Company Auditor Negligence in Australia

EXPRESS DISSERTATION

1.2. Introduction

Extant literature has reported a decided increase in the number of corporate collapses as well as litigation claims (Kadous, 2000. Reffette et al., 2012). While this has been associated with the presence of economic recession it is acknowledged that the auditing profession in Australia as well as other countries around the world has faced number of difficulties and criticisms in recent years in terms of problems faced by auditors in terms of breach of statutory duties as well as problems of professional negligence (Cornell et al., 2012). The continued debate in this area over the last decade has required the need for better clarification of rules in this area with respect to the reporting of financial fraud and illegality. This report aims at establishing the law of negligence and its application to a company auditor.

1.2. Negligence Tort

Schwartz and Rowe (2010) identify negligence as an important tort which is used to cover a number of different situations wherein negligence by one person causes harm to others. There are three primary principles of negligence which have been promoted in literature (Chung et al., 2010; Cornell et al. 2012; Simunic and Stein 1995). These principles need to be established for any claim of negligence

- A duty of care was owed to the claimant by the defendant
- This duty of care was breached by the defendant
- As a result of this breach of duty there was a subsequent foreseeable damage established.

One of the primary elements of negligence which was established is the duty of care. According to Sadler (2009), before the year 1932 there was no established duty of care principles and there were no actions taken against loss suffered due to a result of negligence. Styliano (2011) further argued that cases against which negligence was established was in cases of accidents on roads or due to collapsed buildings. However, in the year 1932 a landmark case called as the Donoghue vs Stenvenson (1932) was passed. This case presented a well established tort principle called as the neighbour principle which helped in determining whether duty of care was breached resulting in loss due to negligence.

This case was brought before the courts due to the presence of a decomposed snail in a ginger beer bottle. The claimant of this case, Mrs. Donaghue claimed £500 damages from the defendant, Stevenson (the manufacturer of the beer). The claimant was unable to sue the manufacturer under the law of contract due to the absence of a contract between the parties. The courts decided in favour of a claimant and the neighbour principle was established. This ruling was the first to establish that duty of care was owed by every person to his neighbour. The ruling also defined the neighbour as one who could be injured due to the act of lack thereof of the same (Cornell et al., 2012). According to Kadaus (2000), this ruling also set the precedent for negligence resulting in physical injury.

The establishment of duty of care following the Donoghue & Stevenson [1932] AC 562 ruling resulted in a subsequent increase in the number of cases claiming negligence. This required the need to look into measures which helped differentiate physical loss from financial loss. An examination of such loss is important to this report as negligence of an auditor is often associated with financial loss. Reffet et al., (2012), reports on how senior judges in the UK understood the need to set a clear set of parameters to establish negligence. Therefore, in a landmark care Capro Industries PLC vs Dickman and Ors (1989) a three stage test was established. The following figure summarises the primary steps involved in this three stage test.

