FACTORS CAUSING CHANGES IN ROLES

The law enforces the respective roles of auditors and directors in the preparation of financial statements, providing an ever-present influence on these two parties, who can be sued in order to recover losses caused through the use of negligently prepared financial statements. Previously, through out-of-court settlements it was possible to recover only a fraction of the total claim sought. CLERP 9 recommends that auditors have proportionate liability and capped professional liability. The government is currently considering these recommendations (Merritt, 2003, p. 3). The obvious question that arises is if total losses can not be recovered from auditors, other parties may be sued, with the directors being the obvious target.

A significant case that seemed to restrict auditor's liability was the Caparo case in the United Kingdom. Caparo Industries plc v Dickman and others (1990 1 All ER 568) was the first case that imposed stringent tests for third parties to sue auditors. The judgement for the Caparo case was given in 1990 and emphasised that auditors would suffer an unreasonable liability if foreseeability were the test allowing third parties to successfully sue auditors. Under this test a third party could successfully sue an auditor if the auditor could foresee or ought to foresee that a third party would rely on the audited financial statements in any financial decision. In rejecting foreseeability, Lord Oliver of Aylmerton stated that foreseeability would 'create a liability wholly indefinite in area, duration and amounts and would open up a limitless vista of uninsurable risk for the professional man' (at 593).

It may be argued that the Caparo case led to the Eise (Commonwealth Bank of Australia v Friedrich & ors, (1991), 9 ACLC 946) case in Australia, where Eise, a director of the National Safety Council had damages awarded against him of $97 million. In 1991 the Commonwealth Bank won a judgement against Eise, the non-executive chairman of the National Safety Council. Eise was found liable for $97 million of debts incurred after the National Safety Council was deemed to be technically insolvent. The harsh test for third parties to sue auditors adopted in the Caparo case may have led to the Commonwealth Bank suing directors rather than auditors. The large amount of damages awarded in this case has forced directors to re-examine their responsibilities and consider adopting corporate governance systems to protect themselves against paying such large damages. For the record, the auditors of the National Safety council were sued by the liquidator for $256 million, but paid only around $2 million in an out-of-court settlement.

References

Merritt, C 2003, 'Govt opens way for liability cap', *The Australian Financial Review,* 11 March, p. 3.

Cases examined

Caparo Industries plc v Dickman and others (1990) 1 All ER 568
Commonwealth Bank of Australia v Friedrich & ors, (1991), 9 ACLC 946.