BOLD SPIRITS VINDICATED? ACCOUNTANTS' LIABILITIES

The decision of the High Court of Australia in the *President, Councillors and Rate-payers of the Shire of Frankston and Hastings* v. *Cohen*[1] raises a question of importance to accountants and lawyers alike; the vexed question of the nature and extent of liability of auditors to persons with whom they are not in a contractual relationship.

If we examine the judgments of the members of the High Court we are struck by the fact that their Honours apparently did not find it necessary to characterize the remedy they gave, but contented themselves with saying that a remedy did lie against the council auditor. However, in the circumstances of the case, it will be contended that no matter what basis is given to the remedy, it goes far beyond previous authority and leaves open many matters which may occupy appellate courts in Australia for years to come.

The Facts.

The case came to the High Court on appeal from the Supreme Court of Victoria. The Statement of Claim alleged that the defendant accountant, having been appointed under the Victorian Local Government Act an auditor of the accounts of the plaintiff Municipality, had so negligently conducted the audit that an officer of the Municipal Council had been able to misappropriate large sums of money.[2] The substantial question, heard by consent on an interlocutory summons to strike out the plaintiffs' Statement of Claim was "whether the bare facts that the defendant Cohen was a municipal auditor with a certificate of competency, that he has been duly appointed by the Governor-in-Council under the Act to be an auditor for a municipality, and that he, in consequence, conducts an audit of its accounts", were "sufficient to place him under a duty to the municipality to use care and skill in auditing accounts".[3]

Smith, J., of the Victorian Supreme Court, answered this question in the negative in an unreported judgment. The High Court, consisting of Dixon, C.J., Fullagar, Menzies and Windeyer, J.J. (McTiernan, J. dissenting) reversed this decision and held the respondent to owe a duty of care to the municipality to conduct the audit skilfully and carefully. In the result the local council was able to recover from the auditor the loss which it had suffered as a result of the negligent audit.[4]

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[1] (1959-60) 102 C.L.R. 607.

[2] So far as is material the Statement of Claim alleged: "15. The third-named defendant was at all times material a municipal auditor and the holder of a certificate of competency. . . . 16. The third-named defendant was duly appointed pursuant to the Act to act as auditor of the accounts of the plaintiff. . . . 19. In conducting such audit as aforesaid the third-named defendant owed a duty to the plaintiff to audit the accounts with skill and care but did so in a careless negligent and slipshod fashion unbefitting a skilled professional auditor holding a certificate of competency as aforesaid. 21. As a result of such breach of duty, the thefts or embezzlements of X escaped detection and he was enabled to steal and embezzle the sum of £10,956/10/5. . . ."

[3] *Id.* at 611-2.

[4] While the Council recovered in this case the whole amount of its loss, it should be noted that the measure of damages would be confined only to the loss actually resulting from the negligent audit. Thus where even if the audit had been carefully conducted some amount of the plaintiff's loss would still have remained undiscovered then the auditor could not be held responsible for such loss. *Cf.* cases cited *infra* on the duties of accountants and auditors.

The Judgments.

Fullagar, J., with whom Dixon, C.J. and Windeyer J., concurred, in giving the main judgment of the Court, pointed out that the Victorian Local Government Act provides that the Governor-in-Council can "appoint *for* each Municipality" some person "to be Auditor and . . . remove any person so appointed."[5] It also provides that the auditor is required to be of a certain standard of professional competency and is to be remunerated out of Council funds. The auditor is given wide semi-judicial powers concerning objections to accounts.

His Honour pointed out[6] that the prime purpose of the audit provisions of the Act was to provide for independent examination and supervision of municipal accounts. Although the auditor is not in the relation of a servant to the municipality, his primary function is to "audit the accounts". His Honour cited with approval the definition of audit given by Mr. R. A. Irish in *Practical Auditing.*[7]

> An audit may be said to be a skilled examination of such books, accounts and vouchers as will enable the 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.[8]

Some argument was raised that the judicial functions given to the auditor by the Local Government Act affected the liability of the auditor. The Court dismissed this argument by relegating the judicial powers to a position where they were ancillary to the auditor's main function — the conduct of an audit.

