

THE STATUTORY AUDIT – UNDERSTANDING THE LEGAL DUTIES AND RESPONSIBILITIES OF THE AUDITOR - Part I

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Abstract

The objective of this paper is to discuss, in a holistic manner, the legal duties and responsibilities of the statutory auditor (accountant). The headline on accounting failures of the early twenty-first century involving Enron, WorldCom, Adeptia, Tyco, and many others is reason enough to study in depth the core legal duties, responsibilities, and liabilities of the Statutory Auditor. The Auditors' legal liabilities in most countries can be categorized under the following headings: liability under legislation (either civil or criminal) and liability arising from negligence under common law.

Accountants have historically played an important role in the detection and deterrence of fraud; but fraud is much more than numbers. It involves complex human behaviours such as greed and deception factors that are difficult to identify and quantify. Unfortunately, the duties and responsibilities of statutory auditors have become the subject of interest to the investor community in the light of the spate of corporate collapses in recent years. These scandals have widened the expectation gap of the public about accountants. Their integrity has been truly dented. The calls for tighter controls over the profession are being spearheaded by President George Bush of the USA.

The profession is indeed in a quagmire. There is the need for swift remedial action to redeem its image. Sadly, not many people (even the educated) understand the core legal duties, responsibilities, and liabilities of the statutory auditor. This paper is an attempt to draw on decided cases in the United Kingdom (since there are very few or no decided cases in Ghana) to explain the legal duties, responsibilities, and liabilities of the statutory auditor. Again, because of Ghana's colonial history, it is an undisputed fact that Ghana's political, economic, legal, business, and educational systems are largely structured and

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Testing can show the presence of errors, but not their absence. - E. Dijkstra

based on the British system. This is evidenced in the extensive use of British cases as precedents in Ghana's law courts.

This article is in two parts. Part II will follow in the next issue of the Journal.

The Auditor's Duty of Care

Introduction

Auditing involves the conduct of independent examination of the firm's accounting related records. The audit exercise involves the use of generally accepted auditing standards to gather sufficient competent evidential matter in an effort to issue an opinion on the "true and fair" nature or otherwise of the audited financial statements. The "opinion" is contained in the Audit Report on the audited financial statements.

A Chartered Accountant within the meaning of the Institute of Chartered Accountants 1963 (Act 170) of Ghana and appointed as auditor under the (Ghana) Companies Code 1963 (Act 179) is said to be a statutory auditor (an independent accountant).

Section 124 of the (Ghana) Companies Code 1963 (Act 179) requires directors of a company to ensure the preparation and furnishing of shareholders and debenture holders, at least once a year, with a profit and loss account and balance sheet, directors' report, and an auditor's report. The company will not be deemed to be keeping proper books of accounts if it does not keep such books as are necessary to give a "true and fair view" of the company's affairs. Under section 133 of the Companies Code, the auditor's report should contain statements on the matters mentioned in the Fifth Schedule. Paragraph 4 of the Fifth Schedule obliges the auditors to state whether, in their opinion the balance sheet, and the profit and loss account prepared by management present "a true and fair view" of the financial state of the company. Post 1963 financial accounting requirements have added cash flow statement to the above requirement.

A certified copy of the company's balance sheet,

profit and loss account, and the auditors' report, inter alia, is to accompany the annual return of the company. The annual report and other documents registered with the Registrar of Companies are available for inspection by the public or any person who wishes to do so upon the payment of the requisite fee.

In their statutory role, under section 136 of the Companies Code 1963 (Act 179), auditors stand in a fiduciary relationship to the members of the company as a whole. They are required to act in such a manner as faithful, diligent, careful, and ordinarily skilful auditors would act in the circumstances.

The Expectation Gap Conundrum (The Image of Statutory Auditors)

Fraud has always been a major concern to the accountancy profession and businesses. However, it has never been more so than today. Fraud and the crimes that it finances, including mass terrorism is receiving unprecedented worldwide attention now.

From being widely viewed by the public as a victimless, white-collar crime of relatively little importance, fraud is now seen for what it is – a disease that can ruin lives, destroy even multinational companies, damage investor confidence, and destabilize society. Fraud is a disease that has to be prevented and, where found, totally eradicated.

