

CHAPTER THREE

THE COMMON LAW SCOPE OF THE AUDITOR'S DUTY OF REASONABLE CARE AND SKILL

1. GENERAL OBSERVATIONS.

This Chapter will deal with the case law relating to the auditor's duty of reasonable care and skill.¹ Chapter Two dealt with the duty of care concept and the law relating to negligence and it was concluded that an auditor's failure to detect fraud does not *per se* amount to negligence or wrongfulness. As will be seen in this Chapter the courts generally adopted this approach and refused to place an obligation on auditors to detect fraud. Instead, the courts have ceaselessly demanded auditors to exercise *reasonable* care and skill and have also fairly liberally defined the auditor's duty of reasonable care and skill.² In this Chapter the researcher will look at the earliest judgments on this subject and investigate how the scope of the duty of care has since evolved and whether it to any

¹ According to Cilliers *et al Corporate Law* 3rd ed 411 the concept of reasonable care and skill is a relative one and is subject to variation according to the circumstances of each case. The authors make this assertion on the strength of the remarks of Lopes LJ in *In Re Kingston Cotton Mill (No2)* [1896] 2 Ch (CA) 279 284 where he said that, "what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case..." Cilliers *et al* also state that the duty is relative because standards (or norms) evolve with the passage of time. The case *Re Thomas Gerrard and Son Ltd* [1967] 2 All ER 525 Ch 534 supports this view because in this case Pennycuik J refused to be bound by the standard set in the *Kingston Cotton Mill* case because he reasoned that "standards of reasonable care and skill are...more exacting today than those which prevailed in 1896." These two assertions by Cilliers *et al* are significant because they show that the standards of care and skill put forward by this research are not exhaustive but provide a general guide only and are subject to further revision and improvement.

² The fact that the courts have generally refused to place an obligation on the auditors to detect fraud must not be seen as a concession to the audit profession. It is in line with the law. As was seen in Chapter Two, skilled persons only pledge to perform their duties to the standard of a reasonable skilled person in their trade. Thus requiring auditors to take reasonable care to ensure that the financial statements they audit reflect fairly the financial position of an entity and the results of its business is merely a statement of the law.

degree, included the detection of fraud. Foreign case law on the subject will be prominent because of the impact it has on our law and the fact that the underlying principles are substantially applied internationally.

2. THE EVOLUTION OF THE AUDITOR'S DUTY OF REASONABLE CARE AND SKILL.

2.1. Earliest Cases Prior to 1900.

2.1.1. An auditor must not depart from his auditing duties.

An auditor exercising reasonable care and skill should stick to his duty to audit and refrain from performing tasks that are not related to auditing. In the case, *In Re London General Bank Ltd: Ex Parte Theobald (No 2)*³ it was pointed out that an auditor must certify to the shareholders only what he believes to be true.⁴ It was held further that it is no part of an auditor's duty to give advice, either to directors or to shareholders as to what they ought to do. It was also stated that it should be of no significance to him whether the business of the company was being conducted prudently or imprudently. The question arises whether this is authority for the proposition that the concept of auditor independence had early beginnings. It is hard to say whether Lindley LJ contemplated the concept of auditor independence and its importance as we know it today. Nevertheless his statements show us that already at an early stage a reasonably careful auditor had to refrain from performing duties outside his normal functions because this could cloud his judgment. This is precisely why auditor independence is important to this day. It would be undesirable that the same auditor who has performed

³ [1895] 2 Ch 673 682-84. This case represents one of two occasions in the 1890s where the courts assessed the standard of care that an auditor must adopt. Lindley LJ here rejected the notion that an auditor is an insurer who guarantees the absolute correctness of the accounts.

⁴ *Supra* note 3 683 where it was stated that, "such I take to be the duty of the auditor: he must be honest i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true."

duties for a company is also expected to conduct a proper audit of a company's financial statements to ascertain whether they do in fact reflect fairly the financial position and results of its operations. These principles and considerations still apply and are more prominent today.⁵

Moreover, it was stated that an auditor's business is to ascertain and state the true financial position of the company at the time of his audit and that an auditor's duty is limited to that. In answering the question on how a company's financial position should be ascertained, it was stated that it should be done by examining the books of the company. This, it was held, cannot be done without taking trouble to ascertain that the books actually reflect the company's true financial position. Lindley J stated in this regard that the examination of books cannot be done without inquiry and reasonable care because without this an audit would be an idle farce. The conclusion that can be drawn from this judgment is that reasonable auditors were even at an early stage under an obligation to examine the books of account of entities they audited, which is in line with the statutory requirements of today.⁶

It was stated further in *Theobald's* case that an auditor is not an insurer and that, in carrying out his duties, he is only obliged to exercise a *reasonable* amount of care and skill. The degree of reasonable care and skill would depend on the circumstances of that case. If there is nothing which ought to excite his suspicion less care may be required than in a case where suspicion is or should have been aroused. It was stated that an auditor *does not* guarantee that the balance sheet is accurate in terms of the company's books of account because if he did he would be responsible for errors on his part even if he had been deceived, without lack of reasonable care and skill on his part. The principle that an auditor does not guarantee the accuracy and fairness of financial reports therefore existed from a very early stage.

⁵ *Ibid.*

⁶ The Companies Act, 61 of 1973 and the Auditing Profession Act, 26 of 2005 require an auditor to examine the accounting records of a company before formulating an opinion in terms sections 300 (b) and 44(3) (c) respectively.

It is important to note that the standards of care set in this case required an auditor to exercise more care where suspicion is aroused but Lindley J qualified this requirement and stated that *even* in a case of suspicion an auditor is *still only* bound to exercise reasonable care. As shall be seen later on in this Chapter, this standard no longer applies because modern standards require auditors to probe suspicious matters thoroughly which by implication means that additional care is required in such instances.

This case however set some standards which have remained applicable to this day. These standards are:

- a. Where there is nothing that excites suspicion, very little inquiry will be reasonably sufficient. An auditor may in these circumstances perform his audit on a *test basis* because according to Lindley J, "...in practice businessmen select a few cases at haphazard, see that they are right and assume that others like them are correct also." As will be seen in Chapter Five this standard applies in the U.S.
- b. An auditor can justifiably rely on the opinion of an expert where special knowledge is required.

2.1.1.2. Reasonable care does not mean that an auditor is a “bloodhound.”⁷

The case of *In re Kingston Cotton Mill Co (No 2)*⁸ is also one of the earliest cases on this subject, and was reported shortly after the *Re London General Bank* case. In this case it was famously pointed out that “an auditor is not bound to be a detective” or to “approach his work with suspicion or with a foregone conclusion that there is something wrong”

⁷ See Reves F W “The Human Side of Auditing” (1946) 21 (1) *The Accounting Review* 82. Reves, an internal auditor, appears to say in this article that an auditor must be friendly. He says that at one time he received a letter that read as follows: “Some auditors are very helpful and friendly when they come and I would like to have them here. Others, when they come, think that the way to be helpful is to be mean, gruff and critical, and these I would like to help to the door with the toe of my shoe.” This remark could perhaps serve as support for Lopes LJ’s view that an auditor is not a “bloodhound.” Forensic auditors are however employed for the purposes of being a lot more vigilant than auditors generally. KPMG forensic auditor, Johan Van Der Walt (who is said to have compiled a detailed dossier on current ANC president Jacob Zuma’s financial affairs and business dealings) is nicknamed “The Bloodhound”, presumably because of his vigilant approach. See Jurgens A and Naidoo Y “Witnesses from all walks of life” *Sunday Times*-06/01/2008 4.

