use by him?' Lord Oliver endorsed this test and set forth a test which requires advice rendered for a purpose wherein the advisor knows that the recipient will use the advice for that purpose and the recipient does in fact use the advice for that purpose to his detriment. See also *Glanzer* v. *Shepard,* 135 N.E. 275 (1922).

77 Supra note 17.

78 125 D.L.R. (4th) 353.

79 *Hercules,* supra note 17.

80 Ibid. at paras. 49, 54, 56.

Hercules limits the common law right against auditors for negligent misrepresentation. The Supreme Court was persuaded by the floodgates argument and the view that the purpose of audit reports is for shareholders to assess the performance of management. Yet the distinction drawn by the court with respect to the purposes for which financial statements are prepared is not tenable: one's investment decisions inevitably stem from one's oversight and evaluation of management's performance. Nevertheless, *Hercules* provides authoritative precedent for future courts to negate a *prima facie* duty of care once established on the basis of policy. Some commentators have even concluded that *Hercules* has rendered the audit function meaningless and that it effectively prevents shareholders from succeeding in a claim against auditors for negligent misrepresentation.[81]

However, there are limitations on the reach of the *Hercules* decision, including judicial support for finding auditors liable at common law. In *Kripps* v. *Touche Ross,* the plaintiff investors who purchased debentures issued by a mortgage company that went bankrupt sued the auditors. They claimed that in deciding to purchase the debentures, they had relied on the auditors' report attached to the financial statements that formed part of the prospectus issued by the company the previous year. They argued that the auditors' report was a negligent representation, since the financial statements had not accurately reflected the corporation's financial position.[82] The plaintiffs argued that the auditors should have been aware that they, as investors, would rely on the auditors' certification that the company's financial statements were accurate.

The British Columbia Court of Appeal held that the auditors were liable. Although the auditors complied with existing GAAP, they allowed the company to understate its losses in a fashion that could mislead investors. The court held that the auditors provided their report knowing that its purpose was to facilitate the sale of debentures to the public. The auditors thus assumed the potential risk of reliance by the plaintiffs on the financial statements approved in their report.

81 See P. Anisman, 'Investors Need More Protection Against Negligent Auditing' *Financial Post* (10 June 1997) 13: 'Hercules suggests 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.' See also A. Rosen, 'Auditors Not Legally Liable to Investors, Top Court Rules' *Financial Post* (24 May 1997) 3 [hereinafter 'Investors]: 'The annual financial statement is now a joke. Public Accountants may think this is a wonderful win for them. But in the long run I see this as a disaster. Who really needs an audit of financial statements that are not useful for investor decision-making?' See also 'Editorial Opinion' *The Financial Post* (27 May 1997) 18.

82 *Kripps,* supra note 68. Note that this British Columbia Court of Appeal case was decided *before Hercules* but that leave to appeal was denied *after Hercules.*

The apparent distinction between *Kripps* and *Hercules* is that in *Kripps,* the auditors signed a statement that was filed with the prospectus. Because the prospectus is a selling document on which investors rely in making their investment decisions, the auditors were held to have notice that investors would rely on the financial statements. In *Hercules,* the financial statements at issue were not part of a prospectus or other selling document but formed part of the corporation's annual financial disclosure. Thus the auditors provided a report but did not know that it would be relied on by investors in their purchase of securities. An authoritative judicial attempt to reconcile the two decisions would certainly be useful.[83] The post-Enron regulatory disposition toward heightened accountability of auditors will inevitably colour such an analysis and leads one to question whether *Hercules* would be decided differently today.

A further caveat to the *Hercules* decision is that it concerns negligent misrepresentations and can be distinguished on its facts from cases involving fraudulent statements. Had the auditors acted fraudulently and not simply negligently, policy concerns might not have overridden the resulting liability.[84] However, a claim of fraudulent misrepresentation will generally be difficult to pursue for separate reasons. Though average investors have access to information disclosed publicly, they cannot easily obtain sufficient information to ground a claim of fraud.[85]

While avenues for individual shareholders may appear limited after *Hercules,* it is possible in theory for shareholders to act collectively against auditors through a class action for misrepresentation. Provincial class proceedings legislation[86] does not create a new cause of action for shareholders but, rather, provides a procedural mechanism for asserting claims *en masse.*[87] The legislation is relatively recent, and it appears that

83 For discussion, see J. Swan, B. Reiter, & N. Bala, *Contract Law: Cases, Notes and Materials,* 6th ed. (Toronto: Butterworths, 2002) at 680–1; J. Blackier & M. Paskell-Mede, 'Auditor Liability in Canada: The Past, Present and Future' (1999) 48 U.N.B.L.J. 65.

84 The elements of a claim for fraudulent misrepresentation are 'false misrepresentation of fact made with knowledge of its falsehood, or recklessly, without belief in its truth, with the intention that is should be acted upon by the companioning party, and actually inducing him to act upon it.' *Parna* v. *G. & S. Properties Ltd.* (1970), 15 D.L.R. (3d) 336 at 34 (S.C.C.).

85 P. Anisman, 'Comments on Class Proceedings, Securities Market Liability and the CSA Proposal' in *Selected Topics in Corporate Litigation: Proceedings of the Queen's Annual Business Law Symposium* (Kingston, ON: Queen's Printer, 2001) 111 at 115 [hereinafter 'Comments']: 'It is less likely that an action based on negligent misrepresentation would be allowed to proceed. This scenario is far from promising for plaintiffs.' [footnotes omitted]

86 See, *e.g., Class Proceedings Act,* S.O. 1992, c. 6 [hereinafter CPA].

87 J.A. Campion, 'Misrepresentation in Class Proceedings: The Cardozo Nightmare?' in *Selected Topics in Corporate Litigation: Proceedings of the Queen's Annual Business Law Symposium* (Kingston, ON: Queen's Printer, 2001) 70.

no class actions by shareholders against auditors have been certified to date.

Shareholders' statutory ability to bring a class action claim is hampered by a number of barriers. First, under the legislation, plaintiffs must demonstrate the existence of a cause of action in order to obtain certification.[88] As common law negligence cases have demonstrated, establishing a cause of action – and particularly shareholders' reliance on an auditor's report – can be difficult.[89] Nevertheless, courts have indicated a willingness to certify classes where the issues will move the litigation forward. For instance, in a recent case, the Ontario Court of Appeal treated negligent and fraudulent misrepresentation claims alike,[90] overturning the decision at first instance in which the fraudulent but not the negligent misrepresentation claims had been certified.[91] This case may mean that, at least in certification decisions, the separate constituent elements of the particular tort may be less important than whether they raise common issues of fact or law that advance the litigation.[92] However, the cause of action itself will without question require plaintiffs to prove all the constituent elements of the tort, including reliance. This will necessitate individual trials to determine reliance following the trial of the common issues. In light of *Hercules,* proving reliance and thus succeeding on an action for negligent misrepresentation will be difficult for shareholder plaintiffs.

Second, the stated objectives of class proceedings include the pursuit of meritorious but individually uneconomic claims, the resolution of a large number of disputes in a common proceeding, and the modification of wrongful behaviour on the part of the defendants.[93] But these objectives have posed difficulties for shareholders in the advancement of their

88 CPA, supra note 86 at s. 5(1).

89 See P.D.S. Jackson, 'Comment: Misrepresentation in Securities Class Proceedings – How Close Are We to Doing Away with the Issue of Reliance?' in *Selected Topics in Corporate Litigation: Proceedings of the Queen's Annual Business Law Symposium* (Kingston, ON: Queen's Printer, 2001) 132 [hereinafter 'Comment'].

90 See *3218520 Canada Inc.* v. *Bre-X Minerals Ltd. et al.,* 51 O.R. (3d) 236, application for leave to appeal to the Supreme Court of Canada dismissed (18 October 2001) [hereinafter *3218520 Inc.*], in which MacPherson J.A. stated, in holding that both the claims regarding negligent and fraudulent misrepresentation should be certified in the class action, 'I see no principled basis for treating the claim in negligent misrepresentation differently. Under both torts, the focus will be on the defendants, their knowledge and their conduct. Did they know (fraud) that there was no gold in Busang? Were they careless about (negligence) their knowledge of the state of affairs in Busang?'

91 *Carom et al.* v. *Bre-X Minerals Ltd. et al.,* (1999) 44 O.R. (3d) 173 (S. Ct.) (Winkler J.) [hereinafter *Carom*].

92 *3218520 Inc.,* supra note 90 at para. 49. See also Jackson, 'Comment,' supra note 89.

93 CPA, supra note 86 at s. 5(1).

claims because they set so high a threshold that shareholder plaintiffs have difficulty in falling within their ambit. For example, in *Abdool* v. *Anaheim Management Ltd.*, the Divisional Court held that a class proceeding would not be a preferable procedure to resolve a common issue regarding alleged auditor misrepresentation, since separate trials on individual issues would still be necessary to determine the question of liability.[94] One questions, therefore, whether it is at all possible for a class proceeding against a corporation's auditors to permit the resolution of many disputes in a common proceeding. It may be the case that class actions are not a preferred route for shareholder plaintiffs in claims against the corporation's auditors, since the same results can be achieved through a common law action without the addition of the intervening steps involved in certifying the class.

