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Mapping Out A Case of Auditors' Duties to Shareholders**

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ABSTRACT

The term 'auditor' in Latin, means 'to listen'. Nonetheless, when scrutinising the duties of auditors, it reveals that they do not merely listen. They also report to the company, on its accounts. Moreover, the scope of these duties has amplified over recent years. This is due to the changes in the corporate landscape. On the other hand, significant judgments have been laid down by courts across jurisdictions whereby in Re Kingston Cotton Mill Co (No 2) [1896] 2 Ch 673 Lopes LJ stated that "...auditors are watchdogs but not bloodhound…" and the statement of Cardozo CJ in Ultramares Corporation v Touche (1931) 174 NE 441 that to hold auditors liable results to a case of "…liability of an indeterminate amount for an indeterminate time to an indeterminate class…" In the midst of these, it is pertinent to determine the legal position in Malaysia. Essentially, the current legal framework governing auditors must be reassessed in the wake of the scandals involving auditors both in the domestic and international forefront. The study then examines the legal position in United Kingdom, Australia and New Zealand. The study finally explores the appropriate litmus test in determining the duties of auditors to shareholders.

Keywords: *auditors, shareholders, duties*

Merancang dengan Teliti Suatu Kes Mengenai Tugas-Tugas Auditor kepada Pemegang Saham

ABSTRAK

Perkataan "auditor" dalam pengertian Bahasa Latin bermaksud "mendengar". Namun demikian, apabila penelitian dibuat ke atas tanggungjawab auditor ia menunjukkan bahawa mereka sebenarnya tidak hanya mendengar semata-mata. Mereka juga menyediakan laporan kepada syarikat, sebagai memenuhi tanggungjawab mereka. Tambahan pula, skop tanggungjawab mereka telah bertambah sejak beberapa tahun kebelakangan ini. Ini adalah diakibatkan oleh perubahan yang berlaku di dalam rangka kerja pengkorporatan. Dari sudut lain pula, penilaian yang signifikan telah disediakan oleh pihak makkamah ke atas kuasa perundangan di mana pada kes Re Kingston Cotton Mill Co (No 2) [1896] 2 Ch 673 Lopes LJ telah dinyatakan bahawa "...auditor adalah anjing pemerhati dan bukan anjing pemburu…"dan kenyataan dari Cardozo CJ dalam Ultramares Corporation v Touche (1931) 174 NE 441 bahawa untuk menjadikan auditor sebagai pemegang tanggungjawab akan mengakibatkan kepada suatu kes "…tanggungan bagi sesuatu jumlah yang tidak menentu dalam tempoh yang tidak menentu sehingga membawa kepada suatu tahap yang tidak menentu …." Dalam kekelibutan seperti ini, maka adalah penting untuk menentukan kedudukan perundangan di Malaysia. Pada dasarnya, rangka kerja perundangan masa kini yang menguasai perlakuan auditor perlu dibuat penilaian semula berikutan berlakunya berbagai skandal yang

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melibatkan auditor yang merangkumi persekitaran tempatan dan antarabangsa. Dengan itu, kajian ini menilai kedudukan perundangan di United Kingdom, Australia and New Zealand. Kajian ini juga meneroka kajian litmus yang tepat untuk mementukan tanggungjawab para auditor kepada pemegang saham.

Katakunci: *auditor, pemegang saham, tanggungjawab*

INTRODUCTION

This study examines the legal position of the shareholders to whom auditors owe their duties. The examination will unfold whether the scope of the auditors owing their duties to shareholders is restrictive. The study will then investigate whether the scope should be widened and the legal justifications for attaching such a duty.

Background of Study

Auditors do not stand in a contractual relationship with existing shareholders. The auditors only stand in a contractual relationship with the company. Essentially, the contractual relationship with the company does not mean that the auditors have a contractual relationship with the existing shareholders. This is because the shareholders are not privy to the contract (Bidin, 2001). Furthermore, the company is a separate legal entity from its existing shareholders as laid down in *Salomon v A Salomon Co Ltd* (1897).

