Conceptual, Practical and Procedural?' (1987) 13 *Monash University Law Review* 164; S Worthington, 'Directors' Duties, Creditors' Rights and Shareholder Intervention?' (1991) 18 *Melbourne University Law Review* 121; R Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] JBL 1; A Keay, 'The Duty of Directors to Take Account of Creditors' Interests: Has It Any Role to Play?' [2002] JBL 379; HC Hirt, 'The Wrongful Trading Remedy in UK Law: Classification, Application and Practical Significance?' (2004) 1 *European Company and Financial Law Review* 71; PL Davies, 'Directors' Creditor-Regarding Duties?' (2006) 7 *European Business Organization Law Review* 301; J Zhao and J Tribe, 'Corporate Social Responsibility in an Insolvent Environment: Directors' Continuing Obligations in English Law?' (2010) 21 (9) *International Company and Commercial Law Review* 305.

[19] *Dicta* to this effect in *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 at 249, per Cooke J are, it is submitted, too wide.

[20] Special leave to appeal to the High Court has apparently been filed.

[21] Although the litigation was not, in the end, against the directors for these breaches, but against the banks for 'knowing assistance' in the directors' breaches (in the UK, 'dishonest assistance'). In 2009, Owen J found against the banks, and awarded A$1.56 billion in equitable compensation. The Court of Appeal, by a 2:1 majority (Lee AJA and Drummond AJA, Carr AJA dissenting), upheld this award, increased by additional interest, damages and costs.

[22] See Lord Wedderburn, 'Employees, Partnership and Company Law?' (2002) 31 ILJ 99.

[23] These parts draw on contributions made earlier to *Palmer's Company Law Annotated Guide to the Companies Act 2006* (2007).

[24] See LS Sealy, '"Bona Fides" and "Proper Purposes" in Corporate Decisions?' (1989) 15 *Monash University Law Review* 265; S Worthington, 'Corporate Governance: Remedying and Ratifying Directors' Breaches?' (2000) 116 LQR 638.

[25] [1920] 1 Ch 77.

[26] (1968) 121 CLR 483, Aust HCt.

[27] (1972) 33 DLR (3d) 288.

[28] More accurately, voidable: see *Bamford v Bamford* **[4.32]**.

[29] (1953) 90 CLR 425 at 445, Aust HCt.

[30] But see P Finn, *Fiduciary Obligations* (1977), p 73, who contends that members' decisions should be subject to a similar test to those of the directors; also S Worthington, who advocates a proper purposes test (but not fiduciary duties) for all members' decisions: 'Corporate Governance: Remedying and Ratifying Directors' Breaches' (2000) 116 LQR 638.

[31] See the White Paper, *Company Law Reform* (Cm 6456, 2005), para 3.3; CLR, *Modern Company Law for a Competitive Economy: A Strategic Framework* (1999), para 5.

[32] Committee on Corporate Governance, *Final Report*, para 1.17.

[33] On this, see the 2012 Kay Review, noted at 'General issues', p 261.

[34] In the context of s 172(1)(b), also see the power to make provision for employees on cessation or transfer of business (s 247): s 247(2) states that this latter power 'is exercisable notwithstanding the general duty imposed by s 172'.

[35] [1896] 2 Ch 743.

[36] On nominee directors, see E Boros, 'The Duties of Nominee and Multiple Directors?' (1989) 10 *Company*

Lawyer 211 and (1990) 11 *Company Lawyer* 6; and P Crutchfield, 'Nominee Directors: The Law and Commercial Reality?' (1991) 12 *Company Lawyer* 136.

[37] The qualification is warranted, because Australian courts may be said to have led the way in developing the law on directors' negligence (see, eg, *Daniels v Anderson* at Note 2 in '"Reasonable" directors: keeping informed and delegating responsibilities', p 357), and yet have done so on the basis that their statutory provisions largely restate the common law, including the common law as stated by Romer J in *Re City Equitable Fire Insurance Co* **[7.19]**.

[38] There are arguments that the common law and equitable rules are different, and, perhaps more forcefully, that they are not: see fn 43.

