Auditors — To What Extent Do They ‘Care’?

by SM Shanmugam and Chng Keng Lung

Auditors play a pivotal role in fostering confidence in the financial sector. They are tasked to state the true and fair view of the financial position of the companies that they have been engaged to audit. External parties rely on the information furnished by auditors to make informed decisions.

It should not come as a surprise that in law, auditors owe a duty to their clients in contract and tort, and by statute.1 In certain circumstances, an auditor may also owe a duty to third parties.2

However, the issue is the extent to which auditors are expected to discharge their duties. A common expectation is that not only should auditors’ statements accurately reflect the financial position of the company, but they should also uncover any malpractice and fraud. This is especially so where the financial position at stake concerns a public company. As with directors, auditors are thrown into the limelight in situations of financial scandal.

How onerous, then, is the auditor’s duty?

Duty of care

An auditor owes a duty to his client. This holds true in contract and also in tort:

“In advising the client who employs him the professional man owes a duty to exercise that standard of skill and care appropriate to his professional status and will be liable both in contract and in tort for all losses which his client may suffer by reason of any breach of that duty.”3

The contractual duty of an auditor would depend on the terms of the engagement.4 These terms may be stated in a formal document or to be gleaned from correspondence. The court will ascertain the duties and obligations by which their work is defined.5 In any event, it is an implied term of the contract of engagement that auditors will exercise reasonable care and skill:6

“... whatever the precise content of his audit duty, the auditor promises, first, to conduct an audit of some description and, second, to provide a report of his opinion based on his audit work, which report has to comply with the Companies Act and the articles, and also impliedly agrees to exercise reasonable skill and care in the conduct of the audit and in making the report.”7 (Emphasis added)

There is little practical difference whether the claim against the auditor is brought in tort or in contract. Both duties co-exist and are concurrent.8 There is no rule, whether arising from negligent service or negligent misstatement, which prohibits or restricts the claimant to either a tortious or a contractual remedy.9 The aggrieved party is entitled to take advantage of the remedy which is most advantageous.10 This is so unless the tortious duty is so inconsistent with the applicable contractual terms that the latter must be taken to have the effect of limiting or excluding the former.11

Traditional standard

In the late 18th century, the English courts took what would now be considered a conservative view of the auditor’s duty:

1 For example, the duties of auditors under s 266 of the Companies Act 2016 [Act 777]
2 Hedley Byrne & Co Ltd v Heller & Partners Ltd [1963] 2 All ER 575, Caparo Industries plc v Dickman [1990] 1 All ER 568
3 Caparo Industries, supra n 2, per Lord Bridge at 576
4 International Laboratories Ltd v Dewar [1933] 3 DLR 665
5 Ibid
6 Henderson v Merrett Syndicates Ltd [1995] 2 AC 145 (HL) at 194
7 Pacific Acceptance Corporation Ltd v Forsyth [1970] 92 WN (NSW) 29 (SC), per Moffitt J at 51
8 Ibid at 155, cited with approval by the High Court of Australia in Astley v Austrust [1999] 161 ALR 155
9 Henderson, supra n 6 at 193-194
10 Ibid at 194
11 Ibid at 193-194
“An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.”12

An auditor discharges his duties by examining the books of the company and by taking reasonable care to ascertain that they show the company’s true financial position.13 But he is not an insurer; he does not guarantee that the books correctly show the true position of the company, and neither does he guarantee that the balance sheet is accurate. Because if he did, he would be responsible even for errors by which he himself would have been deceived:

“His obligation is not as onerous as this... Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient... Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.”14

It was considered the duty of an auditor to perform to the level of the skill, care and caution which a reasonably competent, careful and cautious auditor would.15 What is reasonable skill, care and caution would depend on the particular facts and circumstances of each case. The court cautioned against imposing too onerous a duty on auditors:

“If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of that kind he is only bound to be reasonably cautious and careful.

“... It is not the duty of an auditor to take stock; he is not a stock expert; there are many matters in respect of which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all fraud... The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate.

“... Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an auditor intolerable.”16

It appears from this view that an auditor ought to enquire or investigate when his suspicion is triggered, but otherwise, he need do no more than be reasonably cautious and careful.