⁸ *Supra* note 1. The accounts of the company had for many years been falsified by its managing director, Jackson. Jackson during those years had deliberately overstated the quantity and values of the cotton and yarn in the company’s mills. He had been so successful in falsifying the accounts that what he had done, was never discovered or even suspected by his fellow directors. The company’s auditors simply adopted the entries of Jackson and inserted them in the balance sheet as “per manager’s” certificate. It was believed that the auditors had acted honestly in believing in the accuracy and reliability of Jackson. The action against the auditors was based on the fact that they had failed to compare different books and add the stock at the beginning of the year and the amount purchased and deduct the amounts sold. It was argued that this would have exposed a large discrepancy which would obviously have called for an explanation. It was however contented that they should not have trusted the figures of Jackson and should have investigated the matter further. Jackson was a trusted officer of the company and all the other directors had unflinching confidence in him. There was nothing on the face of the accounts to provoke suspicion. There was also no indication that the auditors were wanting in skill, care or caution in not testing Jackson’s figures. Lopes J stated that it is not the duty of an auditor to take stock since he is not a stock expert and that there are many matters in respect of which he may have to rely on the honesty and accuracy of others. It was stated further that an auditor does not guarantee the discovery of all fraud.

because “he is a watchdog and not a bloodhound.”⁹ This statement according to Cilliers *et al* means that the auditor has to be *alert* without being *suspicious*.¹⁰ The authors state that Lopes LJ was saying that the auditor’s duty is verification and not detection, because by being watchful and alert an auditor is not going all out (like a bloodhound) to detect fraud but he will simply be on the lookout for irregularities.¹¹

Lopes LJ, in response to a charge that the auditors had been negligent in trusting company employees stated that an auditor is “justified in believing trusted servants of the company in whom confidence is placed.” It was however held further that if there is anything that excites his suspicion an auditor should probe matters to the bottom but in the absence of anything exciting suspicion he is only bound to be reasonably cautious and careful.

This case like the *Ex parte Theobald* case before it also sets some standards that are still applicable today. The statement by Lopes LJ that auditors are not negligent by simply failing to track down ingenious and carefully laid schemes of fraud where there is nothing suspicious and where the fraud is perpetrated by ‘trustworthy’ company officers and is undetected by company directors for a long time is in line with current legal principles. As was seen in Chapter Two, the law does not impose a duty on professionals to perform their duties to absolute perfection meaning that auditors, for instance, are not required to detect material misstatements all the time.

The relaxed approach that was initially adopted in *In Re Kingston Cotton Mill* and *Ex parte Theobald* in relation to the standards of care and the expectation of fraud detection

⁹ *Supra* note 1 288. This watchdog formulation by Lopes LJ has been suggested by some to have been directly motivated by Lindley LJ’s dicta in *Re London General Bank* which stated that “...auditors are to be appointed by the shareholders and are to report to them directly, and not to or through the directors.” See Baxt R “The Modern Company Auditor. A Nineteenth Century Watchdog” (1970) 33 (4) *The Modern Law Review* 413 417.

¹⁰ *Op cit* note 1 412.

¹¹ This shows that auditors were formerly only required to be “alert” so that they would have a reasonable opportunity to detect fraud. Later on it will be seen how this standard evolved.

by reasonable auditors can be explained in the context of broader economic developments. The effect of growing company sizes meant that auditors could not possibly or reasonably be expected to scrutinize the considerable volume of material available. At this early stage in corporate development, time and cost constraints rendered the full checking of statements unrealistic, as well as unacceptable to fee conscious clients and service providers alike.

The standards of care set by these two early benchmark cases were accepted by the courts to be the norm after 1896. The question is how far the standards that were adhered to in 1895 and 1896 should still apply today. This is because according to Baxt,¹² there was no statutory obligation on companies to file annual financial statements at the registry in 1896. Until 1900 entities were also under no legal obligation to appoint an auditor. After 1900 legislation imposed various obligations on entities¹³ that were groundbreaking. Consequently, says Baxt, “it is neither real nor acceptable to view the common law principles of 1896 as exactly applicable.”¹⁴ The standards outlined by Lord Lindley and Lopes LJ are not discarded entirely though. They are still useful as a background to any discussion of the subject of an auditor’s duties and should be applied in conjunction with the current statutory requirements of accurate financial information being made available to shareholders. Some of these principles, such as the one that requires auditors under given circumstances to probe matters to the bottom still apply today.

2.2. Early Twentieth Century Perceptions.

The standards set in the 1890s were obviously subject to constant change and development because the law and auditing standards had to develop to meet the demands of a more sophisticated business environment. Thus as early as 1904, Lord Alverstone in

¹² Baxt R *supra* note 9.

¹³ *Ibid.* Such obligations according to Baxt included the preparation, filing, auditing and distribution of accounts. Entities were required to supply the information to the company registry and to their shareholders.

¹⁴ Baxt *supra* note 9 419.

*London Oil Storage Co v Seear Hasluck and Co*¹⁵ expressed what can be termed as a slender dissatisfaction with the watchdog formula as set by Lopes LJ. He stated that an “auditor is contemplated by law to protect the interests of the company and its shareholders” and in the process he must not only exercise “reasonable and watchful care.” He must also remember that the company relies on him to protect its interests. This, it was held, is not supposed to make him a man “constantly going about suspecting other people of doing wrong”, nor is he bound to suspect or presume that he is dealing with fraudulent and objectionable people. Lord Alverstone stated further that an auditor has a duty to probe suspicious matters that relate to the company’s financial position to the bottom.

This case does not constitute a significant progression from the early approach in the *Kingston Cotton Mill* or *Ex Parte Theobald* cases. The approach in this judgment is similar to the earlier judgments in two significant respects. The first is to be found in the statement that an auditor is not a man who is inherently suspicious of wrongdoing by others which is similar to the principle formulated by Lopes LJ in the *Kingston Cotton Mill* case where he stated that an auditor must not operate with a foregone conclusion that something is wrong. The second is the requirement that was approved in all three judgments, namely that auditors must probe all *suspicious matters* to the bottom. The *London Oil Storage* case is however important in that it reminded auditors to exercise reasonable care and skill with full knowledge and appreciation of the fact that they are protecting investor and company interests.

2.2.1. Suspicious circumstances.

In another case, that of *Henry Squire (Cash Chemist) Ltd v Ball, Baker and Co*¹⁶ Lord Alverstone formulated a stricter test than the one of Lopes LJ. In this case he stated in a thinly veiled reference to the colourful *dicta* of Lopes LJ in the *Kingston Cotton Mill*

¹⁵ [1904] 31 *The Accountant* LR 1.

