

CHAPTER TWO

CONCEPTUAL ANALYSIS

1. INTRODUCTION.

It is trite law that an auditor must conduct his work with the care and skill that can reasonably be expected from a reasonable auditor. This Chapter explores the concept of the auditor's duty of reasonable care and skill and other criteria for determining negligence.

2. CONCEPTS OF NEGLIGENCE AND WRONGFULNESS.

2.1. General Observations.

The auditor's common law duty of reasonable care and skill stems from the principles of the English law relating to the tort of negligence. In negligence a person is blamed for his careless and thoughtless actions or imprudence if he fails to pay sufficient attention to his actions and consequently to observe the standards of care that he is by law required to observe. In *South African* law the criterion adopted to find whether a person has conducted himself carelessly or negligently is the well known objective standard of the reasonable person, or the so called *diligens paterfamilias*, also referred to as the *bonus paterfamilias*.¹ This test involves an inquiry into what the reasonable person who finds himself in the same circumstances as the wrongdoer would have done. If he would have acted differently the wrongdoer should also have acted differently. Conversely if reasonable person would have done what the wrongdoer has done then the wrongdoer is not negligent.

¹ A person is negligent if a reasonable person in his position would have acted differently. In *Kruger v Coetzee* 1966 (2) SA 428 (A) 430 Holmes JA stated that *culpa* arises if (a) a *diligens paterfamilias* in the position of the defendant (i) would have foreseen the reasonable possibility of his conduct injuring another in his person or causing patrimonial loss to his property, and (ii) would take reasonable steps to guard against such occurrence and (b) the defendant failed to take such steps.

The *diligens paterfamilias* is a fictional creature of the law created with the intention to obtain a workable objective norm for conduct in society. He is a person who is not exceptionally gifted or talented, careful or developed. He is also not an underdeveloped reckless chancer who does not display any prudence. His qualities can be found between these two extremes.² The reasonable person possesses the qualities which the community expects from its members in their day to day interaction with each other. These qualities include a certain minimum knowledge and mental capacity. The fact that a particular person may be silly, uneducated, inattentive, intellectually challenged or mentally questionable is neither entertained by the law nor a valid defence. Since everyone is equal before the law, it is only fair that everyone is required to conform to the objective standard of the reasonable person.

2.2. Skilled Persons.

The question in discerning minds is now whether this general objective test is applied in the same way in all instances to all persons including a person from whom the law may justifiably be expecting more because he is skilled in a particular trade. The answer is in the negative. Regarding skilled persons or those that possess proficiency or expertise in a particular field the test is still that of the reasonable person but here the reasonable person in the same circumstances must be one with the same qualifications and expertise as the defendant.³ It has to be said that the reasonable expert is similar to the reasonable person

² In *Herschel v Mrupe* 1954 (3) SA 464 (A) 490 it was stated that the concept of a *bonus paterfamilias* is not that of a timorous fainthearted always in trepidation lest he or others would suffer some injury. On the contrary he ventures out into the world, engages in affairs and takes reasonable chances. He takes reasonable precaution to protect his person and property and expects others to do the same.

³ Dias RWM in *Clerk and Lindsell on Torts* 16th ed 513 shows that the test in relation to skilled persons in English law is essentially the same. Dias states that in English law the 'Bolam' test is used. This test was formulated by McNair J in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582 586. In this case McNair J stated that, "where you get a situation which involves the use of some special skill or competence, then the test as to whether there has been negligence or not is not the test of the man on the top of a Clapham omnibus, because he has not got this special skill. The test is the standard of the ordinary skilled man exercising or professing to have that special skill. A man need not possess the

in all material respects but he has to possess that extra but *reasonable* amount of applicable expertise. The test is still the objective one of the *reasonable expert* in that field. In line with the remarks in the judgment of *Herschel v Mrupe* the reasonable expert is not expected to live up to the standards of the most competent members of his profession, but below average levels of expertise may not be acceptable as a criterion either.⁴ It does not amount to negligence on the part of a skilled person like an auditor if he fails to detect fraud or in the case of a medical expert to fail to provide a cure.⁵

Some authors⁶ state that when determining the negligence of an expert, one is actually concerned with accountability because more is expected from those who know more. Others⁷ dismiss this view as incorrect and state that the negligence of an expert is not concerned with the capacity to distinguish between right and wrong but with the manner in which and care with which an activity is expected to be performed by an accountable expert.

It is trite law in England that whenever a person engages voluntarily in an operation that requires skill, knowledge, capacity or strength to perform it properly, he is under an obligation to display a reasonable degree of such skill, knowledge or capacity. Any prudent person will otherwise abstain from undertaking a task for which he has no skill,

highest expert skill; it is well established law that it is sufficient if he exercises the ordinary skill of an ordinary competent man exercising that particular art.”