Modern standard

Approximately 60 years later, the English court17 rejected the notion that the proper functions of an auditor are merely to verify the sum, arithmetically, by referring to the books and all necessary vouching material and oral explanations. The courts came to look upon this view as being too narrow, and stated that an auditor must discharge his duties by having an inquiring mind — not to be suspicious of dishonesty, but to be suspicious of the possibility of an error or mistake being committed by someone somewhere.18

This view was adopted by the Australian court,19 which held that, since the classic statements in the late 18th

12 Re Kingston Cotton Mill Co (No 2) [1896] 2 Ch 279, per Lopes LJ at 288
13 Re London & General Bank (No 2) [1895] 2 Ch 673, per Lindley LJ at 682-683
14 Ibid
15 Re Kingston, supra n 12 at 290
16 Ibid at 289-290
17 Fomento (Sterling Area) Ltd v Selsdom Fountain Pen Co Ltd [1958] 1 All ER 11, per Denning LJ
18 Ibid at 23
19 Pacific Acceptance, supra n 7, per Moffitt J
century, there had been considerable changes in the organisation of the affairs of companies, and a continuing and increasing experience of and notoriety of danger signs of mismanagement and fraud:20

"The matter cannot be dismissed by reference to the well-known dicta regarding suspicion and metaphors concerning dogs and detectives, for such are rather directed to the auditor’s state of mind and do not suggest that a careful auditor, without suspicion in his mind but doing his duty, will pay no heed to the reality that there is always a material possibility that human frailty may lead to error or fraud in the financial dealings of any organisation."21

In departing from the traditional standard, the Australian court took the view that rather than waiting for suspicion to be triggered, auditors must be wary of the possibility of error, fraud or unsound accounting.22 This is to be achieved by framing and carrying out their procedures so that if substantial or material error or fraud has permeated into the affairs of the company, they would have a reasonable expectation that such activities will be uncovered.23

A common dilemma that auditors face concerns the inspection of documents — to what extent are they required to sight the originals. The substantial question, really, is what is the minimum procedure required.24 In one case, the question which arose was whether, in ascertaining the existence of material mortgages, the auditors ought to have inspected the original documents. The court held that the essence of the audit approach is to inspect original documents unless there is some good reason to the contrary.25 Where, for instance, the inspection of documents will cause inconvenience or delay, it may be reasonable for auditors to rely on appropriate certificates from solicitors.26

The auditors would be negligent if they neither inspected the original documents nor took steps to verify them by some other acceptable means.27

In all circumstances, auditors must make proper communication, and would be in breach of their duties if, having uncovered fraud or having suspicion of fraud in the course of audit, they fail to report it to the directors or to the management of the company,28 a “duty to warn”.29

Professional scepticism
A similar approach has also been adopted by the New Zealand courts.30 Auditors should display an attitude of “professional scepticism” when planning and performing the audit.31 They should not assume that instances of fraud or error are isolated occurrences — instead, they ought to recognise that certain conditions or events may be encountered during the course of audit which necessitates the questioning of whether frauds or errors exist.32

It is crucial that thorough planning is concluded prior to the commencement of the audit.33 This should be achieved by way of a preliminary survey to enable the auditors to review the company’s operations and to acquire sufficient knowledge of the company’s organisation, systems and activities necessary for the preparation of a worthwhile audit plan and strategy.34

20 ibid at 73
21 ibid at 63G-64A
22 ibid at 63G
23 ibid at 69E
24 ibid at 83A
25 ibid at 84D
26 ibid at 85C-D
27 ibid at 87A
28 ibid at 53D
29 ibid at 54F
30 Dairy Containers Ltd v NZI Bank Ltd; Dairy Containers Ltd v Auditor-General [1995] 2 NZLR 30 (HC) at [30]-[45]
31 ibid at [20]
32 ibid
33 ibid at [15]-[30]
34 ibid at [10]-[15]
“I also agree that the question cannot be dismissed by reference to well-known dicta and metaphors concerning dogs and detectives. Such dicta are generally directed to the state of mind of the auditors, such as whether they were sufficiently sceptical or suspicious — or should have been sceptical or suspicious.

