Daniels V Anderson : Its Applications of Contributory Negligence on Auditors' Duty of Care in Malaysia

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ABSTRACT

As Malaysia gears towards a developed nation by year 2020, we have to prepare ourselves to face and overcome various challenges and complexities, and especially for the businesses to survive. We need to identify a required standard of accountability and liability of auditors, hoping to see a higher degree of social responsibility from auditors. There has been considerable development of the common law principles regarding auditors' liabilities in recent years. The apportionment of damages for contributory negligence which may be caused by concurrent but independent acts or omissions of two or more parties resulting in a loss suffered by the company will fairly and justly hold every party responsible and liable according to the damage caused by them. Due to these, we need to identify and legislate, if needed, new provisions and use new approaches relevant to this present era to cater for current environment. One of the consideration is to adopt the concept of contributory negligence and the subsequent application of apportionment of liabilities among the company, management and auditors upon any losses resulted from negligence cause by these parties.

Keywords : standard of accountability, liability of auditors, contributory negligence, apportionment of liabilities

iNTRODUCTION

The auditors form a significant part of the overall mechanism for the protection of the public especially shareholders and the corporate governance process[2]. They have an important statutory function which establishes them as a kind of independent checking mechanism. Audit serves as a reasonable assurance as to the truth and fairness of a companyôs financial information and enhances the reliability of accounts verified by the independent third party. In Malaysia, the laws governing audit and auditors are the Companies Acts 1965, the provisions of the Listing Requirements of the Stock Exchange and the By-laws (on professional conduct and ethics) issued by the Malaysian Institute of Accountants.[3]

The objective of an audit is best summed up as follows :

[2] Ben Pettet, *Company Law*, Longman Law Series, 2001, page 203
[3] Corporate Law Reform Committee for the Companies Commission of Malaysia, A Consultative Document (No 12), *Auditors' Roles and Responsibilities*, December 2007, page 19

> It has been pointed out that the principal object of an audit is to examine and report an opinion upon the periodical financial statements. There are two other ancillary objects, that is to detect errors and to detect fraud.[4]

Thus, the main objective of an audit are to certify the correctness of the financial position of the company, the detection of errors and the detection of frauds. Section 174 of the Companies Act 1965 (CA 1965) requires the auditors to make a report to the companyôs members on all annual accounts of the company of which copies are to be laid before the company in general meeting during their tenure of office

RESEARCH FRAMEWORK

This research will focus on the applications of the concept of contributory negligence to the duty of care of auditors as expected to be accountable from the role and powers of auditors in discharging their duties based on current Companies Acts 1965 vested on the auditors. The research will analyse the factors relating to the weaknesses and ineffectiveness of carrying out the duty of care by the auditors based on the present statute especially the Companies Act 1965.

We will extract the rationale of the ruling in Daniels v Anderson and how it can apply to our local context. Two main areas will be dealt with at length, that is the question of how to determine whether the auditors too may be contributorily liable, and how to measure the apportionment of damages that is caused by an interested party if it involves multiple parties. At the same time, it will look into Caparo case and do a comparative study of its ruling against that of Daniels v Anderson, which is considered a more recent case and the ruling is binding to our Malaysian courts.

SCOPE OF DUTY OF CARE

An auditor is expected to use reasonable care and skill in carrying out the audit and in forming an opinion on the companyôs accounts. A failure to use reasonable care and skill renders an auditor liable to the company in damages for breach of contract. In Pacific Acceptance Corp Ltd v Forsyth[5], Moffit J. stated :

> It is beyond question that when an auditor, professing as he does to possess the requisite professional skills, enters into a contract to perform certain tasks as auditor, he promises to perform such tasks using that degree of skill and care as is reasonable in the circumstances as they then exist.

The courtsô view of the appropriate standard of care and skill which an auditor must use has changed over time. In Re Kingston Cotton Mill Co[6], the auditors failed to detect certain frauds perpetrated by the companyôs director and the audited accounts showed profits and consequently dividends were paid. Had the values of stocks been properly determined, the discrepancy would have been apparent. An action was brought against the auditors seeking to recover the loss caused by the wrongful payment of dividends. The auditors were held not to be in breach of duty. The standard of care did not require them to take stock, and were

[4] Irish, R, *Auditing*, 4th Edition, 1982, page 4
[5] (1970) 92 W.N. (N.S.W.) 29
[6] (No. 2) [1896] 2 Ch. 279

allowed to rely on the managerôs certificates as there were no grounds for suspicion and the manager was regarded as a man of good character and trustworthy.

