

## **Abbreviations**

ABL – The Swedish Companies Act (Aktiebolagslag 2005:551)

BDO – BDO Nordic Stockholm AB

CA – Court of Appeal (Hovrätt)

DC – District Court (Tingsrätt)

FAR – The Swedish Institute of Authorised Public Accountants (Föreningen Auktoriserade Revisorer)

PwC – PricewaterhouseCoopers

RNL – The Swedish Audit Act (Revisionslag 1999:1079)

RL – The Swedish Auditor Act (Revisorslag 2001:883)

SC – Supreme Court (Högsta Domstolen)

SkL – The Swedish Tort Liability Act (Skadeståndslagen 1972:207)

SOU – The Swedish Government Official Reports (Statens Offentliga Utredningar)

## **Translations**

Company management – Bolagsledning

Contractual liability – Inomobligatoriskt skadeståndsansvar

Evidentiary alleviation – Bevislättnad

Failure to act – Underlåtelse

Generally Accepted Audit Standards – God revisionssed

High probability – Klart mera sannolikt

Indemnity liability – Utomobligatoriskt skadeståndsansvar

Justifiable trust – Befogad tillit

Nearby and foreseeable – Närliggande och i farans riktning

Negligence – Oaktsamhet

Probability – Övervägande sannolikt

Standard protection doctrine – Normskydd

Supervisory Board of Public Accountants – Revisorsnämnden

Swedish Institute of Authorised Public Accountants – Föreningen Auktoriserade Revisorer

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# 1 Introduction

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*In the introductory chapter the reader is introduced to the topic and the purpose of the thesis. The authors aim to demonstrate some of the problems associated with auditor liability and the relevance of the matter today. The chapter comprise a brief overview of auditor liability and an introduction to the court cases chosen for the study. The problem discussion leads directly to the purpose of the thesis and the research questions.*

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## 1.1 Background

In recent years the amount of litigations against auditors and audit firms have increased rapidly and many liability claims have reached disproportionate levels (De Martinis & Burrowes, 1996; Moberg, 2003; Revisorers skadeståndsansvar, 2008; Svensson, 2015). Often, there is no proportionality between the amount of damages that the auditor is charged with, and the audit fee earned from the contract (De Martinis & Burrowes, 1996). In Sweden, approximately 35 % of the claims against auditors are based on negligence. In this type of claims, when there has been a violation of the Swedish Companies Act (2005), the amount required is often much larger than compared to a claim based on, for instance, faulty tax services. It is not uncommon that a claim amounts to billions of SEK, a claim of such magnitude leaves the audit firm in a complex situation (Revisorers skadeståndsansvar, 2008). According to Bo Svensson (2013a), former chairman of the Supreme Court (SC), there is a risk that large audit firms in Sweden will be imposed with a fine so large that it will force them to bankruptcy. This indicates the risk that auditors and audit firms are facing. Today, liability of auditors in Sweden is unlimited which has caused a situation where auditors are sued on large amounts and often have to bear much of the responsibility for the financial damage, even though their involvement in the events that leads to company losses may be relatively minor (Free, 1999; Revisorers skadeståndsansvar, 2008; Svernlöv, 2014).

Auditor liability in Sweden has developed over the years. Initially the auditor was liable only to the company, though, the 1930s crash of Ivar Krüger's financial empire changed the role of the auditor and has had a significant impact on today's perception of the role of the auditor and auditor liability. In the wake of the Krüger crash it was decided that a legislative change was necessary (Carrington, 2010; Jonäll & Rimmel, 2011). In the preparatory work of the Swedish Companies Act (1944) it was confirmed by law that the auditor was no

longer only liable to the company but also to creditors and to third party investors, thus the width of auditor liability grew significantly (Carrington, 2010). Ever since the development of the audit profession there have been debates about the function and the responsibilities of the auditor, particularly in the event of corporate scandals (Agevall & Jonnergård, 2013; Moberg, 2003; Moberg, Valentin & Åkersten, 2014). In Sweden there have been several scandals within the audit industry that have raised questions about the role of the auditor and the width of auditor liability. Carnegie, HQ Bank, Panaxia, Skandia and Telia Sonera are among these. The common denominator of these scandals is that it was argued that the auditor failed to perform his<sup>1</sup> duties in accordance with Generally Accepted Audit Standards (Audit Standards) (Danielsson, 2012). Generally scandals like these cause a loss of confidence in auditors and a further widening of the expectation gap that exists between the public's perception of the work of the auditor and the actual work that the auditor is supposed to perform (De Martinis & Burrowes, 1996; O'Malley, 1993).

There are different factors that contribute to the problems that auditors are facing today. Some of the aspects are regulated within Swedish legislation. For instance, auditors are obliged by law to have liability insurance (RL, 27§), in contrast the company management is not (Svensson, 2013b). As a consequence, auditors are often the main targets of liability claims (Anderson, 1996; Free, 1999; Lambe, 2005). Recently in Sweden there have been high-profile lawsuits where auditors and audit firms have been sentenced to pay large fines, these lawsuits have indicated the extensive liability of auditors (Revisorers skadeståndsansvar, 2008; Nya regler för revisorer och revision, 2015). A recent example of such a lawsuit was between the IT company Prosolvía and the audit firm Öhrlings PricewaterhouseCoopers (PwC), finalised in the Court of Appeal (CA) in 2013. PwC was accused for negligence in performing the audit and the bankruptcy estate sued PwC, who was sentenced to pay a 2,1 billion SEK fine (T-4207-10), one of the largest fines ever condemned in the Swedish history of tort law (Svensson, 2013a). The outcome of the Prosolvía-case was much debated, particularly in terms of the causality judgment in the event of negligence by an auditor. It was regarded as specifically questionable to apply the principle of evidentiary alleviation for the plaintiff (Svernlöv, 2013). The audit industry reacted strongly on the final order of the court and professionals in the industry worried that it would lead to an increased amount of similar liability claims and lawsuits against

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<sup>1</sup> For simplifying reasons, "the auditor" and "a user of financial statements" are referred to as "he" in the thesis, it could however as well have been "her".

<sup>2</sup> A limited liability company in Estonia

auditors as evidentiary alleviation could make it easier for the plaintiff to indicate causality between financial damage and a negligent auditor. A clarification regarding the causality judgment in the event of negligence by an auditor was requested (Awerstedt, 2014; Svernlöv, 2013).

In the meantime of the Prosolvía-case, the CA made a similar judgment in another case, the BDO-case. The BDO-case was between the company Antilu Services OU<sup>2</sup> (Antilu) with the owner Hubert Johansson (H.J.), and the audit firm BDO Nordic Stockholm AB (BDO). H.J. was one of the main-owners of the company 24hPoker AB (24hPoker) that was acquired by the publicly listed company Daydream Software AB (Daydream) in 2005. H.J. had his entire holdings placed in an endowment insurance. After H.J. had accepted the terms of the acquisition, the share price decreased significantly, consequently he suffered from financial losses. The responsible auditor, Bertil Oppenheimer (B.O.) had submitted an unqualified audit report regarding the financial year 2005. Though, he had failed to review two of the accounts in accordance with Audit Standards as inaccuracies were found. Antilu accused BDO for negligence in performing the audit of the financial year 2005 and claimed that the auditor was liable for damage. In contrast to the Prosolvía-case, which was only treated by the CA, the BDO-case was treated by the SC (NJA 2014, pp. 272-273). BDO lost in the first and second instance but appealed to the SC and won (NJA 2014, p. 278). The case was intensively observed and debated, partly due to the similarity of the Prosolvía-case and the completely different outcomes, but mainly due to the desire for clarification of specific matters relating to auditor liability (Awerstedt, 2014; Svernlöv, 2014). When the lawsuit was finalised there was a sight of relief among professionals in the industry as the auditor was not held liable for damage. The lawsuit was much discussed and has been argued to be an important milestone for individual auditors and the profession at large (Svernlöv, 2014).

## **1.2 Problem Discussion**

In the aftermath of the Prosolvía-case there were uncertainties regarding the judgment, specifically in terms of the causality judgment in the event of a negligent auditor. There were also uncertainties about the width of auditor liability and concerns that the outcome of the Prosolvía-case would lead to an increased amount of similar lawsuits. When the SC

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<sup>2</sup> A limited liability company in Estonia

agreed to examine the BDO-case a clarification was expected by the audit industry (Svernlöv, 2014).

The judges in the BDO-case treated many interesting and relevant questions, the majority of them concerned the width of auditor liability and the causality judgment. For instance it was discussed whether it is reasonable that an investor attach all confidence to an audit report or the share price, and claim liability for damage from the auditor if an investment fails? How wide should auditor liability be and who may reasonably ask the auditor for compensation? Is it possible that an auditor act negligently without being liable for damage in the event of negligence, or failure to act? How should a causality judgment be carried out in cases of company law in the event of negligence by an auditor? There was an expectation among many professionals that the judges in the SC would provide clarifications regarding these matters (Awerstedt, 2014; Svernlöv, 2013, Svernlöv, 2014). With respect to the recent finalisation of the BDO-case one may question whether it has affected auditor liability in Sweden and whether the court provided the requested clarifications. Today, there is an on-going lawsuit in Sweden where the audit firm and the responsible auditor has been sued, thus auditor liability remains a current matter. The lawsuit concern the company Kraft & Kultur and the audit firm Grant Thornton, the compensation that is required amounts to 1,7 billion SEK (Hellberg, 2015). The District Court (DC) will return their verdict in July 2016, which implies that there will then be a first indication of possible in fact developments of auditor liability after the BDO-case.

The finalisation of the BDO-case has given the possibility to conduct in-depth studies of the reasoning of the court in order to examine possible impacts on auditor liability, especially since there were uncertainties after the finalisation of the Prosolvias-case. By reviewing the statements and the specifics of the court case it is possible to examine the probable impacts on auditor liability in Sweden. Except from the different outcomes, the BDO-case and the Prosolvias-case are similar in many aspects, thus it is interesting to examine the BDO-case with the knowledge of the outcome in the Prosolvias-case. As there were many uncertainties after the Prosolvias-case it is possible to further understand the clarifications that perhaps were made in the BDO-case. Further, with respect to the recent finalisation of the BDO-case (April 2014) there has not been any academic research conducted regarding auditor liability from this specific perspective, and with regards to the access of this specific empirical data. It has thus given the authors the unique possibility to

contribute to the literature by the examination of the reasoning of the court in the BDO-case, in order to examine the possible impact of the judgment on auditor liability. Thereof the following research questions have been formulated:

### **1.3 Research Questions**

How has the BDO-case affected auditor liability in Sweden?

- How may one regard the width of auditor liability after the BDO-case?
- How may one regard the causality judgment in the event of a negligent auditor after the BDO-case?
- How does the reasoning regarding the causality judgment in the BDO-case differ from the Prosolvias-case?

### **1.4 Purpose**

The purpose of this thesis is to examine the impacts of the BDO-case on auditor liability in Sweden. The study is conducted from the perspective of the auditor. More specifically, the objective is to examine what reasoning the SC applied regarding the judgment of causality in the event of a negligent auditor and the width of auditor liability. Further, the authors intend to examine parts of the Prosolvias-case to investigate the differences in terms of the causality judgment to further explore the possible impact of the BDO-case.

### **1.5 Delimitations**

The study is limited to Sweden, thus only Swedish legislation and Swedish case law is examined, further the legal framework is not examined in total, only the parts that concern auditor liability are examined. The study makes no claim of being a juridical study, therefore juridical concepts are not presented more in detail than necessary for the purpose of the study and for increased understanding. Due to time limitations, information published after March 2016, such as the Official Report from the Swedish Government “Revisorns skadeståndsansvar” (2016) concerning assignment of responsibility has not been taken into consideration in this study.

### **1.6 Outline**

The thesis begins with the *first chapter*, which comprises an introduction to the subject of matter and the problem discussion, followed by the purpose of the study. Then follows the



frame of reference, which constitutes the *second chapter*. The chapter starts with an overview of the role and the responsibilities of the auditor. Further, liability for damage and some of the main aspects that have given rise to the problems associated with auditor liability are described. Lastly, the legal terms needed for enhanced understanding of the court cases are described. This is followed by the method in the *third chapter*, this section comprise an overview of the collection of the data as well as the work procedure. The *fourth chapter* comprise the empirical data in which two court cases are presented, the BDO-case represents the majority of this information. The second and fourth chapter form the basis for the analysis, which is presented in the *fifth chapter*. The thesis ends with a conclusion in the *sixth and final chapter*, followed by discussion and societal and ethical issues.

