

The Auditor's Legal Responsibilities in the Detection of Fraud

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1 Introduction

Auditors perform a very important function because they are the only independent examiners of corporate financial statements before they are released to the public. Audited financial statements are somewhat reassuring to interested parties who may well be tempted, on the strength of an unqualified audit report, to believe that they are true and fair in all material respects. When such financial statements are subsequently found to be materially misstated, auditors frequently get the blame for alleged misrepresentation. The perception that auditors are there to ensure the absolute correctness of financial statements is no doubt one of the major reasons for litigation against auditors.¹ It is debatable whether that this litigation has substantially threatened the existence of the auditing profession. But it is clear that litigation against auditors for failure to detect fraud has affected this profession adversely and continues to do so. Many of the lawsuits run into enormous sums of money.² While it has been established that auditors are sometimes complicit in the perpetration of fraud by companies,³ the perception that auditors are essentially 'fraud policemen' is incorrect.

This is mainly because an audit is not necessarily a guarantee that fraud will be detected.⁴ There is an inherent risk that fraud causing harm to third

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¹ See generally J Clulow 'Where were the Auditors' July (2002) *Accountancy SA* 3.

² According to RA Dye 'Auditing Standards, Legal Liability and Auditor Wealth' (1993) 101 *Journal of Political Economy* 101 at 101, the most profound change in relation to the auditing profession in the USA has been the number of suits to which it has been subjected. He quotes one observer of the profession as saying that 'more suits have been filed against accountants in the past 15 years than in the entire history of the profession'. He also states that in 1992, suits against auditors were estimated to amount to \$30 billion.

³ See J Tackett, F Wolf & G Claypool 'Sarbanes-Oxley and Audit Failure: A Critical Examination' (2004) 19 *Managerial Auditing Journal* 340. It is stated here 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 (SEC) investigation. RJ Chambers 'Accounting and Corporate Morality – The Ethical Cringe' (1991) 1 *Australian Journal of Corporate Law* 15 at 16-7 states:

'We should speak of the immorality of accounting; for it has been the quirks of accounting that have provided an opportunity for the misdemeanours on the part of corporate officers; and corporate accounting does not do violence to the truth occasionally, and trivially, but comprehensively, systematically and universally, annually and perennially.'

This remark shows the negative perception that is, to a certain extent, exacerbated by glaringly negligent or even fraudulent accounting and auditing practices.

⁴ According to South African Auditing Standard (SAAS) 240R: 'The Auditors Responsibility to Consider Fraud and Error in an Audit of Financial Statements' (SAAS240R), fraud is a deliberate or intentional act by an individual or individuals in management or by those tasked with the governance of an entity, employees or third parties that incorporates the use of deception to obtain an undesired

parties or the client itself may not be detected, regardless of the fact that the audit was conducted with due care and skill and in compliance with auditing standards.⁵ This is so because fraud may entail a complex procedure aimed at concealing it. In such cases, the detection of the fraud may not necessarily depend on an auditor's knowledge and experience but on independent factors such as the expertise of the perpetrator, the frequency of commission and the influence of the persons involved.⁶ Fourie observes: 'Auditors face many hazards when they are asked to examine the books of business entities which have organized themselves in such a way that it is difficult for outsiders to get a clear picture of what is happening within these entities.'⁷

The characteristics of fraud that may hinder its detection are stated in par 12 of the USA auditing standard AU 230: 'Due Professional Care in the Performance of Work'.⁸ They include:

- (a) concealment through collusion among management, employees or third parties that may take the form of total omission from the accounting records and financial statements, meaning that there is nothing for the auditor to examine;
- (b) documentation that is withheld, misrepresented, or fabricated; and
- (c) the inherent ability of management to override effective controls in unpredictable 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' par 02, which states that because of 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.

In cases of deliberate misstatements, collusion between individuals in management and flawed documents, audit procedures aimed at verifying

advantage. An auditor is concerned or should be concerned with fraudulent or incorrect reporting that culminates in material misstatement in the financial statements. Fraudulent financial reporting involving deliberate misstatements and omissions of figures is in many instances aimed at leading financial statement users into thinking positively about an entity's profitability and prospects. It can take the form of manipulation or changing of accounting records or related documents, misrepresentation or intentional omission of relevant information from the financial statements. In the majority of cases, fraudulent financial reporting involves instances of management overriding the existing controls by using a range of techniques. These include the recording of non-existent journal entries, the holding or acceleration of the recognition of transactions that took place during the financial reporting period, and the utilisation of complex procedures intended to misrepresent the financial position and performance of the entity. South African Auditing Standards are found on the website of the South African Institute of Chartered Accountants (<http://www.saica.co.za>).

⁵ South African Auditing Standard (SAAS) 240R: 'The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements' (SAAS240R) in par 20.

⁶ Idem in par 18.

⁷ JSA Fourie 'Auditors and Corporate Illegality and Fraud' (1994) 6 SA Merc LJ 178 at 178. Some scholars such as R Tomasic 'Auditors and the Reporting of Illegality and Financial Fraud' (1992) 20 *Australian Business LR* 198 succinctly describe the position of an auditor or a professional adviser as one of legitimising the activities of the corporation and to provide a smokescreen of respectability to its misdeeds.

⁸ See the website of the American Institute of CPAs (<http://www.aicpa.org>) for all US Auditing Standards issued to date.

financial statements may often be useless.⁹ SAAS 240R does not state that auditors cannot detect fraud in all instances. It merely states that auditors who adhere to auditing standards issue a reasonable assurance that the financial statements reflect fairly on the company's financial position and performance.¹⁰ There is no guarantee that material misstatements will be uncovered. This view is supported in *Tonkwane Sawmill Co Ltd v Filmalter*,¹¹ where Boshoff J stated that in auditing, no assurances are given or to be inferred that the audit will necessarily unveil material misstatements due to fraud.¹²

There is certainly a need for clarity on the auditor's position and responsibilities vis-à-vis the detection of fraud.¹³ This article will show that, contrary to popular belief, auditors have no inherent duty to detect fraud. This basic principle is not construed here to mean that auditors have no role whatsoever in the detection of fraud. The auditor's responsibilities in this regard will be clearly spelt out with reference to the requirements imposed by the law.¹⁴ As is clear in this discussion, an understanding of the auditor's responsibilities is important because it may well lead to less litigation against auditors for failing to detect fraud. Auditor liability, which is always based on the negligent or fraudulent failure to detect fraud, can be limited if auditors adhere to the duties discussed in this article.

2 Does an Auditor Have a Legal Duty to Detect Fraud?

2.1 The Auditor's Statutory Obligations

The auditor's statutory duties are mainly set in the Auditing Profession Act (APA).¹⁵ In terms of s 44(2) of the APA an auditor may not express an unqualified opinion on the financial statements or on any supplementary information of the entity he has audited unless he is satisfied that the financial statements:

- (a) fairly¹⁶ reflect in all material respects the entity's financial position, its cash flow and the results of its ventures; and

⁹ Op cit note 4 in par 20.

¹⁰ Idem in par 21.

¹¹ 1975 (2) SA 453 (W).

¹² Idem at 455.

¹³ See TH Lee, AM Ali & JD Gloeck 'A Study of Auditors' Responsibility for Fraud Detection in Malaysia' (2008) 8 *Southern African Journal of Accountancy Research* 27 at 28, stating that the auditor's role in the detection of fraud has not been clear from the start. But that article does not define the auditor's roles in this regard. These are to be found in this article.

¹⁴ Although it is true to state that auditors have no inherent duty to detect fraud, it is imperative that auditors take a leading role in its detection. This is crucial for the audit profession to remain credible. EM Odendaal and H De Jager 'Regulation of The Auditing Profession In South Africa' (2008) 8 *Southern African Journal of Accountancy Research* 1 at 1 state that the society's trust in a group of professional persons is the heartbeat of that profession, and they note that the South African auditing profession has suffered from a public loss of confidence in its role and importance because of corporate scandals such as Saambou, MacMed, and Regal Treasury Private Bank. The authors argue that to regain that confidence there should be enhanced regulation of the profession.

¹⁵ Act 26 of 2005 (APA).

¹⁶ The Auditing Profession Bill contained the words 'fairness or the truth or correctness' of the financial statements. This was changed to align the requirement with International Auditing Standards that only require an auditor to report on the *fairness* of the financial statements.

- (b) are properly prepared in all material respects in accordance with the principles of the financial reporting framework the financial reports are said to comply with,¹⁷

unless he is satisfied that the criteria in s 44(3), which constitutes the statutory standard of care, have been followed.

