

SUPREME COURT OF NORTH CAROLINA

COMMSCOPE CREDIT UNION,)

Plaintiff-Respondent)

v.)

From Catawba County

12 CVS 3021

BUTLER & BURKE, LLP, a North)
Carolina Limited Liability Partnership,)

Defendant-Petitioner)

v.)

BARRY D. GRAHAM et al.,)

Third-Party Defendants)

**BRIEF OF AMICI CURIAE NORTH CAROLINA ASSOCIATION
OF CERTIFIED PUBLIC ACCOUNTANTS (NCACPA) AND AMERICAN
INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)
IN SUPPORT OF PETITIONER**

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Interests of Amici Curiae In This Matter

The North Carolina Association of Certified Public Accountants (NCACPA) is an organization dedicated to promoting the competence, integrity, civic responsibility, and success of CPAs in North Carolina. Since its founding in 1919, it has grown to over 14,000 members, serving all aspects of the accounting

profession. NCACPA's services include a comprehensive curriculum of professional education, and a commitment to maintaining the highest standards of professional excellence in accounting practice in North Carolina.

NCACPA's committees, chapters, task forces, and advisory groups regularly interact with the North Carolina State Board of CPA Examiners, American Institute of Certified Public Accountants, Financial Accounting Standards Board, Internal Revenue Service, and other regulators who shape state and national accounting standards. Based on its role, history, and experience as a member service organization for North Carolina CPAs, NCACPA has a strong interest in issues affecting the independence of auditors.

The American Institute of Certified Public Accountants (AICPA) is the world's largest member association representing the accounting profession, with approximately 400,000 members in 128 countries, and a 126-year history of service to the public interest. AICPA's diverse membership represents many areas of practice, including public accounting, business and industry, government, education, and consulting. AICPA has been an authoritative source in the development of accounting and auditing standards and issuing professional publications to improve the quality of services provided by CPAs. Because of its historical role in formulating standards related to audits and other professional

engagements, and the reports issued thereon, the AICPA maintains a strong interest in the scope and bases of civil liability sought to be imposed on accountants.

Neither NCACPA nor AICPA has a direct stake in this particular dispute. However, because of their extensive understanding of the accounting profession and commitment to the public interest, these organizations are deeply concerned on behalf of their members and the public about the decision of the Court of Appeals in this case, particularly as it relates to a significant misunderstanding of auditor independence, a fundamental component of an auditor's responsibilities. As discussed below, the Court of Appeals' holding that an auditor may owe a fiduciary duty to an audit client cannot be reconciled with professional auditing standards and North Carolina law, which mandate an auditor be independent of the audit client. It also departs from settled precedent in other jurisdictions recognizing the public policy supporting independent audits and holding that the auditor-client relationship by its nature cannot be a fiduciary one.

Amici respectfully submit that the Court of Appeals' opinion involves legal principles of major significance and the subject matter is one of significant public interest, thus meriting this Court's review. The decision of the Court of Appeals creates confusion regarding whether North Carolina CPAs may conduct independent audits and further may impair the ability of North Carolina CPAs to continue to perform independent audits that are important to North Carolina

businesses, their creditors, and North Carolina's economy as a whole. NCACPA and AICPA therefore respectfully submit this brief of *amici curiae* to request that this Court grant Butler & Burke, LLP's Petition for Discretionary Review and uphold longstanding principles of auditor independence.

ARGUMENT

I. INDEPENDENCE IN AUDITING IS THE BEDROCK OF PUBLIC ACCOUNTING PRACTICE.

As a preliminary matter, it is important for the Court to note that an "auditor" is a specific kind of accountant. While accountants generally may be associated with the preparation and filing of personal and business tax returns, auditors perform a substantively different and valuable service. An "audit" is "a professional service whereby a CPA is engaged to examine financial statements . . . in order to express an opinion on whether the financial statements . . . are presented in conformity with generally accepted accounting principles or other comprehensive basis of accounting." 21 NCAC 08A.0301(b)(6). Audits are intended to "enhance the degree of confidence that intended users can place in the financial statements." AICPA Auditing Standard AU-C § 200.04. As discussed below, audits are conducted in accordance with specific professional standards, referred to as "Generally Accepted Auditing Standards" ("GAAS").

