Held – by the Court of Appeal, affirming the decision of Vaughan Williams J – that the auditors had been guilty of misfeasance, and were liable to make good the amount of dividend paid. It is the duty of an auditor to consider and report to the shareholders, whether the balance sheet exhibits a correct view of the state of the company's affairs, and the true financial position at the time of the audit. He must take reasonable care to see that his certification is true, and must place the necessary information before the shareholders and not merely indicate the means of acquiring it. In the course of his judgment Lindley LJ said:

> An auditor [. . .] is not an insurer; he does not guarantee that the books correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company [. . .] but, he must be honest, i.e. he must not certify what he does not believe to be true, and he must use 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 the case.

Theobald, the auditor, stated the true position to the directors, and if he had done the same to the shareholders, his duty would have been discharged.

(b) As we have seen, there is no statutory duty upon an auditor to detect fraud but if suspicions are aroused the auditor has a duty to investigate matters. A standard issued by the Auditing Practices Board (SAS 110) states that an auditor's prime duty is to ensure that the company's accounts give a true and fair view of its position and not to detect fraud. Nevertheless, says the standard, material fraud can distort a company's accounts and auditors should be alert to the possibility of its existence. Other guidelines issued by the APB state that auditors may be barred from auditing financial services companies if they detect fraud and fail to report on it to the relevant regulator, e.g. the Financial Services Authority.

(c) An auditor may have to value shares and in this connection it should be noted that if on the facts of the case the court takes the view that the auditor was employed in the capacity of arbitrator rather than expert there is no liability in negligence. However, in most cases the auditor will be regarded as valuing as an expert because the parties are seldom in dispute with regard to the value of the shares and are simply seeking a professional valuation. Where the auditor values as an expert he will be liable in negligence under the rule in ***Hedley Byrne & Co*** v ***Heller & Partners*** [1963] 2 All ER 575 if he reaches a valuation without the exercise of proper skill and care. In addition, the auditors' valuation of shares is generally binding on the parties even if it is wrong. The courts are reluctant to set aside a professional valuation in the absence of fraud, or collusion (***Baber*** v ***Kenwood Manufacturing Co*** [1978] 1 Lloyd's Rep 175), and this makes the remedy against the auditors more attractive provided, of course, negligence can be established.

(d) The auditor should be familiar with the company's constitution, i.e. its memorandum and articles (***Re Republic of Bolivia Exploration Syndicate Ltd*** [1914] 1 Ch 139) and must, of course, check and verify the company's accounts (***Leeds Estate, Building and Investment Co*** v ***Shepherd*** (1887) 36 Ch D 787).

(e) The auditor is not under a duty to take stock and can accept as honest any statements made by the company's officers and servants so long as he acts reasonably in so doing and the circumstances are not suspicious (***Re Kingston Cotton Mill Co*** (1896), below). In other words, he must act as a reasonably careful and competent auditor would.

Re Kingston Cotton Mill Co [1896] 2 Ch 279

The directors of a company were enabled to pay dividends out of capital because the stock in trade of the company was overstated for several years. The auditors had not required the production of the stock records but had accepted the certificate of the company's manager regarding the value of the stock.

Held – by the Court of Appeal – the auditors were not liable. It was stated that an auditor is 'a watchdog not a bloodhound'. He can assume that the company's servants are honest and can rely upon statements they make unless there are suspicious circumstances which would give reason for distrust. *Per* Lopes LJ:

> 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. 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 there is something wrong. He is a watchdog, but not a bloodhound. 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 uses reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful [. . .] It is not the duty of an auditor to take stock; he is not a stock expert; there are many matters on which he must rely on the honesty and accuracy of others.

Comment

The rule laid down in the above case has been modified by subsequent cases. In ***Westminster Road Construction and Engineering Company Ltd*** (1932) unreported, a company paid dividend out of profits which were overstated by reason of the overvaluation of work in progress. This figure was supplied by the manager and secretary and it was held that the auditor was liable to repay the money paid out as dividend because he had accepted the certificate given by them without making proper enquiries which would have revealed that the valuation was inflated.