The new Companies Act 71 of 2008,¹⁸ unlike the outgoing Companies Act 61 of 1973 in s 300, does not have a comprehensive list of duties that an auditor must perform. This omission may have been intended to eradicate the statutory duplication of duties since s 44(3) of the APA contains a list of all the duties that were covered by s 300 of the Companies Act 1973.¹⁹ Consequently, the new Companies Act in ss 30(2) and 30(3) simply states that annual financial statements must be audited and include an auditor's report. The auditor's report is an essential part of the financial statements, and although the scope of the auditor's duties is not defined by the new Companies Act, it can be understood by referring to the definition of 'audit' in s 1 and s 44(2) of the APA.

Section 44(2) of the APA described above shows that the auditor's primary statutory duty is to audit and express an opinion on the fairness of a company's annual financial statements. The auditor fulfils his primary function by issuing a report in which he expresses an opinion on the fairness of the financial statements. This seems to be the case internationally since auditing standards are predominantly global. For instance, in the United Kingdom, the Companies Act 2006²⁰ deals with the auditor's report, which encapsulates the auditor's primary function, in s 495. Section 495(3) of this Act states that the report must state whether in the auditor's opinion the annual accounts give a true and fair view, in the case of an individual balance sheet, of the state of affairs of the company and, in the case of an individual profit and loss account, of the profit and loss of the company for the financial year. The report must also state whether the financial reports have been properly prepared in accordance with the relevant financial reporting framework and have been prepared in accordance with the Companies Act 2006. This Act further requires auditors to identify in their report the annual accounts that are the subject of the audit and the financial reporting framework that was applied in their preparation, and also to describe the scope of the audit and the auditing standards that governed the audit.²¹

¹⁷ This means that a reasonably skilled auditor has to be aware of the different financial reporting frameworks in use today. Companies are required to produce financial reports that comply with the prescribed financial reporting standards (see s 29(1)(a) of the Companies Act 71 of 2008). These standards exist in a number of forms, such as the UK GAAP, the South African GAAP, the International Financial Reporting Standards (IFRS) and the US GAAP.

¹⁸ Hereinafter 'the new Companies Act'.

¹⁹ Chapter 3 part C (incorporating ss 90 to 93) of the Companies Act 2008 deals with auditors. Section 90 deals with the auditor's appointment, s 91 with the auditor's resignation issues, and s 92 with auditor rotation.

²⁰ This Act is available online at <http://www.legislation.gov.uk/ukpga/2006/46/contents>.

²¹ Section 498(2)(a) and (b) of the Companies Act 2006 (c. 46) in the United Kingdom.

All the other statutory duties that an auditor must perform, imposed by the APA in South Africa, relate to the way in which this duty is to be performed. These entail the following duties to:

- comply with official procedures and to ensure the integrity of the audit;²²
- use reasonably appropriate methods in particular circumstances;²³
- ensure that all accounting records have been kept;²⁴
- obtain all the relevant information and explanations;²⁵ and
- examine the directors' report.²⁶ This requirement is not found in the APA. Section 30(3)(b) of the new Companies Act states that annual financial statements must include a director's report. Section 1 of the APA defines an 'audit' as an 'examination of financial statements', which means that an auditor has a duty to examine the director's report. This report describes the company's state of affairs, its business, profit or loss and any matter that is material to the shareholders. As a result, it can easily be biased if it is not subject to examination.

To enhance the auditor's efficiency in the performance of his duties, s 93 of the new Companies Act grants the auditor certain rights. One of them is that the auditor is entitled to access, at all times, a client company's books of account and other documents and to enquire from directors and any other officers any information and explanations that may be required. The auditor also has the right to attend any general meeting of shareholders.²⁷ This right is available for auditors working on holding companies.²⁸ An auditor who has been frustrated or otherwise prevented from performing his functions has a right to approach the court for an order enforcing these rights. The court may make an order of personal costs against any director, officer or employee who wilfully and knowingly frustrates or attempts to frustrate the auditor from performing his duties.²⁹ This new dispensation shows that the days when auditors were deliberately frustrated and excluded are gone. It is clear that an auditor has no statutory obligation to detect fraud. But the requirements set in

²² Section 44(3)(a). See ML Benade et al *Entrepreneurial Law* special ed (2009) at 245 for a description of the auditor's statutory duties.

²³ Section 44(3)(b).

²⁴ Section 44(3)(c). Section 498(1)(a) of the UK Companies Act also states that an auditor must ensure that a company has kept accounting records sufficient for accounting purposes and that returns sufficient for his audit have been obtained from the branches that he has not visited.

²⁵ Section 44(3)(d). In *Cuff v London and County Land and Building Co* [1912] 1 Ch 440 (CA) at 444, the vast array of documentary evidence to be considered by the auditor was described as the 'area which covers accounts, vouchers, invoices, and documents constituting the materials out of which the entries in the books originate'.

²⁶ In accordance with s 300(j) of the Companies Act 61 of 1973. Section 496 of the UK Companies Act 2006 requires an auditor to report on the director's report. This appears to be an additional report over and above the one on the truthfulness and fairness of the financial statements. In this report, the auditor must state whether in his opinion the information provided in the directors' report for the applicable financial year is consistent with the accounts.

²⁷ Section 93(1)(a).

²⁸ Section 93(1)(b).

²⁹ Section 93(2)(a).

the APA and the new Companies Act on how the audit must be performed enhance the chances of detecting fraud if they are met.

2.1.1 The Role of the Audit Committee³⁰

The audit committee has the important duty of ensuring that the integrity of a company's financial statements is not questioned. Each public company, state-owned company and any other company that elects to have an audit committee must have an audit committee manned by at least three members.³¹ Members of the audit committee must be directors but must not be full-time officers or employees of the company and take part in the ordinary day-to-day management of the company or have done so at any stage in the three years before appointment, and must not be material suppliers to or customers of the company in a way that reasonably raises questions regarding impartiality.³²

The duties of the audit committee that are aimed at ensuring the integrity of a company's financial statements are listed in s 94(7) of the new Companies Act. In terms of this section, the audit committee must nominate for appointment as auditor a registered auditor who in its view is independent of the company.³³ The Act does not describe the non-audit services that an auditor may perform. This duty is imposed on the audit committee that must determine the nature and extent of any non-audit services that an auditor may perform for the company.³⁴

The audit committee has reporting duties. It must report on whether it is satisfied with the auditor's independence in the annual financial statements.³⁵ This report must include the committee's comments on the financial statements, accounting practices and the internal financial control of the company.

Another significant function of the audit committee is to receive and deal properly with any internal or external concerns or complaints regarding the accounting practices and internal audit of the company, the content or auditing of the company's financial statements, the company's internal financial controls and any other related matter.³⁶ The audit committee may deal with these issues on its own initiative. It is common that entities that produce fraudulent financial statements have weak internal control systems and

³⁰ The Companies Act 1973 also deals with the audit committee in ss 269A and 270A, added by the Corporate Laws Amendment Act 24 of 2006. The Companies Act 2008 does not substantially change the requirements pertaining to audit committees.

³¹ Section 94(2).

³² Section 94(4).

³³ Section 94(7)(a). In terms of s 94(8) the audit committee, in measuring the auditor's independence, must be sure that he does not receive any direct or indirect payment or other benefit from the company that is not related to his audit duties or his authorised non-audit work. The audit committee must also consider the impact of the auditor's previous engagement as the company's auditor and past performance of consultancy work on his independence. The guidelines relating to auditor independence or conflict of interest set by the Independent Regulatory Board for Auditors (established by the APA) must also be considered.

³⁴ Section 94(7)(d).

³⁵ Section 94(7)(f).

³⁶ Section 94(7)(g).

questionable accounting practices. Interested parties may identify these issues and approach the audit committee, which, according to this requirement, must deal appropriately with the concerns raised. The audit committee may also not rely on external or internal parties to identify issues. It must act on its own initiative to ensure that the financial reporting system is functioning properly. This shows that the Act recognises the audit committee as a principal actor together with the company itself in ensuring that the company complies with its obligation to produce fair financial statements.³⁷

2.2 The Position at Common Law

At common law an auditor must meet the standard of the reasonable person (*bonus paterfamilias*). The test for this standard is simple; if a reasonably competent and cautious auditor in the circumstances would have detected the fraud, the duty to detect fraud exists. Conversely, this duty cannot be established if the fraud could not have been detected by a reasonably careful and skilled auditor.³⁸ A case to illustrate this point is *International Laboratories Ltd v Dewar*.³⁹ The Court held that 'auditors should not be liable for not tracking down ingenious and carefully laid schemes of fraud where there is nothing to arouse their suspicion'.⁴⁰ This was in reference to circumstances in which it is impossible for a reasonably skilled and competent auditor to detect any fraud. However, in reference to circumstances in which a reasonable auditor would have detected the fraud, the Court held that 'the greater the number of undiscovered frauds or misappropriations the more difficult it will be for auditors to resist a finding of negligence in failing to find them'.⁴¹ Dennistoun JA sums up the circumstances in which a reasonably skilled and competent auditor would detect the fraud by stating:

'I emphasise this for the purpose of showing that these auditors failed to detect this persistent, almost daily, practice which some very simple and ordinary checks would have disclosed. If we were dealing with a small number of cunningly designed and carefully concealed frauds, the auditors might be permitted to say that they were not employed to act as detectives to discover unusual crimes, when there is nothing to arouse suspicion. But when we have this long list of peculations, hundreds of them; small and great, carried out under their eyes for such a long period of time it is not sufficient answer to say we knew nothing and suspected nothing. We trusted everybody in authority and accepted the statements of an honest official of the plaintiff company when at the same time we knew he was in a strategic position to feather his own nest if he felt disposed to do so.'⁴²

In the light of the characteristics of fraud discussed in par 1 above, the

³⁷ In terms of s 29(1)(c) of the new Companies Act, a company must produce financial statements that fairly reflect the financial position of a company and the results of its operations.

