

## A SHORT NOTE ON THE LEGAL ASPECTS OF AUDITING PRACTICE IN MALAYSIA

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### SINOPSIS

Kertas ini meneliti sebahagian dari aspek-aspek undang-undang berkenaan dengan amalan audit di Malaysia, seperti kelayakan menjadi seorang juruodit, perlantikan dan persaraan juruodit, tugas-tugas, hak-hak, dan tanggungjawab-tanggungjawab juruodit. Penelitian ini adalah berdasarkan atas undang-undang yang berkuat-kuasa di Malaysia, dan juga keputusan mahkamah dan pernyataan profesyen di luar negeri.

### SYNOPSIS

*This paper examines some of the legal aspects of auditing practice in Malaysia, such as: eligibility of being an auditor, appointment and retirement of auditor, duties, rights and liabilities of auditor. In the examination, refernces were made of the legislation being enforced in Malaysia, as well as some of the court decisions and professional pronouncements of foreign countries.*

#### A. Who Can Be An Auditor in Malaysia

The Governing legislation is the Accountants Act 1967. The accountants Act 1967 was enacted to provide for the registration of accountants and matters connected therewith. Under this Act a body called the "Malaysia Institute of Accountants" (MIA) was established. The Act classifies accountants registered with the Malaysian Institute of Accountants into three categories: (a) public accountants, (b) registered accountants and (c) licensed accountants.

Section 22 of the Act provides, "No person shall, unless he is registered as a public accountant under this Act and has his principal or only place or residence within Malaysia — practice or hold himself out as a . . . , auditor, . . ."

Thus to be an auditor in Malaysia, one must register oneself as a Public Accountant with the MIA, and resides in Malaysia.

To be eligible for registration as a public Accountant with MIA, the applicant must meet the requirements of section 14(1)(a) and section 15(1) of the Act.

Section 14(1)(a) specifies the academic qualification necessary, ". . . passed the examination specified in Part I of the first schedule or . . . a member of one of the associations of accountants specified in part II of that schedule . . ."

Part I of the first schedule reads "The final examinations of the Malaysian Institute of Accountants shall be recognised examinations for the purpose of section 14(1)(a)". Part II of the same schedule reads: "The associations recognised for the purpose of section 14(1)(a) are:

- (a) Malaysian Associations of Certified Public Accountants,
- (b) Institute of Chartered Accountants of Scotland;
- (c) Institute of Chartered Accountants in England and Wales;

- (d) Institute of Chartered Accountants in Ireland;
- (e) Association of Certified Accountants (United Kingdom);
- (f) Institute of Chartered Accountants in Australia;
- (g) Australian Society of Accountants;
- (h) New Zealand Society of Accountants;
- (i) Canadian Institute of Chartered Accountants;
- (j) Institute of Chartered Accountants of India; and
- (k) Institute of Cost and Management Accountants (United Kingdom)

It might be noted that thus far the MIA has not conducted any examination for the purpose of section 14(1)(a). However section 14(2) provides that "For the purpose of subsection (1)(a) a person shall be deemed to have passed the examination referred to in that subsection or any part of such examinations, as the case may be, if he has passed an examination or part of an examination (whether in Malaysia or elsewhere) which is recognized by the Institute as being equivalent to or higher than the examinations or part thereof first mentioned in this subsection". In this light, the Diploma in Accounting (University Malaya), The Bachelor of Accounting (University Malaya) and the Bachelor of Accounting (Universiti Kebangsaan Malaysia) have been recognized by MIA as being "equivalent to or higher than" the "final examination" of the Institute. Thus, for example, a graduate of Universiti Kebangsaan Malaysia with a Bachelor of Accounting is deemed to have fulfilled the requirement of section 14(1)(a).

Section 15 specifies the practical experience required for one to be registered as a public accountant under the Act. The applicant for registration as a public accountant must have at least five years' experience (re-

duced to four years in the case of Higher School Certificate holders and to three years in the case of graduate of approved University or Institutions and those who has obtained the experience after he has satisfied the requirements of section 14(1)(a)). Note that the practical experience must be gained "in the office of a public accountant or of a practising accountant overseas who is a member of the recognized bodies specified in Part II of the First Schedule" (S(15(1)(a))). Any other type of practical experience gained such as in governmental department, manufacturing industries, banks etc., will only entitle the person to be registered as a registered accountant or licensed accountant. However the council of the MIA has been empowered to admit a registered accountant or a licensed accountant as a public accountant under section 15(2) and section 16(3) respectively. Also, applicants who have "authority under section 8(2) and (6) of the Companies Act, 1965 to act as a company auditor without limitation or conditions" are exempted, under section 15(1)(b) from the practical experience specified in section 15(1)(a).

