

Entrepreneurial Law Incorporating The New Companies Act Manual

Special Edition

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- (e) The registered auditor then sends another report to the IRBA. The second report can state that:
- (i) the registered auditor is now of the opinion that no reportable irregularity has taken place or is taking place (that means that new or additional facts were brought to his attention that led him to change his initial opinion);
 - (ii) the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant; or
 - (iii) the reportable irregularity is continuing and give detailed particulars and information supporting such statement.

(f) The IRBA must as soon as possible after receipt of a report containing a statement that the reportable irregularity continues, notify any appropriate regulator in writing of the details of the reportable irregularity to which the report relates and provide it with a copy of the report.

20.37 In forming his opinion and performing his duties in terms of section 45 of the Auditing Profession Act 26 of 2005, the registered auditor must have regard to all the information which comes to his knowledge from any source. For the purpose of the reports referred above, a registered auditor may carry out such investigations as the registered auditor may consider necessary.

Legal Liability of the Auditor

Civil and criminal liability

20.38 In today's complicated business environment it has become increasingly important that an auditor should be aware of the various forms of liability he could incur in the course of the performance of his functions. Not only can he incur civil and criminal liability, but he may also find himself subject to the disciplinary measures administered by the IRBA.

Liability of the Auditor

Liability to the company and to third parties

20.39 A clear distinction must be drawn between an auditor's civil liability to the company (the client) which has appointed him as auditor and his liability to third parties, that is, persons falling outside the auditor-company (client) relationship who act to their detriment on the strength of financial information prepared or certified by the auditor. Instances where the potential liability of an auditor to the company may arise are, for example, where the company alleges that it suffered a loss as a result of the auditor's failure to detect the fraud of one of the directors or to properly verify the existence of the company's assets. The auditor's potential liability to a third party may arise in cases where, for example, the third party alleges that he suffered a loss as a result of the fact that he, for example, relied on the company's financial statements to make a loan to the company or to buy shares in the company.

Liability towards the company: Reasonable care and skill

20.40 In the performance of his duties to the company in terms of his contract, the auditor must act with reasonable care and skill, that is to say he must "bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful, and cautious auditor would use" [Lopes LJ in *Re Kingston Cotton Mill Co (2)* 1896 2 Ch 279 (CA) 288]. In the Australian case the court pointed out that although, in modern times, there have been considerable changes in the organization of the affairs of companies, "the legal duty, namely, to audit the accounts with reasonable skill and care, remains the same, but reasonableness

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and skill in auditing must bring to account and be directed towards the changed circumstances" [Moffitt J in *Pacific Acceptance Corporation v Forsyth* (1970) 92 WN (NSW) 29 at 74]. If the auditor acts without reasonable care and skill, he is liable to the company for any damages suffered by the company.

Civil liability towards the company: Client company's civil remedies against its auditor

20.41 The company will usually be able to choose between suing its auditor for breach of contract or in delict, as the same conduct on the part of the auditor is usually actionable on either of these two grounds. In practice, the company may rely on either of the grounds for framing its action in the alternative.

20.42 In an action for damages against the auditor for breach of contract, the company will have to prove the contractual relationship, the breach of contract complained of and the loss it suffered as a result of that breach. In the case of breach of contract, damages are computed on the basis that the injured party should be placed as nearly as possible in the same position as he would have been had the contract been properly executed. If, for example, the auditor neglected his duties and thus failed to detect the fraud of an employee of the company, the company should be placed in the position that it would have been in, had the auditor duly complied with his duties.

20.43 In *Thoroughbred Breeders' Association v Price Waterhouse* [2001 (4) SA 551 (SCA)] the audit contract was not reduced to writing but it was tacitly agreed that the audit would be conducted in accordance with the generally-accepted auditing standards and with the due professional care required of an auditor in public practice. The audit failed to discover the theft of a promissory note by the association's financial manager and that several substantial sums of cash had not been deposited for long periods. The association knew that the financial manager was previously convicted for fraud and served time in prison, but never disclosed this fact to the auditor. Damages were claimed from the auditor on the grounds that if he had performed his duties, the thefts perpetrated by the financial manager would have been uncovered and further thefts by him would have been prevented.

20.44 The court found that the auditor was negligent and therefore had committed breach of contract. There was also factual causation between the breach of contract and the loss suffered by the plaintiff. The loss suffered by the plaintiff was also not too remote as it flowed naturally and generally from the breach. However, the court also found that plaintiff was careless and negligent in their supervision of the financial manager and the control that it should have exercised over its own management.

