

CHAPTER FOUR

THE AUDITOR'S DUTY OF REASONABLE CARE AND SKILL IN SOUTH AFRICA: A STATUTORY AND PROFESSIONAL PERSPECTIVE.

1. GENERAL OBSERVATIONS.

The guideline as to what the auditor's duty of reasonable care and skill entails is not only found in common law. It has for quite some time been dealt with in statutes as well and in internationally accepted auditing standards. This Chapter will analyze the standards of care as pronounced in all the relevant Acts like the Auditing Profession Act, 26 of 2005 and the Companies Act, 61 of 1973. Where relevant and to a limited extent this Chapter will also compare provisions in the Companies Act, 61 of 1973 with the recently passed U.K. Companies Act (c 46) with a view to showing the international trends as formulated in the U.K.¹ The official pronouncements of the profession itself which amount to internationally accepted auditing standards will also be analyzed. It will be revealed that these pronouncements have legal backing and provide useful information on how auditors should do their work. This Chapter also serves a very important purpose, which is to show that auditors are not under any *statutory duty* to detect fraud and that the directors are collectively as a board accountable for the presence of material misstatements in the annual financial statements.

¹ The U.K. Companies Act (c 46) received Royal Assent on 8 November 2006. See www.opsi.gov.uk/acts2006 and follow the link on the Companies Act and its Explanatory Note. The Department of Trade and Industry in the UK commissioned a fundamental review of company law and a Steering Group led the Company Law Review whose mandate obliged it to consider how core company law could be modernized with a view to providing a simple and effective framework for British business in the twenty first century. After consulting heavily with all the interested parties the Company Law Review presented its Final Report to the Secretary of State for Trade and Industry on 26 July 2001. This report contained a number of recommendations for substantive changes to many areas of company law.

2. THE PUBLIC ACCOUNTANTS AND AUDITORS ACT, 80 of 1991.

This is the Act (hereinafter referred as the PAAA) that was repealed by the Auditing Profession Act, 26 of 2005. It regulated various issues peculiar to auditors. Section 20 is however the one that is peculiar to this research. This section dealt with the standards of care expected from auditors. Reasonably competent auditors needed to be aware of its provisions.

2.1. Statutory Standards of Care.

Section 20 of the PAAA laid down certain requirements which applied to any audit. In terms of section 20 (1) no person acting as an auditor to any undertaking was pursuant to any audit allowed to certify, report or express an opinion to the effect that a financial statement including any annexure thereto that relate to the business in question, presented fairly or correctly or gave a true and fair view, without appropriate qualification, of a company's financial position or the results of its operations unless certain conditions were met.

These conditions were:

- i. He must have carried out the audit with freedom from any restrictions whatsoever.²
- ii. He must have checked that proper accounting records have been kept in any one of the official languages, so as to reflect and explain all transactions and record all assets and liabilities in a correct and adequate fashion.³

² Section 20 (1) (a).

³ Section 20 (1) (b).

- iii. All information, vouchers and other documents which are necessary for the proper performance of his auditing duties must have been obtained.⁴
- iv. He as auditor must have complied with the laws and other requirements relating to the audit of any business.⁵
- v. He must have, by the use of reasonably appropriate methods, satisfied himself of the existence of all assets and liabilities reflected in the financial statements or any annexures thereto.⁶
- vi. He must have been satisfied as far as is reasonably practical of the fairness or truth or correctness as the case may be of the financial statements and annexures⁷
- vii. Any material irregularity referred to in section 20 (5) must have been adjusted to his satisfaction.⁸

In addition to the performance of these duties the Public Accountants and Auditors Board's Code of Professional Conduct stressed fundamental principles of integrity, objectivity and independence⁹ as well as knowledge and skills and professional conduct

⁴ Section 20 (1) (c).

⁵ Section 20 (1) (d).

⁶ Section 20 (1) (e).

⁷ Section 20 (1) (f).

⁸ Section 20 (1) (g).

⁹ Puttick G and van Esch S *The Principles and Practice of Auditing* 8th ed identify the two main aspects of independence namely:

- i. The auditor's responsibility to come to an unbiased opinion and to possess the conviction required. He must not allow himself to be led by forceful personalities he may encounter to accept statements with which he is not completely satisfied.
- ii. An auditor must be seen to be independent and abstain from acts or relationships which are likely to undermine his independence. Such acts would include investments in clients or

which has to be adhered to. It is quite obvious that an auditor who was reasonably careful and competent could not simply certify financial statements as true without verifying that proper accounting records had been kept.¹⁰ A reasonably competent and careful auditor had to be aware of the provisions of this Act and all other rules governing the conduct of an audit.

2.2. Duty to Report all Material Irregularities.

In terms of section 20 (5) (a), if any person who in performing his duties as an auditor of a business is satisfied or has reason to believe that a material irregularity is taking or has taken place in the conduct of the business and which has caused or has the potential to cause financial loss to the business or to any members or creditors he must report the irregularity in writing to the person in charge of that business. Such a report must furnish particulars of the irregularity. The Act did not define a material irregularity. It can however be inferred from the wording of section 20 (5) (a) that it must have caused financial loss or at least have the potential of causing financial loss to the members or creditors. The second apparent requirement was that the irregularity must have taken place.

By its very nature, fraud easily fits into the ambit of the material irregularities an auditor was required to report on. A casual look at the section would possibly suggest that an auditor was only required to report on the existence of a material irregularity if he was “satisfied or had reason to believe” that such an irregularity existed. He was not required by this provision to have an absolute belief or engage procedures that would at any time reveal a material irregularity or cause him to believe it was taking place. Section 20 (5) (a) only required an auditor to carry out any investigation he deemed fit for the purpose

indebtedness to them, trusteeships associated with clients, acceptance of gifts from clients and personal relationships with client personnel.

¹⁰ This would have been in contravention of section 20 (1) (b).

of determining whether such an irregularity exists or not.¹¹ There were no specific guidelines as to what would be a sufficient investigation into the existence of an irregularity. This would obviously depend on the circumstances of the case.

Section 20 (9) dealt with the liability of an auditor for negligence or malice in the performance of his duties. In terms of subsection 9 (a) an auditor could not be liable to his client or a third party if he expressed an opinion without negligence or malice. Section 20 (9) (b) provided that an auditor could only be liable if there was proof that he acted negligently and that as a result of his negligence a third party suffered financial loss and if he knew or could reasonably be expected to know that such an opinion would be used by his client to encourage or discourage a third party into a transaction,¹² or that a third party would rely on such opinion.¹³ Section 20 (9) (b) (ii) provided that an auditor would be liable to a third party if he negligently gave a wrong opinion on financial statements or in any way represented to the third party that his report was accurate if he knew or could reasonably be expected to know that the third party would rely on his opinion and act or refrain from acting in relation to a particular transaction with harmful consequences.

¹¹ This requirement complemented the common law requirement discussed in the previous Chapter. In the cases *Dairy Containers v NZI Bank* [1995] 2 NZLR 30, *In re Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279, *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29 and *Thoroughbred Breeders Association of South Africa v Price Waterhouse* 1999 (4) SA 968 (W) it was stated that an auditor who finds himself faced with something suspicious in the financial statements must proceed and probe it to the bottom. In *Thoroughbred* this requirement was qualified. It was held that an auditor must use his professional judgment in deciding which matters are material and should be probed.

¹² Subsection (aa).

¹³ Subsection (bb).

3. THE AUDITING PROFESSION ACT, 26 OF 2005.¹⁴

The Auditing Profession Act (the Act) repealed the PAAA and contains provisions that deal with the standard of care with which all auditors should comply when they are performing an audit. In terms of section 44 (2) an auditor may not express an unqualified opinion on the financial statements or on any supplementary information of the entity he has audited unless he is satisfied that the financial statements:

- (a) fairly¹⁵ present in all material respects the financial position of the entity and the results of its operations and cash flow; and
- (b) are properly prepared in all material respects in accordance with the principles of the financial reporting system the financial reports purport to follow¹⁶ unless he is satisfied that the criteria in section 44 (3) have been followed.

3.1. Specific Duties in Relation to the Audit.

3.1.1. Duty to comply with official procedures and to ensure the integrity of the audit.

Section 44 (3) (a) prohibits an auditor from expressing an opinion to the effect that financial statements are a fair presentation of the financial position and results of an

¹⁴ This Act was assented by the state President and became law on 12 January 2006. One of its main objectives contained in its preamble is to regulate the conduct of registered auditors.