The standard of care and skill now expected from auditors is more exacting, as the publicôs expectations on the competencies of auditors grow. While the legal principle that the auditor must use reasonable degree of care still applies today, the standards of reasonableness depend on the circumstances and are affected by the changed expectations, resulting in a higher standard of care and skill now applied than was in the past.

DUTY OF CARE AND LIABILITIES

The courtôs view of standard of care of auditors has evolved and changed over time. What is a reasonable care depends on the particular circumstances of each case. Auditors face various liabilities to different parties in the course of performing their functions. Liabilities may arise from the law of contract or tort, or fundamental common law duty, or statutory duties, or even strangers who claimed to rely on auditorsô reports which resulted an incurrence of losses in certain transactions made. Besides, auditors too have to abide to rules and procedures set up by the professional body like the Malaysian Institute of Accountants. Generally the various heads of liabilities are as follows :

- liability to the company from contracted duties
- liabilities to shareholders or the company due to failure of auditors to exercise a reasonable standard of care in doing their work.
- liability to Registrar of Companies, the company or shareholders due to or default or negligence in performing the statutory duties under the Companies Act 1965

The requirements to test and determine whether a duty of care of auditors exists are based on these basic elements :

- foreseeability of harm or loss ;
- proximity ; and
- whether imposition of a duty is just and reasonable.

PRINCIPLES IN DANIELS V ANDERSON (1995) 13 ACLC 614

Fact of the case

AWA Ltd, a large listed company, engaged in foreign exchange dealings to hedge against its potential losses caused by foreign currency fluctuations[7]. An employee, Koval, managed these dealings. AWAôs senior executives did not put in place adequate internal controls to monitor Kovalôs activities, nor were proper record kept. During 1986 and 1987, Kovalôs unsupervised activities generated large losses. For a time, Koval was able to conceal this from his superiors by unauthorized foreign currency borrowings from a number of banks.

During this time AWAôs auditors, Deloitte Haskins & Sells, carried out two audits. Daniels, the audit partner, warned AWA management of the inadequacies of the internal controls. However, notwithstanding the fact that Daniels knew that the management had not acted on his warning, he failed to inform AWAôs board of directors of the full extent of the

[7] Shanty, Rachagan, Jamine Pascoe, *Concise Principles of Company Law in Malaysia*, Malayan Law Journal, 2004, p.302

inadequacies of the internal controls and accounting records. Instead, in December 1986, he wrote a letter to the board suggesting improvements to the companyôs internal audit procedures without specifically mentioning the problems with the foreign exchange operations or stressing the urgency of the matter. The board did not become aware of the full extent of Kovalôs foreign exchange dealings and the unauthorized loans until the end of March 1987.

AWA sued its auditors for negligence. The auditors claimed contributory negligence on the part of AWA and instituted a cross-claim against the directors seeking contribution. The auditors alleged that AWAôs directors had been negligent. The New South Wales Court of Appeal held that the auditors were negligent but that AWAôs contributory negligence arose because both its senior executives and chief executive officer were held to have been negligent and this was attributed to AWA. The court held that AWAôs non-executive directors did not breach their duty of care because of the fact that they made inquiries and requested information about the foreign exchange dealings from senior management and the auditor, but the full details were concealed from them.

Hooke, AWAôs chairman and chief executive officer, was in a different position. He breached his duty to act with reasonable care because he failed to make inquiries of senior management which would have led to a better appreciation of the risks and dangers of the foreign exchange dealings. As the companyôs chief executive officer, he was under a continuing obligation to supervise management and seek satisfactory explanations regarding the deficiencies of the foreign exchange trading system and procedures.

Determinations of Contributory Negligence

> This judgment concerned the apportionment of liability between AWA and its auditors, and dealt with the claim by the auditors for contribution from Hooke.
>
> **Two further issues were raised by the auditors.**
>
> **First**, it was submitted by the auditors that the statutory duty in s 286 of the Companies Code 1981[8] requiring them to state in their report their opinion as to whether proper accounting records had been kept, and with which they had failed to comply, was only a regulatory provision and did not give rise to a cause of action at the suit of a private litigant.
>
> **Second**, the auditors submitted that where there is a claim for economic loss, arising from a breach of statutory duty, contributory negligence provided an absolute defence.
>
> Held : Decision of court was as follows **:** finding the auditors liable for 80% of the loss, AWA liable for 20% of the loss and Hooke liable to contribute 10% of the 80% of the loss for which the auditors were responsible.