DUTY TO COMPANY

S. 174(1) of the Companies Act 1965 'the Companies Act' reads "Every auditor of a company shall report…" This means that an auditor is engaged by the company. The provision then continues by providing "…on the company's accounting and other records…" These words show that the auditors are required to audit the company's accounts. In other words, the auditors are required to perform their duties and obligations for the company. Therefore, auditors should owe their duties to the company.

Nevertheless, the provision provides "…shall report to the members on the accounts required to be laid before the company in general meeting…" Essentially, the provision does not read that the auditors shall report to the company. Thus, 'the Companies Act' does not explicitly state that a duty is owed by the auditors to the company. If the legislature had intended that the auditors shall report to the company, it would have used the word "…company…" However, the legislature did not to do so. Furthermore, the usage of the words "…before the company in general meeting…" shows that the report is to be submitted to the members of the company. Arguably, the term 'members' does not mean the company.

Thus, the question is whether the duties and obligations stipulated in 'the Companies Act' can necessarily suffice that implicitly, auditors owe their duties to the company. Although it is not explicit that the auditors owe their duties to the company, under 'the Companies Act' it can be implied from the words used in the provision (i.e. every auditor of a company shall report… on the company's accounting and other records…). Hence, the auditors owe a statutory duty to the company as provided in 'the Companies Act'.

Furthermore, in the Australian case of *AWA Ltd v Daniels t/as Deloitte Haskins & Sells* (No 2) (1992) the court found that auditors must comply with their statutory duties and obligations of reporting to the company. Thus, a duty is owed to the company. The statutory duties and obligations under the Australian legal position are similar to the auditors' statutory duties and obligations in Malaysia. Nonetheless, the pivotal issue is whether auditors owe a duty to shareholders.

AUDITORS' DUTY TO SHAREHOLDERS

The court in Re Kingston Cotton Mill Co (No 2) (1896) noted that there is no duty owed to existing individual shareholders. The auditors only owe a duty to the existing shareholders collectively, which represent the company. However, the court failed to recognize that there is a possibility where the collective interests of the existing shareholders are independent of the company. Nevertheless, in such a case, the auditors do not owe a duty to the shareholders collectively since the interests do not represent the company's interests. In such a case, the company cannot bring an action since it did not suffer any loss. On the other hand, the existing shareholders cannot bring an action in their own name, as there is no duty owed to them although they have suffered a loss collectively. This is unfair to the collective interests of the existing shareholders.

Furthermore, the court did not explain how to determine the collective interests of the existing shareholders. It should be noted that collective interests are not akin to absolute interests or majority interests. This is because assume a company has two shareholders where one holds 90% of the company's shares and the other holds 10%. The company's interest cannot be based on the interest of the majority shareholder. If the law states that the auditors do not owe a duty to the minority shareholder (i.e. the one who is holding 10% of the company's shares), it shows that the law is not protective over the shareholder who is in a vulnerable position. The law should not fail to offer protection where there is a real need for it. Otherwise, there will be a mismatch between the existing shareholders' expectations and the results share markets produce (Andrews, 2002).

Furthermore, the decision of Re Kingston is questionable since it was decided in 1896 whereby the corporate atmosphere has changed much since then (Rohatgi, 1981). In today's corporate atmosphere, much emphasis is placed on individual interests and rights. This is because there is a greater concern for an individual in the light of consumerism (Singh, 1976).

Moreover, a shareholder's interests cannot be equated to the interests of the company or the interests of shareholders collectively. The loss suffered by the existing individual shareholders cannot be the same as the loss suffered by the shareholders collectively.

The court in *London Oil Storage Co v Seear Hasluck & Co* (1904) remarked that the auditors are contemplated by the law to protect the interests of the shareholders as such. The shareholders wish to know the detail management of the company (Ali, 1999). In Re London & General Bank (No 1) (1895) Lindley LJ adverted that the auditors are appointed to check on the Board of Directors and the management of the company. Thus, the existing shareholders will expect the auditor's report to be true. Nonetheless, both the decisions are questionable since no duty is owed by the auditors to the shareholders. It is pointless to declare that auditors are appointed to safeguard the shareholders' interests if there are no rights attached to the existing shareholders as against the auditors.

