

CHAPTER ONE.

INTRODUCTION.

1. GENERAL OBSERVATIONS.

In terms section 1 of the Auditing Profession Act, 26 of 2005,¹ the word audit² means:

“The examination of, in accordance with prescribed or applicable auditing standards,

- a. financial statements with the objective of expressing an opinion as to their fairness or compliance with an identified financial reporting framework and any applicable statutory requirements; or
- b. financial and other information prepared in accordance with suitable criteria with the objective of expressing an opinion on the financial and other information.”

Auditors perform audits by attesting³ that the financial statements⁴ of an organization fairly reflect, in accordance with international standards of accounting, the financial

¹ Signed by the President on 12 January 2006 and it repealed the Public Accountants and Auditor’s Act 80 of 1991.

² Audit is a Latin word meaning, “he hears”. The word audit has been used in the way it is used today since ancient times; the accounts of an estate, domain or manor were verified by being announced to those in authority by those who had compiled them. See Woolf E *Auditing Today* 6th ed 1.

³ To attest to information is to provide assurance as to its reliability. Auditors attest by way of reporting on the annual financial statements which the directors are required to lay before the annual general meeting in terms of section 286 (1) of the Companies Act, 61 of 1973 (hereinafter the Companies Act). Meskin PM, Blackman MS, Glaser MD, Konyn IE and Mullins SF *Henochnberg on the Comapnies Act* 4th ed 444 (hereinafter Meskin *et al*) identify the auditor’s report as the medium by which an auditor satisfies his duties to the members in terms of section 301 (1). This direct report to members without intervention from the directors is done to secure independent and reliable information in respect of the financial position of the company at the time of the audit.

position and profitability of that organization.⁵ The Companies Act, 61 of 1973 obliges auditors to report on the financial statements' adherence with the requirements of section 285A.⁶ In simpler terms auditing is an undertaking by auditors to collect evidence, search and verify accounting records and examine other evidence supporting the financial statements and provide a reasonable assurance that they reflect fairly the financial position of the organization.⁷

This function of attesting is important because:

“dependable information is essential to the very existence of our society. The investor making a decision to buy or sell securities, the banker deciding whether to approve a loan, the government in obtaining revenue...all relying upon information provided by others. In many of these situations the goals of the providers of information run directly counter to those of users of the information. Implicit in this line of reasoning is the recognition of the social need for independent auditors; individuals of professional competence and integrity who can tell us whether the information on which we rely constitutes a fair picture of what is really going on.”⁸

⁴ Financial statements consist, in terms of section 286 (2) of the Companies Act, of a balance sheet, an income statement and additional components as required by financial reporting standards, a summary of significant accounting policies and other explanatory notes, a cash flow statement, a directors report and an auditor's report.

⁵ In terms of section 285A of the Companies Act financial statements must reflect fairly the financial position and profitability of a company.

⁶ Section 300 (h) of the Companies Act states that it is the function of an auditor to evaluate the company's financial reporting and the reliability thereof.

⁷ Whittington R and Pany K *Principles of Auditing* 11th ed 4.

⁸ *Ibid* 1. See also Lee Tom *Corporate Audit Theory* 1st ed 27 who states that the major role of the audit process of monitoring and control is societal because it provides a critical service to the community as well as persons and institutions in need of assurance and comfort because of prior doubts and uncertainties in the real world in which they have an interest. Lee states further that the audit process has an economic role to play because much of human activity in today's developed society has considerable economic consequences and the audit process assists in the management and control of economic risk.

Put simply, a sizeable number of persons rely on the fairness of financial and audit reports. In an attempt to make auditors produce fair and reliable reports, the Companies Act provides them with rights which generally include the right to access at all reasonable times the accounting records, all books and documents of the company,⁹ and to have access to financial statements of any subsidiary of the company,¹⁰ and to attend every general meeting.¹¹

The Auditing Profession Act, 26 of 2005¹² also obliges auditors not to attest to any financial statements unless certain conditions have been met, thereby setting a standard for diligence. The purpose is obviously to place the auditor in a position to come to a fair and informed attestation. Primarily however an auditor must have adequate technical training and proficiency, be of independent status and consistently display an independent mental attitude when he prepares his report.¹³ Of great importance in this context is the requirement that an auditor must exercise reasonable professional care and display reasonable skill in the preparation of his report.¹⁴

This is done by helping where doubts and uncertainties about the economic outcomes of business decisions and actions exist because of a largely unknown future.