## 2 Frame of Reference

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*The second chapter provides the reader with the information that is necessary in order to understand the empirical data. Further, the theoretical background is an essential section for the authors in the process of analysing the empirical data. The primary focus is aimed at auditor liability and the different aspects relating to it, though general information about the auditor, the audit and legal terms are presented as well.*

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### 2.1 The Role of the Auditor

In limited liability companies, where the owners are not accountable for the responsibilities of the company, it is of great importance that there is a true and fair view of the economic health of the company. Thus, there is a need to have financial statements and accounts reviewed by an auditor (Agevall & Jonnergård, 2013; Doost, 1999; FAR 2006). The audit profession originates back to the 19th century, when there was a formation of limited liability companies in Europe and America (Agevall & Jonnergård, 2013). Since 1987, it is mandatory for limited liability companies in Sweden to have an auditor. However, today it is the size of the company that determine whether limited liability companies in Sweden are required to have an auditor (Carrington, 2010). Publicly limited liability companies are required to appoint an authorized auditor (ABL, 9:13).

The auditor is a controlling organ, in contrast to the company management who is an establishing organ (Moberg, 2003). The auditor's role is to assure the quality of the information, whereas the company management are responsible for the information (Supervisory Board of Public Accountants, n.d.). The auditor is strictly guided by regulations and principles in his work, the main duties, responsibilities and competence requirements of the auditor are found in the 9th chapter of the Swedish Companies Act (2005). The auditor shall, in accordance with Audit Standards, review the company's accounts and annual report as well as the administration of the board of directors and the managing director (ABL, 9:3). The main responsibility of the auditor is to formulate and submit an opinion about the annual report, which is published in the auditor's report (ABL, 9:5; FAR, 2006). Moreover, the auditor is not only responsible for actions taken in an audit, it is also a matter of what the auditor did not do to prevent or minimise loss to occur. Thus an auditor can be accused for failure to act (O'Malley, 1993). There has been a discussion about what the role of the auditor is, what responsibility auditors have and whether the

auditor is trustworthy (Agevall & Jonnergård, 2013; Power 1997; Moberg, 2003). By using audited statements investors are allowed to invest in companies without knowing the companies personally. Thus, auditor trust is an essential ingredient for a well functioning capital market (Agevall & Jonnergård, 2013).

### **2.1.1 Audit Process**

The purpose of the audit is to create trustworthiness and reliability for the financial information received from companies (FAR, 2006). In Sweden, the first law demanding auditing was established in 1895. During this period it became increasingly common to conduct business in the form of a limited liability company where there was a clear separation between owners and those managing the business. Initially, the purpose of the audit was to enhance the shareholders' control over the board of directors of the company, and to make sure that the administration was taken care of properly and in accordance with appropriate law (Moberg et al. 2014). Nowadays the purpose of the audit has expanded further and is not only carried out on behalf of the shareholders, it is also of great importance for the audited companies as well as for a wide range of stakeholders. Additionally, it serves an important controlling function and is an essential ingredient for a well functioning business society (Carrington 2010; Moberg, 2003).

The audit is a process where the auditor reviews the company's annual report, accounts as well as the administration of the company (RNL, 5§). The audit shall be as detailed and comprehensive as required by the Audit Standards (ABL, 9:3). The Audit Standards are primarily norms regarding the auditor's duties and the audit procedure. It mainly concerns knowledge, experience and professional judgment. The Swedish Institute of Authorised Public Accountants (2012) defines the Audit Standards as good practice among experienced auditors with big integrity and professional judgment. Furthermore, they emphasise that trust is the main pillar of auditing. Competence, independence and secrecy are basic requirements in order for the auditor to earn trust from external parties (FAR, 2012). The purpose of the Audit Standards is to enhance the degree of confidence of users of the financial statements by the expression of the audit opinion which communicates whether the financial statements demonstrates a true and fair view of a company's financial health (ISA 200.3, 2009).

The auditor shall assess the information in the annual report by choosing a sample of the transactions and other information in the report, thus the auditor does not have to review all of the individual accounting records (Supervisory Board of Public Accountants, n.d.). In order to examine the probability of errors, the auditor use samples and assess the internal controls of the company, thereof the auditor may express his statements regarding the annual report with high, but not absolute guarantee that the reports are free from misstatements (Baines, Gay & Schelluch, 1998; Carrington, 2010; FAR, 2006). The reason for this is the inherent limitation in the process of an audit (Baines et al., 1998). The auditor's objective in the audit process is to detect material errors and circumstances. Whether the company is a publicly listed company or not, is highly influences the judgment as there are stricter requirements on the auditor when the audited company is publicly listed (Supervisory Board of Public Accountants, n.d.). Material information refers to such information that is significant for the users of the financial reports. To be able to identify material errors, the auditor decides a materiality level, this level indicates which errors the auditor can accept without having to submit a qualified audit report (Carrington, 2010). An audit can be performed in accordance with Audit Standards and yet the financial reports may contain misstatements that are not discovered by the auditor (Supervisory Board of Public Accountants, n.d.).

### **2.1.2 Audit Report**

In the end of every fiscal year, three weeks prior to the Annual General Meeting, the auditor submits an audit report to the board of directors (ABL, 9:5; ABL, 9:28). The statement in the report shall specify if the annual report reflects a true and fair view of the company's result and financial position, and whether it contains material errors (ABL, 9:31). The Supervisory Board of Public Accountants (n.d.) in Sweden states that the auditor is not supposed to comment on minor deviations from best practice, he is however required to remark on material errors in the report, such remarks may lead to a qualified audit report. As stated by Guan Hua (1997), a qualified audit report is non-desirable as it generally means bad public relations for the firm.

The purpose of the audit report is to add credibility to the financial statements and it is the most tangible output in the process of the audit (Free, 1999). The audit report is the only public report that the auditor submits and it is also the only connection between the auditor and the stakeholders of a company regarding the outcome of the audit, thus it

serves a very important purpose (Carrington, 2010; Libby, 1979). There has been a discussion regarding the audit report and its purpose and content (FAR, 2006; Siliciano, 1988; Siliciano, 1997). The current format of the audit report has been criticised and it has been argued that it contains too little information and that it does not serve the best interest of the users (Asare & Wright, 2012; Carcello, 2012; Coram, Mock, Turner & Grey, 2011). Previous empirical research has indicated that an extended audit report would enhance users' understanding of the main areas of the financial reports, the limitations of the financial reports and the objectives and nature of the audit. This would allow deeper understanding and lead to more reasonable perceptions and expectations (De Martinis & Burrowes, 1996). On one hand, the audit report shall serve the public interest and add credibility to companies' financial statements, but on the other hand it does not mean that investors and other stakeholders may disregard other information from companies and not create their own opinion (Supervisory Board of Public Accountants, n.d.). The annual report and the audit report jointly serve as a basis for decision making, not one or the other alone (FAR, 2006). Though, Siliciano (1988) argues that individual investors may rely solely on the integrity of the auditor's report in deciding whether to invest in a company.

The Supervisory Board of Public Accountants (n.d.) stress that an unqualified audit report does not imply that stakeholders, regulatory agencies and analysts do not have to carefully read and interpret the information in the annual report. The Swedish Institute of Authorised Public Accountants (2006), also stress that an audit report that has been established in accordance with the standard design never guarantees that everything is in order. Nevertheless, prior studies have demonstrated that financial statement users often associate an unqualified audit opinion with absolute assurance that the financial report and accounts are free from all types of material misstatements (Epstein & Geiger, 1994; Okafor & Otolor, 2013). With regards to EU-Directive 2014/56/EU it has been decided to extend the audit report, from 2016 there have been changes in Swedish legislation concerning the content of the audit report. The auditor shall hereinafter state whether there has been any material uncertainty relating to events or circumstances that may result in doubts about the company's ability to continue as a going concern (Nya regler för revisorer och revision, 2015).

## **2.2 Liability for Damage**

### **2.2.1 Personal Liability for Damage**

Auditor liability was initially discussed in 1895 when the limited liability company was established. Back then, the auditor was liable to compensate damage caused to the company by brute negligence in the audit or if he announced incorrect information. After the Krüger crash, in 1944, the role of the auditor underwent a major change. Auditor liability was further extended to cover responsibility for third party damages and the principle of joint and several liability was introduced in Swedish law (Moberg et al., 2014; Revisorers skadeståndsansvar, 2008).

An auditor who has intentionally or negligently, directly or indirectly, caused damage to a company shall compensate the damage (ABL, 29:2; Moberg et al., 2014). The same applies when the damage is caused to a shareholder or another. An auditor has an external as well as an internal responsibility, the internal responsibility is towards the company and the external responsibility is towards third parties (ABL 29:2). Four basic requisites must be fulfilled in order to claim liability of an auditor. Similar rules apply to the company management.

1. Damage must have occurred,
2. the damage was caused within the completion of the assignment of the tortfeasor,
3. the tortfeasor has acted neglectfully or intentionally, and
4. adequate causality must exist (Dotevall, 2008).

### **2.2.2 Liability Insurance**

According to the Swedish Auditor Act (2001), the auditor and the audit company are legally obliged to have insurance for damages caused in the audit process (RL, 27§). Though, as the risk for audit firms to face large liability claims have increased it is difficult to obtain liability insurance and the insurance premiums have reached high levels (Lambe, 2005; Revisorers skadeståndsansvar, 2008). There have been discussions concerning the mandatory liability insurance for auditors, and the non-mandatory liability insurance for the company management (Anderson, 1996; Free, 1999; Lambe, 2005; Revisorers skadeståndsansvar, 2008). It has been argued that it cause problems for auditors as they become main targets of liability claims even though their negligence may be minor in

comparison to other company organs<sup>3</sup> (Anderson, 1996; Free, 1999; Revisorers skadeståndsansvar, 2008). According to Lambe (2005), the mandatory liability insurance for auditors has been a contributing factor to the so-called ‘deep-pocket litigation’<sup>4</sup> where auditors solely may bear responsibility for financial damage caused.

Misstatements in the financial reports and accounts of a company exist partly due to the negligence of the company management, and partly due to the failure of the auditor to detect the errors. Nevertheless, the company management are not obliged by law to have liability insurance for the liability of damages caused in the process of publishing the financial reports and in handling the company accounts. As a consequence, the company management is generally not brought to justice when they have acted negligent (Free, 1999; Revisorers skadeståndsansvar, 2008). In the event of a corporate collapse the company generally become insolvent and unable to meet their obligations, as a consequence the auditor and the audit firm are sued by shareholders and creditors for misstatements in the financial reports (Anderson, 1996). It has been argued that this approach is unreasonable, as the persons who have established the information and guaranteed the accuracy of it by signing the annual report should be held liable at first hand, and not the auditor alone (Revisorers skadeståndsansvar, 2008).

### **2.2.3 Joint and Several Liability for Damage**

According to the Swedish Companies Act (2005), when several individuals cause damage together, they shall be held jointly and severally liable for damage. Joint and several liability builds upon the principle of recourse, meaning that the liable party who has compensated the damaged party may seek recourse from the other liable parties (ABL 29:6; Moberg et. al., 2014). Joint and several liability implies that, if the auditor and the company management cause damage together, they shall be held jointly and severally liable for damage. However, a plaintiff may ask any of the liable parties for compensation, it does not have to be proportionality between the damage caused and the amount asked from one party (Moberg et. al., 2014).

Anderson (1996) explains that in practice joint and several liability means that a plaintiff may ask any of the liable persons for recovery, however, as the company management are

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<sup>3</sup> The board of directors, the managing director and the auditor comprise the company organs

<sup>4</sup> In this study, the term ‘deep-pocket’ refers to litigations filed against a wealthy defendant because of the potential for full compensation (Lambe, 2005). In this case, it is the insured auditor who has a ‘deep-pocket’.

not required by law to have an insurance there is no incentive to demand assets to cover losses from that party, instead full recovery may be obtained from an insured auditor. This has been argued to be a very unfair treatment as the insured auditor generally becomes the target of liability claims rather than other parties who have acted negligent (Free, 1999). Recently in Sweden there have been lawsuits where the auditors and the audit firms have been sentenced to pay large fines, when in fact the company management could have been held equally responsible for the financial damage. This has caused an uncertainty regarding the assignment of responsibility between the auditor and the company management for damages caused by errors in the accounting (Nya regler för revisorer och revision, 2015).