The mere fact of appointment by the Crown of the municipal auditor his Honour held, did not affect the duty owed by the auditor to the municipality for the audit is "a matter of internal interest to the Municipality itself"[9] as well as to the Crown who appoints the auditor. The acceptance of the appointment and entering into the task of auditing the accounts by a professional man of ability and skill gives rise to the duty of care and not the appointment itself. Some stress was, however, laid on the words of the Act that the auditor's appointment was "*for* the Municipality".[10] These words, it was suggested, could imply a relationship of a contractual nature between the auditor and the municipality although both Fullagar, J. and Menzies, J. seemed to base the action in tort.

Menzies, J., in a separate judgment, with which Windeyer, J. concurred, held that the duties owed by the auditor to the municipality did not depend on

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[5] *Id.* at 615.
[6] *Id.* at 616.
[7] R. A. Irish, *Practical Accounting* 1.
[8] Mr. R. R. A. Austin has pointed out that the courts have always distinguished the *standard* required of "an accountant taking out accounts and an auditor investigating the accuracy of prepared accounts submitted to him". Thus in *The Trustees of the Property of Apfel (a bankrupt)* v. *Annon Dexter & Co.* (1926) LXX *Acct. L.R.* 57-69), Astbury, J. pointed out that accountants of the former categories were not responsible for the correctness of entries in the books but only responsible for ascertaining from the books when made up, the position of the business as so shown. Auditors on the other hand are responsible for ascertaining the true position of the business whether disclosed properly by the books or not. (See generally R.R.A. Austin, "Legal Liability of Accountants" (1961) 14 *The Australian Lawyer* 86-89.

These analyses of the functions of an auditor deal with the standard required in the carrying out of the audit and do not go to the actual duty of the auditor giving rise to a liability in damages for breach of the required standard.
[9] (1959-60) 102 C.L.R. 607, 618.
[10] *Id.* at 616.

any bargain made between the two parties but upon the character of the auditor's office.[11] The fact that a qualified person was appointed, that the results of the audit were communicated to the municipality and that it was the municipality which remunerated the auditor, pointed, in his Honour's view, to the establishment of a relationship which had as an element the duty of the auditor to the municipality to perform his work properly. The municipal auditor was in the same position as the company auditor in this respect, subject to the important difference that the former's concern was with the investigation of the books and accounts of a governmental institution.

Basis of the Decision.

There are at least three categories into which the remedy granted in the *Frankston Case* could have been placed had the High Court chosen so to do. These are:

1. An action at common law for negligence of the auditor.
2. An equitable remedy based on the principle of *Nocton* v. *Ashburton*[12] arising at common law under the fusion of law and equity resulting from a Judicature Act system.
3. Breach of a statutory duty lying on the auditor giving rise to a civil liability in the auditor at the suit of the council.

Counsel for the appellant stated specifically "The plaintiff sues in tort. . . . This is a claim for the negligent performance of a task undertaken by a person possessed of special skills and qualifications." He referred *inter alia* to *Donoghue* v. *Stevenson*[13] as the basis for his argument.[14] Counsel dealt also with the possibility of liability arising from the breach of statutory duty but dismissed this as being not for that reason different from an action in negligence. As authority on this point he referred to *Fisher* v. *Ruislip - Northwood Urban District Council.*[15] Roper, C.J. in Equity, giving the judgment of the full Supreme Court of New South Wales in *Long* v. *Darling Island Stevedoring and Lighterage Co. Ltd.*,[16] had held that a claim for damage in respect of injury caused by breach of a statutory duty is separate and distinct from a claim for damages in respect of injury caused by negligence. His Honour pointed out that in his opinion "in an action based solely upon negligence the failure to observe the provisions of some statutory regulation is not conclusive evidence of negligence although the injury in question may have followed from that failure."[17]

As to the third suggested basis no reference can be found in the argument as reported, although Menzies, J. intimated that reference was made in argument to "the number of cases where a duty of care has been inferred from a particular relationship."[18] His Honour did not, however, find it necessary to consider these cases.