⁹ Section 281 (a).

¹⁰ Section 281 (b).

¹¹ Section 281 (c).

¹² Sections 44 (2) and (3) of this Act require auditors to refrain from attesting unless they have carried the audit free from restrictions and by applying whatever means that are necessary having regard to the nature of the enterprise. Auditors are furthermore required to attest *inter alia* only if they are satisfied that proper accounting records have been kept in one of the official languages and when all the necessary information has been obtained.

¹³ The Companies Act, 61 of 1973 contains provisions aimed at securing auditor independence in sections 274A and 275A. These provisions are discussed in more detail in Chapter 4.

¹⁴ A general overview of what constitutes due professional care is given in the Australian case *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29 64 where it was said "...his vital task is to take care to see that errors are not made, be they errors of computation or errors of omission or downright untruths. To perform this task properly he must come to it with an enquiring mind, not

Despite these measures, there are in fact many instances where financial statements issued by accountants and attested to by auditors as showing a fair reflection of the financial position of the company have subsequently turned out to be false. Persons who act on the assumption that such an auditor's report is true and consequently suffer losses often blame the auditors. Enormous class actions are instituted by such persons against the auditors for alleged negligence and even worse, dishonesty or fraud.¹⁵ The question, "where were the auditors"¹⁶ becomes a deafening refrain in these circumstances. Auditors argue that they are not obliged to detect fraud and even if it were the case, it would be an onerous duty to comply with since they rely on officers of the company for information. According to them, the responsibility should be placed on the company directors who in the first place are responsible for ensuring fair reporting and who may fraudulently withhold essential information.

What many do not realize is that the auditor's role in scrutinizing annual reports has some significant limitations. In the first instance, the reports are historical, and do not predict the future at all. As such, they are only but one tool among several that investors and their advisers need for the purpose of making informed investment decisions about companies. Secondly, the auditor only looks at the accuracy of the company's financial statements, and does not consider other data that may be relevant to the company's performance.

Blaming auditors for corporate collapses would certainly not always be fair. It will inevitably be asked whether the duty to exercise reasonable care and skill incorporates or

suspicious of dishonesty but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none."

¹⁵ Godsell David *Auditors' Legal Duties and Liabilities in Australia* 1993 quoted by Fourie JSA "Auditors and Corporate Illegality and Fraud" (1994) 6 SA Merc LJ 178 stated that the largest accounting firms in the USA have paid out more than \$500m in settlement of mostly audit related suits.

¹⁶ See Clulow John "Where were the Auditors" July (2002) *Accountancy* SA 3.

should incorporate the duty to detect fraud, and whether it is legally justified to blame auditors who in some respects are the convenient soft targets.¹⁷ This dissertation is primarily concerned with answering this question and showing that auditors have no inherent legal duty to detect fraud. This dissertation does not really distinguish between the auditor's duty to the client or to third parties because it focuses on negligence and issues that affect wrongfulness which clients or third parties must prove to establish auditor liability.

2. STATEMENT OF THE PROBLEM.

2.1. General remarks.

The conflict of expectation alluded to above can be described as a phenomenon that is popularly termed the 'audit expectation gap.' This gap consists of the different perceptions of the duties and responsibilities of auditors as held by the business community and investors and the public at large on the one hand and those of auditors and the auditing profession as reflected in official pronouncements, on the other.¹⁸ It cannot be questioned that this gap largely contributes towards a culture of blaming auditors whenever companies collapse due to fraud. Comments made by Mark Burrows¹⁹ illustrate the existence of this gap:

¹⁷See Fourie JSA *supra* note 15 185 where one Adelaide lawyer is quoted as saying, "it is too expensive to run complex corporate claims. Persons will not run...unless they are satisfied that the individual is worth suing as directors can shed assets. It is more productive to sue auditors."

¹⁸ See Papadakis G "Closing the Expectation Gap" April 2003 *Accountancy SA* 6 where the biggest component of the gap is said to be the auditor's perceived incapacity to detect fraud and to give a warning of an imminent corporate collapse. This fraud expectation gap emanates from the public's opinion that auditors should detect fraud and spill the beans, whereas auditors themselves do not accept this responsibility.

