

CHAPTER FIVE

COMPARATIVE ANALYSIS: US LAW ON AUDITOR'S DUTY OF CARE

SECTION A: INTRODUCTION AND STATUTORY LAW.

1. GENERAL CONSIDERATIONS.

No discussion of the auditor's duty of care can be complete without reference to U.S. law. This is so because that country has had its fair share of corporate collapses in which auditor negligence occurred.¹ While the Enron collapse was unbelievable and the most notorious it was not the only one.² The Enron collapse was due in no small part to the

¹ Wells JT in "Accountancy and White Collar Crime" (1993) 525 *Annals of the American Academy of Political and Social Science* 83 states that due to the occurrence of several cases where the independent auditor fails to detect fraud and white collar crime the audit profession may change for good. He states further that auditors are increasingly being held responsible for the misdeeds of management with dire consequences in enormous lawsuits.

² *Ibid* 84. Wells JT writes about another case of corporate collapse involving a certain Barry Minkow who at the age of 16 started a carpet cleaning business named ZZZZ Best Carpet Cleaning in his garage. Four years later this business became a public company valued at \$200 million on Wall Street. According to Wells By 1990, Minkow was broke and serving a 25 year prison term and from his prison cell he stated that the only problem with him and the company was that they were both frauds. Wells states that the big six accounting firms were the unwitting aides in Minkow's rise. As a person without the required business ability to raise a company from scratch, Minkow was documented to have used fake financial statements to obtain credit from banks. When that credit ran out, Minkow turned to loan sharks who exhausted his meager funds. His only option was a public stock offering. He bought a Nevada corporation which had at one time been listed on the exchange and contracted a firm of auditors to do a due diligence assessment that was required for a stock offering. By manufacturing documents Minkow duped his auditors into believing that he had made a lot of money. In reality, his company was teetering on the brink of insolvency. Wells states that the auditors failed to detect the frauds and gave Minkow the stamp of approval that allowed him to participate in a public stock offering. Months later Minkow's stock rose and he made plans to raise an additional \$80 million to purchase a competing business. He was just days away from realizing his objectives when a housewife complained to the *Los Angeles Times* that his company had defrauded and overcharged her for a cleaning service. An investigation by a reporter revealed that Minkow had cheated hundreds of customers in the same way. The newspaper published this

negligence and in fact criminal activities of the auditors from Arthur Andersen.³ The only good thing that resulted from the debacle was the passing by the U.S. Congress of an Act known as the Sarbanes Oxley Act of 2002. It was enacted in an attempt to restore public confidence in the securities markets and its main focus was to reduce audit failures to a minimum and sterner government regulation of the accounting profession. This Chapter will analyze the scope of the auditor's duty of care in the U.S. and show that despite all the accounting scandals it must still be borne in mind that also in the U.S. there is no legal obligation on auditor's to detect fraud in all instances.

2. STATUTORY LAW

2.1. The Sarbanes Oxley Act⁴

As has been stated earlier on, this Act was passed in response to the Enron collapse with a view to imposing tighter control on auditing firms and re-establishing investor confidence in the capital markets. This Act does not like the South African Companies Act, 61 of 1973 or the Auditing Profession Act, 26 of 2005 and the Companies 2007 Bill

information and the stock price of Minkow's company collapsed. Later on it was discovered that 80% of the assets listed in Minkow's financial statements were non-existent. Assets purportedly amounting to \$200 million were sold for less than \$50 000. Minkow is quoted by Wells to have said that in his view the auditors were too accepting and too believing in him. Minkow stated, "They had no idea I was committing fraud."

³ Tackett J, Wolf F and Claypool G "Sarbanes-Oxley and Audit Failure, A Critical Examination" (2004) Vol 19 (3) *Managerial Auditing Journal* 340. In this article it is stated that after the 2001 collapse of Enron it was discovered that its auditor Arthur Andersen had shredded audit documents after being notified of a Securities Exchange Commission investigation.

⁴ This Act, a US Federal law, was signed by the US president on 30 July in 2002. President George W Bush remarked as he signed the Act that it contained "the most far reaching reforms of American business practices since the time of Franklin D Roosevelt." It was named after its sponsors Senator Paul Sarbanes and Representative Michael G Oxley. See www.wikipedia.org/wiki/Sarbanes-Oxley_Act (accessed on 25/7/2007). The Sarbanes-Oxley Act is available on its website at www.sarbanes-oxley.com

contain a list of standard duties that an auditor must perform.⁵ It however focuses largely on issues relating to fair financial reporting.

2.1.1. Auditor independence.

The Sarbanes-Oxley Act⁶ contains provisions aimed at promoting auditor independence and disclosing activities that are to be regarded as outside the scope of an auditor's duties.⁷ As shown by experiences in the U.S.A., auditor independence is crucial for the proper performance of an audit because any attachment to the company may cause the auditor to become biased. It is imperative to note that there can be no reasonable care on the part of an auditor if he allows himself to be in any way attached to the company whose books he is auditing. The SOX in section 201 contains a list of services that auditors may not perform for their clients in order to maintain independence. According to this section it is unlawful for any registered public accounting firm⁸ and any person associated with that firm in a way the Securities Exchange Commission deems to be sufficient to perform concurrently with an audit any non audit services for the client.⁹

The non-audit services prohibited include *inter alia* bookkeeping and any other services connected to the accounting records, management functions and services related to human resources, legal services and other professional services that are unrelated to the

⁵ See Chapter Four above for the list of duties.

⁶ To be referred to as the SOX, its popular name in the USA. The SOX is also known as the Public Company Accounting Reform and Investor Protection Act of 2002.

⁷ Tackett, Wolf and Claypool *supra* note 3 340. They said here that after the collapse of Enron it was discovered that Andersen, the auditing firm, had received a sum of \$27 million from Enron for consulting services, a sum which was more than the sum obtained for the auditing services it provided. It was also revealed that Disney's audit fee for 2001 was a miserly \$8.7 million compared to the \$32 million paid to the accounting firm Price Waterhouse Coopers for non-audit services. This scenario creates a major conflict of interest which can realistically force an auditor to provide a glowing report at any time because of his fear of losing substantial revenue. One of the causes for audit failure according to the authors is undue influence due to a direct or indirect financial connection to the company.

⁸ Auditors are commonly referred to as public accountants in the USA.

⁹ Section 201 (g).

audit, actuarial services, internal audit services and any other services the Board¹⁰ may from time to time determine to be impermissible by regulation.¹¹

The SOX prohibits the provision of bookkeeping and other services to audit clients if the services are connected to the accounting records.¹² This provision is aimed at ensuring that auditors do not audit themselves. In South African law an auditor is precluded in terms of the Companies Act¹³ from performing this particular service and a few other non-audit services.¹⁴ This means that auditors may no longer perform such services without contravening these laws.

In *Axiam Holdings v Deloitte and Touche*¹⁵ the auditors were allowed to perform bookkeeping services classified as a non-audit service by the SOX with disastrous consequences. The auditors in this case *prepared and completed* the financial statements of the clients and must have obtained considerable revenue for this non-audit service, but

¹⁰ The SOX in Title 1 establishes a Board known as the Public Company Accounting Oversight Board. Its function is to provide an independent oversight of public accounting firms that provide audit services. It is similar to the functions of the South African equivalent, the Independent Regulatory Board for Auditors.