Further, Siliciano (1988) argues, when third parties seek for compensation, they may state their claims based on fraud or negligence directly against the company. However, as noted previously, the company is most likely insolvent which undermines the possibility for compensation. Instead, the third party turn to the auditor for compensation arguing that if the audit had been properly performed the company's problems would have been discovered and the third party would have been able to avoid its financial losses. Under these circumstances, the insolvent company may leave the audit firm in an undesirable role not only as the deep pocket, but as the only pocket (Siliciano, 1988; Siliciano, 1997). The auditor has the right to seek for recourse from the other liable parties (ABL 29:6). However, the claims are often very extensive which leaves the auditor without sufficient funds to plead the cause regarding the recourse. Additionally, the other liable parties generally are insolvent which makes recourse pointless (Revisorers skadeståndsansvar, 2008).

As an alternative to joint and several liability, auditors have considered that each defendant should compensate the plaintiff in proportion of individual negligence (Anderson, 1996). Proportionate liability implies that the auditor remain liable for the consequences of his own actions but not for the damage caused by others, such as the managing director and the board of directors (Revisorers skadeståndsansvar, 2008). Thus, if one of the defendants is insolvent, the unrecovered loss will burden the plaintiff and not the remaining defendants, such as the solvent auditor. However, a consequence could be that plaintiffs may be undercompensated in lawsuits against auditors and the company management (Free, 1999).



#### 2.2.4 Financial Damage

In accordance with the principles of Swedish tort law one must determine what type of damage the liability for damage concerns; personal damage, property damage, financial damage or immaterial damage (Heuman, 2005). In liability claims against auditors it is generally a matter of financial damage. The prerequisites of a liability claim when there is a matter of a financial damage are stricter compared to personal and property damage (Hellner & Radetzki, 2007). There are two types of financial damage, general financial damage and pure financial damage. Further, there may be liability for damage within, as well as without contractual agreements. Indemnity liability is the denotation used in tort law for liability claims where two parts are not in a contractual agreement with one another, for instance an auditor and a third party stakeholder of a company. In contrast, contractual liability refers to a situation where there is an agreement between two parties, for instance an auditor and a company. In Sweden there is a restrictive approach to liability claims concerning pure financial damage when there is a situation of indemnity liability (Kleinman, 1987). The damage must be caused by a criminal act in order for liability for damage to exist (SkL, 2:2), nevertheless there are several exceptions and cases of doubt, generally when the tortfeasor has acted neglectfully or intentionally (Kleinman, 1987). The purpose of the restrictive approach is the so-called floodgate argument. The floodgate argument refers to a situation where the width of liability for damage may be too large in relation to the neglectful act if a restrictive approach is not applied. Further, it is an argument against a particular decision on the ground that it will lead to a large number of new claims. For example, if the negligent auditor would be responsible for every individual who trades on the stock market the number of claims would be very large (Kleinman, 1987).

There is an additional restriction regarding liability for damage, the so-called standard protection doctrine. The standard protection doctrine may lead to an exception from liability for damages when it is clarified that the damage is not within the protection purpose of a certain rule or standard. In order to explain how a certain rule of law shall be interpreted, the standard protection doctrine may be applied. By regarding the standard protection doctrine one may determine which cases of liability claims that may be disregarded, thus there is a limitation concerning liability for damages. In accordance with the principle of the standard protection doctrine there shall only be compensation for

damages when the damage falls within the protection purpose of a violated standard (Hellner & Radetzki, 2010).

### **2.2.5 Causality**

In order to hold a defendant liable for damage there is a requirement of causality between an act (or failure to act) and the damage caused (Hellner & Radetzki, 2010). This means that act A must be linkable to damage A. Furthermore, the causality must be sufficient, this means that it must be adequate causality. Causality alone is generally not sufficient to claim liability, thus adequate causality increase the probability of a successful liability claim (Hellner & Radetzki, 2007). In order to determine whether there is sufficient causality, a causality test in two steps is carried out. The first step includes an investigation to determine whether the requirement of causality is fulfilled, this implies that one must determine if there is an actual link between the act (or failure to act) and the damage caused. The important factor of the first step is to determine the actual cause of the damage, this is pursued with the use of an empirical test. In the second step it is determined whether there is adequate causality (Hellner & Radetzki, 2010).

### **2.2.6 Adequate Causality**

Adequate causality implies that that the damage only would have occurred if the action was taken and that the act is directly relatable to the damage. Further, in the judgment of adequate causality it is investigated whether the damage was nearby and whether the damage was a foreseeable consequence of the act. If the damage was considered to be nearby and foreseeable there is an indication of adequate causality and the probability of a successful claim is greater. Damages that lie outside of the aforementioned requisites are generally regarded as random and remote consequences of the act, thus not sufficient to result in a liability for damage. The purpose of the requirement of adequate causality is to prevent that random and remote consequences of an act lead to liability claims (Hellner & Radetzki, 2010).

The importance of adequate causality in litigations against auditors is emphasised in a study conducted by Cloyd, Frederickson and Hill (1996). According to principles of tort law, third parties must demonstrate adequate causality, this implies that there must be evidence that there is a link between losses and an auditor's work, otherwise an auditor cannot be held liable for damage. Nevertheless, it has been indicated that third parties often sue

independent auditors even though adequate causality may be weak, or fully lacking (Cloyd et al., 1996). In an earlier study conducted by Cloyd, Frederickson and Hill (1994), it was argued that auditors face the risk of becoming insurers of their client's financial health when plaintiffs are not required to demonstrate a clear causal link between the financial loss and the neglectful act. Despite the importance of adequate causality, Cloyd et al. (1996) found that it appeared as less important than it should be under the principles of tort law. They emphasised the need to strengthen the requirements of adequate causality in order to decrease the amount of litigations against independent auditors where the adequate causality is weak, or non-existent (Cloyd et al., 1996).

### **2.2.7 Evidentiary Burden and Evidentiary Requirement**

The plaintiff has the evidential burden in a lawsuit when there are uncertainties regarding the fact in issue. The evidentiary requirement further establishes the level of evidence that a plaintiff must present in order to fulfil the evidential burden. The SC has specified the level of evidence that is required in order to claim that damage was caused by a certain act. Within case law the principle of "high probability" that the damage was caused by a certain act has been applied for a long time. When there are difficulties in determining if a negligent act has caused certain damage there are sometimes a change in the theme of proof. The purpose is to give the plaintiff evidentiary alleviation (Heuman, 2005).

The approach to evidentiary burden and evidentiary requirement is different when there is a matter of a failure to act. To determine whether a failure to act has caused certain damage is complicated. It is particularly complex to determine whether a failure to act corresponds to the requirement of adequate causality, this is a situation when evidentiary alleviation may be necessary. Generally, it is easier to indicate causality when it is a matter of a damaging act, since there is a concrete situation to examine. In the event of failure to act the court has to examine a hypothetical sequence of events, in which the damaging party had acted in the way that the plaintiff argued would have been correct and that would have prevented the damage from occurring. This is associated with difficulties in presenting evidences, as the caused damage could have been avoided by several different actions. Further, the failure to act must be relatable to the caused damage and it has to be considered the determining cause (Heuman, 2005).



## 2.3 Expectation Gap

The society has specific expectations on the services that auditors offer, when auditors fail to meet the expectations there is a widespread disappointment (Porter, 1993). Liggio (1974) introduced the phrase 'Expectation Gap' in auditing and described it as the difference between the level of expected performance "as envisioned by the independent auditor and by the user of financial statements". Porter (1993) conducted an empirical study on the topic and defined the expectation gap as "the gap between what society expects auditors to achieve and what auditors can reasonably be expected to accomplish". Thus, the expectation gap exists due to users' unreasonable expectations on the auditor and its function, and not due to inadequate performance of the audit function (De Martinis & Burrowes, 1996).

According to O'Malley (1993) there is a vicious spiral in terms of the public's expectations on auditor performance. O'Malley (1993) argues that third parties and shareholders believe that auditors are absolute guarantors against fraud, failure and financial loss. These expectations are unrealistic and have created a problematic situation for auditors. Third parties and shareholders do not realise that there is an inherent risk in investments and thus they ask the auditor for compensation if they suffer from losses and the investment does not meet their expectations, even if the auditor is not negligent (O'Malley, 1993). As noted by O'Sullivan (1993), it could be difficult for courts to identify whether an alleged loss has arisen from auditor negligence or if it is simply due to normal business risks that an investor shall be aware of. Financial damage occurring from normal business risks should not make a plaintiff entitled to compensation from the auditor (O'Sullivan, 1993). Though, the public's disappointment cause further criticism regarding auditor performance, an increased amount of similar lawsuits and an increased pressure for an extension of auditors' responsibilities (O'Malley, 1993). Porter (1993) concluded that auditors' failure to meet society's expectations undermines the confidence in the audit profession and that there must be actions taken to narrow the expectation gap. However, De Martinis and Burrowes (1996) argue that due to the increasing amount of lawsuits against auditors, the public's perception of the auditor's performance and audit quality have changed which have caused a further widening in the expectation gap. There have also been studies that suggest that higher educated investors are less likely to demand higher auditor assurance, which may decrease the expectation gap (Epstein & Geiger, 1994; Okafor & Otor, 2013).

## 3 Method

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*In the third chapter the method and methodology chosen for the study is presented. The authors describe the advantages and the disadvantages of the chosen research strategy and design, as well as the gathering of the data. The purpose of the section is to provide the reader with information about the working process and thus allow for individual interpretation of the result and reliability of the study, based on the selected methods.*

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### 3.1 Research Strategy and Design

According to Bryman (2012) one must distinguish between a quantitative research and a qualitative research. A qualitative strategy is characterised by great emphasis on formulations and vocabulary in the collection and analysis of data. Further it is based on, and influenced by interpretations and individual perceptions (Bryman, 2012). In contrast, a quantitative strategy focuses on collection of large amounts of data that shall not be influenced by either interpretations or individual perceptions (Bryman & Bell, 2013). In this study there was a need to thoroughly analyse the court cases to be able to answer the research question(s), therefore a qualitative strategy was considered appropriate. The chosen strategy is suitable as it allows for detailed analysis of the court cases and it offers the opportunity to highlight the present circumstances of the cases and the reasoning of the courts. A quantitative strategy would not have been appropriate as the focus of the study has not been to collect large amounts of data.

In the execution of the study one may choose between an inductive and a deductive approach to the relationship between theory and research. In a deductive approach the authors deduce a hypothesis from existing theory and in an inductive approach the theory is the outcome of the study (Bryman, 2012). According to Bryman (2012) a qualitative strategy mainly emphasises an inductive approach to the relationship between theory and research. In this study the authors have examined one court case thoroughly and a second court case has been included for informative reasons and to provide a deeper understanding of the BDO-case and its possible impacts. Based on the result of the study there has been a possibility to draw reasonable conclusions about the impact on auditor liability in Sweden. The intention has not been to confirm or reject a specified hypothesis. Instead it has been to analyse the cases and draw conclusions from them, therefore the

method chosen for this thesis corresponds better to an inductive approach than a deductive.

The purpose of the study often indicates the research design best suited for the study (Yin, 2012). In this case the purpose of the thesis was to study how auditor liability has been influenced by the BDO-case. In order to fulfil the purpose of the study there was a need to carefully examine the court cases. According to Bryman (2012) and Stake (1995) a case study design is preferable under these circumstances as it is concerned with the complexity of the cases at hand and as it entails a detailed and intensive analysis of them. Therefore, the research design chosen for this study is the case study design. Further, the purpose has been fulfilled by a study of relevant theory, practice of law and analysis of the reasoning of the SC. Thus, a wide range of sources have been used. Yin (2012) argues that the case study design is favourable when this is the case as it offers the opportunity to take advantage of a wide range of sources, such as archival records, documents, interviews and observations (Yin, 2012). Though, one may not generalise from the results as only two cases are studied, this is a disadvantage of the chosen research design (Bryman, 2012). The case study design is one among several designs of conducting research. Another design that may have been appropriate for this study is the comparative design. In the comparative design the purpose is to use identical methods in the analysis of two contrasting cases, thus there is an emphasis on the comparison of the cases (Bryman, 2012). In this thesis two cases are included in the empirical study. Though, the intention has been to only analyse one of the cases thoroughly, the BDO-case. Additionally, the focus of the study has not been to make a detailed comparison of the cases. Thus, the case study design is considered more appropriate than the comparative design.