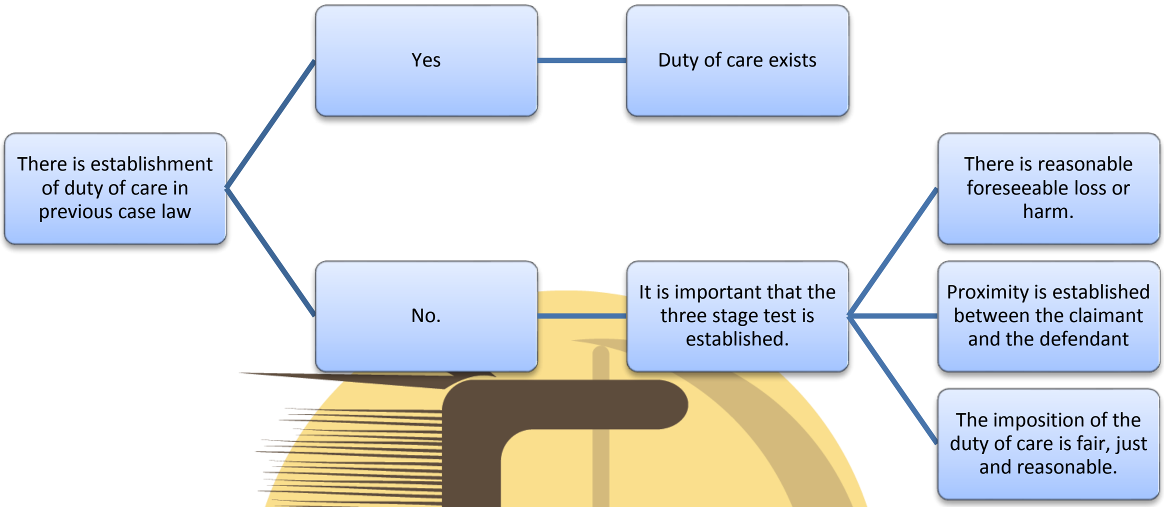

Figure 1: Three Principle Test (Adapted from Turner, 2010)

1.3. Liability of Company Auditors in Australia: Case of Negligence

Liability of company auditors in Australia is subjected to different aspects of law ranging from contract law to statue law. There are also a number of provisions and conduct principles established by the ICAA (Institute of Chartered Accounts of Australia) and CPA Australia (CPA). Some authors argue that the wide range of rules and laws presented on the auditing profession in Australia had lead to a greater level of liabilities in other countries like the UK, USA and New Zealand (Peecher et al., 2013). Pacini et al., (2002) argue that the Corporations Act 2001 and the Trade Practices Act 1974 extended the liabilities of the auditors to third parties which was absent in countries like the UK and US. Since then researchers and policymakers have called for a need to reform these laws to limit the negligence and liabilities of this profession.

1.4. Duty of Care and Proximity and Reliance

In the Pacific Acceptance Corporation Ltd v Forsyth it was held that the duty is imposed on the auditor to ensure that they promote reasonable skills and care while auditing a company's financial statements (Chung et al., 2010). It was held that the defendant auditors were negligent as they did not inform the plaintiff with regards to the presence of frauds and irregularity. From this, it is established that standards of care are established as primary principles in negligence of auditors of companies. According to Styliano (2011) such an argument was line with the rulings in the UK.

Another ruling is with regards to the test of proximity and reliance. In the Mutal Life and Citizens Assurance Co Ltd V Evatt ruling was made regards to the test of proximity and reliance. Nguyen and Rajapakse (2008) observed that the Australian courts were able to restrict findings of liability in relation to third parties by using tests of proximity. The plaintiff claim was made by citing the Hedley Bryne case. However, the Privy Council made the decision that MLC cannot be held liable as no special skill was present. It can be argued that MLC could have been held liable if they had been an investing company instead of a bank. In contrast in the case Columbia Coffee and Tea Party Ltd v Churchill it is understood that the auditors were held liable to the third party. This is because the auditor's manual dictated that any third party who was a potential purchaser of shares held the responsibility and hence was liable (Styliano, 2011). This was in contrast to the economic loss as a result of negligence torts in the UK.

1.5. Economic Loss as a Result of Negligent Statement

Economic loss as a result of negligent statement was established in 1964 in the Hedley Bryne and Co V Heller (1964). This case held that in certain special circumstances (i.e. due to the presence of a special relationship between the parties) the presence of the duty of care could be established. However, since Heller had presented a disclaimer the advice so given was to be identified as one without responsibility and hence the defendants were found to be not-liable (Turner, 2010). This principle could be applied to negligence on the part of the company auditors as discussed below.

The auditor's financial statements are used by different stakeholders in their pursuit of making business and investment decisions. The negligence of the auditor in terms of his duty of care has been related to two main stakeholders: company and its shareholders as well as the investors of the company. According to Nguyen and Rajapakse (2008), the auditors of a company have a duty of care and are directly liable to the company. This is due to the presence of a contract between the auditor and the company and thereby defines their relationship under the presence of a contract law. The established contract between the auditor and the company has been given in the case Simonious Vischers V Holt Thompson. In this case, the auditor is established to be bound to the company by the presence of a contract in lieu of the fee that is agreed to be paid to the auditor from the client i.e., the company so that the obligations of the auditor are upholded (Wilkens et al., 1996).