⁴ *Supra* note 2. Thus in auditing it is not excusable to state that a particular auditor lags behind or is more gullible and easily misled. He must still meet the standards of a reasonable auditor.

⁵ Dias *op cit* note 3 612-613. This view finds support in English case law. Dias quotes Tindal CJ in *Lanphier v Phipos* 1838 8 C and P 475 where it was said that a “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 your case, nor does a surgeon undertake that he will perform a cure, nor does he undertake to use the highest possible degree of care and skill.”

⁶ Van der Merwe and Olivier *Die Onregmatige Daad in die Suid Afrikaanse Reg* as quoted by Neethling *et al Law of Delict* 5th ed 124.

⁷ Neethling *et al Law of Delict* 5th ed 125.

knowledge or capacity.⁸ The required degree of skill, knowledge or capacity will be no more than that which can reasonably be expected, having regard to the level of skill in the profession or class of persons who practise the undertaking.⁹

2.3. Duty of Care.

It has been stated above that in South African law the determination of negligence is dependent on the test of the reasonable person. In English law on the other hand the doctrine of the duty of care is applied in relation to the tort of negligence, to establish negligence. This approach entails that it must firstly be determined whether the defendant owed the plaintiff a duty of care and whether this duty was in fact breached. If these two questions can be answered in the affirmative, negligence is established.

In determining whether a duty of care was owed it must be asked whether a reasonable person in the position of the defendant would have foreseen the possibility of his conduct harming another. In answering the question whether the duty of care was breached, it must be considered whether the defendant adhered to a standard of care that can reasonably be expected of him or from persons in his profession i.e. to avoid such harm being done to the other person. The duty of care is therefore not a general duty since it only applies to the so-called foreseeable plaintiff for example a particular person or persons or a particular class of persons. Because a different test for negligence is used in South Africa, the duty of care doctrine flies in the face of Roman Dutch law, on which the South African law of delict is based.

⁸ In *Dobbin v Waldorf Toilet Saloons Ltd* [1937] All ER 331 it was stated that a person who undertakes the skillful trade of bleaching hair and who proceeds with the treatment without testing one or two hairs of the client causing the client's hair to fall of, can be found liable as a having done the work in a negligent and unskillful manner.

⁹ The same is required in South African law. In *Mitchell v Dixon* 1914 AD 519 it was stated that a medical practitioner is not to be expected to exercise the *highest* possible degree of professional skill. He was held to be required to only exercise the reasonable degree of care and skill of a person in his profession and will be liable if he fails to do so.

According to some authors the duty of care approach should be discarded since it has no historical basis in South African law and more importantly, “is an unnecessary and roundabout way of establishing something which may be established directly by means of the reasonable person test” in addition to the fact that “the use of the duty of care doctrine may confuse the test for wrongfulness with the test for negligence.”¹⁰ Neethling *et al* state that “in most cases our courts simply use the test of the reasonable person.”¹¹ This is not particularly true with respect to reported South African cases that deal with auditor negligence because there is always a remark that auditors must exercise reasonable care and skill in the performance of their duties.¹² These cases seem to follow the duty of care approach as the test for determining the auditor’s negligence. It is therefore accurate to conclude that the duty of care doctrine has found some acceptance in South African law, at least in relation to auditor negligence¹³ and it is therefore appropriate to discuss this duty further.

In English law the duty of care is basically defined as “the duty to avoid doing or omitting to do anything the doing or omitting to do which may have as its reasonable and probable consequence injury to others, and the duty is owed to those to whom injury may reasonably and probably be anticipated if the duty is not observed.”¹⁴ Care implies foreseeing harm to others. A person must take precaution against his acts causing injury to others. This applies where the likelihood of such harm would be realized by a reasonably prudent person. A person however needs not take precaution against the *mere possibility* of harm that does *not amount to a likelihood* and where it would not have been

¹⁰ Neethling *et al op cit* note 7 149-150.

¹¹ *Ibid* 150.

¹² Chapter Three below will look at a number of cases that deal with auditor’s duties and all South African cases quoted refer to the duty of care test.

¹³ A possible reason for this is a desire to adopt an approach that is to some extent in harmony with English law as the system on which South African corporate law is based. It could also be due to the fact that the early cases on auditing and negligence such as *In Re Kingston Cotton Mill (No 2)* [1896] 2 Ch 279 were decided in England. These judgments provided guidance to other Commonwealth jurisdictions on how negligence on the part of auditors should be determined.

¹⁴ Per Lord Macmillan in *Bourhill v Young* [1942] 2 All ER 396 (HL) 402.

realized by a reasonably, prudent person. In *Farmer v Robinson GM Co*¹⁵ Innes CJ stated that *culpa* consists in a failure to exercise reasonable foresight, not a failure to predict the future. In *Cooper v Armstrong*¹⁶ it was stated that the test is not that of a timorous person who constantly anticipates death.

