

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

1. GENERAL OBSERVATIONS.

An auditor is employed to attest to the truthfulness and fairness of financial statements. As was shown in the cases discussed in the previous Chapters, not all financial statements truthfully and fairly reflect the financial position and profitability of an entity. Deviant directors and other influential but unscrupulous figures frequently commit fraud by misrepresenting facts and figures in the financial statements. In the event of these fraudulent activities, society tends to expect auditors to act as detectives and detect the fraud perpetrated.

This expectation to detect fraud transcends a number of boundaries and disregards the fact that fraud can be onerous to detect. This expectation probably stems from the fact that auditors are employed to certify, after investigation, that the financial statements are true and fair. As such, public policy dictates that auditors must be considerably more diligent than before because their role is seen as the protection of the public interest.¹ This results in auditors being accused of negligence and sued for enormous sums of money. This expectation, as was shown in Chapter One, is firmly based on a misunderstanding of the auditors' actual duties, which is the underlying reason for this research and a detailed analysis of the auditor's duty of reasonable care and skill. In establishing whether the auditor has performed his duties negligently it is important to consider only the legal principles relating to delictual liability and negligence and not the expectations of society. An auditor must not be found negligent merely because he failed to live up to society's expectations.

¹ See *Lipschitz v Wolpert and Abrahams* 1977 (2) SA 732 (A) 740 C-F 742A where Holmes JA basically stated that an auditor is for the most part the shareholders' safeguard and states that the "dichotomy between and those who put up the money and those who run the company is... the main reason for the statutory appointment of an auditor." In *Haig v Bamford* 72 DLR (3d) 68 (1976) Dickson J stated that "with the added prestige and value of his services (an auditor's) has...a concomitant and commensurately increased responsibility to the public."

It is against this background that this research was motivated. This research has set out to show that despite the expectations, the law does not impose a duty on auditors to detect fraud and to identify the actual elements of the auditor's duty of reasonable care and skill.

2. IMPORTANT CONCLUSIONS FROM THIS RESEARCH.

2.1. An Auditor does not have a Duty to Detect Fraud.

As has been shown, auditors are employed to certify that an entity's financial statements fairly reflect its financial position and the results of its operations. Does it follow if the financial statements are materially misstated that the auditor must detect such misstatements? If he fails to detect misstatements, can it be concluded that the auditor was negligent? The answer to both questions cannot always be in the affirmative.

In *International Shipping Co (Pty) Ltd v Bentley*² Corbett CJ stated that to establish auditor liability all the elements of delict have to be proved. These elements are conduct, wrongfulness, fault (intention or negligence), damage and causation. This case is discussed in detail in Chapter Two. This means that negligence is just one of the elements to be proved. According to the legal principles that have been formulated in the case law, only a person who in any given circumstances acts, either positively or negatively, in a manner that is contrary to relevant legal principles or not approved by public policy can be liable in delict. In other words a person can only be found to be negligent if after an inquiry it is shown that he failed to meet the standards of the reasonable person in the same circumstances. As a skilled person an auditor should conform to the standard of the reasonable skilled person, or the reasonable auditor.³ This means that if an auditor fails to detect fraud after having performed his

² 1990 (1) SA 680 (A).

³ In *Kruger v Coetzee* 1966 2 SA 428 (A) it was stated that *culpa* arises if a *diligens paterfamilias* would have acted differently in the same circumstances. In English law the so called 'Bolam test' as formulated by McNair J in *Bolam v Friern Hospital Management Committee* (1957) 1 WLR 582 586 is utilised. In this case it was stated that a skilled person does not have to possess the highest expert skill possible because ordinary skill of an ordinary competent man exercising a particular trade

audit in the same manner in which the reasonable auditor would have performed it, he cannot be held to have acted negligently. Conversely, an auditor may be found to have acted negligently if he failed to perform his audit in a manner consistent with what the reasonable auditor would have done under the same circumstances.

This essentially means that there is no inherent duty on auditors to detect fraud simply because they audit financial statements. The fact that fraud exists with the result that there are material misstatements in financial statements does not give rise to such a duty either.⁴ The duty to detect fraud only arises if it is reasonably possible to detect the fraud. These principles are the guiding force behind the cases that were discussed in this research.

2.2. What therefore are the Duties of the Auditor in relation to Fraud?

This question is important because it suggests that auditors should not be oblivious to the existence of fraud simply because they have no duty to detect it. This research answers this question by looking at the elements of the auditor's duty of care as formulated in case law, legislation and international auditing standards. The auditor's duties in relation to fraud that can be deduced from this research are:

- i. An auditor must duly consider the possibility of fraud and in so doing, evaluate the reliability of a client's system of control and the integrity of its management on a continuous basis.⁵ In paying due regard to the

suffices. This test if applied to auditors simply means that auditors are expected to exercise the degree of care and skill that a reasonable auditor would have exercised.

⁴ *Pacific Acceptance Corporation v Forsyth* (1970) 92 WN (NSW) 29. It was stated here that auditors have no duty to detect fraud and the mere fact that fraud exists does not make this duty applicable.