In *Caparo Industries plc v Dickman Ors* (1990) the court found that there must be more than just foreseeability of reliance for an auditor to owe a duty to an existing individual shareholder. The House of Lords observed that in order for a duty to arise there must be foreseeability of harm or loss, proximity of relationship and the imposition of liability must be just and reasonable.

However, the court did not elaborate the requirements for establishing a duty. Their Lordships acknowledged that the terms were vague. In fact, the decision does not accord with the UK legislature's intention of increasing disclosure provisions in their laws (Davies & Prentice, 2003). The auditors' report cannot be merely meant for circulation in the company. It should be noted that the Court of Appeal in Caparo found that the auditors owe a duty to an existing individual shareholder but this was disapproved by the House of Lords.

Essentially, the House of Lords has taken a narrow approach in Caparo. In fact, Caparo is an unfinished business in relation to auditor's duty (Cadbury, 1995). It does not reflect the contemporary corporate atmosphere. Lord Bridge of Harwich pointed out that there is nothing in the statutory provisions which suggest that auditors owe a duty to individual shareholders. However, on the same premise, there is also nothing to suggest that auditors owe a duty to the company. Nevertheless, the courts have held that auditors owe a duty to the company. It can be seen that the courts are not consistent on this point.

Furthermore, the House of Lords declared that the auditors do not owe a duty to the shareholders because an existing individual shareholder will not suffer a loss that was distinct from the loss suffered by the company. This does not accord with the principle that a company is a separate legal entity from its shareholders. This is because it has always been a cardinal principle that a company is a separate entity from its shareholders, officers and employees. The loss of the company belongs to the company. The loss of the company cannot be treated the same as the loss of the shareholders. Thus, the House of Lords' argument on this point is unacceptable.

However, the cases after *Caparo Industries plc v Dickman & Ors* (1990) have begun analyzing on what basis there can be 'special relationship' between the auditors and the stakeholders. In *Henderson v Merret Syndicates Ltd* (1995) the House of Lords have used the term assumption of responsibility. It means that the auditors have assumed responsibility, which must be carried out in the interests of those relying on the auditors' report. In *Electra Private Equity Partners v KPMG Peat Marwick* (2001) the Court of Appeal made it clear that 'special relationship' does not require that the auditors should consciously assume responsibility. Therefore, the moment the auditors have taken up their position to discharge their auditing duties, they have assumed their responsibility. Consequently, they are in a 'special relationship' with the persons relying on the report. There is no requirement of actual knowledge on the auditors' part.

Nevertheless, the auditors should not owe any duty to the existing shareholders, as that will expose the auditors to unlimited liability. This was succinctly pointed out by Cardozo CJ in *Ultramares Corporation v Touche* (1931) that auditors will be liable for an indeterminate amount for an indeterminate time to an indeterminate class. Auditors only owe a duty to persons known to them and not to persons, reasonably known to them.

Observably, the court did not dismiss that a duty should not be owed by the auditors to existing shareholders. The court is concerned that there will be floodgates of litigation (i.e. the auditors will be subjected to numerous litigations). The auditors' profession will then become a high-risk profession. This shows that the court is concerned about the extent of the auditors' liability (Baxt, 1997). Fundamentally, the core issue should be whether a duty is owed to the existing shareholders.

In *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* (1997) the High Court of Australia found that foreseeability alone is not the touchstone of establishing a duty is owed to an existing individual shareholder. Furthermore, the auditors must have known that the existing individual shareholder is likely to rely on the auditor's report for entering into a transaction. Nonetheless, it is unclear as to what can be more than foreseeability. The only thing that can be, is actual knowledge which is a question of evidence. Be that as it may, it is difficult to prove that there was actual knowledge even if there was.