¹⁹ The one time chairman of the Australian Companies and Securities Advisory Committee quoted by Fourie JSA *supra* note 15. According to Dye RA "Auditing Standards, Legal Liability and Auditor Wealth" (1993) 5 *The Journal of Political Wealth* 101 the most profound change in relation to the auditing profession in the US has been the amount of suits it has been subjected to. He quotes one

“I am very critical of auditors. I think it is amazing that we have a whole lot of major accounting firms that signed accounts twelve months ago, two years after the crash, with respect to the adequacy or otherwise of disclosure of billion dollar companies that subsequently went down the gurgler. The market didn’t change, so the rot must have been evident at the time of the preparation and auditing of the accounts.”²⁰

It is true to say that auditors are generally seen in an unfavourable light whenever fraud is subsequently uncovered. It is the auditor that becomes the scapegoat and is blamed, invariably with the benefit of hindsight in the event of a misfortune like fraud by a client’s employee. Godsell²¹ concedes that some of the criticisms leveled at auditors are justified but points out that the media and other interested parties may be failing to recognize that the primary responsibility for a company’s affairs lies with the directors. Directors owe fiduciary duties to the company²² and must therefore conduct the affairs of the company with due care and integrity as well as in the best interests of the company.²³ It must follow that the responsibility to detect, investigate and prevent fraud and errors actually lies with the directors and management. However unscrupulous directors are often the persons who commit the fraud or are responsible for the mismanagement of the

observer of the profession as saying that, “more suits have been filed against accountants in the past 15 years than in the entire history of the profession.” He also states that in 1992, suits against auditors were estimated to amount to \$30 billion.

²⁰ Quoted by Fourie JSA *supra* note 15 179.

²¹ *Supra* note 15 185.

²² See *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 where it was stated that directors must observe the utmost good faith in their dealings with the company even where they cannot be construed to be agents of the company. See also *Novick v Comair Holdings Ltd* 1979 (2) SA 116 (W) where it was held that fiduciary duties include the duty to act at all times in the company’s best interests in addition to the duty not to act in a manner which creates a conflict between the interests of the company and personal interests and the duty to refrain from misusing information.

²³ In *Mills v Mills, High Court of Australia* (1938) 60 (CLR) 150, Latham CJ stated that “...it is urged that the rule laid down by the cases is that directors must act always and solely in the interests of the company and never in their own interests...”

company. The tragedy for auditors is that they are made the scapegoats if the company fails or suffers losses due to the negligence or fraud of directors and company officers.

The Cohen Commission of Inquiry into the American Auditing Profession²⁴ acknowledged the difficulties associated with the societal and sometimes judicial demands on auditors. It came to the conclusion that the auditor's responsibility to detect and disclose the illegal acts of their clients should be limited because auditors cannot reasonably be expected to do that. This is so because auditors are primarily accountants in the ordinary sense, trained in the field of finance. Auditors performing the conventional auditing functions are not lawyers²⁵ or criminal and forensic investigators²⁶ and obviously do not possess the professional skills of lawyers or forensic experts. It is accordingly unrealistic to expect them to do what they are not trained to do and impose professional liability on them if they fail to perform that function.²⁷ The Cohen Commission found that, against the background of the obsession with white collar crime, some parties regard independent auditors as public agents to be used in the detection of fraud.

It must however be noted that the accounting profession must also be sensitive to the society's need for an evolution of the range of services that can be offered by the profession,²⁸ but to require auditors to depart from standard practice to the extent of

²⁴ 1978, referred to by Fourie JSA *supra* note 15.

²⁵ Although they are well trained in the field of law relevant to their profession.

²⁶ Various auditors specialize in forensic work but this dissertation is mainly concerned with the general functions of auditors.

²⁷ Professional liability is explained by Tindal J in *Lannphier v Phipos* 1838 8 C & P 475 as, "every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill. He does not undertake, if he is an attorney, that at all events you shall gain in your case, nor does a surgeon undertake that that he will perform a cure, nor does he undertake to use the highest possible degree of care and skill."