⁵ See *Pacific Acceptance Corporation v Forsyth* (1970) 92 WN (NSW) 29 where it was stated that the auditor's primary duty to audit also entails a further duty to pay due consideration to the possibility of fraud. In *Dairy Containers Ltd v NZI Bank* [1995] 2 NZLR 30 it was also stated that an auditor must in planning his work recognise the possibility of fraud in the financial statements. In the US, section 78j-l (a) of the United States Code requires an auditor to perform his audit in conformity with international auditing standards and include procedures that are designed to provide a reasonable assurance that illegal acts having a material effect on the financial statements will be detected.

possibility of fraud an auditor must perform his audit in a manner that provides a reasonable assurance that irregularities will be detected.

- ii. An auditor must be able to identify suspicious matters and fraud risk factors.⁶ Such factors are identified as *inter alia* the desire to meet third party expectations and obtain extra revenue, the provision for or prospects of additional bonuses if abnormal profit targets are met and the desire to evade tax. Another important suspicious circumstance is the strength or efficacy of the internal control system. Devious individuals might be spurred to commit fraud by the urge to exploit lax controls.
- iii. After having identified the risk factors that may promote fraud an auditor must adjust his work programme accordingly and investigate suspicious matters to the bottom. An auditor must in this regard take all reasonable steps either to ensure that fraud or irregularities are exposed or that they do not exist and if suspicion cannot be removed, to qualify his report accordingly.⁷
- iv. An auditor must exercise professional scepticism. This formulation enjoys some support in international auditing standards. SAAS 240R and AU Section 230 state that an auditor must perform his work with an attitude of professional scepticism which encompasses a questioning approach to auditing. This means that an auditor will not

⁶ Paragraphs 48 and 49 of auditing standard SAAS 240R discussed in Chapter Four state that an auditor should be wary of factors that provide an incentive to commit fraud.

⁷ The case law which requires auditors to thoroughly probe suspicious matters is discussed in Chapter Three. The case of *Thoroughbred Breeders Association v Pricewaterhouse* 1999 (4) SA 968 (W) stands out because it was stated in that case that an auditor must exercise professional judgment in deciding which matters justify further investigation. Section 45 of the Auditing Profession Act, 26 of 2005 deals with reportable irregularities and basically states that these irregularities should be fully investigated. In the US the requirements on suspicious matters are somewhat draconian. Section 78j-1 (b) of the United States Code states that auditors must investigate all suspicious matters *whether they are material or not*. Paragraph 61 of SAAS 240R states that probing suspicious matters to the bottom entails the construction of audit procedures that address the identified risks adequately.

necessarily assume that management is honest. The courts have supported this requirement and have stated that an auditor must perform his audit with an enquiring mind that is not suspicious of dishonesty but of the possibility that someone may have made a mistake somewhere which must be checked to confirm its existence or non-existence.⁸

- v. An auditor must adhere to statutory requirements and international auditing standards.⁹

This research showed that the responsibility to produce financial reports that fairly reflect the financial position and profitability of an entity lies primarily with management and definitely not with the auditor. The directors and officers of a company are the ones who should serve the interests of the entity and are in that context, accountable.

3. RECOMMENDATIONS.

This research identified a few problems in South Africa's legal system and a number of recommendations are directed at those that are responsible for legal reform.

3.1 Recommendations in relation to Legislation.

3.1.1. Duties on directors and officers to certify the correctness of financial statements should be imposed.

⁸ See *Fomento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd* [1958] 1 All ER 11 (HL) 23. This attitude is important because, according to Vanasco RR, Scousen CR and Jensen RL "Audit Evidence: the US standards and landmark cases (2001) 16 (4) *Managerial Auditing Journal* 207, absence thereof has contributed largely to audit failures.

⁹ The statutory requirements in the Companies Act 61 of 1973, the Auditing Profession Act, 26 of 2005 and international auditing standards amplify the common law duty of reasonable care and skill. Adherence to auditing standards and statutory provisions will not automatically lead to the discovery of fraud but will certainly enhance its detection.

A statutory duty on directors or chief financial officers to report on the fairness of financial statements should be imposed. This can be added to the proposed section 96 (5) and (6) of the Companies Bill, 2007.

The rationale behind this recommendation is that since directors and management are responsible for drafting financial statements,¹⁰ a director must in his report attest to the fact that the financial statements fairly reflect the financial position and profitability of his entity. They are the persons most closely related to the entity and its dealings and are more informed on these matters than external auditors. The current situation as provided by the Companies Act 61, of 1973 is that it is an offence for directors and other officers to cause the financial statements to be materially misstated.¹¹ The Companies Act also requires every widely held company to publish financial statements which fairly reflect the financial position of a company and this is a responsibility of the directors.¹² An additional reporting burden on directors will encourage them to ensure that financial statements that are signed by each director contain a fair reflection of the financial position and results of their entities.