An auditor is aware of the fact that many persons generally rely on his opinion in relation to the financial statements of an undertaking. A reasonably prudent auditor should be able to foresee the harm a negligent report may cause. A reasonably careful auditor will take reasonable steps to ensure that his reporting will not cause harm to others.

For the duty to exist, two factors must therefore be present.

- a. Firstly, the injury must have been foreseeable and reasonably guarded against.
- b. Secondly the nature of the interest infringed must be one which the law protects against negligent conduct.¹⁷

2.3.1. To whom is the duty of care owed?

Lord Atkin in *Donoghue v Stevenson*¹⁸ stated that

“you must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who then in law is

¹⁵ 1917 AD 522.

¹⁶ 1939 OPD 140.

¹⁷ *Robinson v Roseman* 1964 (1) SA 701 (T) 715. In this case it was stated that the essence of negligence which depends on the care of a diligent man, requires the plaintiff to prove that (a) the defendant should have foreseen the possibility of his conduct injuring another in his person or his property and causing him patrimonial loss and (b) that the defendant failed to take reasonable steps to have guarded against such occurrence.

¹⁸ [1932] All ER 1 (HL).

my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions that are called in question.”¹⁹

In other words the care must be owed to a particular individual or individuals. A plaintiff must show that there was a breach of a duty that was owed to him and there must have been a *nexus* of duty between himself and the defendant.²⁰ According to MacIntosh and Scoble,²¹ it is not sufficient for a plaintiff to show that he has suffered damage and that such damage was avoidable but for want of certain precautions even though there exists a general duty not to harm others by lack of due care. The plaintiff, they say, must apply the general duty to the particular facts and bring himself and his facts within the scope of the duty since Roman Dutch law like English law requires the existence of a duty of care owed by the defendant to the plaintiff.

There is no exhaustive list of categories in which a duty to take care is owed. Changing social needs and standards may from time to time require new categories of persons to exercise a duty of care.²² Auditors have an important role to play. In *Lipschitz v Wolpert and Abrahams*²³ Holmes JA described the auditor’s role and stated that

¹⁹ This means that to be liable in English law a person must owe another the duty to take care. Rogers WVH in *Winfield and Jolowicz on Tort* 13th ed 72 states that a man cannot be held responsible in law for every careless act that causes damage. He can only be liable in negligence if he is bound by a duty to take care. In addition, Percy RA in *Charlesworth and Percy on Negligence* 7th 4 ed 17 states that, “put in a compendious form, a man is entitled to be as negligent as he pleases towards the whole world provided that he does not owe anybody a duty to take care.”

²⁰ *Davies v Cargo Fleet Iron Co and another* [1956] CA 24 where it was stated that “a bystander is not bound to warn another whom he sees walking into danger, but it is a different matter when the danger is of his own making.”

²¹ *Negligence in Delict* 5th ed 14.

²² “How wide the sphere of the duty of care in negligence is to be laid depends ultimately on the court’s assessment of the demands of society for protection from the carelessness of others”, per Lord Pearce in *Hedley Byrne v Heller* [1963] (2) ALL ER 575 (HL).

²³ 1977 (2) SA 732 (A) 740 C-F and 742A.

“the general body of shareholders put up and risk their money...yet they have no control over or knowledge of the day to day administration of the company by their elected directors, although shareholders do have a voice and certain rights at general meetings...This dichotomy between those who put up the money and those who run the company is in my view the main reason for the statutory appointment of an independent auditor, whose performance of his prescribed duties provides the shareholders with independent information on how the company is faring...For the most part the auditor is the shareholder’s safeguard. Furthermore, inasmuch as the Companies Act permits shareholders to enjoy limited liability to creditors, to some extent the independent auditor’s scrutiny operates to provide a measure of safeguard to creditors. And doubtless the legislature knew that in some cases the Secretary for Inland Revenue...would not be unappreciative of the fact that companies’ financial statements are statutorily subjected to independent auditorial scrutiny.”

In *Haig v Bamford*²⁴ the Supreme Court of Canada stated that the fast changing modern day corporation has brought along a new perception of the role of the professional accountant. This case serves to show that the days when the accountant or auditor served the owner of a company and was answerable to him only are long gone. Developments like taxation, separation of ownership from management *inter alia* have led to marked changes in the role and responsibilities of the professional accountant, and in the trust that the public places in his work. The financial statements on which an auditor reports can have an effect on the economic interests of the general public, creditors and potential investors and shareholders. Dickson J, with five other judges of the Canadian Supreme Court concurring, opined that “with the added prestige and value of his (auditor’s) services has come...a concomitant and commensurately increased responsibility to the public. It seems unrealistic to be oblivious to these developments.”²⁵

²⁴ 72 DLR (3d) 68 (1976).

²⁵ *Ibid* 74. The required standards of care have also increased without a doubt.