¹⁶ (1911) 27 TLR. 269 271.

case¹⁷ that “figures of speech are dangerous.” He stated further that an auditor when acting as a reasonable man would act in accordance with what the circumstances dictate. This should cause him to act like a detective whenever his suspicion is aroused. An example of circumstances that should be regarded as suspicious by a reasonable auditor can be found in *Nelson Guarantee Ltd v Hodgson*.¹⁸ It was held that the auditor breached his duty of reasonable care where he was aware of the fact that his client’s bookkeeper had once been dismissed by another accounting firm for borrowing from the firm’s clients. With this in mind the auditor should have advised the person responsible for the checking of the bookkeeper’s work to exercise more care. Another example of suspicious circumstances was when the client’s bookkeeping was in arrears and the responsible bookkeeper was newly employed and obviously not the typical tried and tested servant whom the auditor could justifiably trust in line with the remarks of Lopes LJ in the *In Re Kingston Cotton Mill (No2)* case.¹⁹

Another case which dealt with suspicious circumstances is *Re City Equitable Fire Insurance Co Ltd*.²⁰ It was alleged in this case that the auditor of the company had failed to detect certain irregularities. Money belonging to the company that was held by stockbrokers was at the end of every year invested in treasury bills. These bills were at all times recorded as being sold soon after the end of each financial year. The auditor accepted confirmation of the purchases of the bills by relying on either a letter received from a stock broking firm or from an examination of the records. However since the company’s records were never followed up beyond the end of a financial year, the pretended sales of these bills shortly after the end of each year were not detected until the following period. The court dismissed a claim against the auditor that was based on his alleged negligence. Romer J stated

¹⁷ *Supra* note 1. One can guess that the ‘figure of speech’ that is being referred to here is the statement that an auditor “is a watchdog, but not a bloodhound.”

¹⁸ (1958) NZLR 609 619.

¹⁹ *Supra* note 1.

²⁰ [1925] 1 Ch 407.

“that it is the duty of a company’s auditor in general to satisfy himself that the securities of a company in fact exist and are in safe custody cannot, I think be gainsaid.”²¹

Romer J however added that Lindley LJ’s comments in *Re London General Bank* cannot be interpreted as denying the auditor the right to rely on another’s certification that the securities of the company actually exist.

The Court of Appeal upheld this decision and can be said to have taken a more protective stance towards auditors. The Master of the Rolls stated that a certificate from the bank that securities existed would have been sufficient. He stated that he did not wish in any way to discharge auditors from their duties as set in the *Kingston Cotton Mill* case but he added that in his view an auditor “must take a certificate from a person who is in the habit of dealing with and holding securities, and whom he, on reasonable grounds, believes to be, in the exercise of the best judgment, as a trustworthy person to give a certificate.”²² The court in this case appeared to have stated that an auditor may only place reliance on a person after the auditor himself had exercised due care in *evaluating* the reliability of that person. He should not simply assume that such a person is trustworthy only because his client trusts that particular person.

2.2.2. The auditor’s duty is not rigid.

In the Irish case of *Irish Woollen Co Ltd v Tyson and Others*²³ the court criticized the somewhat mechanical approach towards an auditor’s duties. In this case it was discovered that the company had paid dividends out of capital. This was found after an examination of the books of account which turned out to have been falsified. A claim was made against the auditor. It was alleged that the auditor had breached his duties by failing to discover that the company’s stock had been overvalued, by failing further to

²¹ *Ibid* 497-498.

²² *Ibid* 513-514.

²³ (1900) 26 *The Accountant* LR 13.

discover that the book debts had been overvalued and that the company's liabilities had been understated. In respect of the first two allegations the court ruled in favour of the auditor. However with respect to the third allegation Holmes LJ²⁴ stated that he could

“not understand how the carrying over of the invoices (resulting in the understatement of liabilities) could have escaped detection by the auditor, who should have used due care and skill and who was not a mere machine. The invoices carried over were ultimately posted to the ledger. If they were posted to their true dates it would have been at once apparent that they were not entered in at the proper time.”

3. CASES REPORTED DURING THE SECOND HALF OF THE TWENTIETH CENTURY.

3.1. An Auditor has to be Suspicious.

Lord Denning in *Fomento (Sterling Area) Ltd v Selsdon Fountain-Pen Co Ltd*²⁵ formulated a more exhaustive and satisfying test than the one of the 1890s. In assessing the obligations of the auditor he stated that the proper function of an auditor is not limited to the verification of sums and arithmetical calculations. He dismissed this view as being too narrow since it writes off auditors as “adder uppers and subtractors.” He held that for an auditor to perform his task properly he must come to it with an enquiring mind that is not suspicious of dishonesty or fraud, but suspecting that someone might have made a mistake somewhere and that a check must be made to ensure that there has been none. Some measure of suspicion has therefore become the standard and qualified the principle that an auditor needs not be suspicious in the absence of anything that arouses suspicion.

²⁴ *Ibid* 611.

²⁵ [1958] 1 All ER 11 (HL) 23.

The standard set by Lord Denning, that an auditor must approach his work with suspicion that someone may have made a mistake flies in the face of the principles set by Lopes J in the *Kingston Cotton Mill* case. This however is in line with the modern auditing standards that are currently applicable. As will be discussed in Chapter Four it is required that an auditor must approach his work with a measure of professional scepticism which is essentially similar to what Lord Denning said.

In the case of *In Re Thomas Gerrard and Son Ltd*²⁶ Pennycuick J stated that standards of care had become more exacting with time and need to be reviewed constantly to keep up with developments in the auditing environment. In this case the managing director of Thomas Gerrard and Son Ltd falsified the books of the company to conceal the company's losses. The auditor questioned the managing director about the alterations but accepted his explanations. The auditor was rushed and he had little time to do the audit. He was nevertheless held to be in breach of his *contractual duty of care* and was compelled to compensate for dividends unlawfully paid out of capital, because the company was actually making a loss. He was also held liable for tax wrongfully paid on the exaggerated profit figures which he had audited. The altered invoices should have put the auditor on enquiry. He should have informed the Board. The fact that the auditor lacked time was not a defence. It was stated that he should either have declined to make a report or qualified his report accordingly.

This supports the notion that in an age where fraudulent activities are getting rife, auditing standards of care need to evolve. However in finding that the auditors were negligent Pennycuick J was reluctant to depart from the formulation in the *In Re Kingston Cotton Mill* case. His decision was satisfactory on the facts but he failed to update the law. Pennycuick J only went as far as acknowledging that there is need to have the standards of care reviewed from time to time but the remarks of Lord Denning in *Formento* were not referred to and an opportunity to develop the law was missed

²⁶ [1967] 2 All ER 525.

3.2. An auditor must be Reasonably Competent and Cautious.

In *Tonkwane Sawmill Co Ltd v Filmalter*,²⁷ a South African case, the auditor's reasonable care and skill was analyzed. This was a delictual action for damages based on the alleged negligence of an auditor. It was contended that during the period May 1968 to March 1970 a sum of R 2 179 was stolen from the plaintiff and a sum of R 533 was stolen from Tonkwane Estates Ltd. It was alleged further that these losses occurred as a result of the negligence of the defendant. The defendant allegedly failed to exercise reasonable care and skill and engaged practices that were insufficient to detect the fraud and did not properly verify and audit the company's books of account to ascertain whether the sums of money drawn on behalf of both companies for payment of wages, exceeded the sums actually paid by the two companies in respect of wages. The defendant auditor denied being negligent and averred that the losses suffered by the plaintiff were caused by the plaintiff's own negligence. The defendant alleged further that when he was appointed as auditor of Tonkwane Estates it was agreed that a director and manager of Tonkwane Estates would sign the cheques for the plaintiff, verify the amounts drawn for the payment of wages and that one of them would be present when payments of wages were made. The defendant basically alleged further that the plaintiffs failed to execute their duties when they could and should have done so. The directors failed to avoid their loss through their own negligence and failure to perform their duties and one can justifiably sense that they were in this case trying to make good their losses by putting the blame on the auditor.