It is therefore recommended that legislation in South Africa include a provision similar to the one in section 302 (a) (2) of the Sarbanes Oxley Act which states that the principal executive officer or the chief financial officer must certify in the financial statements that the financial statements do not contain a materially false entry or do not omit items that cause the financial statements to be inaccurate. The current provision that deals with the director's report is not sufficient and is not clear.¹³

¹⁰ See section 297. See also the proposed section 96 of the Companies Amendment Bill, 2007.

¹¹ Sections 249-251.

¹² Section 285A.

¹³ Sections 299 (1) and (2) require the directors to include matters which may assist in the appreciation of a company's profit or loss or state of business in their reports. This provision is far too general. There is no provision that specifically requires directors of South African companies to certify that to the best of their knowledge, the financial statements do not contain a materially false item or omit an item that causes the financial statements to be materially misstated, despite the fact that they play a prominent role in drafting financial statements. This gap in the law can and should be filled.

3.1.2. Legislation should be more specific on auditor independence.

It was shown that the Companies Act as amended by the Corporate Laws Amendment Act, 24 of 2006 now contains provisions aimed at establishing and promoting auditor independence. Sections 274A and 275A (2) deal with auditor rotation and prohibit an auditor of a widely held company from performing certain non-audit services respectively. These provisions, although they are definitely steps in the right direction, are not specific and do not specify the non-audit services to be proscribed.

While consultancy and advisory work has largely been outlawed by section 201 of the Sarbanes Oxley Act, section 270A (5) (b) of the South African Companies Act empowers the audit committee of a company to determine the extent of consultancy and advisory work an auditor may perform.¹⁴ It is clear that South African legislation lags behind on this aspect. Legislation should therefore be amended along the following lines:

1. The Companies Act or, ideally, the Auditing Profession Act should be a little more specific on the non-audit services to be outlawed and like the Sarbanes Oxley Act, impose further restrictions on consultancy work for audit clients. The example set by section 201 of the Sarbanes Oxley Act of listing the prohibited non-audit services, over and above giving the relevant authorities the power to prohibit more non-audit services, should be followed.
2. The Companies Act or preferably the Auditing Profession Act should contain provisions aimed at avoiding conflict of interest situations because these two Acts are absolutely silent on this very important matter. The provision could be modelled on section 206 of the Sarbanes Oxley Act which makes it unlawful for a public accounting firm to perform an audit for any entity whose chief executive officer, chief financial officer or officials responsible for

¹⁴ This also raises the question of inconsistency because the audit committee of one company may allow certain consultancy work that can be refused by the audit committee of another company. There is a need to follow the example of outlawing consultancy work set by the Sarbanes Oxley Act.

financial matters were in the employ of the public accounting firm during the one year period immediately prior to the audit.

3.2. The Courts.

3.2.1. The courts must take note of and refer more to auditing standards.

This research referred to a number of auditing standards which enjoy recognition by statutes, for instance section 44(3) (b) of the Auditing Profession Act 26 of 2005. In the U.S., auditing standards are recognised as part of the legal requirements that auditors have to adhere to. Authors like Rabel¹⁵ wrote about the synchronicity of auditing standards and the law and basically pointed out that auditing standards were accepted long ago as part of the legal requirements in the U.S. In South African law the case *Thoroughbred Breeders Association v Pricewaterhouse*¹⁶ fully accepted the use of auditing standards in determining auditor negligence.

This researcher recommends the increased use of international auditing standards as part of the laws that are applicable to audit procedures and therefore indicative of wrongfulness as well as being relevant in determining auditor negligence, because these standards reflect standard practice and show what a reasonable auditor has to do in the performance of his duties. As has been pointed out, auditing standards that deal with the auditor's duty of care are perfectly in line with the law.

3.2.2. The courts must consider the impact of audit limitations.

SAAS 240R states that because of limitations associated with an audit, there is an inherent a non-derogable risk that material misstatements in the financial statements will not be detected and this may cause harm to either the client or third parties.¹⁷ These limitations are related to external factors that have nothing to do with the reasonable care and skill displayed by the auditor. They may even hamper the

¹⁵ "Auditing standards and procedures in the light of court decisions" (1944) 42 (6) *Michigan Law Review* 1009.

¹⁶ 1999 (4) SA 968 (W).

¹⁷ Paragraph 9 of SAAS 249R.

success of an audit conducted with reasonable care and skill. These limitations entail the craftsmanship of the fraudster(s), the frequency of the manipulation and the position of the person(s) involved. As such it is retrogressive to expect auditors to detect fraud that is carefully concealed or has been tracelessly perpetrated. That would make the auditor's duties unfairly onerous. The courts should carefully consider these external circumstances that make the detection of fraud difficult.

4. CONCLUDING REMARKS.

It is hoped that these recommendations will assist in addressing the fear that the liability of auditors for negligent misrepresentation is enormous if not unlimited. This research was conducted for the purpose of putting the relevant principles in perspective. It is submitted that if due consideration is given to all the requirements for *aquilian* liability and the relevant principles in this context that relate to wrongfulness, negligence and causation, there will be more clarity on the extent of an auditor's liability for misstatements in a company's financial statements. The researcher hopes that this research will indeed make a contribution in this regard.