[39] The action also sought to make the auditors liable, and on these issues went to the Court of Appeal; but the auditors too were held, having acted honestly, to be exonerated by the special provision in the company's articles.

[40] Such articles are now invalidated by statute: see CA 2006 ss 232 and 532, although auditors can limit their liability (ss 534–536): see 'Auditors' liability', pp 466ff.

[41] [1911] 1 Ch 425.

[42] Also see *Rolfe v Rolfe* [2010] EWHC 244 (Ch), extracted at Note 2 following *Re Duomatic* **[4.15]**, p 208, on the application of the *Duomatic* principle where there is a single shareholder.

[43] The controversial opinion of the majority of the court in this case, that directors' liability could be founded in the tort of negligence rather than as a breach of purely equitable obligations, is now academic in the UK, given the introduction of a statutory rule in s 174. The controversy persists in other forms, however: see the Questions following *Medforth v Blake* **[16.06]**.

[44] Also see *Weavering Macro Fixed Income Fund Ltd (In Liquidation) v Peterson and Ekstrom* FSD 113 of 2010 (Grand Court of the Cayman Islands).

[45] CA Riley, 'The Case for Non-Governing Directors in Not-For-Profit Companies?' (2010) 10 (1) *Journal of Corporate Law Studies* 119. See also SM Bainbridge, 'Why a Board? Group Decisionmaking in Corporate Governance?' (2002) 55 *Vanderbilt Law Review* 1.

[46] Also see R Nolan, 'Directors' Self-Interested Dealings: Liabilities and Remedies' [1999] *Company Financial and Insolvency Law Review* 235; J Lowry and R Edmunds, 'The Corporate Opportunity Doctrine: The Shifting Boundaries of the Duties and its Remedies?' (1998) 61 MLR 515; D Kershaw, 'Lost in Translation: Corporate Opportunities in Comparative Perspective?' (2005) 25 *Oxford Journal of Legal Studies* 603.

[47] [1896] AC 44 at 51.

[48] These cases are now dealt with by CA 2006 s 177, requiring only notification to the directors *before* the transaction takes place, but where there *is* a breach, it seems the statutory ratification rules in s 239 apply equally; the equitable difference has been abolished.

[49] [1902] AC 83, PC.

[50] Cf the discussion on promoters, 'Promoters and their dealings with the company', pp 481ff.

[51] (1913) 85 LJPC 167n.

[52] (1874) 9 Ch App 350.

[53] (1726) Sel Cas Ch 61.

[54] This approach, where the no profit rule is regarded as part of the no conflict rule, is evident in *Bray v Ford* [1896] AC 44 at 51–52, and *Boardman v Phipps* [1967] 2 AC 46 at 123. But other cases have regarded the two rules as distinct, although overlapping, so that a breach of the no profit rule cannot always be readily analysed as a conflict of duty and interest (see, eg, *Regal (Hastings) Ltd v Gulliver* **[7.23]**).

[55] But see the next extract, which declines to apply the rule in *Aas* in the context of companies and their directors: **[7.27]**.

[56] Note that this assertion relates to transactions *between* the company and its director (see CA 2006 ss 177 and 182), not to contracts between the director and third parties, and it is only the latter where the scope issue in relation to 'corporate opportunities' arises.

[57] See D Prentice and J Payne, 'The Corporate Opportunity Doctrine?' (2004) 120 LQR 198.

[58] *Foster Bryant Surveying Ltd v Bryant, Savernake Property Consultants Ltd* **[7.29]**.

[59] But note that in *CMS Dolphin Ltd v Simonet* [2001] 2 BCLC 704 at [91], Lawrence Collins J said that Laskin J's 'or' highlighted here was probably meant to be 'and'.

[60] See S Beck, 'The Saga of *Peso Silver Mines*: Corporate Opportunity Reconsidered?' (1971) 49 *Canadian Bar Review* 80; and, by the same author, 'The Quickening of the Fiduciary Obligation' (1975) 53 *Canadian Bar Review* 771.

[61] Bull JA was one of the majority judges in the court below (British Columbia Court of Appeal (1965) 56 DLR (2d) 117.)

[62] [1965] Ch 992, affd by the House of Lords [1967] 2 AC 46: see Note 1.