As must be expected and like all other professions, accounting practitioners are always seen glorifying the image and the practice of auditing. However, the truth is that some cases of willful deceit, and criminal negligence or recklessness on the part of some statutory auditors have led to several instances of celebrated massive frauds such as the famous "South Sea Bubble". In this case, the prospectus of a company was painted in terms more flowery words or much than the circumstances genuinely justified. This scandal immediately drew the attention of the profession to the need for some form of control. In view of the many scandals and fraud cases, the accountancy profession started by breaking new grounds in

relation to the in-depth assessment of the legal liability of the statutory auditor. It started to seek legal advice to address the possible liabilities for negligence under the common law i.e. general liability and/or liability to third parties; statutory liability i.e. civil and/or criminal; and reliance on information from third parties.

The accountancy profession then commenced the issuance and enforcement of Regulatory Measures in Accounting Standards, Auditing Standards' Recommended Practices, etc. All of these are with the view to measuring the performance of practitioners with standards the profession has set itself for the proper and competent conduct of their professional duty.

The celebrated or classic case of *Re Kingston Cotton Mills Limited (1896)* and *Re London and General Bank (1895)* advise that what is reasonable skill and care in any particular case depend on the circumstances of the case. This was vividly echoed by judge Lopez in the *Re Kingston Cotton Mills limited* case. He stated that: – "Auditors (the practitioners of the profession) are not 'grey hounds' but are mere 'watch dogs', however, if anything arouses their suspicion, they should probe it to the bottom." This indeed is the test of reasonable care and skill which unfortunately is not described in any statute. However, by implication, it is accepted as the "auditor's duty to perform the work required of him by statute and any additional work required by the client. It is also accepted by the accountant as part of his brief, with the skill and care that a reasonably competent accountant will employ" (Solicitor Michael Pugh).

Today, at every august programme or ceremony organized by accountants, the key speakers continue to appeal to accountants to redeem their image – the corrupt image that has bedeviled the accountancy profession, especially in the year 2002 – "the SCANDALOUS 2002". Indeed, the year 2002 will go down in history as accountants' "tumultuous and scandalous year" – "The accountancy profession's annus horribilis."

The Enron collapse, the WorldCom fiasco, the Mytravel accounting scandal, the Pamalat saga and many more were terrible corporate frauds and

failures with professional accountants in the centre of all of these scandals and corporate failures.

In Ghana, on a daily basis, there are shocking revelations of corruption in low and high places everywhere. All the instances of corruption are usually blamed on accountants. The managers of the economy and business of the country have become highly involved in corruption. The question that we want to pose now is whether or not all the scandals and corrupt practices can be rightly blamed on the statutory auditor.

The answer is 'Yes' and 'No'. We can conveniently say that 'Yes', there are some bad nuts – indeed morally bankrupt and corrupt statutory auditors in the system. On the other hand, we can say 'No', because there are equally very good and sharp statutory auditors in Ghana. These auditors have upheld the moral tenets of the profession. They exercise reasonable due care and skill, honesty, integrity, independence, and accountability in the discharge of their duties.

The sour point is that in Ghana, sound corporate governance exists only in very few registered companies. These are mostly the foreign or multinational companies operating in the country. It is said that a sound understanding of good corporate governance – organisational transparency, disclosure, and accountability – is essential for maximising an organisation's performance and enhancing its reputation and system of controls.

Statutory Auditors' Rights and Duties

For the purpose of performing their roles, auditors are accorded certain rights. The first pertains to unimpeded access to all information. Thus, they have a right of access at all times to the company's books, accounts, vouchers and other documents relevant to their work. They may require from the company's officers such information and explanations as they think necessary and relevant for the performance of their duties as auditors. An officer, who provides misleading information exposes himself to criminal penalties. Auditors also have the legal right to receive notices and other communications relating to any general meeting,

to attend that meeting, and to be heard on any part of the business, which concerns them as auditors.

The auditor therefore plays important roles in modern corporate governance by providing a critical service of independent monitoring of the financial state of the company. The audit is a pragmatic process by which accountability of directors to shareholders can be guaranteed.

"In determining whether an auditor has fulfilled his duty, the courts rely on the accepted auditing standards to decide whether there has been a breach of duty" (Woolf, J., 1987). In *Lloyd Cheyham & Co Ltd v Littlejohn & CO* (1987), the plaintiff bought a 50% shareholding in a company. The decision to invest was largely influenced by the audited accounts of the company, which were audited by the defendants. The defendants knew that the accounts would be relied on by the plaintiffs in their assessment of the prospects of the company. The company wound up shortly after the plaintiffs' investment. Plaintiffs sued the defendants for breach of duty. The court held that, in determining whether there was a breach of duty "compliance or non-compliance by the auditor with the relevant professional standards was a key issue."