¹⁵ The Bill contained the words 'fairness or the truth or correctness' of the financial statements. This was changed to get the requirement in line with International Auditing Standards which only require an auditor to report on the *fairness* of the financial statements.

¹⁶ This means that a reasonably skilled auditor has to be aware of the different financial reporting frameworks in use today. Companies are required to use generally accepted accounting practice (GAAP) principles by section 285A of the Companies Act 61 of 1973. These practices however have so many facets. There are *inter alia* UK GAAP, South African GAAP, International Financial Reporting Standards (IFRS) and US GAAP.

entity or are properly prepared in all material respects unless he is satisfied that he has carried out the audit free from any restrictions whatsoever.¹⁷ The provision goes on to *provide legal backing to international auditing standards* by stating that an auditor must be satisfied that his audit is in compliance with official auditing pronouncements that are applicable to the conduct of the audit. The purpose of this provision is to express that an auditor in exercising reasonable care and skill must ensure that he exercises his right to independence and complete freedom when conducting an audit. If he is restricted from accessing certain information or conducting the audit according to his plans, he must not certify the financial statements as true and he must qualify his report accordingly. The auditor must also ensure that he is reasonably skilled by constantly educating himself on the latest developments in his profession regarding procedures, laws and standards because according to this provision, international auditing standards should be adhered to.¹⁸

3.1.2. Duty to use reasonably appropriate methods in particular circumstances.

Section 44 (3) (b) states that an auditor may only attest without qualification if he has used reasonably appropriate methods, having regard to the nature of the entity to satisfy himself of the existence of the assets and liabilities shown on the financial statements. This requirement clearly obliges an auditor to take positive steps to ascertain whether or not the assets or liabilities that an auditor reflected in the statements actually exist. Fraud schemes often take the form of understated liabilities or exaggerated assets. This provision also obliges an auditor to utilize methods that best suit his assessment of the risk of fraud considering the particular entity and circumstances, and it essentially does away with the use of standard audit methods for different entities and financial statements.

¹⁷ Such restrictions may entail the withholding of information relevant to the audit of the financial statements or limitation of an auditor's access to information which he may deem essential.

¹⁸ In American law, a person who becomes and takes the title of certified public accountant (an auditor in South Africa) has an obligation to be "currently informed and continually updated on new developments affecting their profession." See Frascogna JL JD 1972 *CPA Law Review* 4th ed 19.

3.1.3. Duty to ensure that all accounting records have been kept.

According to this Act an auditor has to ensure that the accounting records have been kept by the company in one of the official languages.¹⁹ The purpose of these records is to reflect and explain all transactions and to record all assets and liabilities. An auditor must not audit annual financial statements straight away without first examining the accounting records. It is inherently superficial to focus exclusively on the annual financial statements because these are only the tip of the iceberg. He must ensure that the information in the financial statements is fairly based on the accounting records. This is similar to the provisions in section 300 (b)²⁰ of the Companies Act, 61 of 1973.

3.1.4. Duty to obtain all relevant information.

In terms of the Auditing Profession Act an auditor must obtain all information, vouchers and other documents which in his opinion are necessary for the proper performance of his audit.²¹ This means that an audit is not confined to annual financial statements only. Other information which in particular instances is in the auditor's opinion necessary must be obtained. Since this provision cannot prescribe which information is relevant due to the fact it is a matter that cannot be legislated, an auditor must use reasonable skill and professional judgment to determine the relevant information that he needs to acquire for the proper performance of his audit.

3.2. Duty to Report all Reportable Irregularities.

In terms of section 45 (1) (a) of the Act, any auditor of an entity who is satisfied or has reason to believe that a reportable irregularity has occurred or is occurring in that entity must, without delay send a written report to the Regulatory Board. The report must furnish the Board with particulars of the irregularity in question and must be

¹⁹ Section 44 (3) (c).

²⁰ See paragraph 4 below.

²¹ Section 44 (3) (d).

accompanied by any other information the auditor may consider appropriate.²² The definition in section 1 of the Act states the characteristics of an irregularity.

In terms of section 1 of the Act an irregularity is “any unlawful act or omission committed by any person responsible for the management of an entity, which

- a. has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, investor or creditor of the entity in respect of his or her dealings with the entity, or²³
- b. is fraudulent or amounts to theft,²⁴ or
- c. represents a material breach of any fiduciary duty owed by such person to the entity or to any partner, member, shareholder, investor or creditor of the entity under any law applying to the entity or the conduct of management thereof.”²⁵

This represents a significant change from what was known as a ‘material irregularity’ in accordance with s 20 (5) of the repealed Public Accountants and Auditors Act, 80 of 1991. Firstly it has to be an unlawful act or omission. Secondly it has to be perpetrated

²² Section 45 (1) (b).

²³ This means that the auditor has to assess (the likelihood of) the damage being material to the persons mentioned

²⁴ A reportable irregularity may also entail fraud and theft. Because the reference to (the likelihood of) material financial loss is not repeated under (b) the intention is obviously to bring all instances of fraud and theft within the ambit of section 45 (1) (a). What appears to be odd, however, is that (b) is also linked to the preamble of the definition namely the reference to an unlawful act or omission committed by a person responsible for the management. Theft or fraud is unlawful *per se* and might well have been committed by others not in the management structures.

²⁵ Here the auditor has to assess whether the breach of fiduciary duty can be regarded as material. The following query suffices. What is a material breach? A serious breach in the sense that it is grossly reprehensible irrespective of the (material) financial loss for instance where it brings irreparable loss of confidence or breach of amicable relations or is *ejusdem generis* with financial loss. Others who are not part of management may also owe and breach fiduciary duties.

by management. In addition to these, it has to be material. An auditor is required to assess the materiality of any likely financial loss and any breach of fiduciary duties.²⁶ Irregularities that may cause or have caused financial loss or that amount to breaches of fiduciary duties are only reported if they are regarded as material. If the irregularity amounts to fraud or theft then it has to be reported even if no financial loss was or could have been suffered by any party. Materiality is not considered. A material breach of a fiduciary duty has to be reported even if no financial loss has occurred or is likely to occur.

It is essential to note that an auditor is required to report an irregularity only if he is “satisfied or has reason to believe” that such irregularity has occurred or is occurring. The satisfaction that a reportable irregularity is taking place, has taken place or is probably taking place may come from normal auditing procedures.²⁷ By its own nature fraud constitutes a reportable irregularity. The fact that fraud is one of the most serious of all reportable irregularities does not however sway the requirements in favour of a more investigative approach in relation to instances of fraud. The auditor must still only report fraud if he is satisfied that it took place, is taking place or has reason to believe that it is taking place. It therefore does *not mean* that he has to *detect* reportable irregularities. He is required to (constantly) have regard to the possibility of their existence

What happens after the initial reporting of the irregularity is important. An auditor’s duty is not limited to the reporting of irregularities to the Regulatory Board. He must within 30 days after reporting discuss the irregularity with the management board and afford them an opportunity to explain. Thereafter he must send another report to the Regulatory

²⁶ The requirement of materiality has undergone a very significant change from the time of the PAAA. In terms of the PAAA, an auditor was required to assess the amount of the potential financial loss connected with the irregularity and the materiality of the irregularity itself.

²⁷ There is however nothing precluding an auditor from probing deeper into suspicious matters or auditing with an open and enquiring mind, or like a “bloodhound.” It is just that he is not required by law to do so and will by so doing make his own work more onerous and consequently more costly.

Board in terms of section 45 (3)(a), (b) and (c).²⁸ These requirements serve as further guidelines as to the standard of diligence expected from auditors faced with a situation of irregularities. In consultations with the management an auditor must exercise reasonable care because he may well be misled.

3.2.1. How does an auditor determine that an irregularity exists?

Section 45 (5) of the Act states that an auditor must carry out the necessary investigations before determining whether an irregularity exists or may exist and in the course of such an investigation he must consider information from any source.²⁹ This provision is similar to the one contained in section 25 (a) of the PAAA and it is commendable that the legislature in repealing the PAAA did not do away with some of its important provisions. Section 45 (5) of the APA requires an auditor to carry out an investigation into the existence of a reportable irregularity by using any method which he considers to be appropriate. There is no guidance on what an appropriate investigation entails because no prescribed procedure can fit all circumstances. The auditor will have to exercise reasonable care, skill and professional judgment.