³⁸ The highest degree of care and skill is not required (see *Herschel v Mrupe* 1954 (3) SA 464 (A)). But it is also clear that below-average levels of skill and care cannot suffice either. The qualities of the reasonable man are therefore to be found between these two extremes. In *Mitchell v Dixon* 1914 AD 519 it was held that a medical practitioner is required to exercise not the highest possible degree of professional skill but the reasonable degree of care and skill of a person in his profession, and he will be liable if he fails to do so.

³⁹ [1933] 2 WWR 529 (Man CA).

⁴⁰ *Idem* at 670.

⁴¹ *Ibid.*

⁴² *Ibid.*

auditor's position regarding the detection of fraud the reasonable man concept should operate. In other words, where there is expert concealment of facts that arouse suspicion of fraud by the audit client's influential employees, there is practically nothing that the reasonably careful and competent auditor can be expected to do to detect fraud.

The case *Re Kingston Cotton Mill (No 2)*⁴³ presents an example of a situation in which fraud and its indicators were expertly concealed. The accounts of the client had been falsified by its managing director, Jackson, for many years, during which he had deliberately overstated the quantity and values of the cotton and yarn in the company's mills. He had been so successful in falsifying the accounts that what he had done was never discovered or even suspected by his fellow directors. The company's auditors simply adopted the entries of Jackson and inserted them in the balance sheet as 'per manager's' certificate.⁴⁴ It was believed at the time that the auditors had acted honestly in believing in the accuracy and reliability of Jackson.

The action against the auditors was based on the fact that they had failed to compare different books and add the stock at the beginning of the year and the amount purchased and deduct the amounts sold. It was argued that this would have exposed a large discrepancy that would obviously have called for an explanation. It was further contended that the auditors should not have trusted Jackson's figures and should have investigated the matters further. Jackson was a trusted officer of the company, and all the other directors had unflinching confidence in him. There was nothing on the face of the accounts to provoke suspicion. There was also no indication that the auditors were wanting in skill, care or caution in not testing Jackson's figures. Lopes LJ stated that it is not the duty of an auditor to take stock since he is not a stock expert and that there are many matters in respect of which he may have to rely on the honesty and accuracy of others.⁴⁵ It was stated further that an auditor does not guarantee the discovery of all fraud.⁴⁶

In response to a charge that the auditors had been negligent in trusting company employees, Lopes LJ stated that an auditor is 'justified in believing tried servants of the company in whom confidence is placed by the company'.⁴⁷ This also means that company officials who are not trusted by the company itself or are involved in suspicious activities are not to be

⁴³ [1896] 2 Ch 279 (CA).

⁴⁴ *Idem* at 280.

⁴⁵ *Idem* at 289.

⁴⁶ *Ibid.* This remark accords with par 26 of SAAS 240R, which states that an auditor is not required to authenticate documents in the normal course of his audit. He is not trained in this particular field, and it is abnormal to expect him to undertake these duties. As such, it is reasonable for an auditor in the absence of anything that suggests the contrary to accept documents and records as genuine. But if he encounters anything that excites his suspicion, he must undertake further investigations by engaging the services of an expert to scrutinise the document's authenticity. The attitude of blaming auditors for a perceived lack of thoroughness shown in the *Kingston Cotton Mill* case is discouraged by Boshoff J in *Tonkwane Sawmill Company Ltd* supra note 11 at 455G where it is said: 'Management is responsible for safeguarding the assets of the undertaking and is not entitled to rely upon the auditor for protection against defects in its administration or control.'

⁴⁷ *Re Kingston Cotton Mill (No 2)* supra note 43 at 288.

trusted. It was held in this regard that if 'there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful'.⁴⁸ It is clear that Jackson used his position to commit a perfect fraud that could not have been detected by a reasonably careful and skilled auditor. Nowadays auditing standards regulate the treatment of submissions by management to the auditor, and Lopes LJ's dicta regarding 'tried servants' will be mainly disregarded.⁴⁹

This old case is sound evidence of the relativity of the auditor's duty. Lopes LJ stated that what in any particular circumstances would constitute reasonable care and skill in relation to the detection of fraud should be governed by the circumstances of that case.⁵⁰ This is essentially a restatement of the basic law on establishing negligence. If in a given case a reasonably competent and cautious auditor would have detected fraud, then his standard of care and skill would have to be adhered to.

2.3 Contractual Obligation to Detect Fraud

Where the audit contract imposes an obligation on the auditor to detect fraud, it is submitted that the auditor will have a legal duty to detect fraud. In practice it is hard to find an auditing contract that contains such a draconian provision.⁵¹ The more common provisions in auditing contracts would be those to be found in *Thoroughbred Breeders' Association of South Africa v Price Waterhouse*.⁵² In this case, the auditor was sued for failing to detect certain frauds perpetrated by his client's financial manager. The audit contract did not require the auditor to detect fraud but imposed a duty on him to conduct his audit in accordance with generally accepted auditing standards, to perform the audit with the degree of reasonable care and skill that could be expected of an auditor in public practice and to give a reasonable assurance that the financial statements fairly presented in all material respects the

⁴⁸ *Idem* at 289.

⁴⁹ See SAAS 240R par 39. In *Pacific Acceptance Corporation Ltd v Forsyth* (1970) 92 WN (NSW) 29 at 68 it was stated that an auditor must obtain sufficient, relevant and reliable evidence to substantiate his opinion on matters. It was also stated that it is not sufficient for an auditor to rely purely on management. This assertion takes into consideration the fact that management itself may have committed the fraud and that to rely readily on its submissions would be somewhat careless. In another case, *Dominion Freeholders Ltd v Spargo; Aird (Third Party)* (1966) 40 *Australian LJ* 237, the New South Wales Court of Appeal rejected the argument put forward by the company's auditor that his statutory duties were fulfilled by placing absolute reliance on the company's accountant in the preparation of the company accounts.

⁵⁰ *Re Kingston Cotton Mill (No 2)* supra note 43 at 288.

⁵¹ In some cases, the auditor was in the unenviable position that he was contractually bound to detect fraud. Thus in *Smith v London Assurance Corporation* 109 AD 882 (NYAD 2 Dept. Dec 29, 1905) at 884, the New York Supreme Court, Appellate Division stated that the discovery of fraud was an implied term of the audit contract because it was within the 'reasonable contemplation of the parties'. In *City of East Grand Forks v Steele* 121 Minn 296 (Minn 1913) at 300 the Supreme Court of Minnesota, in finding the auditors liable, stated that they 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'.

⁵² 1999 (4) SA 968 (W).

financial position and the results of the operations of the plaintiff for the year in question.⁵³

Whether there is a specific obligation to detect fraud or not, an auditor, to fulfil his contractual obligations properly, requires the co-operation of his client's personnel who must respond honestly to his enquiries. Since auditing involves interviewing the client's personnel, it is advisable for the auditor to negotiate for the inclusion in the auditing contract of a clause that obliges his client's personnel, to desist from deliberately misleading the auditor. It has been stated in par 1 above that fraud may be difficult to uncover because of the client's attempts to conceal it. This clause would enhance the application of the provisions of the new Companies Act, which grants auditors the right of access to company financial records and documents in s 93(1). This section should in this regard be read together with s 28(3), which outlaws the making of fraudulent financial records, and s 29, which generally sets the standards that financial statements have to meet and outlaws the production of fraudulent or misleading financial statements.

The overall impression created by these provisions is solid, but there seems to be an assumption that auditors will necessarily limit their enquiry to items in the financial records and statements. Audit work frequently involves interviewing the client's personnel, who may take the opportunity to misrepresent facts to the auditor. The value of a contractual clause that requires truthfulness in verbal communication can therefore not be disregarded.