It has been held in the case of John Stephen Nelson Noronha V the Attorney – General, Malaysia and Malaysian Institutes of Accountants that "An applicant who satisfies the court that he has the qualification prescribed in section (14(1)(a) and has fulfilled the requirement of section 15 would be entitled **as of right** to be registered as a public accountant upon payment of the prescribed fee" It is not necessary for the applicant to be actually in public practice at the time of application.

Thus to be an auditor in Malaysia, one must have one's principle or only place of residence within Malaysia, and register oneself as a public accountant under the Accountants Act 1967. To be registered as a public accountant under the Act, one must pass the relevant examination or be a member of one of the accounting associations specified and have the relevant and sufficient practical experience. Diagrammatically, the legal requirements of being an auditor in Malaysia may be shown below:

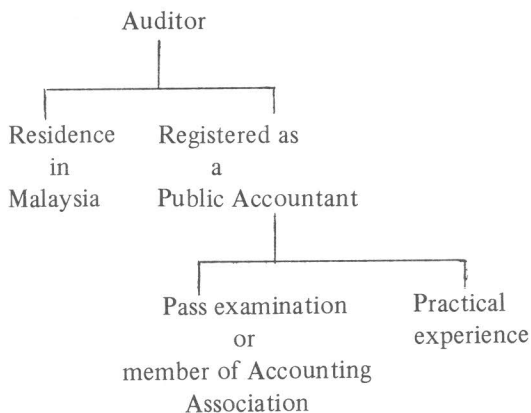


Diagram 1: Requirements of being an auditor in Malaysia

It might be noted here, that any person, who is less than 21 years of age or who, in the opinion of the council of MIA, is not a fit and proper person to be admitted as a member of MIA would not be admitted as a member. (S14(3))

Also a body corporate would not be eligible for membership of the Institute (S14(6))

## B. Appointment and Retirement of An Auditor

Companies incorporated under Companies Act 1965 are required to have their annual financial statements audited by an approved company auditor. Other forms of business organization are not under any statutory requirement to appoint an auditor to audit their financial statements. Thus the following discussion centers largely on the statutory requirements under the Companies Act 1965.

To act as an auditor of companies incorporated under the Companies Act 1965, approval to do so must be sought from the Minister of Finance as required by section 8 of the Act. Such approval, which is renewable every third year, is granted through the Treasury. The Treasury has been insisting that applicant must be member of the Malaysian Institute of Accountants and it evaluates independently the public accounting experience of each applicant.

It should be pointed out at this juncture that an auditor who has been approved to act as a company auditor may nevertheless be prohibited under section 9 of the Companies Act 1965 to do so, if he is (1) indebted to the company or to a corporation that is deemed to be related to that company in an amount exceeding \$2500, or (2), he is (i), an officer of the company, (ii) a partner, employer or employee of an officer of the company, or (iii) a partner or employee or an employee of an officer of the company, or (3) he is responsible for or if he is the partner, employer or employee of the person responsible for the keeping of the register of members or the register of holders of debentures of the company." The purpose of this section seems to be to ensure independence of auditors. (It might be noted that, strangely enough there does not seem to be a direct exclusion of shareholding). Thus an auditor who is an approved company auditor, shall nevertheless not act as auditor of a company if he is not independent (as defined in section 9) of the company. The conditions under which an auditor is deemed to be not independent for the company may be shown diagrammatically below:-

The statutory requirements regarding the procedure in the appointment of a company auditor are stated in section 172 of the Companies Act.

At any time before the first Annual General Meeting (AGM) of a company, the directors of the company may appoint an auditor to hold office up to the 1st AGM (note: The first AGM of a company must be held within 18 months after incorporation). The Act provides that if the directors do not make an appointment, the company may do so during a general meeting. At each subsequent AGM, the company (not the directors) shall make the appointment. However the directors are empowered to appoint an approved company auditor to fill any casual vacancy in the office of the auditor of the company. In any event, if the company fails to appoint an auditor, the Registrar of Companies may, on the application in writing of any member of the company make the appointments.