¹¹ The list of prohibited non-audit services is contained in section 201 (g) 1-9.

¹² Section 201 (g) 1.

¹³ 61 of 1973.

¹⁴ A comparison of the SOX and the Companies Act, 61 of 1973, is beneficial to South African law due to two considerations. Firstly, the SOX is a modern Act that was passed in 2002 while the Companies Act 61 of 1973 is somewhat old and since it became law in 1974 was subjected to numerous amendments, the latest one being the Corporate Laws Amendment Act, 24 of 2006. Secondly and more crucially, the SOX was passed in reaction to a spate of audit failures which means that the legislators knew exactly what to remedy and benefited from hindsight whereas the Companies Act was drafted at a time when there were no such problems. It is important to see how far the Companies Act as amended can go in the prevention of corporate illegalities. The Auditing Profession Act, 26 of 2005 can also fit into the comparative analysis. It is submitted that the drafters of the Auditing Profession Act erred in not including provisions that promote auditor independence because it is a subject that affects the quality of audits and is a matter of considerable interest today.

¹⁵ 2006 (1) SA 237 (SCA).

failed to conduct the audit with reasonable care and skill. The auditors by failing to exercise care and skill grossly misrepresented the net value of their client company and attested to generally flawed financial statements. There may be no evidence available to prove that the auditors provided a ‘thumbs up’ report to please their client but this possibility cannot be disregarded. The auditors in this case marked their own homework, without contravening any statute that was in force at that time.¹⁶

The Companies Act addresses the issue of auditor independence in a number of sections. Section 275A (2) is the section that can be said to be the equivalent of section 201 of the SOX. This section contains prohibited non-audit services that an auditor may not perform and is clearly intended to prohibit an auditor from performing bookkeeping and accounting services that entail internal audit functions for his client and which relate to the financial period for which he is the auditor. More provisions aimed at prohibiting non-audit services are to be found in section 270A that deals with the functions of audit committees. This section empowers an audit committee firstly to nominate auditors who in its view are independent of the company¹⁷ and secondly to determine the non-audit services which the nominated auditor may perform for the company.¹⁸

While there is evidently a progression from the Companies Act in its original form before its amendment in terms of the Corporate Laws Amendment Act, 24 of 2006, the amended Companies Act should still have contained a comprehensive list of proscribed non-audit services. Instead, the Companies Act as amended leaves the prerogative to the audit committee which may create inconsistency, because what the audit committee of company A may deem to be a permissible non-audit service may not be acceptable to the

¹⁶ Section 275A (2) of the Companies Act now assigns the duty to the Independent Regulatory Board of Auditors to ensure that the code for professional conduct proscribes non audit services that may lead to circumstances in which matters will be subject to an auditor’s own auditing. This provision no doubt covers bookkeeping services.

¹⁷ Section 270 A 1 (a).

¹⁸ Section 270A 1 (d). Section 270A 5 (b) empowers the audit committee to determine the extent of consultancy and advisory work an auditor may perform.

audit committee of company B.¹⁹ It is submitted that the approach in the SOX is much better because it has a near exhaustive list over and above giving the Securities Exchange Commission the right to proscribe additional non-audit services. It has been said that reasonable care entails a distancing of oneself from the company's management and maintaining independence.²⁰ To do this, South African auditors must have strong guidance from the law, as their American counterparts have.

2.1.1.2. Requirements in conflict of interest situations.

The concept of auditor independence is not limited to the performance or non-performance of non-audit services. The SOX by dedicating a whole Title to this subject deals with other issues such as *inter alia* auditor rotation. These issues are important for auditor independence but are strictly speaking outside the scope of this research. However, the theory of conflict of interest is still of considerable value. Section 206 of the SOX provides that it is unlawful for a public accounting firm to perform an audit for any entity whose chief executive officer, controller, chief financial officer or chief accounting officer was in the employ of the public accounting firm during the one year period immediately preceding the audit. This provision may well have been directly motivated by the fact that Richard Causey, Enron's chief financial officer at the time of its collapse, was a former senior manager of Andersen.²¹ An investigation into some of

¹⁹ The Institute of Directors South Africa in its commentary on the Companies Bill that can be found on its website www.iodsa.co.za (follow the link on Companies Bill, accessed on 27/7/2007) seems to be satisfied with the adequacy of the provision that allows the audit committee to determine the non-audit services that are permissible. The commentary on its 8th page actually states that this requirement is sound in terms of international trends.

²⁰ The 2007 Companies Bill in South Africa empowers the audit committee to insert into the annual financial statements an opinion on the independence of the auditors in terms of section 270 A 1 (e) (ii). This provision has its own merits but is ineffective where the audit committee has sanctioned certain non-audit services which to them have no effect on independence. They would still report that the auditors were independent when in fact they might not have been.

²¹ For a report on the prevalence and dangers of such a practice and the expose of how it was practised at the Enron company see an article entitled "When accountants switch codes" www.cfo.com/printable/article.cfm/3004152/c_3036064?f=options (accessed on 27/7/2007). It was said

the decisions that he had made as chief accounting officer revealed that he went 'well over the aggressive.'²² Because of this, one can say that section 206 of the SOX is contextual and peculiar to the U.S. because of the experiences in that country.

The South African Companies Act does not contain a conflict of interest provision. It is to be welcomed that the Auditing Profession Act²³ contains a conflict of interest provision because it is an obvious lack of care for auditors to ignore the conflict of interest that might arise if they audit financial statements drafted by a person who was their supervisor or colleague in the recent past.

2.2. The Responsibility for Fair Financial Reports.

A very important provision is included in section 302 contained in Title 3 of the SOX. Title 3 generally relates to corporate responsibility for financial reports. According to this section the principal executive officer (CEO in South Africa) or principal financial officer or other officers performing similar functions for a company must certify in the annual or quarterly financial reports that they are satisfied that the officer who is responsible for signing the reports has in fact reviewed the reports.²⁴ These senior officers must also certify in their reports that according to their knowledge, the reports do not contain any false statement of a material fact or do not omit a material fact.²⁵ The purpose is to ensure that the report is fair. The same officers must also certify that the financial statements contained in the report fairly reflect the financial position of the company and the results of its operations for the period mentioned. The provision that is close to being

in this article that the scenario described above can generally create cosy relationships and lead to trouble.

²² *Ibid.*

²³ 26 of 2005 section 44 (6). In terms of this provision an auditor may not conduct an audit of the financial statements of a client if he has or had a conflict of interest in respect of that client. Although this provision does not list a number of situations that may give rise to a conflict of interest; the wording is wide enough to cover a situation like the one envisaged in section 206 of the SOX.

²⁴ Section 302 (a) 1.

²⁵ Section 302 (a) 2.

the equivalent of such a certification in South African law is to be found in section 299 (1) and (2) of the Companies Act that deals with the director's report. In terms of this section the directors must insert their report into the financial statements of the company and this report must include any matter which may assist in the appreciation of the company's profit or loss, state of affairs and business.²⁶

The duties noted above of senior management of a corporation imposed by the SOX show that in the U.S., corporate responsibility for fraud is taken a little more seriously. The requirement that *senior officers* of American corporations must certify that as far as they are concerned the financial reports do not contain false statements of a material nature and present fairly the actual financial position of a corporation is actually very close to what the *auditor* in South Africa is required to certify in his report under the Companies Act.²⁷ By requiring directors to report in this way the SOX goes a long way in placing the responsibility for the drafting of fair financial statements on directors and senior officers of a corporation. Sections 302 (1) and (2) of the SOX are useful in discouraging a culture that can be identified in some cases in Chapter Three of relying completely on auditors to ensure that there is no material misstatement in the financial statements.