²⁸ It has to be noted on the other hand that the demands of society on this profession seem to be extremely onerous because there is no room for failure. The law does not however demand that professionals must guarantee results. Evidence of failure to detect fraud does not in itself constitute failure to use reasonable

detecting fraud whenever it exists will be too radical and time consuming with serious implications on the fees that they charge.²⁹ This might contribute towards closing the so called audit expectation gap but it would not be reasonable in terms of the cost and legal implications thereof.

In the recently decided case of *Axiam Holdings Ltd v Deloitte & Touche*,³⁰ it was held that where an auditor expresses an opinion in good faith without knowing the defects in such opinion but should have *become aware* of those deficiencies at a later stage, he is under a duty to warn even a third party of the inaccuracy of his opinion. The court found that the firm Deloitte and Touche was liable and ruled that a reasonable auditor in their position ought to have alerted a third party if the auditor could reasonably be expected to know that such a third party would rely on the accuracy of his opinion.³¹ It is submitted that this decision constitutes a dramatic extension of the auditor's duty to exercise reasonable care and skill, also to incorporate instances where an auditor ought to have been aware at a later stage of the fact that his opinion is deficient. It is immaterial whether he, in fact, knew of the deficiency at the time he performed the audit or at a later stage.

This extension of the duty of reasonable care and skill is no doubt motivated by experiences where auditors were found to be grossly negligent. In the groundbreaking

care and skill. In *Thake v Maurice* [1986] 2 WLR 316 (CA) it was held that a gynecologist sterilizing a patient is not liable simply because the client conceives again.

²⁹ See *Caparo Industries plc v Dickman* [1989] 2 WLR 316 where it was held that an auditor is not obliged to draw the accounts, turn every stone and open every cupboard. He is not liable for failing to find irregularities that would not have been found by a reasonably competent auditor.

³⁰ 2006 (1) SA 237 (SCA) decided under section 20 (1) of the Public Accountants and Auditors Act 80 of 1991 (which sets out the standard of diligence required from an auditor before he can report or provide an opinion that the financial statements fairly reflect the position of a client company) and section (9) (b) (ii) (which gave a third party the right to sue an auditor if the auditor knew or could reasonably be expected to know that a negligent statement could be relied on by the third party).

³¹ In a minority judgment, Cloete JA and Heher JA came to the conclusion that a person cannot disclose what he does not know and cannot be held liable for what he ought to have known.

and much publicized collapse in the U.S. of the former energy giant Enron, the auditing profession lost a lot of respect. In this scandal Kevin Howard, the then Chief Financial Officer of the Enron Broadband Services and Michael Krautz, who was responsible for accounting operations, caused false entries to be made in the Enron books that reflected revenue of U.S. \$111 million for the period between 2000 and 2002.³² The auditors certified the financial statements. Investors, including many of the company's own employees, invested billions of dollars in Enron because it purported to record massive profits. Before long their stock turned to dust amidst indications that the financial statements were a farce. When the Securities Exchange Commission requested copies of Enron's financial statements chief auditor David Duncan of Arthur Andersen unauthorizably shredded key documents³³ in an attempt to frustrate the investigations.³⁴ This certainly tarnished the image of the auditing profession.

This research attempts to show that the liability of an auditor is not unlimited and failure to detect fraud simply because fraud exists does not constitute negligence on the part of auditors. It should not give rise to liability in delict or otherwise, *neither to the client nor to third parties*. This therefore applies irrespective of whether the client or third parties seek to claim from the auditor. This research will not distinguish between these two situations because as shall be seen in Chapter Two, both situations require the element of

³² See <http://news.yahoo.com>. "US federal jury convict ex-Enron executive acquits another." (accessed on 12/4/2006). The trial of Howard and Krautz hinged on Enron's agreement with retail video store Blockbuster in April 2000. The deal was a failure and did not generate any revenue for Enron. It was cancelled in March 2001 but Enron's books showed revenue of US\$111 million which represented the revenue that was expected to be generated over the twenty years of the contract.

³³ David Duncan was dismissed for the destruction of the documents relating to Enron's audit. An Andersen lawyer referred to Duncan as a 'client pleaser.' See Raghavan Anita 'How a bright star at Andersen burned out along with Enron' at http://online.wsj.com/page/0,,2_0801,00.html (accessed 10/3/2006).