An appointment under the Companies Act 1965 to act as a company auditor carries with it the duties specified in the Act. It is not possible to contract out of the statutory duties.

Section 174 of Companies Act 1965 requires the auditor to attest to the financial statements during his tenure of office. The auditor may give an unqualified opinion or an adverse opinion under subsection (1) or a qualified opinion under subsection (2).

The relevant provisions of the Companies Act 1965 are as follow:

Section 174(1): Every auditor of a company shall report to the members as to every balance sheet and profit and loss account (including every consolidated balance sheet and consolidated profit and loss account) laid before the company in general meeting during his tenure of office and shall state in the report whether, in his opinion:-

- (a) The balance sheet and profit and loss account are properly drawn up in accordance with the provisions of this Act and so as to give a true and fair view of the state of the companies affairs;
- (b) The accounting and other records (including register) examined by him are properly kept in accordance with the provisions of this Act; and
- (c) The director's report made pursuant to subsection (5) of section 169 in so far as it is required by this Act to deal with matter dealt with in the accounting and other records examined by him, gives a true and fair view of such matters.

It should be mentioned at this juncture that International Accounting Standard 7, "Statement of Changes in Financial Position" adopted by MACPA, requires that effective from January 1, 1979, a third statement, entitled "Statement of Changes in Financial Position" is to be included as part of the basic

financial statements. Presumably, as from January 1, 1979 all auditors who are members of MACPA will be required to report on this new statement.

It should be remembered that the keeping of books of account and preparation of financial statements are the responsibility of the management, not the auditors. Management is responsible for presenting financial statements that reflect underlying events and transactions in conformity with generally accepted accounting principles. The auditor only evaluates the appropriateness of the management presentation.

It should also be noted that the wording of section 174 "... report to the members ..." dictates that the auditors duty is to report to the shareholders, not to the directors. However the auditor is not obliged to circulate his report to the shareholders, mere delivery of the report to the secretary of the client company has been held to be sufficient.

An example of the auditor's report in fulfillment of his duty under section 174 of Companies Act 1965, is shown below:-

#### **"Auditor's Report**

To The Members of ABC Berhad  
In Our opinion:-

- (a) the annexed Balance Sheet and Profit and Loss Account together with the notes there on are properly drawn up in accordance with the provisions of the Companies Act 1965 and so as to give a true and fair view of the state of affairs of the Company at 31st December 1980 and of the results of the Company for the year ended on that date.
- (b) the accounting and other records (including registers) examined by us have been properly kept in accordance with the provisions of the said Act and;
- (c) the Director's Report in so far as it

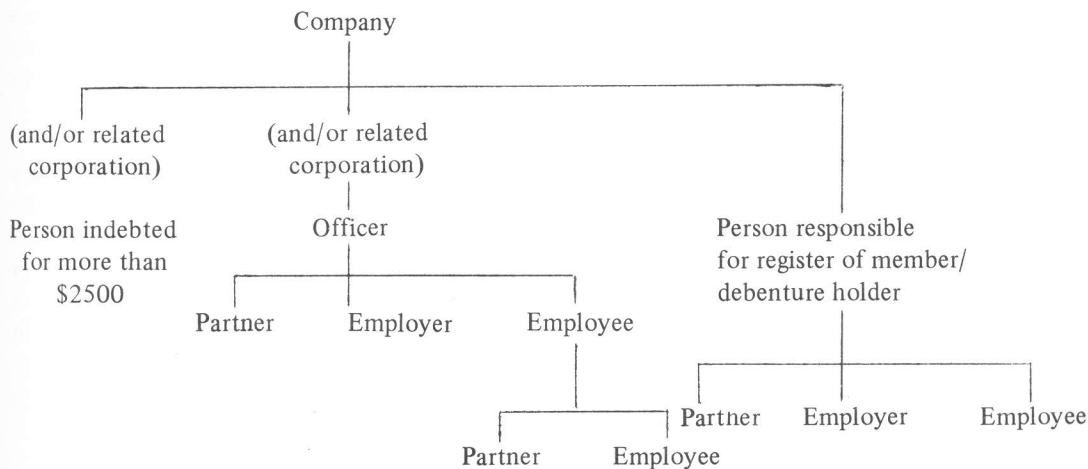


Diagram 2: Persons not eligible for appointment as an auditor of a particular company under Companies Act 1965.