Third, Canadian courts have rejected the US 'fraud on the market' theory in claims of misrepresentations on the part of the issuer and other related parties.[95] Fraud on the market theory essentially removes the necessity for the plaintiff to prove reliance as a fact, so long as he can establish that the misrepresentation had an impact on the market price of the stock at issue.[96] In theory, therefore, it holds much potential for plaintiff shareholders. Yet case law has indicated that fraud on the market doctrine has no place in Canadian law because it is based both on a statutory framework not present in Canada and on a number of assumptions that may be inapplicable in Canadian markets.[97] In short,

94 *Abdool* v. *Anaheim Management Ltd.* (1995), 21 O.R. (3d) 4534 (Div. Ct.). See *Williams* v. *The Mutual Life Assurance Company of Canada* (2000), 51 O.R. (3d) 54, and *Zicherman* v. *The Equitable Life Insurance Company of Canada,* [2000] O.J. No. 5144, where certification was denied on the basis that there was not a common issue that could preferably be resolved by a class proceeding. But see *Campbell* v. *Flexwatt Corp.* (1997), 15 C.P.C. (4th) 1 (B.C.C.A.); *Anderson* v. *Wilson* (1999), 44 O.R. (3d) 673; and *3218520 Inc.*, supra note 90, which emphasize that it may not be necessary that the common issues resolve the litigation if the litigation would nevertheless be significantly advanced.

95 *Carom,* supra note 91.

96 *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975). The FMT presumes that stock markets are efficient and that information in the market will cause the price of a stock to fluctuate. The theory assumes that enough knowledgeable people learn of the information and act on it so as to drive the stock's price up or down. The few individuals without such information (and subsequent reliance on it) are buying and selling their stock at a price effectively fixed by the people who were knowledgeable and acted on the basis of that knowledge. Therefore, a connection between misrepresentations and the plaintiffs' loss is established without the need to demonstrate direct reliance. See Nicholl Paskell-Mede [NPM], 'Fraud on the Market? Not in Canada' *The Canadian D&O Liability Reports* (January 1999), online: Encon Group Inc. <http://www.encon.ca/English/lcb/bulletins/display.cfm?ID=77> (date accessed: 25 May 2003).

97 Mr Justice Winkler held that the *Hercules* case requires reliance to be proven as a fact in every case alleging negligent misrepresentation. *Carom,* supra note 90. See also *Kripps,* supra note 68.

actual reliance must be proven as a fact in order for a plaintiff to succeed in a claim for negligent misrepresentation.

In sum, shareholders have limited remedies against auditors. At common law, shareholders' main recourse is to bring an action based on fraudulent or negligent misrepresentation. Yet in fraudulent misrepresentation cases, shareholders will face barriers in gathering evidence to demonstrate the fraud itself; in negligence cases, plaintiffs will need to demonstrate that all of the requirements of the duty of care test for negligent misrepresentation have been met (including the existence of a special relationship and reliance). They will also need to demonstrate that the prevailing policy rationales for limiting the scope of recoverability for pure economic loss are inapplicable to their case. Whether the claim is one of fraudulent or of negligent misrepresentation, obtaining the necessary certification in class action cases will be fraught with procedural barriers.[98] Finally, shareholders have not been able to benefit from fraud on the market theory to date, although some argue that recent proposed amendments to Ontario's Securities Act, discussed in the next section, will allow the theory in through the 'back door.'

3. Statutory remedies

In *Hercules,* shareholders claimed that they were prevented from properly overseeing management because of misleading audit reports. They further argued that they would have intervened to prevent the corporation's receivership and the consequent loss of their equity. But the court held that the role of overseeing management is a managerial one and that in performing this role, shareholders are not simply individual holders of equity. Rather, their actions are collective and are made in respect of the corporation. The court further held that in this type of case, the derivative action is the more appropriate remedy to pursue. Thus, the Supreme Court held that where shareholders as a group have suffered a wrong, the rule in *Foss* v. *Harbottle*[99] applies: shareholders cannot bring individual claims in respect of wrongs done to the corporation.

The possibilities of success for shareholders qua shareholders under the derivative action, while perhaps more appropriate than a common law claim in many cases, are also limited. A derivative action is one brought on behalf of the corporation for a wrong done to the corpora-

98 As one commentator has stated, 'Launching a securities class action is not for the faint of heart.... Issuers will retain top-flight counsel, and will confront class counsel with a full array of procedural objections.' W. Branch, 'Securities Class Actions in Canada: Haven or Hinterland?' online: <http://www.branmac.com/Images/securities.pdf> (date accessed: 7 November 2003).

99 (1843), 2 Hare 460, 67 E.R. 189. The rule from *Foss* v. *Harbottle* is that individual shareholders have no cause of action for wrongs done to the corporation.

tion. But a complainant requires leave of the court,[100] and the court must be satisfied that conditions relating to notice, the complainant's good faith, and the corporation's interest have been met. Further, while the court has broad powers relating to remedies,[101] in theory the remedy accrues to the corporation, not to the individual complainant, since the action is not a personal one. Consequently, remedies in the form of damages may not flow to the aggrieved shareholders.[102] Without doubt, there are procedural barriers to shareholders' ability to bring and receive the benefits from a derivative action against an auditor.[103]

Further, it is unlikely that shareholders can use the oppression remedy[104] against an auditor for negligently prepared financial statements. Canadian case law contains no precedents of successful oppression claims by shareholders against auditors. In an attempted case, the Ontario Court of Justice (General Division) held that the corporate statute does not permit an oppression claim by shareholders against auditors of the company.[105] Arguably, however, an audit report that contained a misrepresentation could fall within the statutory language as an action that is unfairly prejudicial or oppressive or that unfairly disregards

100 CBCA, supra note 8 at s. 239(1). See also corresponding sections of the OBCA, supra note 8 at s. 246(1); QCA, supra note 8 at s. 123; BCCA, supra note 8 at s. 201(1).

101 CBCA, ibid. at s. 240. See also corresponding sections of the OBCA, ibid. at s. 247; QCA, ibid. at s. 123; BCCA, ibid. at s. 201(4).

102 J.G. Fleming, 'The Negligent Auditor and Shareholders' (1990) 106 L.Q.Rev. 349 at 352. As Fleming notes, 'a suit by the company would be futile and of no help to shareholders who, as it is, have little legal protection either against the management or ... against auditors who are beholden to management.'

103 See, *e.g.*, *Kaplan* v. *Peat, Marwick, Mitchell & Co*, 529 A.2d 254 (Del. Ch. Ct. 1987), 540 A.2d 726 (Del. S. Ct. 1988), where directors who neither objected to nor supported shareholders' derivative action took a neutral position that was not tantamount to authorization of derivative action. Thus shareholders' failure to demand that directors sue the independent auditor and failure to establish wrongful rejection of demand barred derivative action. See also G.M. Berne & M.A. Friel, 'Common Law and State Law Claims: What's Left After SLUSA' (2002) 1309 P.L.I./Corp. 109 at 112.

104 CBCA, supra note 8 at s. 241(1). See also corresponding sections of the OBCA, supra note 8 at s. 248(1); QCA, supra note 8 at s. 123; BCCA, supra note 8 at s. 200(1).

105 See *Budd* v. *Gentra Inc.*, [1996] O.J. No. 3515 (1998), in which a shareholder's oppression remedy pleadings against auditors were held to be bald assertions (at para. 21). As Farley J. stated at para. 20, 'it would not appear to me that auditors of a corporation qua auditors could fit within the pigeon holes of s. 241(2)(a), (b) or (c). Unless they were to take over de facto control of the corporation, they could not commit an act or omission of the corporation. Similarly auditors do not carry on the business of a corporation; and by definition of "affairs" they are not part of that relationship. Lastly they do not exercise the powers of directors.' See also the appeal decision at 43 B.L.R. (2d) 27 (Ont. C.A.), in which the oppression claim against the defendant's officers and directors was struck because the statement of claim contained no allegation of specific acts done by any of the defendant individuals.

shareholder interest.[106] But here a roadblock exists, since it is the 'corporation or any of its affiliates' that must have acted oppressively and it is questionable whether auditors fall within the ambit of this term.[107]

In all, courts are disinclined to allow individual shareholder recovery against auditors.[108] Case law tends toward the view that the corporation itself, or a shareholder through the derivative action, must bring a suit against auditors, since the state of the corporation's financial condition is in shareholders' collective interest.[109] Current law disadvantages shareholders, first because individual shareholders will have difficulty succeeding against auditors in common law tort actions for negligent misrepresentation, and second, because both class actions and derivative actions are procedurally difficult to bring.[110]

A caveat to the general conclusion that shareholder rights are limited is contained in recent proposed amendments to the Securities Act (Ontario).[111] These proposed amendments give investors in the secondary market the right to sue issuers, officers, directors, and experts such as accountants, lawyers, geologists, and engineers for making public material misrepresentations, written or oral, about the company or for failing to comply with continuous disclosure requirements. If enacted, the legislation will help to ensure that auditors are accountable to investors who rely on audit reports in their investment decisions by removing

106 See J. Chapman, 'An Alternative to Common Law Misrepresentation Claims' in *Selected Topics in Corporate Litigation: Proceedings of the Queen's Annual Business Law Symposium* (Kingston, ON: Queen's Printer, 2001) 128, who makes a similar argument.