³⁴ Duncan admitted to obstruction of justice saying, "yes I obstructed justice. I instructed people on the team to follow the document retention policy, which I knew would result in the destruction of documents." See <http://money.cnn.com/2002/05/13/news/Andersen/> 'Duncan admits to obstructing justice.' The Enron scandal will be discussed in more detail in Chapter Five.

negligence to be established. However, a contract between an auditor and a client may impose specific and even draconian duties on an auditor.

2.2. Specific Problems.

The specific problems this dissertation will analyse entail:

- i. Whether the existence of fraud in financial statements that were audited and certified as fair in itself reflects negligence on the part of the auditor of the financial statements. As has been stated, auditors are required to exercise reasonable care and skill in the performance of their duties. Does this requirement mean that auditors are under an obligation to detect fraud and if so, to what extent?
- ii. This dissertation will analyze the scope of the auditor's duty of reasonable care and skill and show that this duty does not *per se* include the duty to detect fraud.

3. LITERATURE REVIEW.

In discussing the auditor's duty of reasonable care and skill, authors generally agree that this duty does not automatically include the responsibility to detect fraud. Meskin *et al* rely on the judgment in *Tonkwane Sawmill Co Ltd v Filmalter*³⁵ to state that the mere fact that an audit does not uncover a discrepancy is not in itself *prima facie* evidence of negligence because an auditor is not required to detect defalcations.³⁶ Meskin *et al* state further that an auditor must in the performance of his duties act with the skill, care and caution which a reasonably competent, careful and cautious auditor in the same circumstances would use. The *Tonkwane* case basically stated that an auditor must exercise reasonable care and skill and went to some length in defining an auditor's reasonable care and skill. This case will be discussed in more detail in Chapter Three.

³⁵ 1975 (2) SA 453 (W) 456.

³⁶ *Op cit* note 3 444.

Other authors also state that an auditor must perform his work with reasonable care and skill.³⁷ This duty, they say, is relative and may vary according to the circumstances of each case. The reasoning is the same as Meskin *et al*'s regarding a distinction that has to be drawn between circumstances that do not excite suspicion and those that in fact do. Less care is reasonable where the circumstances do not demand it. Conversely more care is necessary if suspicion ought to be aroused.³⁸ This duty according to Cilliers *et al* is relative in the sense that it is susceptible to change with the passage of time. In the case of *In Re Thomas Gerrard and Son Ltd*,³⁹ Pennycuik J stated that standards of care get more exacting with time and need to be reviewed repeatedly to keep up with developments in the auditing profession.

Cilliers *et al* state further that an auditor must in the performance of his duties be alert without necessarily being suspicious.⁴⁰ The authors refer to judgments in leading cases such as *In Re Kingston Cotton Mill (No 2)* where Lopes J said that an auditor is not bound to be a detective.⁴¹ Accordingly, an auditor's task is verification and not detection. The audit process can however only be completed by taking into account the fact that the affairs examined may not always be accurately reflected because errors may occur, irrespective of whether they were made innocently, negligently or even intentionally. In

³⁷ Cilliers HS, Benade ML, Henning JJ Du Plessis JJ, Delport PA, De Koker L, and Pretorius JT *Corporate law* 3rd ed 412 (hereinafter Cilliers *et al*). Cilliers *et al* also stated that this duty can be regarded as an implied term of the contract which however could accurately be described as a duty incidental to the auditor's office or as coming from the inherent nature of the professional relationship between the auditor and his client which is established by contract.

³⁸ Cilliers *et al* *ibid* 412 quote the decision of *In Re Kingston Cotton Mill Co (No 2)* [1896] 2 (Ch) 279 where it was said that it is not part of the duty of an auditor to take stock in the absence of suspicion.

³⁹ [1968] Ch 455 discussing the applicability of *In Re Kingston Cotton Mill Co (No 2)* *supra*, Pennycuik J stated that *Re Kingston Cotton Mill (2)* can be distinguished because the standards of reasonable care and skill are more exacting today than they were in 1896.

⁴⁰ *Op cit* note 37 412.

⁴¹ The decision in *Kingston* on auditors not being obliged to work as detectives and acting as watchdogs instead of blood hounds was referred to by Boshoff J in *Tonkwane supra* note 35.

Pacific Acceptance Corporation Ltd v Forsyth,⁴² another case to be discussed in more detail in Chapter Three, the auditor's duty of reasonable care and skill was well defined and the expectation to detect fraud was dealt with.