[63] Note that this means that the director need not necessarily be a party to the deal for the transaction or arrangement to be subject to this section.

[64] So, in practice, retaining the criminal sanctions imposed by the predecessor provision, CA 1985 s 317.

[65] That, at least, is clear from the separation of ss 177 and 182, which eliminates many of the early debates that surrounded CA 1985 s 317. These debates were finally resolved by recognising as quite separate the different requirements of s 317 and the equitable conflict rules: failure to comply with the disclosure obligations in s 317 constituted an offence; failure to make the disclosures required by the equitable rules (ie to the shareholders), as amended by the articles (often substituting the directors for the shareholders), rendered the offending contract voidable, not void: see *Hely-Hutchinson v Brayhead Ltd* [1968] 1 QB 549, CA **[3.09]**; and *Guinness plc v Saunders*, HL**[5.01]**.

[66] *York and North Midland Rly Co v Hudson* (1853) 16 Beav 485.

[67] (1726) Sel Cas Ch 61.

[68] (1747) 1 Ves Sen 9.

[69] See J Poole and A Keyser, 'Justifying Partial Rescission in English Law?' (2005) 121 LQR 273.

[70] CA 2006 does not spell out whether the remedies for breach of s 174 (duty to exercise reasonable care, skill and diligence) should be assessed on common law or equitable principles. Arguably it is the former, given the exclusion of s 174 in s 178(2). This would lay to rest the debates in that area (*Henderson v Merrett Syndicates Ltd*[1995] 2 AC 145; *Bristol & West Building Society v Mothew* [1998] Ch 1).

[71] Also see M Conaglen, 'Equitable Compensation for Breach of Fiduciary Dealing Rules?' (2003) 119 LQR 246; M Conaglen, 'The Nature and Function of Fiduciary Loyalty?' (2005) 121 LQR 452.

[72] *Warman International Ltd v Dwyer* (1995) 182 CLR 546, Aust HCt.

[73] As *Metropolitan Bank v Heiron* (1880) 5 Ex D 319, where a director who had received a bribe was regarded as only personally liable to pay the sum to the company.

[74] To similar effect, see Lewison LJ in *FHR European Ventures LLP v Mankarious* [2013] EWCA Civ 17 at [25].

[75] Although Lewison LJ and the Chancellor (Etherton LJ) put the case in Category 2, and Pill LJ in Category 1.

[76] And New Zealand, Singapore, the United States and Canada all favour the approach taken in *Reid* over that taken in *Lister/Sinclair*.

[77] [1911] AC 498.

[78] [1920] 1 Ch 46, CA.

[79] Dillon LJ qualified this in *West Mercia Safetywear Ltd v Dodd* (1988) 4 BCLC 30, by saying that these remarks only apply to a company which is solvent at the time.

[80] See, eg, *Re D'Jan of London Ltd* **[7.20]**; *Green v Walkling* [2007] All ER (D) 299.

[81] [1894] 1 Ch 616, CA.

[82] See S Elliott and C Mitchell, 'Remedies for Dishonest Assistance?' (2004) 67 MLR 16.

[83] (1874) 9 Ch App 244.

[84] This approach was explicitly endorsed in *Fiona Trust* [2010] EWHC 3199 (Comm) at [63]–[66].

8. Company Auditors and Promoters

Chapter: **(p. 463)** 8. Company Auditors and Promoters
Author(s): Len Sealy and Sarah Worthington
DOI: 10.1093/he/9780199676446.003.0008

Introduction

The previous chapter considered the liabilities of a company's directors to the company. This chapter fills out that picture. It examines the duties and liabilities of the company's auditors and its promoters. The duties of auditors derive from contract and tort. Promoters, too, may owe duties in contract and tort, but their more significant duties are imposed in equity, and map very closely the duties owed by the company's directors.

The issues addressed in this chapter also reinforce the notion of the company as a separate legal person (re-read 'Particular illustrations of a company's separate personality', p 79) and the special issues that arise because the artificial legal construct that is a company can only operate through human agents (see Chapters 2 and 3generally). The problems that arise in this context are especially acute in the context of 'one man companies' and their relationship with the fraudsters who might run them and the auditors and general creditors who might deal with them (see *Stone & Rolls Ltd (In Liquidation) v Moore Stephens* **[8.05]**). The temptation—which must be resisted—is to blur the distinctions between the company as a separate legal person and the individuals who are the company's agents (especially any fraudulent individuals who act as the company's 'directing mind and will'[1]).