Other jurisdictions acknowledge the value of client oral input in auditing. In the United States of America, the Sarbanes-Oxley Act⁵⁴ (SOX) s 303(a) Title III (Corporate Responsibility) makes it unlawful for any officer or director of a company or any person working under the direction of the company to fraudulently influence, coerce, manipulate or mislead any public accountant with the intention to render the financial statements misleading. The Canadian case of *Jamieson, Austin and Mitchell Ltd v Battrum*⁵⁵ supports this provision. 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. This case, together with the provisions of the SOX and the new Companies Act, shows that clients have an important role to play in the

⁵³ *Idem* at 986A.

⁵⁴ This Act, a US Federal law, was signed by the US President on 30 July 2002. President George W Bush remarked as he signed it that it contained 'the most far-reaching reforms of American business practices since the time of Franklin D Roosevelt' (see Schumpeter 'Two Cheers for Sarbanes-Oxley' *The Economist* (1 July 2010), available at http://www.economist.com/node/16478996?story_id=16478996). It was named after its sponsors, Senator Paul Sarbanes and Representative Michael G Oxley.

⁵⁵ [1934] 1 WWR 324 (Alta SC). In the *International Shipping Laboratories* case *supra* note 39 at 667 the audit client's offending accountant, Harris, was found to have concealed crucial books of accounting that would have revealed certain falsifications. The auditors were only made aware of the books when making the supplementary audit after allegations of negligence in auditing financial statements had been laid.

detection of fraud. They diminish the auditor's contractual responsibility to uncover fraud if they deliberately mislead the auditors.

The limitations of an audit stated in par 1 above frequently counter the detection of fraud. Where an auditor fails to perform a contractual duty to detect fraud, he can still obtain relief by pleading impossibility of performance if he can prove that the obligation would be impossible to fulfil and would otherwise unduly and cumbersomely burden him. It is established law in South Africa that the court may exercise its discretion to release a defendant from his contractual obligations if it is proved that enforcing the obligation would impose an impossible or unduly cumbersome burden on a defendant.⁵⁶ Hefer JA illustrates the operation of this discretion in *Benson v Mutual Life Assurance Society*⁵⁷ by stating that the discretion is not:

'completely unfettered. It remains, after all, a judicial discretion and from its very nature arises the requirement that it will not be exercised capriciously, nor upon a wrong principle. . . . It is aimed at preventing an injustice – for cases do arise where justice demands that the plaintiff be denied his right to performance – and the basic principle thus is that the order which the Court makes should not produce an unjust result which will be the case, eg, if, in the particular circumstances, the order will operate harshly on the defendant'.⁵⁸

The fact that fraud perpetrated by manipulative executives who may be skilled enough to conceal it and have the authority clandestinely to restrict the scope of the audit may weigh in the auditor's favour where the defence of impossibility of performance is sought to be raised.

The same relief can be found in other jurisdictions. In American law, breach of contract consists in the 'wrongful non-performance of a promissory duty under a contract'.⁵⁹ Non-performance is wrongful where there is a contractual duty to render immediate performance and that performance has not been rendered according to the terms of the contract and there is no legal justification for such non-performance.⁶⁰ This means that auditors who fail to detect fraud where there is a duty to do so breach their contractual obligations if there is no justification for their failure to perform. If it is proved that the fraud was carefully perpetrated and concealed and that fulfilling the obligation to detect it would have imposed a nearly impossible task on the auditor, the auditor can be released from the obligation to uncover the fraud.⁶¹

⁵⁶ See *Haynes v Kingwilliamstown Municipality* 1951 (2) SA 371 (A). Here the defendant municipality was bound by agreement with the plaintiff to release to the plaintiff 250 000 gallons of water per day. Owing to a drought, the municipality could only release 1 500 to 2 000 gallons per day to the plaintiff. Even though other sources of water were available to the plaintiff, she claimed an order that the municipality should release 250 000 gallons of water per day. The Court held that to order the municipality to release 250 000 gallons of water per day from the storage dam while the drought continued would work great hardship not only on the municipality but also on the citizens of Kingwilliamstown. Accordingly, the order for specific performance was denied. De Villiers AJA at 378 stated that 'although the Court will as far as possible give effect to a plaintiff's choice to claim specific performance it has a discretion in a fitting case to refuse to decree specific performance and leave the plaintiff to claim and prove his *id quod* interest'.

⁵⁷ 1986 (1) SA 776 (A).

⁵⁸ *Idem* at 783C.

⁵⁹ JL Frascona *CPA Law Review* 4 ed (1972) at 126.

⁶⁰ *Idem* at 129.

⁶¹ EA Farnsworth *Contracts* 4 ed (2004) at 743 states that 'a court will not order performance that has become impossible, unreasonably burdensome or unlawful' in American law.

3 General Observation

The discussion so far has shown that auditors have no inherent responsibility to detect fraud, because the detection of fraud in many cases represents an exceptional and generally unsustainable effort by an auditor. Consistent in the letter of the law on this matter is the concept of reasonableness. If it is reasonably possible to detect fraud in a particular instance, the duty to detect it follows. If there is a contractual duty to detect fraud that unduly burdens an auditor, the latter may have respite by pleading impossibility of performance. The auditor's statutory duties may also be reasonably expected to be performed, even if not expressly defined and prescribed in the statutes discussed.

Even so, there are expectations on auditors to detect fraud all the time.⁶² This dichotomy between the provisions of the law and the perception of the audit profession on the scope of its member's duties with regard to the detection of fraud, on the one hand, and the general perception of the public, on the other, is known as the 'audit expectation gap'.⁶³ This concept is defined as comprising two elements:

- the reasonableness gap, which is the gap between what society expects auditors to achieve and what auditors can reasonably be expected to achieve; and
- the performance gap, which is the gap between what society can reasonably expect auditors to achieve and what auditors themselves are prepared to achieve.⁶⁴

The continuous litigation or litigation risk that auditors face if they fail to detect fraud is to a large extent attributable to this gap.⁶⁵

4 The Auditor's Legal Duties with Regard to the Detection of Fraud

The existence of the 'audit expectation gap' necessitates a discussion of the auditor's legal responsibilities in detecting fraud. It has already been

⁶² See Clulow op cit note 1 at 3.

⁶³ CK Hian & ES Woo 'The Expectation Gap in Auditing' (1998) 13 *Managerial Auditing Journal* 147 at 147 state:

'The expectation gap exists when auditors and the public hold different beliefs about the auditors' duties and responsibilities and the messages conveyed by audit reports. Apparently, there is a gap between what the public expects and what it actually gets.'

For an overview of the audit expectation gap, see also G Papadakis & J Edrich 'Closing the Expectation Gap' April 2003 *Accountancy SA* 6. This audit expectation gap in South Africa is illustrated as follows: a 1993 survey showed that 91,5% of the external auditors in public practice did not consider the detection of fraud as part of their duties; and 57,8% were of the opinion that the users of the audit report would disagree with them (M Marais & EM Odendaal 'Fraud Examination: Do Auditors Need the Knowledge and Skills?' 2008 (8) *Southern African Journal of Accountancy Research* 35 at 38).

⁶⁴ B Porter 'An Empirical Study of The Audit Expectation – Performance Gap' (1993) 24 *Accounting and Business Research* 49.

⁶⁵ M Jennings, DC Kneer and PMJ Reckers assert that auditor liability depends on the audit litigants' attitude towards the audit profession (see 'The Significance of Audit Decision Aids and Precase Jurists' Attitudes on Perceptions of Audit Firm Culpability and Liability' (1993) 9 *Contemporary Accounting Research* 489 at 490).

established that this gap has no basis in law. To strengthen this position it is important to discuss certain specific legal duties that an auditor has to perform generally, and those that he must perform where fraud is either suspected to have taken place or is discovered. These entail the duty to consider the possibility of fraud; the duty to exercise professional scepticism and identify suspicious matters and fraud risk factors; the duty to apply audit procedures that adequately address identified fraud risk factors; and the duty to report fraud as a reportable irregularity to the independent regulatory body for auditors.

4.1 The Duty to Consider the Possibility of Fraud

This duty is a general duty that shows due care in an audit of financial statements. It is clearly not to be confined to instances where fraud is suspected to have taken place. In *Pacific Acceptance Corporation v Forsyth*⁶⁶ it was held that the auditor's primary duty is to audit financial statements. This primary duty was held to encompass a duty to pay due consideration to the possibility of fraud. In circumstances where suspicion is present or should be aroused, an auditor must actively investigate the possibility. Moffit J stated that paying due regard to the possibility of fraud is done by framing and carrying out procedures that provide a reasonable assurance that the fraud as perceived by the auditor will be detected. The judge warned that it is unjust to criticise a particular procedure that the auditor relied on to detect fraud, because with hindsight it may be easy to think of procedures that in the circumstances would have been more appropriate to detect the fraud.⁶⁷

In *Dairy Containers Ltd v NZI Bank Ltd*⁶⁸ Thomas J reaffirmed the principle that the auditor's primary duty to audit must be performed with due regard to the possibility of fraud. It was also stated here that the auditor's 'basic duty [is] to plan and carry out the audit of the company cognisant of the possibility of fraud . . .' and that

'in planning and carrying out their work auditors must be mindful of the possibility of fraud and if they discovered an apparent irregularity they must carry out such further tests or make such further inquiries as might be required to be satisfied that, in fact, no irregularity existed. If there was a reasonable suspicion of fraud, they must necessarily report their suspicion to the general manager or the board, or even the shareholders of the companies, as might be appropriate in the circumstances of the case'.⁶⁹

The courts have not defined the practical meaning of the expression 'paying

⁶⁶ Supra note 49 at 65.