The Ghana National Auditing Standards (GNAS) issued by the Institute of Chartered Accountants (Ghana) (2001), states on page 9 that:

"Auditors who do not comply with Auditing Standards when performing company audit and other audits in Ghana make themselves liable to regulatory action by the professional standards and Ethics Committee which may include the withdrawal of registration, and hence eligibility to perform company audits. All Committee pronouncements and, in particular, Auditing Standards are likely to be taken into account when the adequacy of the work of auditors is being considered in a court of law or in other contested situation."

The rationale for the company audit was explained as follows by Lord Oliver in *Caparo Industries Plc v. Dickman* (1990):

"... The primary purpose of the statutory requirement that a company's accounts shall be audited annually is almost self-evident.... It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been provided."

He went on to reject the argument that the UK Companies Act (1985) reflect a wider commercial purpose, namely to enable those to whom the accounts were addressed or circulated to make informed investment decisions, for example to sell or buy shares. This perception of the limited purpose of the accounts and audit required by the UK Companies Act (1985) has been echoed in a series of subsequent cases. *Hobhouse J. in Berg Sons & Co. Ltd V. Mervyn Hampton Adams* (1993), expressed the purpose of the statutory audit more starkly as:

"... To provide a mechanism to enable those having a proprietary interest in the company or being concerned with its management or control to have access to accurate financial information about the company. Provided that those persons have that information, the statutory purpose is exhausted. What those persons do with the information is a matter for them and falls outside the scope of the statutory purpose. Such matters do not fall within the scope of the duty of the statutory auditor."

This perception has been the foundation for the rejection of claims in tort by shareholders and parties, other than the company itself, against auditors based on alleged negligent audits.

Contractual Duties

The duties of an independent accountant or auditor

will primarily depend upon the contract between him and his client, the company, not the members as individuals. This will regulate the nature and extent of his task and the standard of its performance.

Thus, in *International Laboratories Ltd v. Dewar* (1993), Robson J.A. stated thus:

"It cannot be doubted that the measure of the responsibility of auditors depends on the terms of the employment in the particular case. That the relation did exist here is a fact though regard must be had to its exact terms. The defendants were appointed auditors at the shareholders' meeting only on one occasion when the terms of appointment were general. There was discussion during the argument as to whether the audit was to be merely the statutory audit under the relevant company statute. I think the Court will have to ascertain the duty and obligation of the defendants from the correspondence by which their work was defined and that the limit of the statutory requirement will not prevail against the understanding."

It is particularly important to establish the nature of the task, for example, whether it is an audit or some more limited accountancy function. The extent of investigations required will be much greater in the case of the former than in the case the latter. It is prudent for an accountant to record his precise instructions in writing to his client. Many professional negligence claims against accountants culminate from disputes over the precise scope of the particular engagement.

Duties Independent of Contract

There can no longer be any doubt that, in common with other professional persons, an accountant generally owes a duty of care in tort to his client quite apart from any contract between them. Denning, L.J., so concluded as long ago as 1951 in his dissenting judgment in *Candler v. Crane, Christmas & Co.*

Denning, L.J.'s judgment dealt in some detail with the types of statements in respect of which professional accountants owed a general duty of care and the persons and transactions to which that

duty extended. As to types of statements, he considered that accountants were not liable for:

- (a) Casual remarks made in the course of conversation; nor for:
- (b) Statements made outside their work; nor for
- (c) Statements not made in their capacity as accountants.

Accountants are, "in proper cases" apart from any contract in the matter, under a duty to use reasonable care in the preparation of their accounts and in the making of their reports. As to the persons to whom accountants owed a duty of care, Denning L.J. said:

"They owe the duty, of course, to their employer or client; and also I think to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or to take some other action on them. But I do not think the duty can be extended still further so as to include strangers of whom they have heard nothing and to whom their employer, without their knowledge may choose to show their accounts. Once the accountants have handed their accounts to their employer, they are not, as a rule, responsible for what he does with them without their knowledge or consent... The test of proximity in these cases is: did the accountant know that the accounts were required for submission to the plaintiff and use by them."