In view, therefore, of the meagre references in argument and judgments to the above three possible categories of decision, it becomes necessary to review

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[11] *Id.* at 624.
[12] (1914) A.C. 932.
[13] (1932) A.C. 562.
[14] (1959) 102 C.L.R. 607, 609.
[15] (1945) K.B. 584. In dealing with the case of a negligent performance of a statutory duty of the Council to light, the Court said at 595 "Negligence is the breach of a duty to take care. That duty arises by reason of a relationship in which one person stands to another. Such a relationship may arise in a variety of circumstances. . . . Similarly if the right which is being exercised is not a common law right but a statutory right, a duty to use care in its exercise arises, unless on the true construction of the statute, it is possible to say that the duty is excluded".
[16] (1956) S.R. (N.S.W.) 137 and Note (1956) 30 *A.L.J.* 635.
[17] *Id.* at 635.
[18] (1959) 102 C.L.R. 607 at p. 628.

in turn the authorities in each category with a view to assessing their appropriateness for application in the instant case.

Common Law Action for Negligent Words.

In *Candler* v. *Crane Christmas & Co.*[19] the members of the Court of Appeal were divided in opinion as to whether an action in negligence in respect of negligent advice lay. "On the one side there were the timorous souls who were fearful of allowing a new course of action. On the other side there were the bold spirits who were ready to allow it if justice so required".[20] The facts of the case were simple. An accountant was instructed to prepare accounts with the knowledge that they were to be used to induce the plaintiff to invest money in the company. The accounts were prepared negligently but without fraud and did not give a true statement of the financial position of the company. The plaintiff investor who suffered loss as a result of his investment brought an action grounded in negligence to recover the money which he had invested in the company. The majority of the Court of Appeal (Cohen and Asquith, L.J.) held that no such action lay against the accountant in the absence of a contractual or fiduciary relationship. Their Lordships came to this conclusion on the authority of the two cases of *Derry* v. *Peek*[21] (an action for fraud founded on a false statement by a director in a prospectus) and *Le Lievre* v. *Gould*[22] (an architect's certificate given negligently), from which certain principles fundamental to the decision were derived:

1. That a distinction exists between damage caused as a result of physical acts and damage caused as a result of non-physical, i.e. verbal, acts. 2. That damages in respect of negligent words are not sufficiently proximate to be recoverable. 3. That the test laid down by Lord Atkin in *Donoghue* v. *Stevenson*[23] does not therefore apply with respect to damage caused through negligent advice.

Denning, L.J., however, took a broader approach and proclaimed himself one of the "bold spirits". He argued that persons whose profession and occupation is to examine books, accounts, etc., and to report upon them to people other than their clients with whom there is implied a duty to conduct the audit carefully, have a duty to use care in the preparation of these reports. The duty proposed by his Lordship arose from the professional status and training needed in the preparation of such reports.[24] In support of his argument Denning, L.J. quoted examples where the "situation and employment necessarily imply a competent degree of knowledge in making such entries. . . ."[25]

The persons to whom this duty is owed are their employer or client (in an

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[19] (1951) 1 All E.R. 426.
[20] *Id.* at 432.
[21] (1889) 14 App. Cas. 337.
[22] (1893) 1 Q.B. 491.
[23] (1932) A.C. 562.
[24] His Lordship speaking of the remedy he proposed to allow, said that "a country whose administration of justice did not afford redress in a case of the present description would not be in a state of civilisation" (at 431). This was no doubt an overstatement of the problem for as Austin points out *op. cit. supra* n. 8. "The public at large has a special faith in accounts prepared or audited by qualified and independent accountants" (at 86-87).

The result of their work affects a wide field of investors, lenders, bankers, suppliers of goods and services on credit, and so on. The accountants are not themselves unaware of their responsibilities. The standard they have set themselves goes far beyond the standard imposed by the law. It would seem therefore desirable that the law should recognise the improved standard. Austin suggests (at p. 87) that legislative intervention would be desirable to overcome the decision of the majority in *Candler* v. *Crane Christmas & Co.*

It may be that the decision of the High Court in the *Frankston Case* has anticipated this need.
[25] *Id.* at 433.

action based on contract) and also any third person to whom they themselves show the accounts or to whom they know their employer (or client) is going to show the accounts so as to induce investment, or some other action, as a result of the accounts. The test of proximity in such cases his Lordship defined as "did the Accountant know that the accounts were required for submission to the Plaintiff and use by him?"[26] This liability was, however, confined to transactions for which the accountant knew his accounts were required.