⁶⁷ Idem at 66. In *Re London General Bank (No 2)* [1895] 2 Ch 673 (CA) at 683 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 that others like them are correct also'. If one is to qualify this remark with the requirement duly to consider the possibility of fraud, it would mean that after duly considering the possibility of fraud and having found nothing to excite suspicion, lesser inquiry will suffice. Conversely, if the possibility of fraud is duly acknowledged and suspicious circumstances are discovered, then an auditor is bound to probe those circumstances more deeply. In this regard, see *In Re Kingston Cotton Mill* supra note 43 and *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30.

⁶⁸ Supra note 67.

⁶⁹ Idem at 34 (headnote) read with Thomas J's judgment at 55.

due regard to the possibility of fraud'. The question how the auditor may duly regard the possibility of fraud in financial statements is aptly answered in pars 27 and 32 of SAAS 240R dealing with the audit team and its audit discussions. This auditing standard states that prior to and during an audit, the members of the engagement team must discuss the likelihood of the financial statements being materially misstated because of fraud.⁷⁰ According to SAAS 240R, the discussion is basically an exchange of ideas on the auditing procedures that may be relevant in responding to the likelihood of fraud in the entity's financial statements.⁷¹ The discussion must take place with a critical mind, disregarding any trust in the integrity and honesty of management or the directors, and must emphasise the importance of auditing with an open mind in relation to material misstatements because of fraud.⁷²

SAAS 240R also states that the discussion should entail a consideration of the means by and areas in which the audit team believes that the entity's financial statements may be exposed to fraud and how management could commit fraud.⁷³ This should be coupled with an identification of particular external and internal circumstances with a bearing on the entity that may encourage management or any other person to perpetrate fraud. If suspicious factors such as noticeable or abrupt behaviour changes of management are observed, these should be analysed. The audit team must also consider the potential of management to override the system of internal control.⁷⁴

This discussion and the general approach to auditing that it promotes is supported by the *Dairy Containers Ltd* case where Thomas J stated that many of the tests that auditors normally apply proceed on the assumption that some person or persons may have been dishonest or fraudulent.⁷⁵

4.2 The Duty to Exercise Professional Scepticism and Identify Suspicious Matters and Fraud Risk Factors

This is another general duty an auditor must comply with when performing his duty to audit financial statements. Professional scepticism is defined in SAAS 240R par 23 as an attitude that necessarily entails an investigative mind and a detailed assessment of audit evidence. Professional scepticism demands a continuous investigation of the information and audit evidence and questioning whether there is proof or a possibility that a fraudulent or material misstatement exists. In showing that an attitude of professional scepticism

⁷⁰ Paragraph 27 of SAAS 240.

⁷¹ *Idem* in par 30.

⁷² *Ibid.*

⁷³ *Ibid.*

⁷⁴ *Ibid.*

⁷⁵ *Supra* note 67 at 35. H Labuschagne and G Els (in 'Corruption and Fraud: Any Lessons for the Auditor?' (2006) 14 No 1 *Meditari Accountancy Research* 29 at 41) state that to consider the risk of fraud or corruption

'does not mean that the auditor commences the audit with a preconceived and unsubstantiated view that management is corrupt or that the organisation is without integrity. Such a biased approach would seriously jeopardise the auditor-client relationship, distract auditors from their true role and may even have a negative impact on the objectivity of the audit judgement'.

should characterise an auditor's general approach to an audit, par 24 of SAAS 240R states that this attitude must be maintained throughout the audit without regard to the honesty and integrity of management established by past engagements.

Paragraphs 48 and 49 of SAAS 240R state that when analysing an entity, its operations and system of internal control, the auditor should be wary of factors that provide an incentive to commit fraud. Such factors include the desire to meet third-party expectations, to obtain extra revenue, provision for and prospects of additional bonuses if certain profit targets are met, and the desire to take advantage of lax controls for personal gain. The mere presence of these factors does not necessarily suggest the presence of material misstatement or fraud. But these factors should arouse suspicion, and a reasonably competent and careful auditor must identify them and carefully conduct further investigations.

4.2.1 Revenue Recognition

In quite a number of cases material misstatements because of fraud stem from an exaggeration of revenue. This can be done through premature recognition of revenue by recording it as received revenue when, in fact, it has not been received, or by the recording of non-existent revenue. It may also be done by understating revenue, for example, with the intention to deceive the tax authorities or to pay small dividends or by recognising revenue at a later period. An auditor exercising due care is expected to acknowledge the potential of fraud in revenue recognition.⁷⁶

4.2.2 Sceptical Attitude to Fraud Risk Factors

The lack of a sceptical attitude in considering risk factors in securing appropriate audit evidence has played its part in audit failures.⁷⁷ This view is illustrated by two cases. In *Fisher v Kletz*⁷⁸ 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*,⁷⁹ the

⁷⁶ Paragraph 60 of SAAS 240R.

⁷⁷ See RR Vanasco, CR Scousen & RL Jensen 'Audit Evidence: The US Standards and Landmark Cases' (2001) 16(4) *Managerial Auditing Journal* 207.

⁷⁸ 266 F Supp 180 (DCNY 1967), discussed in Vanasco, Scousen & Jensen op cit note 77 at 211.

⁷⁹ 283 F Supp 643 (DCNY 1968), discussed in Vanasco, Scousen & Jensen op cit note 77 at 211. See also A Huss 'Corporate Crooks: What Keeps CEOs Awake' (2009) March *Business Today* 63 at 64, stating that demotivated employees are likely to commit damaging fraud because they are underpaid, feel useless and have received empty promises from management. Auditors may do well if they exercise professional scepticism when they encounter these particular employees.

plaintiffs contended that the registration statement for debentures contained statements that were materially false, and that this was made worse by some material omissions. In reprimanding the auditor for not maintaining a sceptical attitude, the Court 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.⁸⁰

Further, in *Tonkwane Sawmill Company v Filmalter*⁸¹ a client sued its external auditor for negligence in failing to detect fraud. It was alleged that the auditor did not detect stolen moneys because he failed to employ reasonable care and skill and to verify the books of account properly by determining the difference between the money drawn as payment of wages and the money actually paid to the employees.⁸² Boshoff J, whose words here elaborate on professional scepticism, stated that the case had to be considered in the light of the remarks by Lord Denning in *Fomento (Sterling Area) v Selsdon Fountain Pen Co Ltd & Others*⁸³ that

[an auditor’s] vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly he must come to it with an inquiring mind – not suspicious of dishonesty, I agree – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none’.⁸⁴

This case explains professional scepticism as an investigation that is not necessarily a witch-hunt from the outset but a confirmation of the accuracy or lack thereof of financial statements, particularly where there is a reasonable belief in the integrity of the financial statements. Boshoff J found that the auditor was satisfied with the internal management of the entity and had no reason to suspect that the employees were fraudulently administering the financial affairs of the entity.⁸⁵ In such instances it can be justified to have less scepticism than will be required where there is glaringly suspicious evidence.

4.3 The Duty to Apply Audit Procedures That Address Identified Fraud Risk Factors Adequately

After identifying and assessing the risk of material misstatements because of fraud in the financial statements, a reasonably competent auditor must apply audit procedures that by their very nature address these risks adequately.⁸⁶ This accords with the dictates of ISA 330: ‘The Auditor’s Procedures in Response to Assessed Risks’, which provides that an auditor should perform procedures that are specific to the risks identified as significant. This has a direct relationship with the auditor’s professional

⁸⁰ Vanasco, Scousen & Jensen op cit note 77 at 211.

⁸¹ Supra note 11.

⁸² Idem at 453.

⁸³ [1958] 1 All ER 11 (HL) at 23.

⁸⁴ Quoted by the Court in *Tonkwane Sawmill Co Ltd v Filmalter* supra note 11 at 455H.

⁸⁵ Idem at 455.

⁸⁶ SAAS 240R in par 61.

scepticism. An auditor who has identified risks must display increased sensitivity in the selection of the types of records to be analysed and the depth of the analysis. It is blatantly negligent for an auditor to ignore fraud risk factors that have been identified.