Principles in Contributory Negligence

Contributory negligence is a common law defense to a claim based on negligence, an action in tort. It applies to cases where plaintiffs have, through their own negligence,

[8] Companies Code (NSW) 1981

contributed to cause the damages they incurred as a result of defendants' negligence. For example, a pedestrian crosses a road carelessly and is hit by a driver who is also driving carelessly. Contributory negligence is distinguishable from contribution, which is a claim brought by one or more defendants seeking to have a third party pay some or all of any money damages awarded to a plaintiff.

At common law, contributory negligence was originally an absolute defence. If a defendant successfully raised the defense, he would be able to avoid liability for the tort completely. This could lead to injustice where the negligence of a plaintiff or claimant was slight. The defense of contributory negligence would prevent them from recovering any damages at all.

CONCLUSIONS

In Daniels v Anderson, there is the question of contributory negligence, or in other words, shared responsibility for the companyôs loss. The auditor is not to be blamed for the shortcomings of management which may cause a company to lose money. The auditorôs fault lies in not alerting the board in time so that remedial measures may be taken. To establish the auditorôs liability, three things[9] must be shown :

i. that because of the auditorôs negligence, the company lost the opportunity to avoid or mitigate the damage it suffered

ii. that the company would have availed itself of the opportunity if it had been able to do so

iii. that the lost opportunity had an economic value.

Another issue is in relation to contributory negligence where the auditors claim that the failure of the company directors and employees to cooperate contributed to their breach of duty. In Daniels v Anderson[10] the company sued its auditors for negligence and they in turn argued that there was contributory negligence on the part of the directors of the company. The Court of Appeal held that the auditors were negligent but there was contributory negligence on the part of the company due to the conduct of the chief executive officer and the senior executives.

PRINCIPLES USED IN CAPARO INDUSTRIES PLC V DICKMAN [1990] 2 WLR 358

Facts of The Case

Caparo was a shareholder in Fidelity Plc and made a successful takeover bid for Fidelity Plc soon after Fidelityôs audited accounts were issued reporting a profit. Caparo sued Fidelityôs auditors, Touche Ross & Co, for negligent misstatement alleging that in fact Fidelity had suffered a loss and had this been known it would not have made its bid. Caparo argued that Fidelityôs auditors owed him a duty of care as a shareholder and an investor. The issue before the court was whether the auditor owed a duty of care to Caparo in this circumstance. The House of Lords held that auditors owe a duty of care to shareholders as a

[9] Woon, Walter, Company Law, Sweet & Maxwell Asia, 2nd Edition, 1997,p.397
[10] (1995) 13 ACLC 614

body. As such, auditors do not owe a duty of care to individual shareholders such as Caparo. Lord Jauncey of Tullichettle[11] said in the Caparo ruling:
ñSince I have concluded that the auditor owed no duty to an individual shareholder, it follows that this argument must also failé .ò

Principles in Caparo

The statutory duty owed by auditors to shareholders is a duty owed to them as a body. The Companies Act 1985[12] imposes a duty to shareholders as a class and the duty should not extend to an individual save as a member of the class in respect of some class activity. The auditors owe no duty of care to individual members of a company. The auditorôs duty is owed to members as a body and that right can be enforced by the company. In Caparo case, the House of Lords unanimously held that auditors owed no duty of care to shareholders or potential investors.[13]

COMPARATIVE STUDIES BETWEEN DANIELS AND CAPARO

In Daniels v Anderson, we note that a company can be held to share responsibility for any loss which is caused by the activities of its employee, by its management and/or by its board of directors. Contributory negligence applies when any party suffers loss as a result partly of his own fault or negligence and partly of the fault or negligence of other parties, the loss to be reduced to an amount deemed to be just and equitable taking into consideration each partyôs share in the responsibility for the loss. Daniels v Anderson involves all parties with fiduciary relationship. This case also touches on the apportionment of liabilities between the parties involved to the loss incurred by the company.