20.45 The association had the choice to sue the auditor on the basis of delict or for a breach of contract. If the association brought a delictual claim, the court would have been able to apply the Apportionment of Damages Act 34 of 1956 to reduce the company's claim to the extent that it contributed to its own loss. The association, however, brought its claim on the basis of a breach of contract and the Apportionment of Damages Act does not apply to a claim for a breach of contract. The association therefore succeeded with its full claim against the auditor even though it contributed to its own loss. Although this conclusion was legally correct, it was deemed to be unfair. Section 58 of the Auditing Profession Act 26 of 2005 therefore extended the scope of the Apportionment of Damages Act to damages caused by a breach by the registered auditor of a term of a contract concluded with the registered auditor.

Civil liability towards third parties: Common law

20.46 An auditor usually stands in a contractual relationship to the company which appoints him as such. As auditor of the company, however, he does not stand in a contractual or fiduciary relationship to third parties such as creditors or prospective creditors of the company, its clients, and individual members of the company or prospective purchasers of the company's shares. Consequently, if any such third party should seek to hold the auditor liable for the latter's wrongful conduct, that liability would, apart from statutory arrangement where the liability of auditors is circumscribed within a defined scope, have to be established on the basis of the general principles of common law delictual liability.

20.47 The general principle of our common law in this regard is that culpable wrongful conduct by a person which causes damage to another constitutes a delict and gives rise to liability to compensate that other for his damage. In order to establish delictual liability, all the elements of the delict must therefore be proved to be present. These elements are:

- (a) *Conduct* (which may consist of an act or an omission that is failure to act when the circumstances demanded it).
- (b) *Wrongfulness* (which means that the conduct must have infringed some subjective right of another or constituted a breach of a duty of care).
- (c) *Fault* (that is, the perpetrator's conduct must have been culpable in the sense that he intended that the consequences of his conduct should happen (intent) or that he ought to have foreseen the likelihood of harm and should have governed his conduct accordingly (negligence)).
- (d) *Damages* (that is, the loss suffered by the injured party).
- (e) *Causation* (which implies that there is a causal link between the damage and the conduct of the perpetrator).

20.48 In *International Shipping Co (Pty) Ltd v Bentley* [1990 (1), SA 680 (A)] the common law liability of auditors towards third parties was put under scrutiny by the Appellate Division [now the Supreme Court of Appeal]. The facts, considerably simplified, were that on the strength of the financial statements of a group of companies (the D Group), the appellant continued to provide certain financial facilities to the D Group. It was later discovered that the financial statements on which this decision was based, did not reflect the true financial position of the D Group. Action for damages was instituted against the auditor. The claim was dismissed by the court *a quo* since the facts of the case indicated that the appellant continued to provide the financial facilities even after it was discovered that the financial statements did not reflect the true financial position of the D Group. The appellant thereafter brought the appeal under consideration.

20.49 It is clear that, in order to succeed in the common law action against an auditor, the third party will have to prove all the elements of the delict. The court thus dealt with each of these elements separately. It was held that the respondent's act (the preparation of the financial statements) was in fact materially false and misleading. The appeal court accepted the court *a quo*'s finding that as regards the element of fault, the respondent at least acted negligently. Furthermore, the court held that there was a legal duty owed by the respondent to the appellant and that the respondent was in breach of that legal duty and thus acted unlawfully (wrongfully). The appeal was, however, dismissed on the element of causation. The court confirmed that there should be a factual as well as a legal causation between the respondent's wrongful act and the eventual loss suffered by the appellant. Even though factual causation was present, the court held, after an analysis of various factors that may point to legal causation, that "there was not a sufficiently

close connection between respondent's negligence and the loss ... for legal liability on respondent's part ... [701H]. The connection between the auditor's negligence and the ultimate loss suffered by the appellant was thus too remote to satisfy the element of causality. This case provides an excellent exposition of the elements to be considered in determining the common law liability of an auditor towards a third party and serves as the leading South African authority in this area.

20.50 The civil liability of the auditor for misstatement is, however, also regulated within a statutory framework set out in the Auditing Profession Act 26 of 2005. The relevant provisions must be considered to determine whether a third party has a valid claim against the auditor.

Civil liability towards third parties: The statutory dispensation

20.51 Section 46 of the Auditing Profession Act 26 of 2005 regulates aspects of auditors' liability in connection with an audit, that means in connection with the examination in accordance with applicable audit standards of financial statements and information with the objective of expressing a professional opinion on them.