South African law however does not lag too far behind on this particular subject.²⁸ The criminalization of knowingly inserting materially false statements in financial statements

²⁶ The director's report must also comply with the provisions in Schedule 4 to the Companies Act that deal with the contents of the report. In terms of Schedule 4 a director must include matters like, *inter alia*, the nature of the company's business, the names of the directors and secretary.

²⁷ Section 301 (1) of the Companies Act requires auditors to report, after complying with the provisions of this Act and conducting the audit free from any restrictions, that in their opinion the financial statements reflect fairly the financial position of the company. This is very close to what *directors* of US companies are required to do in terms of section 302 (a) (2).

²⁸ Section 98 (3) (a) of the Draft Companies Bill states that the annual financial statements of a company must be approved by the board and signed by an authorised director. This essentially amounts to a director certifying that the financial statements fairly present the financial position and profitability of an

in terms of section 249 (1) of the Companies Act shows that under our law the responsibility for drafting fair financial statements is placed on company directors and officers. Section 250 does the same, by making it an offence to conceal, destroy, mutilate, falsify, or insert a false entry into, *inter alia*, financial statements with the intention to deceive. Section 251²⁹ goes a step further by stating that the directors, officers, accountants or auditors or any other persons employed or in the service of a company who is part of the making, circulation or publication of any materially false statements in relation to the affairs of the company shall be guilty of an offence.³⁰

The effect of these provisions is that company officials in South Africa are criminally liable for *deliberately* making false statements in financial reports or in terms of section 251, making such statements *carelessly*. This basically makes senior officials of South African companies responsible for fair financial reporting. This is in addition to the fact that section 287 states that the financial statements of a widely held company must comply with financial reporting standards and that such a company must prepare, through its directors, financial statements that fairly reflect the financial position of the company and the results of its operations. It is however still submitted that it would have been preferable if directors as well as senior officers in South Africa were under a an obligation, like their American counterparts, to attest to the fairness of the financial statements and to certify that the financial statements do not, to the best of their knowledge, contain material misstatements, instead of just being liable for deliberate or carelessly made misleading statements.

entity. If this section becomes law it will put South African company law on par with international trends as seen here and in Chapter Five.

²⁹ Section 251 is complemented by section 287A that states that if the financial statements of a company are misleading, any person who was part of their construction, circulation, or publication or approval and who knew or could reasonably have known that they are false or misleading, shall be guilty of an offence.

³⁰ Unless the party had reasonable belief that the statement was correct after conducting a reasonable investigation in terms of section 251 (2).

The SOX has a provision similar to section 250 of the Companies Act. It is provided in terms of section 802 of the SOX contained in Title VIII (Corporate Criminal and Fraud Accountability) that anyone who knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intention to prejudice an investigation shall be guilty of an offence.³¹ This provision, unlike section 250 of our Companies Act, does not only target directors or officers. It prohibits *everyone* from engaging in the proscribed conduct, meaning that the net is wide enough to cover auditors, accountants, secretaries and other officers or anyone acting under their influence. It can be argued that section 250 of the Companies Act could be made applicable to specified influential persons other than directors, although there is possibly no need to extend its provisions to “anyone.”

2.2.1. Responsibilities of the signing officers.

Section 302 of the SOX focuses on signing officers who attest to the fairness of financial reports. In section 302 (a) 4 A-D it is stated that the officers are responsible for the setting up and maintenance of internal controls, evaluation of the effectiveness thereof and the reporting of the results of such an evaluation. In South African law there is no statutory equivalent of this provision. This does not mean that there is no rule that places the responsibility for setting up internal controls to detect fraud on somebody. SAAS 240R discussed in Chapter Four above states that it is the responsibility of management to establish and maintain a system of internal control. The case *Tonkwane Sawmill Company v Filmalter*³² discussed in Chapter Three also deals with the matter. In this case it was stated that an audit is not a substitute for management and management is responsible for the protection of its assets by establishing an internal control system.

³¹ This SOX provision was in all likelihood motivated by the shredding of documents by David Duncan, a former partner of Arthur Andersen LLP who admitted in court that he obstructed justice by shredding vital documents. See a newspaper report under the title, “Duncan says he knew shredding of documents was illegal” on <http://www.chron.com/disp/story.mpl/special/andersen/1409425.html> accessed on 30/8/2007.

³² 1975 (2) SA 453 (W) 454.

Management cannot rely on the auditor to remedy defects in its system. It was stated in the *Tonkwane* case that reasonable care merely requires an auditor to *examine the effectiveness* of his client's internal control system before placing reliance on it.

It is interesting to note that in terms of South African law, following the *Tonkwane* case, auditors must evaluate the effectiveness of their client's internal system before they can rely on it. In the U.S. the signing officers are required in terms of section 302 (5) A and B to disclose to the audit committee and auditors all substantial defects in the design and operation of the internal control system that may have an effect on its capacity to record and analyze financial information. They must further identify material weaknesses in the internal control system and disclose them to the auditor. In terms of subsection B, the signing officers must in addition disclose to the audit committee and the auditors any fraud, material or immaterial, by management or other officers involved in the internal control system. This provision clearly indicates where the primary responsibility to detect fraud actually lies.

It is submitted that in South Africa, the precedent as was laid down in *Tonkwane* as long ago as in 1975 should be amplified by statutory provisions. There is a need for the adoption of a provision similar to the one in the SOX. Too much is required from an auditor if he has to take responsibility for examining the quality of the client's system of internal control³³ without having the advantage of relying on the company's own assessment thereof. Auditors must in terms of the SOX also be informed about any fraud committed by employees so that they can treat the reports associated with such employees with suspicion.³⁴

³³ The scenario where an auditor must first determine the efficiency of his client's system of internal control can be likened to a situation where a doctor is required to treat a patient without being briefed by the patient on the nature and extent of the sickness. The doctor may yet succeed but would much prefer to have background information.

³⁴ Sections 305 (5) A and B reaffirm the position in terms of the SOX that fair financial reporting is the responsibility of company management by requiring the officers to refrain from spoiling the financial reports by misleading the auditor.

2.2.2. Misleading the auditor.

The SOX envisages situations where influential officers deliberately mislead the auditor or engage in conduct that misleads the auditor. In section 303 (a) under Title III (Corporate Responsibility) the SOX provides that it is unlawful for any officer or director of a company or any other person working under the direction of the company to fraudulently influence, coerce, manipulate or mislead any public accountant or auditor who is performing an audit of the financial statements of the company, with the intention to render the financial statements materially misleading. This provision is aimed at allowing an auditor to conduct his audit without any misleading interference from influential officers. It also encourages officers to be truthful in their submissions to the auditor and in this way it complements section 302. It would therefore be difficult to place the blame on an auditor after he has been misled by company officials. Section 303 (a) at least partially resurrects an aspect of the old case of *In re Kingston Cotton Mill (No 2)*³⁵ where it was stated that auditors are justified in believing trusted servants of the company. Auditors in the U.S. will at least be placed in a position where they can make an informed assessment of the company's system of internal control if trusted servants of the company are required to be truthful in their interaction with the auditor. An auditor may then be justified in expecting them to be honest and to obey the law.