In Caparo, we observe that a legal claim was from a stranger, that is an investor, who has no contractual relationship. The loss incurred was upon the investor and not the company. Judgement on this case strongly stated that auditors owed no duty to investor or individual shareholders, and at the same time require the necessity to establish óproximityô to consider duty of care and liability of auditors.

RECOMMENDATIONS

1) I agree with the Corporate Law Reform Committeeôs view[14] that consideration should begiven to the establishment of an independent Auditing Oversight Body. This body would have some features similar to that of the Public Company Accounting Oversight Body of the US. The members of this body should comprise persons other than members from the professional accounting bodies such as regulators, investor associations and industry associations, to ensure that public interest will be adequately represented in this body. This body will co-exist with professional accounting bodies which would be responsible for the professional functions of the audit profession. With this, it will warrant auditors to adhere to a new level of corporate governance[15]. Our government is continuously seeking to ensure high quality and standards among

[11] Shepherd, Chris, *Company Law*, Old Bailey Press, @nd Edition, 2002, page 75
[12] Companies Act 1985 (UK)
[13] [1990] 2 WLR 358
[14] Corporate Law Reform Committee for the Companies Commission of Malaysia, A Consultative Document (No 12), *Auditors' Roles and Responsibilities*, December 2007, p.15
[15] Starbiz, 24 Sept 2007, p. B14

industry players and Deputy Finance Minister II Datuk Dr Awang Adek Hussin had this to say :
`...In light of the recent issues that have emerged, the auditing industry may wish to consider the feasibility of setting uo an oversight body that would ensure that quality and standards of the industry players are preserved at high levels..ò[16]

2) Consideration should be given to the insertion of contributory negligence arising out of the conduct of the auditors, directors or/and management of a company as an additional provision in the Companies Act 1965 and also to stipulate the quantum of claims based on apportionment of liabilities of each party/parties to cover the loss incurred by the company. This proposal is to ensure that public interest will always be adequately protected and any negligence has to come with a price. This will ultimately alleviate the indifference attitude and at the same time maintain a high quality assurance by the auditors, which is deemed to be a cornerstone for good corporate governance.

3) To adopt the ruling of Caparo in determining whether a duty of care exists through establishing three essential requirements-
   - to establish óproximityô between vested parties
   - it should be fair, just and reasonable
   - there should be a duty on one party for the benefit for the other

   With this, we do not assume that supposedly auditors do not owe a duty of care to individual shareholder or any third party. Rather we need to consider the causation and damage, and identify through various tests, if needed to determine a duty of care on a case per case basis.

4) To recommend the rotation requirements of auditors after a certain numbers of succesive years in one particular company so as to ensure independence of auditors are not easily compromised.

5) To improve the regulatory mechanism of Malaysian Institute of Accountants so as to enforce the standards of ethics expected of auditors by means of certain set prosedure for disciplining its members who do not conform.

CONCLUSION

This paper describes how auditors can become liable for contributory negligence and the amount of damage is generally related to its causation. In Malaysia, up to today, we still have to rely on the Civil Law Act 1956 as there is no other local statute that enables this application. The Civil Law Act 1956 section 12(1) allows the apportionment of damages in actions for the tort of negligence in cases where the plaintiff or some third party has contributed to the loss.

The loss of an opportunity to prevent any damage of the company is avoidable if in the first place the company quickly takes steps to rectify the weaknesses once it is known to them. In this instance, is it fair to put the blame on the auditor for the companyôs loss which was actually caused by the inaction of the company itself to prevent this loss? In Daniels v

[16] The New Straits Times, Sept 2007,p.58

Anderson case, the question was to establish whether the directors would have taken steps to avoid the losses if AWA was informed of the situation. The court assumed that the directors would have taken ófairly dramatic steps to put the Foreign Exchange operation on a proper basisò had they been alerted earlier. This assumption is questionable and could not be proven in any way.

Contributory negligence represents one of the legal mechanisms that have been developed to ensure auditors are liable for torts or other civil wrongs, and even can enable the auditors to claim contributory negligence on the part of the company and institute a cross-claim against the directors seeking their fair share of contribution due to their negligence too. The approach to determine the amount of damage on each party is based on the apportionment of liabilities upon any losses incurred by the company resulted from the negligence caused by them.

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