Boshoff J stated in this case that in the performance of his duties an auditor has to act with reasonable care and skill meaning that he must bring to bear on the work he has to perform that skill, care and caution which a reasonably competent and cautious auditor would use.²⁸ Bosshoff referred to the decision in *Re London and General Bank: Ex Parte*

²⁷ 1975 (2) SA 453 (W).

²⁸ See the remarks on 455 of the report. The case of *Van Wyk v Lewis* 1924 AD 438 was referred to. In this case a surgeon performed an urgent and difficult abdominal operation on a plaintiff. This operation took place in a hospital at night and a qualified nurse was present to assist the surgeon with the procedure. At

Theobald (No2). In determining what in any given event would constitute reasonable care and skill the learned judge stated that it is not obligatory for an auditor to check in detail all his client's transactions and operations.²⁹ It was stated further 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 and his impression must be based on his own investigations on whether this system is in place and being effectively applied. An auditor must therefore investigate whether the internal system is being applied effectively before placing any reliance thereon. However the responsibility of setting up this system still lies exclusively with the management.

Boshoff J crucially stated in his judgment that an audit is no substitute for management and no assurances are given by an auditor or are to be inferred from it that it will *necessarily disclose* fraudulent misappropriations. It is imperative to note in this regard that the responsibility for the financial control and fairness of the accounts of a venture rests on the shoulders of management and the directors. In terms of section 285A of the Companies Act, a widely held company must (through its directors) comply with financial reporting standards and issue financial statements that fairly present the financial position of the company as at the end of its financial year of and the results of its operations during that financial year.

the end of the operation one of the swabs used by the defendant was overlooked and left behind in the plaintiff's body for twelve months. From the evidence it was clear that it was usual hospital practice to rely on the qualified nurse who also acted as the theatre sister to count and check the swabs used. It was also clear that at the end of the operation the surgeon had made the most careful search that the critical condition of the patient allowed. It was held that negligence could not be inferred from the mere fact that the accident occurred. It was held further that the defendant was bound to exercise reasonable care and skill and had done so by leaving the duty of checking the swabs to the theatre sister. This case may serve as authority for the proposition that the mere presence of fraud does not point to an auditor's negligence. However, it is inconceivable these days for an auditor to rely on the work of his subordinates without supervising their work. See SAAS 240R in Chapter Four.

²⁹ Lord Denning in *Fomento (Sterling Area) Ltd v Selsdon Fountain-Pen Co Ltd* *supra* note 25 remarked that "an auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computation. His vital task is to take care that errors are not made, be they errors of computation, or errors of omission or commission or downright untruths...".

Boshoff J stated further that management is responsible for safeguarding the assets of the company and is not entitled to rely on the auditor for protection against defects in its administration or control. It is management's duty to ensure that adequate records are maintained and that the accounts required by statute or required for use for other reasons are prepared in a manner that provides a true and fair reflection of the entity's financial standing. This decision can be applauded because the managers of Tonkwane were not allowed to escape liability for their own indiscretions by placing the blame on the auditor. This echoes the decision in the *Kingston Cotton Mill (No 2)* case that an auditor is justified in believing tried servants of the company in whom confidence is placed by the company, provided the auditor has himself also made an evaluation of their reliability. He is then entitled to assume that they are honest and to rely on their presentations.

3.2.1. Audit procedures.

Audit procedures do not have to be exceptionally thorough. As has been seen, the *Tonkwane* case reaffirms the standard set in the *Theobald* case that an auditor is entitled to conduct his audit by applying test checks. It was stated in the *Tonkwane* case that an auditor is not necessarily obliged to check his client's entire transactions and operations. It was however held that an auditor must determine the nature and extent of the tests which are to be applied in the light of his assessment of the efficacy of his client's management and internal control system.³⁰

³⁰ Boshoff, as can be seen, accepted the audit procedure or standard of applying test checks where there is nothing to excite suspicion and warrant deeper investigation. This was criticized by Cookson CR and McQuoid-Mason "Twentieth Century Auditors: Watchdogs, Bloodhounds or Cross-Breeds?" 1975 *Natal University LR* 164 who stated that the court should not have placed great reliance on the procedures adopted by the audit profession itself in determining auditor negligence. It is submitted that this criticism is unfair on auditors because adopted standards and procedures essentially constitute what the reasonable auditor knows and would exercise. If the point by Cookson and McQuoid-Mason is to be taken seriously, auditors would be required to depart from procedures practised in their profession in order to pass the reasonable care and skill test. The researcher fully supports Boshoff J's approach of utilizing auditing procedures to determine negligence.

3.2.2. Management's submissions.

Reasonable care as pronounced in the *Kingston Cotton Mill* case means that the auditor may not blindly rely on management's submissions. The New Zealand High Court in *Mirage Entertainment Corp Ltd v Arthur Young*³¹ illustrates this point. In this case the Receivers of Mirage Entertainment, a film making company, sued the auditors Arthur Young for professional negligence. Arthur Young was retained to value assets, mainly film projects. The value of the film projects depended on assessments of net revenue from the films over the following five years. The projections made by the company were, it transpired, *all wrong*, and in some cases *grossly so*. Arthur Young *accepted these projections without question* and argued that it was entitled to rely on information provided by the company. Smellie J held that Arthur Young was liable. The onus was on Arthur Young to establish any special term in its contract with the company which would excuse it from checking the reasonableness and reliability of the projection. As no such term existed and no check was made, Arthur Young was in breach of its duty of care to the company, whether as an implied term in the contract or in tort.

3.3. The Ten Principles.

Pennycuik J in 1967 failed to update the law but it was only a matter of time before it was done in another judgment. Moffit J delivered the judgment in the case of *Pacific Acceptance Corporation Ltd v Forsyth*,³² which is one of the benchmark cases on the auditor's duty of reasonable care and skill and which in fact updated the law. In this case Pacific Corporation alleged that its auditors were negligent in their duties. The principal negligence the Pacific Corporation complained of consisted of a failure to detect certain fraudulent and irregular features in loans made by one of its offices. In his judgment, Moffit J made various important statements regarding an auditor's duty of care and skill.

³¹ (1992) NZCLC 68. See also www.commerciallaw.ac.nz/susan_watson/AUDART.DOC (accessed on 13.11.2006) for the article 'The Application of "Common Sense" Liability of Auditors in New Zealand' (1999) taken from the *Journal of Business Law*.

³² (1970) 92 WN (NSW) 29.

It was stated that although the auditor's legal duty to exercise reasonable care and skill in his work had remained unchanged over the years, the test for reasonable care and skill that has to be applied is the one that is prevalent in the light of current standards of professional conduct and practices. When Moffit J delivered his momentous judgment in the *Pacific Acceptance* case he put to rest the conservative and comfortable nineteenth century view of the role and nature of the company auditor. According to Fourie³³ the *Pacific Acceptance* case has significance on ten issues. These issues entail:

- i. *The primary duty of auditors is to audit and to warn management of any reasonable suspicion that fraud or error may exist.*³⁴
- ii. *This primary duty to audit encompasses further a duty to pay due consideration to the possibility of fraud.* In circumstances where suspicion is present or should be aroused an auditor must actively investigate the possibility. Moffit J stated that paying due regard to the possibility of fraud is done by framing and carrying out procedures that provide a reasonable assurance that the fraud as perceived by the auditor will be detected. The learned judge warned that it is unjust to criticize a particular procedure the auditor relied on to detect fraud because with hindsight it may be easy to think of procedures that would in the circumstances have been more appropriate to detect the fraud.³⁵
- iii. *Auditors have no duty to detect fraud or error where circumstances which arouse suspicion are absent. The mere fact that fraud or error exists in the*

³³ Fourie JSA "Auditors and Corporate Illegality and Fraud" (1994) 6 SA Merc LJ 187 188-189.