107 Supra note 105, *per* Farley J.

108 *Caparo,* supra note 70 at 580: 'the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of a company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders.' See also *Roman,* supra note 64 at 255.

109 *Roman,* ibid. at 261.

110 In the United States, the ability of shareholders to claim against auditors has recently been curbed under the *Private Securities Litigation Reform Act,* Pub. L. No. 104-67 (1995) [hereinafter PSLRA]. The PSLRA requires heightened pleading standards compelling a plaintiff to plead facts that give rise to a 'strong inference' that a fraud was committed. It also provides a safe harbour for forward-looking information, which permits unrealized material forecasts to escape liability if the forecast included meaningful cautionary language or was not known to be false when made. These provisions work collectively to narrow the scope of relief available to investors against auditors under US federal securities laws. Subsequent legislation moved cases to state courts, where they are now principally litigated.

111 Bill 198, supra note 2 at ss. 138.3 ff. Though much of Bill 198 was proclaimed in force in April 2003, the provisions dealing with liability for secondary market disclosures were not. With the election of a new government in the province of Ontario in September 2003, one questions whether these provisions will indeed be implemented.

the requirement for plaintiffs to show reliance.[112] The touchstone of liability will be whether the misrepresentations are made knowingly or not rather than whether or not investors 'relied' on the misrepresentation. For misrepresentations made unknowingly, liability is capped and is proportionate.[113] For misrepresentations made knowingly, liability is not capped and is joint and several.[114]

This statutory cause of action is a necessary step in bridging an expectations gap between shareholders, who think that the audit is a security blanket on which they can rely in making investment decisions, and auditors, who can hide behind obscure rules (GAAP), assumptions, and spot checks in completing their audits.[115] Admittedly, it will be difficult to distinguish between misrepresentations that are made knowingly and those that are made unknowingly. But using 'knowledge' as opposed to reliance as the basis of liability is advantageous for shareholders; it allows recovery by investors who may have suffered damage indirectly because of the effect of the misrepresentation on the security's market price.[116]

From the plaintiff's point of view, the key question will be whether the damage ceilings are in addition to any other damages that could be claimed, for instance, at common law. In the case of negligent misrepresentations, it appears that *Hercules* will stand and that plaintiffs will be able to claim under statute only for misrepresentations that are unknowingly made. In the case of fraudulent misrepresentations, however, *Hercules* (a case about negligent misrepresentation) will not apply.[117] Therefore, in theory, shareholders could be successful both at common law and pursuant to the statutory right where damages are uncapped.

The proposed enactment of a statutory civil right for misrepresentation in continuous disclosure documents signals that legislators view current law as insufficient to protect shareholders. However, a key issue is whether the statutory right will provide a realistic alternative to class action lawsuits at common law.[118] The legislation is complex, which may

112 See Five Year Review Committee, *Final Report: Reviewing the Securities Act (Ontario)* (21 March 2003) at 133, online: Ontario, Ministry of Finance < http://www.gov.on.ca/FIN/english/publications/2003/5yrsecuritiesreview2.htm> (last modified: 19 September 2003) [hereinafter *Final Report*].

113 Bill 198, supra note 2 at s. 138.1(f). The limit is the greater of $1 million and the revenue that the auditor earned during the year preceding the misrepresentation.

114 Bill 198, ibid. at s. 138.6(2).

115 I discuss specific aspects of the audit function below at Part III, section C, subsection 2.

116 J.A. Campion, 'Misrepresentation in Class Proceedings: The Cardozo Nightmare?' in *Selected Topics in Corporate Litigation: Proceedings of the Queen's Annual Business Law Symposium* (Kingston, ON: Queen's Printer, 2001) 70.

117 'Ontario Legislative Response to *Hercules Management*' *National Post* (27 November 2002).

118 Anisman, 'Comments,' supra note 85 at 114. See also P. Anisman, Dissenting Statement in *Final Report: Responsible Corporate Disclosure – A Search for Balance*(Chair T.A Allen) (Toronto: Toronto Stock Exchange, 1997) [hereinafter *Responsible Disclosure*].

impede its utility.[119] As in the derivative action, there is a requirement to obtain leave to proceed that will be granted only if the court is satisfied that the action is brought in good faith and that there is a reasonable possibility that the action will be resolved in favour of the plaintiff at trial.[120] Furthermore, auditors have a 'due diligence' defence. That is, if the auditor proves that it conducted or caused to be conducted a reasonable investigation and that it had no reasonable grounds to believe that the document contained a misrepresentation, it will be excused from liability.[121] In short, it is not necessarily the case that the imposition of secondary market liability is a boon for shareholders. It is indeed a first step, but only time will reveal the efficacy of the statutory regime if implemented.

C. FINANCIAL DISCLOSURE IS NOT MEANINGFUL

1. Financial data are not lucid

A bedrock of the securities regulatory system is disclosure of information.[122] Yet much debate has occurred in recent years about 'meaningful disclosure' and 'transparent disclosure.' The debate stems from concerns that individual investors do not have the ability or time to decipher corporate disclosure documents, including financial statements and lengthy notes to these statements.[123] Other investors remark that even if they had the time, financial disclosure data are too complex; the documents are not readable.[124] One scholar has even likened financial disclosure to

119 Anisman, 'Comment,' supra note 118.

120 Bill 198, supra note 2 at s. 138.8. These grounds for the granting of leave appear less onerous than in the derivative action but in practice could be more onerous. See *Responsible Disclosure,* supra note 118.

121 Bill 198, ibid. at s. 138.4(6). Auditors may also limit their liability by taking corrective action: Bill 198, ibid. at s. 138.4(15).

122 See W.M.H. Grover & J.C. Baillie, 'Disclosure Requirements' in *Proposals for a Securities Market Law for Canada,* vol. 3 (Ottawa: Consumer and Corporate Affairs, 1979) 349.

123 See remarks of M. Singletary in 'U.S. Securities and Exchange Commission, Investor Summit, 10 May 2002' online: SEC <http://www.sec.gov/investor/summit/isummit05 1002.htm> (date accessed: 10 November 2003) [hereinafter 'Investor Summit']: 'From nine to five, I am trying to chase an 18-month-old around, to not tear up my house, a four-year-old who threw up on my bed last night, a husband who likes to play on the computers, and you know, a seven-year-old who thinks she's 50. I don't have time to be going over these [financial reports]. Many people don't know the difference between the A shares and the B shares and the C shares, but we've got lives to lead, and that's why we have to depend on the information that's out there, that it be truthful. That's why we have to depend on the SEC and other regulators to do their jobs. I think it's unfair to ask every-day people who are just trying to lead their lives to be able to wade through this stuff ...'

124 See remarks of J.G. Parkel in 'Investor Summit,' ibid.: 'the readable issue is not only making it understandable, but ... it has to be readable, whether it be size or whether it be language ...'

providing insider information, since it is likely to be understood only by a sophisticated few, thereby giving them additional advantages over most other investors.[125] The lack of lucidity in financial disclosure has led to calls for reform of disclosure practices, such as plain language documents that have various 'layers' or levels of sophistication.[126]

Admittedly, financial reporting and the principles upon which it is based are complex. It may therefore seem unrealistic to propose that revealing information about a corporation's financial affairs can be communicated to shareholders in a short, simple manner.[127] Nevertheless, shareholders' difficulty in understanding financial disclosure contributes to their isolation, as they are uncertain about where the corporation has been or is headed.

One may question whether institutional investors require such changes to corporations' disclosure practices. These investors are more sophisticated and arguably do not have difficulty in reading and understanding financial disclosures. Yet a public company can never be certain that its shareholders will be sophisticated and, even if they are, where this sophistication lies. It may be that disclosure requirements should play to the 'lowest common denominator' insofar as this is feasible. At the very least, financial statements, and particularly the notes to the financial statements, should be provided in a simple format for the benefit of those who read them. Plain language initiatives would certainly alleviate these difficulties.

2. Other limitations of financial reporting rules and practices

Currently, in Ontario, a corporation is not required to have its quarterly financial statements reviewed by an external auditor prior to their release; they need only be approved by the board of directors or the audit committee.[128] Yet in many instances, it is quarterly financial statements

125 J. Winsen, 'Investor Behavior and Information' (1976) 11 J.Fin.& Quantitative Analysis 13 at 14.

126 See remarks of H. Pitt (Chairman) in 'Investor Summit,' supra note 123. See also H.L. Pitt, 'Written Testimony Concerning Accounting and Investor Protection Issues raised by Enron and other Public Companies' (testimony before the Committee on Banking, Housing and Urban Affairs, United States Senate, 21 March 2002), online: SEC <http://www.sec.gov/news/testimony/032102tshlp.htm> (date accessed: 30 April 2003) at 12 [hereinafter 'Testimony']. For example, in a disclosure document, the first layer would contain a summary or 'big picture' of the document in extremely plain language. The layers would permit investors to 'drill down' to the level of detail they wish to see.