For any new appointments being proposed, notice of the nomination must be given to the company by a member not less than 21 days before the AGM. A copy of the notice must be sent to the nominee, to the present auditor of the company and to each person entitled to receive notice of the AGM of the company. For the reappointment of the existing auditor, no such notice is necessary. In any event, Section 9(6) of the Companies Act provides that the auditor must, prior to being appointed, consent in writing to act as the auditor of the company.

Section 172 of the Companies Act also provides for the removal of the auditor.

Subsection 4 reads: "An auditor of a company may be removed from office by resolution of the company at a general meeting of which special notice has been given, but not otherwise". There are certain statutory procedures to be followed and the auditor has certain rights in the event of a proposed removal. First of all, a special notice must be given. The company, after receipt of the special notice shall send a copy of the notice to the auditor and to the Register. The auditor may, within 7 days after receipt by him of the copy of the notice make representation in

writing to the company and request that a copy of the representation be sent by the company to every member of the company to whom notice of the meeting is sent and also require that the representations be read out at the meeting at which the resolution is to be considered. After removal of the auditor, the company shall give the notice of removal to the Registrar of Companies.

Statutory requirement regarding resignation of a company auditor is provided for in section 172(14) and (15) of the Companies Act.

Section 172(14) reads: "An auditor of a company may resign – (a) if he is not the sole auditor of the company, or (b) at a general meeting of the company – but not otherwise". Section 172(15) provides that if an auditor gives notice in writing to the directors of the company that he desires to resign, the directors shall call a general meeting for the purpose of appointing an auditor in place of the auditor who desires to resign. The resignation takes effect on the appointment of new auditor.

### C. Duties of An Auditor

When the appointment is made by a sole proprietor or partnership, the auditor's duties will depend primarily upon the terms of the contract made at the time of the appointment. In most cases, there are no statutory provisions governing the audits of these forms of business organization.

is required to deal with matters dealt with in the accounting and other records, examined by us, gives a true and fair view of such matters.”

Companies Act 1965 imposes additional statutory duties on auditor of a borrowing corporation. Under section 175 of the Act, the auditor is required to send by post a copy of the relevant documents to every trustee for the holder of debenture of the borrowing corporation, and also to report in writing to the borrowing corporation and the trustee of any matter relevant to the exercise of power and performance of duties of the trustee of the holder of debenture of the corporation.

An auditor if already appointed, must examine and report upon the share allotment and cash received therefrom and all receipts and payments on capital amount as contained in the statutory report.

Besides the statutory duties as per Companies Act 1965, an auditor must, in every case, perform his audit to accepted standard of professional skill, care and competence. Lopes L.J. in the case of the **Kingston Cotton Mill Company Ltd.**, (1896) said “. . . It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. . .”

It is however not an auditor's duty to be suspicious. Lopes L.J. in the same case continued, “. . . An auditor is not bound to be a detective, or as was said, to approach his work with suspicious or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a blood hound . . . He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care . . .”

However if the auditor becomes aware any-

thing calculated to excite suspicion, it is his duty to probe it to the bottom. In a Malaysia case **Re-Pinder**, the judge said, “. . . If the auditors find cause for suspicion in the accounts . . . the character and the role of the auditors changes from that of being a watch-dog and becomes that of a bloodhound. . .”

**In Re London an General Bank Ltd. (1895)** the judge imposed on the auditors the duty of being honest. Lindley L.J. “. . . Such I take to be duty of the auditor: he must be honest — i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believe that what he certifies is true. . .”

It should hardly be necessary to add that the confidential relationship between auditor and client must be preserved. There is a duty of secrecy in relation to the client affairs. This is emphasised in the case of **Fogg V Goutler & Blane** where the accountants is held liable in breach of their duty of secrecy for allowing the solicitors to inspect their file and supplying copies of plaintiff's income tax returns to the solicitors.