³⁴ This primary duty was also explained in detail at an early stage in *In Re London General Bank Ltd: Ex Parte Theobald (No 2)* [1895] 2 Ch 673 682-84.

³⁵ *Supra* note 32 66.

*financial statements does not give rise to this duty either.*³⁶ It was stated in this case that care must be taken to prevent the auditor's duty of reasonable care and skill from being onerous. In this regard Moffit J opined that once fraud is revealed it becomes easy to connect it to earlier manifestations of fraud and stated that the auditor's conduct must be examined in a practical way on the matters as they came to him at the time when he had an unsuspicious mind. Moffit J however stated that if material irregularities appear a careful auditor can normally be expected to remember and consider other irregularities especially those occurring in a connected way. In this regard an auditor may reasonably be expected to revisit past working papers to bring to mind irregularities.³⁷

- iv. *An auditor must obtain sufficient, relevant and reliable evidence to support his opinion on matters.* It is not sufficient to rely purely on management.³⁸ Obtaining such evidence is critical because according to Moffit J, an auditor is not different from a "skilled inquirer", who knows that it is better to know by direct examination than by relying on the hearsay of others or by inference. Hearsay or inference may be acceptable alternatives if the expenses and difficulty of making a direct examination cannot be justified by the gravity of the matter in question.³⁹

³⁶ In *International Laboratories Ltd v Dewar* 1933 DLR 665 682 the court held, as in *In Re Kingston Cotton Mill (No 2)* *supra* note 1 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 went further and qualified this and 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."

³⁷ *Supra* note 32 63.

³⁸ In *London Oil Storage Co v Seear Hasluck and Co* [1904] 31 Acct LR 1 the principle was enunciated that it amounts to negligence if auditors rely on management in substitution for enquiries they should have made themselves. See also *Mirage Entertainment Corp Ltd v Arthur Young* *supra* note 30.

³⁹ *Supra* note 32 68.

- v. *It is not sufficient to excuse auditors in the event of a claim by an outsider of their negligent conduct on the ground that the client's directors were also negligent or even fraudulent. Auditors must still perform their duties according to the standards of a reasonable auditor to be excused.*
- vi. *An auditor may not substitute audit procedures with independent sources of evidence.*
- vii. *Professional standards regulate the auditing profession and provide guides only. The courts retain the prerogative to assess the reasonableness of these standards and to determine what constitutes reasonable care and skill. Moffit J stated in this regard that the court should not require higher standards merely because higher standards will be adopted by the profession. This is so because the courts should apply the law. Moffit J also stated that when the conduct of an auditor is subject to legal proceedings it is not the province of the auditing profession itself to determine what the legal duty of auditors is or to determine what reasonable care and skill would require to be done in a particular case. He however stated that standards adopted by the profession provide a sound guide in determining what is reasonable.⁴⁰*
- viii. *A qualified report must be clear and unambiguous.*
- ix. *An auditor may not place reliance on internal controls without scrutinizing its effectiveness beforehand. According to Moffit J three essentials must be met before an auditor can reasonably rely on an entity's system of internal control. The first one is a proper inquiry to understand the entity's system and its strengths, weaknesses and reliability. Secondly, the auditor must appraise the system and check that the system is operating as intended. Thirdly, the*

⁴⁰ *Supra* note 32 74.

operation of the system must be tested.⁴¹ This amounts to a thorough analysis of the reliability of the system of internal control.

- x. *Auditors must carefully plan, supervise and review their work. The same applies to work done by subordinate staff.* Moffit J stated in this regard that there is no problem with employing inexperienced staff provided the inexperience and risk of error associated with such employment are appreciated and offset by appropriate supervision and review.⁴²

This case is evidence of a significant refinement and development in relation to the relevant principles. These ten principles identified by Fourie are of assistance in understanding the scope of the auditor's duty of reasonable care and skill. Of particular interest is the reference to auditing standards by the judge. This is the first case where reference was made to auditing standards and their importance. Moffit J stated that they are *useful but not conclusive* in determining auditor negligence since the court will have a final say. This statement put auditing standards in the frame and paved the way for their acceptance in subsequent cases.

In *Dairy Containers v NZI Bank*⁴³ it was again stated that an auditor has a duty to exercise the care and skill that a reasonably skillful and competent auditor would exercise in the performance of his duties. It was also stated that the degree of care that is to be expected in any given case may not be less than that which is reasonably necessary to enable auditors to perform their statutory duties and their contractual obligations to the client. Auditors must perform the audit with such a degree of care and skill as is necessary to reach a conclusion on whether or not, in their opinion, the financial

⁴¹ *Supra* note 32 87.

⁴² *Supra* note 32 79.

⁴³ (1995) 2 NZLR 30. This case discusses the standards expected from auditors. The New Zealand Dairy Board Executives misappropriated money from a subsidiary. The company sued the auditors and claimed that they were negligent in failing to detect the fraud. It was held that the auditors were negligent.

statements present a true and fair reflection of the state of the company's affairs. This case also acknowledged the importance of using auditing standards in determining auditor negligence. Thomas J stated that the auditing standards issued by the New Zealand Society of Accountants provide a *concrete guide* as to what may be expected from a reasonably competent auditor. This shows a development from *Pacific Acceptance* discussed above.⁴⁴

3.4. An Auditor must have due Regard to the Possibility of Fraud.

Thomas J in the *Dairy Containers* case⁴⁵ also stated that auditors must be wary of the possibility that fraud may exist in a particular case and derided the *Kingston Cotton Mill (No 2)* case by stating

“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 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 determine that no fraud exists or report 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.”

⁴⁴ Thomas J in the *Dairy Containers* case fully accepted the role of generally accepted auditing standards by stating that these standards provide a concrete guide as to what is reasonable care and skill and can therefore be said to have progressed from Moffit J's assertion in *Pacific Acceptance* that auditing standards are important but not conclusive.

⁴⁵ *Supra* note 43.

This judgment, like the judgment in the *Pacific Acceptance* case before it, is important in that it sets the precedent that auditors must pay due regard to the possibility of fraud. Thomas J stated that an auditor in planning his work *must recognize the possibility of fraud in the financial statements*. This requirement adds to the one in the *Fomento* case where it was stated that auditors must work with a suspicion that someone may have made a mistake somewhere and that it must be checked.

This must however not be seen as a complete transformation of an auditor's duties. It is still important to note that paying due regard to the possibility of fraud is *very different* from requiring auditors to detect fraud, as society and the business fraternity would probably like to see. That is why it is important to refer to the decision in *Caparo Industries plc v Dickman*⁴⁶ where it was held that an auditor is not obliged to draw the accounts, to turn every stone and open every cupboard if circumstances do not warrant it. An auditor is not liable for failing to find irregularities that would not have been found by a reasonably competent auditor.