127 Not all corporations provide disclosure information that is difficult for the average investor to understand. For example, see disclosures of Berkshire Hathaway in the United States and Fairfax Financial in Canada.

128 OSC Rule 52-501, 'Financial Statements' (2000) 23 O.S.C.B. 8372 at ss. 2.2(6), (7). The Commission recommends that the external auditors review quarterly financial statements: Companion Policy 52-501CP to OSC Rule 52-501 at s. 2.1.

that assist investors in evaluating the present financial condition of the corporation. Furthermore, if the audit committee is not composed of members who are independent of management, there is the possibility that mere approval by the audit committee is simply veiled approval by management. There is the additional possibility for management and the audit committee, which has already approved the corporation's financial statements for the first three quarters, to be pitted against the views of auditors in the audit of the annual financial statements.[129]

In completing an audit, auditors need not give an opinion on whether or not the financial data reveal fraud or other malfeasance.[130] In the most common type of audit completed, called an 'attest audit,' auditors attest that the applicable accounting rules were followed wherever they decided to look. But auditors are not required to indicate the absence of large-scale fraud or pronounce on potential bankruptcy issues. Rather, they need only indicate that the firm can remain a going concern for a period of one year from the date of the audit. In other words, auditors do not provide assurances that 'all is well' with the company, nor do they audit all of the corporation's books and records, as shareholders may assume.

Thus, there is a gap between investors' expectations and the type of review auditors provide.[131] Investors view audited financial statements as a key piece of information relevant to the corporation's well-being. In turn, they base decisions on financial statements regarding whether they should hold on to shares of a corporation or divest themselves of their current holdings. But this expectation is misplaced, since, apart from commenting that the firm is a going concern, auditors do not evaluate the solvency, or potential solvency, of the corporation and say nothing about such issues in their form letter to shareholders. Thus, as Rosen states, 'In reality, annual financial statement audits provide very little assurance to investors and creditors.'[132]

IV *Regulatory prescriptions*

The argument above does not refute the gatekeeper role of auditors. Indeed, it says little about auditors per se. Rather, it rests on the claim that under the current legal regime, shareholders are isolated in the corporation's relationship with its auditors. In Part IV, I argue that shareholder isolation is not desirable and that enhanced shareholder

129 Five Year Review Committee, *Draft Report: Reviewing the Securities Act (Ontario)* (29 May 2002), online: Ontario, Ministry of Finance <http://www.osc.gov.on.ca/en/Summary/srac_5yr-draft-report-20020529.htm> (date accessed: 10 November 2003) [hereinafter *Draft Report*].

130 *Re City,* supra note 22. See also Rosen, 'Safety Net,' supra note 62 at 27.

131 *CICA Report,* supra note 10.

132 Rosen, 'Safety Net,' supra note 62.

participation in the selection and monitoring of the corporation's auditors is a means of achieving heightened corporate accountability. I propose amendments specifically targeted at enhancing shareholder rights in the corporation's relationship with its auditors.

This argument differs from the approach adopted in the Sarbanes-Oxley Act of 2002. While Sarbanes-Oxley implements far-reaching reforms (such as auditor oversight and independence requirements; retention of audit and review records; and audit committee composition and standards),[133] it does not re-conceptualize the relationship between shareholders and the auditor. Rather, it regulates by making existing requirements more onerous. For instance, the board still appoints the audit committee, but under Sarbanes-Oxley, the committee must be composed of certain types of people, such as independent and financially literate members. The Sarbanes-Oxley Act also requires the placement of independent individuals on the board itself and in the auditor's position.[134] In short, the Sarbanes-Oxley Act 'tweaks' the current system rather than adopting a new regulatory approach in which there is a transfer of oversight power from the board and its appointed audit committee to another stakeholder group, such as shareholders.

Some will disagree with this characterization of the Sarbanes-Oxley Act, arguing that it allows for greater shareholder participation if one views directors (including independent directors) on the board and audit committee as representatives of shareholders. However, this argument rests on the assumption that heightened independence can ensure the removal of conflict. As scholars have discussed in relation to directors of the corporation, independence is an ideal that likely cannot be attained in practice.[135] Furthermore, given empirical evidence that indicates no positive correlation between directorial independence and corporate performance, it is not certain that reforms aimed at achieving independence will be effective in this regard.[136] Sarbanes-Oxley may

133 See, *e.g.*, Sarbanes-Oxley Act, supra note 2 at ss. 103, 302, 906.

134 Consider Title II of the Sarbanes-Oxley Act, supra note 2 at ss. 201–209, which contains numerous provisions to ensure auditor independence, including restricting services outside the audit function, audit partner rotation, and auditor reports to audit committees.

135 On director independence see V. Brudney, 'The Independent Director: Heavenly City or Potemkin Village?' (1982) 95 Harv.L.Rev. 597.

136 Empirical evidence on the relationship between director independence and corporate performance has not uniformly indicated a positive correlation. Some studies find that corporate performance is positively correlated with boards that have a majority of independent directors, while others find no such correlation. See S. Bhagat & B. Black, 'The Uncertain Relationship between Board Composition and Firm Performance' (1999) 54 Bus.Law. 921; S. Bhagat & B. Black, 'The Non-Correlation between Board Independence and Long Term Firm Performance' (2001) 27 J.Corp.L. 231. Much of the academic literature on this issue has been completed in the context of takeover

represent a new regulatory approach, but one must question the benefit of these reforms to the corporation as a whole – to say nothing of their costs, which are likely significant and may not be outweighed by the intended benefits.[137]

Recent research in the field of psychology points to the impossibility of achieving true auditor independence.[138] Max Bazerman et al. argue that individuals, and auditors in particular, are unable to interpret information in an unbiased manner. Rather, individuals have innate 'self-serving biases' that exist because they are imperfect information processors. Self-interest is one of the most important non-objective influences on information processing and leads individuals to confuse personally beneficial decisions with fair or moral ones.[139] Indeed, it may not be possible to correct individuals' 'self-serving biases.' The Bazerman argument suggests that we must be cautious about relying too heavily on traditional assumptions about the benefits of independence in devising new regulation. It seems difficult, if not impossible, to completely counter self-interest through legal sanction.[140]

Nevertheless, securities regulators in certain Canadian jurisdictions have followed the US lead and have proposed rules relating to the functioning and responsibilities of audit committees. Like the Sarbanes-Oxley Act, the CSA Rule provides that the external audit be conducted independently of the issuer's management. It mandates that the audit committee oversee the work of the external auditors and make recommendations to the board relating to the nomination and compensation of auditors. Thus, the CSA Rule also relies on the concept of independence as a cornerstone for the proposed reforms by requiring that members of the audit committee be independent members of the board of directors.[141]

bids. See, *e.g.*, R.C. Hanson & M.H. Song, 'Managerial Ownership, Board Performance and the Division of Gains in Divestitures' (2000) 6 J.Corp.Finance 55 , and L. Bebchuk, J. Coates, & G. Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy' (2002) 54 Stan.L.Rev. 887; L. Bebchuk, J. Coates, & G. Subramanian, 'The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants' (2002) Stan.L.Rev. 885.

137 See discussion in text accompanying note 169 infra.

138 See Bazerman et al., 'Impossibility,' supra note 38. See also Moore et al., 'Auditor Independence,' supra note 38.

139 Ibid. at 91.

140 Ronen, 'Post-Enron,' supra note 15 at 48, would agree. He states, 'I conclude that no exogenous force – legislation, regulation, or litigation – can satisfactorily resolve the intractable conflict of interest. I would argue that only severing the agency relation between the client-management and the auditor can remove the inherent conflict of interest.'

141 CSA Rule, supra note 2 at ss. 2.3, 3.1. See also Companion Policy 52-110CP to Multilateral Instrument 52-110 at s. 2.1, which states that the audit committee will manage, on behalf of shareholders, the relationship between the corporation and the auditors..

Yet one questions whether these reforms are both necessary and sufficient to achieve independence (if, in fact, it can be achieved at all). Corporate statutes already stipulate that auditors must be independent[142] and that independence is 'a question of fact.'[143] The statutory provision explains types of conduct that do not meet the independence criterion. Specifically, an auditor is not independent if she is a director or officer or employee of the client or any of the client's subsidiaries.[144] The auditor is not independent if she owns a material interest in the client or its affiliates.[145] Finally, an auditor disqualified for lack of independence must resign.[146] Thus, most Canadian jurisdictions already seek to ensure some degree of auditor independence under their respective corporate statutes. Arguably, securities regulators are unnecessarily treading into a domain that has not traditionally been within their legislative purview.[147]

Furthermore, the reforms embodied in the CSA Rule are insufficient to address the issue of auditor independence. That is, even if the reforms go some way toward eliminating conflicts inherent in the current system, it is unlikely that they will be wholly successful in accomplishing this task. The reason for this is that audit committee members can still suffer from the conflict between their own self-interest and those of the shareholders they ostensibly represent. The requirement that they be 'independent' (however independence is defined) does not necessarily eradicate this conflict. On the other hand, shareholders' incentives are uniform. Individually and collectively, shareholders' ultimate objective is to maximize shareholder value, and they will favour reforms (including auditor changes) that will have a positive impact in this regard. Even if an audit committee composed of independent directors can be counted on to act in the best interests of shareholders most of the time, it is possible for it to be influenced by other considerations.[148] By definition, share-

142 CBCA, supra note 8 at s. 161(1). See also corresponding sections of the OBCA, supra note 8 at s. 152(1).

143 CBCA, ibid. at s. 161(2)(a). See also corresponding sections of the OBCA, ibid. at s. 152(2)(a).

144 CBCA, ibid. at s. 161(2)(b)(i); OBCA, ibid. at s. 152(2)(b)(i).

145 CBCA, ibid. at s. 161(2)(b)(ii); OBCA, ibid. at s. 152(2)(b)(ii).

146 CBCA, ibid. at s. 161(3); OBCA, ibid. at s. 152(3). This definition of 'independence' in the CSA Rule is more specific than the definition contained in the business corporations statutes, but the two do contain similar requirements and are at least partly redundant. See CSA Rule at s. 1.4 and business corporations statutes cited supra notes 142–4.