The Caparo Industries Plc V Dickman was a case which was based on the negligence of the auditor towards other external users including the company directors and shareholders, investors and other third parties. However Nguyen and Rajapakse (2008) argue that the auditor owed duty to uphold the required care and standards of skill to the company and would be found liable by tort and contract if any loss is resultant due to the breach of duty. This case related to the claims that the auditors had been negligent in detecting and reporting presence of misstatements in the financial statements. Furthermore, Ojo (2012) argue that the existence of duty of care to potential investors was non-existent. The ruling held that the duty of care of the auditors was towards the existing members and shareholders of the company. The ruling also indicated that the auditors could only foresee that no direct neighbour could be established and that the auditors could only foresee that an unknown investor can foresee and act upon their report.

According to Styliano (2011), this case was primary in ensuring that professionals who make statements would not be asked to present duty of care to a large number of people who would rely on their statements. It was observed that a claim for pure economic loss as a result of the issue of a negligent statement can be held only if the claimant is able to establish the existence of a special relationship between the parties. In this ruling three main principles were laid out which would help decide the presence (or absence) of a special relationship between the defendant and the claimant.

- To establish a special relationship between the defendant and the claimant it should be established that the defendant knew that the statement is to be presented to the claimant (named/unnamed individual or a group).

- To establish a special relationship between the defendant and the claimant it should be established that the advice given by the defendant was in connection with an identifiable transaction.

- To establish a special relationship between the defendant the claimant there should be anticipation on the part of the defendant that the claimant could rely on the purpose of the transaction without seeking independent advice.

Esana Finance Corp Ltd v Peat Marwick Hungerfords is an ideal example to sho2 the current stance of Australia with regards to the liability of an auditor. The case similar to the ruling of Caparo Industries Plc V Dickman in the UK helped narrow the scope of liability of the auditors. The ruling of the court helped in denying third parties success with respect to their claim against the auditors for negligent misstatement. The case was initiated by finance company (third party) against the auditor of a company. The claim of negligence was made under the principle of economic loss due to negligent statement. However, the court found in favour of the defendant. The ruling was the auditors were responsible to report to the company members (directors and the shareholders) and that the auditors had no prior knowledge that the financier would act on the audited accounts (Nguyen and Rajakpakse, 2008). Furthermore, Styliano (2011) argue that such a ruling indicates that though the auditor had knowledge of the financial position of the company, the reports prepared were only to the board and the shareholders and not the financing company.

A primary argument made by the claimants of Esanda was that through the audit manual the auditors have a responsibility to the third party. However, the judges claim that such an assumption will not hold in this case and that third part loss can be held only if there is established knowledge on the part of the auditor that the third part would use such a report. Furthermore Turner (2010), argued that the unreasonable reliance on the part of the plaintiff financer cannot be held as the party should have looked for other sources of information.Thus it can be concluded that the auditors cannot be held liable for to third parties in terms of negligent misstatements. The Essanda Finance case as well as the Caparo Industries case brings to light the idea that a number of strict tests need to be satisfied in terms of determining the cases of negligent misstatement. Therefore, there is a change in the third part negligence tort through the Essanda Finance case.

1.6. Contributory Negligence

Another line of thought which needs to be examined is the presence of contributory negligence. In the AWA Ltd vs Daniels T/A Delloite Haskins and Sells and Ors case it was held that the plaintiff company along with the auditors were found to be held liable. This is because, the company failed to maintain its own standards of care and was in clear dereliction of its duty of care policy (Chung et al., 2010). According to Nguyen and Rajapakse (2008), this was a landmark case which overruled the Pacific Acceptance Corporation vs Forsyth case which held that auditors cannot excuse negligence on the grounds that the directors or employees were also negligent. Through the AWA Ltd case the ruling that was held was that though the auditor was negligent, equal negligence was also on the part of the company. Through these rulings it is concluded that the auditors and the company had to appropriate blame fairly especially when financial losses occur due to commercial misjudgement.

1.7. Conclusion

Through the above report it is observed that negligence of the auditor is relatively more strongly pursued in Australia when compared to the countries like UK and US. It is understood that the presence of the system of joint and several liability has resulted in substantial cost on auditors. In line with this Nguyen and Rajapakse (2008) argue for the abolishment of this rule. The researcher also concludes that auditors are privy only to economic loss and that it is impossible to foresee all possible users of their statements. It is therefore recommended that a statutory capping and proportionate liabilities scheme be implemented as suggested by Nguyen and Rajapakse (2008) as this system will not only ensure that the auditors keep to their code of principle but will also ensure a fair allocation of liability.

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