Within a case study design a distinction between a single case study design and a multiple case study design must be made. A single case study design is appropriate when the authors have access to a case that is revealing or a case that has attracted much attention, for example a case that has not been available for scientific observations earlier (Yin, 2006). The BDO-case was recently finalised and has been argued to be of relevance for auditor liability in Sweden (Awerstedt, 2014; Svensson, 2015; Svernlöv, 2014). Much attention has been paid to the case and the circumstances of it, however no scientific observations of it have been made so far. In this study, the main focus was to thoroughly analyse the chosen case and to fully understand how this specific case has affected auditor liability in Sweden,

thereof, a single case study design is considered most suitable. One could argue that this thesis is a multiple case study as there are two cases in the empirical data. Though, the multiple case study design is not appropriate for all types of studies, as it tends to make the researcher pay less attention to the specifics of the cases, and instead pay more attention to how to contrast the cases (Dyer & Wilkins, 1991). To contrast the cases from each other was not the purpose of this thesis. The BDO-case is the main focus and the Prosolvias-case is primarily included to indicate the differences of the judgment and to provide deeper understanding of the BDO-case and its possible impacts. Further, there are four different types of case study designs; descriptive, explanatory, cross case and case study evaluations. When researchers formulate a question, such as “what is happening or has happened?” a descriptive design is preferable. Descriptive case study is a common case study design as it can offer rich and revealing insights into a particular case (Yin, 2012). Thus, in order to fulfil the purpose, which is to describe possible impacts of the BDO-case on auditor liability, of the thesis the authors have chosen a descriptive case study design.

## **3.2 Research Method**

The technique used to collect data is referred to as the research method (Bryman, 2012). The research method chosen for this study is an examination of documents and archival records consisting of legislation, case law and academic articles.

### **3.2.1 Empirical Data Collection**

The majority of the rules and regulations for auditors and the audit are found within law and generally accepted standards. However, legislation often leaves room for individual interpretation, therefore case law is an important tool to understand how a particular law shall be interpreted. In this study, the main focus was aimed at understanding how a recent and relevant court case has affected auditor liability, thus it is an essential part of the empirical study.

In order to provide a rich and qualitative analysis and ultimately answer the research questions there was a need to demonstrate the full complexity of the BDO-case and parts of the Prosolvias-case that were of relevance for the study. Case law can be very comprehensive and complex, therefore it was of importance to use a well thought through technique to collect the relevant data. In the beginning of the process, an overall interpretation of the cases was made to sort out the data most relevant for the thesis as well

as determine how to present it in the best way. Two main subjects were identified in the BDO-case, width of auditor liability and the causality judgment. To establish a good structure it was decided to use these main subjects as a base when collecting the empirical data from the case. The decision to focus on two subjects was motivated by the possibility to dig deeper into the areas of the case that were considered most prominent and important. By identifying two main areas, a better structure that was easy to follow and understand was established, it also formed the structure of the analysis. In this way it could be assured that all information included in the empirical data would be analysed and that the research questions would be answered. Further, the empirical data would then be more in-depth and not only touch the surface of the information. Though, other areas of the case, which could have been of relevance, were given less attention.

The empirical data starts with a short summary of the background of the case. This is followed by a detailed outline of the reasoning of the court, separated in the two subjects as previously mentioned, and lastly the final judgment. The same structure has been applied for the additional case, Prosolvía. Though, in the Prosolvía-case only the subject of causality has been examined since this was the part that was considered to be of relevance in comparison to the BDO-case. As the Prosolvía-case was finalised prior to the finalisation of the BDO-case it was logical to present the Prosolvía-case first and the BDO-case secondly. Further, as the purpose of the study was to examine the impact of the BDO-case on auditor liability in Sweden, the BDO-case constitutes 75 % of the empirical data, and the Prosolvía-case constitutes 25 %.

### **3.2.2 Selection of the Court Cases**

To access the court cases the database “Karnov Juridik” was used. From previous knowledge and studies within the field, the authors were familiar with a recently finalised and debated court case that treated auditor liability, the BDO-case. It had been widely discussed in media and much attention was paid to the lawsuit and the final judgment. It was argued that the case had a major impact on the industry, on the profession and on auditor liability in particular (Awerstedt, 2014; Svensson, 2015), thus the case was considered appropriate for the study. Moreover, the BDO-case is case law as it has been treated by the SC, therefore it shall be precedent for similar types of lawsuits (Sveriges Domstolar, 2015), this indicate the significance of the case as it shall provide guidance in similar issues (Högsta Domstolen, 2014).



It was also chosen to include an additional case, the Prosolvias-case. The SC has not treated the case, thus it is not case law. The decision to include the Prosolvias-case was motivated by the similarity of the case compared to the BDO-case, though the outcomes were completely different. It was therefore considered interesting to examine some parts of the Prosolvias-case to analyse how the judges in the SC differed in their reasoning in the BDO-case, compared to the CA that judged the Prosolvias-case. The main focus was aimed at analysing the reasoning regarding the causality judgment. Thereof, the intention was to analyse one of the cases thoroughly, the BDO-case, and solely use the second case, the Prosolvias-case, for informative reasons and to indicate the differences that may occur in the judgment of disputes.

### **3.2.3 Empirical Data Analysis**

A large amount of information is included in the empirical data of the thesis. Thus, a well-organised structure of the analysis was essential in order to be able to provide a rich and deep analysis, and ultimately answer the research questions. It was therefore chosen to have similar main areas in the analysis, as those in the empirical study. Thus, each section that is included in the empirical study was carefully analysed in order to examine possible indications and conclusions. Further, the headings relate to the research questions to ensure that all essential parts were included and thoroughly analysed. This was believed to result in a stronger analysis that was within the main thread of the thesis, but it would also offer enhanced understanding for the reader. Further, the theoretical framework is used throughout the entire analysis to confirm or reject the observations made in the empirical data.

To be able to answer the main question of this study: *“How has the BDO-case affected auditor liability in Sweden?”* the focus was primarily aimed at answering the sub-questions and conduct thorough analyses within the scope of those questions. By doing so, it was possible to draw conclusions that, in the end of the process, all together made it possible to answer the main question.

### **3.2.4 Criticism of the Sources**

Regardless of the type of sources used in a study one must review them with a critical mindset and continuously be aware of their strengths and weaknesses (Bryman, 2012).

Documents and archival records constitute the information included in this thesis, therefore the source criticism is directed toward this type of sources. In order to understand how auditor liability has been affected by case law it was essential to analyse the information in the chosen cases, thus it was appropriate to use secondary data in the study. Though, a study that is exclusively based on secondary data implies a risk as secondary sources generally are not impartial and they may be considered incomplete (Lundahl & Skärvad, 1999). Nevertheless, there are many advantages of secondary data. It provides reliable and high quality data as the sampling procedures generally have been more rigorous than what one is likely to achieve in a student thesis. Additionally, the data is easy and inexpensive to access (Bryman, 2012). The authors have put a great effort to find relevant and reliable articles from well-known publishers. Despite this there is always an inherent risk for misstatements and flaws, but there has been an effort to decrease the risk of errors caused by non-reliable sources.

### **3.3 Quality of Method**

#### **3.3.1 Reliability**

The strengths of the case study design are that it allows in-depth studies of one specific case and that it enables the use of a variety of documents (Yin, 2012). In this study it was essential to thoroughly analyse two specific cases and for this purpose, the chosen method was considered appropriate. When conducting a research with a qualitative strategy there is a probability that the result is influenced by the authors' interpretations and perceptions (Bryman & Bell, 2013). The authors have translated and interpreted the court cases which implies that the result of the research may be somewhat influenced by their interpretation. There has been an effort to maintain objectivity by the use of a variety of sources and reliable information. Additionally it has been an effort to limit individual interpretation by the use of academic articles as well as by the use of statements by authorities. As noted by Bryman (2012) academic articles cover the research done within the area and contribute with different opinions and perspectives. The academic articles used in the thesis are written by researchers within the relevant area as well as been cited in other academic articles. Additionally, they have a wide time perspective, which is believed to contribute to increased objectivity. Thus the risk that the authors' interpretations influence the result is decreased and the result of the thesis is argued to be reliable. In the starting phase of the thesis it was considered whether to conduct interviews for increased reliability. This could

have broadened the author's perspective and contributed with valuable insights from experts in the industry. Though, this would have been associated with complexities. It was considered difficult to obtain a sufficient amount of data to be able to withdraw conclusions from the information and it would have meant that the study would have been mirrored by the individual views of the auditors. This was not in line with the purpose of the study and was not considered to contribute to greater credibility. Instead, the interest of the authors was to investigate the impact of the BDO-case on auditor liability and this was argued done most appropriately without the use of mirrored opinions of auditors.

### **3.3.2 Replicability**

A specific court case is permanent and will not change. Though, when searching for court cases at a later moment the outcome may not be the same as there are on-going processes, such as the case concerning Kraft & Kultur. The court cases chosen for this study are finalised and if they would be analysed from the same perspective by other researchers a similar result should be reached. Though, this assumes that the same information is collected from the cases, this is not given as authors may consider different information relevant. Further, as mentioned previously, an inherent risk of a qualitative strategy is that the result is somewhat influenced by the authors interpretations and perceptions (Bryman & Bell 2013). Therefore, the possibility for the research to be replicated at a later moment and show the same result is not given.

### **3.3.3 Validity**

The thesis has been structured in a way that makes it complicated to generalise from the result. This is a common concern about case studies (Yin, 2012). The result only suggests possible developments based on two cases, it does not provide any generalizable beliefs about other cases, such as the on-going lawsuit concerning Kraft & Kultur. Since all cases are unique there is no single solution that applies to all. However, the SC has addressed specific issues in the BDO-case, additionally the case is case law which implies that the same reasoning shall be applied in similar cases (Sveriges Domstolar, 2015). It is nevertheless important to note that external validity may be reduced as the result may be influenced by the interpretation of the authors. Hence, several cases could have been included to increase the validity. However, it is complicated to find case law with the same attributes that are possible to compare with each other on the same basis.

## 4 Empirical Data

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*In this section the authors present the empirical findings of the study. Two court cases are presented, the Prosolvias-case and the BDO-case. For enhanced understanding the cases have been structured similarly and with a focus on causality and width of auditor liability. The authors have chosen to present a short background of the cases followed by claims, reasoning and lastly the judgment.*

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### 4.1 Prosolvias (T 4207-10)

#### 4.1.1 Background

T 4207-10 (Prosolvia-case) is a case between two parties, the Prosolvias's bankruptcy estate and the audit firm PwC with the responsible auditor Nils Brehmer (N.B.), finalised in 2013. In 1995 Prosolvias hired PwC, and N.B. was appointed the responsible auditor. N.B. submitted an unqualified audit report in April 1998, regarding the financial year 1997 (T 3715-01, p. 22). Prosolvias was a successful and rapidly expanding business within the IT-sector, in 1997 Prosolvias was listed on OMX Stockholm (T 3715-01, p. 23). One year later, the Swedish newspaper Dagens Industri published an article concerning accounting irregularities in the financial statement. This was followed by negative attention in the media as well as on the stock market (T 3715-01, p. 25). The Stockholm stock exchange decided to do a year review of the company in which several errors were found, revenues and receivables were inflated by 128 M SEK and the financial statement did not provide a true and fair view of the company. Prosolvias was imposed with a fine and the share price was negatively affected (T 3715-01, p. 26). After this, funding of the business became impossible, customers and cooperation partners were negative and a new share issue was not possible. Prosolvias became incapable of paying their debts and in December 1998 they filed for bankruptcy (T 3715-01, p. 26).

#### 4.1.2 Claims

The bankruptcy estate accused N.B. for negligence in the process of the audit of the financial year 1997 (T 4207-10 p. 34). It was argued that PwC had failed to perform the audit in accordance with appropriate law and audit standards (T 4207-10, pp. 76-77). It was argued that the negligence by the auditor was the reason for the negative attention, which consequently resulted in bankruptcy (T 4207-10 p. 34).