Turning to the nature of the transactions to which accountants' general duty of care extended, Denning, L.J. similarly confined them to transactions for which the accountants knew their accounts were required. On the facts of *Candler*, the plaintiff initially invested £2,000 in reliance upon the accounts prepared for him by the defendant accountants and a further £200 two months after entering the company's service as a working director. Denning, L.J. concluded that the defendant accountants' duty of care extended to the former £2,000 but not to the latter £200. Nevertheless, he was conscious of the problem of indeterminate liability: when he said, "I can well

understand that it would be going too far to make an accountant liable to any person in the land who chooses to rely on the accounts in matters of business”.

Denning L.J.'s judgment was approved by the House of Lords in *Hedley Byrne & Co. Ltd v. Heller & Partners Ltd.* (1964) and also expressly approved in *Caparo* (1990).

Similar principles have been followed in a number of US cases in the U.S.A. For example, in *Credit Alliance v Arthur Anderson & Co* (1985), it was held that to be liable, the auditors must be aware that the financial statements were to be used for a particular purpose and that third parties would rely on them. Practice however varies among the States of U.S.A. For example, in a New Jersey case, *H Rosenblum Inc v Adler* in 1983, it was held that auditors could be liable for ordinary professional negligence to any foreseeable relying party. This so called New Jersey Rule is adopted in many US States.

Fiduciary Duties

An accountant owes fiduciary duties to his client. It was held in the Australian case of *Morton v. Arbuckly* (No. 2) (1919) that an auditor's duty was a duty 'uberrimae fidei' and of complete and full disclosure of all facts properly coming within the ambit of the inquiry he was conducting. Examples of an accountant's fiduciary duties would be a duty not to disclose confidences or to use his position to make a secret profit.

Duties to Third Parties

The 1980s witnessed major changes in the prevailing orthodoxy as to the test for establishing a duty of care and as to the circumstances for recovery of economic loss, financial or pecuniary loss unrelated to physical injury or damage to property, under the tort of negligence. At the beginning of the period, the dominant approach, as reflected in *Anns v. Merton London Borough Council* (1978), was to seek a single general principle, centered on the concept of reasonable foresight, which might be applied in all circumstances to determine the existence of a duty

of care. This tended to be plaintiff oriented and encourage a surge of tort-based claims against professionals, including accountants. In the mid-1980s, however, that approach was repeatedly eschewed in a series of appellate authorities and support given to a more analytical approach formulated around established paradigms. Cardozo C.J. in *Ultramares Corporation v. Touche* (1931) expressed his concern about the risk of imposing “a liability in an indeterminate amount for an indeterminate time to an indeterminate class”

The caution is particularly apposite in the case of accountants since the range and number of persons who may suffer loss consequent upon negligent performance of certain engagements by them are very large. For example, in the case of a negligent report by an auditor on a company's accounts, the range may include existing shareholders of the company, potential investors, i.e. future shareholders, banks and trade creditors, all of whom may have relied upon the report.

The 1980s surge of tort claims against accountants can now be seen to have met its Stalingrad in the decision of the House of Lords in *Caparo Industries Plc v. Dickman* (1990). Here the case was resolved by reference to a tripartite test for the imposition of a duty of care in a particular situation: foreseeability of damage, proximity of relationship, and reasonableness. Proximity focuses on the closeness and directness of the relationship between the parties. It involves description of circumstances from which, pragmatically, the courts conclude that a duty of care exists.

The starting point for assessing the merits of a third party's claim against accountants, including auditors, is the decision of the House of Lords in *Caparo Industries Plc v. Dickman*. Previous case law demonstrated a gradual broadening of the test for a duty of care and the consequent expansion of the range of third parties to whom accountants might incur liability as a result of errors in financial statements, especially arising from the performance of the audit function. *Caparo* has repulsed that trend and severely restricted the circumstances in which liability may be incurred by accountants to third parties based on the tort of

negligence.

The claim in the case of Caparo arose out of the takeover in 1984 of Fidelity Plc by Caparo Industries Plc, both listed companies on the Stock Exchange. The case was brought against two of Fidelity's directors and the auditors of its accounts for the year ended 31st March 1984. In early March 1984, a press release was issued forecasting a significant profits shortfall. Over that month, Fidelity's share price fell sharply. In May 1984, the auditors reported upon the accounts giving a clean certificate to the effect that they were properly prepared and gave a true and fair view of relevant matters. The next day, Fidelity's directors announced profits that fell far short of predictions. On June 8, Caparo began to buy Fidelity's shares. The accounts were sent to the shareholders on June 12, 1984, but Caparo was not registered as a shareholder until later nor did it attend Fidelity's annual general meeting on July 4, 1984 when the auditors' report was read and the accounts adopted. Two days later, Caparo had acquired 29.9 percent of Fidelity's issued shares. In September, it made a bid for the remaining shares and subsequently acquired them, some compulsorily.

