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Abstract

Fundamental to the auditor’s consideration of risk, is the fact that the auditor can be sued by the client under contract law (professional negligence, failure to spot a material fraud etc.) or by a third party in a tort. The auditor’s liability springs from the general principle of law that where a person is under a legal duty to take such care, whether imposed by specific contract or otherwise, the failure to exercise reasonable standard of care will make that person responsible for any resultant damage or loss to those to whom the duty is owed.

What conduct satisfies the standard of care required will, in any particular case, depend entirely upon the circumstances. The general degree of skill and diligence demanded of, and attained by auditors today is unprecedented. The question as to whether an auditor is or not guilty of negligence in any particular case, is largely determined by reference to the standard to which contemporary members of the profession conform.

This part (Part 2) of this article makes compelling arguments for the need to understand auditor’s legal duties and responsibilities as regards fraud. It provides concluding thoughts on the subject matter. We advance various arguments and proposals for enhancing the image of the statutory auditor.

The Auditors’ Responsibility for Detection of Fraud

The Ghana National Auditing Standards (GNAS) defines fraud as the “intentional misrepresentation
(of financial information by one or more individuals among management, employees or third parties”. The GNAS outlines fraudulent practices as involving:

a) Manipulation, falsification, or alteration of records or documents;

b) Misappropriation of assets;

c) Suppression of omission of the effects of transactions from the records or documents;

d) Recording of transactions without substance;

or

e) Misapplication of accounting principles.

In the Australian case of Frankston and Hastings Corporation v. Cohen (1960) the detection of fraud was described as one of the main objects of an audit and of primary importance. In that case, the court gave approval to the view of Irish R.A. who stated that, “An audit may be said to be a skilled examination of such books, accounts, and vouchers as will enable an auditor to verify the balance sheet. The main objects of any audit are:

(a) To certify to the correctness of the financial position as shown in the balance sheet, and the accompanying revenue statements.

(b) The detection of errors.

c) The detection of fraud. The detection of fraud is generally regarded as being of primary importance.”

The above definition of an audit was also recited in Pacific Acceptance Corporation Ltd v. Forsyth (1970). Whatever its ranking, relative to other objects of an audit, it is apparent from cases, both in Commonwealth nations and the United Kingdom, that the courts regard the detection of fraud as an important purpose of an audit. In the Australian case of Pacific Acceptance Corporation Ltd v. Forsyth, Moffit J. in a detailed judgement analysed the functions and duties of an auditor having regard to modern audit practices and procedures, particularly auditors' increasing reliance upon a company's internal system of accounting controls.

The plaintiff, a finance company (Pacific), had a head office in Sydney and a branch office in Melbourne. The defendants were the plaintiff's auditors (the Pacific auditors). The professional negligence claim brought in contract against the Pacific auditors related to four audit years ending on June 30, 1958, 1959, 1960, and 1961 respectively. The plaintiff complained of failure to discover and to warn of fraudulent and irregular features in loans made by the Melbourne branch office between about 1957 and 1961 to the defendant and his group of companies and also to certain fictitious companies, and in some loans made through the defendant as an estate agent. These loans were supposedly secured by registered first mortgages. Being unaware of these irregularities, Pacific in 1959 entered into a joint venture with a company controlled by the defendant. The venture was operated through a jointly owned subsidiary company (Pavic). Pavic engaged in house development and sales through a group of subsidiary companies. The defendant was a director of Pavic and its subsidiaries. Pacific advanced to the joint venture large sums of money which were eventually lost.

In the middle of 1960, Pacific entered into a takeover agreement with the defendant whereby Pacific acquired various interests of the defendant became a wholly owned subsidiary of Pacific prior to the 1960 balance date and the defendant became a principal shareholder and director of Pacific. Within the framework of the joint venture and takeover, the defendant committed further frauds and misappropriations.

In September 1960, before completion of the 1960 audit, and to the knowledge of the Pacific auditors,
there was a second takeover whereby Pacific acquired virtually all of the defendant's assets. At this time, the defendant and his companies were in grave financial difficulties. Shortly before reporting an unqualified opinion upon a Pacific's consolidated accounts for 1960, the Pacific's auditors received from the auditors of Pavic (the Pavic auditors) their report upon Pavic's consolidated accounts but took no action upon it.