This provision can be complemented by common law and international auditing standards. In Chapter 3 it was stated that an auditor must be cognizant of the possibility of fraud. This requirement was highlighted, *inter alia*, in the judgment in *Dairy*

²⁸ In this second report the auditor must verify his initial report stating whether the irregularity actually took place or is taking place is no longer taking place and corrective measures have been taken or report that the irregularity is continuing

²⁹ Section 45 (5) of the APA requires an auditor to carry out an investigation into the existence of a reportable irregularity thus stating rather belatedly in the Act that one of the duties of the auditor is to investigate for the existence of reportable irregularities. It appears that in South African statutory law the primary duty of an auditor is to audit and obtain a reasonable assurance that the financial statements reflect fairly on the financial position of the company and the results of its operations. The duty to investigate into the existence of reportable irregularities can be regarded as the secondary duty.

Containers v NZI Bank,³⁰ where it was stated that an auditor who has come across anything suspicious must probe it to the bottom. This indicates that statutory law is in this regard actually complemented by common law. Auditors have to conduct a *reasonable inquiry* into the existence of fraud and other irregularities.

3.3. Auditor's Liability under the Auditing Profession Act.

Section 46 of the Auditing Profession Act deals with an auditor's liability to clients or third parties. In terms of this section an auditor incurs liability to a third party or client if in the course of his duties he maliciously or fraudulently expresses an opinion, issues a statement or reports after a negligent performance of his duties with the result that a third party or client suffers financial losses. The section states further that it must be proved that an auditor issued the report, opinion or statement pursuant to a negligent performance of his duties. This means that negligence on the part of an auditor must be proved before there can be a question of liability.

The question arises whether liability under the Auditing Profession Act is substantially different from *aquilian* liability. As can be seen the conduct element is covered because, by reporting or issuing a statement, an auditor acts. Fault is covered by the requirement that an auditor must have acted negligently or maliciously. Causation is covered by the fact that clients or third parties must have suffered loss as a result of their reliance on a flawed auditor's report, opinion or statement. Damage is established by the requirement that clients or third parties must have incurred financial loss. The element of wrongfulness is however not covered. This element could have been included if section 46 of the Auditing Profession Act had, in addition to excluding auditor liability in the absence of negligence, also excluded liability provided the auditor had complied with

³⁰ *Supra* note 11. Other cases which required auditors to probe to the bottom all suspicious circumstances are *In re Kingston Cotton Mill Co (No 2)* [1896] 2 Ch 279, *Pacific Acceptance Corporation Ltd v Forsyth* *supra* note 11 and *Thoroughbred Breeders Association of South Africa v Price Waterhouse* *supra* note 11.

international auditing standards and statutes. The same could also have been achieved if the Act required auditors perform their duties in line with the demands of public policy.

However, one can state that the Act succeeds in doing what it was intended to do, namely limitation of auditor liability. This is so because sections 46 (a) and (b) basically state that an auditor must have known at the time of his negligent audit or report, statement and opinion that a particular client or third party would act upon it. This requirement limits the liability of an auditor to third parties. It is however submitted that the Act could have done more, by excluding liability on the grounds that an auditor did not act wrongfully.

4. COMPANIES ACT, 61 of 1973.³¹

4.1. The Responsibility for Financial Reporting that Fairly Represents the Financial Position and Results of a Company.

Section 300 of the Companies Act 61 of 1973 contains a list of duties an auditor has to perform. These duties relate to standards of care and are obviously not exhaustive or intended to be such. In terms of this Act an auditor's primary duty is to audit and examine a company's annual financial statements and where necessary group annual financial statements which are placed before the annual general meeting.³² How carefully this audit is to be conducted is a matter that will be discussed shortly.

It is important at this stage to note that the Companies Act lays the *responsibility for preparing* annual financial statements on *the directors* of a company.³³ This Act does that by also making it an offence for every director or officer of a company to make, circulate publish or concur in making, circulating or publishing any certificate, written statement, report or financial statement in relation to any property or affairs of the

³¹ As amended by the Corporate Laws Amendment Act 24 of 2006.

³² Section 300 (a).

³³ Section 285A.

company which is false in any material respect.³⁴ In our law, unlike in English law, an auditor is not an officer of the company so this section does not apply to auditors.³⁵ This provision is in addition to the one in section 250 which provides that it is illegal for any director or other officer of a company or any other person, auditors therefore included, to conceal, destroy, mutilate, falsify or make a false entry in any book, register, document, financial record or financial statement of any company with the intention to defraud or deceive. The provision also makes it illegal for any person to effect any erasure in any book (this includes minute books) irrespective of whether it is or has been kept in electronic format. Section 249 makes it a punishable offence for anyone to deliberately make a materially false statement in the financial statements.

Section 96 (1) of the 2007 Draft Companies Amendment Bill states that a company must keep *accurate* accounting records which are necessary to present fairly the state of affairs and business of the company³⁶ and show its assets, liabilities and equity, as well as its income and expenses and any other required information.³⁷ This requirement will obviously apply to a company's management and directors and this again shows further where the responsibility for fair financial reporting lies. To strengthen this requirement section 96 (4) of the Draft Bill states that the accounting records and the financial statements must not be incomplete or false and misleading in any material way. Section 96 (5) imposes criminal liability on the director(s) of a company which does not comply with section 96 (4) and on any person who was party to the preparation, approval, publication or issue of the accounting records and financial statements if he knew or

³⁴ Section 251.

³⁵ This principle was enunciated in the case *Lipchitz v Wolpert and Abrahams* 1977 (2) SA 732 (A).

³⁶ Section 96 (1) (b).

³⁷ Section 96 (1) (c). This provision will not, if enacted, constitute a significant departure from section 284 of the Companies Act. Section 96 (1) of the Draft Bill states that accounting records must be accurate while section 284 (1) states that accounting records must fairly present the status of a company and its business. If anything, section 96 is a little clearer than section 284.

ought reasonably to have suspected, that the statement contained false or misleading material.³⁸

4.1.1. The U.K. Companies Act (c 46) 2006.³⁹

a. Director's duties in relation to fraud and corporate financial reporting.

In the U.K. directors are responsible for the drafting of financial statements that truly and fairly reflect an entity's financial position and performance. Section 393 (1) of the Companies Act (c 46)⁴⁰ states that the directors of a company must not approve accounts unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, in the case of individual accounts.⁴¹ In the case of group accounts directors must be satisfied that the financial reports present a true and fair view in so far as it concerns members of the company.⁴² This provision

³⁸ Section 96 (5) (a). The existing section 284 (4) of the Companies Act also criminalises the publication of non-compliant accounting records by directors and other specified officers, though the Draft Bill has a wider net which may cover auditors as well.

³⁹ This Act is available on line on www.opsi.gov.uk/acts2006.

⁴⁰ Hereinafter the U.K. Act.

⁴¹ The inclusion of assets and liabilities, profit or loss is laudable because fraud often takes the form of an understatement or overstatement of these items. In the case of *Axiam Holdings Ltd v Deloitte and Touche* 2006 (1) SA 237 (SCA) it was shown that the financial statements presented TBB's actual net loss of R77 899 201 as a net profit before tax of R299 261 176. A sum of R10 300 000 whose origins were unknown was inserted as a profit. A provision like this section might assist in combatting such anomalies.

⁴² As has been seen section 285A of the South African Companies Act states that a widely held company must prepare financial statements that fairly present the financial position and profitability of a company. Since financial statements are required, in terms of section 284 (2) of the Companies Act, to include *inter alia* a balance sheet (which shows a company's assets and liabilities and financial position) and an income statement, (which shows profit or loss) one can see that South African law is in line with the most recent of developments in leading jurisdictions because in South African and U.K. law, assets and liabilities and profitability of an entity must be truthfully stated. The one area where the South African Companies Act lags behind is the requirement that directors must approve financial statements. Section 285A is obviously intended to apply to directors but the fact that they are not required to approve the

means that directors in the U.K. have a duty to verify the truthfulness and fairness of financial statements before they may approve them. This function is similar to the audit function in that the director here essentially attests to the truthfulness and fairness of financial statements.