“The questions tend to obscure the auditor’s basic duty to plan and carry out the audit of the company cognisant of the possibility of fraud. If and when the auditors discover an apparent irregularity, they must carry out such further tests or make such further inquiries as may be required to be satisfied that, in fact, no irregularity exists.

“If an irregularity is found to exist they must be satisfied, or take such further steps as may be necessary to be satisfied, that the irregularity will not affect the truth of the accounts.

“If the circumstances are such as to give rise to a reasonable suspicion of fraud, they must necessarily proceed further and either determines that no fraud exists or reports their suspicion to the general manager, or the board, or even the shareholders of the company, as may be appropriate in the circumstances of the case.”35

Malaysian position

The modern view, propounded in the English,36 Australian37 and New Zealand38 cases, was considered and endorsed by the High Court of Sabah and Sarawak in Ng Wu Hong,39 in which auditors were alleged to be negligent because their audit failed to disclose fraud perpetrated in the company they were auditing.

The principal complaint centred on the auditors’ failure to obtain a Malaysian Central Depository (MCD) printout40 directly from the MCD terminal at the company or from the MCD office in Kuala Lumpur. Instead, the auditors relied on a printout provided by a senior executive of the company who, as it turned out, had fabricated it.

The question arose as to whether it was reasonable to expect the auditors to source the MCD statements directly from the MCD terminal which was in a secured area in the company. The court held that it would be unreasonable, especially since there were no suspicious or special circumstances which would warrant a suspicion that the MCD printouts handed over to them were forged.41 The court took into account the fact that the auditors did not blindly accept the word of the company’s employees and chose to procure some documentation, in the form of MCD printouts, as proof.42

Taking into account the failure of the internal audit department and another firm of auditors in detecting the same fraud, the court held that the auditors were not in breach of their duty of care, particularly in the absence of evidence that an auditor acting with reasonable skill and care would have discovered the fraud.43

The lesson to be drawn from the modern cases is that the auditors must ostensibly seek to inspect documents, and if not the original, to have a good reason why it was not convenient, always assuming that there are no other circumstances which might give cause to suspect any wrongdoing.44

35 Ibid at [30]-[45]
36 Fomento, supra n 17
37 Pacific Acceptance, supra n 7
38 Dairy Containers, supra n 30
39 Ng Wu Hong v Abraham Verghese TV Abraham [2011] 6 CLJ 322 (HC)
40 Statement of shares held
41 Ng Wu Wong, supra n 39 at [38], [41]
42 Ibid at [38]. The court must have considered that for the auditors to obtain an original printout would have been inconvenient as the MCD terminal in the company was in a secured area, while the MCD office in Kuala Lumpur is at least a few hours’ flight away.
43 Ibid at 344 [37]
44 The court did not, however, consider whether thorough planning was carried out by the auditors prior to the commencement of the audit — an element which the New Zealand court deemed crucial: Dairy Containers’ case
**Statutory duty**

It is likely that the modern standard will apply also to the auditor’s duty under written law\(^{45}\) to state whether the financial statements of a company are, in his opinion, properly drawn up

(a) so as to give a true and fair view of the matters stated in the financial statements;\(^{46}\)

(b) in accordance with the Companies Act 2016 so as to give a true and fair view of the company’s affairs; and

(c) in accordance with applicable approved accounting standards.

Auditors also have a duty to state any defect or irregularity in the financial statements in the way of obtaining a true and fair view of the matters dealt with by such financial statement.\(^{47}\)

**Conclusion**

In practical terms, it would be prudent for an auditor to take the following minimum steps:

(a) Have a clear audit plan before commencement of the audit;

(b) Take all steps necessary in order to ascertain the true financial position of the company;

(c) Where a logical step is dispensed with, for convenience or practical reasons, ensure that the alternative measures taken are a reasonable and justifiable substitute; and

(d) Expressly communicate all requests that he deems reasonable to make, and all difficulties they encounter.

In a situation where one may face an accusation based on hindsight, the auditor does well who ensures that his conduct of the audit is accountable at every stage, by accounting for and communicating, with clear reasons, his decisions and conduct throughout.

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\(^{45}\) Companies Act 2016, s 266

\(^{46}\) Ibid, ss 248 and 249

\(^{47}\) Supra n 45, s 266(2)(d)