#### D. Rights of Auditors

When the appointment is made by sole proprietorship or partnership the auditor's right will depend primarily upon the terms of the contract made. However if the right are restricted in a way which prevent him from carrying out the normal audit procedures, the auditor should make appropriate reservation or qualification in his report.

Auditors appointed under the Companies Act 1965 have their rights derived from the Act. These rights can of course, be extended by the article of association, contract or common law.

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*(A statutory report is a report prepared by the directors of a public limited co. to be presented to the members at the statutory meeting which must be held within a period of not less than one month and not more than three months after the date at which the co. is entitled to commence business).*



Under section 174 (3) of Companies Act 1965, every auditor has a right of access at all time to the accounting and other records (including registers) of the company. The use of the words "at all times" suggests that the auditor is entitled to access as and when he wishes, and to examine the books for whatever length of time he considers necessary to form his opinion. It is an offence against the Act for any officer of the company to refuse or fail without lawful justification to allow the auditor access to the accounting and other records, in his custody or power (S174(6)).

To enable the auditor to carry out his duties, the same subsection of the Act also confers on the auditor the right to require from the officers of the company and from the auditor of a related corporation such information and explanation as he desires for the audit. It is also an offence against the Act for any officer of a company to refuse or fail without lawful justification to give any information possessed by him as and when required by the auditor (section 174(6)).

The auditor also has the right under section 174(4) of the Act "to attend any general meeting of the company and to receive all notices of and other communications relating to any general meeting which any member is entitled to receive and to be heard at any general meeting which he attends on any part of the business of the meeting which concerns him as auditors"

As stated earlier on, if an action to remove him is proposed, the auditor is entitled to a special notice and has the right to make representation in writing to the company (not exceeding a reasonable length) within 7 days after receipt of the notice and request that, prior to the meeting at which the resolution is to be considered, a copy of the representations be sent by the company to every member of the company to whom notice of the meeting is sent. The auditor may also (without prejudice to his right to be heard orally) require that the representation be read out at the meeting (section 172).

It is generally considered that the auditor has a right, under the common law, to retain possession of working paper which he has prepared or which are relevant to accounts on which he has reported. It may be an important issue if his work is called into question or if a change in auditors occurs. This issue was considered fully in USA in the case of **Ipswich Mills V Dillon & Anov** (Massachusetts Report 453) in which the supreme court held that copies of tax returns, letters and work sheets other than papers which originated in the client's office were the property of the accountant and need not be delivered to the client.

The issue as to whether the auditor has the right to retain possession of working paper has been largely settled in several English cases.

In the case of **Chartrey Martin & Co. V Martin** (1953) the court of appeal held that the auditor's working paper were the property of the firm of accountants who acted as auditor for a company. The expression 'working paper' is used in this case to mean any document that the auditor or his staff may prepare in order to help him carry out the audit, for example, schedule prepared from incomplete records, memorandum, draft profit and loss account, draft balance sheet and draft reports. These documents are clearly prepared for the accountants's own purposes and a client can have no claim on them.

In the above case, the Court of Appeal also held that correspondence between the auditor and the Inland Revenue in regard to the client's account and tax computation thereon (both the copies of letters sent and the originals of letters received) were the property of the client. This decision was on the basis that the accountants have been acting as agents for the client for the purpose of settling with the Inland Revenue the client's tax liability. This decision follows from the principle that if an agent brings into existence certain documents whilst in the employment of his principal, they are the principal's documents and the principal can require that the agent should hand them over.

Having regard to the basis on which the Court of Appeal reached its decision regarding correspondence with the Inland Revenue, it is considered probable that the courts would hold communications with third parties and copies of communications by the auditor to third parties are the property of the auditor where the relationship is that of client and professional men. It is considered probable for example, that certificates of bank balance, letters of confirmation to debtors would be held to be the property of the auditor, notwithstanding that they have been brought into existence in connection with work done for the client.

As to the issue of the auditor's right of lien on the books of his client, it has been held in the cases of *Burleigh V Ingran Clork Ltd.* (1901) and *Re Gleebs Pte. Ltd.* (1933) that the auditor has no right of lien on the books for unpaid fees, except to the extent that he has actually written up any of them, and even then his lien would not hold good as against a liquidator or trustee in bankruptcy, or attach to a book, such as the register of member, which must be open to public inspection under the Companies Act.