See also ***Re City Equitable Fire Insurance Co Ltd***, 1925 (Chapter 17).

It should be borne in mind, however, that the cases relating to the general duty of care of the auditor are rather old and that professional standards have risen since they were decided. Thus, it is now generally accepted that an auditor should not rely on the accuracy and honesty of other persons even in the matter of stocktaking, and that he should carry out a check on at least one or more sample items. The standard of care required of an auditor at the present time was probably more accurately expressed by Lord Denning in ***Fomento (Sterling Area) Ltd*** v ***Selsdon Fountain Pen Co Ltd*** [1958] 1 WLR 45 at p 61 where he said:

> An auditor is not confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional 'adder-upper and subtractor'. His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly he must come to it with an enquiring mind – not suspicious of dishonesty [. . .] – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.

This higher duty of care was to some extent applied in the following case.

Re Thomas Gerrard & Son Ltd [1968] Ch 455

The managing director of the company had falsified the accounts by three methods one of which involved including non-existent stock and altering invoices. The auditors who were put on inquiry by alterations of invoices negligently failed to investigate the matter and gave a falsely favourable picture of the profits of the company as a result of which it declared dividends it would not otherwise have declared which in turn resulted in extra tax being payable. The company was wound up and in misfeasance proceedings under what is now s 212 of the Insolvency Act 1986 against the auditors they claimed that they had not been given enough time to do their work.

Held – this was no defence and the auditors must repay the dividends, the cost of recovering the extra tax and any of the extra tax not recoverable. In the course of his judgment Pennycuick J made the following points:

(i) if directors do not allow the auditors adequate time to make proper investigations, they must either refuse to make a report at all or qualify it;

(ii) while leaving open the question whether the auditors would have been in breach of duty had the only fraud been falsification of stock, the judge held that once they were on notice of the altered invoices, they had a duty to make an exhaustive inquiry. Having failed to do so, they were liable to the company under what is now s 212 of the Insolvency Act 1986.

Auditors' liability

The liability of auditors can be brought under three headings as set out below.

By statute

As we have seen in ***Re Thomas Gerrard*** (above) an auditor may be liable in a winding-up for misfeasance or breach of any fiduciary or other duty in relation to the company. Under this provision an order may be made to repay money or to make compensation as the court thinks just.

In contract

An auditor has a contract with the company and if he is in breach of his duty in regard to the work he has agreed to do for the company, which is normally set out in a 'letter of engagement', he can be sued by the company for damages.

In tort

The claim here will normally be in negligence. It is unlikely that a professional person would make statements which he *knew* to be false in order dishonestly to deceive a party, but if he did the claim would be in the tort of deceit.

To succeed in a claim for negligence, the claimant must show that the defendant auditor owed him a duty of care, that the auditor was in breach of that duty, and finally that the breach caused the damage to the claimant.

Duty of care

The duty of care in regard to negligent misstatements by auditors has been considered in a number of cases since the early 1950s. However, the present position has been the subject of comprehensive analysis by the House of Lords in ***Caparo Industries plc*** v ***Dickman*** [1990] 1 All ER 568 and by the High Court in ***Al Saudi Banque*** v ***Clarke Pixley*** [1989] 3 All ER 361.

From these decisions and important later ones the position would appear to be as follows:

(a) Auditors do not owe a duty of care to potential investors in the company, e.g. those who rely on the audited accounts when contemplating a takeover bid. The fact that the accounts and auditors' report might foreseeably come into their hands and be relied on is not enough to create a duty of care. In addition, it was decided in ***James McNaughton Paper Group*** v ***Hicks Anderson*** [1991] 1 All ER 134 that even if an auditor knew that the audited accounts would be used by a bidder as the basis of a bid, he would not be liable if he reasonably believed and was entitled to assume that the bidder would also seek the advice of his own accountant.