2.3.2. Foreseeability Test.

The duty of care is based on the reasonable foreseeability of harm. The critical question is always whether the reasonable man would, not could, have foreseen the harm.²⁶ Once it is concluded that the reasonable man would have foreseen the likelihood of harm the court will hold that the defendant should or ought to have foreseen the ensuing harm.²⁷

It is however important to note that foreseeability by itself has been found to be insufficient to provide the final answer in relation to the inquiry as to the existence of the duty of care on the part of an auditor. This is so because a value judgment has to be made, taking into account several considerations of judicial policy and the balancing of interests. In *Scott Group Ltd v McFarlane* it was stated that whenever the financial statements of a company are required to be filed with the registrar it simply means that the auditor must be well aware of the fact that they will be made available for public inspection and may be relied upon for some transaction by a third party. Where the shares of a company are listed on a stock exchange the auditor knows that members will receive copies of the statements and may invariably make copies available to other parties.²⁸ However all these factors merely show that an auditor of a company should

²⁶ *Herschel v Mrupe* 1954 (3) SA 464 (AD) 465E. In this case Schreiner JA stated that the test is whether the reasonable man would, not could, have foreseen the harm. He stated further that the situation must be such that the reasonable man not only would have foreseen the harm but would have governed his conduct accordingly and guarded against the danger. In *Union Government v National Bank of South Africa Ltd* 1921 AD 121 130 Innes CJ stated “the test as to the existence of the duty of care is by our law the judgment of a reasonable man. Could the infliction of injury to others have been reasonably foreseen? If so, the person whose conduct is in question must be regarded as having owed a duty to such others, whoever they might be, to take due and reasonable care to avoid such injury.”

²⁷ In *Cape Town Municipality v Paine* 1923 AD 207 217 Innes CJ stated that “once it is clear that the danger would have been foreseen and guarded against by the *diligens paterfamilias* the duty to take care is established and it only remains to ascertain whether it has been discharged.

²⁸ (1975) 1 NZLR 553 (CA) 568. Richmond J in this case said that it would be going too far to treat accountants as assuming responsibility towards all parties dealing with the business and rely on the accuracy of the financial statements simply because it was reasonably foreseeable in broad terms.

contemplate that the statements may be relied upon by third parties. It was however stated that this is not sufficient to give rise to a general duty of care.²⁹

2.3.3. Preventability (Avoidability).

Another matter which is a central theme of this dissertation relates to the steps a reasonable person can be expected to take to avoid harm to other persons or to conclude that he has exercised reasonable care and skill. In the context of this dissertation, what steps should be taken by an auditor to detect fraud? Is the mere fact that fraud is subsequently uncovered evidence of negligence? What careful steps should an auditor take to detect fraud and is the mere presence of fraud evidence of negligence? Van der Walt and Midgely³⁰ identified four factors that are relevant to determine whether the reasonable person has taken adequate steps to guard against loss or damages to others. Only three are relevant here. They are the following.

- i. The nature and extent of the risk that is relevant to the conduct. Where the risk of potential harm to others is not high or the potential harm not of a serious nature the reasonable person would not take extensive steps or go to extremes to minimize or eliminate the risks.³¹

²⁹ Other considerations to be noted include the fear of an unmanageably wide liability. In *Ultramares Corporation v George A Touche* 1931 255 170 NY - 74 ALR 1139 1145 it was classically stated that “if liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.” According to Naude SJ “Negligent Misstatements in Companies Annual Financial Statements” 1979 1 (3) *Modern Business Law* 133, liability should be limited because the flow of commercial information should be encouraged. He says in collaboration with this that the great value of the information in financial statements implies concomitant responsibility on the part of auditors but not unrestricted liability. Another consideration suggested by Naude is that limiting liability will discourage auditors from resorting to disclaimers.

³⁰ *Op cit* note 7 13.

³¹ In *Herschel v Mrupe supra* note 2 Schreiner JA stated that “the circumstances may be such that a reasonable man would foresee the possibility of harm but would nevertheless consider that the slightness of the chance that the risk would turn into actual harm, correlated with the probable lack of seriousness if

- ii. The seriousness or extent of the damage if the risk should materialize, even where the prospects of the risk materializing are slim. The authors submit further that especially in instances where the wrongdoer creates the likelihood of serious damage occurring, he should take reasonable steps to avoid the damage.³² This means that the standards of care and skill required from auditors are high, particularly because the potential harm that may ensue can be enormous if they fail to exercise due care and diligence in the performance of their duties. It is however submitted that this does not mean that an auditor is expected to go to all extremes to detect fraud.
- iii. The difficulty of taking precautionary measures owing to limiting factors such as costs and available time. It can be readily accepted that a reasonable person would take whatever precautionary measures that can in the circumstances eliminate the risk of harm without considerable costs.³³ Unfortunately it is not always taken into consideration that the costs or difficulty of taking precautionary measures may sometimes be out of proportion with the risk involved and that the reasonable person cannot be expected to incur these

it did would require no precautionary action on his part... [and] if...the harm, if it happened would be trivial the reasonable man might not guard against it even if the chances of it happening were fair or substantial.” This is the reason why auditors are only required to guard reasonably against *material* misstatements in the financial statements for instance only those that are likely to cause considerable financial harm.