> I could 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, for that would expose him, in the words of Cardozo, C.J., in *Ultra Mares Corpn.* v. *Touche* (174 N.E.444), to . . . liability in an indeterminate amount for an indeterminate time to an indeterminate price.[27]

The High Court in the *Frankston Case* seem implicitly to have allied themselves with the "bold spirits".[28]

Denning, L.J. pointed out that the duty of care arises when professional men bring their professional skill and knowledge into play. Similar statements are made by Fullagar, J. in the *Frankston Case,* when he says that the task of auditing accounts ". . . requires special qualifications, and in entering upon it, in the words of Willes, J. in *Harmer* v. *Cornelius*[28a] *'Spondes peritiam artis*: Thus if an apothecary, a watchmaker or an attorney be employed for reward, they each impliedly undertake to *possess and exercise* reasonable skill in their several arts. The public profession of an art is a representation and undertaking to all the world that the professor possesses the requisite ability and skill. . . .' In my opinion a duty of care exists, and it is a duty owed to the municipality."[29]

Although the representation may be, as Willes, J. suggests, to all the world, clearly the duty of care owed is to a more limited class. We have seen that Denning, L.J. restricted this class to those persons for whose use the accountant knew accounts were being prepared. This appears similar to the test propounded by Fullagar, J. in the *Frankston Case.* His Honour in the latter case seems to say that to bring an action for breach of duty against an auditor there must be present some internal interest in the primary and essential function of the auditor. The Court considered that clearly the local municipal council had such an interest for "when the Act says that the Auditor shall audit the accounts, I feel no doubt that it is just as much concerned with protecting the Municipality and the Council from fraud as with ensuring that the Council itself keep within the law."[30]

But while there are marked similarities between the judgment of Denning, L.J. in *Candler* v. *Crane Christmas & Co.* and the judgment of the High Court in the *Frankston Case,* it would be unfair to carry the comparison too far for the following reasons:

1. Although the Statement of Claim was grounded in negligence, none of the judgments of the Court positively based the action in common law negligence, although Menzies, J. expressed the view that the action lay in tort, which could mean that it lay in common law negligence. Fullagar, J. left open the possibility that the liability was perhaps in the last analysis contractual in nature,[31] or a breach of statutory duty.

2. At no stage did the High Court appear to consider itself bound to follow *Candler* v. *Crane Christmas & Co.* nor was the case referred to by any member of the Court. It seems that the case was not raised in argument before the High Court. The similarity between the High Court decision and the judgment of

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[26] *Id.* at 434.
[27] *Id.* at 435.
[28] But see later argument for limitations of this comparison.
[28a] (1858) 5 C.B. (N.S.) 236.
[29] (1959-60) 102 C.L.R. 607 at 618-19.
[30] *Ibid.*
[31] *Id.* at 612.

Denning, L.J. may be therefore purely accidental.

3. Another influence may have had more bearing upon the result than did the *Candler* v. *Crane Christmas & Co.* decision, namely the cases involving a breach of the duty arising out of a quasi-fiduciary relationship.

Nocton v. *Lord Ashburton and beyond.*

It will be recalled that in *Nocton* v. *Lord Ashburton*[32] a mortgagee brought an action against his solicitor claiming to be indemnified against a loss which he had sustained by having been improperly advised and induced by the solicitor to release a part of the mortgage security whereby the security had become insufficient. It was argued before the House of Lords that the decision in *Derry* v. *Peek*[33] covered the matter and that unless wilful fraud was proved against the solicitor no action would lie. The Court held, however, that the decision in *Derry* v. *Peek* meant only that "the facts proved as to the relationship of the parties . . . were not enough to establish any special duty arising out of that relationship other than the general duty of honesty."[34]

In a classic statement of law, Viscount Haldane discussed the relationship between the liability in negligence at common law and the equitable doctrine of liability for a breach of duty arising from the fiduciary relationship. "Although liability for negligence in word has in material respects been developed in our law differently from liability for negligence in act, it is none the less true that a man may come under a special duty to exercise care in giving information or advice . . . whether such a duty has been assumed must depend on the relationship of the parties and it is at least certain that there are a good many cases in which that relationship may be properly treated as giving rise to a special duty of care in statement."[35] In the words of Lord Dunedin these duties may arise "from a relationship without intervention of a contract in the ordinary sense of the word."[36]