Section 393 (2) of the U.K. Act states that an auditor performing his audit must have regard to the director's duty under section 393 (1). This provision gives auditors the benefit of relying on the assurances given in a directors' approval of the financial statements. Does it mean that auditors may argue that they assumed that the directors were accurate and honest in their approval of the financial statements if they rely on directors' approval and neglect to perform the audit as thoroughly as can reasonably be expected? Reasonable care and skill requires auditors not to simply assume that management is honest as much as they must not assume that it is dishonest.⁴³ As such, auditors who exercise reasonable care and skill should not interpret this provision too liberally because external auditors perform an independent inquiry and directors' approvals will never attain the same level of independence.⁴⁴

Section 396 (1) of the U.K Act defines individual accounts as accounts which comprise a balance sheet as at the last day of the financial year and a profit and loss account.⁴⁵ The balance sheet is required by section 396 (2) (a) to give a true and fair view of the state of affairs of the company as at the end of the financial year and the profit and loss account is required by section 396 (2) (b) to give a true and fair view of the profit and loss of a company for the financial year. The U.K. Act has specific requirements for each component of the financial statements and it requires directors to ensure that each

financial statements is in contrast with the requirements of section 393 (1) of the UK. Companies Act (c 46). This might be about to change because section 98 (3) of the Draft Bill in South Africa requires financial statements to be approved by the board and signed by a director. This provision is in line with international trends.

⁴³ Also known as professional scepticism, as formulated in SAAS 240R, which is based entirely on ISA 240 which applies in the UK.

⁴⁴ See generally Chapter 4 paragraph 5.3.

⁴⁵ Section 396 (1) (a) and (b).

financial statement provides a true and fair view of whatever aspect of the company it is supposed to reflect.

b. The director's report.⁴⁶

The U.K. Act contains some useful advances on how the director's report must be drafted. Section 418 of the U.K. Act deals with the contents of a director's report with specific reference to disclosure to auditors.⁴⁷ This section is aimed at ensuring that directors disclose relevant information to auditors. Section 418 (2) states that a directors' report must contain a statement which states that the directors are satisfied that the auditor has received all the relevant information. The reporting director must take the necessary steps to make himself aware of any relevant audit information and ensure that the auditor is aware of that information.⁴⁸ Section 418 (5) prohibits directors from certifying in their reports that they have availed the relevant audit information to the auditor when in actual fact they have not. These provisions in relation to the directors' report further provides that directors in the U.K. may not withhold relevant information until the auditor asks for such information. A director must provide the auditor with all information which is relevant to the audit whether such information has been requested by the auditor or not.

A provision like section 418 (2) is not replicated in South African law. Section 299 of the South African Act only requires a director to deal with the state of affairs of the company and its business or profit and loss. The scope of the directors' report in terms of South African law *should* include a report on the disclosure to auditors because it enhances the directors' responsibilities in relation to fair financial reporting.

⁴⁶ A director of a company is required to report on the financial statements by section 415 (1)

⁴⁷ Paragraph 17 and 18 SAAS 240R and ISA 240 both state that fraud may be difficult to detect if directors willfully withhold information and lists this as one of the limitations of an audit.

⁴⁸ Section 418 (3) defines relevant audit information as the information needed by the auditor in connection with preparing his report

It can therefore be concluded that it is the responsibility of directors and other officers locally in South Africa and in the U.K. to prepare accurate financial statements. It is against this background that this research in the final Chapter will recommend the use of these two provisions to nab errant company directors and officers.

4.2. Duties of the Auditor under the Companies Act, 61 of 1973.

4.2.1. Duty to ensure that accounting records have been kept.

In terms of the Companies Act an auditor must satisfy himself that proper accounting records have been kept by the company and that proper returns for his audit have been obtained from all the branches he has not visited.⁴⁹ A reasonably careful and skilled auditor must then “satisfy himself that the company’s annual financial statements are in agreement with its accounting records and returns”.⁵⁰ It will amount to negligence on the part of an auditor to ignore the accounting records because they have a bearing on the fairness of the financial statements. The same is true where an auditor merely satisfies himself of the existence of these records without verifying that they are in agreement with the financial statements. This Act further requires an auditor to examine the accounting records and carry out all tests and auditing procedures he considers necessary in respect of such records in order to satisfy himself that the financial statements in question fairly present the financial position of the company (and where applicable, its subsidiaries) in

⁴⁹ Section 300 (1) (b). Section 284 of this Act requires every company to keep in one of the official languages all accounting records that are necessary for a fair presentation of the company’s state of affairs and business. Such records include those that show the assets and liabilities of the company, a register of fixed assets, day to day entries showing sufficient details of all cash received and paid out, and goods sold and purchased together with sufficient details of the purchasers and sellers thereof. Section 498 (1) (a) of the UK Act also states that an auditor must ensure that a company has kept accounting records sufficient for accounting purposes and that returns sufficient for his audit have been obtained from the branches he has not visited.

⁵⁰ Section 300 (1) (g). Section 498 (1) (b) of the UK Act also requires an auditor to ensure that a company’s individual accounts are in line with its accounting records and returns.

accordance with generally accepted accounting practice. He may only after having done so certify that the annual financial statements comply with these requirements.

4.2.2. To obtain all the relevant information and explanations.⁵¹

An auditor must obtain all the information and explanations which to the best of his knowledge and belief are crucial for the audit.⁵² This means that it is not sufficient for an auditor to examine the financial statements only.⁵³ He must take steps to obtain more information by interviewing key individuals and seeking clarity on matters of interest.

4.2.3. To examine the directors' report.

An auditor must also satisfy himself that the statements made by the directors in their report accompanying the financial statements are consistent with a fair interpretation of the company's performance and does not distort the meaning of the financial statements.⁵⁴ Directors play a major role in the drawing of financial statements and it is always probable that they are parties to a fraud scheme. As such they may want to reflect their financial statements in a favourable light at the expense of users and potential users. They may do this by writing a biased and misleading report or a report that underplays the presence or possibility of fraud in the financial statements. Reasonable care and skill requires auditors to extend their examination to the director's report.

⁵¹ In *Cuff v London and County Land and Building Co* [1912] 1 Ch 440 444 it was stated that the vast array of documentary evidence to be considered by the auditor was described as the "area which covers accounts, vouchers, invoices and documents constituting the materials out of which entries in the book originate." An auditor is obliged to obtain all relevant information and documents because according to Benade *et al Entrepreneurial Law* 3rd ed 230, due professional care also requires the auditor to base his opinion regarding financial statements on sufficient and acceptable evidence which he obtains through inspection, observation, inquiry and confirmation.

⁵² Section 300 (1) (f). This requirement is closely related to the one in the Auditing Profession Act 26 of 2005 section 44 (3) (d) and in section 102 (2) (e) of the Companies Bill.

⁵³ In terms of section 300 (1) (h).

⁵⁴ Section 300 (j).

Section 496 of the U.K. Companies Act (c 46) of 2006 requires an auditor to report on the director's report. This appears to be an additional report over and above the one on the truthfulness and fairness of the financial statements. In this report the auditor must state whether in his opinion the information provided in the directors' report for the applicable financial year is consistent with the accounts.⁵⁵

4.2.4. To report company closure.

Auditors are required by the Companies Act to report to the Registrar if they get to know or have reason to believe that the company is not carrying on business or is not in operation or has no plans of resuming business in the foreseeable future.⁵⁶ In cases of corporate failure auditors are also required to comply with this requirement. It is important to note that auditors must only report if they *get to know or have reason to believe*, that a company is not operating or will not operate in the foreseeable future. If there is no reason to believe or no knowledge whatsoever an auditor is not required to report on this matter.

4.2.5. To report on the fairness of the financial statements.

The auditor fulfils his primary function to audit by issuing a report in which he attests to the fairness of the financial statements. In terms of section 301 (1) an auditor may after complying with the provisions of section 300 and after conducting his audit free from any restrictions, report to the shareholders of a company and certify that in his opinion the financial statements reflect fairly the financial position of the company as at the end of the financial year and the results of its operations during the reporting period. An analysis of this section shows that an auditor must first comply with the standards set in

⁵⁵ It is interesting to note the drafters of our Companies Act only required the auditor to examine the directors' report and what happens after the examination is not specified. The Legislature may have intended to require the auditor to include the results of such examination in his main report otherwise the examination would be meaningless.