An auditor responding to the risk of material misstatements because of fraud must determine the desirability of assigning work to, and supervising individuals. In considering the appointment and supervision of personnel, the auditor must gauge the ability, skill and knowledge of such personnel in relation to the identified risk. When using his professional judgment, the auditor may consider it fit to assign more personnel with specialised expertise such as forensic and information technology experts.⁸⁷

The duty to deal extensively with identified fraud risk factors tallies perfectly with the auditor's duty at common law to investigate suspicious matters to the bottom.⁸⁸ In *Thoroughbred Breeders' Association of South Africa v Price Waterhouse*⁸⁹ this duty was qualified and made more practical. It was stated in this case that in the course of an audit, questions rise in the auditor's mind, and he may seek an explanation and hundreds of explanations may occur, especially in large audits.⁹⁰ Because of this, it is a question of judgment whether the auditor probes a particular matter further. Goldstein J held: 'Auditing is frequently a matter of feel and more an art than a science, with much depending on the auditor's own judgment.'⁹¹

It was stated further that the auditor is, to a degree, entitled to believe in the integrity of management as long as he has exercised a degree of professional scepticism and care. There is no hard and fast rule, and the auditor's decision whether to believe the members of an entity's management depends entirely on the circumstances.⁹² Only if the explanation is not satisfactory may an auditor be reasonably expected go further and conduct a thorough investigation.

This analysis calls for a professional judgement by the auditor in identifying the suspicious circumstances to be thoroughly investigated. This is because in large audits it is both impractical and expensive to probe each suspicious circumstance to the bottom.⁹³ According to SAAS 240R, an auditor should concern himself with material misstatement caused by fraud or

⁸⁷ Paragraph 67 of ISA 330.

⁸⁸ Supra note 67 at 35.

⁸⁹ Supra note 52.

⁹⁰ Idem at 1010I-J. The judge added:

'Very different kinds of queries must surely arise during an audit. When, one may ask, does a query in the mind of an auditor amount to suspicion? Surely no answer can be formulated which will cover all eventualities.'

⁹¹ Idem at 1011B.

⁹² Idem at 1011A-B.

⁹³ See Labuschagne & Els op cit note 75 at 42, acknowledging the effect of time and cost on audits: 'When determining the degree of care which is required from an auditor when considering the possibility of unethical conduct, it would be unrealistic to ignore factors such as time and budgetary constraints. However, such constraints can not excuse auditors from their duty to be sensitive to ethical issues whilst focusing on their primary task of performing an audit.'

error. In other words, an auditor should only probe matters that in his professional judgment would result in material misstatement in the financial reports.

In *International Shipping Co (Pty) Ltd v Bentley*⁹⁴ a third party instituted a claim against the auditor for alleged negligence. The auditor in this case certified materially misleading financial statements as correct. The auditor's client, the D Group of companies, was granted credit by International Shipping, allegedly on the strength of the accuracy of the financial statements. But the D Group was in trouble. Certain indicators of this position were ignored by both the auditors and International Shipping. The D Group manipulated expenses and turnover within its companies to evade tax. This was done by arbitrarily transferring turnover actually earned by another company to the credit of another, effectively diminishing on paper the profits of the transferring company and boosting that of the receiving company.⁹⁵ It was also found that the full amount of future rentals payable was brought to account as income.⁹⁶ Generally speaking, the D Group was motivated by a desire to please International Shipping, its creditor. This factor alone should have been identified by the auditor as a fraud risk factor and should have been acted upon accordingly. The manipulation of the turnover and rental payable were also supposed to be identified as indicators of deeper fraud and investigated properly.

Corbett CJ stated⁹⁷ that he could not disagree with the findings of the Court a quo that

'in regard to two of the complaints, viz the inter-company manipulation of turnover and expenses and the taking to income of future rentals accruing under pledged paper, the respondent had acted negligently and that, had he carried out his duties with proper diligence, these complaints would probably not have arisen – in the sense, presumably, that these defects in the financial statements would have been detected and either eliminated or drawn to the attention of International by way of a qualification to the statements'.

However, the action by International Shipping failed because it failed to prove that the auditor's negligent report was the legal cause of its financial loss, which was International Shipping's own negligence in continuing to extend credit despite the fact that the D Group was clearly illiquid.⁹⁸ The failure by the auditor to consider apparent fraud risk factors may have tilted the case against the auditor on another day. Due regard to indicators of fraud is crucial in an audit of financial statements.

4.4 The Duty to Report Fraud as a Reportable Irregularity to the Independent Regulatory Body for Auditors

Auditors have a statutory obligation to report reportable irregularities, which may be in the form of fraud, to the authorities. In terms of s 45(1)(a) of

⁹⁴ 1990 (1) SA 680 (A).

⁹⁵ *Idem* at 689.

⁹⁶ *Idem* at 691.

⁹⁷ *Idem* at 693-4.

⁹⁸ *Idem* at 702.

the APA, an auditor of an entity who is satisfied or has reason to believe that a reportable irregularity has occurred or is occurring in that entity must without delay send a written report to the Regulatory Board. The report must furnish the Board with particulars of the irregularity in question and be accompanied by any other information that the auditor may consider appropriate.⁹⁹ A reportable irregularity is defined in s 1 of the Act as

'any unlawful act or omission committed by any person responsible for the management of an entity, which –

- (a) has caused or is likely to cause material financial loss to the entity or to any partner, member, shareholder, creditor or investor of the entity in respect of his, her or its dealings with that entity; or¹⁰⁰
- (b) is fraudulent or amounts to theft;¹⁰¹ or
- (c) represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof;¹⁰²

This represents a significant change from what was known as a 'material irregularity' in terms of s 20(5) of the repealed Public Accountants and Auditors Act 80 of 1991 (PAAA). First, under the new legislation the reportable irregularity has to be an unlawful act or omission. Second, it has to be perpetrated by management. In addition, it has to be material. An auditor is required to assess the materiality of any likely financial loss and any breach of fiduciary duties.¹⁰³ Irregularities that may cause or have caused financial loss or that amount to breaches of fiduciary duties are reported only if they are regarded as material. If the irregularity amounts to fraud or theft, it has to be reported even if no financial loss was or could have been suffered by any party. Materiality is not considered. A material breach of a fiduciary duty has to be reported even if no financial loss has occurred or is likely to occur.

It is essential to note that an auditor is required to report an irregularity only if he is 'satisfied or has reason to believe' that such irregularity has occurred or is occurring. The satisfaction that a reportable irregularity is taking place, has taken place or is probably taking place may come from normal auditing procedures.¹⁰⁴ By its own nature, fraud constitutes a reportable irregularity.

⁹⁹ Section 45(1)(b).

¹⁰⁰ This means that the auditor has to assess the likelihood of the damage being material to the persons mentioned.

¹⁰¹ A reportable irregularity may also entail fraud and theft. As the reference to (the likelihood of) material financial loss is not repeated under (b), the intention is obviously to bring all instances of fraud and theft within the ambit of s 45(1)(i). What appears to be odd, however, is that (b) is also linked to the preamble of the definition, namely the reference to an unlawful act or omission committed by a person responsible for management. Theft or fraud is unlawful in itself and might well have been committed by others not in the management structures.

¹⁰² Here the auditor has to assess whether the breach of fiduciary duty can be regarded as material. The following query suffices: what is a material breach? It is a serious breach in the sense that it is grossly reprehensible, irrespective of the (material) financial loss, for instance, where it brings irreparable loss of confidence or breach of amicable relations or is *eiusdem generis* with financial loss. Others who are not part of management may also owe and breach fiduciary duties.

¹⁰³ The requirement of materiality has undergone a significant change from the time of the PAAA. In terms of the PAAA, an auditor was required to assess the amount of the potential financial loss connected with the irregularity and the materiality of the irregularity itself.

¹⁰⁴ But there is nothing to prevent an auditor from probing suspicious matters or auditing with an open and enquiring mind, or like a 'bloodhound'. It is just that he is not required by law to do so and will by so doing make his own work more onerous and consequently more costly.

The fact that fraud is a serious irregularity does not, however, sway the requirements in favour of a more investigative approach in relation to instances of fraud. The auditor must still report fraud only if he is satisfied that it took place or is taking place or he has reason to believe that it is taking place. It therefore does not mean that he has to detect reportable irregularities. He is required (constantly) to have regard to the possibility of their existence.

What happens after the initial reporting of the irregularity is important. An auditor's duty is not limited to the reporting of irregularities to the Regulatory Board. Within 30 days of reporting, he must discuss the irregularity with the management board and afford them an opportunity to explain it. After that, he must send another report to the Regulatory Board in terms of s 45(3)(a), (b) and (c).¹⁰⁵ These requirements serve as further guidelines on the standard of diligence expected from auditors faced with irregularities. In consultations with management on identified irregularities, an auditor must exercise reasonable care, because he may be misled.