THE MALAYSIAN LEGAL POSITION

In the Companies Act 1965 (the Companies Act), it is not expressly elucidated that auditors owe a duty to the individual shareholders (Rachagan, Pascoe & Joshi, 2002). Neither is it elucidated that the auditors owe a duty to the shareholders collectively. However, Raja Azlan Shah J (as His Highness then was) in *Mooney & Ors v Peat, Marwick, Mitchell & Co & Anor* (1967) found that the auditors owe a duty to the shareholders collectively under S.174 (1) of 'the Companies Act'. This is on the basis that the provision requires auditors to report to the members at the company's general meeting. Moreover, the provision shows where the responsibility of auditors lie (Sin, 1990). Hence, it can be seen that the auditors' relationship is with the existing shareholders.

Nevertheless, the court is guided by the same principles as laid down in Re Kingston Cotton Mill Co (No 2) (1896) i.e. that the auditors only owe a duty to the shareholders collectively.

Notably, Raja Azlan Shah J (as His Highness then was) was influenced by the decision of *Hedley Byrne & Co Ltd v Heller & Partners Ltd* (1964) where the House of Lords held that there must be a special relationship between the person making a statement and the person relying on the statement. In the context of auditing, the auditors do make statements i.e. the auditors' report and are aware that the report will be relied upon.

However, the House of Lords did not explain what special relationship is (Oliver & Enid, 1994). Nonetheless, it could be found in cases where the person making a statement is an expert; the maker of the statement knows that his skill and advice is relied upon and the other person actually relied upon the advice. The auditors are experts in their own field; they are aware that the shareholders will rely on their report and the shareholders do rely on the report. The auditors' report is provided to the shareholders as the information therein enables them to better exercise their respective proprietary rights (Anandarajah, 2001). Thus, it is arguable that a duty should be owed to existing individual shareholders.

In Teoh Peng Phe v Wan & Co (2001) the court held that the auditors had failed to disclose the irregularities in the accounts to the company. Furthermore, the auditors owed a moral duty to disclose the identity of the wrongdoer (i.e. the directors, to the minority shareholders). This is because the debtors of the company were the directors. This was not disclosed to the shareholders.

It is pointless to create a new category of duty known as 'moral duty'. Although the court found that the auditors are under a duty to provide information to the shareholders, in the event the auditors failed to do so, the shareholders have no recourse of action since it is not a legal duty. The shareholders have no legal rights attached. Furthermore, the duty will be taken lightly by the auditors since there are no legal consequences if the duty is breached. Most importantly, it does not have any significant impact on the role, duties and obligations of auditors.

It should be noted that in Teoh Peng Phe's case, the shareholder was unable to obtain full information with regards to the disclosure of the true identities of the wrongdoers because the copies of the accounts were with the auditors. Since the auditors were given the right of access to the documents by virtue of S. 174(4) of 'the Companies Act', they should be obliged to disclose the true identities of the wrongdoers to persons who do not have access to such documents. Arguably, the existing shareholders are not outsiders. They have rightful interests in the company. The issue could be resolved if there was a duty owed by the auditors to the existing shareholders. Clearly, this is an example where the interests of the shareholders are separate from the interests of the company.

In the High Court of Singapore in *Ikumene Singapore (Pte) Ltd v Leong Chee Leng* (1993) it was also held that auditors owe no duty to an individual shareholder of the company as the duty is only owed to the shareholders as a body. The court found so, on the basis that the rationale behind S. 207(1) of the Singapore Companies Act is to establish a relationship between the auditors and the shareholders as a general body.

However, the relationship between the auditors and an existing individual shareholder is close enough that it goes beyond the ordinary relationship between the auditors and the shareholders as a general body. It was pointed out by the High Court of Australia in *Shaddock & Associates Pty Ltd v Parramata City Council* (1981) that sometimes information or advice is given in a serious matter and thus, the speaker ought to realize that he is being trusted to give the best of the information. The other party will take certain actions based on the information and it is reasonable to do so. In the context of auditing, this is apt.

Essentially, an existing individual shareholder does not have the same interests as a company. An existing individual shareholder invests in a company for financial returns. If he is not satisfied with the financial returns he will invest elsewhere.