³² See *Lomagundi Sheetmetal and Engineering (Pvt) Ltd v Basson* 1973 (4) SA 523 (RA). Here the defendant was in the employ of the plaintiff to put a roof on top of a silo. When the defendant’s employees were welding they ignited bales of stover stacked against the silo. The court concluded that even though the risk of the stover being ignited by the welding was at best negligible, the possible amount of the damage which was likely to be caused by such an occurrence could be so enormous that a reasonable person would have taken steps to prevent the damage from occurring. See also *Union National South British Insurance Co Ltd v Victoria* 1982 (1) SA 444 (A) where it was held that failure to wear a seatbelt is blameworthy conduct despite the possibility of an accident being negligible, simply because of the consequences of not wearing one are potentially serious.

³³ One such inexpensive precautionary measure was held in *Grobler v Santam Versekering Bpk* 1996 (2) SA 643 (T) to be the removal of a dead horse from the road.

expenses.³⁴ The same considerations apply when the taking of precautionary measures would be disproportionately time consuming and expensive. Will a defence that material misstatements due to fraud could have been detected only by a thorough and expensive audit of the financial reports suffice? The courts will always have to look at the complexity of the audit and weigh it against the potential harm that may be caused if any misstatements are not detected. The same applies if it would disproportionately time consuming to probe matters to the bottom.

2.4. The Circumstances.

Negligence must always be judged in the light of the circumstances of each case. Greater care is always expected when someone deals with dangerous objects such as bombs, loaded guns or toxic substances.³⁵ Finance can hardly be regarded as dangerous in this context but the potential for serious prejudice in cases of fraud or misrepresentation is obvious. At a time when corporate illegalities and irregularities are rife, a greater degree of care is inevitably expected of persons who certify that any given financial report is a fair reflection of the financial position of the entity. The fact that many persons rely on financial reports sometimes to make huge investments makes it an industry where a high degree care must be the order of the day.

Customs and the opinions of the community may amount to an indicator of the degree of care that is required. This however should not be conclusive in determining the extent of the duty of care. A negligent person cannot be allowed to survive by relying on popular practice. In South Africa the question whether the reasonable person would have acted in

³⁴ In *Gordon v Da Mata* 1969 (3) SA 285 (A) the plaintiff slipped on a cabbage leaf which had fallen on the floor of the defendant's vegetable shop. The court held that a reasonable person would have taken steps to prevent leaves from falling by way of a simple and cheap precautionary measure.

³⁵ See generally *Havenga v Minister of Police* 1981 (2) SA 344 (T).

the same way should always be asked.³⁶ This could perhaps be interpreted as a valid reason not to allow the accounting standards as proof of the degree of care that is required in the auditing profession.

However as will be discussed in Chapter Four these standards that are binding on auditors and also constitute a comprehensive guide as to what a reasonably competent auditor should do when dealing with the possibility of fraud in an audit. The auditing profession strives towards the setting of standards that are commendably high³⁷ and would be loathe to be seen as sanctioning careless conduct by its members. The remarks about community practices and negligence should continue to apply generally in the community. They should not apply to a well organized section of the community like the auditing profession because as will be seen below, this is a section of the community that sets very high standards of care for its members, presumably to maintain a good public image. It would be tragic if the courts fail to have due regard to auditing standards which, as shall be seen, have statutory backing.

2.5. Negligent Statements.

It is important to find out whether in South African law, auditor negligence, which manifests in negligent statements, is actionable. Macintosh and Scoble state that liability for false statements has been clouded by the notion that in terms of the general principles of contract an innocent misrepresentation cannot give rise to an action for damages.³⁸ South African courts in the past have not been unanimous in relation to a person's liability for issuing a false statement that *negligently* causes damages to a person who relies thereon. In *Dickinson v Levy*³⁹ it was stated that apart from a situation where a

³⁶ Neethling *et al op cit* note 7 135. The authors state that "if common practice were accepted as conclusive determination of the required standard of care it would follow that people engaged in similar activities were free to formulate their own standards of care by adopting careless methods."

³⁷ The increased use of the auditing standards passed as measures of what the reasonable auditor should do in the performance of his duties will be recommended in Chapter Six.

³⁸ *Op cit* note 21 18.

³⁹ 11 SC 33.

misrepresentation leads to the conclusion of a contract, a false representation causing damage is not actionable in the absence of fraud. In *De Kock v Gafney*⁴⁰ it was stated that moral fraud must be present. In *Alliance Building Society v Deretich*⁴¹ it was ruled that apart from contract, a false representation causing damage is not actionable unless it is fraudulent because there is no duty towards any other not to be negligent.