In South African law there is no provision that is similar to section 303 (a). The inclusion of a similar provision in the Companies Act, 61 of 1973 and the Auditing Profession Act, 26 of 2005 would be a step in the right direction. This is so because in the *Thoroughbred* case³⁶ the company appointed as financial manager a person who it knew had a criminal history. Despite this knowledge the company failed to inform the auditor of the person's history. The act of appointing such a person into a management position might have misled the auditor into believing that the person was honest, with the result that the auditor failed to detect the acts of fraud perpetrated by that person. The company did not

³⁵ [1896] 2 Ch 279 288. This case is discussed in detail in Chapter Three above.

³⁶ 1999 (4) SA 968 (W).

suffer any penalties for its failure to disclose this vital information. It is submitted that having a provision like section 303 (a) of the SOX would do away with such practices.

3. THE UNITED STATES CODE.

The United States Code is a codification of the laws that apply in that country and is made up of fifty titles. It is published every six years by the Office of the Law Revision Counsel of the United States House of Representatives and the current version is available online.³⁷

3.1. Title 15: Commerce and Trade: Chapter 2B-Securities Exchange.

3.1.1. Section 78j-1: Audit requirements.

Section 78j-1 of Chapter 2B in Title 15³⁸ deals with the audit requirements that specify what an auditor must do when he is conducting an audit. As was stated earlier in this Chapter, the SOX does not contain a list of duties that an auditor must perform. These are to be found in section 78 of the U.S. Code.

In terms of section 78j-1 (a) an audit must be in accordance with international auditing standards and must include procedures that are designed to provide the client with a *reasonable assurance* that illegal acts having a direct and material effect on the determination of the financial statements will be detected. This provision does not prescribe the procedures and as such it leaves it to the discretion of the auditor. In other words reasonable care in relation to the U.S. Code means that an auditor must ensure that he makes use of audit procedures that would assist in placing him in a position where he can give a *reasonable* assurance that illegal acts and material misstatements will be uncovered. Absolute assurance is not required. It is interesting to note that the statutory duties of an auditor in the U.S. are focused on detecting fraud but auditors are not

³⁷ See <http://www.gpoaccess.gov/uscode/index.html> (accessed 27/7/2007).

³⁸ To be referred to as section 78.

required to provide an absolute assurance that fraud will always be detected. The primary duty seems to be that an auditor is expected to take steps that can reasonably place him in a position to detect fraud.

In South African law the Companies Act in sections 300 (1) (a)-(l) deal with audit procedures that define reasonable care. There is no mention of the requirement to provide a reasonable assurance that illegal acts will be detected. The same applies to section 44 of the Auditing Profession Act, 26 of 2005. It seems as if the primary duty of auditors in South Africa is to audit and provide a reasonable assurance that the financial statements are fair and correct. The provisions of these two Acts are discussed in Chapter Four. If one however combines legislation and case law one can find that apart from being required by legislation to follow set procedures and to give the client a reasonable assurance that the financial statements are fair and correct, South African auditors are required by common law to be cognizant of the possibility of fraud and use their professional judgment and skill to probe suspicious matters to the bottom.³⁹

3.2.1. Response to findings.

In terms of section 78j-1 (b) an auditor who complies with the provisions discussed in 3.1.1 and who discovers or becomes aware of illegal activities or misstatements, whether material or immaterial, that have or may have occurred must according to international auditing standards take the following steps:

1. Determine whether it is likely that the illegal activity has taken place or whether a statement is materially false.⁴⁰
2. If the illegal activity has indeed taken place the auditor must then determine and consider the possible effects thereof on the financial statements of the company.⁴¹

³⁹ The South African case of *Thoroughbred Breeders Association v Pricewaterhouse* supra note 36 *inter alia* focuses on this issue. This case is discussed in detail in Chapter Three.

⁴⁰ Section 78j-1 (b) A (i).

3. Inform, as soon as possible, the relevant senior officers of the corporation and ensure that its audit committee is sufficiently informed of the illegal acts that have been detected. If such a committee does not exist this information must be submitted to the board of directors. This provision does not apply if the illegal act is plainly inconsequential or immaterial.⁴²

These provisions are indications of the standards of diligence that must be adopted by an auditor who *has discovered* fraud and illegal activities and are well in line with the requirements as were set in the cases discussed in Chapter Three. The case law requires auditors to probe to the bottom all suspicious and irregular matters.⁴³ In South African Law the Auditing Profession Act, 26 of 2005 in section 45 requires auditors to report on reportable irregularities they detect in their audits of financial statements or otherwise to the Independent Regulatory Board for Auditors. An must in addition notify management of the irregularity that is taking place or has taken place.⁴⁴ After this initial reporting stage the auditor must within 30 days discuss the irregularity with the management and consider their representations, after which he may send another report to the Regulatory Board to notify it that the irregularity has been corrected or is continuing or has in fact never existed.⁴⁵

Of great importance is the requirement in terms of the Auditing Profession Act, that for the purposes of these reports an auditor must carry out all investigations that he may deem fit and in the subsequent meetings with the management he must also consider information from any other source.⁴⁶ This provision means that an auditor who detects a reportable irregularity must carry out whatever further investigations which he thinks

⁴¹ Section 78j-1 (b) A (ii).

⁴² Section 78j-1 B.

⁴³ See *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29, *Dairy Containers v NZI Bank* (1995) 2 NZLR 30 and *Thoroughbred Breeders Association v Pricewaterhouse* *supra* note 36.

⁴⁴ Section 45 (2) (a).

⁴⁵ Section 45 (3).

⁴⁶ Section 45 (5).

may shed more light on the nature, the existence or non-existence of the reportable irregularity. This is in line with international practice (as is also found in the U.S. Code section 78j-1). The principle that an auditor must, as an element of his duty of reasonable care and skill, probe to the bottom any suspicious matter he identifies clearly has statutory backing in the U.S. and in South Africa.

The differences in the way illegal acts and irregularities are dealt with by auditors in the two countries relate to the nature of the irregularities themselves. In the U.S. an auditor is required by section 78j-1 (b) (1) to investigate every illegal act, material or immaterial, and take the necessary steps or abstain from taking such steps if the auditor finds the illegal act or fraud to be inconsequential. This suggests a higher level of diligence since auditors may only abstain from reporting any given illegal act after being satisfied that it is inconsequential. In other words, the U.S. Code requires auditors to investigate all illegal acts whether they perceive them to be material or not.

In South African law auditors are required by section 45 (5) of the Auditing Profession Act to investigate only *reportable* irregularities before and after submitting a report to the Regulatory Board. This approach is far more realistic and easier to apply in practice. Before an auditor can investigate an irregularity further he must use his professional judgment to determine whether a particular circumstance warrants further investigation. Auditors must be allowed to exercise their discretion. In the U.S. the requirements set by section 78j-1 (b) (1) of the U.S. Code make the whole exercise tedious. One can sense however that in practice, auditors in the U.S. only investigate matters that truly justify an investigation.