(b) Auditors do not owe a duty of care to potential investors even if they already hold shares in the company since, although they are shareholders and auditors are under a statutory duty to report to shareholders, the duty of the auditors is to the shareholders as a whole and not to shareholders as individuals.

(c) Even where the auditors are aware of the person or persons who will rely upon the accounts, they are not liable unless they also know what the person or persons concerned will use them for, e.g. as the basis for a takeover.

(d) Where there is knowledge of user and use, then in that restricted situation the Court of Appeal held in ***Morgan Crucible Co plc*** v ***Hill Samuel Bank Ltd*** [1991] 1 All ER 148 that a duty of care would exist in regard to the user. However, even in such a situation the auditor will not be liable if, in the circumstances, he was entitled to assume that the user would also seek the advice of his own accountant and not rely solely on the audited accounts (see the ***McNaughton*** case, above).

(e) A case which appears to widen the liability of auditors beyond misstatements to mere omissions is ***Coulthard*** v ***Neville Russell*** [1998] 1 BCLC 143, where the Court of Appeal held that as a matter of principle auditors have a duty of care to advise that a transaction which the company and its directors intend to carry out might be a breach of the financial assistance provisions of the Companies Act (see also Chapter 7).

See p. 144

(f) In addition, the High Court ruled in ***Abbott*** v ***Strong*** (1998) *The Times*, 9 July, that a circular issued by a company to its shareholders in connection with a rights issue and allegedly containing misleading profit forecasts by the directors together with an allegedly negligent letter from the company's accountants and management consultants affirming that the forecast statement was properly compiled and in accordance with the company's accounting policies did not lead to the accountants having a duty of care in negligence to the shareholders who acquired shares in the rights issue so that their attempt to claim against the accountants failed. Mr Justice Ferris ruled that the accountants did not owe a duty of care to the shareholders individually for their alleged loss. The judge proceeded by analogy with the issue of shares under listing particulars or prospectus. In such cases, as we have seen, there is a requirement that any statement by accountants should make clear that it has been given with their consent and that the consent has not been withdrawn. This shows that the accountants *adhere to or are part of* the issue process and, of course, in that situation they can be liable for their misstatements. There was, said the

judge, no such statement in this case. Once again, the court has decided that there is no duty of care in those advising companies to the individual shareholders, maintaining the ***Caparo*** line. There were in fact 200 claimants in this case, so the decision may be based on public policy, bearing in mind the problems of obtaining indemnity insurance.

(g) The High Court has ruled that two companies that invested venture capital in a shop-fitting company that later went into receivership were entitled to damages from the company's auditors on the basis of negligent misstatements by the auditors in the company's accounts and in letters sent by the auditors to the investing companies. The auditors owed those companies a duty of care (see ***Yorkshire Enterprises Ltd*** v ***Robson Rhodes New Law Online*** (1998) 17 June, Transcript Case No 2980610103 approved judgment). A main problem had been that the provision for bad debts was inadequate. The court was saying in summary that if the auditors had carried out the audit work thoroughly, they would have found certain bookkeeping errors and would have made a greater and more appropriate provision for bad debt (or qualified the accounts). In consequence, the auditors were liable in damages. The facts of the case showed that the auditors were aware of the user of their statements and the use to which they would be put.

Breach of duty

An auditor will not be liable if, given a duty of care, he is not in breach of it. An auditor is not likely to be in breach of duty if he follows Auditing Standards and Guidelines, Statements of Standard Accounting Practice and Financial Reporting Standards devised and issued by the profession. If he does that, he will at least have the advantage of the judgment of McNair J in ***Bolam*** v ***Friern Hospital Management Committee*** [1957] 2 All ER 118. He said in connection with doctors: 'A doctor is not guilty of negligence if he has acted in accordance with a practice accepted as proper by a responsible body of medical men skilled in that particular art . . . merely because there is a body of opinion who would take a contrary view.' The statement is of course equally applicable to other professions including that of accountant and auditor.