The independence of an auditor is the critical foundation of the modern practice of auditing. The need for independent audits has been recognized since at

least the mid-18th century,¹ coincident with the growth and importance of corporations in commerce. Since at least 1950, AICPA publications have described independence as “both historically and philosophically ... the foundation of the public accounting profession.”²

A fiduciary relationship is not one of independence, but rather a relationship where one party is bound to act in the interests of another. A fiduciary relationship “exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence.” *Abbitt v. Gregory*, 201 N.C. 577, 598, 160 S.E. 896, 906 (1931); *Compton v. Kirby*, 158 N.C. App. 19, 581 S.E.2d 452 (2003); Restatement (Second) of Torts § 874 cmt. a (1979) (“A fiduciary relation exists between two persons when one of them is under a duty to act or to give advice for the benefit of another upon matters within the scope of the relation.”)

As further explained below, the requirement of auditor independence is mandated by professional standards, as well as state and federal law in many instances, such that when an auditor is engaged to provide an audit, that relationship *cannot* be fiduciary. The two concepts are mutually exclusive.

¹ See Berryman, R. Glen. *Auditor Independence: Its Historical Development and some Proposals for Research*, in Contemporary Auditing Problems (1974).

² AICPA, *Audits by Certified Public Accountants: Their Nature and Significance* (1950), p.25.

A. Independence in auditing is mandated by North Carolina law and ethical standards in the accounting profession.

In North Carolina, as across the United States, the principle of auditor independence is mandated by professional standards and applicable law. The rules governing North Carolina CPAs require that a CPA engaged to provide an audit must do so in compliance with applicable “generally accepted auditing standards.” 21 NCAC 08N.0403 (App. 2).³ Those standards are the Generally Accepted Auditing Standards (“GAAS”) adopted by the AICPA. *Id.* AICPA’s standards emphasize the critical nature of independence in audit engagements:

This standard requires that the auditor be independent; aside from being in public practice (as distinct from being in private practice), he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be. However, independence does not imply the attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report, as in the case of prospective owners or creditors.

³ Chapter 8 of Title 21 of the North Carolina Administrative Code contains the rules governing CPAs, promulgated by the State Board of Certified Public Account Examiners. 21 NCAC 08N.0403 requires CPAs to follow generally accepted auditing standards, and 21 NCAC 08N.0402 mandates independence in an auditing engagement. By rule, the GAAS which accountants must adhere to are the standards adopted by the AICPA. *Id.*

AICPA Auditing Standard AU § 220.02 (App. 8) (emphasis added) (standard effective through 2012).⁴

AICPA standards make clear that an auditor may *not* have any bias or duty in favor of the audit client:

It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners.

AICPA Auditing Standard AU § 220.03 (App. 8) (emphasis added).

In addition to North Carolina's adoption of the AICPA's generally accepted auditing standards, the North Carolina rules governing CPAs also specifically require that an issuer of an audit report be independent. 21 NCAC 08N.0402 ("Independence") (App. 1). Under 21 NCAC 08N.0402, no audit report may be issued if independence is impaired. Examples in the rule of when independence would be impaired include when the auditor provides any service to a client that would create a special duty, such as serving as a director, officer, or trustee. *Id.*

⁴ Over time, AICPA standards have been subject to recodification. The standards cited in this brief are generally those applicable during the 2001-09 time period at issue in the Complaint. Citations to "AU-C" sections are standards which came into effect in December 2012. The fundamental nature of the independence requirement for auditors has not changed.

The requirement of independence of auditors is also an ethical obligation. The AICPA Code of Professional Conduct (AICPA Code) recognizes that any relationship where an accountant would be “promoting an attest client’s interests or position” is a threat to independence. AICPA ET § 100-1.14.⁵ Thus, for example, in the context of benefit plan administration services, the AICPA Code advises that an accountant who “serve[s] as a fiduciary as defined by ERISA” cannot comply with the independence requirement required to perform an audit. AICPA ET §101.05.⁶ It is therefore clear that a CPA cannot maintain the independence required to conduct an audit if the CPA is also serving in a fiduciary role.