#### 4.1.3 Reasoning – Causality

The CA concluded that PwC had deviated from Audit Standards in the audit of the administration, financial statements and the annual report and the interim reports (T 4207-10, p. 57, 69, 73). The CA clarified that according to the 29th chapter §2 of the Swedish Companies Act (2005) an auditor may be liable towards a company if he fails to accomplish his role as a controlling function. It was concluded that PwC were negligent in their role and that they should compensate the damage (T 4207-10, pp. 75-76). The CA concluded that it was a matter of a financial loss and that Prosolvía had the evidential burden in terms of the negligence by the auditor, the occurrence of the damage and the size of it (T 4207-10, pp. 79-84).

To require liability for damages there must be causality between the neglectful act and the damage. In determining whether there was causality or not, the CA applied a method where it was examined if the damage would have occurred if the action was not taken. If the damage would have occurred regardless of the neglectful act there would have been an indication that the action had not caused the damage. This method was associated with complexities as it was a matter of failure to act by the auditor and not an action taken by him. It was therefore decided to apply the reasoning of another recently finalised case, the Landskrona-case (NJA 2013 p. 145; T 4207-10, p. 127). The case concerned arson and property damage, and thus another area of law. Despite this, the CA considered it useful in order to examine causality in the event of failure to act by an auditor (T 4207-10, p. 84). The case concerned a 13-year-old girl who was taken care of due to mental illness. While being temporarily placed at her mother's house she started a major fire. It was argued that the social service department, who was responsible for the girl, had acted negligently as they failed to supervise the girl, thus the municipality of Landskrona was sentenced with liability for damage for those affected by the fire (NJA 2013 p. 145). In the Landskrona-case it was considered that there were difficulties in the judgment of causality in the event of failure to act, therefore it was decided to introduce evidentiary alleviation for the injured party. According to the CA, evidentiary alleviation would be applied for Prosolvía as well (T 4207-10, p. 84).

The injured party had to present a hypothetical sequence of events, in which the damaging party did not act neglectfully and the damage did not occur (T 4207-10, p. 86). Prosolvía

presented several hypothetical sequences of events where they avoided bankruptcy (T 4207-10, p. 86). First, the CA examined whether there was causality between the claimed misstatements in the accounts and the negative media attention (T 4207-10, p. 92). PwC argued that the information in the media did not conform to the misstatements that the bankruptcy estate claimed. The bankruptcy estate argued that there was no need for precise conformity and the CA agreed with this reasoning, thus causality was indicated (T 4207-10, p. 93). Secondly, it was examined whether the negative media attention caused the loss of confidence in the company (T 4207-10, p. 94). Lastly, it was examined whether the loss of confidence in the company had caused the incapability to pay the debts. The CA stated that it was a complex matter as it concerned a judgment of a hypothetical sequence of events, therefore the judgment may be built upon assumptions and experience. Due to the complexity of the matter, the CA applied evidentiary alleviation with the requirement that the sequence had to be “probable” (T 4207-10, p. 97). The CA made the assessment that there was a causal relationship between the loss in confidence and the incapability to pay the debts, and further that it was likely that Prosolvía in the hypothetical sequence would have been able to pay their debts and thus survived. It was estimated that the company value would have amounted to 650 Million SEK if the auditors had not acted negligently. The CA concluded that there was a causal relationship between the negligence by the auditor and the damage (T 4207-10, p. 103).

Further, on one half of a page it was examined whether there was adequate causality. It was concluded that the negative outcome of the auditor’s negligence was expected and predictable. Thus, adequate causality was indicated (T 4207-10, p. 104).

#### **4.1.4 Judgment**

The CA concluded that PwC and N.B. were severally liable for damage towards Prosolvía’s bankruptcy estate. They were sentenced to pay a 2,1 Billion SEK fine (T 4207-10, pp. 1-2). PwC appealed to the SC, though the case was never treated, the parties reached conciliation and PwC paid a 742,5 Million SEK fine. PwC had no possibility to seek for recourse as the period of limitation had expired (T 4207-10, p. 122).

## 4.2 BDO (NJA 2014 p. 272)

### 4.2.1 Background

NJA 2014 p. 272 (BDO-case) is a case between the parties Antilu, the audit firm BDO and the responsible auditor B.O. H.J., the owner of Antilu, had his placings in an endowment insurance owned by Ancoria Insurance (Ancoria). H.J. was one of the main shareholders in the company 24hPoker. In 2006, the publicly listed company Daydream offered to acquire all of the shares in the company 24hPoker. In contrast to 24hPoker, Daydream was a publicly listed company traded on OMX Stockholm. A prospectus was published on the 2nd of May 2006 and the acquisition was carried out on the 31st of May 2006. In early May 2005, B.O. was appointed the responsible auditor in Daydream. B.O. performed the audit for the financial year 2005 as well as reviewed parts of the prospectus<sup>5</sup>, which formed the basis for the acquisition offer for the owners of 24hPoker. After the issuance of the shares, H.J. argued that misleading information in the financial statements had fooled him and that he used the audited financial statement as a base for his decision to accept the terms of the acquisition. B.O. did not leave any remarks in the audit report regarding the company's accounts (NJA 2014, pp. 272-273).

The share price decreased immediately after the acquisition was finalised, and kept decreasing afterwards. H.J. sold his shares in 2006 and in 2008, the average price decreased from 4 SEK / share to 0,66 SEK / share (NJA 2014, p. 273). After the acquisition of 24hPoker, a new board of directors was appointed in Daydream, the new board hired the audit firm PwC to review the accounts. Inaccuracies were found, the goodwill account had not been reviewed in accordance with Audit Standards and B.O. had failed to take into account that one of the subsidiaries had a payment obligation of 900 000 SEK concerning an EU contribution (NJA 2014, p. 273). The new board of directors and OMX Stockholm reported B.O. to the Supervisory Board of Public Accountants, who gave B.O. a warning. The reason for the warning was B.O.'s deviation from Audit Standards and that he disregarded his obligations as an auditor. The circumstances were considered extraordinary as Daydream was a publicly listed company. After the inaccuracies were found it was decided to liquidate the business (NJA 2014, pp. 274-275).

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<sup>5</sup> The owners of 24hPoker signed the business agreement before the auditor reviewed the prospectus, therefore the actions against the auditor regarding the prospectus has not been taken into consideration in the case (NJA 2014, pp. 272-273).

## 4.2.2 Claims

Antilu claimed that BDO and B.O. acted negligently in the performance of the audit for the financial year 2005. It was argued that the negligence by the auditor caused damage to Ancoria (or) H.J. It was further argued that, in accordance with the 29th chapter §2 in the Swedish Companies Act (2005), BDO and B.O. were severally liable towards Antilu, who had taken over the compensation claim from Ancoria (or) alternatively H.J.<sup>6</sup> (NJA 2014, p. 273). BDO claimed that they were not liable for damage as Ancoria had not suffered from any financial damage and that H.J. could not be considered as “another”, as noted in the 29th chapter §2 in the Swedish Companies Act (2005) (NJA 2014, pp. 274-275).

## 4.2.3 Reasoning

### 4.2.3.1 Width of Auditor Liability

Three plaintiffs were taken into consideration in the lawsuit, H.J., Antilu and Ancoria. Initially it was discussed whether the insurance company Ancoria had suffered any financial losses. The SC concluded that Ancoria had not suffered any losses, as it was the insurance holder (H.J.) who suffered or benefited from an increase or decrease of the funds. Thus, Antilu had no right to claim compensation for the damage caused to Ancoria as it was concluded that Ancoria had not suffered any losses (NJA 2014, p. 299). Instead, it was investigated whether H.J. had suffered compensable damage. The DC and the CA thoroughly examined whether he belonged to the category “shareholder or another” (ABL 29:2). The CA stated that placing one's holdings in an endowment insurance is common and that auditors must be aware of that the audit is of essential nature for such insurance holders' investments (NJA 2014, pp. 288-289). Therefore, it was argued that it was not unreasonable to extent auditor liability to third parties and thus they considered that H.J. belonged to the category “shareholder or another” (NJA 2014, p. 289).

Though, the SC did not focus on the term “another”, instead they applied another line of reasoning. They mainly took two aspects into account:

- The *standard protection doctrine* behind the principle that an audit shall be performed in accordance with Audit Standards (NJA 2014, p. 285), and
- the *floodgate argument*. The SC clarified that it was a matter of pure financial damage in this case, within Swedish legislation there is a restrictive approach in this type of

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<sup>6</sup> H.J. was the owner of Antilu, it was however Antilu who plead the cause in the case (NJA 2014, p. 272). In the empirical data Antilu and H.J. may be regarded as synonyms.



liability claims, so called indemnity liability. The purpose of the restriction is “the floodgate argument”, which intend to reduce the risk of a too burdensome liability for damage as well as the risk of having a too wide group of individuals that are entitled to compensation (NJA 2014, p. 294).

The SC clarified that a “shareholder or another” (ABL, 29:2) may be entitled to compensation in the case of financial losses, despite the restrictive approach regarding the group of individuals entitled to compensation in terms of indemnity liability. The legislation as such do not provide guidance regarding how to determine what is required for such responsibility to exist, instead one have to consider the violation of the standard protection doctrine. This determines the conditions for liability and the group of individuals entitled to compensation. Further, it was clarified that the principle of the Audit Standards is to protect users of financial statements, though only when they have justifiable trust. The concept of justifiable trust indicates that an investor must have justifiable trust when making a decision that is based on an incorrect financial statement in order to claim compensation for damage (NJA 2014, p. 295). Justifiable trust is determined by how the injured party has received the information, what kind of transaction it is, whether the financial statement represents a material part of the decision basis and if the decision concerns a business agreement (NJA 2014, p. 296). In this case there is a distinction between a purchase of a significant amount of shares outside the stock exchange, and an investment based on the share price. In the former transaction, the SC clarified that the financial statement is material information. Whereas it was clarified that trust that is attached to the share price is indirect and distanced and that the financial statement is not of the same significance in this matter (NJA 2014, p. 297). The SC noted that there must be a restrictive approach in determining whether justifiable trust exists, otherwise there is a risk of disproportionate liability for damage that could cover a wide group of injured parties (NJA 2014, pp. 297-298).

The SC concluded that H.J. had justifiable trust when he used the financial statement as a decision basis. When a business decision has been based partly on the financial statement, it is not of relevance whether the plaintiff attached trust to the audit report or not, if there is justifiable trust it might be sufficient to hold the auditor liable for damage, assuming that the audit was not performed in accordance with Audit Standards. Thus, one may not state that trust was attached to the audit report and claim liability for damage (NJA 2014, p.

296). The argument in H.J.'s case was that the transaction of the shares was relatively large and that the shares were acquired by a non-cash issue. The financial statement is typically an essential part of the decision basis in this type of transaction. Further, the SC concluded that H.J. was considered an acquirer of shares as he alone had the financial interest, he suffered or benefited from an increase or decrease of the funds and he alone made the decision to take part in the business agreement. Based on the aforementioned background, the SC concluded that H.J. could be eligible to compensation (NJA 2014, pp. 298-299). Though, it was clarified that a decision made with justifiable trust is not sufficient for eligibility to compensation. There must be causality between the negligence by the auditor and the financial damage (NJA 2014, p. 292).

#### **4.2.3.2 Causality**

In accordance with the statement from the Supervisory Board of Public Accountants, the SC concluded that B.O. had deviated from the Audit Standards in the audit of the financial year 2005 (NJA 2014, p. 280). It was further examined whether there was a causal relationship between the deviation from the Audit Standards and the damage. The SC stated that the damaged party is only eligible to compensation when a properly performed audit would have resulted in a more beneficial financial outcome (NJA 2014, p. 299). The SC emphasised that the important factor was not what would have occurred if the auditor had submitted a qualified audit report. It was argued that one must assume that companies correct the misstatements raised by the auditor, and that the financial report thus is correct. Thereof the examination focused on what would have occurred if the financial statements were free from misstatements. Thus, it was the financial statement of Daydream, as it would have been presented if the audit had been properly performed, that was used as a base for the causality judgment (NJA 2014, p. 300).