20.52 Section 46(2) provides that in respect of any opinion expressed or report or statement made by a registered auditor in the ordinary course of duties, the registered auditor does not incur any liability to a client or any third party, unless it is proved that the opinion was expressed, or the report or statement made maliciously, fraudulently or pursuant to a negligent performance of the registered auditor's duties. In essence, this section rules out strict liability (liability without fault) of an auditor in this context.

20.53 Section 46(3) of the Auditing Profession Act 26 of 2005 attempts to mirror the principles of common law liability of auditors towards third parties by stating some specific requirements for such civil liability for negligence. Under this section a registered auditor incurs liability to a third party for financial loss suffered as a result of having relied on an opinion, report or statement of that registered auditor, but only if it is proved that:

- (a) The opinion was expressed, or the report or statement was made, pursuant to a negligent performance of the registered auditor's duties; and
- (b) The registered auditor knew, or could in the particular circumstances reasonably have been expected to know, at the time when the negligence occurred that:
 - the opinion, report or statement would be used by a client to induce the third party to act or refrain from acting in some way or to enter into the specific transaction into which the third party entered, or any other transaction of a similar nature, with the client or any other person;
 - the third party would rely on the opinion, report or statement for the purpose of acting or refraining from acting in some way or of entering into the specific transaction into which the third party entered, or any other transaction of a similar nature, with the client or any other person; or
 - the registered auditor in any way represented, at any time after the opinion was expressed or the report or statement was made, to the third party that the opinion, report or statement was correct, while at that time the registered auditor knew or could in the particular circumstances reasonably have been expected to know that the third party would rely on that representation for the purpose of acting or refraining from acting in some way or of entering into the specific transaction into which the third party entered, or any other transaction of a similar nature, with the client or any other person.

2054 The mere fact that a registered auditor performed the functions of a registered auditor is not in itself proof that he could reasonably have been expected to know that his client or the third party will act as envisaged above [section 46(5) of the Auditing Profession Act 26 of 2005]. An auditor may therefore know that third parties will in general receive and read the statements but that does not prove that he should therefore have known that the specific third party will use it to decide to act in a specific manner or to refrain from acting in such a manner.

2055 Section 46(8) of the Auditing Profession Act 26 of 2005 provides that a registered auditor may not through agreement or in any other way limit or reduce the liability that the auditor may incur in terms of this section.

2056 Although the statutory dispensation mirrors the principles of common law liability of auditors towards third parties, it does not amount to a codification of the principles regarding the auditor's potential liability. It should rather be seen as the minimum necessary conditions that have to be complied with before an auditor can incur liability for negligent misstatement. The legal position of the auditor for common law delictual liability for intentional misrepresentation, for instance, remains unaltered. In addition, it is specifically provided that section 46(3) of the Auditing Profession Act 26 of 2005 does not affect any liability of the auditor based on a contract between a third party and the registered auditor, or any other statutory provision (for instance the Companies Act 61 of 1973) or the common law [section 46(6) of the Auditing Profession Act 26 of 2005].

2057 Section 46 of the Auditing Profession Act 26 of 2005 resembles section 20 of the Public Accountants' and Auditors' Act 80 of 1991, which is clearly the predecessor of section 46(3). In practice, third parties found it very difficult to hold auditors liable under that section. It is only in very specific cases that a third party is able to prove that the auditor knew or should have known that the specific third party will be affected by his negligent act [see *Axiam Holdings Ltd v Deloitte & Touche* 2006 (1) SA 237 (SCA) for such a rare case]. There is little reason to expect that it will prove easier under the Auditing Profession Act 26 of 2005.

Criminal Liability of the Auditor

2058 An auditor can incur criminal liability under many of the provisions of the Companies Act 61 of 1973. Although it is not feasible to attempt to state all those offences here, the following instances in which an auditor is criminally liable in terms of the Companies Act 61 of 1973 and Auditing Profession Act 26 of 2005 deserve to be mentioned, namely:

- (a) if he knowingly makes a materially false statement in any statement, return, report, certificate, financial statement or other document required by an Act;
- (b) if he conceals, destroys or falsifies any book, register, document, financial record or financial statement of a company, or with the intention to defraud makes any erasure therein;
- (c) if he makes or circulates any certificate, written statement, report or financial statement in relation to any property or affairs of the company which is false in any material in particular, he may, however, raise the defence that he acted with reasonable care to ensure that the report or document is true;
- (d) if he acts as an auditor of a company while disqualified to do so;