147 A. Anand, 'OSC Power Warrants Close Scrutiny' *National Post* (27 June 2003) FP15.

148 Lucian Bebchuk makes a similar argument in L. Bebchuk, 'Shareholder Access to the Ballot,' John M. Olin Center for Law, Economics and Business Discussion Paper No. 428 (August 2003) at 15 [hereinafter 'Access'] with regards to the Securities and Exchange Commission's proposal to allow shareholders who hold a certain threshold level of

holders always have an incentive to make choices that serve shareholders.[149]

This argument at least raises the possibility that the CSA Rule and the Sarbanes-Oxley Act may not ensure the achievement of auditor independence. Thus, it is worth considering whether greater independence can be achieved in another manner. In particular, I propose a re-conceptualization of the auditor's relationship with the corporation by arguing in favour of greater auditor accountability to shareholders. Currently, management and the board (including committees of the board) hold the power over the auditor's relationship with the corporation. By interjecting shareholders into various parts of this process, such as in the appointment and monitoring of auditors, greater auditor independence can be achieved. I believe that in the long term, these reforms are more likely than Sarbanes-Oxley-style reforms to increase corporate performance.

One may argue that the CSA Rule or Sarbanes-Oxley model is preferable because shareholders are either rationally apathetic or too dispersed to exercise effective oversight.[150] That is, implementing an enhanced shareholder rights regime is futile because, regardless of reforms in place, shareholders will not change their current behaviour in any significant way. Thus, a regime that enhances the role of the board and audit committee (composed of independent members) will be more effective in alleviating the conflicts that currently plague the relationship between auditors and the corporation.

Yet investors are likely to be apathetic about some issues but not others. They can and likely will exercise oversight on certain important issues (which can be termed 'first-level issues'), such as the corporation's relationship with its auditors. They will be less concerned with 'second-level issues' such as corporate decisions to complete an offering or other financing. In addition, to say that shareholders are too dispersed to exercise effective oversight is to overlook the fact that controlling shareholders and institutional investors hold significant positions in a preponderance of Canadian public companies.[151] It is likely that these shareholders will indeed exercise rights given to them in the election and monitoring of the corporation's auditors. As I have argued above, the more signifi-

shares to place names of directors that they propose in the proxy circular. See Securities and Exchange Commission, 'Proposed Rule: Security Holder Director Nominations' 17 C.F.R. Parts 240, 249, 274 [Release Nos. 34-48626, IC-26206; File No. S7-19-03 RIN 3235-AI93].

149 Bebchuk, ibid.

150 CSA Companion Policy, supra note 141 at 5007.

151 See G. Livingston, 'Investors Aim to Hold Companies Responsible: One Voice: Pension and Mutual Funds Join Forces to Push for Changes' *National Post* (15 July 2002) MF2.

cant its holdings in a corporation, the less apathetic a shareholder will be.[152]

But even if shareholders do not exercise the rights proposed here, this does not mean that they should not have such rights.[153] Law relating to corporations is based not only on the practicalities of capital markets activity (including investor behaviour) but also on normative considerations about what rights corporate constituents should have. Taken to its logical extreme, rational apathy theory and the dispersion argument suggest that shareholder rights in many areas – proxy solicitation, takeover bids, and remedial actions – could justifiably be removed or diluted. Indeed, one could question why we have a business corporations statute at all if these arguments were to serve as the rationale for regulation.

This argument may give rise to the neoclassical claim that rather than implementing more significant shareholder rights through legislation, we should depend on the free market to weed out firms that do not voluntarily institute an optimal rights regime. This argument is based on the view that if a greater shareholder role were truly beneficial, corporations competing for scarce capital would themselves provide an enhanced role for shareholders in the corporation's relationship with its auditors. In response to this argument, one can point to a host of reasons why firms would not voluntarily adopt these measures.

At the IPO stage of a firm's development, managers face cognitive limitations in quantifying the intended benefits of the proposed reforms. It is difficult to assess the long-term benefits of mechanisms designed to improve corporate governance, especially when a firm is in the process of going public and has no established shareholder base. On the other hand, the costs of reforms aimed to enhance shareholder participation in the election of auditors are more readily discernible. For example, the additional time needed to research alternative auditing firms and to place such information in the proxy circular is, relatively speaking, more quantifiable than the benefits that may accrue from so doing. Firms may be willing to forgo a higher share price at the IPO stage, which would result from having these measures in place, because the costs are visible while the long-term benefits are unknown.

At the midstream stage of their development, firms may forgo the increased share price that may accompany such reforms, but the decision

152 See discussion at Part II supra and Black, 'Passivity,' supra note 27. The existence of the Canadian Coalition for Good Governance is testament to this argument. See CCGG, supra note 32. Note also that the US Securities and Exchange Commission has adopted this line of thinking in its proposal to allow shareholders who hold a certain threshold level of shares to place names of proposed directors in the corporation's proxy circular. See SEC, supra note 148.

153 Bebchuk, 'Access,' supra note 148 at 15.

will largely depend on the shareholder structure of the firm. In firms with a widely dispersed shareholder base and no controlling shareholder, the corporation (through its directors and managers) will be reluctant to implement stronger shareholder rights, since it continues to be unsure of the long-term pay-offs of such reforms. Because of concerns regarding shareholder apathy, the corporation may also doubt the positive impact that enhanced rights (which, in their view, will remain unexercised) will have on corporate performance.

Alternatively, management may weigh any potential increase in the corporation's share price against the possibility that increased shareholder participation will weaken management's control over the corporation. Management will reason that one can never be sure whether participation emanates from valid shareholder concerns or from non-credible issues raised by disgruntled investors trying to wreak havoc on an otherwise efficient system. Because of such uncertainties, the corporation may choose to accept a reduced share price instead of adopting reforms aimed at allowing shareholders greater participation in corporate decision making.

In firms with a controlling shareholder, one of two alternatives is possible. On the one hand, the corporation may be inclined to implement a strong shareholder rights regime. Management and the board know that the controlling shareholder will likely be active in the choice of the corporation's auditor and believe that the reforms will have some impact in achieving benefits (such as enhancing corporate accountability) in the short and long term. The corporation would therefore voluntarily implement reforms of this nature. On the other hand, management may believe that the controlling shareholder will let its views be known (either through the auditor appointment process or otherwise) if it thinks that the auditor is not performing adequately. In light of the accompanying costs of the reforms, the corporation will see no necessity to give the controlling shareholder even more influence over corporate decisions.

Thus, there are various reasons why corporations (at the IPO and midstream stages) may choose not to implement stronger shareholder rights in the election and appointment of auditors. These arguments cast doubt on the neoclassical claim that firms will voluntarily adopt governance measures if they are in fact beneficial. We turn now to a consideration of the proposed reforms.

A. ELECTION VERSUS APPOINTMENT

One powerful regulatory response to shareholder isolation is to reform the auditor selection process by disengaging management from the decision making. Specifically, shareholders could be empowered to elect the corporation's auditor, as opposed to voting in favour of or against an auditor chosen by management or by the audit committee. Shareholders could be presented with names of several potential auditors so that they are able to vote in favour of the auditor that they would like the corporation to engage. The list of auditors that is presented to shareholders could be initially chosen by an audit committee. Information about each auditor (such as criteria investors could use to select auditors) could be inserted in the proxy circular to assist and inform shareholders' voting decisions. The incumbent audit firm could be specifically identified to shareholders so that shareholders make a conscious decision to replace the auditors (or not).

One may question whether this proposed reform will make any difference, since shareholders currently have rights to appoint and remove auditors that are rarely exercised. My argument has been that one of the reasons shareholders cannot benefit from the existing legal regime is that the rights that they are accorded are meaningless. In particular, the right to 'appoint' an auditor is simply a rubber stamp on a decision that has already been made by management. The reforms proposed here transform shareholders' current right to appoint the corporation's auditors into a more meaningful right to elect them.