4. DUTIES IN RELATION TO CONTRACT.

In *Thoroughbred Breeders Association of South Africa v Price Waterhouse*⁴⁷ the plaintiff was the client and complained that the defendant had in auditing the plaintiff's financial statements breached the auditing agreement by failing to detect the fact that several substantial sums of cash⁴⁸ had for long periods not been deposited as well as the theft of proceeds of the encashment of a promissory note in favour of the plaintiff with a face value of R 138 864. The cash that had not been deposited was stolen by the financial manager who, to cover his actions, had encashed the promissory notes. The allegation relating to the theft was denied by the defendant who admitted the allegation regarding the promissory note.

⁴⁶[1989] WLR 316 (CA).

⁴⁷ 1999 (4) SA 968 (W).

⁴⁸ A total amount of R 143 403, 44.

The financial manager after the audit but before his activities were discovered went on to embezzle another R 1 389 801, 90. The plaintiff alleged that this subsequent theft was avoidable if the defendant had carried out his audit properly and discovered the financial manager's earlier indiscretions. The plaintiff claimed damages from the defendant but the defendant claimed that the plaintiff could only blame itself because it persisted in employing its financial manager despite his theft and tainted criminal record. Damages were successfully claimed from the auditor because of his failure to detect the thefts perpetrated by the financial manager which would have prevented further thefts. The auditor was found to have been negligent and his negligence was found to be the legal cause of the plaintiff's loss⁴⁹

In this case it was common cause that the audit and indeed all the other audits, had to be conducted in accordance with generally accepted auditing standards⁵⁰ and to be performed with the degree of reasonable care and skill that can be expected of an auditor

⁴⁹ The company *knew* that the financial manager had a criminal record but failed or neglected to disclose this fact to the auditor. (The court actually found that the appointment of a person with a criminal background to a financial management position was careless – Benade *et al Entrepreneurial Law* 3rd ed 233). It is submitted that the discovery of the frauds perpetrated by the financial manager depended in no small measure on whether the auditor knew, or could reasonably be expected to know, of the financial manager's criminal history because he would then have treated all transactions relating to him with suspicion or scepticism. Since the company failed or elected not to inform the auditor of this vital information the auditor was left in an unenviable position because he can reasonably be expected to trust the financial manager's actions in the absence of anything suggesting otherwise. In the judgment the trial judge stated that there was so much from the financial manager that could and should have made the auditor suspicious but one can say that hindsight may have played a role in the making of that assertion. One may also submit that the auditor could not reasonably have been expected to detect the fraud perpetrated by the financial manager who covered up his actions carefully. In the case *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."

⁵⁰ This constitutes an acceptance in South African law of the use of the prevailing international auditing standards in determining whether an auditor has acted reasonably or not. In this context the judgment in the *Thoroughbred* case can be said to have gone a step further than the *Pacific Acceptance* case where *only* the importance of auditing standards was acknowledged.

in public practice. Predictably the parties' expert witnesses presented different opinions on the duties of an auditor in auditing financial statements. The plaintiff's expert witness claimed that the purpose of an audit is to detect fraud and error.⁵¹ The defendant's expert witness contended that an audit is conducted merely to seek corroboration of the assertions in the financial statements and to seek persuasive rather than conclusive evidence of such assertions. The defendant's expert witness contended further that the purpose of an audit is not to detect fraud or other material misstatements or errors.

In his judgment Goldstein J looked at the auditing contract between the parties from which it appeared that the duty to ensure the correctness of the assertions in the financial statements was on the plaintiff⁵² and that the auditor's duty was to give a reasonable assurance that the financial statements fairly presented in all material respects the financial position and the results of the operations of the plaintiff for the year in question. The auditor *was not required to guarantee* the material correctness of the statements.

This means that the mere presence of some material inaccuracies cannot justify a conclusion that the auditor was negligent or in breach of his contractual obligations and a reasonable assurance to the effect as stated above would not suggest that he had examined every entry in the financial statements but only that he had examined them on a test basis. Where the auditor decided to examine any given entry he was bound to do the examination with reasonable care and to display the skill and caution that would normally be expected from a reasonably competent and cautious auditor. It was further held that whenever an auditor considers the likelihood of misstatements⁵³ he is only bound to exercise that care and skill and to conduct such investigations as the circumstances of the case would demand.

⁵¹ This claim flies in the face of all precedents noted in this Chapter.

⁵² In terms of section 285A of the Companies Act, 61 of 1973, a company is, through its directors, under an obligation to prepare financial statements for the company that fairly represent the company's state of affairs.

⁵³ Also see *Dairy Containers v NZI Bank supra* note 43 where the need for auditors to pay due regard to the possibility of fraud in financial statements was highlighted.

On the question whether the defendant auditor had committed a breach of contract in relation to the outstanding deposits the court found that, if the defendant had reperfomed the year end reconciliation of 31 October 1993, the amounts received in the cashbook and those reflected in the bank statements would have revealed a discrepancy. It was found that there was a need for a reperformance of the year end reconciliation and it followed that the audit clerk should have examined the reconciliation in question with careful consideration of long outstanding deposits and other unusual items.⁵⁴ The defendant's expert witness conceded that a reperformance of the year end reconciliation was necessary.

On the question whether the defendant had been negligent in relation to the promissory notes it was held that the question was whether the clerk ought to have verified the notes. The issue rested on the question of materiality and depended on the size of the item judged in terms of the circumstances of the case. The figures were of prime importance. The defendant's expert witness stated that R108 500 was immaterial in relation to assets amounting to R1 862 366, moreso in relation to the plaintiff's assets that amounted to some R16 million. The audit clerk was however found to have been negligent because he failed to examine the note in question despite the fact that it was listed as an asset only after its maturity date. This is clearly another case of investigating suspicious matters that had to be probed to the bottom.

4.1. To what extent should a Reasonably Cautious Auditor act to investigate Matters that arouse Suspicion?

⁵⁴ Also see *Dairy Containers v NZL Bank Supra* note 43 997. However it is too easy to say with hindsight that the audit clerk should have checked the reconciliation. Cilliers *et al op cit* note 1 415 state that the auditor's duties *should not be influenced by the benefit of hindsight*. However it is imperative to note that reasonably competent and careful auditors would supervise the work of their clerks. Cilliers *et al* also state that the risk of error associated with employing inexperienced audit clerks can be offset by appropriate supervision and review. The presence of shortcomings in the work performed by clerks (like in this case) reflects poorly on the auditor's standard of care.

The *Thoroughbred* case answered this question in a unique way. Goldstein J stated that the financial manager who had embezzled some of the funds might have overcome the hurdle of explaining the missing promissory notes but his explanation would certainly fall short in many respects. This would have resulted in a reasonably astute auditor becoming suspicious and calling for a thorough investigation that would have exposed the instances of theft.⁵⁵ How far a reasonably astute auditor would investigate suspicious matters is, according to Goldstein J, a question that cannot be answered with reference to a hard and fast rule because the auditor's decision depends entirely on the circumstances. It was stated further that the fact that an auditor is entitled to believe in the integrity of management means that he still has to display a degree of professional scepticism. Auditors are required by international auditing standards to exercise an attitude of professional scepticism. This attitude obliges them not to assume that management is honest as much as they should not assume it is dishonest.⁵⁶ Needless to say that the expert witnesses of both parties expressed conflicting views on this issue.