In *Perlman v Zoutendyk*⁴² on the other hand it was ruled that a sworn appraiser may be held liable for his negligent misstatement where he had issued a certificate to a certain P that reflects the valuation of a certain piece of land knowing that such certificate would be used to induce other persons to lend money on the security of that land. The result was that the plaintiff was deceived by the negligent misstatement and suffered a substantial loss in making advances on the supposed security.⁴³ In *Western Alarm System (Pty) Ltd v Coini*⁴⁴ authority is found for the proposition that a statement may give rise to liability for damages if it is made negligently and directly to another with the knowledge that the other person will act upon it. It will attract liability if that statement turns out to be false and causes damage to the informee.

The current legal position in South African law is that a culpable wrongful act by a person which causes damage to another constitutes a delict and gives rise to liability for compensation for the damage caused. In the case *Administrateur, Natal v Trust Bank van*

⁴⁰ 1914 CPD 377 382.

⁴¹ 1941 TPD 203 211.

⁴² 1934 CPD 151.

⁴³ Watermeyer J at 156 held that the Roman Dutch law required the care of a *diligens paterfamilias*, in that the defendant ought to have foreseen the likelihood of damage being suffered by prospective mortgagees and that the principles of English law as set out in *Noctan v Ashburton* [1914] AC 932 only govern actions for deceit and do not exclude actions based on negligent misrepresentation. The learned judge at 157 furthermore considered that it is here that Roman Dutch law and English part inasmuch as the former permits larger latitude of inquiry that Roman Dutch Law is preferable to the more rigid limits of the English rules.

⁴⁴ 1944 CPD 271.

*Africa Bpk*⁴⁵ it was confirmed that delictual liability for negligent misrepresentation existed. In relation to auditors the conduct that may give rise to delictual liability to third parties is an intentional or negligent misrepresentation by the auditor in respect of the financial position, prospects or share value of an entity which may be contained in or based on the entity's annual financial statements.⁴⁶ As has been seen, the development of delictual liability for auditors who make representations negligently and fail to exercise the degree of care and skill of a reasonable auditor in the same circumstances developed slowly.⁴⁷

3. ANALYSIS OF THE AUDITOR'S AQUILIAN LIABILITY: *INTERNATIONAL SHIPPING COMPANY (PTY) LTD v BENTLEY*.

A distinction must be drawn between the auditor's civil liability to the company and liability to third parties who act, with dire consequences, on the strength of the financial information prepared or certified by the auditor. The auditor stands in a contractual and fiduciary relationship with the company but not with the third parties. This means that an auditor can be sued for breach of contract by the company which may also elect to couch its action on damages in delict.⁴⁸ Where a company or a third party institutes proceedings

⁴⁵ 1979 (3) SA 824 (A) 831-833.

⁴⁶ In the event of an intentional or fraudulent misrepresentation, i.e. where an auditor knowingly makes a false representation with the intention to deceive third parties into acting there is no doubt that the auditor would be liable to the third party, Cilliers *et al Corporate Law* 3rd ed 422.

⁴⁷ According to Cilliers *et al Corporate Law* 3rd ed 422 since 1977 South African courts have accepted that a negligent misrepresentation which causes pure economic loss causes delictual liability.

⁴⁸ An example of a case where an action was based on breach of contract is to be found in the case *Thoroughbred Breeders Association v Price Waterhouse* 1999 (4) SA 453 (W). In this case the contract between the auditor and the client company was not in writing but it was tacitly agreed that the auditor would conduct his audit in accordance with international auditing standards and with the due professional care that can be expected of an auditor. The auditor was sued for breach of contract after failing to detect the theft of a promissory note by one of the company's managers and after failing to detect the fact that certain substantial sums of cash had not been deposited over a period of time. The court found that the auditor had been negligent and held that the auditor was liable for the loss because his negligence was the

against an auditor according to the general principles of common law delictual liability all the elements of delictual liability must be present.⁴⁹ The fact that this dissertation focuses entirely on negligence does not mean that in South African law all that is needed to establish auditor liability is the presence of negligence. These elements entail:⁵⁰

3.1. Conduct.

In order to constitute a delict, one person must have caused damage to or harm to another by means of an act or conduct. This can be positive or negative, namely an act or an omission where circumstances demand action, respectively. In the case of an auditor this element is satisfied if he acted or failed to take action under circumstances where he was expected to take action. His certification without qualification of annual financial statements that contain fraudulent or otherwise material misstatements or his failure to take the steps that are necessary for a reasonable prospect of detecting the fraud or misstatement may constitute such an act or omission.

According to Van der Walt,⁵¹ “an omission to take certain measures in the course of some activity is... not necessarily a form of conduct but may well indicate that the action was negligently performed.” This view, which Neethling *et al* support as correct⁵², would

legal cause of the plaintiff's loss. It is also clear from this case that in establishing an auditor's liability negligence must be present.