An auditor who acts with the required care and skill must, according to Cilliers *et al*, probe to the bottom any serious or irregular matters uncovered during the audit.⁴³ This is what was stated in *Dairy Containers Ltd v NZI Bank Ltd*⁴⁴ and other cases discussed in Chapter Three. Cilliers *et al* state in addition that an auditor's conduct must not be judged with hindsight and must not be motivated by the desire to find a scapegoat.⁴⁵

The Enron scandal in the United States of America which was described as the worst in history, led to the passing of an Act known as the Sarbanes Oxley Act. This Act deals with the ethics of the auditing profession and imposes stringent reporting requirements. According to Thomas Donaldson, Professor of Business Ethics at the University of Pennsylvania's Wharton School the Act was

“rushed into existence. Its main aim was to calm the markets, to calm investor sentiment which it did. At the same time it has been interpreted by accounting firms in extremely expensive suffocating ways, and it costs way too much. The bang is not worth the buck.”⁴⁶

This Act will be discussed in greater detail in Chapter Five.

⁴² *Supra* note 14.

⁴³ Section 20 (5) of the repealed Public Accountants and Auditors Act, 80 of 1991 required auditors to report to the Public Accountants and Auditors Board and the client's management any 'material irregularity' that may come to their attention. The Auditing Profession Act 26 of 2005 in terms of section 45 (1) obliges auditors to report any 'reportable irregularities' to the management and to the Independent Regulatory Board for Auditors.

⁴⁴ (1995) 2 NZLR 30.

⁴⁵ *Op cit* note 37 415.

⁴⁶ See <http://news.yahoo.com>. "After Enron climax US rethinks law on corporate scandals." Accessed on 13.3.2006.

4. ASSUMPTIONS OF THE STUDY

In this study there are assumptions that do not necessarily need to be proved. The first is that auditors, except forensic auditors, are not specifically trained to detect fraud. They can only detect fraud if it is reasonably possible to do so and not because of any obligation. Secondly, investors, creditors, other interested parties and society at large tend to lay the blame on auditors in practically all instances of corporate fraud. This is so because, before financial statements may be approved they have to be certified by auditors and this makes auditors vulnerable to charges where they give approval to something that subsequently turns out to be inaccurate.

5. AIMS AND OBJECTIVES.

5.1. Aims.

This research is aimed at showing that although the blame for corporate failure and fraud is often placed on auditors it is in most instances unwarranted and motivated by a desire to find a scapegoat. Auditors do not have an inherent duty to detect fraud. This research intends to deduce and explain the elements of the auditor's duty to exercise reasonable care and skill from the case law, statutes and international auditing standards and to investigate the circumstances under which and the extent to which a more extensive investigation can be expected from an auditor for the purposes of establishing whether fraud or material misstatements exist.

5.2. Objectives.

To adequately do justice to the aims stated above, the following specific objectives will be pursued:

1. To investigate the scope of the auditor's duty to apply reasonable care and skill and its links with the statutory provisions in the various Acts and auditing standards.
2. To examine the legal principles relating to negligence and professional negligence.
3. To investigate whether the duty to exercise reasonable care and skill encompasses the duty to detect fraud and other illegal acts or whether the law is developing in that direction.
4. To examine the scope of the duty of reasonable care in the United States of America, as enunciated in its statutory law, case law and auditing standards.
5. To analyze the responses in the United States of America to fraud and the safeguards put in place in that country. The research will be limited to responses that are related to the auditor's duty of reasonable care and skill. This will be aimed at determining whether South Africa should put similar safeguards in place.
6. To recommend possible changes that can be made to our law to bring it in line with international trends and to bring clarity to the extent of an auditor's duty of reasonable care and skill.

6. JUSTIFICATION AND LIMITATIONS.

6.1. Justification of the study.

The fact that auditors as convenient scapegoats are blamed for many corporate collapses involving fraud is not debatable. They are the targets to make good the losses suffered by others and in the first instance, caused by the indiscretions of directors. It is interesting to note that the chorus is almost always 'where were the auditors' and nothing is being done to determine the scope and limitations of their duties. This study is motivated by the desire to expose the unreasonableness of blaming auditors for failing to do what they cannot reasonably be expected to do and to show that auditors have no legal duty to detect and possibly prevent fraud on the part of their clients' employees. Put differently, the researcher recognizes the importance of alerting all involved to the reality that it is legally unjustifiable to subject an auditor to liability for negligence where he acted with the degree of care and skill that can reasonably be expected from an auditor under the same circumstances. This area of the law therefore needs to be clarified and developed.