In addition, the explanatory foreword to the profession's Auditing Standards and Guidelines states that 'a court of law may, when considering the adequacy of work of an auditor, take into account any pronouncements or publications which it thinks may be indicative of good practice. Auditing standards and guidelines are likely to be so regarded.'

The importance of professional pronouncements was also stressed in ***Lloyd Cheyham*** v ***Littlejohn*** [1987] BCLC 303 where Woolf J remarked that 'while SSAPs are not conclusive so that a departure from their terms necessarily involves a breach of duty of care and they are not rigid rules, they are very strong evidence as to what is the proper standard which should be adopted and unless there is some justification a departure will be regarded as constituting a breach of duty'.

This statement would, of course, apply with equal force to the more recent Financial Reporting Standards.

The effect of the decision in ***Bolitho*** v ***City and Hackney Health Trust*** [1997] 4 All ER 771 is considered in Chapter 9 in relation to company distributions and should be referred to again at this point by way of revision.

See p. 195

Damage

It must be shown that the breach caused the damage. Thus, in ***JEB Fasteners Ltd*** v ***Marks Bloom & Co*** [1983] 1 All ER 583, the accounts of BG Fasteners were prepared by the defendants who

were the auditors of BG. Unknown to the auditors, they were handed to the directors of JEB by the directors of BG as part of a takeover discussion. JEB took over BG and then complained through its directors that it had paid too much for BG and that this was the result of relying on the defendants' accounts which, it was alleged, were negligently prepared and showed BG to be a better proposition than it actually was.

In the High Court it was decided that the auditors should have foreseen the use of the accounts by JEB in the takeover and that this was enough to establish the duty of care. This part of the decision cannot now be supported in view of the requirement of *knowledge of use and user* in ***Caparo*** and subsequent cases. However, the High Court went on to hold that the auditors were not liable because it appeared in evidence that a major motive in taking over BG was to obtain the technical services of its two directors. It was admitted that JEB would have taken over BG anyway, regardless of the accuracy or otherwise of BG's annual accounts. The auditors' alleged negligence did not cause the damage and they were not liable.

Developments in exclusion of liability

The case of ***Royal Bank of Scotland plc* v *Bannerman Johnstone Maclay (a firm)*** 2003 SLT 181 raised issues in regard to auditors' liability and also their ability to exclude that liability.

The bank lent money to a company APC Ltd on the strength of accounts audited by the defendants. It was alleged by the claimant that the audited accounts were less than adequately informative in terms, for example, of the going concern factor. The bank had later to appoint a receiver to the company which was insolvent.

The auditors had notice that under overdraft facility letters the bank was entitled to see management accounts and annual audited accounts. However, they contended that the claimant had to prove that as auditors they *intended* the bank to rely on the accounts to make further loans or advances. The auditors said in effect 'when auditing the accounts our only intention was to carry out Companies Act duties to audit the accounts'. The Scottish Court of Session (Outer House) in this case, equally applicable in England and Wales, ruled that the case law did not support a requirement of intention. The compelling effect of the authorities was that knowledge of user and use formed the basis of a duty of care for those making information or advice available. The auditors had the requisite knowledge and therefore owed a duty of care.

On appeal to the Inner House of the Court of Session in May 2005, it was held that the element of positive intention was not a *sine qua non* of the existence of a duty of care and the pursuers were entitled to inquiry on the averments made. The absence of a disclaimer might be a relevant circumstance pointing to an assumption of responsibility in respect of the information or advice tendered. A major matter relating to this case was that *the auditors had not disclaimed liability to third parties such as the bank*. In this connection, the Institute of Chartered Accountants in England and Wales has stated that it is clear that auditors assume responsibility for the contents of the audit report to shareholders as a body under s 495 of the Companies Act 2006. It also states that the absence of a disclaimer may in some cases enable a court to draw an inference that the auditors have assumed responsibility for the audit report to a third party such as the bank in this case. *The ICAEW recommends* that auditors include the following wording in audit reports to clarify their duty of care to third parties by indicating that no such duty is owed.