A company is not an investor in itself. In fact, the general rule is that a company is not allowed to invest in itself by virtue of S. 67(1) of 'the Companies Act' unless it satisfies the requirements as provided in S. 67A of 'the Companies Act'. Furthermore, a company is an engine to generate revenue. It will rely on the auditors' report to determine its future direction. It will determine whether to slow down, progress further or to hold stock. Hence, it is often not the company which have suffered loss but its existing shareholders (Gullick, 1987). Thus, it cannot be said that the loss suffered by an existing individual shareholder is not distinct from a company.

Moreover, S. 174(1) of 'the Companies Act' reads "Every auditor of a company shall report to the members…" 'The Companies Act' does not state that the auditors are required to report to the company or that a duty is owed to the company. Thus, if it can be implied that the auditors owe a duty to the company, it can also be implied that auditors owe a duty to the shareholders.

Furthermore, there are provisions which empower existing shareholders to appoint auditors under S. 172(2) of 'the Companies Act', remove auditors under S. 172(4) of 'the Companies Act' and fix auditors' remuneration under S. 172(16)(a) of 'the Companies Act'. The powers are granted for the purposes of ensuring that only suitable and eligible persons audit the company's accounts. The auditor may have the necessary academic qualifications, knowledge and skills coupled with the approval of the Minister. However, the auditors must have earned the trust and confidence of the existing shareholders. This trust and confidence is built upon the relationship between the auditors and the existing shareholders. It is pointless to empower existing shareholders, if the relationship between auditors and the existing shareholders is only at the surface level.

Arguably, since the auditors' report is laid at the general meeting, it shows that the shareholders are treated collectively (Tabalujan, 1992). It is not meant for individual shareholders to make individual decisions with regards to their investment in the company (Pennington, 2001).

Nevertheless, S. 170 of 'the Companies Act' provides that a copy of the auditors' report shall be sent to all the members of the company. This shows that every existing shareholder has a right of access to the auditors' report. Thus, it cannot be said that the shareholders are treated collectively. It also cannot be said that the auditors' report is not meant for individual shareholders to make individual decisions with regards to their investment in the company. Furthermore, the member has a right to inspect the report. At the general meeting, he is allowed to seek further explanations and information on the report. He need not do so on behalf of the other members. He may do so for his personal consumption.

The purpose for which an existing individual shareholder refers to auditors' report is of essence. This is because the company's accounts can be used for various purposes (Kinross, 1991). A close examination shows that the purposes are threefold. Firstly, an existing individual shareholder will decide as to whether he wishes to continue his investment in the company or invest elsewhere. Secondly, he wishes to know whether his investment has been managed properly by the company's management. Thirdly, he wishes to decide whether he should invest more in the company since his investment has been managed well by the company.

Essentially, the decision revolves around shares, which is clearly within the knowledge of the auditors unless the existing individual shareholder has some other intention of making reference to the auditors' report. In the latter's case, it is clear that it not reasonably foreseeable to know what the purpose is. However, as regards to the decision to be made concerning shares, it is reasonably foreseeable. In fact, corporate atmosphere has taken a matured phase that it is reasonably foreseeable what investors will do to their shares.

Fundamentally, the concern is the legal justification for different treatment between an existing individual shareholder and a shareholder which is a holding company i.e. institutional shareholder. Rightfully, the law should be fair to all shareholders whether they are natural persons or artificial persons.

This is because as discussed earlier the auditors of a subsidiary company owe a duty to the holding company on the basis that the holding company is a shareholder of the subsidiary company. The reasoning is that the holding company has an interest in the subsidiary company. Be that as it may, the same reasoning should apply to shareholders who are natural persons since they have an interest in the company. Interestingly, the duty is owed although the holding company only holds a majority of the shares in the subsidiary company. Nonetheless, auditors do not owe a duty even if an existing individual shareholder holds 99% of the company's share capital.

Furthermore, the reason why the auditors do not owe a duty to an existing individual shareholder is because the latter is considered as a third party. Hence, he is not privy to the contractual relationship between the company and its auditors. On that premise, a holding company is also a third party since the contractual relationship is between the subsidiary company and the auditor. However, duty is owed by the auditors of a subsidiary company to the holding company.

