LEGAL BRIEF

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The Duties & Liabilities of A Credit Union's Auditors: Capital Community Credit Union v. BDO Dunwoody

This recent case reviewed the duties and standard of care required of the external auditors of a credit union. We are advised that this decision is under appeal.

Auditor’s Standard of Care

The Court confirmed the established law on the general duties of auditors: That they must make appropriate inquiries and conduct appropriate tests to enable them to express an informed opinion that the financial statements prepared by management fairly present the financial position of the credit union. This does not mean that auditors guarantee that the financial transactions on which the statements are based, or the statements themselves, are necessarily free of error or even of fraud-provided that such error or fraud would not have been discovered on reasonable inquiry and testing. If error or fraud is discovered, it must be reported and followed up by the auditor to determine how it occurred and whether it is evidence of a more serious problem.

The auditor must also evaluate the sufficiency of the credit union's internal controls on which he relies, and advise the credit union’s directors of any significant weaknesses discovered. However, the auditor is not required, as part of the basic audit duty, to conduct a study to determine if internal control is sufficient for management’s purposes.

An auditor is expected to have some knowledge of the credit union's business, including financial policies, capital structure and legal and regulatory requirements. and to identify and discuss with the credit union any non-compliance which the auditor discovers.

Whether the work done by auditors is sufficient in any given case will depend on the circumstances of the particular audit.

The Facts

In this case, the external auditors of Ottawa Community Credit Union (the name of the credit union before it was renamed Capital Community Credit Union), BDO Dunwoody, had assumed duties in addition to the basic audit function outlined above. These duties included conducting interim reviews to confirm proper authorization of all investment transactions and all insider transactions in accordance with legal, regulatory or internal policy requirements, and reporting on the soundness of the credit union's business and financial practices generally.

The Court also found that BDO Dunwoody had developed a reputation as the auditor of choice for credit unions, and that it was therefore reasonable to expect it to be particularly familiar with the legal and regulatory requirements governing the financial operations of the credit union, and with a 1979 paper published by the Institute of Chartered Accountants of Ontario entitled, " Accounting and Auditing Guidelines for Ontario Credit Unions and Caisses Populaires".

The Court found that the auditors failed to meet tile basic audit standard by failing to report serious deficiencies in the credit union' s accounting and business practices which should have (and in some cases, did) come to their attention in the course of their examination. In the memorable words of the Court: "While not expected to be bloodhounds, they were expected to be watchdogs. Unfortunately, they proved to be lapdogs."

In fact, in this case, the auditors provided periodic "management letters" which tended to downplay the significance of irregularities discovered and consistently reported "no significant problems." Although the Court confirmed that the auditors' basic duties do not necessarily include written reports to the directors on matters of internal control, it also confirmed that auditors will nevertheless be held liable for the content of any such reports if they are inaccurate or misleading.

Court Awarded Damages

The credit union's damages were calculated to be the amount of losses on its loan portfolio from the date of submission of the first negligently prepared auditor's report until receipt by the credit union of a report from a Central examiner (in which the problems that the auditors failed to report were noted) less an allowance for “inevitable” losses based on industry averages. The resulting amount was further reduced by 30 per cent because of the contributory negligence of the directors in failing to properly supervise management and thereby allowing the problems to develop. In the end, the credit union was awarded $428,698, after 53 days of trial over 13 months.

Implications

The bottom line: Auditors must conduct reasonable tests and inquiries upon which to express an opinion (not a guarantee) that the financial statements prepared by management fairly present the financial position of the credit union. If their tests and inquiries are reasonable in the circumstances of the particular audit, they will not be held liable for errors, omissions, fraudulent transactions or weaknesses in internal control not discovered. However, they will be held liable for the consequences of failure to report any such items which should have, or do, come to their attention. If they do choose to expand the scope of their duties, or comment in an area beyond the scope of the basic audit, they must do so accurately and make clear any limitations on the scope of the additional work or report.

Note also that the directors were found to have contributed to the credit union's damages by failing to properly supervise management. Directors cannot be passive in their direction of the activities of management or their review of the work of the auditor.

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