⁵⁶ Section 300 (j A).

section 300 of the Act before he may issue such a report. It will in other words amount to gross negligence on part of an auditor to issue a report without following the set standards of care.

The U.K. Companies Act also deals with the auditor's report in section 495. This section is a little more comprehensive because it requires auditors to identify in their report the annual accounts that are the subject of the audit and the financial reporting framework that was applied in their preparation, and also to describe the scope of the audit and the auditing standards which governed the audit.⁵⁷ Section 495 (3) states that the report must state further whether in the auditor's opinion the annual accounts give a true and fair view, in the case of an individual balance sheet, of the state of affairs of the company and in the case of an individual profit and loss account, of the profit and loss of the company for the financial year. The report must also state whether the financial reports have been properly prepared in accordance with the relevant financial reporting framework and have been prepared in accordance with the Companies Act of 2006 (c 46). This shows that reasonable skill for U.K. auditors entails knowledge of the law relating to financial reporting and indepth knowledge of different financial reporting frameworks.

4.2.6. Auditor independence.

The Companies Act in line with international trends contains provisions aimed at promoting auditor independence. The importance of the concept of auditor independence to the auditor's duty of reasonable care is beyond doubt. This is so because if auditors are allowed to have a cosy relationship with their clients relaxation or complacency may set in and affect the auditor's professionalism. Section 274A (1) calls for the rotation of auditors of a widely held company who have served for a period of five years. Subsection (2) states that an auditor who has served for two or more consecutive financial years before ceasing to be auditor may not be appointed again until a period of at least 2 financial years has lapsed. This section imposes a duty on companies to play their part in maintaining auditor independence.

⁵⁷ Section 498 (2) (a) and (b).

Section 275A also deals with the very critical issue affecting auditor independence in so far as it pertains to non-audit services. Subsection (1) states that auditors may not perform non-audit services that are prohibited by the code of professional conduct mentioned in section 21 (2) (a) of the Audit Profession Act, 26 of 2005.⁵⁸ Subsection (2) prohibits the performance of non-audit services that will be audited by the auditor himself when he performs his audit. This provision may be construed as outlawing certain non-audit services like bookkeeping and internal audit because these items are audited and if the auditor performs these services he essentially marks his own homework.⁵⁹

⁵⁸ The APA in section 21 only provides for the formation, composition and mandate of the committee for auditor ethics that sets the code of ethics. It does not disclose the non-audit services to be outlawed.

⁵⁹ The Companies Act, 61 of 1973 and the Auditing Profession Act, 26 of 2005 seem to devote little attention to the issue of auditor independence with the result that, as shall be seen in the ensuing Chapters, the provisions are not comprehensive and clear compared to similar legislation in other jurisdictions. The King II Report on Corporate Governance supplements the two Acts but falls short of establishing clear standards of auditor independence itself. In Section 3 chapter 1 paragraph 8 the Report seems to be laying the responsibility of determining factors that affect auditor independence on the board and the audit committee. According to the Report, the board should consider the structure and ownership of an accounting firm and whether the accounting firm has formed alliances with entities that provide the kind of services to the company that the accounting firm itself cannot provide. Paragraph 9 states that the audit committee must possess the business acumen required to address the external auditor independence issues on a case by case basis. As can be seen, there is no clear guideline on the non-audit services that may not be performed. The current scenario breeds inconsistency because different boards and audit committees may decide differently on issues of auditor independence.

4.3 Role of the Audit Committee.⁶⁰

The Companies Act now provides that it is compulsory for all public interest companies in every financial year to establish an audit committee. This committee must have at least two members who are independent non-executive directors of the company.⁶¹ The concept of independence is central to the audit committee. Thus in terms of section 269 (4) (c) of the Act, a director is independent if he expresses opinions and judgments impartially and is not related to the company or any shareholder of the company or director of the company⁶² or a material supplier or customer of the company.⁶³ The audit committee has many duties⁶⁴ but the most important ones for this discussion are the duty to nominate for appointment, auditors who are in its opinion independent⁶⁵ and the duty to insert into the financial statements a report describing how it performed its functions and stating its satisfaction or dissatisfaction with the auditor's independence in relation to the company.⁶⁶

The establishment of the audit committee is meant to give an air of respectability and independence to a company's system of financial control. In the event of corporate fraud that causes financial loss to other parties, can the audit committee be found to have been negligent? That would be the logical conclusion if the committee fails to appoint auditors who in its opinion are independent, where reasonable persons in the position of the

⁶⁰ In the USA the Sarbanes Oxley Act in section 302 (2) and (3) requires issuers (public companies) to have an audit committee whose duties entail the appointment, remuneration and oversight of external auditors for the issuer. As in South Africa, the audit committee must be made up of at least two directors who are independent.

⁶¹ In terms of section 269 (4) (a) and (b) of the Act such directors must not be involved in the day to day management of the entity, or a full time remunerated employee of the company, and not related to any remunerated employee or anyone who runs the entity on a day to day basis.

⁶² Section 269 (4) (c) (i).

⁶³ Section 269 (4) (c) (ii).

⁶⁴ Set out in section 270 A (1) (a)-(h).

⁶⁵ Section 270A (1) (a).

⁶⁶ Section 270 A (1) (f).

members of the committee would have acted differently. It is important to make other role players in the financial reporting chain accountable where they are found to have been negligent rather than focus on the external auditors.

5. AUDITING STANDARDS.

Auditing standards show the level of performance that must be standard to satisfy the professional requirements of audit work. No auditing standard may be in direct conflict with the law and they also enjoy its support.⁶⁷

5.1. South African Auditing Standards.⁶⁸

Statements of SAAS are to be applied in the audit of financial statements. They contain the basic principles and essential procedures together with explanatory material. Only in exceptional circumstances may an auditor depart from the dictates of a statement of SAAS. The purpose of such a departure must then be to achieve the objectives of the audit more effectively. An auditor should be prepared to justify the departure. Statements of SAAS need only be applied to material matters. In terms of section 44 (3)

⁶⁷ Berryman RG “Auditing Standards and the Law” (1960) 35 (1) *The Accounting Review* 70, stated back in 1960 that standards which are more specific, like the ones to be discussed below, were needed to satisfy professional and legal needs. He states that auditors who fail to adhere to standards display evidence of lack of due care and can be sued for breach of contract or negligence. Cilliers *et al Corporate Law* 3rd ed 413 are of the opinion that the determination of the question whether the auditor acted with the required reasonable care and skill when he performed his audit should be done by reference to generally accepted auditing standards. The case *Pacific Acceptance Corporation Ltd v Forsyth supra* note 11 73-74 discussed in Chapter Three above partially accepted the use of generally accepted auditing standards while *Thoroughbred Breeders Association v Pricewaterhouse supra* note 11 fully accepted the utility of these standards in determining auditor negligence.

⁶⁸ Commonly referred to as SAAS or statements of international auditing standards. These statements have legal backing. In terms of section 1 of the Auditing Profession Act, SAAS are part of the “auditing pronouncements” prescribed by the Regulatory Board with which every registered auditor or accountant must comply in the performance of his audits. For a list of SAAS issued so far see www.paab.co.za/content.asp?page=10 Accessed 03.04.2007.

(b) of the Auditing Profession Act, auditors must comply with the official pronouncements regarding the conduct of the audit. This provision no doubt gives some legal backing to auditing standards that the profession sets for itself.

5.1.1. SAAS 240 (REVISED): “The Auditors Responsibility to Consider Fraud and Error in an Audit of Financial Statements.”

This statement was issued in May 2004 and its purpose is to define standards and guidelines on the auditor’s responsibility to consider fraud and error in the auditing of financial statements. A number of auditing standards have been passed with a view to setting directives an auditor must follow when he conducts an audit. The vast majority of all these standards discuss matters that are beyond the scope of this study. SAAS 240R which deals with the auditor’s responsibility to consider fraud however falls directly within the scope of this research and will be analyzed extensively.

SAAS 240R contains the original wording of the International Standard of Auditing (ISA) 240 (Revised) that was issued by the International Auditing and Standards Assurance Board (IAASB). Its main purpose is to provide guidelines and essential procedures to be followed when an auditor considers fraud in the auditing of company’s financial statements. Broadly speaking the standard requires an auditor to maintain an attitude of professional scepticism, discuss the susceptibility of an entity or business to material misstatements due to fraud and to utilize procedures that may be useful in identifying the risks of material misstatements due to fraud.