A further issue that arises is whether current reforms pertaining to audit committees will eradicate the conflict inherent in the practice of management's control over the selection of auditors. Under the CSA Rule and the Sarbanes-Oxley Act, for example, the audit committee is directly responsible for the nomination, compensation, and oversight of the auditor.[154] The audit committee must be independent in the sense that it does not contain individuals affiliated with the issuer.[155] In this way, the choice regarding the selection of auditors is removed from management's grasp and placed in the purview of the audit committee as delegatees of the board and representatives of shareholders.

The interposition of the audit committee in the process may be a step forward in achieving independence. For example, nomination of audit firms will originate with the audit committee as opposed to management. However, since auditors are gatekeepers of information for shareholders and the investing public at large, it makes sense to institute a meaningful election process that ensures direct accountability. As I have noted above, shareholders' incentives are uniform, whereas this is not necessarily true of audit committee members, even if they are ostensibly independent. Shareholders should be provided with a right stronger than one that merely allows them to approve (or withhold their vote) a choice previously made for them. Furthermore, from a cost perspective, there is little apparent reason why shareholders cannot be presented with a list of potential auditors, and corresponding descriptions of the profile and

154 CSA Rule, supra note 2 at s. 2.3; Sarbanes-Oxley Act, supra note 2 at s. 301(2).
155 CSA Rule, ibid. at s. 3.1; Sarbanes-Oxley Act, ibid. at s. 301(3)(ii).

benefits of each potential choice, in the proxy circular. This reform would ensure that a base level of independence exists between auditors and management.

It is true that this reform potentially undermines the business judgement rule, which accords deference to business decisions that have been made honestly, prudently, in good faith, and on reasonable grounds. As noted above, the election of auditors is a 'first-level' issue similar in importance to the election of the directors themselves. One need not consider shareholder election of auditors as a significant derogation from the business judgement rule when the effect of the reform would be to improve corporate governance and when, generally speaking, the rule remains firmly in place.

Furthermore, there should be some limitations on the shareholders' right to elect auditors. Current law allows the directors to retain a new auditor if there is a vacancy in this office.[156] Based on the arguments presented above, one could maintain that management or the board (through the audit committee) should not be able to propose a change of auditor and that shareholders alone should have this right.[157] The choice of auditor is significant and should, like the election of board members themselves, rest not with an independent audit committee or with management but with shareholders alone. However, the balance that needs to be struck here is one between attributing additional rights to shareholders, on the one hand, and adhering to a broad interpretation of the business judgement rule, on the other. The corporate structure is based on delegation by the board to management of day-to-day control over corporate affairs. Allowing shareholders the *exclusive* right to 'hire and fire' auditors not only intrudes on this broad power but could also lead to inefficiencies in cases where the auditor must be dismissed or where auditors resign their appointment. The selection of an interim auditor by the board should be permitted, with the selected auditor appearing on the list presented to shareholders at the next annual meeting.

B. DISCLOSURE AND OTHER COMMUNICATIONS WITH AUDITORS

Current law provides that if an auditor resigns or learns that it is going to be removed, the auditor *may* submit a statement of the reasons why it opposes any action that has been taken by the corporation to remove it.[158] The corporation must send a copy of any statement made to every

156 CBCA, supra note 8 at ss. 166(1), 166(3), provides that directors shall fill vacancies in the office of the auditor subject to contrary provisions in the corporation's articles. See also corresponding sections of the OBCA, supra note 8 at s. 149(4).

157 It appears that shareholders' rights at present are not exclusive. CBCA, ibid. at s. 165(1), states that shareholders *may* by ordinary resolution at a special meeting remove the auditor from office. See also corresponding sections of the OBCA, ibid. at s. 149(1).

158 CBCA, supra note 8 at s. 168(5). See also corresponding sections of the OBCA, supra

shareholder entitled to receive notice of the meeting.[159] If management is proposing new auditors, the corporation is required to make a statement outlining reasons for the proposed replacement.[160]

These rules are a necessary beginning, but more extensive requirements should also be considered. First, outgoing auditors should not merely have the option of making a statement to shareholders regarding reasons for their removal or resignation but should be required to do so. Shareholders should know why it is that the auditors may be removed. Second, disclosure about management's choice of a replacement auditor is not an adequate substitute for a shareholder's right to vote for a specific auditor, as argued above. Disclosure allows shareholders to be informed about whether they wish to remain in or exit the corporation, but it does not provide them with full participation rights in the corporation on a major issue. At the next shareholder meeting, shareholders should be able to exercise voting rights in favour of or against the auditor as one choice in a list of auditors presented to them.

Third, auditors' communications with management should be more visible to shareholders. Recent reforms to the *CICA Handbook* require auditors to communicate with the audit committee more frequently, such as when it is developing the audit approach and after the audit is completed.[161] While these reforms are useful, auditors should be required to disclose *to shareholders* their communications with management on issues of concern relating to the company's financial data. Admittedly, such disclosure may have a chilling effect on communications between auditors and management and could lead to more oral and fewer written communications.[162] One could even argue that communications between

note 8 at s. 149(6); BCCA, supra note 8 at s. 185(3).

159 CBCA, ibid. at s. 168(6). See also corresponding sections of the OBCA, ibid. at s. 149(6); BCCA, ibid. at s. 185(3).

160 CBCA, ibid. at s. 168(5.1) (there no corresponding section in the OBCA).

161 *CICA Handbook*, supra note 15 at s. 5751. The new s. 5751 of the *CICA Handbook* reflects recent changes made to the responsibility and role of the audit committee and aligns Canadian communication standards with contemporary international and American ones. Additional mandatory communications now required of auditors include auditor independence and objectivism with respect to Rules of Professional Conduct/Code of Ethics; judgements on qualitative aspects of accounting principles used by the client, especially those that affect comprehensibility and comparability. The new section is effective on all audit engagement periods ending on or after 15 December 2002.

162 I. Ivankovich, 'A Question of Privilege: Confidential Communications and the Public Accountant' (1994) 23 C.B.L.J. 201 at 220–2, 232–3:

> Because financial statements are the representation of management, and because an auditor has a duty to report to shareholders whether, in his or her opinion, those financial statements are in accordance with generally accepted accounting principles, there must be open and frank communications between the auditor and management throughout the audit. The earlier discussion highlighted the potential serious consequences which may ensue when an auditor attempting to obtain sufficient audit

the auditors and the corporation should be privileged, as are communications between lawyer and client.[163] Yet, from the shareholders' point of view, it is not sufficient to receive only one document from auditors (*i.e.*, the auditor's report) with the annual financial statements. Auditors report to shareholders and should therefore be accountable to them – in practice as well as in theory. Thus, shareholders should be entitled to regular updates from auditors, including concerns that auditors have about the financial reporting of the corporation. At the very least, quarterly financial statements should be required to be audited.[164]

Further, shareholders should be entitled to communicate directly with auditors on issues of concern to them. The corporate statute contains a procedure for any shareholder to make proposals to management regarding 'any matter' that the person proposes to raise at an annual meeting.[165] While the corporation has broad ambit to reject the proposal,[166] the shareholder proposal mechanism is nonetheless an established avenue for shareholders to communicate with management and other shareholders. Similarly, a mechanism should be developed to allow shareholders to communicate with auditors in writing regarding questions relating to the audit. A procedure allowing for this type of communication could be established in the corporate statute.

Recent reforms to the CBCA enable shareholders (or directors) to compel the corporation's auditors to attend any meeting of shareholders.[167] This is a useful amendment that potentially allows shareholders to

evidence is placed in conflict with a solicitor and client intent on preserving solicitor-client privilege. In such circumstances, clients may become increasingly reluctant to provide complete access to legal correspondence files, knowing that the information contained in those files may lose its privileged status, and solicitors may well incline to something less than complete candour in fashioning the response to an audit enquiry letter. In either case, an auditor's only recourse would be to qualify or deny his or her opinion. It is a conundrum and one which may be solved only by legislative intervention.

163 Though this argument may be reduced to a case-by-case analysis. See *Missiaen* v. *M.N.R.,* [1967] 68 D.T.C. 5039 (Alta. S.C.); *R.* v. *Gruenke,* [1991] 3 S.C.R. 263, 67 C.C.C. (3d) 289, and Ivankovich, ibid. In *Gruenke,* the Supreme Court of Canada refused *obiter* to recognize accountant–client communications as being privileged across the board, but recognized that such privilege may be available in individual cases.

164 *Draft Report,* supra note 129 at 93; *Final Report,* supra note 112 at 158. Note also that this reform proposal reiterates arguments in favour of a 'long form audit report,' which would have required auditors to discuss relevant findings in the audit and other observations such as management integrity, quality of internal controls ,and accounting systems and procedures.

165 CBCA, supra note 8 at s. 137(1)(a). See also corresponding sections of the OBCA, supra note 8 at s. 99(1)(a); QCA, supra note 8 at s.99(1); BCCA, supra note 8 at s. 147(2).