⁴⁹ *International Shipping Company (Pty) Ltd Bentley* 1990 (1) SA 680 (A). Third parties like creditors, prospective creditors of the company, a company's clients, individual members and prospective purchasers of the company's shares can only base their action on delictual liability because an auditor does not stand in a fiduciary or contractual position to them. Benade *et al Entrepreneurial Law* 3rd ed 234. According to Cilliers *et al Corporate Law* 3rd ed 421, there is no reported South African case in which a third party has successfully claimed economic loss from the auditor of a company sustained as a result of the auditor's negligence because it is difficult in practice to establish all the elements for delictual liability. Since the publication of their work, *Axiam Holdings Ltd v Deloitte* 2006 (1) SA 237 SCA was the first reported case where the auditor was held liable for delictual damages.

⁵⁰ Benade *et al op cit* note 49 234.

⁵¹ Quoted in Neethling *et al Law of Delict* 2nd ed 27

⁵² *Ibid.*

mean that auditors who fail to supervise audit clerks or to verify explanations and documents and qualify audit opinions may also be described as negligent.

3.2. Wrongfulness.

According to Neethling *et al*⁵³, an act which causes harm to another is of itself insufficient to lead to delictual liability. Liability follows where the prejudice was caused wrongfully or in a legally reprehensible or unreasonable manner. Cilliers *et al* state that for wrongfulness to be established the conduct must have infringed another person's subjective rights or amounted to a breach of the duty of care.⁵⁴ Violation of a legal norm must therefore be present. The general criterion employed when determining whether a particular infringement is unlawful is the legal convictions of the community or the *boni mores*. The *boni mores* test is essentially an objective test based on the criterion of reasonableness. In employing the *boni mores* test the general question is whether, in terms of the legal convictions of the community and with reference to the particular circumstances of the case, the defendant infringed the interests of the plaintiff in an unreasonable manner.⁵⁵

In the context of auditors wrongfulness lies in the fact that the auditor failed to comply with the relevant statutes and international standards of auditing in taking such steps as are reasonably required to perform his duties properly including reasonable steps to detect fraud or material misstatements should they exist. Public policy does not expect an auditor to guarantee the correctness of the financial statements that he audits because as will be seen later, an audit has certain limits which may hinder an auditor's chances of detecting fraud. Public policy also does not expect auditors to detect carefully perpetrated fraud. This means that auditors cannot be held liable if their conduct as described above is not wrongful or if they conduct their audit in accordance with

⁵³ Neethling *et al op cit* note 51 29.

⁵⁴ Cilliers *et al op cit* note 49 421.

⁵⁵ Neethling *et al op cit* note 51 33.

international auditing standards, statutory law and general principles of reasonable care and skill.

As will be seen in subsequent Chapters, international auditing standards and statutory provisions if adhered to provide the auditor with a reasonable assurance that fraud and other material irregularities will be detected. These standards and statutory provisions amplify an auditor's duty of reasonable care and skill meaning that an auditor who complies with them essentially exercises reasonable care and skill and cannot be found to have acted wrongfully. It will be shown that the responsibility to draft financial statements that fairly reflect an entity's financial position and profitability lies with the entity's directors and not with the auditor, especially in the light of recent statutory reform that entails requirements of auditor independence. As such it is submitted that it is contrary to public policy to expect auditors to guarantee the fairness, let alone the correctness of financial statements that they are not supposed to draft.

3.3. Fault.

Fault exists where the perpetrator's conduct was culpable in the sense of malicious intent where he intended the consequences of his conduct to materialize or negligence where he could and should have foreseen the likelihood of harm and should have governed his conduct accordingly. Fault can only exist where a person has acted wrongfully because it is illogical to blame someone who has acted lawfully.⁵⁶ As can be seen fault takes two forms namely intent and negligence. Negligence as has been seen earlier in this Chapter is established if the reasonable person in the position of the defendant would have acted differently. An auditor is negligent if a reasonable auditor with the same qualifications and experience would have detected the fraud that has not been detected.

3.4. Damages.

This is the loss that is sustained by the injured party.

⁵⁶ Neethling et al *op cit* note 51 113.

3.5. Causation.

The causing of damage through conduct is required for a delict. This implies that *but for* the auditor's negligent act the other party would not have suffered any loss. For this element to be established, factual as well as legal causation has to be proved.

The case *International Shipping Co (Pty) Ltd v Bentley*⁵⁷ analyzed the common law elements in detail in relation to the liability of auditors towards third parties. International Shipping (I.S.) was a company carrying on the business of financiers and shippers and agreed to extend financial facilities to a certain entity, identified as the D Group of companies. Bentley was the appointed auditor of the D Group. In 1979 Bentley issued reports on the financial statements of each subsidiary of the D Group and also issued reports on the group's financial statements for the year ended 20 December 1978. All these reports were not qualified and Bentley stated in each report that he had examined the financial statements in question and found them to be in compliance with section 300 of the Companies Act, 61 of 1973, that he was satisfied that the statements fairly presented the financial position of the company as at 20 December 1978 and the results of its operations for the period in the manner required by the Companies Act.