Specific Guidelines.

a. Fraud and error.

SAAS 240R distinguishes between fraud and error.⁶⁹ The primary factor in the distinction is the element of intention. An error is correctly defined as an unintentional misstatement

⁶⁹ Paragraph (4) and (5).

in the financial statements.⁷⁰ Fraud is defined as a deliberate or intentional act by an individual or individuals in the management or by those tasked with the governance of an entity, employees or third parties that incorporates the use of deception to obtain an undeserved advantage. An auditor is concerned or should be concerned with fraudulent or incorrect reporting that culminates in material misstatement in the financial statements. In other words an auditor focuses only on reporting those flaws that affect the financial statements substantially.

Fraudulent financial reporting involving deliberate misstatements and omissions of figures is in many instances aimed at leading financial statement users into thinking positively about an entity's profitability and prospects. It can take the form of manipulation or changing of accounting records or related documents, misrepresentation or intentional omission of relevant information from the financial statements. In the majority of cases fraudulent financial reporting involves instances of management overriding the controls that were put in place by using a range of techniques. Such techniques include the recording of non-existent journal entries, the holding or speeding of the recognition of transactions that took place during the financial reporting period and the utilization of complex procedures bent on misrepresenting the financial position and performance of the entity. The identification of common fraudulent reporting styles in SAAS 240R is important. Auditors need to be aware of them and be on the lookout.

b. Duties of company management and those tasked with its governance.

SAAS 240R places the responsibility for fraud detection and prevention on those tasked with governance and with management.⁷¹ Management and those who govern must strongly emphasize fraud prevention and deterrence by establishing a culture of honesty and ethical behavior. They should also employ the right personnel and take appropriate

⁷⁰ As has been stated, this research is not concerned with immaterial errors that may have no bearing on the financial statements.

⁷¹ Paragraph 13.

action when fraud actually occurs.⁷² Those who govern an entity must take steps to ensure that the entity establishes and maintains a system of internal control. A system of internal control may go a long way in ensuring the reliability of financial statements.⁷³ In executing their responsibility to oversee management actions, directors should reflect on the management's potential to override controls or other undesirable influences over the financial reporting process.⁷⁴

In this section it is obvious that the management and the directorate of a company hold the *primary responsibility* to detect fraud. Auditors however still need to exercise reasonable care and skill and in cases where auditors were negligent and are sued by third parties it is not a defence to state that the management or directors were negligent and should have detected the fraud themselves because they (management and directors) may be the perpetrators.⁷⁵

c. Limitations of an audit.

The limitations of an audit are such that there is an inherent and non derogable risk that some material misstatements causing harm to third parties or the company itself will be present in the financial statements and may not be detected, regardless of the fact that the

⁷² Paragraph 14.

⁷³ Paragraph 15.

⁷⁴ Section 285A of the Companies Act provides for financial reporting standards which a company must adhere to. Company directors must cause the financial statements to reflect fairly the financial position and results of the company. This provision read with sections 249, 250 and 251 of the Companies Act shows that the responsibility for fair financial statements is with the directors.

⁷⁵ In *Pacific Acceptance Corporation Ltd v Forsyth supra* note 11 it was stated that an auditor must obtain sufficient, relevant and reliable evidence to substantiate his opinion on matters. It is not sufficient to rely purely on management. In *International Laboratories Ltd v Dewar* 1933 DLR 665 682 the court held that "auditors should not be liable for not tracking down ingenious and carefully laid schemes of fraud where there is nothing to arouse their suspicion. The court nevertheless warned that "the greater the number of undiscovered frauds or misappropriations the more difficult it will be for auditors to resist a finding of negligence in failing to discover them.

audit was conducted with due care and in conformity with auditing standards.⁷⁶ In other words performing an audit in adherence to auditing standards does *not guarantee* that fraud and error will be detected, although it is evidence of due care and skill. This is so because material misstatements that result from fraud may entail complex and expertly planned schemes aimed at veiling it. Such schemes may have been crafted by accountants themselves. An auditor's detection of fraud does not necessarily depend on his knowledge and experience. It often depends substantially on independent external factors such as the skillfulness or craftsmanship of the perpetrator, the frequency of the manipulation⁷⁷ and the standing of the persons involved.⁷⁸

Where management has perpetrated the fraud the odds of detecting it degenerate because management is well placed to directly or indirectly manipulate accounting records and publish materially misstated financial statements. There are levels of management that can override control procedures aimed at fraud prevention by ordering subordinates to record information incorrectly.⁷⁹

It is because of these limitations that in the event of subsequent discovery of material misstatements the auditor should not be blamed with the benefit of hindsight without taking into account that this is not necessarily indicative of the auditor's failure to exercise due care and skill. In cases of deliberate misstatements, collusion between individuals in management and flawed documents, audit procedures may often be useless.⁸⁰

⁷⁶ Paragraph 17. This statement clearly supports the conclusion in Chapter Two that the presence of fraud does not necessarily constitute evidence of auditor negligence.

⁷⁷ See *International Laboratories Ltd v Dewar supra* note 75 682. The approach in this case seems to be that the auditor who is reasonably competent and careful must be able to detect manipulations in financial statements if such manipulations are present in substantial quantities.

⁷⁸ Paragraph 18.

⁷⁹ Paragraph 19.

⁸⁰ Paragraph 20.

In deciding whether an auditor was negligent in failing to detect a material misstatement due to fraud the courts have to consider these limitations. A reasonably competent and careful auditor may fail to detect fraud in the cases mentioned above and it is a defence to show that the fraud scheme was so carefully laid down that it is undetectable by the reasonable auditor. That is why Cilliers *et al* argue that the auditor's duty should not be judged with the benefit of hindsight or matters exposed after the fact. The urge to find a scapegoat who can pay is also a tendency that should be discouraged rigorously.⁸¹

d. Responsibility of the auditor to detect material misstatements due to fraud.

SAAS 240R does not state that auditors do not have to detect fraud in all instances. It merely states that auditors who adhere to auditing standards issue a reasonable assurance that the financial statements reflect fairly on the company's financial position and performance. There is no guarantee that material misstatements will be uncovered. In *Tonkwane Sawmill Co Ltd v Filmalter*⁸² Boshoff J stated that in auditing, no assurances are given or to be inferred that an audit will necessarily unveil material misstatements due to fraud.

e. Professional Scepticism.

As required by ISA 200 an auditor is expected to maintain an attitude of professional scepticism in auditing financial statements. Professional scepticism entails a questioning approach to auditing and a determination of whether the information and audit evidence points to the probability of a material misstatement existing in the financial statements.⁸³

⁸¹ *Op cit* note 67 415.

⁸² 1975 (2) SA 453 (W).

⁸³ In *In re Kingston Cotton Mill (No2) supra* note 11 it was stated that an auditor cannot approach his work with a foregone conclusion or suspicion that fraud exists or that there is something wrong. This approach is no longer favoured or applicable in the twenty first century. According to the principle of professional scepticism, an auditor must conduct his work with a questioning mind recognizing the possibility that a material misstatement due to fraud may exist. This case however also formulated principles that remain applicable today.

Professional scepticism requires an auditor not to rely too much on previous experiences with the members of an entity because circumstances may change. It is on the other hand impossible for auditors to disregard past experiences completely but auditors exercising professional scepticism must not be content with unsatisfactory audit evidence, simply because the entity's members were honest and scrupulous in the past.⁸⁴ It would in any case be shocking if an auditor is allowed to rely on a defence to the effect that the directors and the management in the past had acted in an honest and ethical manner. The latest amendments to the Companies Act place emphasis on auditor rotation and independence to avoid situations where an auditor becomes too closely connected to an entity and those involved in its business or management in a way that is likely to cloud his judgment and affect his professional scepticism.⁸⁵ Auditor rotation will ensure that auditors with fresh minds and no knowledge of the client's history will perform further audits without taking unnecessary consideration of the client's historical adherence to ethics and honesty.

f. Authentication of documents.

An auditor is not required to authenticate documents in the normal course of his audit. He is not trained in this particular field and it is abnormal to expect him to undertake these duties. As such it is reasonable for an auditor in the absence of anything which suggests the contrary to accept documents and records as genuine. However in the event of him encountering anything that excites his suspicion he must undertake further investigations by engaging the services of an expert to scrutinize the document's authenticity.⁸⁶ This is in line with the principle that an auditor who finds anything suspicious must probe it to the bottom set in *Dairy containers Ltd v NZI Bank*⁸⁷

⁸⁴ Paragraph 25.

