

## **Legal Aspects of Management and Administration (3)**

### **The Auditor**

#### **1) Introduction**

An auditor is someone who reports on a company's accounts in accordance with the Companies Act legislation - true & fair view - independent

#### **2) Appointment**

- S.385 CA 1985 - AGM's, Directors
- Appointed at first general meeting at which the accounts are laid, and re-appointed annually at successive general meetings.
  - By directors
  - Private companies - elected to dispense with the accounts, within 28 days of accounts to company members, general meeting
  - Private companies can dispense with the annual reappointment ⇒ current auditors are re-appointed each year

#### **3) Remuneration**

- S.390A(1) CA 1985
- When appointed, level of remuneration decided at that general meeting
- If appointed by directors, the directors should fix the level of remuneration; but, ultimately, the Secretary of State can fix the level if the directors have not decided on this issue

#### **4) Qualification**

- S.289 CA 1985 as amended by CA 1989 - 8<sup>th</sup> EC Company Law Directive on Auditors
- Sets out certain recognised bodies which qualify someone as an auditor - tightened up by the 1989 amendment to the 1985 Companies Act and by the 8<sup>th</sup> EC Company Law Directive on Auditors
- There are five professional bodies: ICAEW, ICAS, ICAI, ACCA, Association of Authorised Public Accountants

- Secretary of State can recognise similar qualifications gained abroad
- An individual or a body of individuals can be appointed, but where there is a conflict of interest (e.g. a family connection) cannot be an auditor

## **5) Duties**

- S.236 CA 1985
- An auditor audits the company accounts (This is fundamental ... or plain obvious!)
- Nature of duties have greatly changed over the last 100 years
- When first talked about in case-law, the duty was not particularly onerous ...

Formento (Sterling Area) Ltd v Selsdon Fountain Pen Co Ltd [1958] 1 All ER 11

*An auditor must approach his work " ... with an inquiring mind - not suspicious of dishonesty ... but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none" (Per Denning)*

- It has been questioned whether one can approach a set of accounts with an inquiring mind, not suspecting dishonesty, only expecting mistake. However, does form a basis for the auditors' duties, and Denning said that an auditors' duties also included:
  - To verify arithmetical accuracy
  - To make checks to establish that the accounts do not mark error or dishonesty
  - Reporting on the accounts as to whether they provide reliable information respecting the true financial position of the company
- These three assertions are uncontroversial and are still true today, and are in addition to the overriding duty that the accounts show a "true & fair view"

## **6) Liability**

- An extension of the duties owed, more onerous now than they were ...

Re Kingston Cotton Mill (No 2) [1896] Ch249

*"An auditor is not bound to be a detective ... he is a watchdog not a bloodhound" - Per Lopes LJ at p288*

- One of the starting points when determining the limits of auditor liability

- Although in terms of metaphor, it is a nice summary of what an auditors' duties are

In the case, the auditors had taken an assessment made by management on trust as to the amount of cotton, failed to make a physical check of the stock themselves.

Assessments made by management were fraudulent - made the company look more flush than it actually was. They only ensured that the summary of stock equalled what was in the accounts - they didn't check the accuracy.

The court held the auditors not liable - on the basis that they were entitled to rely on the statement made by the management of the company

- More onerous and strict today ...

### Re Thomas Gerrard [1967]

*"The standards of reasonable care and skill are, upon expert evidence more exacting than those which prevailed in 1896"* (Per Pennychick J)

The liabilities were considered more strictly in this case, and again, similarly, overstatement as to nature and value of stock held. Also, the invoice dates had been changed to falsely enhance the value

Auditors were held liable in this case - they should have noticed the changes to the invoice dates

There are three main areas of liability:

- Tort (the most controversial)
- Contract
- Statute

#### *a) Liability in Tort:*

### Hedley Byrne & CO Ltd v Heller & Partners Ltd [1964] AC 465

- Significantly limited third party liability
- Also established economic loss can be recovered if the relationship between the parties is regarded as sufficiently proximate