I.S. continued to provide financing to the D Group until the subsidiaries of this Group were liquidated in April 1981. At the time of the liquidation the D group owed I.S. R 977 318 of which only R 593 826 was recovered by I.S. meaning that I.S. lost R 383 492. I.S. instituted an action for damages against Bentley alleging that the financial statements were materially false and misleading and in so reporting Bentley acted fraudulently or alternatively negligently towards I.S. I.S. also alleged that it relied on the auditor's reports in reviewing, maintaining and increasing the financial facilities to the D Group and alleged further that had the 1978 financial statements fairly presented the financial position of the D group and its subsidiaries, it would not have extended the financial facilities to the D group. I.S. essentially alleged that its loss was a result of Bentley's fraud or alternatively, negligence.

⁵⁷ *Supra* note 49.

The court dealt with each of the elements of delict separately. Corbett CJ stated that “at common law, in order to succeed in this action, International had to prove-

- a. that the financial statements in question were in fact materially false and misleading;
- b. that in reporting on the financial statements as he did the respondent acted fraudulently;
- c. or alternatively to (b), that in so reporting the respondent acted unlawfully (wrongfully) and negligently *vis-à-vis* International; and
- d. that respondent’s fraud or negligence, caused International’s eventual loss.”⁵⁸

The court held that the financial statements were, in fact, false and misleading and that the court a quo’s finding that negligence had been established in respect of some aspects of the financial statements was correct. The court also held that unlawfulness had been established because it could not be said that Bentley had properly complied with his statutory duties in terms of section 300 of the Companies Act. As to causation, factual causation had been established because but for Bentley’s negligent report on the 1978 financial statements I.S. would not have sustained the loss it did.

As to legal causation however a number of issues which separated cause and effect were analyzed. Such issues included the time factor because two years had elapsed between Bentley’s reporting and the financial loss and the fact that I.S. elected to implement a support programme for the group at a stage when it knew that the group’s financial position was bleak. Other factors that played a role were the decision to allow the group’s indebtedness to escalate and fraud committed by the group’s managing director also contributed financial loss sustained by I.S. The court found that the support programme which essentially amounted to uninhibited lending to the D Group without

⁵⁸ *Supra* note 49 684.

added security was the real cause of I.S.'s loss because to that extent I.S. did not rely on the 1978 financial statements as audited by Bentley.

This case shows that in South African law the presence of negligence does not of itself lead to liability because other elements have to be present as well. It is important to note that the fraud committed by the group's managing director was found to have played an important role in causing loss to I.S. The managing director, Cunningham had painted a false picture of the financial position of the group to I.S. Cunningham had also manipulated inter company transfers to evade tax, postponed the Group's year end accounting to avoid having to produce audited financial statements and predicted ill founded forecasts of future profits. The identification of these issues by Corbett CJ was important because it exposed the activities of the managing director. The fraud or alternatively, negligence, of directors in financial reporting should be highlighted to avoid fixation on auditors.

4. CONCLUSION.

This Chapter is important in that it analyzes the basis for an auditor's liability and focuses not only on the issue of negligence, which is one of the themes of this research, but also the other requirements for *aquilian* liability. In South African law the reasonable person test is used and according to this test a person is negligent if in any given circumstance he fails to act in the same way as a reasonable person would have acted in the same circumstances. It also shows that in all endeavors, a person is required to act to prevent harm to others only in a reasonable fashion because it would be unreasonable, impractical and cumbersome for the law to demand a high degree of care. It would in fact be contrary to public policy. Since auditors are skilled persons, they are required to exercise more care than lay persons on matters that relate to their profession. This requirement is however similar to the standards of the reasonable person because the criterion of the reasonably skilled person will be used

The practical implications for auditors are that the law of negligence only requires them to exercise a degree of reasonable care as dictated by the circumstances of each case. This means that auditors may only be held liable for failing to detect fraud *if* their conduct does not conform to the standards of the reasonable auditor and if the action is based on delict, if all the other elements for *aquilian* liability are present. Auditors exercising reasonable care and skill in their work are not and cannot be found to be negligent simply because it later turns out that the financial statements contain a fraudulent or materially incorrect statement.

This Chapter concentrates on general concepts. It is submitted that only reasonable efforts are required to be made to avoid harm to others and that auditors cannot be expected to detect fraud at all times. This would be both unreasonable and out of step with the general principles of our law. Auditors are however liable for failing to detect fraud that is so apparent that it would have been detected by a reasonable auditor after steps have been taken which will with reference to the circumstances of each case, ensure a reasonable probability of detecting it.