⁸⁵ Sections 274A and 275A deal with the issue of auditor independence.

⁸⁶ Paragraph 26.

⁸⁷ *Supra* note 11. In *In re Kingston Cotton Mill Co (No 2)* *supra* note 11 Lopes J also stated that an auditor must probe to the bottom anything he finds to be suspicious. It is plausible to state that in probing suspicious matters thoroughly an auditor may engage the services of an expert whenever it is required.

g. The audit team.

Prior to and during an audit the members of the engagement team must discuss the likelihood of the financial statements to be materially misstated due to fraud.⁸⁸ The discussion must take place with a critical mind disregarding any trust in the integrity and honesty of the management or the directors.⁸⁹ This discussion generally entails;

1. Consideration of the means and areas they believe the entity's financial statements may be exposed to fraud and how management could commit fraud.
2. Identification of particular external and internal circumstances with a bearing on the entity that may encourage management or any other person to perpetrate fraud.
3. Analysis of noticeable or abrupt behavior changes of management.
4. Consideration of the potential of management to override the system of internal control.
5. Emphasize the importance of auditing with an open mind in relation to material misstatements due to fraud.
6. Exchange of ideas on the auditing procedures that may be relevant in responding to the likelihood of fraud in the entity's financial statements.

These discussions are meant to analyze the susceptibility of an entity to fraud and provide further guidelines on how to properly audit a particular entity according to its unique profile.

⁸⁸ Paragraph 27.

⁸⁹ Paragraph 30.

h. Inquiries with management.

To obtain the management's own assessment of the risk of fraud in the financial statements, inquiries with management are critical since management is in most cases responsible for the entity's system of internal control and drafting the financial statements. Due care and practical common sense requires an auditor not to rely only on the submissions provided by management because management itself may be responsible for the fraud in question and would certainly not disclose anything about that to the auditor.⁹⁰ The auditor must therefore make further inquiries with other well placed individuals who may be able to provide useful information.⁹¹ When making these further inquiries an auditor may interview internal audit personnel and find their views on the risk of fraud in the financial statements. He may also make inquiries, *inter alia*, directly with employees who are involved in the processing of transactions which are unusual and complicated, their supervisors and resident legal advisors.⁹²

i. Presence of incentives to commit fraud.

When analyzing an entity, its operations and system of internal control the auditor should be wary of factors that provide an incentive to commit fraud.⁹³ Such factors include the desire to meet third party expectations and to get extra cash, provision for and prospects of additional bonuses if abnormal profit targets are met and the urge to take advantage of lax controls for personal gain.⁹⁴ The mere presence of these factors does not necessarily

⁹⁰ In the U.S. a certain fraudster Barry Minkow, highlighted the need for auditors to be vigilant when dealing with management submissions (see Chapter Five below). His case is discussed by Wells JT "Accountancy and White Collar Crime" (1993) 525 *Annals of the American Academy of Political and Social Science* 83 84. It is stated here that Minkow believed that he got away with much because the auditors were too accepting and believing in him. Minkow is quoted as saying, "they had no idea I was committing fraud."

⁹¹ Paragraph 39.

⁹² Paragraph 41.

⁹³ Paragraph 48.

⁹⁴ Paragraph 49.

suggest the presence of material misstatement or fraud. These factors however excite suspicion and a reasonably competent auditor must identify them and carefully conduct further investigations.

j. Revenue recognition.

In quite a number of cases material misstatements due to fraud stem from an exaggeration of revenue. This can be done through premature recognition of revenue by recording it as received revenue although it has not yet been received, or the recording non existent revenue. This may also be done by understating revenue for instance with the intention to deceive the tax authorities or to pay small dividends or by recognizing revenue at a later period. An auditor exercising due care is expected to acknowledge the potential of fraud in revenue recognition.⁹⁵

k. Responses to the risk of fraud.

After identifying and assessing the risk of material misstatements due to fraud in the financial statements, a reasonably competent auditor must apply audit procedures that by their very nature address these risks adequately.⁹⁶ This is in line with the dictates of ISA 330 which provides that an auditor should perform procedures that are specific to the risks identified as significant. This has a direct relationship with the auditor's professional scepticism. An auditor who has identified risks must display increased sensitivity in the selection of the types of records to be analyzed and the depth of the analysis. It is horrendously negligent for an auditor to ignore fraud risk factors that have been identified.

⁹⁵ Paragraph 60.

⁹⁶ Paragraph 61.

I. Overall Responses.

An auditor responding to the risk of material misstatements due to fraud must determine the desirability of assigning work to, and supervising individuals. In considering the appointment and supervision of personnel the auditor must gauge the ability, skill and knowledge of such personnel in relation to the identified risk. The auditor when using his professional judgment may deem it fit to assign more personnel with specialized expertise such as forensic and information technology experts.⁹⁷

An auditor must further consider the accounting policies of the entity. There are accounting practices that relate to subjective judgments and sophisticated transactions that may in some instances be calculated to confuse financial statement users into believing that the entity is profitable.⁹⁸ An auditor must also include an element of surprise in the selection of the nature, timing and extent of audit procedures. This is specifically desirable when he conducts an audit of entities where there are individuals who are well versed with the audit procedures usually performed in relation to that entity. Such individuals may be in a good position to conceal fraud. The element of unpredictability may take the form of engaging procedures that are not contemplated or by adjusting the timing.

A failure to identify an *apparent fraud risk factor* and to *respond adequately to identified risks* would constitute negligence on the part of the auditor.

5.2 SAAS 200: “Objectives and General Principles governing an Audit of Financial Statements.”

SAAS 200 deals with the objectives an auditor has to strive to achieve when conducting an audit of financial statements. The one objective set is to opine whether the financial statements are presented fairly in all material respects and in accordance with an

⁹⁷ Paragraph 67.

⁹⁸ Paragraph 68.

appropriate reporting framework.⁹⁹ This statement recognizes that the auditor's opinion enhances the credibility of the financial statements but states that users can neither interpret his opinion as an assurance or guarantee as to the future performance of the entity nor rely on the opinion to gauge the efficiency or effectiveness with which those tasked with governance and management have conducted the affairs of the entity.¹⁰⁰

5.2.1. General principles governing an audit.

Some of the ethical principles relating to the auditor's professional responsibilities are professional competence and due care, integrity and technical standards.¹⁰¹ SAAS 200 also deals with professional scepticism. This statement provides that an attitude of professional scepticism is critical in the audit process to enable the auditor to reduce the risk of overlooking suspicious circumstances or not paying due regard to audit observations. Accordingly an auditor does not assume that management is dishonest as much as he does not assume that management is honest.¹⁰²

5.2.2. Reasonable assurance

SAAS 200 provides further that an audit conducted in accordance with international auditing standards is intended to provide a reasonable assurance that the financial statements contain no material misstatements.¹⁰³ There is no absolute assurance, partly because of the limitations previously discussed in relation to SAAS 240R above.¹⁰⁴

⁹⁹ Paragraph 2.

¹⁰⁰ Paragraph 3.

¹⁰¹ Paragraph 4.

¹⁰² Paragraph 6.

¹⁰³ Paragraph 8.

¹⁰⁴ See paragraph 9 for more limitations.

5.2.3. Responsibility for the financial statements.

SAAS 200 also recognizes the responsibility of the auditor for forming and expressing an opinion on the financial statements. It however lays the responsibility for *preparing* and *presenting* the financial statements in accordance with the applicable financial reporting framework on the management and the directorate.¹⁰⁵ It states further that auditing does not relieve management and directors of their duties.

5.3 SAAS 610: “Considering the work of internal auditors.”¹⁰⁶

Internal auditing entails duties determined by management and its objectives differ from those of the external auditor. External auditors are mandated to report independently on the financial statements and are concerned with material misstatements in the financial statements.¹⁰⁷ Internal auditing is part of the activities of the entity. Regardless of the degree of independence and objectivity of the internal audit it cannot achieve the status of an external audit.¹⁰⁸ Expressing an opinion on the financial statements is the

¹⁰⁵Section 285A of the Companies Act.

