1. Duty of care owed

- When is a duty owed?
  - The duty of care considers whether the auditor owes a duty to the plaintiff to take care in the performance of the audit. This involves consideration of what duty is owed and to whom it is owed.
  - Donoghue v Stevenson (snail in the bottle)
    - Who do you owe a duty of are to? Did the manufacturer owe Ms Donoghue a d.o.c.?
    - “persons who are so closely or directly affected by my actions that I might reasonably have them in my contemplation”
      - I owe a duty to anyone that I hurt because they’re there
      - Realising that you can hurt them
    - Idea of a neighbour – person you could affect (eg when driving – other cars)
    - Understand that actions affect the other party

- Owe by Auditor
  - Auditor to Client
  - Auditor to Shareholders
  - Ask yourself – who is the audit report prepared for?

2. Duty of care breached?

- The determination as to whether there has been a breach of the duty of care owed is primarily focused on the actions of the auditor. This requires consideration of what the auditor is required to do because of the duty, compared to what the auditor actually did do in the situation.
- Two parts
  - What is the duty owed? → standard of care expected
  - Did the actions lead to a breach? → match actions against standard expected
- Ask yourself:
    - What was expected of the auditor?
    - Did the auditor do what is reasonably expected of them?

Duty of Care Breached – What is Expected?

- Kingston Cotton Mill Co (1896)
  - Skill, care and caution of a reasonably competent, careful and cautious auditor
  - “watchdog not a bloodhound” - investigate fraud if found
    - watchdog responds if a problem occurs, a bloodhound actively seeks for those problems.
  - Auditor did not physically observe inventory but relied on a certificate from management
  - In the Kingston Cotton Mills (1896) case the judge found that the auditor was required to complete the audit with “that skill, care and caution which a reasonably competent, careful and cautious auditor would use”. The court highlighted that the auditor was not to be a detective; that is the auditor is “a watchdog, but not a blood hound”. It was however noted that if the auditor did find something that aroused suspicion, then “he should probe it to the bottom”, but that “the duties of auditors must not be rendered too onerous”.
- London and General Bank (1895)
  - “he is not an insurer; he does not guarantee the books”
  - Argued against unrealistic expectations
  - The London and General Bank (1895) case the court found that “the duty of an auditor is to convey information, not to arouse enquiry”. Thus the role of the auditor was seen to be one of review, not necessarily proactive in nature.

- Implications of the Kingston Cotton Mill and London and General bank cases

- The auditor is not necessarily answerable for an error of judgement, provided they exercise the skill and care of a reasonable competent and well-informed member of the profession

- Pacific Acceptance Corporation Ltd v Forsyth (1970)
    - Court looked at what a 'reasonable' auditor should do
    - Set of expectations that an auditor should met in order to show that they have taken due care
        1. Pay due regard to the possibility of material fraud or error in framing or carrying out audit procedures so the auditor has a reasonable expectation that the fraud or error will be detected.
            - Recognise that there may be errors in the accounts and anticipate to find them
            - Plan the audit in a way that will detect any fraud or error
        2. Promptly report fraud or warn of suspicion of fraud, whether material or not.
            - Even if the fraud may appear small at the moment, it may escalate
            - Fraud is intentional
            - Because its deliberate, there tends to be a follow on effect
            - Therefore, auditors must report the fraud immediately
        3. Closely supervise and review the work of inexperienced staff.
        4. Properly document audit procedures in a written audit program which is to be amended as necessary as the audit progresses.
            - Document what you do and adapt it
        5. Audit the whole of the year, not just the year-end balances; the duty to audit encompasses the client's financial affairs throughout the period of appointment and is not confined to reporting on the year-end balances as presented in the accounts.
            - Audit transactions that have occurred in the period, not just the BS
        6. Carry out proper objective auditing procedures; reliance on independent sources or client personnel is an aid but not a substitute for the auditor's own procedures.
            - Appropriate to rely on what the client has told you, as long as you can verify that what they have said tis true
        7. Do not shirk reporting to shareholders on the pretext that some detriment would arise if the matter were revealed

Duty of care breached – do the actions lead to a breached?

- Facts of the situation
    - What did the auditor do?
- Comparison
    - What is expected?
    - Did the actions meet the breach?

<u>3. Quantifiable loss or damage sustained due to breach</u>

- Once it is shown that a duty was owed and that the duty has been breached, the plaintiff must then show that loss or damage was sustained. The plaintiff must show that the damage is quantifiable, and also that the damage was a result of the breach of duty of care. This is known as causal connection (causal relationship).
    - <u>Causal</u> connection (not casual!!!!!)
        - Link between breach of duty by the auditor and the harm suffered by the plaintiff
        - Relationship must have been reasonably foreseeable and proven to be attributable to the negligent conduct of the auditor
        - Did the lack of meeting the requirements cause the damage?
        - Failure to show link will mean that legal action will fail
- Contributory negligence
    - Relates to the failure of the plaintiff to meet certain required standards of care
    - Together with the defendant's (auditor) negligence, it contributes to bringing about the loss in question
    - Court tends to examine all relevant circumstances to judge the likely proportion of liability attributable to respective parties