It has been generally considered that the class of fiduciary relationship was restricted to certain defined situations such as, for example, the solicitor and client relationship. The professional man and the person who relies upon his advice are not as such in one of the classes of fiduciary relationships which have been comprehended by the equitable doctrine. However, there is a decision of a single judge (Salmon, J. in *Woods* v. *Martin's Bank*[37]) which suggests that from certain classes of relationship (other than the usual type of fiduciary relation) there may arise a quasi fiduciary relationship which in its turn gives rise to a duty of care or that at least the list of fiduciary relationships is not closed.

The *Martin's Bank Case* dealt with a bank which had advertised that expert advice was one of the advantages which the bank offered to its customers. The bank manager in question had given advice to the plaintiff. This advice concerning investment was seemingly honest throughout but there were no reasonable grounds for advising the plaintiff in his own interests to make the particular investments. The money was in fact invested in a company which was a client of the bank; the company collapsed and the plaintiff lost considerable money as a result. Salmon, J. found that "it was and is within the scope of the Defendant Bank's business to advise on all financial matters and that they owed a duty to the plaintiff to advise him with reasonable care and skill in each of the transactions."[38] The reasons for judgment as reported in the Weekly Law Reports or

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[32] (1914) A.C. 932.
[33] (1889) 14 A.C. 337.
[34] (1914) A.C. 947.
[35] *Id.* at 948.
[36] *Id.* at 964.
[37] (1959) Q.B.D. 55, (1958) 3 All E.R. 166.
[38] (1958) 3 All E.R. 173.

All England Reports do not cite much authority for this conclusion nor is the duty which arises from the relationship of banker and customer likened to the duty arising from a fiduciary relationship. The authorised Law Reports, however, contain one sentence which is omitted in the reports of the case mentioned above. There now appear the words: "In my judgment, a fiduciary relationship existed between the plaintiff and the defendant"[39] apparently arising from the relation of the bank and its customers.

The duty owed by the auditor in the *Frankston Case* also was described as one which arose from the relationship of council and auditor. Fullagar, J. said "I would rather regard the duty as arising from a relationship created pursuant to the statute".[40] Menzies, J. reaches a similar conclusion that "the relationship of Municipality and Auditor for the Municipality imports a duty owed by the Auditor to the Municipality".[41]

One difficulty which occurs if the duty in question arises from a quasi fiduciary relationship is that an action in negligence in respect of a breach of such relationship seems more appropriate to a Judicature Act system in which the remedies of law and equity are fused than the system in New South Wales in which it is still important which jurisdiction of the court is invoked in each case. In New South Wales, if the basis of the action lies in the *Nocton* v. *Ashburton* principle, the suit would be brought in the equity jurisdiction of the Court for compensation for breach of the fiduciary duty. This would at least preserve the distinction between negligence (a purely common law remedy) and the *Nocton* v. *Ashburton* remedy. Presumably, if such an action were brought at common law, for damages, the defendant would demur on the grounds that no cause of action would lie and the action would be dismissed. Similarly an action for damages in the equity jurisdiction must fail for the right to such relief has been held necessarily ancillary to the exercise of equitable relief.

No action of a similar kind has, however, been brought in New South Wales. The case of *Tumbarumba Shire Council* v. *S.*[42] referred to by the High Court involved an auditor appointed by the Council itself. The plaintiff council recovered in respect of the auditor's negligence and Ferguson, J. said that the auditor "holds himself out as reasonably competent for the work which he undertakes to do; and must be taken to have reasonable care and skill . . . if he does not use reasonable care and skill he is guilty of negligence."[43] This case appears despite its wide *dicta,* however, to have been based rather on contract than on tort and indeed the High Court expressed their opinion that it was.

Action for Breach of Statutory Duty.