¹⁰⁶Paragraph 4.1.1 of the Code of Corporate Practices and Conduct in the King II Report on Corporate Governance provides that companies should have an effective internal audit function that has the respect and cooperation of the board and the management. Haron H, Chambers A, Ramsi R and Ismail I “The Reliance of External Auditors on Internal Auditors” (2004) 19 (9) *Managerial Auditing Journal* 1148 see no problem with external auditor’s reliance on internal auditors. They however state that the objective of the external auditors is to find the truth and fairness of financial statements and this objective can only be met after the external auditors have evaluated the internal control system of the company and are satisfied that it is capable of preventing and detecting material misstatements caused by fraud. This view illustrates what reasonable care and skill is demanded from the external auditor. The fact that the internal control system of an entity is competent does not necessarily mean that the external auditors may blindly rely on it. In other words its capability to prevent and detect fraud does not mean that it cannot be manipulated by the management since it is still part of the entity. The company’s internal system of control should also be evaluated repeatedly without simply assuming that it has remained effective.

¹⁰⁷ Paragraph 6 of SAAS 610.

¹⁰⁸Wynn-Parry J in *Re Transplanters (Holding Co) Ltd* (1966) 2 NSW 293 provided a distinction between the auditor and the accountant of a company. It was stated here that the accountant is in all respects an

responsibility of external auditors. This responsibility may not be reduced by using the work of internal auditors.¹⁰⁹ In *Pacific Acceptance Corporation v Forsyth*¹¹⁰ it was stated that an auditor may not place reliance on internal controls without scrutinizing them. In another case, *Dominion Freeholders Ltd v Spargo; Aird (third party)* the argument put forward by the company's auditor that his statutory duties are fulfilled by placing absolute reliance on the company's accountant in the preparation of the company accounts was rejected by the court of appeal.¹¹¹

SAAS 610 provides that when planning an audit an external auditor assesses the quality of the internal audit function where it appears that the internal audit is relevant to the external audit of a financial statement. Before an external auditor may rely on the internal audit he must consider two matters, the first being the technical competence of the internal auditor's work. This includes investigations whether the internal audit work was done by individuals who have proper technical training and adequate proficiency as internal auditors. Secondly the external auditor must consider whether due professional care was displayed by the internal auditors. This can be done by investigating whether or not the internal audit work was properly planned, supervised and reviewed. In *Tonkwane*

agent of the company. The auditor on the other hand cannot be regarded for all purposes as an agent. It was stated that if he was an agent for all purposes the main reasons for his existence would diminish and he would have been subject to the same influences that are exercisable over the accountant who is directly employed by the company. In a statement that wrenches an auditor from being the company agent or parrot and that promotes independence, Wynn-Parry J said, "once a man takes upon himself a position of an auditor...he must stand aloof and divorced from the aims, objects and activities of the company." The assertion that the internal audit system can never achieve the status of the external auditors because it is part of the company finds an unlikely foe in the King II Report on Corporate Governance in South Africa (the Report) paragraph 2 Chapter 1 section 3 which states that the internal audit should be independent of the activities audited and that the internal auditors should be objective in performing their work. The Report states further that the fact that internal auditors may be employees of the company does not of itself impair their objectivity. An auditor exercising reasonable care and skill however cannot, on the strength of this statement, assume that the internal auditors do not need evaluation. This statement from the Report is misleading in this regard.

¹⁰⁹ Paragraph 8.

¹¹⁰ *Supra* note 11.

¹¹¹ (1966) 40 *Australian LJ* 237.

*Sawmill Co Ltd v Filmalter*¹¹² it was stated that an auditor must be able to determine the nature and extent of the tests to be applied in the light of his assessment of his client's management and system of internal control. It was also stated that an auditor must investigate whether the internal control system is being applied effectively.¹¹³

The requirements of SAAS 610 can be aligned with the general principles relating to negligence which auditors must comply with. Neethling *et al*,¹¹⁴ state that “generally speaking a person acts according to the standard of the reasonable person when he relies on the fact that another person will act in a reasonable way...this implies that he may expect others to obey the law...”¹¹⁵ The authors go on to say that where negligent conduct is reasonably foreseeable (as is very often the case these days in corporate reporting) a reasonable person should not always rely on others to obey the law. Auditors in particular perform a very specific function and these principles, which are of a general application, cannot be applied without qualification. It has been said that the internal audit function is part of an entity's management hence it can never acquire any acceptable independence. In the light of this consideration it would be undesirable for external auditors to rely unconditionally on the submissions of the internal auditors. Negligence or worse still, fraudulent conduct on the part of internal auditors should be regarded by external auditors as potentially present,¹¹⁶ meaning that it should not be reasonable for external auditors to expect internal auditors to obey the law.

¹¹² *Supra* note 82.

¹¹³ In *In re Kingston Cotton Mill (No 2)* *supra* note 11 it was stated that an auditor is justified in believing tried servants of the company in whom the company has placed confidence. It was also stated further that he is entitled to assume that they are honest and to rely on their presentations, provided however that he takes reasonable care with his evaluation. The approach under SAAS 610 is substantially the same. An auditor may only rely on the internal system after taking careful steps to ascertain its reliability.

¹¹⁴ *Law of Delict* 2nd ed 147.

¹¹⁵ In *Moore v Minister of Posts and Telegraphs* 1949 (1) SA 815 (A) 826 it was said that, “speaking very generally one expects and is entitled to expect reasonableness rather than unreasonableness, legality rather than illegality...” This means that it is not negligence *per se* for an auditor to rely on the work of internal auditors.

¹¹⁶ Even more so in this age where fraudulent activities by those in charge of companies are rife.

6. AUDITING UNDER THE KING II REPORT.

The King II Report on Corporate Governance deals with a variety of issues pertaining to corporate governance and recommended a number of reforms in this regard. Auditing is one of the issues and it is dealt with in Section 5 of the Report. In terms of the King II Report an external audit provides an independent and objective check on the preparation and presentation of financial statements by the directors. An annual audit is considered to be one of the cornerstones of corporate governance.¹¹⁷

According to this Report, the fact that auditors work with the management is not supposed to affect their objectivity and consciousness of their responsibility to shareowners.¹¹⁸ The audit committee, the majority of which should be independent non-executive directors, has the responsibility to maintain the objectivity between the directors and auditors. The King II Report does not deal comprehensively with the auditor's duties. Where it refers to these duties it states that auditors should observe the highest standards of business and professional ethics.¹¹⁹ It also states that an auditor's effectiveness should not be impaired by his performance of other functions such as corporate consultancy.¹²⁰ The King II Report crucially acknowledges the fact that directors and officers may by their acts contribute to a company's failure. It recommends that such individuals be held accountable for their conduct. Auditors should only be accountable for damages in proportion to their contribution to the failure.¹²¹

7. CONCLUSION.

In this Chapter it was shown that the auditor's duty of reasonable care and skill is also regulated by a number of statutory provisions and international auditing standards. The

¹¹⁷ Section 5 chapter 1 Par 1.1

¹¹⁸ *Ibid* Paragraph 1.2.

¹¹⁹ *Ibid* Paragraph 1.5 134.

¹²⁰ *Ibid* Paragraph 1.4 133.

¹²¹ *Ibid* Paragraph 1.6 134.

relevant Acts being the Companies Act, 61 of 1973 and the Auditing Profession Act, 26 of 2005 contain numerous duties an auditor is expected to comply with before he may report on the fairness of the financial statements. These rules do not only serve as guidelines in relation to the professional standards that are expected from auditors, but are submitted to be indicative of what the society at large expects from the profession. Any auditor who therefore fails to comply does not only contravene the provisions of these two Acts but may be found to have acted wrongfully and negligently.

The Auditing Profession Act goes a step further than the Companies Act by requiring auditors in section 45 (5) to conduct necessary investigations into the existence of reportable irregularities. This essentially means that in terms of this statute auditors also have a duty to investigate the possibility of fraud or reportable irregularities if there is a reason to believe that they exist. This obligation does not however mean that auditors have a duty to detect fraud. The primary duty is to report on the fairness of the financial statements and the duty to detect and prevent fraud according to sections 249 to 251 of the Companies Act lies with the directors of a company.

This Chapter also dealt with the statements of SAAS that are based on international auditing standards and it was seen that they are well in line with the law and enjoy crucial statutory backing in terms of section 44 (3) (b) of the Auditing Profession Act. These standards are of assistance in determining standard practice and negligence.