Moffit J. held his report to have been qualified, contrary to the contention by the Pacific auditors that it was unqualified. The Pacific auditors were held negligent in the following respects:

a) In failing to ascertain by proper means whether intended mortgages had been given and registered;

b) Insofar as solicitors engaged to attend to the execution and registration of mortgages were seen as part of Pacific's system of internal control, in relying on that system without proper inquiry, appraisal or test sampling of that system's efficacy;

c) In failing to take sufficient account of various irregularities including endorsements indicating payment to the defendant's private account of many of Pacific's crossed order cheques payable to the defendant's companies and also including various dishonoured cheques drawn by the defendant's group in favour of Pacific;

d) In employing inexperienced staff without adequately supervising them and checking their work;

e) In failing properly to amend the Melbourne audit programme to include procedures to check freehold mortgage loans;

a) In relying on the two takeover agreements providing evidence of value of assets purportedly comprising security for loans;

b) In making no inquiries of Pavic's auditors and no independent checks concerning the Pavic group accounts before relying on them in giving an unqualified opinion on Pacific's consolidated accounts;

c) In giving an unqualified opinion on Pacific's consolidated accounts for 1960, which made no provision for bad and doubtful debts in Pavic group accounts;

d) In failing to discover that a so-called service fee treated as income of Pavic in Pavic's 1960 accounts was not in fact income of Pavic and in giving their unqualified opinion to Pacific's consolidated accounts which accepted the service fee as income.

These defaults constituted breaches by the Pacific auditors of their duty to audit exercising reasonable care and skill and of their duty to report exercising reasonable care and skill. The Pacific auditors were not entitled to be relieved from liability under the Australian equivalent of the English Companies Act 1985, s.727.

In the course of his judgement, Moffit J. dealt with a number of general points relating to the conclusion, terms, and scope of the contract pursuant to which the auditors were engaged to do a statutory audit. For each of the four years in question, the Pacific auditors had been elected as the company's auditors by the shareholders at the company's annual general meeting. Each appointment was an open one in the sense that no special terms were attached. Pacific's claim was pleaded and auditors were engaged in respect of the relevant year's audit. He concluded that the contract in each case arose either from the acceptance of the auditor's offer by the shareholders appointing them or by the acceptance of the appointment by the auditors by virtue of their acceptance of the office, embarking on the work and accepting their remuneration, but nothing turned on which alternative was the more correct. On the issue of terms of engagement,
Motiff J. concluded that the contracts being open had imported into them promises to perform the duties prescribed by the relevant UK Companies Act and also the articles of association of the company. The relevant statute, however, merely required the auditors to report to the shareholders and to give their opinion on certain matters. It did not state what the auditors had to do in order to form their opinions. It was contended for the Pacific auditors that they were required to do more than report to the shareholders using due care and skill. This contention was rejected in the following words: “In the absence of express terms, the scope of the audit will depend on what is directly or indirectly required or indicated by the particular provisions of the Companies Act and of the articles and any relevant surrounding circumstances. However, whatever the precise content of his audit, the auditor promises, first, to conduct an audit of some description and, second, to provide a report of his opinion based on his audit work, which report has to comply with the Companies Act and the articles, and also impliedly agrees to exercise reasonable skill and care in the conduct of the audit and in the making of the report.”

The duty to audit carried with it an incidental duty to warn the appropriate level of management or the directors, during the course of the audit, of fraud or suspicion of fraud uncovered. Thus, if in the course of vouching work, the Pacific auditors had uncovered matters which reasonably required them to the uncovering of the defendant’s fraudulent and irregular dealings, a breach would have occurred at that time. As for the scope of statutory audit, Motiff J. took the view that in planning and carrying out his work an auditor must pay due regard to the possibility of error and fraud.

The Ghana National Accounting Standards issued in 2001 has acknowledged the role of the audit profession in the detection of fraud as follows, “the admitted role of the audit profession in relation to fraud detection is to plan, perform and evaluate the audit work so as to have a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error”. Planning the audit with a reasonable expectation of detecting fraud is explained as adopting an “attitude of professional scepticism.”

The courts have affirmed the above mentioned role of the auditor in relation to fraud in Fomento (Sterling Area) Ltd v Selstdon Fountain Pen Co Ltd (1958), where Lord Denning expressed the opinion that: “An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional “adder-upper and subtractor.” His vital task is to take care to see that errors are not made, be they errors of computation or omissions or downright untruths. To perform this task properly, he must come to it with an inquiring mind - not suspicious of dishonesty, I agree - but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.”