The SC examined whether the reasoning from the Landskrona-case (NJA 2013, p. 145), regarding evidentiary alleviation, could be applied in this case as well. It was argued that testing for causality in the event of failure to act by an auditor, which concerns company law, is different from the situation in the Landskrona-case, which concerned property damage and arson. In the Landskrona-case it was discussed what one could have done to prevent the damage from occurring. It was thus argued that the Landskrona-case was not appropriate to apply in this case since it was not a matter of what could have been done to avoid the harmful situation. Instead, the SC adopted a hypothetical sequence of events and

examined the matter of causality by posing the question: “what would have occurred if the auditor would have acted in accordance with Audit Standards; or more specifically in this case, what would have occurred if the financial statement was correct?” (NJA 2014, pp. 300-301). It was concluded that such examination is complex as it is impossible to prove how one may or may not have acted. It was therefore decided to adopt an objective approach that was independent from the damaged party’s opinion, thus it was considered irrelevant what H.J. argued that he would have done or not would have done if the errors were known (NJA 2014, p. 301).

Generally, for causality to exist there must have been a “serious consideration” of another line of action if the reports would have contained the correct information (NJA 2014, p. 301). Therefore it was examined whether it could be assumed that H.J. would have made a serious consideration of another decision regarding the business agreement. In order to evaluate the possibility that H.J. would have considered another line of action it was decided to examine the impact of the misstatements in the financial report as well as the purpose of the transaction and the circumstances of it (NJA 2014, p. 302). It was noted that it was Daydream’s position on the stock market that was desirable, and not the company as such. This was of fundamental importance in determining whether the misstatements in the financial statement affected H.J.’s decision (NJA 2014, p. 303). Further, it was considered that the two misstatements in the financial statement were not of such relevance that it would have changed H.J.’s decision to accept the business agreement. The SC emphasised that the misstatements must be of relevance for the decision and therefore it was concluded that BDO and B.O. were not liable for the damage caused to H.J. in this matter, since there was no causal relationship between H.J.’s trust in the financial statements and the negligence by B.O. (NJA 2014, pp. 303-304).

Further, Antilu argued that a qualified audit report would have affected the market assessment of Daydream and thus the share price. The SC interpreted this statement as if the share price would have had an impact on the terms of trade in the business agreement. The aforementioned principle, which implied that the examination should be based on the assumed sequence of events if the audit would have been properly performed, was applied in this case as well. The SC stated that the content of a financial statement is somewhat reflected in the share price. Though, if a business decision is based on the share price, it is not a matter of trust obtained from the financial statement, it is rather trust that has been

conveyed by the market (NJA 2014, p. 304). The SC clarified that the primary purpose of the audit is to ensure that correct information is communicated to the market in the broad sense. Though, this does not imply that liability for damage, in the event of a negligent audit, covers transactions made on the stock market, or other transactions based on the share price. The SC emphasised that the factors that relate to the floodgate argument strongly argues against such an extensive liability. They stressed that a situation where the auditor is responsible for the correctness of the share price implies a risk as the width of the group of individuals that are entitled to compensation could be very large, as well as the amount of the compensation. The SC dismissed Antilu's action and concluded that trust in the financial statement may not be conveyed by the share price and thus it is not sufficient reason to make the auditor liable for damage (NJA 2014, p. 305).

With regards to the aforementioned principles, the SC assessed the dispute as follows:

- In terms of the damage claimed by Antilu regarding the exchange of shares from 24hPoker to shares in Daydream, H.J. was considered an acquirer of shares.
- The trust that H.J. attached to the financial statement when he made the decision regarding the business agreement was considered justifiable.
- The trust attached to the share price was not considered justifiable.
- With regards to the purpose of the business agreement and the circumstances of it, the misstatements in the financial report were not considered sufficient reasons to make a serious consideration of another decision regarding the business agreement.
- There was no liability for damage as it was not sufficient causality between the misstatements in the financial report and H.J.'s decision to accept the business agreement (NJA 2014, p. 306).

#### **4.2.4 Judgment**

BDO lost in the first and second instance (NJA, 2014 p. 282, 290). They appealed to the SC who changed the judgment and dismissed the actions of Antilu (NJA 2014, p. 306).

## 5 Analysis

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*The fifth chapter comprise the analysis of the thesis. In this section the empirical data is analysed together with the theoretical background. The chapter is structured around the two cases chosen for the study, the important aspects of the cases are analysed under separate headings. The aim is to provide answers to the research questions as well as to reach deeper insights that relate to the problems of auditor liability.*

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### 5.1 Prosolvía-Case – Causality

In the causality judgment in the Prosolvía-case it was considered appropriate to apply the reasoning of the Landskrona-case (T 4207-10, p. 84). The relevance of the case, which concerned another area of law and arson, may be questionable in the event of negligence by an auditor. In the Prosolvía-case, the CA practically equated the company management in Prosolvía with a 13-year-old girl who is inclined towards arsons and the auditors with a helpless social service department. Thus, there are two completely different interests of protection in the cases. Despite this, it is noted that the application of the evidentiary alleviation of the Landskrona-case was a determining factor of the causality judgment in the Prosolvía-case. The application of evidentiary alleviation in the judgment of causality meant that it was easier for Prosolvía to indicate causality between the negligence by the auditor and the damage. As noted by Heuman (2005) it is complicated to determine whether a failure to act has caused certain damage and therefore the use of evidentiary alleviation may be motivated. Thus, one may argue that the decision to apply evidentiary alleviation in the Prosolvía-case was reasonable.

Further, the hypothetical sequence of events only had to be “probable” (T 4207-10, p. 97), in contrast to the principle of “high probability” that has been applied for a long time (Heuman, 2005). Thus, the use of evidentiary alleviation may have made it easier for Prosolvía to demonstrate a sequence of events where the auditor was liable for the damage. Additionally, the application of evidentiary alleviation in a case with a negligent auditor would not only increase the risk of future similar claims, it would also expose auditors to the risk of not being able to obtain insurance and as well as major reputational losses, which is a common consequence as noted in Anderson’s (1996) study on the auditor’s liability dilemma. Moreover, as the claim was one of the largest condemned in the Swedish history of tort law (Svensson, 2013), a consequence could have been that auditors’

possibility of obtaining liability insurance would be further limited, as indicated by Lambe (2005) as well as noted in the Swedish Government Official Reports (2008).

Another interesting aspect of the case is the limited examination of the question of adequate causality (T 4207-10, p. 104). As noted by Hellner and Radetzki (2010), in order to hold a defendant liable for damage there is a strict requirement of adequacy in causality judgments. Further they state that the purpose of adequate causality is to prevent that random and remote consequences of an act lead to liability claims (Hellner & Radetzki, 2010). In the statement from the CA, on less than a half page, it is stated that the negative outcome of the auditor's negligence was "nearby and foreseeable", without any deeper reasoning. One may question whether this statement conforms to the requirement of adequacy, and whether random and remote consequences were excluded. As noted in a study by Cloyd et al. (1996) adequate causality must be strengthened as it has appeared as less important than it should be under the principles of tort law, perhaps this is indicated in the Prosolvía-case as well. A simplified approach to adequate causality, as stated by Cloyd et al. (1994), means a risk for auditors to become insurers of their client's financial health as the plaintiff does not have to demonstrate a clear causal link, as demonstrated in the Prosolvía-case.

The outcome of the Prosolvía-case also concerns the matter of the assignment of responsibility between the company management and the auditor. In accordance with the Swedish Companies Act (2005) there is a joint and several liability for damage (ABL 29:6), nevertheless the auditor is the primary target due to the mandatory insurance for auditors (Anderson, 1996; Free, 1999; Revisorers skadeståndsansvar, 2008; RL 27§). Thus, as argued by Anderson (1996), there is a risk that cases, such as the Prosolvía-case, lead to an increased amount of similar lawsuits where the auditor is the only solvent party. Further, as Lambe (2005) found in his study, there is also an increased risk that the auditor will face the deep-pocket syndrome more frequently, as the main attention is directed towards him, and the plaintiff generally equate the damage caused with the negligence by the auditor, as occurred in the Prosolvía-case. In accordance with the findings of De Martinis and Burrowes (1996) and O'Malley (1993) this contributes to a widening of the already existing expectation gap and cause further criticism and disappointments regarding auditor performance. Furthermore their studies have indicated that lawsuits, such as the Prosolvía-case, against auditors tend to increase the amount of similar lawsuits (De Martinis &

Burrowes, 1996; O'Malley, 1993). Another important aspect that could have been jeopardised after the Prosolvias-case was the role of the auditor as a trust building function. As emphasised by Agevall and Jonnergård (2013), trust is an essential ingredient for a well functioning capital market, thus one of the main pillars of the purpose of the auditor was questioned.

## **5.2 BDO-Case**

The SC, as well as the first and second instance concluded, in accordance with the statements from the Supervisory Board of Public Accountants, that B.O. had deviated from Audit Standards and thus acted negligently. This clarifies that it was not a question of whether the auditor did something wrong in his role, it was clearly stated that he acted negligently and he received a warning from the Supervisory Board of Public Accountants (NJA 2014, p. 280). Instead, the BDO-case, and thereby this study examines the width of auditor liability, the causality judgment and what damage an auditor reasonably may be held responsible for.

### **5.2.1 Width of Auditor Liability**

In determining the width of the responsibility of auditors it is noted that the SC did not focus on the term “shareholder or another” (ABL 29:2), and whether “shareholder or another” could be considered eligible to compensation, instead they focused on the standard protection doctrine and the floodgate argument (NJA 2014, p. 285, 294). The SC did consider H.J. eligible to compensation, this indicates that an individual who owns shares through an endowment insurance is covered by the standard protection doctrine behind the principle of Audit Standards (NJA 2014, pp. 298-299). The purpose of Audit Standards is to enhance the degree of confidence of intended users of financial statements (ISA 200.3, 2009), thus it may seem reasonable that someone who has used the audited financial information as a decision basis shall be protected by the standard protection doctrine, as stated in the BDO-case (NJA 2014, p. 295). Thus, the empirical data indicates that it should not matter how one's placings are organised, it is instead a matter of the standard protection doctrine of the violated principle (NJA 2014, pp. 298-299). As stated by Hellner and Radetzki (2010), there shall only be a possibility of compensation when the damage caused falls within the protection purpose of a certain violated standard, such as the violation of the Audit Standards in the BDO-case. Though, the standard protection doctrine may mean a limitation of liability for damage when it is clarified that the damage is

not within the protection purpose of a specific standard as noted by Hellner and Radetzki (2010). With regards to the empirical data, there is an indication that the SC did not narrow the group of individuals entitled to compensation, in that specific aspect.

Though, in the BDO-case, the SC refers to the floodgate argument several times and discusses the importance of not having a too large liability for damage (NJA 2014, pp. 294, 297-298, 305). This is partly due to the restrictive approach to cases of indemnity liability when there is a matter of financial damage (Kleineman, 1987; NJA 2014, p. 294). Further Kleineman (1987) states that the floodgate argument is considered important to take into consideration as the auditor otherwise would be faced with a too wide responsibility, and the number of claims would then be very large. In the empirical data it is found that the floodgate argument is frequently referred to when describing the need for careful assessments in terms of auditor liability, this may be an indication that the argument is of importance in this type of claims (NJA 2014, pp. 294, 297-298, 305).

#### **5.2.1.1 Justifiable Trust**

With the requirement of justifiable trust from the SC, it is clarified that not anyone may claim liability for damage from an auditor (NJA 2014, p. 295). The concept of justifiable trust may seem diffuse and one may question what makes trust justifiable, and what does not. Though, the SC clarifies the meaning of the concept by the establishment of four requirements: How the injured party has received the information, what kind of transaction it concerns, whether the financial statement represents a material part of the decision basis and if the decision concerns a business agreement (NJA 2014, p. 296). These requirements may be perceived as rather strict as some certain circumstances must be fulfilled in order for justifiable trust to exist. The requirement of justifiable trust is relatable to the statements by Kleineman (1987) who emphasises the importance of the floodgate argument and thus a restrictive approach to the width of auditor liability and who may, or may not ask the auditor for compensation. In the BDO-case there is a distinction between a purchase of a large amount of shares outside of the stock exchange, and an investment based on the share price. There is only justifiable trust in the former (NJA 2014, p. 297), this implies that not all investors fulfil the requirements of justifiable trust. For instance purchases on the stock market where the financial statement has not been a material part of the decision and the transaction does not concern a business agreement cannot be assumed to fulfil the requirements. Thus, there may be an indication that the group of individuals



entitled to compensation is narrowed, since many of the company's stakeholders are hereby disregarded. By the statement from the SC and with regards to the specifics of the judgments of H.J.'s case, there is an indication that the requirement of justifiable trust contributes to a restrictive approach to the width of auditor liability.