> This report is made solely to the company's members as a body, in accordance with s 495 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the

company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Capping liability

For the larger firms of accountants providing audit services indemnity insurance adequate to cover potential liability is not available. The sums of damages potentially involved are of Armageddon proportions. In consequence the profession continues to lobby the government for a statutory cap on their liability. Failure by the government to respond may result in the larger groups of companies and public authorities being unable to obtain audit services.

Essay questions

1 Detail the provisions of the Companies Act 2006 relating to the qualifications, method of appointment and procedures for the removal of a company auditor.

(*The Institute of Company Accountants*)

2 (a) How may a company remove an auditor from the position he holds before the expiration of the term of his office? What can the auditor do if he is removed?

(b) What can a company do if it considers that the auditor has been negligent in his duties to the company?

(c) Can an individual shareholder sue an auditor if he carries out his duties negligently?

(*The Chartered Institute of Management Accountants*)

3 Lagjet Ltd has a fully issued authorised share capital of £40,000 divided into 40,000 ordinary £1 shares; 75p has been paid up on each share. The shares are allocated as follows:

the directors, Constance, Alan and Jack, each hold 6,500 shares;
James holds 9,500 shares; Alfred and Florence each hold 5,500 shares.

The board wishes to call an extraordinary general meeting to pass the following resolutions:

1 to reduce the company's share capital by extinguishing the liability of shareholders in respect of the unpaid capital on their shares;
2 to appoint a new auditor, Bill, to fill a casual vacancy caused by the sudden death of the auditor appointed at the last annual general meeting.

James, who is owed £5,000 by the company for goods supplied, is opposed to the proposal to reduce the share capital. Alfred and Florence are opposed to the choice of Bill as auditor.

(a) Advise the board on the following matters:

(i) the statutory provisions relating to length of notice before such resolutions can be validly presented to an extraordinary general meeting;
(ii) the number of votes which must be secured before the above resolutions can be passed;
(iii) any further action it can take to secure the appointment of Bill as auditor if it fails to obtain the necessary majority at an extraordinary general meeting.

(b) In the event of the resolution to reduce the company's share capital being passed, advise:

(i) the board as to any further action it must take to make the reduction effective;
(ii) James who is still determined to prevent the reduction becoming effective until he has obtained repayment of his debt.

(c) What possible difference (if any) would it have made if BOTH Florence had not received notice of the meeting due to an error on the part of the company secretary and in consequence had failed to attend the meeting AND Jack had been unable to attend the meeting and had failed to appoint a proxy? (*The Association of Chartered Certified Accountants*)

4 (a) Examine the nature of 'floating charges' as security for moneys lent or credit given to registered companies.

(b) Multifix plc borrowed £1,000,000 from Moneybags giving as security a floating charge over all its undertakings. A clause in the contract provided that the company was not to create any other charges over its assets ranking in priority to or *pari passu* with the floating charge created in favour of Moneybags. Multifix purchased land and several buildings for development and resold most of the properties for substantial profits. A fixed charge was created over the unsold properties valued at £1,500,000 in favour of Finance Limited to secure moneys borrowed from the latter. Multifix has now gone into insolvent liquidation.

Advise the liquidator as to the respective rights of Moneybags and Finance Limited if in the event the assets of the company are insufficient to pay both parties in full.

Would your answer be different if in the contract with Moneybags there was a term to the effect that any attempt by the company to create any other charge over the assets subject to the floating charge, without the consent of Moneybags, would result in the immediate crystallisation of the floating charge? (*University of Plymouth*)

Test your knowledge

Four alternative answers are given. Select ONE only. Circle the answer which you consider to be correct. Check your answers by referring back to the information given in the chapter and against the answers at the back of the book.