Auditors and their relationship with the company

The company's directors are responsible for the company's statutory accounts and reports. But it has long been accepted that the reliability of these outputs will be enhanced if there is independent third party verification of both the documents and the corporate processes that deliver them. The company audit—conducted by the company's independent external auditor—is intended to provide this verification. All the rules and regulations associated with auditors and their conduct of the audit are designed to increase the value of the audit without imposing too high a cost on either the companies or their auditors.

General policy and regulatory issues

If the primary function of the audit is to provide independent verification, then auditor competence and independence are essential. The relatively recent collapses of companies such as Enron have highlighted the crucial importance of this issue. The Audit Directive (2006/43/EC), the Statutory Auditors Regulations (SI 2007/3494 and SI 2008/499) and the Companies **(p. 464)** Act 2006 (CA 2006) Pt 42 provide a regulatory framework in the UK to reinforce the market demands for auditor competence and independence. Public oversight used to be provided by the Professional Oversight Board (a subsidiary of the Financial Reporting Council (FRC)). Since 2 July 2012, following restructuring of the FRC, the Board no longer exists, its previous functions having been transferred to the Conduct Committee and the Conduct Division within the FRC itself. Despite much discussion, there is no blanket ban on the auditors also providing non-audit work to the company, but, especially given how lucrative this work is, there is a clear risk of conflicts of interest. This non-audit remuneration is therefore regulated in the same way as more general conflict situations (see CA 2006 Sch 10).

Secondly, the companies seen to be most at risk (or, more accurately, the companies seen to expose those dealing with them to greatest risks) need to have mandatory audits. Until recently, it was a statutory requirement that *every* company should appoint an auditor or auditors. However, three exceptions are now made (see CA 2006 s 475): for 'small' companies (s 477), for 'dormant companies' (s 480) and for non-profit-making companies

subject to public sector audit (s 482). These exemptions are not available to banking, insurance and certain other categories of company. In addition, a statutory audit must be held if members holding 10% or more of the share capital require one (s 476). There are conditions attached to all these provisions, so the Act needs to be read carefully. Of course, although CA 2006 does not require certain companies to undergo an audit, many do, so as to provide external assurance to their members, creditors or investors. With these voluntary audits, the company is free to choose the scale of audit to suit its purposes. The EU has recently followed suit; there are now proposed changes to Arts 43 and 43b, which will lift the auditing requirement for small undertakings.

Thirdly, the choice of individual auditor and the terms of their appointment can also ensure independence. CA 2006 lays down rules for the appointment of auditors (ss 485–494), their functions and duties (ss 495–509), their removal and resignation (ss 510–526; although note s 994(1A)—see the following paragraph) and their liability (ss 532–538). These rules give a degree of power to shareholders and to audit committees, and so go some way to giving further assurance that the appointed auditor is independent of the directors. Equally, giving power to the auditors to compel the company and its officers to comply with requests for information goes some way to enhancing the value of the audit.

The increasing importance of an independent and competent audit function is clearly reflected in the addition of s 994(1A) to the s 994 'unfair prejudice' provisions in CA 2006. Section 994(1A) deems the 'improper' removal[2] of an auditor to be unfairly prejudicial conduct, thus opening up the wide-ranging remedies for unfair prejudice to any disaffected member (on 'unfair prejudice', see 'Unfairly prejudicial conduct of the company's affairs', pp 681ff). This provision therefore effectively qualifies the general rule that auditors may be dismissed at any time by ordinary resolution of the shareholders, subject to the giving of special notice (ss 510 and 511).[3] Section 994(1A) purports to implement Art 37 of the Audit Directive 2006/43, which stipulates that auditors can only be removed for 'proper reasons'.[4]