Another right of the auditor is that he is entitled, under common law to proper remuneration, provided his duties are properly performed. The fees and expenses of the auditor of a company shall be fixed as provided under section 172(16) of the Companies Act 1965.

### **E. Liabilities of an Auditor**

An auditor holds himself out to the public as an expert willing to perform skilled services for rewards. Accordingly the law imposes exacting obligations on him to carry out the work to an acceptable standard of competence and with due care.

The auditor has legal liabilities which may be laid down by statute, arising from contractual relationship with his client or arising as the result of tort.

#### **(i) Statutory**

Accountants Act 1967 imposes certain ethical rulings on all members of MIA (including auditors) (section 18). Section 29 of the Act provides that any person who commits an offence against the ethical ruling shall, on conviction, be liable to a fine not exceeding five hundred dollars.

Under Companies Act 1965, an auditor who made a statement as an expert for inclusion in a prospectus for the issue of shares or debentures, which is untrue will subject himself both to civil liabilities under section 46 of the Act, ". . . shall be liable to pay compensation to all person who subscribe for or purchase any shares or debentures on the faith of a prospectus for any loss or damage sustained by reason of any untrue statement therein . . ." and a criminal liability under section 47 of the Act ". . . shall be guilty of an offence against this Act . . . Penalty: Imprisonment for two years or five thousand dollars or both . . ." The auditor however can defend himself against the liability under both S46 & 47 on the basis that "he had reasonable ground to believe and did up to the time of the issue of the prospectus, believe the statement was true". The onus of proof of having reasonable grounds for belief is on him and failure to prove so would subject him to both civil and criminal liabilities even though the untrue statement arose from mere negligence (under common law, negligence normally only give rise to civil liabilities).

When an auditor undertakes an audit engagement for a client, a contractual relationship immediately exists. Failure of one or both parties to the contracts to perform in accordance with the contract provisions (which may either be written or orally) constitutes a breach of contract. An auditor might be sued for breach of contract, for example if he fails to deliver his audit report to the client by the date specified in the engagement letter.

#### **(iii) Tort**

Under law of tort, an auditor may be liable for fraud or negligence. Fraud is defined as misrepresentation by a person of a material fact, known by that person to be untrue or



made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured. One important element of fraud is the intention to deceive. Thus unless the auditor misrepresent fact with an intention to deceive, he will not be sued for fraud. Fraud cases arise normally when the auditor surrenders his independence and cooperates with the client to give outsiders a false impression of the financial affairs of the client.

Negligence is a violation of legal duty to exercise a degree of care which an ordinarily prudent person would exercise under similar circumstances, with resultant damages to another party. Thus a legal duty to take care is a prerequisite for a suit for negligence. Common law cases (eg *Re the Kingston Cotton Mill Company, Ltd.*) have imposed on the auditor a duty to bring to bear on the work he has to perform a standard of professional care. American Institute of Certified Public Accountants (AICPA) has set forth as one of its auditing standards thus, "Due professional care is to be exercised in the performance of the examination and the preparation of the report" Thus the client can sue the auditor for negligence if the auditor fails to exercise "due care" in carrying out his work.

An often-asked question on auditor's duty to exercise due care is "does due care include an obligation to research for and discover fraud in the client's operation". Put in other words, does failure to detect fraud constitute proof of negligence on the part of the auditor?

AICPA'S stand on this issue (as stated in Statement of Auditing Standard (SAS) 1 has been ". . . the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, . . . the responsibility of the independent auditor for failure to detect fraud . . . arises only when such failure clearly results from failure to comply with generally accepted auditing standards." This limited view is superceded by Statement of Auditing Standard 16. "The independent auditor's responsibility for the

detection of errors or irregularities" which was issued recently in response to various court decisions on this issue. SAS 16 states, ". . . the independent auditor has the responsibility, within the inherent limitation of the auditing process, to **plan his examination to search for errors or irregularities** that would have a material effect on the financial statements and to exercise due skill and care in the conduct of that examination . . . The auditor should plan and perform his examination with an attitude of **professional skepticism** . . ." (Note: the term irregularities was defined in the statement to refer to "intentional distortion of statements, such as deliberate misrepresentation by management, sometimes referred to as management fraud, or misappropriation of assets sometimes referred to as defalcation").