If we assume that the basis of the Frankston remedy lay in an action for breach of statutory duty the principle would seem inconsistent with or at least a marked extension of the principle governing such an action laid down by the House of Lords in *Cutler* v. *Wandsworth Stadium Ltd.* (in liquidation).[44] That case dealt with the English Betting and Lotteries Act which provided that where a totalisator was operated on a licensed dog racing track, the occupier was not to exclude bookmakers from the track. A bookmaker excluded in breach of the Act brought an action in damages for breach of the statutory duty. In their judgments the Law Lords looked to the Act itself. As Lord Simonds said:[45] "The only rule which in all circumstances is valid is that the answer must depend

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[39] (1959) Q.B.D. 72.
[40] (1959) 102 C.L.R. 621.
[41] *Id.* at 628.
[42] (1916) 3 L.G.R. (N.S.W.) 162.
[43] *Id.* at 164.
[44] (1949) 1 All E.R. 514.
[45] *Id.* at 548.

on a consideration of the whole Act and the circumstances, including the pre-existing law, in which it was enacted", and adopting the words of Lord Kinnear in *Black* v. *Fife Coal Co. Ltd.*[46] said: "We are to consider the scope and purpose of the statute and in particular for whose benefit it is intended."

Their Lordships then looking to the Act decided that primarily the Act was designed to protect the public although it also protected bookmakers. Lord Normand said:[47] "Obviously, the duty operates in a general way in favour of bookmakers and bookmakers have an interest to enforce it." Nevertheless, their Lordships held that the primary purpose of the Act was to regulate the conduct of betting operations, and although this worked advantageously for the benefit of bookmakers, this did not spring "from the primary purpose and intention of the Act."[48] Consistent with this decision, Kitto, J. in *Darling Island Stevedoring & Lighterage Co. Ltd.* v. *Long*[49] said: "A private right exists in the persons for whose protection (the regulation then in question) is made."

However, the High Court in the *Frankston Case,* while undoubtedly holding that it was as much the intention of the Act to ensure that local councils remain within the law as to protect the council from frauds such as the one in that case, nevertheless seemed to place more emphasis on the fact that the audit was a matter of "internal interest" to the municipality and therefore actionable at the suit of that municipality. In other words, the High Court might appear to have laid down the test that where breach of a statutory requirement was of "interest" to a plaintiff, then that plaintiff could bring an action in damages for breach of the statutory duty.

Against this argument the following matters should be fairly mentioned: 1. The Statement of Claim if framed to put at issue the question of breach of statutory duty would have been more appropriate had it set out the requisite statute and alleged a breach.[50] 2. The Court pointed out that in *New Plymouth Borough* v. *The King*[51] where an action was brought by a municipality for an alleged negligent audit Stan, J. (although the point was conceded for the purpose of the action) said that there was some doubt whether a breach of statutory duty by the Audit Office (the auditors appointed by the Crown) gave right to a civil action since the Act was passed for the benefit of the Crown. His Honour cited *Cutler's Case* in support of this proposition. 3. Both Fullagar, J. and Menzies, J. expressed the view that the action did not arise as simply a breach of statutory duty. It will be recalled that Fullagar, J.[52] said, following a discussion of the *New Plymouth Borough Case:* "I would rather regard the duty as arising from a relation created pursuant to the statute." If the action lies in negligence only and breach of the Local Government Act were relied upon evidence of negligence, then the principles of common law negligence would apply and the problem of *Candler v. Crane Christmas & Co.* once more would arise.

The Company Auditor after the Frankston Case.

The *Frankston Case,* as we have seen, dealt with the liability of a shire auditor to the municipal council. However, the members of the Court related the duties of the shire auditor to those of the company auditor. It is in this field that the *Frankston Case* may have its widest implications.

The duties of an accountant engaged as an auditor depend upon the terms

[46] (1912) A.C. 165.
[47] *Id.* at 551.
[48] *Per* Lord Simonds at 549.
[49] (1957) 31 *A.L.J.* 208 at 215.
[50] *Id., per* Williams, J. at 209. This rule is applicable also to Judicature Act systems of pleadings.
[51] (1951) N.Z.L.R. 49.
[52] (1959) 102 C.L.R. 607, 621.

of his appointment, and in the case of the company auditor upon the provisions in the Companies Act regulating his function and the provisions of the articles of association of the company. Leaving aside the provisions of the articles,[53] the Act provides for appointment either by the company or in certain cases the Registrar-General and regulates the holding of office. Section 115 provides that the auditor shall make a report to members on the accounts examined by him and on certain other records and sets out the matters to be included in the report, namely:

(a) Whether or not they have obtained all the information and explanations they have required;

(b) whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company; and whether,

(c) in their opinion, the register of members and other records which the company is required to keep by Law or by its Articles have been properly kept.