4.4.1 How Does an Auditor Determine That an Irregularity Exists?

Section 45(5) of the Act states that an auditor must carry out the necessary investigations before determining whether an irregularity exists. In the course of such an investigation he must consider information from any source.¹⁰⁶ This provision is similar to the one that was contained in s 25(a) of the PAAA. Section 45(5) of the APA requires an auditor to carry out an investigation into the existence of a reportable irregularity by using any method that he considers appropriate. There is no guidance on what an appropriate investigation entails, because no prescribed procedure can be suitable in all circumstances. The auditor will have to exercise reasonable care, skill and professional judgment.

This provision can be complemented by common law and international auditing standards. It was stated earlier here that an auditor must be cognisant of the possibility of fraud. This requirement was highlighted, inter alia, in *Dairy Containers Ltd v NZI Bank Ltd*,¹⁰⁷ where it was stated that an auditor who has come across any suspicious matter must probe the matter to the bottom.¹⁰⁸ This indicates that statutory law is in this regard actually complemented by common law.

¹⁰⁵ In this second report, the auditor must verify his initial report by stating whether the irregularity has actually taken place, is taking place or is no longer taking place. The auditor must also state whether corrective measures have been taken, and if the irregularity is continuing, this must be reported.

¹⁰⁶ Section 45(5) of the APA requires an auditor to carry out an investigation into the existence of a reportable irregularity – thus stating rather belatedly in the Act that one of the duties of the auditor is to investigate the existence of reportable irregularities. It appears that in South African statute the primary duty of an auditor is to audit and obtain a reasonable assurance that the financial statements reflect fairly the financial position of the company and the results of its operations. The duty to investigate the existence of reportable irregularities can be regarded as the secondary duty.

¹⁰⁷ Supra note 67 at 35.

¹⁰⁸ See the discussion of the *Thoroughbred Breeders' Association* case supra note 52 under par 3.3 above.

The provisions of s 45 of the APA are similar to those to be found in the United States, which indicates further that auditing standards are largely universal. The position regarding the reporting of irregularities in financial statements in the United States is governed by s 78j-1(b) of Title 15: Commerce and Trade: Chapter 2B-Securities Exchange of the United States Code.¹⁰⁹ An auditor who conducts his audit in compliance with generally accepted auditing standards 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:

- The auditor must determine whether there is any likelihood that the illegal activity has taken place or whether a statement is materially false.¹¹⁰
- If the illegal activity is found to have taken place, the auditor must then determine and consider its possible effects on the fairness of the financial statements of the company.¹¹¹
- As soon as possible, the auditor must inform the relevant authorities of the company and ensure that its audit committee is sufficiently informed of the illegal acts that have been detected. If the company does not have an audit committee, this information must be submitted to the board of directors. This provision does not apply if the illegal act is judged to be plainly inconsequential or immaterial.¹¹²

These provisions indicate the standards of diligence that must be adopted by an auditor who has discovered fraud and illegal activities under the law of the United States.

5 Auditor Liability

Auditor liability is of serious concern because of the environment in which auditors operate. South African law also recognises liability for negligent misstatement causing pure financial loss.¹¹³ Compliance with the legal responsibilities in the detection of fraud is vital because it may be helpful in

¹⁰⁹ The United States Code is a codification of the laws that apply in that country and comprises fifty titles. It is published every six years by the Office of the Law Revision Counsel of the United States House of Representatives. The current version is available online: see <http://www.gpoaccess.gov/uscode/index.html>.

¹¹⁰ Section 78j-1(b) A(i).

¹¹¹ Section 78j-1(b) A(ii).

¹¹² Section 78j-1 B. Contrast the reporting requirements of these provisions with the actions of the auditors of collapsed US energy giant Enron (see Tackett, Wolf & Claypool op cit note 3 at 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.

¹¹³ See generally C Visser 'Delictual Liability for Negligent Misstatement Inducing a Contract: Some Questions Answered At Last' (1992) 4 *SA Merc LJ* 227 at 230, stating that liability for negligent misstatement was affirmed in *Administrateur, Natal v Trust Bank van Afrika Bpk* 1979 (3) SA 824 (A). According to Visser, Rumpf CJ in this case distinguished between *nalatige wanbewing* (negligent misstatement) and *nalatige wanvoorstelling* (negligent misrepresentation). The latter was referred to as a species of misstatement that induces a contract. This means that auditors who negligently fail to detect fraud can be sued for damages in delict.

proving due diligence and skill. This is important because it nullifies negligence, which is always the starting-point in establishing auditor liability. Where auditors are negligent in failing to detect fraud, their position is made more precarious by the fact that they are usually the last standing, financially, if their client collapses and they become targets if they wrongly certified their client's financial statements. Tomasic states that 'it has become fashionable to sue auditors' and quotes one Adelaide lawyer as saying:

'A lot of companies never go into liquidation . . . [as] . . . there is no cash to finance an enquiry into what happened. Banks do not throw good money after bad. In addition it is too expensive to run complex corporate claims. Persons will not run it unless they are satisfied that the individual is worth suing as directors can shed assets. **It is more productive to sue auditors.**'¹¹⁴

Auditors can limit their liability to third parties and clients if they perform their audits with due regard to their legal responsibilities stated in par 3 above.¹¹⁵ 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. An auditor occupies a contractual and fiduciary relationship with his client, the entity whose financial statements he audits. The same cannot be said about the third parties who rely on the auditor's opinion when making investment decisions. This means that an auditor can be sued for breach of contract by the company, which may also elect to base its action on damages in delict.¹¹⁶

Regarding third parties, the case *International Shipping Company (Pty) Ltd Bentley*¹¹⁷ states that third parties such as 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. This means that the auditor's omission to detect fraud must have wrongfully, intentionally or negligently caused financial harm to the third party before third-party actions against auditors can succeed.

The APA also deals with auditor liability in s 46. In terms of this section an auditor incurs liability to a third party or client if in the course of his duties he

¹¹⁴ Supra note 7 at 211 (original emphasis).

¹¹⁵ A recent publication by the South African Institute of Chartered Accountants (SAICA) shows that the number of people entering or remaining in the auditing profession is declining dramatically (see 'Auditors Must Be Protected Against Spurious Litigation' (2009) March *TaxTalk*). The reasons given for this decline are fear of exposure to litigation and liability for damages. SAICA states that the damages claimed against auditors far outweigh the economic damage caused by auditors. The present discussion, however, implicitly states that flight is not the answer. Instead, all that is needed to prevent liability and litigation is faithful adherence to the responsibilities noted here, which is by no means impractical.

¹¹⁶ An example of a case where an action was based on breach of contract is to be found in *Thoroughbred Breeders' Association v Price Waterhouse* supra note 52. 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 legal cause of the plaintiff's loss.

¹¹⁷ Supra note 94.

maliciously or fraudulently expresses an opinion, issues a statement or reports after a negligent performance of his duties with the result that a third party or client suffers financial losses.¹¹⁸ For an auditor to incur liability to third parties it must be proved that the auditor issued the report, opinion or statement pursuant to a negligent performance of his duties and that the auditor knew or could reasonably be expected to know that:

- the third party would be influenced by the auditor's opinion in making decisions about the audit client; and
- his client would use the auditor's opinion to influence third parties to make a decision regarding any business involvement with the client.¹¹⁹

An auditor will also incur liability to third parties if he makes a representation to a third party stating that his audit opinion is 'correct' if he knows or is in the circumstances reasonably expected to know that the third party will rely on this representation to make business decisions regarding the auditor's client.¹²⁰ These requirements limit liability to persons that the auditor actually knows are, or will, be affected by his report.

Liability in terms of s 46 of the APA is further limited by the provision that an audit of financial statements is not proof that the auditor knows or should reasonably be expected to know that a client will use his opinion to mislead third parties or that third parties will act on the strength of the report.¹²¹ Liability is not limited, though, if the auditor fails to report a reportable irregularity in the manner prescribed. In these instances, he is liable to any partner, member, shareholder and third party.

5.1 Fraud's Direct Relationship with Auditor Liability

The underlying fact is that before there can be a question of auditor liability, there must have been a negligent failure to detect fraud or other material misstatements. The recent case of *Axiam Holdings Ltd v Deloitte & Touche*¹²² illustrates this point very well. The firm Deloitte & Touche prepared and completed a client's annual financial statements – totally against the principle of auditor independence, because auditors cannot audit themselves after doing the financial statements. The new Companies Act states that auditors may not perform any services for a company that would put them in a position of conflict of interest and that is proscribed by the company's audit committee.¹²³

As has been seen in par 2.1.1, the audit committee of a company is made responsible for ensuring that company auditors are independent. These new

¹¹⁸ Section 46(2).

¹¹⁹ Section 46(3)(a).

¹²⁰ Section 46(3)(b).

¹²¹ Section 46(5).