B. Independence is also a fundamental requirement under federal law and international standards.

The requirement of independent audits also applies under federal law and international standards. U.S. Securities and Exchange Commission (“SEC”) rules require auditors to be independent of their SEC audit clients, both in appearance and in fact. These rules also make it unlawful for an auditor not to act independently, 17 C.F.R. § 240.10A-2 (App. 36); 210.2-02(b), and effectively forbid an auditor from serving “in a position of being an advocate for the audit client.” 17 C.F.R. § 210-2.01 (preliminary note) (App. 23).

⁵ See App 10. ET Section 100 (“Independence”) applied during the time period at issue in the Complaint. The current codification of the ethical rule on independence is at AICPA Code 1.200.

⁶ See also AICPA Code 1.295.115 for same prohibition in current version of Code of Professional Conduct.

Moreover, the Public Company Accounting Oversight Board (“PCAOB”), a non-profit corporation, was established under the Sarbanes-Oxley Act of 2002, to improve investor confidence in audits of public company financial statements. 15 U.S.C. § 78j-1; P.L. 107-204, §§ 101, 201-09, 116 Stat. 745, 750, 771 (“Sarbanes-Oxley Act of 2002 – Title II – Auditor Independence”). Firms registered with the PCAOB must comply with SEC independence rules for audits, and are subject to PCAOB oversight and enforcement.

Lastly, the International Ethics Standards Board for Accountants (IESBA) is an independent standard-setting body that establishes internationally appropriate ethics standards. IESBA standards also include strict requirements of independence in audit engagements, and recognize that independence serves the public interest. IESBA Code § 290, *Independence-Audit and Review and Engagements* (App. 37).

C. The Court of Appeals erred by equating an audit relationship with a fiduciary relationship.

As shown above, the laws and standards governing audit engagements strictly require that the relationship between an auditor and the subject of the audit be independent.⁷ This duty of independence is simply incompatible with a

⁷ As Petitioner notes, the requirements of auditor independence also apply, unsurprisingly, to North Carolina credit unions. *See* 04 NCAC 06C.0305 (requiring “Independent Audits”); N.C. Gen. Stat. § 54-109.49. Thus, not only do North Carolina CPAs have a duty to perform independent audits, but North

fiduciary relationship. Thus, the Court of Appeals erred in analogizing that the auditor-client relationship is “much more like that between attorney and client, broker and principal.” (Slip Op. at 8-9).

Indeed, in *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984), the United States Supreme Court recognized that an auditor serves a role wholly different than the duty of an attorney to a client:

[T]he private attorney’s role [is] as the client’s confidential advisor and advocate, a loyal representative whose duty it is to present the client’s case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation’s creditors and stockholders, as well as to investing public.

Id. at 817-18.

The Court of Appeals noted that auditors are “specially trained to perform comprehensive audits,” but this does not make an auditor a fiduciary any more than it makes any competent professional in a given field a fiduciary. This should be especially so in the case of audits, where an auditor strives to act with “judicial

Carolina credit unions must ensure they are *obtaining* independent audits. The allegations of the credit union in this case that its auditor owed it a fiduciary duty would mean, if true, that it has violated North Carolina law. Our courts should never recognize a common law duty that conflicts with existing regulatory and statutory law.

impartiality” in his conduct, and with strict independence. AICPA Auditing Standard AU § 220.02 (App. 8). The Supreme Court of North Carolina is particularly well situated to decide the question of whether it is advisable for North Carolina law to recognize a common law fiduciary duty that would be fundamentally inconsistent with professional standards and applicable state and federal law.

II. RECOGNIZING THE IMPORTANCE OF INDEPENDENCE, COURTS HAVE HELD THAT THE AUDIT RELATIONSHIP IS NOT A FIDUCIARY RELATIONSHIP AS A MATTER OF LAW.