Finally, imposing personal liability on auditors for failure to live up to the standards expected can also assist in raising the standards of the audit. On the other hand, imposing *too* much liability on auditors can have a chilling effect—good auditors are deterred; indeed, the larger the company, the larger the risk, and so it is these companies especially, companies where audits are especially valuable, that are likely to be left without competent auditors to oversee **(p. 465)** operations. After years of lobbying by auditors for changes to the law, new provisions have been introduced in CA 2006 ss 534ff that allow companies to agree to cap auditors' liability. The agreement cannot apply to more than one year's audit; it must be authorised by members (s 536 specifies the requirements); and it cannot limit liability to a sum that is less than what is 'fair and reasonable' (although the provisions of the Unfair Contract Terms Act 1977 ss 2(2) and 3(2)(a) do not apply). In the absence of such a power to contractually limit liability, and in the face of provisions such as CA 2006 s 532 making other arrangements void, the auditors had few options open to them to protect themselves against the risk of enormous claims (see *Caparo Industries plc v Dickman* **[8.04]**, and pp 472ff).

The European Commission has also been active in this area. It has recently proposed a new regulation imposing specific requirements on the statutory audit of Public-Interest Entities (PIE),[5] as well as several proposed amendments to the Directive.[6] These proposals are now before the European Council and the European Parliament. If adopted, the provisions governing PIEs currently contained in Directive 2006/43/EC (Arts 39–43) will be integrated into the new Regulation.[7] PIEs are defined as those entities which are of significant public interest because their businesses affect a wide range of stakeholders. The regulation of their statutory audit might therefore be expected to be most stringent.

In that vein, a number of features of the proposal merit highlighting. As mentioned earlier, there is currently no blanket ban on auditors also providing non-auditing work to their clients. However, as part of a chapter dealing with 'conflicts of interest', the proposals will prevent the provision of non-audit services which are 'fundamentally incompatible with the independent public-interest function of audit'. Auditors may provide 'related financial audit services', subject to the proviso that the fees for such services are limited to 10% of the audit fees paid by the company. Auditors may also continue providing 'other non-audit services that are not fundamentally incompatible with the audit services', subject to assessment and approval by the audit committee or the competent authority. Furthermore, former auditors, key audit partners or their employees are also prohibited from taking up a position within the audited entity which exposes them to conflicts with auditing checks (Chapter I, Title II).

Non-executive members are to be introduced to audit committees, and the regulation will introduce various measures for avoiding uninterrupted appointments of the same audit firm. For instance, there will be mandatory rotation of audit firms after a maximum six years (or, exceptionally, eight years), and where a PIE has two or more statutory auditors or audit firms, then the maximum length of engagement will be six years (or, exceptionally, 12 years). It is hoped that these amendments will address directly the problem of the 'threat of familiarity' (Title III, Chapter V).

Chapter III of Title II sets out the scope of the auditor's duties, and indicates that their role is to provide an opinion as to whether the financial statements give a true and fair view. Their role does not, for instance, include providing an assurance on the future viability of the audited entity, nor does it entail an assessment of the efficiency and effectiveness of management. In adopting this approach, these provisions reflect the court's approach in *Re London and General Bank (No 2)* **[8.01]**.

The proposals also introduce measures to govern the way member states regulate their auditors, and the way auditors operate internally. Title IV mandates each member state to have a designated competent authority for supervising auditors and audit firms auditing PIEs. It also requires auditors to demonstrate a higher degree of transparency, and in particular to **(p. 466)** disclose their financial information, their own corporate governance and matters related to fees (Chapter V).

Overall, the Commission is of the view that auditor self-regulation is not adequate and that auditors should be subjected to a uniform and harmonised framework within the Union, especially in relation to PIEs which often carry out cross-border activities.

The FRC itself is also consulting on possible changes to the UK Corporate Governance Code in relation to auditing committees and the way audits are conducted for all companies. In essence, their proposals embrace the following:[8]

- extending the remit of the audit committee to include consideration of the whole annual report, including the narrative report, with a view to determining whether it provides the information necessary for stakeholders to assess the performance and prospects of the company, and whether the annual report, viewed as a whole, is fair and balanced;
- requiring the audit committee to report to the board on this issue, and the board subsequently to publish this assessment in the annual report;
- requiring the audit committee also to report to the board, and in its own report in the annual report, on the issues considered in relation to the financial statements, including any key judgements that it made, and its assessment of the effectiveness of the external audit and the approach taken to the appointment or reappointment of the external auditor; and
- introducing a 'comply or explain' requirement for companies to put the external audit contract out to tender at least every ten years (which the FRC has subsequently decided should only apply to FTSE 350 companies in the first instance). The draft Guidance recommends that companies indicate their intention to put the audit out to tender in the previous annual report.