Caparo maintained that the accounts were inaccurate and misleading, in particular in overvaluing stock and undervaluing after-sales credits, with the result that there was in fact a loss of £400,000 instead of reported profits of £1.3m. It alleged that its share purchases subsequent to the sending of the accounts to shareholders were made in reliance on those accounts and that if it had known the true position, it would not have purchased them or made the bid at the price paid or at all. It commenced proceedings against the two directors alleging deceit and against the auditors alleging negligence. It contended that the auditors, in carrying out their functions in April and May 1984, owed a duty of care to investors (in the sense of existing shareholders) and potential investors, including Caparo. In support, it maintained that the auditors:

- (1) Knew or ought to have known of:
 - (a) The press release in early March;

- (b) The slide in the share price from 143p on March 1 to 75p on April 2

- (c) Fidelity's need for financial assistance; and

- (2) Ought to have foreseen that Fidelity was vulnerable to a takeover bid and that bidders such as Caparo might well rely on the accounts in assessing a bid and suffer loss if the accounts were inaccurate. An order was made for the trial of a preliminary issue: whether, on the alleged facts, the auditors owed a duty of care to Caparo:

- (a) As potential investors in Fidelity, or

- (b) Shareholders in Fidelity as from June 8 and/or 12, 1984, in respect of the audit of the relevant accounts.

The judge at first instance, Sir Neil Lawson, held that the auditors owed no duty of care to Caparo in either capacity. While recognising that auditors might owe statutory duties to shareholders as a class, he concluded that there was no common law duty of care owed to individual shareholders such as to enable one to recover damages for loss sustained by him in acting in reliance on inaccurate audited accounts.

On Caparo's appeal, the Court of Appeal, by majority (Bingham and Taylor L.J. O'Connor L.J. dissenting in part), allowed the appeal. The Court was unanimously of the view that the requisite relationship of proximity was not established between potential investors in a company and its auditor. Bingham L.J. and Taylor L.J. concluded that it was established between existing shareholders and the auditor. Thus if an individual shareholder sustained loss by acting in reliance on negligently prepared accounts, whether by selling or retaining his shares or purchasing additional shares, he was entitled to recover in tort. O'Connor L.J. disagreed and rejected a duty of care in that case also.

The House of Lords took the same view as

O'Connor L.J. and the judge at first instance and restored the latter's decision. This outcome followed application of the tripartite test for a duty of care, a detailed review of reported cases against accountants including auditors arising from like circumstances and an evaluation of the perceived purpose of the audit provisions in the UK Companies Act 1985. The main speeches were delivered by Lords Bridge and Oliver.

As to the test for a duty of care, Lord Bridge reviewed relevant authorities and concluded that the salient feature of all these cases is that the defendant giving the advice or information, was fully aware of the transaction which the plaintiff had in contemplation, knew that the advice or information would be communicated to him directly or indirectly, and knew that it was very likely that the plaintiff would rely on that advice or information in deciding whether or not to engage in the transaction in contemplation. In these circumstances the defendant could clearly be expected, subject always to the effect of any disclaimer of responsibility, specifically to anticipate that the plaintiff would rely on the advice or information given by the defendant for the very purpose for which he did in the event rely on it. In addition, the plaintiff, subject again to the effect of any disclaimer, would in that situation reasonably suppose that he was entitled to rely on the advice or information communicated to him for the very purpose for which he required it.

The situation is entirely different where a statement is put into more or less general circulation and may foreseeably be relied on by strangers to the maker of the statement for any one of a variety of purposes which the maker of the statement has no specific reason to anticipate. To hold the maker of the statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely on it is not only to subject him in the classic words of Cardozo C.J. in *Ultramares v. Touche* to 'liability in an indeterminate amount, for an indeterminate time, to an indeterminate class': it is also to confer on the world at large a quite unwarranted entitlement to appropriate for their own purposes the benefit of the expert knowledge or professional expertise attributed to the maker of the statement.