English courts have time and again touched on this same issue. The position has been that "due care", at least in a statutory audits imposes a duty to pay due regard to the possibility of fraud. In **Pacific Acceptance** case, the judge commented, ". . . the duty to pay due regard to the possibility of fraud has been recognized by the courts . . . I think it is sufficient to say that the duty referred to (duty to pay regard to the possibility of fraud) exist, as does the consequential duty to warn, and that each is comprised within the duty to with skilled care . . ." However the judge in **Kingston Cotton Mill** case ruled that, ". . . Auditors must not be made liable for not tracking out ingenious and carefully laid out schemes of fraud when there is nothing to arouse their suspicion . . ." It is difficult to see how an auditor, if he carries out his audit with due skill and care, fails to notice something suspicious when there is a scheme of fraud, no matter how carefully laid out. In any event it has been held that if his suspicious are aroused, then it is his duty to probe to the bottom or in the words the judge in **Re-Pinder** ". . . the character and the role of the auditors changes from that of being a watchdog and become that of a bloodhound . . ."

A related issue is the auditor's liability for detection of illegal acts by the client. AICPA

has provided the following guidelines on this issue in its SAS 17 “**Illegal acts by clients**”. SAS 17 states “. . . An examination made in accordance with generally accepted auditing standards cannot be expected to provide assurance that illegal acts will be detected . . . the auditor should (however) be aware of the possibility that illegal acts may have occurred . . . If as a result of those procedures the auditor believes that illegal acts may have occurred, he should inquire of the client’s management and consult with client’s legal counsel . . .”.

After it has been determined that an illegal act has occurred the auditor should report the circumstances to personnel within the client’s organization at a high enough level of authority so that appropriate action can be taken by the client . . . if the client does not give appropriate consideration to the illegal act, the auditor should consider withdrawing from the current engagement or disassociating himself from any future relationship with the client . . . Generally, the auditor is under no obligation to notify those parties (parties other than personal within the client’s organization) . . . However, if the auditor deemed the illegal act to be sufficiently serious to warrant withdrawing from the engagement, he should consult with his legal counsel as to what other action, if any, he should take”.

#### (iv) **Liability to third Party**

As stated earlier on, an auditor is liable to his client for breach of contract, or for tort such as fraud or negligence. Similarly the auditor is liable to a third party beneficiary for the same acts because the third party beneficiary is in privity with the auditors and the client being audited. (A third party beneficiary is a person – not the promisor or promisee – who is named in a contract or intended by the contracting parties to have definite right and benefits under the contract).

The liability of an auditor to third party not in privity has been established in the famous case of **Hedley Byrne & Co. Ltd Heller & Partners Ltd. (1964)**.

In earlier decisions, the English speaking courts were reluctant to extend the obligation to take due care to parties with whom the auditor has no contractual fiduciary relationship i.e. with whom there was no privity of contract. The **Hedley Byrne** case was decisive in indicating that an auditor could be held liable in negligence to third parties who were not privy to a contract with him. The case did not involve auditor, but arose out of a bank giving erroneous favourable financial reference as to one of its customer to the plaintiff’s bank. The House of Lords unanimously indicated that when someone is, or alleges to be, possessed of a special skill undertakes, irrespective of contract, to apply that skill for the assistance of another person who could reasonably be expected to rely and he knows or should have known would rely on his such skill, then a duty of care arises.

It was also held in **Hedley Byrne** case that the duty of care will not arise if responsibility is expressly disclaimed. However in an Australian case of **Mutual life & Citizens Assurance Co, Ltd. V Evatt (1968)**. The chief justice in his judgement saw fit to express doubt as to whether a disclaimer of liability would be effective in all cases.

It might also be noted that the **Evatt** case reiterated that no liability for due care existed when a representation was made on a social or casual occasion.

In this light, it should be noted under the Companies Act 1965, the auditor is liable for an untrue statement in the prospectus to “all persons who subscribe for or purchase any share or debentures on the faith of the prospectus . . .” (Section 46)

The general trend on auditor’s liability for some long time has been to widen the auditor’s responsibility in line with an emphasis of his role of helping protect the public interest. The ultimate would be that the auditor owes a duty of care to everyone whom he can foresee to rely his work. It is an ideal to which the profession probably ought to strive.

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