Auditors' liability

A company contemplating an audit invariably enters into a contract with the auditor for the provision of professional services. Then, like anyone who renders professional services for reward, the auditor will owe the company an implied contractual duty of care in the proper performance of the audit.

Auditors may also be liable in tort for negligent misstatement. This liability is potentially to any third parties to whom the auditors owe a duty of care. Here the courts have protected the auditors by adopting very restrictive approaches to the scope of the auditors' duty.

The standard of care to be exercised by auditors is illustrated by the cases beginning with *Re London & General Bank (No 2)* **[8.01]** which are cited later. But these cases (some of which are a century old) give only half the picture, for today it is the accountancy profession itself (through the Accounting Standards Board) which is largely

responsible for prescribing norms (through its *Financial Reporting Standards* ('FRSs')), for the preparation of company accounts and the duties of auditors in relation to them. Broadly speaking, auditors are unlikely to be held to be negligent if they have conformed to currently accepted professional practices. On the other hand, if they depart from them, this will be regarded as strong evidence of a breach of duty (*Lloyd Cheyham & Co Ltd v Littlejohn & Co* [1987] BCLC 303).

There can be little doubt that the standard of care required from auditors has progressively risen throughout the past century through the influence of the profession itself. CA 2006 also introduces criminal liability for auditors for knowingly or recklessly causing an auditors' report to include any matter that is misleading, false or deceptive in a material particular: s 507.

(p. 467) A rather more difficult question has been: to whom is the auditor's duty of care owed, for the purposes of civil liability? This has been largely resolved by the decision of the House of Lords in *Caparo Industries plc v Dickman* **[8.04]**, although some aspects of it still require clarification.

The reason why an auditor's duty of care is owed to the company, and not its individual members, appears from the case of *Equitable Life Assurance Society v Ernst and Young* [2003] EWCA Civ 1114: since the contract under which the work of a company's auditors is performed is with the company as a separate person, the auditors owe an implied *contractual duty of care* to the company in and about the manner in which they perform their services. Auditors *also* have general liability in tort for negligent misstatement under which individual members may be able to claim. The scope of that duty was defined in *Johnson v Gore Wood and Co* [2003] EWCA Civ 1728. It includes anything and everything which the company in general meeting could be expected to do on the strength of that auditors' report.

Finally, there is the vexed issue—at least for the company—of possible limitations on a company's right to sue its auditor for negligence when the auditor fails to detect a fraud that is being perpetrated by the company's own management: see *Stone & Rolls* **[8.05]**.

The following extracts illustrate the issues and the judicial reasoning in resolving them.

Auditors must exercise reasonable care and skill, and must certify to the members or shareholders only what they believe to be true.

[8.01] Re London and General Bank (No 2) [1895] 2 Ch 673 (Court of Appeal)

This was an appeal by Theobald, one of the bank's auditors, from a judgment in which Vaughan Williams J had held him liable to reimburse the company, now in liquidation, for the amount of certain dividends which had been paid out of capital after the shareholders had been presented with a balance sheet which Theobald had certified as correct. The appeal failed, except for a variation in the sum for which he was held liable. The main respect in which the accounts were defective was the entry of certain loans at their face value when it was known that most of the amounts were not realisable. It was held that none of the following matters absolved Theobald from liability: (i) that he had included in his report the words 'The value of the assets as shown on the balance sheet is dependent upon realisation'; (ii) that he had submitted a full report to the *directors* in which the gravity of the company's position was shown in detail; (iii) that the report (to the *directors*) had initially expressed the view that no dividend should be paid, but the chairman later persuaded the auditors to delete the sentence; and (iv) that the chairman had undertaken to explain the true position verbally to the shareholders in general meeting. (In fact, he had done so only in ambiguous terms.)