The issue in this case was whether auditors engaged by patent licensors to ascertain the amount of royalties due from licensees were entitled to require production by the licensees of specimens or specifications of particular products in order to establish whether they were patented articles or not. The licensees contended that it was outside an auditor’s function to determine whether or not an article was protected by patent. The House of Lords by a majority rejected his contention.

Earlier cases such as Leeds Estate, Building and Investment Co. v. Shepherd (1887) and Re London and General Bank (No. 2 (1895) have established the mental attitude with which an auditor must approach his assignments in order to succeed in detecting fraud. In the former case, Sterling J. stated that it was the “…the duty of the auditor not to confine himself merely to the task of verifying the arithmetical accuracy of the balance-sheet, but to inquire into its substantial accuracy, and to ascertain that it contained the particulars specified
in the articles of association (and consequently a proper income and expenditure account), and was properly drawn up, so as to contain a true and correct representation of the state of the company’s affairs.” In Re London and General Bank (No. 2), Lindley L.J. said this about the auditor’s fraud detecting role. “… 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. However, he does not discharge his duty by merely doing this without inquiry and without taking any trouble to see that the 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 the company, the auditor has to frame a balance sheet showing that position according to the books and 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.”

The facts of the case were that an auditor presented a confidential report to directors pointing out the insufficiency and difficulty of realisation of securities on which loans by the company were advanced. But, in his report to the shareholders, he merely made the vacuous comment that the value of the assets was dependent on realisation. He was held liable upon a misfeasance summons by the liquidator of the company. He had not reported the true financial position of the company and the shareholders had consequently been deceived into voting for a dividend which in the event was proved to have been paid from capital and not from income. This dividend the auditor was required to make good to the liquidator.

There has been increasing pressure on the audit profession to show more commitment in the fight against corporate fraud. The British Corporate and Consumer Affairs Minister, Michael Howard in 1984 expressed the view that the accounting profession was in the “front-line of the public’s defences against fraud, and that the profession should adopt tough new standards on fraud.”

In response to this pressure, the UK Audit Practices Committee issued a Practice Guideline in 1990 stating that it may sometimes be necessary for auditors to make a report of fraud discovered in their audit work to shareholders or regulators. According to this Guideline, the following factors should be taken into account in deciding whether or not a report should be made:

(a) “The extent to which the fraud or other irregularity is likely to result in a material gain or loss for any person or is likely to affect a large number of people;

(b) The extent to which the non-disclosure of fraud or other irregularity is likely to enable it to be repeated with impunity;

© The gravity to the matter;

(d) Whether there is a general management ethos within the entity of flouting the law and regulations;

(e) The weight of evidence and the auditor’s assessment of the likelihood that a fraud or other irregularity has been committed.”

This reporting responsibility, which is recognised by the GNAS, is particularly effective in combating senior management fraud. The efficacy of this procedure is recognised in the UK Financial Services Act 1986, the Building Societies Act 1986, and the Banking Act, 1987, all of which require the auditor, where he considers it expedient, to report suspected fraud to the relevant regulator.
This new audit responsibility was given judicial recognition in the case of Seasea Finance Ltd v KPMG (2000), where the plaintiff company, a member of a group of companies, brought action against its auditors for negligence, for failing to report fraudulent activities carried out by a dominant executive in the group that led to the plaintiff company incurring heavy losses. The English Court of Appeal held that, where a company’s auditors discovered that a senior employee had been defrauding the company on a massive scale and that the employee was in a position to continue doing so, the auditors would normally have a duty to report the discovery to management immediately, not merely when rendering their report. Moreover, if the auditors suspected that the management might be involved in, or was condoning fraud or other irregularities, then the duty to report overrode the duty of confidentiality, and the auditors would have to report to a third party without the management’s knowledge or consent.

**Causing Financial Loss to the State**

The audit function plays an important role in ensuring that the state is not made to suffer financial loss through the actions or omissions of officers in the civil and public services. The charge of causing Financial Loss to the state is founded on section 179(A) (3) (a) of The Criminal Code (Ghana) Act 29, 1960. The section provides that any person through whose willful, malicious, or fraudulent action or omission the state incurs a financial loss commits an offence.

Justice Baddoo, J.A. (as he then was), in the case of The Republic vrs. Victor Selormey, High Court, Unreported, 10th December 2001 explain the meaning of the offence as follows:

“In plain ordinary language, it means any deliberate act or omission of any person which results in a financial loss to the State constitutes an offence. Therefore, for the prosecution to succeed in providing this charge against the accused person, they must show that:

(a) The accused person took certain actions.