In line with its policy that apparently requires extra diligence, the U.S. Code requires auditors to ensure that the audit committee of the board is well informed of all illegal acts which have come to the fore and of whether such illegal acts have a material impact on the financial statements of the user. If the senior management has adopted a lax attitude to the illegal act, or has not been given ample opportunity by the board to take the necessary remedial action, and if this failure to act can reasonably be expected to justify a

departure from an auditor's standard report or his resignation, then the auditor must report his conclusions to the board.⁴⁷ This report must be submitted to the Commissioner by the corporation. Failure to do so entitles the auditor to resign if he so wishes.⁴⁸ This clearly shows that an auditor is required to ensure that management is doing something about the illegal activity.

SECTION B; REASONABLE CARE AND SKILL: CASE LAW IN THE U.S.⁴⁹

1. TESTING AND SAMPLING AUDIT EVIDENCE.

The method of testing and sampling in auditing entails the testing of a selected cluster of information from the financial data and assuming that it represents the financial statements as a whole. This means that if a particular cluster or sample is tested and found to be fair the auditor may assume that the financial statements are fair. The question is whether this practice passes the reasonable care test. According to Rabel,⁵⁰ the courts appear to have accepted this method. In the English case of *In re London General Bank*⁵¹ the court held that "where there is nothing to excite suspicion, very little inquiry will reasonably be sufficient, and in practice business men select a few cases at haphazard, see that they are right and assume others like them are correct also."

Rabel also quotes the Canadian case of, *McBride's Ltd v Rooke and Thomas*⁵² where the Chief Justice made use of comments from a legal textbook dealing with auditors' duties. In the book it was stated that auditors "are not bound to go through every document and

⁴⁷ Section 78j-1 (2).

⁴⁸ Section 78j-1 (3).

⁴⁹ The discussion in this section will derive a lot from an article by Rabel FK "Auditing Standards and Procedures in the Light of Court Decisions" (1944) 42 (6) *Michigan Law Review* 1009 available on www.jstor.com. (accessed 26/7/2007) This article discusses a number of American cases on the subject of this research.

⁵⁰ *Ibid* 1014-1015.

⁵¹ [1895] 2 Ch 673 683.

⁵² Rabel *supra* note 49 1015. [1941] 4 Dom L Rep (KB Sask) 45.

paper of the company; they may for instance, take a few vouchers at haphazard, and if these are in order they may assume that other vouchers are in like case.” The use of this procedure, although it may imply a lack of thoroughness in the audit, actually satisfies the reasonable care test if it is applied in circumstances that do not warrant suspicion.

1.1. Does this Procedure Provide a Reasonable Assurance that Fraud will be Discovered?

This question was considered by the Securities Exchange Commission in 1939 after the *McKesson and Robbins* case.⁵³ There is a considerable risk that a particular tested sample may not be representative of the financial statements as a whole. After the *McKesson* case Clikeman⁵⁴ states that the American Institute of Certified Public Accountants issued its first standard under the title *Statement on Auditing Procedure No 1: ‘Extensions of Auditing Procedure’*, which made the observation of inventory and confirmation of accounts receivable, standard audit procedures. These two procedures would make the detection of McKesson type frauds possible. This standard did not do away with the testing and sampling method. It merely made the verification of certain aspects of financial statements mandatory.

2. THE DETECTION OF FRAUD.

Rabel refers to the decision in *Smith v London Assurance Corporation*⁵⁵ where the New York Supreme Court appears to have stated that the discovery of fraud was within the

⁵³ This case has been described by one commentator as one of the greatest frauds of the last century - see Paul M Clikeman PhD in “The Greatest Frauds of the (Last) Century” available on www.newaccountantusa.com/newsFeat/wealthManagement/Clikeman_Greatest_Frauds.pdf. (accessed 10.5.2007)

⁵⁴ *Ibid.*

⁵⁵ Rabel *supra* note 49 1016. (109 App. Div. 882 884).

“reasonable contemplation of the parties.”⁵⁶ The court also stated that the object of the checking of accounts or auditing may be to “prevent, or at least arrest such practices.” In this particular case the cashier committed fraud by making false entries into the cash book. It would appear at first glance as if all audit agreements in the U.S. reasonably contemplate the detection of fraud but closer scrutiny will reveal that this is not the case.

2.1. Where Detection of Fraud is the Specific Object of the Audit.

There are instances where the detection of fraud is the specific and express object of the audit. Rabel states that municipal audits demand special care and the detection of fraud may be the express or implied object of the audit.⁵⁷ He gives examples of cases where auditors were found to be liable. In one of the cases, *Maryland Casualty Co v Cook*⁵⁸ the auditor was held to have been negligent since he failed to uncover a number of serious irregularities perpetrated by the city treasurer. In another case, *City of East Grand Forks v Steele*⁵⁹ the Minnesota Supreme Court in finding the auditors liable, stated that the auditors were “employed to ascertain among other things, whether any irregularities had occurred in the financial transactions of the city clerk and if so, the nature and extent of such irregularities.” It is clear that where a specific duty to detect fraud is imposed on auditors, an auditor may be liable for negligence if fraud exists and is not detected.

The failure by an auditor to detect fraud in instances where there is a clear and specific duty to do so also constitutes breach of contract. In American law breach of contract consists in the “wrongful non-performance of a promissory duty under a contract.”⁶⁰ According to Frascona, non-performance is wrongful where there is a contractual duty to render immediate performance and such performance has not been rendered according to

⁵⁶ It is submitted that imposing such a term in audit agreements would generally be undesirable because parties to an audit agreement know exactly what they want and auditors should perform that according to the express terms and conditions in the agreement.

⁵⁷ Rabel *supra* note 49 1016.

⁵⁸ *Ibid.* (DC Mich 1940) 35 F Supp 160.

⁵⁹ *Ibid.* 121 Minn 296 300.

⁶⁰ Frascona *JL CPA Law Review* 4th ed 126.

the terms of the contract and there is no legal justification for such non-performance.⁶¹ This means that auditors who fail to detect fraud where there is a duty to do so breach their contractual obligations and this may be due to negligence. There may still be a legal justification however. Where the fraud was carefully perpetrated and concealed the auditor may have a defence that the fulfilling of his obligations would have imposed a near impossible task on himself. The case *Jamieson, Austin and Mitchell Ltd v Battrum*⁶² quoted by Rabel offers another defence for auditors. In this case it was stated that a client who restricts the scope of the audit to make it impossible for irregularities to be disclosed makes it impossible for himself to claim for damages for breach of contract by the auditor.

2.2. Is there a general Duty to detect Fraud?

In the absence of a contractual agreement there appears to be *no general duty* on auditors to detect fraud. Rabel discounts the view of Talbot J of the English High Court of Justice in *Armitage v Brewer and Knott* as the minority view.⁶³ In this case Talbot J stated that it is the auditor's obligation to be suspicious since "that was what they were for" because, "if everybody was honest and careful there would be no need for auditors." Rabel supports the view in *London Oil Storage Co v Seear Hasluck and Co*⁶⁴ that an auditor is not "bound to assume that he is working with fraudulent and dishonest people" and needs only to probe suspicious matters to the bottom.

In *Short and Compton v Brackett*⁶⁵ it was stated that an auditor may assume that the books are correct if there is no suspicion of falsifications. In another case, *Calne Gas Co v Curtis*⁶⁶ it was held that the mere fact that fraud was not detected in an audit is not conclusive proof of negligence in the performance of the audit. In *Guardian Insurance*

⁶¹ *Ibid* 129.