1 Morgan Ltd has just delivered its accounts to 31 December 2004 to the Registrar. The accounting records for that period must under the Companies Act 2006 be kept until:

A 31 December 2005.
B 31 December 2006.
C 31 December 2007.
D 31 December 2008.

2 Plush plc has prepared its accounts for the financial year ended 31 December 2004. What is the last date by which the accounts must be laid before a general meeting and filed with the Registrar?

A 31 July 2005 **B** 31 October 2005 **C** 31 December 2005 **D** 31 March 2005

3 The following resolutions may all be moved at a general meeting of a company:

(i) appointing a person as auditor other than a retiring auditor;
(ii) filling a casual vacancy in the office of auditor;
(iii) removing an auditor before the expiration of his term of office.

Which of these resolutions requires the special notice procedure?

A (i) **B** (iii) **C** (i) and (iii) **D** (i), (ii) and (iii)

4 Which one of the following qualifications does a person require in order to seek the designation 'Registered Auditor'?

A A member of the Chartered Institute of Management Accountants.
B A member of the Chartered Institute of Public Finance and Accountancy.
C A member of the Association of Chartered Certified Accountants.
D A member of the Association of Accounting Technicians.

5 There are provisions in the Companies Act 2006 which relate to the appointment of auditors in the following situations:

(i) where the first auditors are to be appointed before the first general meeting at which the company's accounts are laid;
(ii) where there is a casual vacancy in the office of auditor;
(iii) where a general meeting at which accounts were laid did not appoint an auditor.

In which of the above situations have the directors of a company power to appoint auditors?

A (i) only **B** (i) and (ii) **C** (i) and (iii) **D** (ii) and (iii)

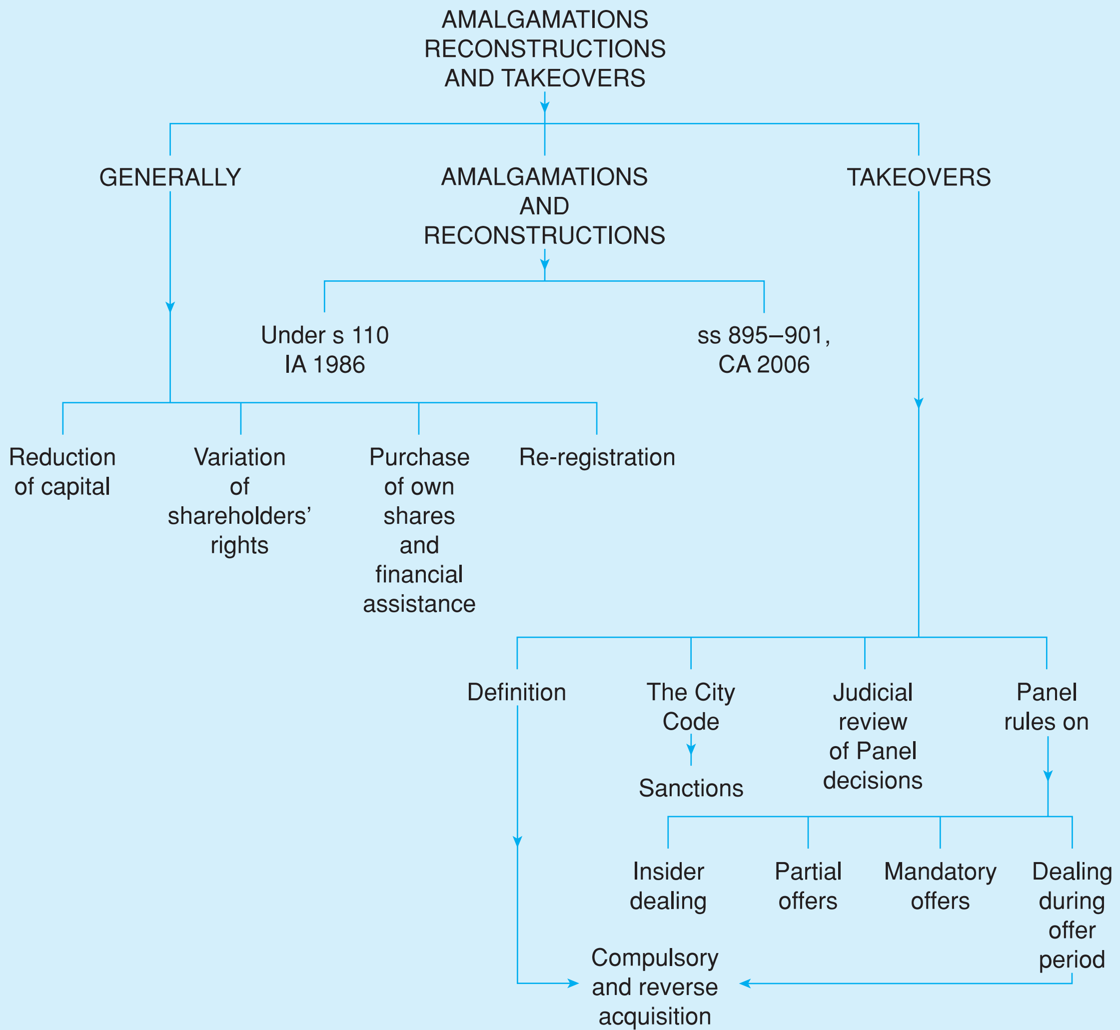
6 The directors of Tomos Ltd want to change their auditors and are putting the relevant resolution before a general meeting. What statutory rights have the auditors got to make representations to the shareholders of Tomos?