Moreover, the auditors of a subsidiary company owe a duty to another subsidiary company of the same holding company. This is so although there is no contractual relationship between the auditors and the other subsidiary company. Rightfully, the other subsidiary company is also a third party. Conversely, a duty is owed too.

Notably, the issue of being a third party or not being privy to the contract does not arise since 'the Companies Act' has provided that a duty is owed to the holding company and subsidiary company. This shows that it is possible for the legislature to provide that a duty is owed. Thus, it is submitted that the legislature should make the necessary amendments to provide that a duty is owed by the auditors to an existing individual shareholder.

Notably, the duty to lay the auditors' report is owed to the shareholders (Pitfield & Hughes, 1979) and not to the company (Abbott, 1982) or the Board of Directors (Pitfield & Hughes, 1979). This means that it must be done at the annual general meeting. Therefore, it is not right for the auditors to lay the report directly to the Board of Directors (i.e. at the Board of Directors' meeting).

It was confirmed in *Spackman v Evans* (1868) that the auditors are the agents of the shareholders for the purposes of laying the report at the general meeting. However, in *Pendleburys Ltd v Ellis Green & Co* (1936), the auditors reported to the directors who were also the shareholders of the company. The court found that this was acceptable since the directors were also the shareholders. Nonetheless, it is submitted that where all the shareholders except, at least one are also directors, the report must be made at the annual general meeting, in the interest of the shareholders.

An important issue is to whom the auditors should submit their report to. It was found in *Mead v Ball Baker & Co* (1911) and Re City Equitable Fire Insurance Co Ltd (1925) that the submission of the auditors' report to the Board of Directors suffices. Nonetheless, in Re Allen Craig & Co (1934) Bennet J found that the submission to the company secretary suffices. This is because it is not the duty of the auditors to ensure that the company holds a general meeting.

This is incorrect. This is because S. 174(1) of 'the Companies Act' is clear that it shall be the duty of the auditors to report to the members at the general meeting. This means the auditors must ensure that a general meeting is held in the first place.

Moreover, it is quite risky to consider that it is not the duty of the auditors to ensure that the company holds a general meeting to lay the auditors' report. This is because the auditors' report may have been amended. There is also a possibility that the management may have manipulated the information. On the other hand, if the auditors knew or have reason to believe that the report is not laid before the shareholders, it is not reasonable for auditors to do nothing about it (Schmitthoff, 1992). Therefore auditors are under a duty owed to the shareholders to ensure that the report is laid at the general meeting.

Furthermore, to ensure there is no unauthorized amendment by any person, the auditors' report must be lodged with CCM, to enable any person including the existing shareholders to inspect the report. Nonetheless, the lodgment of report at CCM does not absolve auditors from laying the report at the company's general meeting.

A point to be noted is that under S. 174(1) of 'the Companies Act', it shall be the duty of the auditors to report to the members at the general meeting. Nevertheless, the provision does not make it compulsory for the auditors to attend the general meeting. The provision also does not provide that the auditors are required to answer any questions from the shareholders. It could be a situation where the shareholders may never meet the auditors and thus have no knowledge about who they are, although in records, the names of the auditors are provided. Hence, the provision should be amended requiring auditors to attend the general meeting and answer any questions from the shareholders.

CONCLUSION

The traditional view in company law is that auditors should only owe their duties to the company since they are under a contractual relationship with the company. This is justified on the basis that the company suffers loss if the report is untrue. Nonetheless, it is trite to declare that others may also suffer a loss if the report were to be untrue (Chan, Cheah & Heng, 2003). If the traditional view continues then shareholders will never be in a secured position. The auditors should not be only concerned with the company. The auditors should also bear in mind the interests of the shareholders. It is not practicable for shareholders to engage their own auditors before taking any steps. This is because the company may not be willing to disclose its financial information to external parties. Thus, the information revealed by the auditors is of primary importance to the shareholders. Many fraudulent activities and ventures can be planned with the ingenious work and plan of the auditors. Therefore, the guiding principles for the auditors should be responsibility and accountability. This responsibility and accountability must be owed to a wider circle of persons (i.e. the shareholders).

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