#### **5.2.1.2 The Share Price - A Basis for an Investment Decision?**

As noted previously, the SC clarified that when a decision is based on the share price it is not a matter of justifiable trust. Once again they referred to the floodgate argument and stated that a responsibility of such magnitude would be unreasonable and involve great risk on behalf of the auditor (NJA 2014, pp. 297-298). As described by Kleineman (1987), the floodgate argument is an argument against a particular decision on the ground that it will lead to a large number of new claims, this reasoning is evident in the SC's statements regarding trust attached to the share price. Further, as indicated by Kleineman (1987) the liability for auditors would be even more extensive and the number of claims would be very large if the auditor would be responsible for every individual who trades on the stock market, the reasoning of the SC conforms to this and indicates the importance of a restrictive approach (NJA 2014, pp. 297-298).

As found by O'Malley (1993), sometimes investors do not realise the inherent risk of investments and believes that auditors are absolute guarantors against financial loss. These tendencies are noticed in the BDO-case as well, specifically with regards to H.J.'s trust attached to the share price and the false belief that it was the responsibility of the auditor to ensure that the share price was fair (NJA 2014, p. 304). As indicated by De Martinis and Burrowes (1998), unreasonable expectations on the auditor and its function contribute to a wider expectation gap and an increased amount of lawsuits against auditors. Assuming that the auditor is responsible for the fairness of the share price may be regarded as an unreasonable expectation, which is also indicated by the SC (NJA 2014, pp. 304-305). In line with Epstein and Geiger (1994), Okafor and Otolor (2013) and Porter's (1993) findings, it is considered that increased knowledge could possibly reduce the expectation gap. Thus, as indicated by the SC, in order to analyse the financial health of a company it is not enough to take the share price into account, investors must create their own opinion and not use an opinion that is conveyed by the financial market (NJA 2014, pp. 304-305). Hereby, there is an indication that the SC emphasise a greater investor knowledge and responsibility.

### **5.2.1.3 The Audit report - A Basis for an Investment Decision?**

The SC clarified that H.J. had justifiable trust when he made a decision based on the audited financial statements, they also clarified that one shall be able to trust audited financial information (NJA 2014, pp. 298-299). Though, they clarified that one may not look at the audit report solely and determine whether to make an investment or not. Such argument is not sufficient to require liability for damage from the auditor (NJA 2014, pp. 296-299). As emphasised by Carrington (2010) and Libby (1979), the audit report is an important connection between the auditor and the shareholders of a company, though it is important to note that the audit report is not the only connection between the company and its stakeholders. The purpose of the audit report is to add credibility to the financial statements of a company (Free, 1999), though, as stated by the Swedish Institute of Authorised Public Accountants (2006), the audit report and the annual report jointly serve as a basis for decision making, not one or the other alone. This reasoning is evident in the BDO-case (NJA 2014, p. 296) and may indicate the need to clarify the purpose of the audit report, how to use it and what the auditor's opinion really means, as suggested by Asare and Wright (2012), Carcello (2012), De Martinis and Burrowes (1996) and Coram et al., (2011) who argue that an extended audit report can contribute to deeper understanding and lead to more reasonable perceptions and expectations among investors. With regards to the changes in Swedish legislation concerning the content of the audit report, there may be a possible change in how third parties perceive the information in the audit report, nevertheless it is too early to state anything with certainty as the new regulation was introduced the same year as the publishing of this thesis (Nya regler för revisorer och revision, 2015).

Further, as stated by Supervisory Board of Public Accountants (n.d.), it must be expected that stakeholders create their own opinion about a company, despite this there are examples noted by Siliciano (1988) when investors have used the audit report as a basis for a decision, which is exemplified in the BDO-case (NJA 2014, p. 296). In accordance with statements from Baines et al. (1998) and the Supervisory Board of Public Accountants (n.d.), an auditor is not supposed to review every transaction and every account of a company in detail and the purpose of the audit is not to achieve absolute assurance regarding the financial statements. Thus, as noted by Baines et al. (1997), Carrington (2010) and the Swedish Institute of Authorised Public Accountants (2006), the auditor makes his

statement with high, but not absolute assurance that the reports are free from misstatements. Though, studies conducted by Epstein and Geiger (1994) and Okafor and Otalor (2013), have indicated that users of audited financial statements often associate an unqualified audit opinion with absolute assurance that a company's financials are correct. This is actualised in the BDO-case (NJA 2014, p. 296), and indicates the unreasonable expectations on auditors and perhaps a lack of knowledge among many users of financial statements, as noted by De Martinis and Burrowes (1996). Though, there are indications that the BDO-case could have an impact in this sense as the statement from the SC is that an investor may not solely look at the audit report and argue that an informed decision with justifiable trust has been made (NJA 2014, p. 296).

### **5.2.2 Causality**

As noted by Hellner and Radetzki (2010), in order to hold a defendant liable for damage there is a requirement of causality between an act, or a failure to act and the damage caused. The importance of causality was emphasised by the SC as they clearly stated that justifiable trust was not sufficient for eligibility to compensation (NJA 2014, p. 292).

The course of action regarding the causality judgment of the hypothetical sequence of events in the BDO-case is the same as the course of action applied in the Prosolvía-case, however the cases differ in one aspect; the use of evidentiary alleviation (NJA 2014, pp. 300-301; T 4207-10, pp. 75-76, 97). In the Prosolvía-case it was considered that there were difficulties in the judgment of causality in the event of failure to act, this corresponds to the research by Heuman (2005) who states that it is complicated to determine whether a failure to act has caused certain damage since one must present a hypothetical sequence of events. This is associated with complexities in terms of presenting evidence as the caused damage could have been avoided by several different actions, in this type of situation evidentiary alleviation may be necessary (Heuman, 2010). Thereof, it could be considered appropriate to apply the principle in a case such as the Landskrona-case, nevertheless the SC clarified that it does not belong in cases of company law (NJA 2014, p. 301). The SC stated that a case that concerns a liability claim against a negligent auditor should be treated differently than a case that concerns arson and another area of law. It is clarified that in the Landskrona-case it was a matter of reducing the risk for damage, whereas in the BDO-case it was not a matter of what could have been done to prevent the damage from occurring (NJA 2014, pp. 300-301). By this statement one may assume that the SC rejected the CA's

reasoning regarding the use of evidentiary alleviation in the Prosolvía-case. The causality judgment in the Prosolvía-case is built upon the principle of evidentiary alleviation, thus one may argue that the main reasoning in the Prosolvía-case collapses with this statement. Further, as the BDO-case shall be precedent for similar types of lawsuits in the future (Sveriges Domstolar, 2015), the judgment from the SC implies that the scope of the application of the Landskrona-case has been restricted and that it probably will be of less relevance for causality judgments in questions of company law in the future. This is most likely positive from the auditor's perspective as the use of evidentiary alleviation probably would have led to an increased amount of similar lawsuits against negligent auditors, which conforms to the findings of O'Malley (1993).

In the BDO-case, in contrast to the Prosolvía-case it was argued that there were no similar difficulties in the judgment relating to the hypothetical sequence of events and that a different approach was needed in terms of auditor liability in the event of negligence. By posing the question: "what would have occurred if the auditor would have acted in accordance with Audit Standards; or more specifically in this case, what would have occurred if the financial statement was correct?" (NJA 2014, pp. 300-301), the SC disregarded what would have occurred if the auditor had submitted a qualified audit report. It was examined whether there was a probability that the plaintiff would have acted differently if the financial statements were correct. By posing a hypothetical question and examine it objectively the difficulties of the judgment of the hypothetical sequence of events decreased, and thus, there was no need for evidentiary alleviation in the BDO-case (NJA 2014, p. 301). By analysing the hypothetical sequence of events objectively, the injured party's individual opinion is not taken into consideration, hence there is no room to claim liability for damage that the auditor's negligence did not have anything to do with. This reasoning indicate that, in the event of negligence by an auditor, one shall examine causality objectively and consider the hypothetical outcome that seems most likely and reasonable to occur, assuming that the financial statement was correct. In accordance with the statement from the SC, when an auditor finds misstatements in the accounts of a company one may assume that the company corrects the misstatements and that the financial statement represents a true and fair view when it is published. It seems less likely that a company would disregard the recommendations from the auditor and rather publish a qualified audit report. Therefore, it is reasonable and logical to assume a situation where the financial statement is correct and consider what choice would have been made under

those circumstances (NJA 2014, p. 300). Further, as Guan Hua (1997) argues, the issuance of a qualified audit report generally means bad public relations for the company, which is not desirable. Thus, there is an indication that negligence by an auditor does not automatically lead to a successful claim, there must be a probability that the plaintiff would have acted differently if the financial statement were correct.

As noted in the BDO-case there was no indication of causality between the damage and the negligence by the auditor (NJA 2014, pp. 303-304), this indicates that the auditor may only be held liable for the misstatements that has caused the damage. Thus, an auditor may have acted negligently, though the misstatements caused by the negligence may not be the directly relatable to the financial damage. This statement by the SC conforms to the important principle that an act shall be directly relatable to the damage as discussed by Hellner and Radetzki (2010). Further, the SC clarified that it is of importance that the misstatements found in the financial report are directly relatable to the damage, that the misstatements were of great relevance for the business decision and that one would have made a “serious consideration” of another decision if the misstatements were known. In the BDO-case there were no indications that H.J. would have made another decision if the financial report were correct (NJA 2014, pp. 303-304), this indicates that an auditor may act negligent, though it does not necessarily mean that he is liable for damage. As indicated by Hellner and Radetzki (2010) this is important as it is necessary to prevent that random and remote consequences of an act lead to liability claims. Further, as stated by Heuman (2005), the examination of a hypothetical sequence of events, even when it is made objectively, is associated with complexities. Normally, the plaintiff has the evidential burden (Heuman, 2005), though in the BDO-case it was the judges who objectively presented the hypothetical sequence of events (NJA 2014, p. 301). Generally it is easier to indicate causality when there has been a damaging act, in the event of failure to act the situation is more complex, particularly in the production of evidence as it is impossible to prove how one may or may not have acted, such as in the BDO-case (Heuman, 2005; NJA 2014, p. 301).

Further, causality is not sufficient to result in a successful liability claim, there is a strict requirement of adequate causality (Hellner & Radetzki, 2010). Since the SC could not indicate causality between the negligent auditor in the BDO-case and the damage caused there was no reason to examine whether there was adequate causality, thus no clarification

regarding the judgment of adequate causality was provided by the court. Though, the aforementioned clarifications by the SC indicate that a possible strengthening of the requirements of causality has been made through the BDO-case. As indicated by Cloyd et al. (1996), there is a need to strengthen the requirements of causality in order to decrease the amount of litigations against auditors where the causality is weak, or non-existent, such as in the Prosolvía-case. As the BDO-case shall be precedent in similar cases (Svenska Domstolar, 2015) the stricter causality judgment may be used as guidance in other lawsuits, such as Kraft & Kultur, where there is a question of negligence or failure to act by an auditor (Hellberg, 2015). As discussed by O'Malley (1993) there may be a decreased risk of similar cases and these types of compensation claims as the requirements to become eligible for compensation from the auditor are stricter. Thus, this study indicates that the requirements that were clarified by the SC may lead to a decreased risk for the auditor to be sued by parties that cannot reasonably blame the auditor for their financial misfortune.

### **5.2.3 Additional Indications of the BDO-Case**

There are other matters that the BDO-case touches upon, such as the fact that the auditor becomes the only pocket for compensation, and matters where the SC emphasises the need of a restrictive approach and careful assessments, this is indicated by the repeated use of the floodgate argument (NJA 2014, p. 294, 305). This indicates a need for further clarifications in terms of auditor liability and the underlying problems associated with it. As noted by Moberg (2003) the auditor is a controlling organ, whereas the company management is an establishing organ that assures the accuracy of the financial information by signing the annual report (Revisorerers skadeståndsansvar, 2008). Despite this, Anderson (1996), the Swedish Government of Official Reports (2008), the Prosolvía-case and the BDO-case have indicated that it is common that the auditor becomes the main target of liability claims. Though, in the BDO-case, the auditor was not held responsible for the raised damage. The damaged party did not get any compensation and the question arises if perhaps he caused the damage himself by not being critical enough in his business decision. As noted by O'Sullivan (1993) it is important to differentiate between damage caused by normal business risks, and damage caused by negligence by the auditor. Further, he argues that it may be difficult for courts to identify the actual cause (O'Sullivan, 1993), the complexities of the BDO-case as well as the Prosolvía-case exemplifies this. Though, in the BDO-case it is notable that the court wants to separate the auditor's responsibility from the

investor's responsibility, which indicates the importance of the differentiation as discussed by O'Sullivan (1993).