Hence, looking only at the circumstances of these decided cases where a duty of care in respect of negligent statements has been held to exist, I should expect to find the 'limit or control mechanism' ... imposed upon the liability of wrongdoer towards those who have suffered economic damage in consequences of his negligence' as an essential ingredient of 'proximity' between the plaintiff and the defendant, that the defendant knew that his statement would be communicated to the plaintiff, either as an individual or as a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind (e.g. in a prospectus inviting investment) and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction or upon a transaction of that kind.

The "limit or control mechanism" was similarly expressed by Lord Oliver. The vulnerability of Fidelity to a take-over bid and the probability of reliance on the accounts by a potential bidder were expressly rejected as factors establishing the necessary nexus of proximity.

The auditing provisions in the UK Companies Act (1985) were particularly invoked in support of Caparo's argument that the auditors owed it a duty of care qua a potential investor shareholder. These provisions were reviewed by Lord Oliver. However, the House of Lords rejected the argument. Lord Bridge expressed the position as follows: "No doubt, these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice, no problem arises in this regard since the interest of the shareholders, e.g. by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of

the company, will be recouped by a claim against the auditors in the name of the company, not by individual shareholders."

Lord Oliver said:

"... The purpose for which the auditors' certificate is made and published is that of providing those entitled to receive the report with information to enable them to exercise in conjunction those powers which their respective proprietary interests confer upon them, and not for the purpose of individual speculation with a view to profit."

Caparo was considered in James McNaughton Papers Group Ltd v. Hicks Anderson & Co (1991) and Morgan Crucible & Co. Plc v. Hill Samuel Bank Ltd, two later decisions of the Court of Appeal.

The claim in James McNaughton Papers Group Ltd v. Hicks Anderson & Co. arose out of the agreed takeover of a company, MK, by the plaintiff company. In the course of the takeover negotiations, draft financial statements were provided by the defendants who were MK's auditors. Also at a meeting between the chairman of the plaintiff company and a representative of the defendants, the latter confirmed that MK was breaking even or doing marginally worse. The plaintiff proceeded with the acquisition but subsequently discovered errors in the accounts. It sued the defendants for negligence and was successful at first instance. The judge held that in providing the draft financial statements and in making the relevant statement, the defendants owed the plaintiff a duty of care. On appeal, however, the defendants succeeded on the basis that in the particular circumstances, they did not owe such a duty. Factors material to this conclusion included the following:

- (a) The accounts were merely drafted accounts, which the plaintiff was not entitled to treat as final accounts;
- (b) They nonetheless demonstrated that MK was in a poor state;
- (c) The transaction was one between

experienced businessmen and the plaintiff had its own accountancy advisers; and

- (d) The relevant statement was very general and it was not possible to attribute to the defendants knowledge that the plaintiff would rely on it without any further inquiry or advice.

McNaughton is very much a case on its own fact but it demonstrates that even in a context in which the defendant accountants may have a third party in specific contemplation as a person who may rely on information provided by them, analysis of the particular circumstances may prompt negation of a duty of care. Moreover, it contains a useful analysis by Neill L.J of matters which are likely to be of importance in most cases in deciding whether or not a duty of care exists. The matters are analysed under six heads:

- (1) The purpose for which the statement was made;
- (2) The purpose for which the statement was communicated;
- (3) The relationship between the adviser, the advisee, and any relevant third party;
- (4) The size of any class to which the advisee belongs;
- (5) The state of knowledge of the adviser; and
- (6) Reliance by the advisee.

Alleged misrepresentations made in the course of negotiations for the acquisition of companies are often the subject of claims against accountants.

The claim in Morgan Crucible & Co. Plc v. Hill Samuel Bank Ltd (1991) arose out of the contested takeover of another public company (FCE) by the plaintiff company (MC). The conduct of the takeover were subject to the then current version of

the UK City Code on Takeover and Mergers. The defendants were the merchant bank, which advised FCE auditors and directors of FCE in the course of the takeover. In the course of the takeover battle, circulars were issued by the chairman of FCE to its shareholders and these were also issued as press releases by the defendant merchant bank. Thus, they were made available to MC's advisers as required by the City Code. The circulars referred to FCE's financial statements for previous years which had been audited by the defendant's auditors and one made an optimistic profits forecast for the forthcoming year. The latter circular included two letters. The first was from the auditors to the effect that the forecast had been properly compiled and on a basis consistent with FCE's usual accounting policies. The second was from the merchant bank to the effect that the forecast had been prepared after due and careful inquiry. MC increased its bid, FCE's chairman recommended acceptance and the bid succeeded.

