

LEGAL UPDATE

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CASE UPDATE

PROFESSIONAL NEGLIGENCE: THE AUDITOR'S STANDARD OF CARE

JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm) [2007] SGCA 40

Executive Summary

In its recent judgment handed down in *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)* [2007] SGCA 40, the Singapore Court of Appeal re-affirmed the framework of principles relating to the scope of an auditor's duty of care. The court also considered the extent of the discretion conferred by Section 391 of the Companies Act ("**Section 391**") to relieve auditors from liability for negligence.

On the facts of this case, the respondent auditors were found to have fallen short of the standard of care required in connection with the verification of a director's remuneration in the course of statutory audits performed in the financial years ("**FYs**") 1999, 2000 and 2001. However, the court exercised its discretion under Section 391 to partially excuse the respondent from liability flowing from its breach of duty.

Background

The appellant is a company engaged in the freight-forwarding business and a subsidiary of JS International Shipping Corporation ("**JSISC**"), a corporation headquartered in the United States. At the material time, the appellant's directors were John Peake Riggs ("**Riggs**"), who was based in Singapore as Asia Director, and James Glenn Cullen ("**Cullen**"), who resided in California and headed JSISC. As Asia Director, Riggs had overall control and responsibility of the appellant's day-to-day operations in Singapore and reported to Cullen on operational and business issues. Cullen was the only person who determined and was privy to Riggs' remuneration and employment terms in Singapore.

Riggs was eventually discovered to have been misusing the appellant's funds over the period of 1998 to 2002. His misappropriations comprised overpayment of salary, non-approved sums for allowances and other benefits, non-approved personal expenses charged as director's benefits, unsubstantiated travelling expenses, doubtful charges for office renovations, fictitious payments to a company controlled by Riggs and the unauthorised issuance of numerous cash cheques for fictitious transactions.

The respondent is a firm of Singapore certified public accountants which had conducted statutory audits of the appellant's accounts in respect of FYs 1999, 2000 and 2001. All three audits were unqualified.

The appellant brought an action against the respondent for loss sustained as a result of the respondent's breaches of its contractual obligations and duty of care in relation to the audits performed for FYs 1999 – 2001.

The High Court Decision

The respondent's breaches of duty were broadly attributed to three key areas: (a) the failure to verify Riggs' entitlement to remuneration; (b) the failure to report abuses by Riggs of the cheque signing limit; and (c) the failure to properly verify certain renovation expenses.

To determine whether the respondent's failure to verify information or detect weaknesses in the above three matters constituted a breach of duty amounting to professional negligence, the trial judge applied the test used in relation to medical doctors in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582 (the "**Bolam test**").

The judge ruled that "*there would be no breach of duty if the auditor has acted in accordance with a practice accepted as proper by a body of skilled and responsible auditors*". He also accepted the respondent's expert's evidence in its entirety and held that the respondent had conducted the three audits in question without breach of duty or negligence.

The appellant appealed against the trial judge's decision.

Decision of the Court of Appeal

Standard of reasonable care

The Court of Appeal did not accept the *Bolam* test as the basis for determining an auditor's breach of duty.

The court reiterated that, while the common practice within the relevant profession was a useful benchmark in assessing whether a professional has been negligent, the court ultimately "*retains the supervisory responsibility to condemn an unjustifiably lax, albeit common, practice as negligent*". VK Rajah JA, who delivered the judgment of the court, cited with approval the following observations of Lord Browne-Wilkinson in *Bolitho v City and Hackney Health Authority* [1998] AC 232:

"[T]he court has to be satisfied that the exponents of the body of opinion relied upon can demonstrate that such opinion has a logical basis. In particular in cases involving, as they often do, the weighing of risks against benefits, the judge before accepting a body of opinion as being responsible, reasonable or respectable, will need to be satisfied that, in forming their views, the experts have directed their minds to the question of comparative risks and benefits and have reached a defensible conclusion on the matter."

The nature and extent of an auditor's professional obligations must be assessed by: (a) the precise contractual obligations undertaken in the assignment; (b) the duties imposed by statute; (c) the relevant industry auditing standards; and (d) the expert evidence adduced in relation to the conduct of the audit. No single all-embracing rule or criterion predominates.

In the final analysis, an auditor must exercise the reasonable care and skill of an ordinary skilled person embarking on the assignment in question. He has to take reasonable care to ascertain that the company's accounts are substantially accurate. The degree of scrutiny and investigative effort which constitutes reasonable care is determined on the facts of each individual case.

Whether the respondent breached its duty of care

The Court of Appeal found that the respondent had breached its duty of care by failing to apply its professional skill and judgment to the verification of Riggs' entitlement to remuneration.