No North Carolina appellate decision has squarely addressed the issue of whether an auditor is in a fiduciary relationship with the subject of the independent audit.⁸ Other courts, however, have considered the issue and have uniformly rejected the notion that an audit engagement creates a fiduciary relationship. In short, a claim for breach of fiduciary duty cannot be grounded on an allegation that an auditor failed to conduct an audit in accordance with generally accepted auditing standards.

⁸ The North Carolina accounting cases cited by the Court of Appeals did not address audit engagements and therefore have no application to that relationship. In *Harrold v. Dowd*, 149 N.C. App. 777, 561 S.E.2d 914 (2002), a non-audit relationship with an accountant was held not to create a fiduciary duty. And in *Smith v. Underwood*, 127 N.C. App. 1, 487 S.E.2d 807 (1997), the plaintiff’s attorneys and accountants made grave errors in the handling of client trust funds and tax filings. The accountant did not perform an audit, and clearly would have been barred by independence requirements from doing so.

In *Resolution Trust Corp. v. KPMG Peat Marwick*, 844 F. Supp. 431 (N.D. Ill. 1994), suit was brought against an accounting firm for damages allegedly caused by improperly conducted audits of a bank's financial statements. Conducting a review of precedent, the court held that the nature of an audit engagement is fundamentally inconsistent with the role of a fiduciary:

An examination of those cases reveals that many courts squarely reaching the question have held that an independent auditor generally is not in a fiduciary relationship with its client. Some courts have gone as far as to observe that the nature of the independent auditor precludes a finding of fiduciary duty. The duty of a traditional fiduciary is to act 'in a representative capacity for another in dealing with the property of the other,' whereas an auditor acts 'independently, objectively and impartially, and with the skills which it represented to its clients that it possessed.' ”

Resolution Trust Corp., 844 F. Supp. at 436 (quoting *Franklin Supply Co. v. Tolman*, 454 F.2d 1059, 1065 (9th Cir. 1971)).

In fact, it appears that every case to have directly considered the issue of whether an audit engagement can create a fiduciary relationship has rejected the proposition. *See, e.g., Wright v. Sutton*, 2011 WL 1232607, at * 5 (S.D. W. Va. 2011) (App. 40) (granting motion to dismiss fiduciary duty claim under “general rule that an independent accountant does not have a fiduciary relationship with its client.”); *Strategic Capital Resources v. Citrin Cooperman & Company, LLP*, 213 Fed. App'x 842, 843 (11th Cir. 2007) (unpublished) (App. 47); *FDIC v. Schoenberger*, 781 F. Supp. 1155, 1157 (E.D. La. 1992) (“Other federal circuits

have held that accountants do not owe a fiduciary duty to their clients when providing services as auditor; rather the nature of an independent auditor is that it will perform the services objectively and impartially.”).

Some courts have acknowledged the possibility that exceptional circumstances could arise in some cases, such as if an accountant were to provide services *beyond* an audit. *See Resolution Trust Corp.*, 844 F. Supp. at 436. However, where the subject of an audit has alleged a fiduciary duty exclusively by virtue of the audit engagement, as the plaintiff has here, fiduciary duty claims have been routinely rejected. *Amici* submit that the overwhelming weight of authority does not recognize the fiduciary duty claim made by the plaintiff in this action, and this Court should not make North Carolina an exception to such a well-reasoned rule.

III. THE DECISION OF THE COURT OF APPEALS COULD NEGATIVELY IMPAIR THE AVAILABILITY OF INDEPENDENT AUDITS IN NORTH CAROLINA.