⁶² Rabel *supra* note 49 [1934] 1 West W Rep (Alta Sup Ct) 324.

⁶³ Rabel *supra* note 49 1018.

⁶⁴ *Ibid* (KB 1904) 800-803.

⁶⁵ Rabel *supra* note 49 1108, (Colchester County Ct 1904) 798 800.

⁶⁶ Rabel *supra* note 49 1108, (KB 1918) 949 958.

*Co v Sharp*⁶⁷ it was stated that auditors are entitled to assume that company officials and employees are honest, provided there is nothing that is calculated to excite suspicion. It was also stated further that the auditor's duty is limited to verification and does not entail the detection of fraud.

In this case, as in *Tonkwane Sawmill co v Filmalter*,⁶⁸ it was stated that a balance sheet with the auditor's signature on it cannot reasonably be expected to amount to a guarantee of the honesty of all members of the client's staff and a guarantee that the auditor's vigilance has been efficient. These cases show that an auditor in terms of U.S. case law is not bound to detect fraud. However, these cases do not relieve an auditor from complying with modern audit standards. International auditing standards require auditors to scrutinize the internal control system and management before placing any reliance or trust on that system.⁶⁹ In the case, *Pacific Acceptance Corporation v Forsyth*⁷⁰ it was stated that auditors may not simply rely on the system of internal control of a company. Rabel supports this view and states that reasonable care implies that an auditor may not rightfully rely on statements by management on matters he can personally verify.⁷¹

3. EFFICACY OF THE INTERNAL CONTROL SYSTEM.

A lot has been said thus far in this research about the audit client's system of internal control. From a reasonable care point of view it is obvious that the auditor must verify the efficacy of the internal control system before relying on it. The analysis of this system in the U.S. is governed by international auditing standards. It is however

⁶⁷ [1941] 2 Dom L Rep (Can Sup) 417.

⁶⁸ 1975 (2) SA 453 (W) 454.

⁶⁹ SAS 54: 'Illegal acts by Clients' requires auditors to consider the possibility of their clients committing illegal acts and SAS 94: 'Consideration of Internal Control in a Financial Statement Audit' requires auditors to analyze the efficacy of the internal control system before relying on its work. Section C of the Chapter deals with internationally accepted auditing standards in more detail.

⁷⁰ *Supra* note 43.

⁷¹ Rabel *supra* note 49 1019.

important to note *how* the courts have interpreted this duty. Rabel refers to the decision in *McBride Ltd v Rooke and Thomas*.⁷² In this case it was stated that it is an auditor's additional duty to familiarize himself with his client's accounting system. It was also stated that the auditor must ascertain whether the client's accounting system operates as an internal control and if so the auditor must verify on its efficacy. The court interestingly held that after having ascertained the efficiency of the system of internal control the auditor may commence his audit from where the internal control has left.⁷³ This last statement may be misleading. According to Rabel, this view must not be construed as relieving an auditor from the duty to personally check and revise material items in his client's financial statements, simply because the client's internal control system is strong.⁷⁴

4. KNOWLEDGE OF LEGAL MATTERS.

Does reasonable skill translate to knowledge of legal matters? According to Rabel the auditor's duties extend to the field of legal questions.⁷⁵ He states that corporate illegalities may occur in the mismanagement of capital stock, surplus accounts, authority for transactions and partnership agreements. Quoting a number of decisions, Rabel finds that the courts have however taken a soft stance in this issue. Lord Chelmsford in the *Spackman v Evans*⁷⁶ stated that it is not part of the auditor's duties to inquire into the validity of every transaction appearing in the accounts of the company, meaning that auditors have no duty to investigate the legality of transactions. In another case, *Trustee of the Property of Apfel v Annan, Dexter and Co*⁷⁷ the auditors were held not liable despite their failure to detect that undue payments had been made to junior partners after

⁷² Rabel *supra* note 49. [1941] 4 Dom L Rep (KB Sask) 45.

⁷³ Rabel *supra* note 49 1019.

⁷⁴ Rabel *supra* note 49 1019.

⁷⁵ Rabel *supra* note 49 1020. Auditors do possess sound knowledge of legal matters relating to their statutory duties and financial reporting.

⁷⁶ Rabel *supra* note 49 1021. LR 3 HL 171 236.

⁷⁷ *Ibid*; [1926] Ch D.

the senior partner had signed documents authorizing the payments without understanding the legal ramifications.

In *Flagg v Seng*⁷⁸ the defendant auditors failed to detect the illegal exchange of capital stock for real estate. They also failed to detect the illegal declaration of dividends. They were however exonerated on the basis of evidence that showed that the transactions in question were part of an established policy that had been approved by legal counsel. In another case quoted by Rabel, *In re Republic of Bolivia Exploration Syndicate*⁷⁹ the court sought to explain the question relating to the amount of legal knowledge auditors ought to possess. It was stated that auditors should be aware of their duties under the articles of incorporation and the Companies Act but there are other matters that they cannot reasonably be expected to know. It was stated further that liability for failure to detect illegal payments made before commencement of the audit must depend on the circumstances of each case.

Rabel believes that, despite the leniency of the courts in relation to this matter, a conscientious auditor should have reasonable knowledge of the major legal questions affecting the financial statements and where necessary, he should obtain legal expert advice.⁸⁰ One can agree with this point of view. This is so because modern auditors have a good knowledge of the laws relating to companies and financial reporting. As such, they should use that knowledge in conducting audits and detecting illegal activities.⁸¹

⁷⁸ *Ibid*; 16 Cal App (2d) 545.

⁷⁹ [1914] 1 Ch 139.

⁸⁰ Rabel *Op cit* note 49 1022.

⁸¹ Auditing standard, AU Section 317: "Illegal Acts by Clients" deals with the issue of the auditor's knowledge of the law and illegal acts perpetrated by clients. Paragraph 03 of this standard states that whether a particular act is in fact illegal is a question ordinarily beyond the scope of the auditor's professional competence. It also states that an auditor presents himself to be an expert in accounting and auditing although his training, experience and knowledge of the client may well lead him to know certain illegal acts. This standard is in line with the opinion of Rabel and this researcher as stated above. In terms of paragraph 04 and 05, auditors may have less knowledge of the existence of an illegality or a particular act if it is removed from the financial statements. However auditors have or should have

The courts should set a limit on what a reasonably skilled auditor ought to know but they should never underestimate the amount of legal knowledge auditors possess.

5. VERIFICATION.

There are items in the financial statements that can easily be falsified by management. It is the auditor's duty to verify such items and see whether they in fact exist. In the case of *London Oil Storage v Seear, Hasluck and Co*⁸² the verification of cash was discussed. Lord Alverston in this case instructed the jury to ascertain whether the auditor had taken reasonable steps to ensure that cash was actually on hand. In answering the question the jury had to consider what the auditor had done, in some cases, the auditor would be justified in trusting the cashier and in others he may have to investigate further. In giving judgment the Lord Chief Justice found that since the auditors *had not taken any steps whatsoever* to verify the cash on hand in the balance sheet the jury had ruled correctly because the auditors had failed in their duty. He stated that auditors do not have to count the cash since this would not be a true reflection of the auditor's duties. The auditors in this case had failed to verify a suspicious circumstance that arose from the fact that cash on hand in the balance sheet had risen sharply in comparison with the previous year.⁸³

6. PROFESSIONAL SCEPTICISM.⁸⁴

knowledge of laws and regulations that have a direct effect on the financial statements. As this standard clearly shows, the views expressed above should not be seen as requiring reasonably careful auditors to have broad knowledge of the law. They should only have knowledge of the legal matters that have a reasonably direct relationship with the financial statements. Knowledge of legal matters relating to an entity's occupational health and safety, environmental protection, employment equity and price fixing which only have an indirect impact on the financial statements would generally fall outside the scope of an auditor's duties.