The case involved bankers' reference, knowing that a third party would use the reference. Due skill and care required in preparing the reference - relationship was

proximate, because of this and since there may have been third parties who seek to rely on the accuracy of the auditors' report

Caparo Industries Plc v Dickman & others [1990] AC 605

The number of people to whom the duty of care is owed was again narrowed. At first instance (Lower court) held that a duty of care was owed to shareholders as a body of people, but could only be enforced by the shareholders acting as a body or class of persons. Also, no duty of care owed to Caparo as individual shareholder or potential shareholder. However, on appeal it was held that the duty of care was owed to Caparo in its capacity as a shareholder at the time of the audit. But no duty of care as in capacity of potential shareholder. More importantly, issue of the purpose of auditing accounts. The court took particular notice that the companies' legislation requires an annual audit and the filing of audited accounts and that the purpose of these requirements was to provide information to existing shareholders - enabled existing shareholders to exercise their statutory rights in General Meetings. So, not the purpose of accounts to provide information as to investment decisions → to potential shareholders.

Barings plc v Coopers & Lybrand [1997] BCC 498

CA accepted that, in principle, the auditor of a subsidiary could owe a duty of care to a parent company.

Barings sought to lay the blame on the auditors for failing to spot inconsistencies - argued the auditors owed a duty of care to Barings.

CA said Barings had a right of action independent to that of the company, and that the group accounts should give a true and fair view of the group' s business.

These and other cases indicate auditors owe a duty of care to the following groups:

- Existing shareholders of the client company, as a group
- Existing shareholders of the client company, when specifically known to the auditors
- Potential shareholders of the client, although not specifically known to the auditors, but where it would be suspected that the auditors would expect that specific interest

Held ⇔ loss flowing from negligence

Narrows the interpretation of who the users of a set of accounts are

Story in tort not closed - will continue to change!

*b) Liability in Contract*

- Liability in contract is generally easier to determine. The auditor has contractual liability if he has a contractual relationship with the company being audited
- Generally, the duties and liabilities are specified in the contract between the company and the auditor
- The company is the only ' person' who can sue the auditor in contract, and damages will be sought on a basis of breach of contract

*c) Statutory Liability*

s.12 IA 1986

- Generally centres around the liability to prepare accounts in accordance with the companies' legislation and in a winding up situation, the auditor can be in breach of statutory duty to the company
- The court will order whatever compensation it sees fit, and will go to the company

**7) Removal**

*s.391 CA 1985 - ordinary resolution:*

An auditor can be removed by ordinary resolution of the company:

- Special notice must be served
- Auditor can make written representations which can be circulated to members of the company
- If removed in breach of their contract, the auditors can make a claim for recompense → companies are advised to have special notice provisions built in to their contract with their auditors

*s.392 CA 1985 - resignation:*

An auditor may also resign from an engagement:

- In writing, delivered to the companies' registered office

- Notice must contain circumstances surrounding the resignation and any relevant information that the auditor thinks that he should be brought to the attention of any members / creditors
- If there are no circumstances, then a statement to this effect must be included

## **8) Conclusion**

Thus, standard expected is high - more onerous than previously - but extent of duties is still unclear

Duties are relatively high / strict

Started narrow → widened in the 70' s and 80' s to include more potential liability

Questioned whether this liability is definite enough, especially in tort - should be on a statutory footing?

*Arguments in favour:*

- Brings certainty to the law that the auditor should know exactly what his duties are, to whom he owes a duty of care, etc.

*Arguments against:*

- Law needs to be flexible:
  - Expand / restrict an auditor' s liability
    - A court can be more responsive to the needs of business than statute can (partly due to time)

Also, slight problem of incorporation - law' s view with the professional bodies' view - sometimes are at variance

*Question:*

Who is best qualified to determine the extent of these liabilities - profession or law?