According to the Supervisory Board of Public Accountants (n.d.), the auditor's role is to assure the quality of the financial information, however the company management are responsible for the establishment of the information. This raises the question of assignment of responsibility between the company organs, is it reasonable that the auditor take full responsibility even though he is not the only negligent party? As regulated in Swedish law (ABL, 29:6) the company management and the auditor could in fact be held jointly and severally liable for damage. Though, as noted by Moberg et al., (2014) it does not have to be proportionality, and therefore it is possible to ask one party for compensation, for instance only the auditor, as in the BDO-case as well as in the Prosolvía-case. Hence, as argued by Free (1999) this is an unfair treatment as the auditor is the only party who is obliged by law to have liability insurance (RL, 27§). Thus, the auditor becomes the main target of liability claims which is demonstrated in Anderson's (1996) study as well as highlighted by the Swedish Government (Revisorers skadeståndsansvar, 2008). This is indicated in the cases of Prosolvía and BDO. According to Swedish law, the auditor has the right to seek for recourse if he caused the damage together with the company management (ABL 29:6). Though, as emphasised by Anderson (1996), the company generally becomes insolvent in the event of corporate collapses and they will probably be unable to meet their obligations and the right to recourse fails, such as in the Prosolvía-case (T 4207-10, p. 122). As the auditor becomes the only pocket to seek compensation from (Siliciano, 1988; Siliciano, 1997), one may understand that the damaged party choose to claim liability from the auditor in the first case.

## 6 Conclusion

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*In the final chapter the conclusions of the study are presented. The conclusion is organised around the research questions, each paragraph discusses one of the sub-questions, and this is followed by a general conclusion that shall provide an answer to the main question. Finally, a discussion, suggestions on future research and social and ethical issues follows.*

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A reasonable assumption is that one may regard the width of auditor liability as widened as well as limited after the statements from the SC in the BDO-case. The group of individuals entitled to compensation is widened, as the SC hesitate to interpret the 29th chapter, 2§ of the Swedish Companies Act (2005) restrictively. Though, the requirement of *justifiable trust* and the statements concerning trust attached to the share price and the audit report indicates that the SC advocates a restrictive approach to the width of audit liability. A user of financial statements shall be protected in accordance with Audit Standards, though he must create his own opinion. This implies that auditors have the responsibility to perform their duties in accordance with Audit Standards, but if they fail to do so they may only be liable for damage towards parties who have *justifiable trust* and who are *protected by the standard protection doctrine*.

A reasonable interpretation is that the causality judgment in the event of a negligent auditor shall be made with a restrictive approach. The question, “*what would have occurred if the financial statement was correct?*” shall be posed and it shall be examined *objectively* with regards to the *relevance of the misstatements* and the likelihood of a *serious consideration* of another business decision. Thus, auditors shall perform their duties in accordance with Audit Standards and if they fail to do so, they shall only be held responsible for financial losses that their negligence is *directly relatable to*.

After examining the cases it is evident that the BDO-case and the Prosolvía-case take different turns in terms of the causality judgment, the use of evidentiary alleviation is the determining and differentiating factor. It is assumed that the application of evidentiary alleviation in the Prosolvía-case widened auditor liability, and the decision by the SC to not apply the principle in the BDO-case probably contribute to a limitation in auditor liability.



Lastly, within this study it is concluded that there is a probability that the BDO-case will have an impact on some aspects of auditor liability. A reasonable assumption is that it should be more difficult to hold an auditor liable for financial losses that their negligence is not directly relatable to. This may indicate that a greater responsibility is put on the investor. The BDO-case provides clarifications that should make it more certain how to assess a question of causality, particularly in the aftermaths of the Prosolvias-case. Along with the requirements of justifiable trust it may result in a decrease of unjustified lawsuit against auditors. Though, it is always a matter of the specifics of each case, hence it is impossible to safely state what impact the BDO-case will have. There are problematic aspects of auditor liability that are not dealt within the BDO-case, such as mandatory insurance for auditors, the expectation gap and joint and several liability. Auditor liability is complex and comprehensive and far from all problems are discussed in the BDO-case, though it is assumed that the clarification of the causality judgment and the requirement of justifiable trust will have a somewhat limiting effect on auditor liability in Sweden.

## **6.1 Discussion**

Auditor liability is an interesting topic, it is frequently discussed in media and there are ongoing lawsuits to follow. It has been rewarding to gain deeper knowledge about the role of the auditor, auditor liability and the many different aspects that relate to it. Within the scope of this thesis it was determined to examine the subject in the light of the BDO-case. This has been associated with some complexities as auditor liability is a comprehensive topic with different possible approaches. Thus, it has been difficult to delimit the study efficiently. Within the process of the thesis the authors have come across a substantial amount of information, which has allowed in-depth studies and several possible conclusions and thoughts about the case, and auditor liability in general.

First, an interesting aspect concerning auditor liability, frequently discussed in the BDO-case, is the “floodgate argument”. The frequent use of the floodgate argument is interesting as it is an indication that the SC advocates a restrictive approach concerning auditor liability. Thus, one could possibly conclude that the highest instance in Swedish law considered auditor liability a current issue in need of limitation. In this study it is believed that the restrictive approach is applied to avoid a situation where liability claims against auditors becomes practically unmanageable and consequently one of the big audit firms goes bankrupt. As the SC highlights the importance of the floodgate argument several

times one may assume that the argument will be of relevance in future similar claims. This is believed to have a positive impact on the audit profession as the use of the argument indicates an identification of the risks of a too wide auditor liability, and thus a need for limitation.

Another interesting aspect of the BDO-case, which was not indicated in the Prosolvias-case, is the establishment of an “investor responsibility”. In the BDO-case the term “investor responsibility” is not specifically mentioned. Nevertheless, some of the aspects that the SC clarified in the BDO-case, such as trust attached to the share price or the audit report, indicates the importance of individual responsibility of the investors to make well-informed decisions based on sufficient information. Perhaps this clarification from the SC is an attempt to increase investor knowledge and narrow the size of the group of individuals that consider themselves eligible to compensation from the auditor. It could possibly also reduce the expectation gap between investors and auditors as investors become more knowledgeable about what to expect from the auditor, versus what is expected from the investor.

Very shortly after the deadline of this thesis the Kraft & Kultur-case will be finalised, this will offer a first indication regarding the development of auditor liability after the BDO-case, and its possible actual impacts. With the finalisation of the case it will be interesting to examine whether the reasoning in the BDO-case has affected the causality judgment in the event of a negligent auditor and the width of auditor liability, in the way that it is assumed in this thesis. After the completion of this study it is concluded that a limitation of auditor liability is not possible only by the development of case law. Future discussions and possibly changes in Swedish legislation to regulate certain questions will most likely be needed to solve the underlying problems of a too burdensome auditor liability. There are aspects that are regulated within Swedish legislation that one could argue complicates liability on behalf of auditors. Among these are mandatory insurance, joint and several liability and uncertainties regarding the assignment of responsibility between the company organs. After obtaining an increased amount of knowledge the authors argue that there is a need to treat some of the issues that are regulated within Swedish legislation. The development of case law is one important aspect, nevertheless, if other important questions are never treated, it is less likely that there will be a notable and lasting change. For instance, as long as the auditor is the only insured party there is no incentive to claim

liability from another company organ. Thus, if it is only a matter of the auditor's negligence, and never a matter of the company management's negligence it does not matter whether it is clarified how to indicate causality, the problem of an extensive liability for auditors remains unsolved.

It is important to keep in mind that it is difficult to draw any generalizable conclusions from one case and to state anything certain about the impacts. One can only make reasonable assumptions. All cases are different and therefore the judgments will also differ in some matters and be similar in others. Width of auditor liability as well as the causality judgment in the event of a negligent auditor are complex matters and the judgments are not easy to make, and will not be easy to make in the future either. It is always a matter of the specifics of each case, hence it is impossible to safely state that auditor liability is in fact affected in one direction, or the other. It is however possible to assume that the SC, through the BDO-case, has clarified some matters that are of relevance for auditors and the industry, specifically the causality judgment and the width of auditor liability.

## **6.2 Suggestions for Further Research**

During the working process of the thesis the authors have discovered that auditor liability is a very comprehensive subject. It is impossible to even be close to cover all aspects within one thesis. Thus, there have been several occasions when there has been a desire to dig deeper into certain questions of auditor liability, though within the purpose of this thesis there have not been any possibilities to do so. Some of the subject areas that the author's have come across and that are believed to contribute to the academic research are presented below.

Several times throughout the working process it has been noticed that many articles touch upon the matter of assignment of responsibility between the company organs. It is remarkable that the auditor often gets the blame, when there in fact are several parties that may have acted negligently and thus jointly caused the financial damage. Though, in corporate collapses it is generally the auditor who is held liable for damage, and not the company management. Within this thesis it is argued that this treatment is unfair, and that legislation is needed to regulate the matter. It should be assumed that the company organs are responsible for their individual part. Throughout this process it has been noticed that the Swedish government, as well as accounting authorities in Sweden have recognised this

matter (Nya regler för revisorer och revision, 2015; Revisorers skadeståndsansvar, 2008). Close to the end of this thesis process, an inquiry concerning the assignment of responsibility between the company organs was submitted by the Swedish Government Official Reports (Revisorns skadeståndsansvar, 2016). Within this inquiry it has been discussed whether there is a need to clarify the assignment of responsibility in the Swedish Companies Act (2005), and whether there are any other possible ways to avoid a too extensive auditor liability. Thus, there is a possibility to examine the content as well as the possible impact of the proposals within the inquiry.

Further, it has also been noticed that a substantial amount of articles discuss how to “solve” the matter of auditor liability. Within many of these articles, concepts such as mandatory insurance for the company management, proportionate liability as well as monetary caps on liability claims are discussed. In some countries in Europe (UK, Austria, Belgium, Germany, among others) some of these concepts have been introduced (Revisorers skadeståndsansvar, 2008). Though, it has not been considered necessary in Sweden, yet. It would be interesting to conduct research into the effects of the concepts in different countries in Europe to see if it is possible to limit auditor liability without compromising the protection purpose of Audit Standards.

### **6.3 Societal & Ethical Issues**

In this study, the authors have taken ethical and social issues into consideration. There has been an attempt to remain objective throughout the whole working process. The study is solely based on information that has been collected from public sources that are accessible for everyone. Much of the information included in the thesis, specifically the empirical data, consists of legislation and case law. This type of information is considered to be very reliable. The translation from Swedish to English has been made with considerable caution to avoid a situation where data is incorrectly presented. The same applies for the interpretation of the court cases.

As the BDO-case was recently finalised and as no similar cases have been treated so far it is difficult to safely state the societal impacts. Though, after the completion of this thesis it is evident that the society has one perception of the role of the auditor, this perception does not necessarily conform to the actual responsibilities of the auditor. A case such as the BDO-case could possibly have a societal impact as it clarifies some of the concerns of

auditor liability, specifically what an auditor may reasonably be held liable for. For auditors and the audit profession it is probably of greater significance, as they are directly affected by the outcome. For third parties it could potentially have an impact as well, though probably not in the same extent as on auditors, simply because they are not as familiar with the issues as auditors are. Thus, one of the main societal impacts that are of importance for the audit industry as well as for businesses in Sweden is that the case could have an impact on future similar claims and that perhaps there will be a decrease of cases where causality is weak or when the plaintiff may not consider himself eligible to compensation from the auditor. Though, as noted previously, many different aspects affect auditor liability. Case law provide useful and important guidance and the BDO-case has clarified some matters, nevertheless other concerns remain untreated, therefore it is argued that the BDO-case is important but that further clarification is needed.

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