166 CBCA, ibid. at ss. 137(5), 137(5.1). See also corresponding sections of the OBCA, ibid. at ss. 99(5), 99(7).

167 CBCA, ibid. at s. 168(2). See also corresponding sections of the OBCA, ibid. at s. 151(2); BCCA, supra note 8 at s. 193. If the auditor or former auditor fails to attend without reasonable cause, it is guilty of an offence and liable on summary conviction to

communicate with the auditors, either in writing or personally at a meeting, and to discuss issues that arise from the financial statements of the corporation. But this right may be ineffective if matters relating to the auditor's duties are not on the agenda for the meeting. Thus, a preferred route might be to allow shareholders to requisition a meeting with the auditors of the corporation[168] or to be able to meet with the corporation's auditors without management in a meeting (which management and the board do not attend) that follows the annual general meeting.

Some may argue that it is difficult to know *ex ante* whether or not increased disclosure of information will be beneficial, especially since shareholders themselves will indirectly bear the costs of the reforms enumerated above. They may argue that it is better for shareholders to be imperfectly informed because the costs of perfect information are high and will decrease corporate monies that could otherwise be paid to shareholders (through dividends, for example).

As discussed above, however, share prices may increase with the implementation of reforms aimed at enhancing corporate accountability (of which enhanced disclosure of management's communications with auditors is one). If this is the case, shareholders will be better off, not worse off, if the proposed rights regime is implemented. Regardless, unlike those required under the CSA Rule and the Sarbanes-Oxley Act, the costs of at least certain of the rights in the proposed shareholder participation regime are unlikely to be significant.[169] For instance, providing shareholders with the ability to elect auditors based on information provided in the proxy circular likely imposes only minimal costs

a fine not exceeding $5 000 or to imprisonment for six months, or both. See CBCA, ibid. at s. 168(4). See also corresponding sections of the OBCA, ibid. at s. 258(1)(h); BCCA, ibid. at s. 345.

168 Under corporate statute, shareholders are able to requisition a meeting if they hold five per cent or more of the corporation's shares. No subject matter for the requisition is specified in the relevant corporate law provisions. See CBCA, ibid. at s. 143(1). See also corresponding sections of the OBCA, ibid. at s. 105(1); QCA, supra note 8 at s. 99(1); BCCA, ibid. at s. 147(1).

169 The Ontario Securities Commission prepared a cost–benefit analysis ((2003) 26 O.S.C.B. 5010) of the proposed CSA Rule, as well as other rules that were published with the CSA Rule (relating to auditor oversight and CEO/CFO certification of financial disclosure, Multilateral Instruments 52-108 and 52-109 (2003) 26 O.S.C.B. 4970 ff). The cost–benefit analysis estimated that the aggregate benefits of all of the proposed rules are in the range of $1.0–10.1 billion, while the expected costs would range between $42.7 million and $165.2 million. The British Columbia Securities Commission published a response to the CSA Rules: 24 September 2003, online: BCSC <http://www.bcsc.bc.ca/Publications/Hyndman_OSC.pdf> (date accessed: 10 November 2003), based on a study completed by Dr April Klein, a professor at the New York University Stern School of Business. Dr Klein's study states that there are several flaws in the OSC's cost–benefit analysis, 'any one of which could reduce the demonstrable level of those benefits to zero.' In other words, the results of the Klein study suggests that the costs could well exceed the benefits of the proposed rules.

on management (*e.g.*, in terms of time) in preparing the circular and researching information to be placed therein. Ensuring greater disclosure of communications between management and the auditor also should not impose significant costs on the corporation, except insofar as the corporation chooses to have its quarterly financial statements audited. But simply having the auditors attend the annual general meeting of shareholders and meet with the shareholders privately after the meeting should not impose significant costs on the corporation.

There will likely be sceptics who argue that the proposed regulatory reforms entail more costs than the current system and that therefore, in the name of efficiency, they should not be adopted. For example, sceptics may argue that increased transparency in the communications between management and the auditors means costs to the corporation to send the disclosure to each individual shareholder, or management time to ensure that such disclosure is inserted in the proxy materials. Even if we assume the existence of at least some costs, there are corresponding benefits that outweigh them. An improved process for electing and monitoring a corporation's auditors would be in the interests of capital market participants – including corporations and investors – at large.[170] Corporate managers would face heightened accountability. The limited cost of these reforms is a small price worth paying for an improved corporate governance system.[171]

C. AUDITOR OVERSIGHT AND CHANGE

In 2002, the Public Interest and Integrity Committee of the CICA released for comment a new draft independence standard to apply to Canadian auditors and other assurance providers.[172] The proposed standard is based on the International Federation of Accountants and incorporates pre-Sarbanes-Oxley SEC requirements for auditors of listed companies.[173] It provides a principles-based framework for analysing independence in respect of each engagement and requires the auditor or other assurance provider to identify threats to independence. It suggests the adoption of safeguards to erase such threats and proposes standards that prohibit certain activities for which adequate safeguards are unavailable.

170 Bebchuk, 'Access,' supra note 148 at 24, makes this argument in the context of enhanced shareholder input to candidates on the nomination slate for the board.

171 Ibid.

172 CICA, Public Interest and Integrity Committee, *Exposure Draft: Independence Standards,* online: Canadian Institute of Chartered Accountants < http://www.cica.ca/multimedia/Download_Library/Public_Interest/Independence.pdf > (date accessed: 10 November 2003). The document was released for comment on 5 September 2002; the comment period closed on 31 October 2002.

173 See CICA, 'Protecting the Public Interest: Independence Standards' (media release), online: Canadian Institute of Chartered Accountants <http://www.cica.ca/index.cfm/ci_id/7755/la_id/1.htm> (date accessed: 21 May 2003).

In addition, in July 2002, federal and provincial securities regulators and Canada's chartered accountants[174] created a new system to oversee the auditors of public corporations in Canada.[175] This body is not controlled by the accounting profession but 'is based on independent, public oversight, tougher practice inspection and more rigorous quality control mechanisms.'[176] The body will require more frequent, rigorous inspections; adopt new auditor independence standards; and require audit partner rotation and second partner review for each public company audit.[177] These initiatives were fuelled by the Sarbanes-Oxley Act, which contains similar reforms.[178]

In the debates preceding the imposition of the Sarbanes-Oxley Act, one issue was whether to implement mandated change of auditors at regular intervals.[179] The drafters of the legislation shied away from instituting this requirement, instead sanctioning 'audit partner rotation' as a compromise position. Mandatory change of audit firms was considered undesirable in part because it would not allow auditors or corporations to choose their own clients.[180] Furthermore, compelling auditor changes is

174 Canadian Securities Administrators, Office of the Superintendent of Financial Institutions (OSFI), and Chartered Accountants of Canada, 'New Independent Public Oversight for Auditors of Public Companies Announced by Federal and Provincial Regulators and Canada's Chartered Accountants' (media release, 17 July 2002), online: Ontario Securities Commission <http://www.osc.gov.on.ca/en/About/News/NewsReleases/2002/nr_20020717_csa_osfi_cica-public-oversight.htm> (date accessed: 13 November 2003).

175 Ibid.

176 Ibid. Note, however, that the body's independence is undermined by the fact that CICA funds cover all costs that incoming fees cannot cover.

177 Canadian Securities Administrators, Office of the Superintendent of Financial Institutions (OSFI), and Chartered Accountants of Canada, 'Requirements for CA Firms that Audit Public Companies' (media release, 17 July 2002), online: Institute of Chartered Accountants of Ontario <http://www.icao.on.ca/multimedia/PDFs/COM/press_releases/3require.pdf> (date accessed: 13 November 2003).

178 Supra note 2 at ss. 101–9.

179 The various views are discussed in Securities and Exchange Commission, 'Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence,' online: SEC <http://www.sec.gov/rules/final/33-8183.htm> (last modified: 9 December 2003). See also discussion in BDO Seidman, LLP, 'Re: Release No. 33-8154 Strengthening the Commission's Requirements Regarding Auditor Independence; File No. S7-49-02' (13 January 2003), online: SEC <http://www.sec.gov/rules/proposed/s74902/bdoseidman1.htm#P72_7615> (date accessed: 10 November 2003) at para. 10 note 2; J. McCaffery, 'Is Auditor Rotation Coming?' *CFO Magazine,* online: CFO.com <http://www.cfo.com/article/1,5309,7269%7C%7CS%7C1%7C344,00.html> (date accessed: 10 November 2003); E. Henry, 'Jail Terms for Lying Execs a Step Closer' *CNBC,* online: MSN Money <http://moneycentral.msn.com/articles/news/capitol/9974.asp> (date accessed: 10 November 2003).

180 However, under the Sarbanes-Oxley Act, the Comptroller General of the United States is required to conduct a study and review of the potential effects of requiring mandatory rotation of registered public accounting firms. See Sarbanes-Oxley Act,

costly for auditors and issuers alike, since new audit firms must spend time learning about the issuer's business. Managers may be concerned that the more experienced the auditor is, the better the audit; a new auditor may not have the requisite industry expertise to complete an effective audit.[181]

Despite the negative effects on freedom of choice, there are obvious benefits to mandated change of audit firms that outweigh the costs isolated above. Mandated auditor change reduces the threat to audit independence that results from an appointment process that is subject to management's influence. Mandated change also prevents the formation of close relationships and the resulting biases, which may affect decisions regarding financial disclosure.[182] Furthermore, the audit firm will be less concerned about losing a client and will therefore see less need to meet management's demands. Mandatory rotation would likely result in further separation between non-audit services and the audit itself. It would also allow new auditors to take a fresh look and perhaps raise concerns not revealed in previous audits. Assuming that the previous auditor's concerns are passed from auditor to auditor, mandatory auditor change would heighten the level of scrutiny provided by an audit. In short, changing audit firms would help to protect shareholders from the 'benefit of the doubt' that an auditor with a close relationship to management would naturally give to its 'client.'