It is hoped that this study will assist in the closing of the so-called audit expectation gap. The fact that auditors, as was the case in Enron, sometimes contribute towards the losses, certainly stir the emotions of those who suffer the losses. This research is intended to contribute towards more realistic expectations on the part of investors, creditors, all interested parties and the society at large in this regard.

It is trite law that auditors need to be fully aware of their legal duties as well as what constitutes reasonable care and skill and what amounts to negligence. It is imperative to note that the new Auditing Profession Act has brought some changes in relation to the standards of care and diligence. This research will hopefully serve as a useful guide to auditors on these issues.

6.2. Limitations and related matters.

This study like any other had inherent limitations. The most important regards the scope of the study. Auditors have many duties to perform some of which are imposed by statute and some derived from the contracts with clients. This research does not focus on these duties in their entirety but only in so far as they are relevant to the duty of reasonable care

and skill. The researcher focused almost entirely on how the courts interpreted the duty of reasonable care and skill, the statutory provisions in this regard⁴⁷ and to a lesser extent how the profession itself views this duty.⁴⁸

Topical issues such as auditor independence and rotation⁴⁹ are only mentioned to the extent that they relate to the duty of reasonable care and skill. The same applies to issues relating to the way in which a company must execute its internal audit function according to good corporate governance principles.

This study pays considerable attention to the relevant U.S. laws on the subject because it has advanced legal principles on this issue. The recently passed U.K. Companies Act (c 46) of 2006 also receives some attention in Chapter Four. Due to the international nature and application of the underlying common law principles, separate Chapters will not be devoted to separate legal systems.

Comprehensive literature on the subject such as an unpublished doctoral thesis of JT Pretorius⁵⁰ was not readily available or available in a language not known to the

⁴⁷ Section 44 of the Auditing Profession Act, 26 of 2005 contains the duties in relation to an audit. These duties constitute what the legislation deems to be reasonable care and skill for example subsection (3) (d) requires an auditor to obtain all information, vouchers and other documents which in his opinion are necessary for the proper performance of his audit before he can attest to the fairness of the organization's financial statements.

⁴⁸ Statements of international auditing standards issued by the South African Institute of Chartered Accountants will be relevant here.

⁴⁹ These issues received significant attention after the spate of corporate collapses in recent years. The recent amendments to the Companies Act dictate that auditors should be rotated every four years and should be nominated for appointment by an audit committee with at least three independent non-executive directors to promote their independence. See sections 270A and 274A of the Companies Act, 61 of 1973.

⁵⁰ Pretorius JT *Aansspreeklikheid van Maatskappyouditeure teenoor Derdes op grond van Wanvoorstelling in die Finansiële State* LLD RAU; also Pretorius JT "Die Rol en Funksie van die Maatskappy-Ouditeur by Finansiële Verlagdoening" (1986) *MB* 82; Pretorius JT "Nalatige Wanvoorstelling en Maatskappy-ouditeur se Belangrike Ongerapporteerde Beslissing" (1987) *SALJ* 577; Pretorius JT *Aansspreeklikheid van*

researcher. This handicap did not substantially affect the study because the researcher attempted to make the research detailed and up to date by referring to primary and secondary sources of the law that are available on the internet and the different libraries of other institutions

7. RESEARCH METHODOLOGY.

The research essentially entails a study of relevant statutes, case law and literature and a comparative analysis between the law of South Africa and recent developments in the U.S. and to a limited extent, the U.K.

7.1. Literature

This study relied on textbooks and articles in relevant journals. The researcher did not limit the research to legal texts but also consulted literature in relation to accounting and auditing where necessary.

7.2. Online sources.

Various research databases such as Jutastat, and J Stor were extensively used.

7.3. Case law.

Case law will constitute the basis of many arguments presented especially in Chapters Two and Three. This research tests auditing standards on their consistency with case law. Important cases such as the recent judgment in *Axiam Holdings Ltd v Deloitte &*

Maatskappy-ouditeurs teenoor Derdes op grond van Wanvoorstelling in die Maatskappy se Finansiële state” (1996) 22 SA Merc LJ 311.