⁸² *Supra* note 64.

⁸³ The question as to what extent does an auditor have to analyze the accounts of previous years was discussed in the case *Morton v Arbuckle* 1919 Vic L Rep 487 where the court held that an auditor is entitled to take as a starting point the balance brought forward from previous years.

⁸⁴ Professional skepticism, as has been discussed in Chapter Four, is an attitude that an auditor must maintain when conducting an audit. It is well supported by the auditing standards in South Africa in

According to Vanasco *et al* the lack of a sceptical attitude in considering risk factors in securing appropriate audit evidence has played its part in audit failures.⁸⁵ They quote a number of cases to support their views. In *Fisher v Ketz*⁸⁶ the client produced materially misstated financial statements that reported an income of \$1. 4 million instead of a loss of \$1. 254 million. In the collection of the audit evidence the auditor failed to maintain a sceptical attitude and was easily persuaded by representations from management. It is clear in this case that if the auditor had not trusted the client and had been a bit more sceptical, the odds of uncovering the fraud would have increased. In another case, *Escott v BarChris Construction Corporation*⁸⁷ the plaintiffs contended that the registration statement for debentures contained statements that were materially false and this was made worse by some material omissions. The judge in reprimanding the auditor for not maintaining a sceptic attitude stated that the auditor “was too easily satisfied with glib answers to his inquiries” and ignored the many danger signals in the materials that justified further investigation.

7. DEVIATION FROM AUDIT PRACTICES.

The question whether an auditor who deviates from particular audit practices in a particular case is negligent is answered in the case, *In the matter of The Hawaii Corporation* (1983).⁸⁸ In this case the American Pacific Group (APG) planned a merger with one of its subsidiaries, the Hawaii Corporation (HC). APG engaged the auditing firm Peat, Marwick, Mitchell and Company (PMM) to prepare the financial statements of APG and HC and also express opinions in relation to the feasibility of the merger. When

SAAS 240R discussed in Chapter Four above and the US in AU Section 316A: “Consideration of Fraud in a Financial Statement Audit.” A few decisions here show that it has been embraced by the courts in the U.S. as well. See generally Vansco RR Scousen CR and Jensen RL “Audit Evidence: The US Standards and Landmark Cases” (2001) 16 (4) *Managerial Auditing Journal* 207.

⁸⁵ Vanasco RP Scousen CR and Jensen AL *supra* note 84 211.

⁸⁶ 266 F Supp 180.

⁸⁷ 283 F Supp 643.

⁸⁸ See Clarkson KW *West’s Business Law Text and Cases* 3rd ed 934

the merger resulted in a needless loss of \$22 million the trustee in reorganization sued the auditors PMM for accounting malpractice. This averment was based on the unusual method PMM used in restructuring the companies. The trustee contended that, had PMM used accounting methods generally applied in such transactions, its financial statements could have reflected a more negative picture and the merger could have been avoided.

In handing out the judgment Panner, the district judge, stated that accountants and auditors have the duty to exercise the degree of care, skill and competence exercised by reasonably competent members of their profession under the circumstances. He stated further that an accountant is not a guarantor and has a duty to act honestly, in good faith and with reasonable care in the discharge of his professional obligations. The district judge concluded that the plaintiff failed to prove by a preponderance of the evidence that the plaintiff was negligent in using the method of accounting he had used for the transaction. Panner also concluded that the procedure the auditor had used was appropriate and that no particular procedure had been endorsed as standard in all situations. It was evident that even if the auditor had used a different procedure the results would not have been significantly different. This case is authority for the proposition that an auditor does not breach his duty to exercise reasonable care and skill by merely adopting a different audit procedure.

8. MANAGEMENT INDISCRETIONS.

Practically all instances of fraud involve management in one way or another. It has been stated that management is in a position to conceal fraud so well that a reasonably careful and competent auditor would not be able to detect it. In such instances, where does liability lie? Two recent American cases answer this question.

In the first case, *American Tissue Inc v Arthur Andersen LLP*⁸⁹ Arthur Andersen had been retained to audit ATI's financials for 1999 and 2000. The firm audited ATI's year end consolidated statements for 1998 to 2000 and certified them as fair without qualification. In September 2001 ATI publicly announced that the financials contained material misstatements which included overstatements of accounts receivable, overvaluation of inventory, failure to disclose inflated sales and inventory reports and incomplete disclosure regarding insider loans. The chief financial officer of ATI stepped down just prior to the announcement, and the company filed for bankruptcy soon after. Two ATI directors also stepped down. The court dismissed the claim that Andersen had been negligent and stated that ATI cannot allege that the auditor had been negligent simply because Andersen certified the faulty financial statements. It was found that on the facts professional negligence had not been established.

In the second case, *In re Rite Aid Corporation, Securities Litigation*⁹⁰ a certain Martin Grass, who was the chief executive officer of Rite Aid, resigned from his post under pressure. A new management team launched an internal investigation that allegedly unearthed evidence of massive fraud and mismanagement by Grass and other top executives. The shareholders got \$93 million in a settlement with some of the individual defendants. Rite Aid's ex chief financial officer pleaded guilty of civil fraud. Grass and a former director admitted guilt and contributed to the settlement.

It is interesting to note that in this case, liability was extended to KPMG on the basis that their audit should have detected the book juggling allegedly perpetrated by Grass and his associates allegedly to inflate profits and understate losses at the drug store giant. KPMG agreed to settle in spite of the fact that it maintained that it would have been extremely difficult for an accountant to uncover financial irregularities by a group of manipulative executives.

SECTION C: AMERICAN AUDITING STANDARDS.

⁸⁹ Civ 7751 (SAS) 2003. This case was accessed on www.google.com.

⁹⁰ MDL 1360 (ED Pa June 2 2003). This case was accessed on google.com.

These are issued by the American Institute of Certified Public Accountants (AICPA) through its senior technical bodies, the Auditing Standards Board (ASB) and the Accounting and Review Services Committee (ARSC).⁹¹ These international auditing standards have legal backing because in terms of section 78j-1 (a) an audit must be in accordance with international auditing standards.

1. AU SECTION 230: “DUE PROFESSIONAL CARE IN THE PERFORMANCE OF WORK.”⁹²

1.1. What is due professional Care?

This standard recognizes the legal requirement that auditors must perform their duties with due professional care and skill. This standard also helps in knowing what generally constitutes due professional care in auditing. According to AU Section 230,⁹³ due professional care entails the observation of auditing standards of field work and reporting in the performance of any audit.⁹⁴ This means that the observation of auditing standards is evidence of due professional care in the performance of work. AU Section 230, as in English and South African law, recognizes the fact that an auditor by professing peculiar

⁹¹ See www.aicpa.org.