> LINDLEY LJ: It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question, How is he to ascertain that position? The answer is, By examining the books of the

company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the **(p. 468)** books themselves show the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor has to certify that the balance-sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company … An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance-sheet is accurate according to the books of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor: he must be honest—ie must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe businessmen select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required. Mr Theobald's evidence satisfies me that he took the same view as myself of his duty in investigating the company's books and preparing his balance-sheet. He checked the cash, examined vouchers for payments, saw that the bills and securities entered in the books were held by the bank, took reasonable care to ascertain their value, and in one case obtained a solicitor's opinion on the validity of an equitable charge. I see no trace whatever of any failure by him in the performance of this part of his duty. It is satisfactory to find that the legal standard of duty is not too high for business purposes and is recognised as correct by businessmen. The balance-sheet and certificate of February 1892 (ie for the year 1891) was accompanied by a report to the directors of the bank. Taking the balance-sheet, the certificate and report together, Mr Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders Mr Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders …

In this case I have no hesitation in saying that Mr Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance-sheet of February 1892 without any reference to the report which he laid before the directors and with no other warning than is conveyed by the words 'The value of the assets as shown on the balance-sheet is dependent upon realisation'. [His Lordship referred to the details of the balance sheet, and to the report made to the directors, including the warning that no dividend should be paid, and continued:] A dividend of 7% was, nevertheless, recommended by the directors, and was resolved upon by the shareholders at a meeting furnished with the balance-sheet and profit and loss account certified by the auditors, and at which meeting the auditors were present, but silent. Not a word was said to inform the shareholders of the true state of affairs. It is idle to say that these accounts are so remotely connected with the payment of the dividend as to render the auditors legally irresponsible for such payment. The balance-sheet and account certified by the auditors, and showing a profit available for dividend, were, in my judgment, not the remote but the real operating cause of the resolution for the payment of the dividend which the directors improperly recommended. The auditors' account and certificate gave weight to this recommendation, and rendered it acceptable to the meeting

…

RIGBY LJ delivered a concurring judgment.

LOPES LJ concurred.

(p. 469) ***It is not part of the duty of auditors to repeat work already undertaken internally: in the absence of***

suspicion, auditors may rely on the assurances of a manager or other apparently responsible employee.

[8.02] Re Kingston Cotton Mill Co (No 2) [1896] 2 Ch 279 (Court of Appeal)

The facts appear from the judgment.

> LOPES LJ: [In] determining whether any misfeasance or breach of duty has been committed, it is essential to consider what the duties of an auditor are. They are very fully described in *Re London and General Bank* **[8.01]**, to which judgment I was a party. Shortly they may be stated thus: It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. 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.
>
> In the present case the accounts of the company had been for years falsified by the managing director, Jackson … Jackson deliberately overstated the quantities and values of the cotton and yarn in the company’s mills. He did this for many years. It was proved that there is a great wastage in converting yarn into cotton, and the fluctuations of the market in the prices of cotton and yarn are exceptionally great. Jackson had been so successful in falsifying the accounts that what he had done was never detected or even suspected by the directors. The auditors adopted the entries of Jackson and inserted them in the balance-sheet as ‘per manager’s certificate’. It is not suggested but that the auditors acted honestly and honestly believed in the accuracy and reliability of Jackson. But it is said that they ought not to have trusted the figures of Jackson, but should have further investigated the matter. Jackson was a trusted officer of the company in whom the directors had every confidence; there was nothing on the face of the accounts to excite suspicion, and I cannot see how in the circumstances of the case it can be successfully contended that the auditors are wanting in skill, care or caution in not testing Jackson’s figures.
>
> It is not the duty of an auditor to take stock; he is not a stock expert, there are many matters in respect of which he must rely on the honesty and accuracy of others. He does not guarantee the discovery of all fraud. I think the auditors were justified in this case in relying on the honesty and accuracy of Jackson, and were not called upon to make further investigation …
>
> LINDLEY and KAY LJJ delivered concurring judgments.

➢ Question

How can this approach be reconciled with the ‘verification’ function of auditors?