A They may speak at the meeting but cannot communicate with the shareholders in writing.
B They may communicate in writing with the shareholders before the meeting but cannot speak at it.
C The auditors may communicate in writing directly with shareholders and speak at the meeting.
D The auditors may communicate in writing through the company with the shareholders before the meeting and can speak at it.

Answers to test your knowledge questions appear on p. 617.

Visit **www.mylawchamber.co.uk/keenancompany** to access study support resources including practice exam questions with guidance, weblinks, legal newsfeed, answers to questions in this chapter, legal updates and further reading.

24 Amalgamations, reconstructions and takeovers



Generally

The ways in which companies can alter their structures are set out below.

Objects clause

This is less of a problem after CA 2006 s 31 which now provides that unless a company's articles specifically restrict the objects of a company, its objects are unrestricted.

Reduction of capital

If the company merely wishes to reduce its share capital it may do so under the procedures set out in Chapter 8. Sections 641–651 of the CA 2006 govern how a company may reduce its share capital.

See p. 162

Companies limited by shares – dual regime

There are two methods for companies limited by shares to reduce their share capital:

1 Court approved reduction of capital: available to both private and public companies limited by shares.
2 Reduction of capital supported by a solvency statement: only available to private companies limited by shares.

Unlimited companies

Unlimited companies are free to reduce their share capital by members' resolution without needing either court approval or a solvency statement (provided they have the power to do so in their articles of association).

The default position under the CA 2006 is that a company limited by shares is free to reduce capital by special resolution of its members (supported by either court approval or, for private companies only, a solvency statement) provided such a reduction is not prohibited by its articles (s 641(6)).

Section 641 of the CA 2006 does not apply to unlimited companies. Therefore, an unlimited company should not undertake a reduction of capital unless it has an article giving it express authority to do so.

Variation of shareholders' rights under the memorandum and articles or under the Companies Acts

If the company wishes to alter the rights of shareholders, this can be effected by the approval of the variation at class meetings followed by a special resolution of the company. There is, of course, always the possibility that dissentients within the class will apply to the court (see further Chapter 7).

See p. 144

The relevant sections apply only to registered companies and in addition do not enable any variation to be made in the rights of creditors, including debenture holders. Often, however, the trust deed of an issue of debentures will contain a similar variation clause under which the rights of debenture holders can be varied. In such a case, however, the only remedy of dissenting debenture holders is to plead a general fraud on the minority.