No penalty is provided for breach of this provision nor is any remedy given to any person to enforce the duty. If, therefore, the *Frankston Case* is authority for the broad proposition of "interest" giving rise to a civil right for breach of statutory duty, then clearly the auditor's appointment and duty is of "international interest" to the shareholders who in their own right might have a remedy against the auditor for breach of the statutory duty. The company too would seem to have an action against the auditor although in that case it may be that the provisions of the Companies Act, which apply irrespective of contract, would be read into the contract for services between the company and the auditor made on the acceptance of the auditor of his appointment as an auditor pursuant to the Companies Act.

Section 308 of the present Act — the misfeasance section — gives rise to an action by the liquidator, any creditor or contributory against *inter alia* "an officer of the Company" for compensation "in respect of . . . misapplication, retainer, misfeasance or breach of trust". This section could reinforce the argument above by providing argument that the prime purpose of the audit provisions was to protect shareholders or even creditors. In *re London & General Bank No. 2* [54] the Court of Appeal held that an auditor was, at least in the context of the Articles of Association of that Company based on Table A, an "officer" of the Company and so liable under that action. Whether the negligent performance of the audit is a misfeasance or non-feasance may be open to doubt; however, the authorities seem to have accepted that it is a misfeasance. The remedy is, however, available only on a liquidation which would be of little advantage to creditors. It should also be added that the amount misappropriated is under the section to be restored to the Company.

Section 361 of the present Act reproduced in clause 365 of the Companies Bill is a warning provision for the company auditor. This section applies specifically to officers of the company or persons employed by a company as auditors, whether they are or are not officers of the company and provides:

1. If in any proceeding for negligence, default, breach of duty or breach of trust against a person to whom this section applies, it appears to the court hearing the case that that person is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and

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[53] Which in Table "A" to the N.S.W. Companies Act 1936 provides that "auditors shall be appointed and their duties regulated in accordance with s.113, 114 and 115 of the Act" (Article 102).

[54] (1895) 2 Ch. 682.

reasonably, and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as the court thinks fit.

The following points seem pertinent:

1. The section applying directly to auditors seems to reinforce the position that auditors may be liable in negligence.

2. The section would exclude most actions for negligence in that the auditor will have acted honestly and reasonably and ought fairly to be excused for his negligence.

Pressure of business may well have been introduced by this section as a defence to an action against the auditor.

3. The section reinforces the view that all auditors are not officers of the company.

4. The section also applies to breach of duty — which presumably means implied and statutory duties.

The draft Companies Bill due to be introduced in all States to implement uniform company legislation in early 1962 throughout the Commonwealth, does not alter the common law position or delineate the duties of the company auditor with any more clarity than the present N.S.W. Act. Accounts and audit are dealt with in Part VI of the Bill and Clause 167 imposes on the auditor substantially similar duties to report as those imposed by s.115 of the present Act.

Clause 305 of the Bill substantially reproduces the misfeasance section of the present Act (s. 308). However, in the Bill "officer" is defined in a way which would exclude the auditor from its ambit. The definition clause (clause 5) does use the word "include" thus indicating that the definition is not an exclusive one. Thus if an auditor were comprehended within the term "officer" in s.308 of the Act, it could be argued that he would be still comprehended within the term as used in clause 305 of the Bill. However, clause 8 (6) of the Bill provides that a person shall not be appointed an auditor *inter alia* if he is or has been for 12 months or longer an officer of the company.

Clause 365 of the Bill reproduced section 361 of the Act in its entirity. Clause 169 (7) of the Bill enables the Minister as defined to bring an action in the name of the company in respect of any fraud misfeasance or other misconduct in connection with the management of the company's affairs *inter alia* for the recovery of property of the company which has been misapplied or wrongfully attained. Mere negligence on the part of the auditor would not seem to come within the scope of this action.