Touche,⁵¹ *Thoroughbred Breeders Association v Pricewaterhouse*,⁵² *Tonkwane Sawmill Company Ltd v Filmalter*⁵³ and many others are referred to and analyzed intensively. Cases decided in other jurisdictions but with a bearing on South African law will also be analyzed. Such cases include, *inter alia*, *Re London and General Bank*,⁵⁴ *In Re Kingston Cotton Mill Company*,⁵⁵ *Caparo Industries plc v Dickman*⁵⁶ and *Re Thomas Gerrard & Son Ltd*.⁵⁷

7.4. Comparative analysis.

A major portion of this research will be dedicated to a discussion of how other jurisdictions define the auditor's duty of care. The United States of America and the United Kingdom were selected because of recent developments and new legislation in these countries. The U.S. was selected because it is plausible to analyze the reaction to the Enron debacle. A comparison between South African law and these leading jurisdictions will form a major and academically stimulating part of this research.

7.5. Legislation.

This research deals with company legislation such as the Companies Act, 61 of 1973 (as amended by the Corporate Laws Amendment Act of 2006), the U.K. Companies Act of 2006 (c 46), the Sarbanes Oxley Act, the Auditing Profession Act, 26 of 2005 and the

⁵¹ *Supra* note 30.

⁵² 1999 (4) SA 968 (W).

⁵³ *Supra* note 35.

⁵⁴ [1895] 2 Ch 673. In this case it was said that an auditor must use reasonable care and skill and must certify to the shareholders only what he believes to be true.

⁵⁵ *Supra* note 38.

⁵⁶ *Supra* note 29. It was decided in *Caparo* that auditors of a company do not owe any duty of care either to members of the public or to existing members of the company.

⁵⁷ *Supra* note 39. An auditor who has been or ought to have been put on inquiry is under a duty to make an exhaustive investigation.

United States Code. These Acts are relevant because they amplify the auditor's duty of reasonable care and skill.

8. STRUCTURE OF DISSERTATION.

The Chapters mentioned below will discuss the auditor's duty of reasonable care and skill from various angles. Chapter Five and to a lesser extent Chapter Four deal with other jurisdictions and compare South Africa's laws to those of the selected jurisdictions. The conclusions in these Chapters will focus on comparing and contrasting the legal principles with South Africa's. The final Chapter contains a number of recommendations aimed at legislation and the courts.

8.1. Chapter One: Introduction

The research problem, delimitation and context of the research is set out in this Chapter.

8.2. Chapter Two: Conceptual Analysis.

The Second Chapter will deal with the legal concepts relating to negligence, professional negligence and the auditor's civil liability.

8.3. Chapter Three: The Auditor's Duty of Reasonable Care and Skill as Formulated in Case Law.

The Third Chapter looks at the present case law on the nature and scope of the auditors' duty of reasonable care and skill. Because of the fact that the underlying legal principles are universally applied, a clear distinction will not be drawn between South African and other cases. The evolution of this duty through the case law generally is shown.

8.4. Chapter Four: The Auditor's Duty of Reasonable Care and Skill in South Africa: A Statutory and Professional perspective.

The Fourth Chapter deals with the components of the auditor's duty of reasonable care and skill as formulated by the relevant statutes. The relationship between statutory law, auditing standards issued by the relevant professional bodies and the broader duty of reasonable care and skill as formulated in the cases are also discussed. This Chapter also focuses on the recently passed Companies Act (c 46) of the U.K. and compares its provisions on relevant aspects with those of the South African Companies Act.

8.5. Chapter Five: Comparative Analysis: The Auditor's Duty of Reasonable Care and Skill in the U.S.

This Chapter looks at the most sophisticated and advanced legal principles on the topic as found in the Sarbanes-Oxley Act. This Chapter discusses the statutory elements of the auditor's duty of reasonable care and skill that can be deduced from legislation in the U.S.

8.6. Chapter Six: Conclusion, Findings and Recommendations.

This is the final Chapter. It contains a comprehensive conclusion, all the findings and relevant recommendations.

The researcher attempted to state the law as at 1 January 2008.

Note that in this dissertation, the researcher uses the masculine to also refer to the feminine gender.