An auditor who has been, or ought to have been, put on inquiry is under a duty to make an exhaustive investigation.

[8.03] Re Gerrard & Son Ltd [1968] Ch 455 (Chancery Division)

The company’s managing director, Croston, had caused the company’s books to be falsified in three ways: (i) by altering the half-yearly stocktaking figures so as to include non-existent stock; (ii) by altering invoices relating to

purchases of stock so that the amounts payable were **(p. 470)** made to appear just *after*, instead of just *before*, the half-yearly 'cut off' date; and (iii) (the converse of (ii)) by advancing *into* the half-yearly period sums due in respect of goods sold which were in fact invoiced *after* the 'cut-off' date. The auditors ('Kevans') had accepted the explanations given by Croston and his brother-in-law Heyes (now deceased) regarding the altered invoices. The court held that Kevans had been negligent in relation to (ii) and (without any finding in relation to (i) and (iii)) held them liable to the company's liquidator in respect of dividends which the company had wrongly paid on the strength of the false accounts.

[PENNYCUICK J referred to *Re Kingston Cotton Mill Co (No 2)* **[8.02]** and continued:] This case appears, at any rate at first sight, to be conclusive in favour of Kevans as regards the falsification of the stock taken in isolation. Mr Walton, for the liquidator, pointed out that before 1900 there was no statutory provision corresponding to section 162 of the Companies Act 1948 [CA 2006 s 498]. That is so, but I am not clear that the quality of the auditor's duty has changed in any relevant respect since 1896. Basically that duty has always been to audit the company's accounts with reasonable care and skill. The real ground on which *Re Kingston Cotton Mill Co (No 2)* is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896. I see considerable force in this contention. It must, I think, be open, even in this court, to make a finding that in all the particular circumstances the auditors have been in breach of their duty in relation to stock. On the other hand, if this breach of duty stood alone and the facts were more or less the same as those in *Re Kingston Cotton Mill Co (No 2)*, this court would, I think, be very chary indeed of reaching a conclusion different from that reached by the Court of Appeal in *Re Kingston Cotton Mill Co (No 2)* …

I find it impossible to acquit Kevans of negligence as regards purchases of stock before the end of each current period of account and the attribution of the price to the succeeding period of account. I will assume in their favour that Mr Nightingale [a partner in Kevans] was entitled to rely on the assurances of Mr Heyes and Mr Croston until he first came upon the altered invoices, but once these were discovered he was clearly put upon inquiry and I do not think he was then entitled to rest content with the assurances of Mr Croston and Mr Heyes, however implicitly he may have trusted Mr Croston. I find the conclusion inescapable alike on the expert evidence and as a matter of business common sense that at this stage he ought to have taken steps on the lines indicated by Mr Macnamara [an expert witness], that is to say, he should have examined the suppliers' statements and where necessary have communicated with the suppliers. Having ascertained the precise facts so far as it was possible for him to do so, he should then have informed the board. It may be that the board would then have taken some action. But whatever the board did he should in each subsequent audit have made such checks and inquiries as would have ensured that any misattribution in the cut-off procedure was detected. He did not take any of these steps. I am bound to conclude that he failed in his duty.

[His Lordship accordingly held the auditors liable for the amount of the dividends wrongly paid.]

The auditors of a company owe no duty of care either to members of the public who rely on the accounts in deciding whether to invest in the company's shares, or to existing members of the company who may also rely on the accounts for the purpose of decisions in relation to present or future investment in the company.

[8.04] Caparo Industries plc v Dickman [1990] 2 AC 605 (House of Lords)

Touche Ross & Co had audited the 1983–84 accounts of Fidelity plc, a listed company, which showed a pre-tax profit of £1.3 million. Both before and after the publication of these accounts, Caparo bought Fidelity shares in the market, and subsequently it made a takeover bid, as a result of which it acquired all the shares. In these proceedings Caparo alleged that it had paid too much for the shares because the trading figures should have shown a loss of £0.4 million **(p. 471)** instead of a profit, and claimed damages from the auditors on the ground that they had been negligent in certifying that the accounts showed a true and fair view of Fidelity's financial position. The House of Lords, reversing in part the judgment of the Court of Appeal, held that the auditors owed