MC contended that the relevant financial statements and forecast were inaccurate, misleading, and negligently prepared. MC also claimed that if it had known the true position, it would not have made the bid and not have acquired FCE. As the claim was originally formulated, it was alleged that the defendant's auditors and the directors were responsible for the financial statements and that both they and the merchant bank were responsible for the forecast, and that in putting those documents in to circulation they owed a duty of care to MC as a person who could foreseeably rely on them. Following the House of Lords decision in *Caparo*, that contention was doomed to failure. Hence MC sought leave to amend its claim so as in effect to restrict the claim to representations made after the launch of the bid. The issue arose as to whether, assuming the facts alleged were true, the proposed amendments disclosed a reasonable cause of action. Hoffman J. at first instance held that they did not. He concluded that the case was distinguishable from *Caparo* and that the necessary relationship of proximity was established on the assumed facts. Such facts were that in making the relevant representations, the defendants were aware that MC would rely on them for the purpose of deciding whether or not to make an increased

bid, and intended that they should (this being one of the purposes of the defence documents and representations contained in them) and MC did rely on them for that purpose. The case was subsequently settled out of court and thus never proceeded to a full trial.

Caparo was also applied in resolving the claims of the third claimant, Hillsdown, in *Galoo Ltd v. Bright Grahame Murray* (1994). The defendant's auditors, BGM, were sued by three companies, Galoo, Gamine, and Hillsdown. Gamine, owned all the shares in Galoo. The defendants were auditors of the first two companies from 1985 to 1991. In 1987 Hillsdown acquired 51 per cent of the shares in Gamine for a price based on Galoo's profits as shown in Galoo's and Gamine's audited accounts for 1986.

Between 1987 and 1993, Hillsdown made large loans to both Galoo and Gamine. In 1991, under a supplementary share purchase agreement, it increased its shareholding in Gamine by 44.3 per cent. In 1992 the companies sued BGM alleging that Galoo's and Gamine's audited accounts for 1985 to 1989 and their draft audited accounts for 1990 were inaccurate in that Galoo's stock and work in progress were materially overstated. The companies alleged that in auditing such accounts BGM were negligent and in consequence they had sustained loss. BGM were sued by both Galoo and Gamine in contract and tort and by Hillsdown in tort. The Court of Appeal, upholding the judge at first instance, struck out the case since it was alleged that BGM knew of Hillsdown's purchase of shares in Gamine and that the 1986 accounts were required for the purchase of calculating their price. Moreover BGM had sent the 1986 accounts to Hillsdown under cover of a letter which represented that the accounts were accurate. However, Hillsdown's other claims were struck out. Hillsdown's claims for loss resulting from making loans to Gamine and other moneys paid, including under a supplementary share purchase agreement, were held to be deficient. Thus it was not alleged that BGM knew that Hillsdown would rely on the audited accounts for the purpose of making such loans and payments or that BGM intended that Hillsdown should so rely.

Third Party Claimants other than Equity Investors

While the context of Caparo was a claim by an equity investor, it is plain from the judgment that the ratio decidendi of the case extends also to other third party claimants, in particular banks, trade creditors, and guarantors. This is exemplified by two first instance English cases, Huxford and others v. Stoy Hayward & Co. (1989), and AL Saudi Banque and others v. Clark Pixley (1990). In the latter case, the plaintiffs were shareholders and directors of a company which went into receivership. They were also guarantors of the company's indebtedness to various banks and trade creditors. The defendants were a firm of accountants. The defendants were initially appointed by one of the banks to report on the company's viability when, owing to financial difficulties, it exceeded its overdraft limit. Two reports were prepared by the accountants and later gave advice to the company and directors. The company's difficulties finally led to the appointment of a receiver by the bank, the sale of the company and loss incurred by the plaintiffs. Peoplewell J. held:

1. The first two reports were prepared pursuant to a contract to which the sole parties were the bank and the accountants and the accountants owed no duty of care to the plaintiffs, whether as shareholders, directors, or guarantors arising therefrom;
2. Whereas subsequently a contractual relationship was established between the accountants and the plaintiffs qua directors such as to give rise to a duty of care both in contract and in tort to them in that capacity in respect of advice given, nevertheless the accounts did not owe them a duty of care in their capacity as guarantors. The claim failed in any event because no breach of any duty or loss caused by any alleged breach were established.