(b) Those actions resulted in a financial loss to the state.

Justice Afreh, in the case of The Republic vrs. Ibrahim Adam, Samuel Dappah, Kwame Peprah, George Sipa-Yankey and Nana Ato Dadzie, High Court, Unreported, 10th December 2001 said that:

“To sum up, the essential elements of causing financial loss under S179A (3) (a) are:

(i) A financial loss;
(ii) To the state;
(iii) Caused through the action or omission of the accused; and
(iv) That the accused:

a. Intended or desired to cause the loss; or
b. Foresaw the loss as virtually certain and took an unjustifiable risk of it; or
c. Foresaw the loss as the probable consequence of his act and took an unreasonable risk of it; or
d. If he had used reasonable caution and observation, it would have appeared to him that his act would probably cause or contribute to cause the loss.

Among the charges against the accused person in the former case were two counts of conspiracy to cause financial loss to the state and two counts of causing financial loss to the state founded on S. 179 (A) (3) (a) of Act 29, 1960.

The fact of the case was that the accused person was formerly the Deputy Minister of Finance. He had a friend by name Dr. Fredrick Owusu Boadu, a Ghanaian resident in Texas, U.S.A. In December 1998, the accused authorised Ecobank to pay an amount of $432,500 to Dr. Fredrick Owusu
Boadu in Texas, by falsely representing to the Bank that Dr. Boadu had performed consultancy services, under the court computerisation project which representation, he knew to be false.

Again in February 1999, the accused authorised the Ecobank to pay to the said Dr. Boadu an amount of $865,000 by falsely representing to the Bank that this was the second payment to Dr. Boadu for the consultancy services he had rendered, under the court computerisation project which representation he knew to be false.

It was the case for prosecution that no consultancy services had been rendered by Dr. Boadu in respect of the court computerisation project to warrant the payment of the total sum of $1,297,500 to him and, by this act, the Republic had incurred a financial loss of $1,297,500.

Among the witnesses who testified for the prosecution was PW9 Nana Baah Opoku Agyeman, an Assistant Director of Audit with the Audit Departments who was helping the Auditor General form an opinion about the operations of the Ministry of Finance. He stated in his testimony that under the Financial Regulations, all warrants issued for the payments of money should be copied to the Auditor General. To make sure that warrants and releases were genuine, the Ministry of Finance had introduced a procedure that insisted that all releases from the Ministry of Finance bore a sticker called hologram. By the mere presence of the hologram, which was strictly controlled by the Ministry under lock and key, the genuineness of the release could be verified. The witness testified that Exhibit A and C, the letters written to Econbank for the release of the total sum of $1,297,500 to LEEBDA, attention Dr. Boadu, did not bear this hologram.

In cross-examination, the witness admitted that he would not know whether the releases from the TIP accounts bore this hologram. However he maintained that Financial Regulations mandated that any account generated should be given to the Auditor General.

The Liability of the Auditor With Respect to Fraud under the Theft Act of the UK of 1968

Section 17 of the Act is of relevance to the liability of the auditor in the detection of fraud. The section provides as follows:

“17. (1) Where a person dishonestly, with a view to gain for himself or another or with intent to cause loss to another, -

(a) destroys, defaces, conceals, or falsifies any account or any record or document made or required for any accounting purpose; or

(b) furnishing information for any purpose produces or makes use of any account, or any such record or document as forsaid, which to his knowledge is or may be misleading, false or deceptive in a material particular; he shall, on conviction on indictment, be liable to imprisonment for a term not exceeding seven years.

(2) For purposes of this section, a person who makes or consurs in making in an account or other document an entry which is or may be misleading, false, or deceptive in material particular or who omits or concurs in omitting a material particular from an...
an account or other document, is to be treated as falsifying the account or document."

The above means than an auditor, while conducting an audit, is under a duty to carry out a thorough investigation consisting of inspection of material documents in order to avoid situation where he will be found to have made use of accounting records or documents which may be misleading, false, or deceptive in the preparation of the audited financial statements of the company.

Where the audited financial statements reflect errors and it is established that the auditor had knowledge of those errors, he will be criminally liable under section 17 of the Theft Act of 1968.

Conclusion

Auditors' responsibilities have become the subject of interest to the investment community in the light of the spate of corporate collapses and fraud in recent years. Auditors need to tighten up their procedures and consider the possibility of fraud more actively, so that the likelihood of detecting material misstatements is improved.

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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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