Apart from the provisions in the Companies Act the duties of an auditor are governed by the common law. These duties have been discussed in many cases and the classic statement is given by Lindley, L.J. in *re London and General Bank No.* 2.[55] In that case an auditor omitted certain information in his report to shareholders, with the result that a dividend was declared out of capital. The Court of Appeal held that the auditor was guilty of misfeasance under s.10 of the Companies Act, 1890, and said:

> Such I take to be the duty of the Auditor; he must be honest — that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case.[56]

This definition of the auditor's duty has been expanded and elaborated in a

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[55] *Ibid.*
[56] *Id.* at 683.

number of decisions, the last of which involved the liquidation of the City Equitable Fire Insurance Company Limited in the early 1920's.[57]

All the cases discussing the liability of the auditor have come before the courts on a Liquidator's Summons for misfeasance of an officer of the company. It has, however, never been the subject of a decision whether an action will also lie against the auditor by a shareholder. Strictly, the auditor is employed by the company itself and it therefore could be argued that any action against the auditor can be taken only in the name of the company and not by individual shareholders. If, however, the reasoning of the High Court in the *Frankston Case* is applied to this situation, it appears that such an action can be brought.

The company auditor is appointed by the company and strictly is not in a contractual relationship with any individual shareholder; the municipal auditor is not in any contractual relationship with the municipal council. The company auditor is appointed to examine the books of the company for the information and benefit of the shareholders; the municipal auditor is appointed to examine the books of the council for the information and benefit of the council. The company audit is one of internal interest to the members of the company; the municipal audit is one of internal interest to the local council. Thus it would seem that notwithstanding the rule in *Foss* v. *Harbottle*[58] an individual shareholder can bring an action against the company auditor for negligence in conducting the audit.

If this is the case, of course, there seems no logical reason why there should be a distinction between investors in shares and investors who lend money on the faith of the auditor's accounts. The bar to this latter action must depend on whether the High Court in the *Frankston Case* intended to overrule the decision of the Court of Appeal in *Candler* v. *Crane Christmas & Co.* It seems probable that this was not the case, as no comment appears in the judgment of the members of the High Court. On the other hand, it should fairly be stated that this interpretation of the *Frankston Case* may carry the analogy between the company auditor and the municipal auditor too far. Perhaps all that can be concluded is that where an auditor is appointed, for example, by the Crown, or Registrar-General, then the company would have a remedy against him for loss suffered in a negligent audit.

Conclusion.

It would seem that an accountant can be held to be liable in negligence for a breach of his duty to take reasonable care in conducting an audit both at the suit of a company and a shareholder. If this be the case, then it would follow that the decision of the Court of Appeal in *Candler* v. *Crane Christmas & Co.* should be examined especially in the light of modern commercial practice with its demands of specialisation. The businessman, the company shareholder, the investor, the company director, and to a large extent the company solicitor, rely upon the specialised knowledge which an accountant brings to bear on the audit of the company.

Furthermore, as pointed out above, the standard of duty which accountants have imposed upon their own work seems to suggest that a remedy should be

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[57] See e.g. *London Oil Storage Co.* v. *Seear, Hasluck & Co.* (1904) *Acct. L.R.* 31; *The Irish Woollen Co. Ltd.* v. *Tyson and Ors.* (1900) *Acct. L.R.* 13; *The Leeds Estate Building and Investment Co.* v. *Sheppard* (1887) 36 Ch. D. 787; *In re Kingston Cotton Mill Co. Ltd.* (1896) 1 Ch. 331 (See 1896) *Acct. L.R.* 77, where Lopes, L.J. remarked: "An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that something is wrong. . . . He is a watchdog but not a bloodhound."

[58] (1843) 2 Hare 461.

at the suit of aggrieved third parties.

Some restraint must of course be placed upon any derogation from the rules which limit liability in tort to physical as against financial damage. It would clearly be fantastic to allow recovery against an accountant by any person at all who relied upon his advice, whether or not reasonably in contemplation, when the audit was conducted. Where, however, the person seeking to recover was directly in contemplation when the auditor accepted his appointment and had a direct personal interest in the result of the audit and in the exercise of reasonable professional skill by the accountant, then if liability is allowed it has still been restricted within the bounds of commercial commonsense.

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