Prior to 1991, shareholders of banks in Canada were required to appoint two auditing firms at each annual meeting and to change at least one of those firms once every two years.[183] The mandated change permit

supra note 2 at ss. 207(a), 207(b), 207(c). See also G. Burns, 'Accounting's Power Slips into Loss Column' *The Chicago Tribune* (10 November 2002), online: Chicago Tribune Online Edition <http://www.chicagotribune.com/business/showcase/chi-0211100536nov10,0,2329323.story?coll=chi-newsspecials-hed> (date accessed: 10 November 2003); O. Kirtley, 'Wall Street Reform' *The NewsHour* (August 2002), online: Online News Hour <http://www.pbs.org/newshour/forum/july02/b_ethics8.html> at paras. 13–15 (date accessed: 10 November 2003).

181 See J.N. Myers, L.A. Myers, & T.C. Omer, 'Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?' (2003) 78 Acc.Rev. 779 at 780.

182 See the similar argument made by E.A. Imhoff, 'Accounting Quality, Auditing and Corporate Governance' (working paper, January 2003) at 16: 'Rotating CPA firms every three years could be the single most effective change for enhancing independence.' See also Rashad Abdel-Khalik, 'Reforming,' supra note 7. However, see Myers et al., supra note 181, who argue that longer auditor tenure on average results in auditors placing greater restraints on management's decisions in the reporting of financial performance. Myers et al. provide evidence that is inconsistent with the claim that earnings quality deteriorates with extended audit tenure under the current voluntary rotation system.

183 See *Bank Act,* R.S.C. 1985, c. B-1, ss. 237(1), 238(2)–(4). See also the current *Bank Act,* R.S.C. 1991, ch. 46, ss. 314(1), 314(2). The shareholders of banks now are required to elect only one auditor and *may* elect two. The mandatory audit firm rotation was implemented in the 1920s. See A.J. Richardson, 'The Canadian Audit Market in the

ted both the auditor and the client to benefit from a build-up of information that occurs as the relationship develops. It also allowed banks to use one auditor as a check on the other. There is thus precedent in Canada for mandated auditor change, which met with approval from the Canadian Bankers Association.[184] If the appointment of two auditors is considered to be too costly for companies, auditor change from one firm to another could still be required, but over a longer period of time (perhaps five to seven years).[185] Furthermore, auditors could return to the engagement after an absence of several years. This practice has been common among banks and could be adopted by firms in other parts of the capital markets.[186]

As I have noted above, another option to reduce the influence of management in the appointment process would be to vest shareholders with the right to elect auditors from a choice of candidates, as opposed to the current appointment process. But on its own, this modification of the appointment process does not ensure auditor change, especially for corporations whose outside shareholders constitute a minority bloc or whose shareholders are apathetic. Mandating a change of auditors could therefore be viewed as a device for protecting minority shareholders; shareholders should be permitted to vote *against* a mandated change if both minority and majority shareholders agree. The proposal for mandatory auditor change is somewhat flexible and need not be adopted if shareholders decide otherwise.

An additional reform that has been suggested elsewhere is to remove the power to appoint and to negotiate fees from anyone associated with the firm and to vest this power in an outside third party.[187] Admittedly, the appointing agency would require legislative approval. A more conceptual difficulty is that this proposal might achieve greater independence but would do so at the expense of shareholders' rights and

First Half of the Twentieth Century' (17 December 1999) (unpublished, archived at Queen's University School of Business) [hereinafter 'Audit Market']: 'After a bank failure in 1923 ... the Bank Act was further revised to require dual auditors, auditor rotations and to prohibit a bank auditor from providing other services to banks. By the mid-1920s the Canadian auditing market, on both the supply and demand sides, had thus taken its current institutional form.'

184 Canadian Bankers Association (CBA), 'The Perspective of Canadian Chartered Banks on An Act respecting Banks and Banking (Bill C-95),' evidence submitted to the House of Commons Standing Committee on Finance (8 March 1991) at para. 21. Citing 'prudential concerns,' the CBA endorsed two auditors for all banks and other financial institutions, including trust and loan companies.

185 The governments of the Philippines and Singapore have ordered banks in those countries to change auditors once every five years. See 'Manila Orders Banks to Change Auditors Every Five Years' *Pacific Business News* (19 August 2002), online: Pacific Business News <http://pacific.bizjournals.com/pacific/stories/2002/08/19/daily5.html> (date accessed: 10 November 2003).

186 Richardson, 'Audit Market,' supra note 183 at 14.

187 *CICA Report,* supra note 10 at 25.

directorial discretion. In this vein, a 1988 CICA report indicated that such an arrangement would be unworkable because 'directors and management would justifiably resent a restriction on their ability to discharge an auditor who was not performing efficiently and effectively.'[188] More pertinent to the argument here is the fact that an outside appointment agency would misappropriate a right (*i.e.*, the right to choose the firm's auditors) from shareholders and would potentially make auditor changes more difficult for shareholders than they already are. Further, the establishment of the outside agency would impose costs on the corporation, and thus the corporation's shareholders, that could be avoided by simply giving the right to the shareholders themselves.

While the appointment of an independent third party is not the preferable solution, neither is the Sarbanes-Oxley approach, which rests on the premise that an enhanced role for the audit committee in the appointment process heightens auditor independence. The likely effectiveness of this approach is questionable, since it assumes that independence is a panacea, that is, that independence of audit committee members will reduce conflicts of interest that arise when the relationship between management and the auditors is so close. One questions why, rather than relying on independence in this way, shareholders' rights to select auditors are not directly enhanced. In addition to placing the audit committee in charge of the appointment process, shareholders could be provided with the ultimate ability to decide whether the audit committee's choice is acceptable to them.[189] The audit committee would place before shareholders the names of the firms that they have selected and the criteria on which they base their selection of each candidate.

Some may argue that information about other corporate decisions – such as whether or not to complete a debt issue or embark on an acquisition – is not presented to shareholders in this fashion and that, therefore, it is unclear why the procedure for choosing the firm's auditor should be established in this way. However, as argued above, the decision about who will be the corporation's auditor is a 'first-level' decision, ranking in significance to the choice of directors on the board. While debt issuances and corporate mergers are significant corporate decisions, they are less fundamental to the governance of the corporation and can therefore be classified as 'second-level.' The fact that selecting a firm's auditor is a first-level decision provides justification for undermining the business judgement rule in the way these reforms do: certain decisions are so significant that they warrant direct participation by shareholders.

188 Ibid.

189 Rashad Abdel-Khalik, 'Reforming,' supra note 7, suggests the establishments of a shareholders board of trustees, which is independent of the board and bears the responsibilities of selecting, retaining, and compensating external auditors.

A common criticism of mandatory rotation is that, practically speaking, there are too few audit firms (*i.e.*, only the 'Big Four') for companies to rotate every five to seven years. In addition, differentiating among the audit firms on the basis of reputation will be difficult, since all of the 'Big Four' have experienced allegations of improper audit practices in some form. However, even if there are no additions to the 'Big Four,' then there would be at least a fifteen- to twenty-year period before a corporation would need to rotate back to the first firm. Further, mandatory rotation would occur only if shareholders sought to change the auditor. It may be the case under these proposals, therefore, that the same audit firm continues with a corporation for longer than the five- to seven-year period. Finally, in the long-term, mandatory audit firm rotation may encourage the growth of audit firms and would certainly spur competition among firms.

V *Conclusion*

Under the current regime, shareholders' rights against auditors are limited. The precise duty owed by auditors to shareholders is not defined either under statute or at common law. The corporate statute permits shareholders to appoint auditors but does not provide them with the ability to select the corporation's auditors through a true election. Furthermore, the common law regime provides few rights to shareholders. *Hercules* effectively bars claims of negligent misrepresentation by shareholders against auditors,[190] and class action lawsuits are procedurally difficult to bring. The statutory remedy in the form of a derivative action is similarly a procedural barrier and no doubt has a deterrent effect on the advancement of shareholder claims. The proposed implementation of statutory liability for secondary market disclosures may enhance shareholder rights, but this remains to be seen.

In reconsidering the regulatory landscape following Enron and other corporate failures, it is important to focus on the rights of shareholders *vis-à-vis* auditors and on the efficacy of these rights. This reconsideration must specify the nature of the duty owed by auditors to shareholders. It must also attempt to strengthen existing shareholder rights by enabling shareholders to participate directly in the election and monitoring of the corporation's auditors. The prescriptions at the heart of this article are important not simply to strengthen shareholders' rights as an end in itself but also to improve corporate governance by heightening management accountability and by making auditors more independent.

190 See Anisman, 'Investors,' supra note 81: '*Hercules* suggests 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.'