Millet J.'s earlier judgement in *AL Saudi Banque and others v. Clark Pixley* (1990), was expressly

affirmed by the House of Lords in *Caparo*. The plaintiff banks had advanced monies to a company on the security of bills of exchange accepted by the company's customers in its favour and then negotiated by it to the banks. The company was ordered to be compulsorily wound up. It had an estimated deficiency of £8.6m. The plaintiffs contended that a large part of the company's business was fraudulent and that bills of exchange provided by its two largest customers were worthless and not supported by any underlying business transactions. The defendants were the company's auditors.

The plaintiffs claimed damages for alleged negligence (firmly denied by the defendants) in auditing and reporting on the company's accounts. They maintained that they:

- (a) Granted new facilities to the company; or
- (b) Renewed, continued, or increased existing facilities in reliance on the accuracy of the company's audited accounts and the defendants' reports.

On a trial of a preliminary issue as to whether the defendants owed a duty of care to one or more of the plaintiffs, Millet J. held that they did not and the claim thus failed. He distinguished between those banks which were not already existing creditors at the relevant balance sheet date and those which were. As regard the former, he considered that their position was directly analogous to that of potential investors in *Caparo*.

It followed that the ratio of that case applied to deny a duty of care owed them. As regards the banks who were existing creditors at the relevant balance sheet date, he rejected the contention that their position was analogous to existing shareholders and held that no duty of care was owed to them also: "... their position is not at all comparable with that of shareholders. They played no part in appointing the defendants as auditors. The defendants were under no statutory obligation to report to them and they did not do so. They did not supply copies of their reports to them, nor did

they send them to the company with the intention or in the knowledge that they would be supplied to them. Clearly to hold that a duty of care was owed to them would be going further than can be supported by any existing English authority. Indeed, he considered it was precluded by authority. The fact that the relevant banks were of a small and limited class and known to the plaintiffs did not establish the necessary ingredient of proximity. In particular, it was necessary to show knowledge of an intention that the information would be supplied to the banks and that was not established". Millet J. also observed that "to hold otherwise in relation to a claim for losses arising from advances subsequent to the audited accounts would not be just and reasonable since it would expose the auditors to an indeterminate liability. Thus the loss would be measured by the amount of the advances which would have been unknown to them and unforeseeable".

Millet J. added. "I would not for my own part, unless constrained by authority, extend the duty of care to a prospective lender, unless the amount or at least the scale of the proposed deal was known to the defendant." In light of Caparo and the express approval therein of Millet J.'s judgment in A1 Saudi Banque, earlier decisions and dicta which suggest a duty of care owed by accountants and auditors to banks and creditors in the absence of a contractual nexus between them must be viewed with caution. ■

To be continued in Part II

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Credit

The paper has undergone the kind review of Mr. Philip D. Dosoo; LLB, LLM of Trustee Services Limited.

However, I accept the responsibility for every word – right or wrong.

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A conference is a gathering of important people who singly can do nothing, but together can decide that nothing can be done.

Fred Allen

RESPONSIBILITY FOR CORPORATE DEBTS IN GHANA: A CONCEPTUAL PERSPECTIVE

Benjamin Mordedzi

Abstract

This paper analyses the corporate entity theory and the lifting of the corporate veil in Ghana. Two major principles form the basis of the analysis. First, a company is a separate legal entity with the powers of a natural person of full capacity. Secondly, members of the company usually have limited liability. The paper notes that there are many inroads into these principles. In some situations, the Companies Code 1963 (Act 179) enforces corporate debts and liabilities against the company. In other situations, the Companies Code enforces the company's debts and liabilities against corporate officers who knowingly allowed the commission of wrongful acts. This paper therefore concludes that, under the Companies Code, a company is both a separate corporate person and an economic entity. To this end, the courts can treat the acts of corporate officers as either those of the company itself or those of the officers themselves. This paper also urges the courts to abandon lifting the corporate veil and suggests that the courts should admit remedies based on well-known business principles in agency, contract, conveyance, industrial law, insolvency, tort, and trust.

Introduction

The corporate form of business has existed in Ghana since 1907 when the colonial government passed the Companies Ordinance (Cap 193). Today, the Companies Code 1963 (Act 179) regulates the activities of companies in Ghana, except those that require special legislation, such as banks and insurance businesses.

Companies are very important institutions in Ghana's economy. They promote economic growth and development by providing opportunities and encouragement for investment. This enables people to invest their surplus funds