The plaintiff's expert witness argued that an auditor must probe to the bottom any suspicious matter and that cannot be sufficiently explained by representations from the client's staff. Counsel for Thoroughbred Breeders Association referred the court to *In Re Kingston Cotton Mill (No2)*⁵⁷ where it was said by Lopes LJ that, "if anything is calculated to excite suspicion he should probe it to the bottom." The court was also referred to *Dairy Containers Ltd v NZI Bank Ltd*⁵⁸ where it was said that "the auditor's basic duty is to plan and carry out the audit of the company cognizant of the possibility of fraud. If and when the auditors discover any irregularity, they must carry out such further tests or make such further inquiries as may be required to satisfy themselves that no irregularity in fact exists." The case of *McBride's Ltd v Rooke and Thompson*⁵⁹ was also

⁵⁵ Goldstein J ruled that the plaintiff had satisfied the *sine qua non* test by proving that, had the financial manager's thefts been uncovered at the time of the audit, he would have been dismissed and been prevented from stealing further.

⁵⁶ Professional scepticism is discussed in more detail in Chapter Four.

⁵⁷ *Supra* note 1.

⁵⁸ *Supra* note 43.

⁵⁹ [1941] 4 DLR 45 48-9.

cited by the plaintiff's counsel, where it was stated that if an auditor in carrying out his work encounters circumstances that arouse or excite his suspicion, "then there is undoubtedly a duty upon him to investigate thoroughly until he satisfies himself whether there are grounds for that suspicion."

The defendant's expert witness had a different view namely that only when a problem arises during an audit is an auditor required to find an explanation from the appropriate individuals regarding that problem. He stated that in the course of an audit hundreds of explanations occur, more so in large audits. An example was the explanation given by the financial manager. Because of this, he said, it is a question of judgment whether the auditor probes a particular matter further. The auditor is and was in this case, to a degree entitled to believe in the integrity of management as long as he exercised a degree of professional scepticism and care. There is no hard and fast rule and the auditor's decision whether or not to believe the financial manager depends entirely on the circumstances. The expert witness stated that only if the explanation is not satisfactory can an auditor be expected to go further and conduct a thorough investigation.

Each of these two conflicting views has its own merit but Goldstein J approved the latter and stated that "*auditing is frequently a matter of feel and more an art than a science, with much depending on the auditor's own judgment.*"⁶⁰ The latter view was found to be more in accordance with the practicalities. This means that under South African Law the requirement that an auditor must probe to the bottom every irregular and suspicious matter is subject to the qualification that the auditor must exercise professional judgment before deciding to probe or not to probe a matter thoroughly. The researcher subscribes to this view because not all suspicious matters may be sufficiently material to justify a full blown investigation.

⁶⁰ *Supra* note 47 1011B.

5. AUDITOR INDEPENDENCE

The King II Report (the Report) on Corporate Governance in South Africa states that the proper functioning of the external auditors depends on their independence. It states further that the competition between auditors for the performance of other functions like management consultancy and corporate finance should not have the unfortunate by product of impairing effectiveness in the performance of audit functions.⁶¹

In the case of *Axiam Holdings Ltd v Deloitte and Touche*⁶² a company referred to as TBB appointed Deloitte and Touche to act as its auditor for the financial year ending on 31 March 1999. The auditing firm then not only conducted the audit but also *prepared and completed* TBB's annual financial statements for that financial year. On 1 July 1999 they issued an auditor's report that stated:

“We conducted our audit in accordance with the statements of South African Audit Standards. Those standards require that we plan and perform the audit to obtain a reasonable assurance that the annual financial statements are free of material misstatements...In our opinion, these annual financial statements fairly present, in all material respects, the financial position of the company at 31 march 1999 and the results of its operations and cash flow for the period then ended in accordance with generally accepted accounting practice and in the manner required by the Companies Act.”⁶³

⁶¹ See section 5 Chapter 1 paragraph 1.4 of the Report. These non-audit services, which have a significant bearing on auditor independence, have grown as logical extensions to the performance of audits in terms of paragraph 4 Chapter 2 section 5 of the Report. The Report in paragraph 5 of Chapter 2 section 5 also states that audit and consultancy services may be construed as contradictory because the former demands objectivity and independence while the latter requires a direct interest in a client's success. The remedy according to the Report is the prohibition of the provision of non-audit services to the audit client. Such services can however be rendered to non-audit clients in terms of par 6 chapter 2 section 5.

⁶² 2006 (1) SA 237 (SCA). Hereinafter *Axiam*.

⁶³ *Axiam* 242.

It was however trite that the 1999 annual financial statements actually failed to present fairly the financial position of TBB. Although the fact that Deloitte and Touche prepared and completed TBB's annual financial statements before issuing an audit opinion is objectionable,⁶⁴ it must have placed them in a better position to acquaint themselves fully with TBB's state of affairs. Yet despite this the annual financial statements of TBB misrepresented TTB's net value by reflecting a net profit before tax of R 29 266 176 where TBB had in fact suffered a net loss of R 77 899 201. This misrepresentation was due to the failure by Deloitte to include a bad debt of R 68 888 000 in the income statement. This amount was inexplicably included as goodwill. A large sum of money, R 10 300 000 in total the origins of which were obscure, was inserted into the financial statements as a profit. A bad debt amounting to R 27 977 3777 which was either irrecoverable or non-existent was shown as a loan to a shareholder.⁶⁵

All these serious anomalies prompted Navsa JA to state that Deloitte in conducting the audit had failed *inter alia* to do so with the required professional and reasonable care and skill and had also failed to comply with generally accepted accounting practice. The learned Judge stated that Deloitte could at least have come up with a qualified report and

⁶⁴ Getting involved in a client's management and offering management services certainly erodes an auditor's independence and this has a direct and adverse impact on the quality and reliability of the audit. Carmichael DR and Swieringa RJ "The Compatibility of Auditing Independence and Management Services - An Identification of Issues" (1968) 43 (4) *The Accounting Review* 697 say that an auditor must have professional independence and audit independence. Professional independence will give him self reliance and free him from subordination to his client and from management influence. Audit independence allows the auditor to abstain from bias and prejudice. In the present case Deloitte did not possess this independence because they relied on management and obtained fees from performing non audit services. The effect was that they could not perform a reliable audit because of bias towards their client. Furthermore since they had prepared the financial statements they could not *audit themselves* fairly. To further highlight the importance of auditor independence Benade *et al op cit* note 49 230 states that "...an auditor must have adequate professional training and proficiency, be of independent status and maintain an independent mental attitude, and exercise due professional care during the audit examination and in the preparation of his report."

⁶⁵ *Axiam* 242.

was therefore, negligent in conducting the audit.⁶⁶ This case is important and requires further analysis but in this context it points to the necessity of independence of an auditor for the proper performance of his duties. One may state that Deloitte had failed to detect various anomalies because they also drafted the financial statements and were in no position to express disapproval in relation to their own work.

6. OTHER FACETS OF THE AUDITOR'S DUTY OF REASONABLE CARE AND SKILL.

Cilliers *et al* summarize the various facets of the auditor's duty of care and reasonable skill.⁶⁷ They derive these from, and formulate a number of additional duties with reference to, the cases that were discussed in this Chapter. They state that the auditor's duty of reasonable care and skill entails the following-

6.1. Verification.

According to Cilliers *et al*,⁶⁸ the auditor must, in conducting the audit satisfy himself of all relevant acts and circumstances through proper and accepted auditing checks and should not rely on rumours and reputations or on what other persons believe.⁶⁹ They state that the better method of verification at the auditor's disposal is and will always be a personal direct examination of the subject matter of the audit. In this regard the auditor is not a different person from the one to whom Moffit J in the *Pacific Acceptance* case refers to as the skilled inquirer who prefers to know by direct examination rather than by hearsay evidence.⁷⁰ Where a personal direct investigation is not feasible or will cause hefty delays, expenses or effort the second best alternatives will suffice. The authors also

⁶⁶ See *Axiam* 242.