In FY 1999, the respondent failed to even enquire about the existence of Riggs' employment contract.

In FYs 2000 and 2001, the respondent failed to adequately pursue and obtain suitable alternative evidence of Riggs' remuneration when Riggs intimated that he had no written employment contract. Instead, the respondent opted to rely on Cullen's signature on the director's reports and draft financial statements as adequate verification of Riggs' entitlement to remuneration despite no attempt having been made to draw Cullen's attention to the fact that his signature would be relied on for this purpose. In this connection, the court noted that "[t]o sanction such an unsatisfactory process would create a charter for the dereliction of core auditing responsibilities".

The court also rejected the respondent's argument that the perceived close oversight and control exercised by JSISC over the appellant's affairs (including the monitoring and review of the appellant's draft financial statements) justified a less rigorous choice of audit procedure. The alleged checks and balances provided by JSISC did not detract from the respondent's core responsibility to directly verify Riggs' remuneration, or, failing which, to seek reasonable assurance by obtaining sufficient and appropriate alternative audit evidence. The court further observed that, "[s]ubject to the practical limitations of an audit, items that can be directly verified should, whenever practical, be in fact directly verified; such verification goes to the core of an auditor's skill and competence and is a function of the appropriate degree of professional skepticism which all auditors must adopt".

The court dismissed the appellant's contentions in respect of the other alleged breaches of duty, namely, the failure to report abuses by Riggs of the cheque signing limit and the failure to properly verify the renovation expenses. In the court's view, there was no particular reason for the respondent to suspect that the cheques were improper, unauthorised or fraudulent and nothing in the renovation transactions appeared to be *prima facie* questionable.

Relief from liability under Section 391

In its final stand, the respondent sought to rely on Section 391 as a ground for total or partial relief from liability. Section 391 confers a broad discretion on the court to relieve persons,

including auditors, either wholly or partially from liability for negligence, default, breach of duty or breach of trust if they appear to have acted honestly and reasonably and if, having regard to all the circumstances of the case, they ought fairly to be excused for such negligence, default or breach.

In relation to the first element of honesty, the court found that there was no doubt that the respondent had been honest in the conduct of the audit.

As to the requirement of reasonableness, the court noted that a person may be regarded as having acted reasonably for the purposes of Section 391 notwithstanding that he may have been found to be negligent. Determination of “reasonableness” for the purposes of Section 391 is not limited to the breach of duty but can encompass wider considerations like the nature of the audit and other factors, such as the conduct of the directors of the company.

The court also found Section 391 wide enough to enable the court to grant partial relief from liability by attribution of fault in a manner similar to a contributory negligence plea.

As it was ultimately Cullen’s “*indifference, laxity in management and failure to properly carry out his fundamental obligation to oversee and monitor the appellant*” that facilitated Riggs’ defalcations, the court took the view that his contributory negligence in exercising appropriate oversight and control could fairly be taken into account in partially relieving the respondent from liability, to the extent that the respondent cannot be fairly held to be completely responsible for the appellant’s losses. As observed by VK Rajah JA:

“The present allocation of responsibility under the auspices of Section 391 remains consistent with the basic “principles of liability” ... by fairly attributing the fault between the auditors and the directors of the appellant, both of whom were negligent, in accordance with the respective degrees of culpability of these parties. From a broader perspective, this emphasises the dual responsibility imposed on auditors and directors to scrupulously adhere to the standard of care in the fulfillment of their occasionally overlapping duties. Effective corporate governance requires both sets of professionals to assiduously discharge their responsibilities.”

In the circumstances, the court awarded the appellant 50% of the losses occasioned by the respondent’s failure to verify Riggs’ entitlement to remuneration as damages, with interests and costs.

Comments

The Court of Appeal has demonstrated that the court would be the final arbiter on the nature and the extent of an auditor’s professional obligations. The body of expert opinion on the existing duties and standards, while of great assistance, would only be accepted if the opinion has a logical basis. Otherwise, the court would be prepared to override the body of opinion.

What this means is that an auditor has to show that he has taken the necessary steps to scrutinise and investigate the absence of supporting documents. He must obtain the appropriate

alternative audit evidence instead of merely relying on the audit company's internal checks and balances.

This case shows that the duty remains as high even when the audit company's management is not forthcoming with the information required. The auditor has to press on to obtain the information and to raise a red flag if necessary.

If you would like more information about this case or wish to discuss how it may potentially affect you or your business, please feel free to contact the dispute resolution lawyers in Drew & Napier LLC (please refer to the Directors' Profiles on our website), or either of the following lawyers:

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