¹²² 2006 (1) SA 237 (SCA).

¹²³ Section 93. For a comparative analysis of the regulation of auditor independence, see J Bourne 'Auditor Independence: An Analysis of the Legislation in the United States of America and South Africa' (2007) 19 SA *Merc LJ* 492.

provisions provide some guarantee of auditor independence, which is necessary for the proper performance of an audit and the detection of fraud.¹²⁴ As one Perth lawyer quoted by Tomasic states:

'Auditors have a marketing drive rather than a watchdog drive. You audit a company as if you are auditing a kindergarten so you can hang on to the job. Liquidators have more of an incentive because they know they will be paid.'¹²⁵

In *Axiam Holdings Ltd v Deloitte & Touche*,¹²⁶ the financial statements of an entity (TBB) did not fairly present the financial position of that entity. The financial statements misrepresented TBB's net worth by reflecting a net profit before tax of R29 266 176 when in fact TBB had suffered a net loss of R77 899 201.¹²⁷ This misstatement was due to the fact that Deloitte failed to include a bad debt of R68 888 000 in the income statement. This amount was inexplicably reflected as goodwill. A non-existent amount of R10 300 000 was included in the financial statements as profit whilst an irrecoverable or non-existent bad debt of R27 977 377 was wrongly reflected as a loan to a shareholder.¹²⁸ This kind of financial reporting prompted Navsa JA to state:

'[5] Deloitte, in conducting the audit and completing the financial statements, did not, *inter alia*, do so with the requisite professional and reasonable skill and care and failed to comply with Generally Accepted Accounting Practice (GAAP). Had Deloitte done so the 1999 statements would have accurately represented TBB's financial position, alternatively, would have contained a qualified audit opinion. Thus Deloitte, in conducting the audit and certifying the 1999 statements, was negligent.'

Liability was imposed on Deloitte in this case because it was held to have known of its negligent audit, audit report and the third party's potential reliance thereon. It is clear here that liability was firmly based on the negligent performance of the auditor, which was so well established that it was not even an issue in the case. If the auditors had performed the audit with due care and skill and complied with their responsibilities to detect fraud, liability would not have been established.

¹²⁴ It is submitted that the discretion left to the audit committees to determine auditor independence and the nature and extent of the non-audit services to be done by the auditor leaves a few gaps. This is because certain non-audit services may be proscribed by one particular audit committee but accepted by another. Consistency needs to be established as in the US SOX s 201, which lists certain non-audit services that are proscribed. These are book-keeping 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 audit, actuarial services and internal audit services. The Public Accounting Oversight Board, which oversees the public accounting profession in the USA, has a right to proscribe more non-audit services. Auditor independence is crucial. According to Tackett, Wolf & Claypool op cit note 3 at 343, after the collapse of Enron it was discovered that Andersen, the auditing firm responsible for auditing Enron, had received a sum of \$27 million from Enron for consulting services, more than the sum obtained for the auditing services that it provided. The authors also reveal 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 that can realistically force an auditor to provide a glowing report at any time because of his fear of losing substantial revenue. According to the authors, one of the causes for audit failure is undue influence because of a direct or indirect financial connection to the company.

¹²⁵ Op cit note 7 at 212.

¹²⁶ Supra note 122.

¹²⁷ Idem at 239E-F.

¹²⁸ Idem at 242.

5.2 Damages Payable Where Liability is Imposed

As has been stated, there are instances in which an auditor's failure to detect fraud is due to the auditor's negligence or even fraud. If it is found that the auditor was negligent in failing to detect fraud and liability for the loss suffered by clients or third parties is imposed, the Apportionment of Damages Act 34 of 1956 applies. Under s 1(a) of this Act a person who suffers damages caused partly by his own fault and partly by the fault of another person will not be compensated to the full extent of the damages. The damages to be paid to the person who suffers damages are those that can be fairly and equitably attributed to the other person's fault. But the injured person's claim cannot be nullified by the mere presence of contributory negligence on his part. Where a party was negligent in relying only on the auditor's report and ignoring other crucial factors, the auditor's liability may be reduced in proportion to the third party's contributory negligence.

Regarding client claims, which are based on breach of contract, the Apportionment for Damages Act was originally held to be inapplicable. This principle was stated in the Supreme Court of Appeal in *Thoroughbred Breeders' Association of South Africa v Price Waterhouse*.¹²⁹ The client there was negligent in employing a person who it knew had a previous conviction for theft as financial manager. The client was also patently negligent in failing to maintain proper financial controls. But the Court held that Parliament did not intend the concept of contributory negligence to apply to claims of breach of contract.¹³⁰

This ruling barred auditors from relying on the defence of contributory negligence, in spite of the fact that most clients who have fraudulent financial statements contribute to the fraud by their own negligence.¹³¹ So there was a real need for legislative intervention allowing the defence of contributory negligence in breach of contract cases, particularly in audit cases.¹³² This came in the form of s 58(2) of the APA, which extended the application of s 1(a) of the Apportionment of Damages Act to damages caused by breach of contract by a registered auditor.

6 Conclusion

It is clear that the main statutory objective of an audit is to enable auditors to express an opinion on the fairness of financial statements. All the statutory

¹²⁹ 2001 (4) SA 551 (SCA).

¹³⁰ *Idem* at 591.

¹³¹ Olivier JA in a dissenting opinion that is well-researched and reasoned states that, according to the plain meaning of s 1 of the Apportionment of Damages Act, which is clear and unambiguous, the defence of contributory negligence is not restricted to delictual claims and extends to breach of contract cases. The judge also reasons forcefully that even a purposive interpretation of the section, which was used in the main judgment to rule out breach of contract cases, does not exclude such cases. See also G Lubbe & S van der Merwe 'Apportionment of Loss Contractual Claims for Damages at Common Law' (1999) 10 *Stellenbosch LR* 142.

¹³² J Neethling, JM Potgieter & PJ Visser *Law of Delict* 5 ed (2006) at 153.

duties imposed on an auditor are designed to ensure that auditors come as close as possible to uncovering material misstatements in the financial statements that they audit. The analysis of the law of negligence has also shown that auditors have no inherent duty to detect fraud. The general position is put succinctly by Thomas J in the *Dairy Containers Ltd* case that

'the ordinary examination directed to the expression of an opinion on the financial statements is not primarily or specifically designed to disclose defalcations and cannot be relied upon for that purpose, although the discovery of fraud may result from the examination'.¹³³

The mere fact that fraud or error exists in the financial statements does not give rise to the duty to detect fraud. This duty can arise only where there is a reasonable probability that an auditor, exercising reasonable care and skill evidenced by compliance with obligations stated in this discussion, can detect the fraud. Support for this assertion can be found in the *Pacific Acceptance* case, where it was stated that care must be taken to prevent the auditor's duty of reasonable care and skill from being too onerous.¹³⁴

Even though auditors have no inherent duty to detect fraud, it has been shown that litigation against auditors and liability to clients and third parties for failure to detect fraud is a constant reality that the audit profession has to face. The primary responsibility to ensure the integrity of annual financial statements lies with companies and their audit committees but this responsibility is sometimes ignored by these parties. Although auditor liability is not as unlimited as it was once feared to be, it is still something that the profession can do without. It is therefore important to keep in mind the auditor's legal obligations in the detection of fraud that when performed must be sufficient to excuse auditors from liability for subsequently discovered fraud.

In the discussion of the auditor's responsibilities in the detection of fraud, the stand is taken that auditors have an important role to play in the detection of fraud. The auditor's duties in this regard entail

- the duty duly to consider the possibility of fraud;
- the duty to exercise professional scepticism and identify fraud risk factors;
- the duty to respond accordingly to fraud risk factors; and
- the duty to report reportable irregularities.

These duties show the level of diligence and skill that can be reasonably expected of auditors today. These duties are not impractical in that they can be

¹³³ Supra note 67 at 57.

¹³⁴ Supra note 48 at 63. According to Cilliers HS et al *Corporate Law* 3 ed (2000) at 415, the auditor's duty regarding the detection of fraud must not be made too onerous and the quality of his work must not be judged with hindsight or influenced by revelations made after investigations. The danger of hindsight was illustrated in the *Pacific Acceptance* case supra note 49. It was stated that once fraud is revealed it becomes easy to connect it to its earlier manifestations of fraud. To prevent this from happening, it was stated that the auditor's conduct must be examined in a practical way on the matters as they came to him at the time when he had an unsuspecting mind. But Moffit J stated that if material irregularities appear, a careful auditor could normally be expected to remember and consider other irregularities, especially those occurring in a connected way. In this regard, an auditor may reasonably be expected to revisit past working papers to bring irregularities to mind.

complied with. It can also be seen from the description of the duties in this discussion that compliance with these duties is evidence of diligence and skill in the detection of fraud, which is what is ultimately expected of auditors.