⁹² This standard defines reasonable care and skill but does not focus on the objectives of an audit. AU Section 110: “Responsibilities and Functions of the Independent Auditor” paragraph 01 appears to state that part of an auditor’s duties is to express an opinion on the fairness of the presentation in the financial statements. Paragraph 02 of AU Section 110 also states that an auditor has a responsibility to plan and perform an audit to obtain a reasonable assurance that the financial statements are free from material misstatements. This is in line with the requirement set in the US Code.

⁹³ Paragraph 02.

⁹⁴ This shows that in the USA, case law, legislation and auditing standards support the notion that the auditor’s duty of reasonable care and skill also entails the observation of auditing standards as set by the relevant professional bodies. This concept has some roots in South Africa as was seen in Chapters Three and Four.

skill binds himself to performing his duties according to such skill.⁹⁵ The use of such skill and the observation of auditing standards will not automatically lead to an absolute guarantee that the auditor will perform impeccably and detect fraud or other material misstatements whenever they exist. In the U.S. law of negligence⁹⁶ it is clear that:

“Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill he possesses with reasonable care and diligence. In all these employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing a degree of skill commonly possessed by others in the same employment, and if his pretension are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully and without fault or error, he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors or judgment.”

This shows that reasonable care is not about doing the utmost and in the case of auditors, detecting fraud. Due professional care instead is about what the auditor does and how well he does it.⁹⁷

AU Section 230 states that an auditor should be assigned a task and be supervised in tandem with his level of experience, skill, knowledge and ability. It is improper and

⁹⁵ According to Fleming JG *The Law of Torts* 8th ed The Law Book Company Limited 108, “skill is that special competence which is not part of the ordinary equipment of the reasonable man but the result of aptitude developed by training and experience. Those who undertake work calling for special skill must not only exercise reasonable care but measure up to the standard of proficiency that can be expected from such professionals. Thus a ship’s officer will be held to the knowledge and experience in matters maritime typical of his calling rather than of a layman.”

⁹⁶ AU 230 quotes Haggard D *Cooley on Torts* 4th ed 472.

⁹⁷ Paragraph 04.

amounts to negligence on the part of an auditor to assign complicated audits to less experienced subordinates.⁹⁸ The auditor who has the overall responsibility for the audit should have the required knowledge about auditing standards and of the client.

1.2. Professional Scepticism.

It was said that auditors exercising reasonable care should maintain an attitude of professional scepticism. AU Section 230 is a standard that actually links this attitude to reasonable care and skill. The description of professional scepticism in this standard is closely related to the one that is in SAAS 240R that applies in South Africa and was discussed in Chapter Four. In terms of AU 230 professional scepticism is an attitude that entails a questioning mind and a critical assessment of the collected audit evidence.⁹⁹ Since audit evidence is collected and evaluated throughout the audit, professional scepticism should be exercised throughout the audit. As is required by SAAS 240R in South Africa, AU 230 states that in exercising professional scepticism the auditor does not assume that management is dishonest. Conversely, the auditor does not assume impeccable honesty on the part of management. The auditor should also not allow his trust in management's honesty to cause him to accept unconvincing evidence that the management may provide.¹⁰⁰

⁹⁸ According to Fleming JG *op cit* note 90 111, "...at the other end of the spectrum of skill are beginners. While it is necessary to encourage them, it is equally evident that they cause more than their fair share of accidents. The paramount social need compensating accident however, clearly outweighs all competing considerations, and the beginner is, therefore held to the standard of those who are reasonably skilled and proficient in that particular calling or activity." This shows that there is a need for senior auditors to assign work according to expertise and experience. In *Jones v Manchester Corp* [1952] 2 QB 852 871 Denning LJ stated that, "it would be in the highest degree unjust that the hospital, by getting inexperienced doctors to perform their duties for them, without adequate supervision, should be able to throw all responsibility on those doctors as if they were fully experienced practitioners." This shows that public accounting firms that assign inexperienced auditors to work that may expose their inexperience and do not adequately supervise them may be found to be negligent.

⁹⁹ Paragraph 07.

¹⁰⁰ Paragraph 09. AU Section 333: "Management Representations", paragraph 02, deals with representations of management in response to enquiries of the auditor. This standard sets the tune for

1.3. Reasonable Assurance.¹⁰¹

According to AU 230 due professional care means that an auditor must plan and perform the audit with a view to obtaining sufficient evidence to limit audit risk and to express an opinion on the financial statements. The auditor can only offer a reasonable assurance that the financial statements are free from material misstatements.¹⁰² AU 230 clearly states that absolute assurance is not practical because of the nature of audit evidence and the characteristics of fraud.¹⁰³ AU 230 also states that an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.¹⁰⁴

professional scepticism and due diligence further by stating that management representations should not be seen by the auditor as a substitute for the application of other audit procedures necessary to obtain a reasonable basis for an opinion. In other words management representations are not sufficient. The auditor must still make a personal inquiry that shows that he does not rely completely on what management has to say in response to his questions. AU 333, paragraph 04, also states that where management representations contradict other audit evidence the auditor must, in line with the case law on suspicious matters discussed in Chapter Three, investigate the circumstances and consider the reliability of the representations. In terms of AU 333 an auditor must generally consider whether his reliance on management representations is appropriate and justified.

¹⁰¹ In terms of paragraph 02 of AU Section 110: “Responsibilities and Functions of the Independent Auditor” reasonable assurance does not apply to material misstatements that do not affect the fairness of the financial statements.

¹⁰² This, according to paragraph 02 of AU Section 110: “Responsibilities and Functions of the Independent Auditor” is because management is responsible for adopting sound accounting practices and for establishing a control system consistent with the assertions in the financial statements. Management is directly in control of an entity’s financial reporting policy and an entity’s assets and liabilities and equity. The auditor’s knowledge of these matters is limited to what he obtains from the auditing evidence. As such an auditor cannot issue an absolute assurance and the responsibility for fair financial reporting in line with generally accepted accounting practices lies with management. The same applies in South African law.

¹⁰³ The characteristics of fraud that may hinder the detection of fraud are stated in AU 230 paragraph 12. They include: (a) concealment through collusion among management, employees or third parties which may take the form of total omission from the accounting records and financial statements meaning that there is nothing really for the auditor to examine; (b) withheld, misrepresented, or fabricated documentation and (c) the inherent ability of management to override effective controls in unpredictable

2. CONCLUSION.

It is clear from the discussion in this Chapter that South African law on this subject is almost at par with U.S. law and international auditing standards. That the law in the U.S. on this subject is advanced is there for all to see. U.S. statutory law and international auditing standards state that auditors have no duty to detect fraud but they must plan their audit in order to obtain a reasonable assurance that material misstatements will be detected. The U.S. case law, like South African cases, also supports the view that auditors are not negligent merely because of failure on their part to detect fraud. However, the case law consulted in this Chapter shows clearly that if auditors fail to exercise reasonable care and skill, sometimes in a gross manner, they may be liable.

ways. These extraneous matters limit the auditor's ability to detect fraud. These points are supported further by AU Section 110: "Responsibilities and Functions of the Independent Auditor" paragraph 02 which states that due to the nature of audit evidence and the characteristics of fraud the auditor is only in a position to obtain reasonable but not absolute assurance that material misstatements will be detected.

¹⁰⁴ Paragraph 10.