If the decision of the Court of Appeals is not overturned, it will cause confusion amongst North Carolina CPAs regarding whether and how they may continue to perform independent audits in conformance with professional standards. Absent clarity from the Court on the issue, the resulting uncertainty can be expected to lead to fewer CPAs willing to perform independent audits in North Carolina and have a negative impact on North Carolina businesses, creditors, and

economy as a whole due to both the reduced availability of and increased costs associated with independent audits. Under state law, and the generally accepted auditing standards of the AICPA (which have the force of law),⁹ North Carolina CPAs cannot issue valid audit reports unless they are independent from their clients. But if auditors are viewed as owing a fiduciary duty to their audit clients, then it is difficult, if not impossible, to reconcile how North Carolina CPAs can issue valid audit reports under existing North Carolina regulatory and statutory law while simultaneously owing a fiduciary duty to the audit client. The confusion over auditor independence will extend to not only CPAs, but also to audit clients and users of audit reports.

The Court of Appeals' decision is unclear as to whether the panel believed a standard audit engagement creates a fiduciary relationship as a matter of law in every case. The Court of Appeals suggested, without apparent consideration of professional accounting standards, that an auditor-client relationship looked "much more like that" of an attorney-client or broker-principal relationship. In doing so, the decision left open the possibility that a standard audit engagement could create a fiduciary relationship. However, this is wholly inconsistent with the concept of independence required by professional standards, and adopted by state and federal law. If the decision were to stand, the law of North Carolina would be at odds with

⁹ See Section I.A., *supra*.

every other jurisdiction that has directly addressed this issue. When a complaint contains allegations that an auditor failed to conduct an audit in accordance with generally accepted auditing standards, as was alleged here, a claim for breach of fiduciary duty should not be permitted.

Without a reversal, the rules and generally accepted auditing standards governing the conduct of audits in North Carolina would appear to be in irreconcilable conflict with judicial precedent. Even if CPAs were to continue performing audits in North Carolina following the confusion created by the Court of Appeals decision, it seems likely that the risk of litigation whenever a “bad result” occurs would increase, with any failing of an audit client now blamed on the auditor, ultimately raising the cost of performing an audit.

Not only would North Carolina CPAs be forced to contend with the potential impairment to their independence from their audit client, , but North Carolina companies could face challenges in finding North Carolina CPAs able to perform an independent audit. Indeed, any North Carolina company required to obtain an independent audit would be affected, including the credit union here , which is itself required by North Carolina law to have an independent audit of its financial statements. 04 NCAC 06C.0305.

For these reasons, *Amici* strongly urge this Court to grant discretionary review and reverse the decision of the Court of Appeals.

IV. THE COURT OF APPEALS' DECISION SHOULD BE REVIEWED ON ALL ISSUES.

The Court of Appeals' misapprehension of the nature of the auditor-client relationship also plainly influenced the court's reasoning when considering the auditor's affirmative defenses of *in pari delicto* and contributory negligence. Although plaintiff-respondent concedes that it alone was required under federal law to file tax returns, the Court of Appeals' opinion detours into discussions such as whether the failure of its general manager to file the returns should be "imputed" to the credit union. Likewise, in discussing the contributory negligence defense, the court suggests the failure to file tax returns could be "excusable conduct." It seems apparent that the court's discussion of the potential liability of the auditor, and the applicability of these defenses, was colored by the court's initial conclusion that an auditor can be a fiduciary of the subject of an audit.

Therefore, *Amici* recommend that the Supreme Court review the entire decision of the Court of Appeals in light of the court's error on the fiduciary duty issue. In considering whether plaintiff should be permitted to proceed with this action, this Court can take into proper consideration the fundamental importance of auditor independence under applicable law and public policy.

CONCLUSION

Amici respectfully submit that the decision of the Court of Appeals is in significant error. *Amici* urge this Court to grant discretionary review and reverse

the Court of Appeals, uphold longstanding principles of auditor independence, and hold that an auditor-client relationship cannot be a fiduciary relationship.

This the 13th day of January, 2015.

SMITH, ANDERSON, BLOUNT, DORSETT,
MITCHELL & JERNIGAN, L.L.P.

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I hereby certify that the foregoing BRIEF OF AMICI CURIAE NORTH CAROLINA ASSOCIATION OF CERTIFIED PUBLIC ACCOUNTANTS (NCACPA) AND AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA) IN SUPPORT OF PETITIONER was served upon the parties to this action by mailing a copy thereof by first class mail to the following counsel:

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APPENDIX

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