⁶⁷ *Op cit* note 1 410-415.

⁶⁸ The assertions of Cilliers *et al op cit* note 1 413 on this aspect are based on the remarks of Moffit J in *Pacific Acceptance Corporation v Forsyth op cit* note 32 67-68.

⁶⁹ Cilliers *et al op cit* note 1 413 also state that in the light of the *Pacific Acceptance* case the general principle is that if a document that is material to the audit exists, it is the auditor's duty to personally examine that document unless there are specific circumstances that force him not to do so.

⁷⁰ *Supra* note 32 66.

state that only in the presence of reasonable grounds to depart from personal examination is an auditor entitled to resort to alternative methods.⁷¹

6.2. Specialist Advice.

Cilliers *et al* state that an auditor may in the process of verification of transactions encounter a matter that requires specialized knowledge for it to be verified effectively. When this happens the auditor must take steps to obtain the relevant specialist advice. If for instance he needs to obtain legal advice on a certain point he must consult with legal experts.⁷²

6.3. Responsibility for the Work of Clerks.

Cilliers *et al* state further that an auditor is responsible for the work performed by clerks under his employment. They state further that if an auditor employs inexperienced clerks he must appreciate their inexperience and the risk associated with employing them and plan his supervision and review accordingly. The presence of shortcomings in the work of unsupervised and inexperienced audit clerks indicates a lack of due care and skill on the part of the auditor who assigned the work to them.⁷³

6.4. Overall View of the Auditor's Duty of Reasonable Care and Skill.

Cilliers *et al* make a valid point namely that the auditor's duty of reasonable care and skill must be viewed reasonably. They state that this duty must not be made *too onerous* and the quality of his work must not be judged with hindsight or influenced by

⁷¹ *Op cit* note 1 413.

⁷² *Op cit* note 1 414. *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd supra* note 25.

⁷³ *Op cit* note 1 415. *Pacific Acceptance Corporation Ltd v Forsyth supra* note 32 79. Benade *et al op cit* note 49 230 state that reasonable care and skill entails the adequate planning of an audit and proper supervision of audit staff.

revelations made after investigations.⁷⁴ This view must be supported. Allegations that the auditors should have performed certain investigations should be discouraged.

7. CONCLUSION.

In this Chapter it was discussed how the principles in relation to the degree of professional care and skill that is required from an auditor was developed and refined by judicial precedent. No distinction was drawn between South African cases and those from foreign jurisdictions because of the international character and universal application of the underlying principles. An analysis of the case law displays an evolutionary process which considerably revised the professional standards of care and skill that is required from auditors. The courts however have never viewed the auditor's duties as entailing a responsibility to detect fraud. The conclusion that can be drawn from this Chapter is that the auditor's duty of reasonable care and skill has the following elements:

1. An auditor must only certify what he believes to be true. It was held in *In Re London General Bank Ltd: Ex Parte Theobald (No 2)*⁷⁵ that an auditor must also make an effort to examine the books of account before he can believe that the financial statements are true. What an auditor believes to be true may turn out to be false since an auditor was held not to be an insurer.
2. An auditor must make a detailed inquiry into matters that he finds suspicious. He is justified to believe trusted servants of the company as long as he also exercises reasonable care and professional scepticism.⁷⁶ In *Pacific Acceptance Corporation v Forsyth*⁷⁷ it was stated that auditors must duly regard the possibility of fraud because their primary duty to audit encompasses the duty to pay due regard to that

⁷⁴ *Op cit* note 1 415. *In re City Equitable Fire Insurance Co Ltd* *supra* note 20; *Re London and General Bank (No 2)* *supra* note 3; *Pacific Acceptance Corporation Ltd v Forsyth* *supra* note 32.

⁷⁵ *Supra* note 3.

⁷⁶ *In re Kingston Cotton Mill Co (No 2)*. *Supra* note 1.

⁷⁷ *Supra* note 32.

possibility of fraud. In *Dairy Containers v NZI Bank*⁷⁸ it was also stated that auditors must at least be wary of the possibility of fraud. An auditor must therefore probe to the bottom all matters that arouse his suspicion.⁷⁹ This was stated in a number of cases including *In Re Kingston Cotton Mill*, *Dairy Containers* and *Pacific Acceptance*.

3. In *Thoroughbred Breeders Association v Price Waterhouse*⁸⁰ it was held that an auditor must use his professional judgment in probing suspicious matters. This means that in South African law auditors must exercise professional judgment to determine which suspicious matters are material and need further investigation.
4. Lopes LJ held that auditors are more like watchdogs than bloodhounds in the *Kingston Cotton Mill* case. The better view that is more suitable to serve present demands is that of Lord Denning in *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen*⁸¹ who stated that auditors must approach their work with a suspicion that someone *may* have made a mistake somewhere and a check must be carried out to ensure that there is no mistake or irregularity. This is closer to the requirement of SAAS 240R that will be discussed in Chapter Four which states that auditors must perform their duties with an attitude of professional scepticism.

⁷⁸ *Supra* note 43.

⁷⁹ In *Nelson Guarantee Ltd v Hodgson* (1958) NZLR 609 619 the fact that the audit client's bookkeeper had previously been dismissed by a certain accounting firm for some irregular practices was held to be a suspicious circumstance since the auditor was aware of the bookkeeper's history.

⁸⁰ *Supra* note 47.

⁸¹ *Supra* note 26.

5. An auditor must structure his work in the light of his assessment of the client's management and system of internal control. He may also not rely on the internal system without first investigating its efficacy.⁸²
6. An auditor must conduct his audit in accordance with international auditing standards.⁸³ Cilliers *et al* state that an auditor's adherence to the international auditing standards that prevail at the time of his audit is a factor that is relevant to determine whether he has performed his audit with reasonable care and skill or not.⁸⁴
7. An auditor must maintain independence from his client and not prepare his client's financial reports as this may cloud his professional judgment.⁸⁵
8. If an auditor detects fraud or material misstatements in relation to the current financial statements, it might in appropriate circumstances be wise for him to reconsider statements of previous years to ensure that those irregularities have not occurred in previous years. This is advisable in the light of the liability that was imposed on the auditor in the *Axiam* case.

These elements are by no means exhaustive. It was said time and again in this Chapter that what is reasonable depends on the circumstances of each case. This means that it must always be remembered that the courts deliver judgment on an auditor's duty of

⁸² *Tonkwane Sawmill Co Ltd v Filmalter supra* note 27.

⁸³ *Thoroughbred Breeders Association of South Africa v Price Waterhouse supra* note 47.

⁸⁴ *Op cit* note 1 413.

⁸⁵ As was seen in *Axiam Holdings Ltd v Deloitte supra* note 62.

reasonable care and skill in light of the circumstances presented before them. It is also generally accepted that the principles in question will constantly change as demands on the profession change with time. Additional elements will certainly be formulated in future litigation on this subject.