AUDITORS' LIABILITY

Serba Dinamik filed an action against KPMG for allegedly being negligent by unreasonably raising audit issues or red-flags over the company's transactions. It has been said that the suit of this kind is unprecedented.

Background

On 25 May 2021, Serba Dinamik announced to Bursa that KPMG, the external auditor, had raised certain audit issues[i]. Bursa on 27 May 2021 made a query to Serba Dinamik following the announcement. On 28 May 2021, SD replied to the Bursa's query. Things had since gone awry.

It is indeed unheard of that a public listed company taking action against its external auditor for raising red-flags. The most typical case of auditor's or accountant's negligence is the failure to make audit findings on shady transactions or failure to highlight factors which could impact the actual value of the company.

Over and above his statutory duties, an auditor certainly owes contractual duties toward its client i.e the company that instructs it to prepare the audit. An auditor is subject to the conditions of his appointment.

However, an audit report prepared by an auditor would not only have an impact on the company, but also would be relied on by the shareholders and potential shareholders, in deciding on their investment. The question here is whether the auditor also has a duty of care towards shareholders as well as potential shareholders.

Locus Classicus

This question has been answered in the celebrated tort case of *Caparo Industries PLC v Dickson*[ii]. In this case, a company called Fidelity plc, manufacturers of electrical equipment, was the target of a takeover by Caparo Industries plc. Fidelity was not doing well. In March 1984 Fidelity had issued a profit warning, which had halved its share price. In May 1984, Fidelity's directors made a preliminary announcement in its annual profits for the year up to March. This confirmed the position was bad. The share price fell again. At this point Caparo had begun buying up shares in large numbers. In June 1984 the annual accounts, which were done with the help of the accountant Dickman, were issued to the shareholders, which now included Caparo.

Caparo reached a shareholding of 29.9% of the company, at which point it made a general offer for the remaining shares, as the City Code's rules on takeovers required. But once it had control, Caparo found that Fidelity's accounts were in an even worse state than had been revealed by the directors or the auditors. It sued Dickman for negligence in preparing the accounts and sought to recover its losses, which was the difference in value between the company as it had and what it would have had if the accounts had been accurate.

The case went up to the House of Lords whereby the House of Lords decided that the negligent auditor owed no duty at all, either to the existing shareholders or to any

future investors. The purpose of the statutory requirement for an audit of public companies under the English Companies Act 1985 was the making of a report to enable shareholders to exercise their class rights in general meetings. It did not extend to the provision of information to assist shareholders in the making of decisions as to future investment in the company.

Thus, whenever the auditor prepares an annual report for the company, he owes no duty of care towards the shareholders or potential shareholders for the purpose of making decisions on their investment.

However, each and every case must be examined differently based on the Caparo Tripartite Test laid down by the House of Lords as follows:-

1. harm must be reasonably foreseeable as a result of the defendant's conduct (as established in *Donoghue v Stevenson*),

2. the parties must be in a relationship of proximity, and

3. it must be fair, just and reasonable to impose liability

Malaysian Perspective

Although the decision in Caparo has been accepted and applied quite extensively in Malaysian jurisprudence, there were some developments. In 2014, the Court of Appeal in the case of *CIMB Investment Bank Bhd V. Ernst & Young & Another Appeal*[iii] had the opportunity to evaluate the application of the Caparo Tripartite Test in a negligence suit against an auditor.

The main question in the CIMB Investment case was whether E&Y, the auditor, owes a duty of care towards the client of the investment company for which the annual reports were prepared by E&Y. The High Court, applying the Caparo Tripartite Test held that there was no proximity between the auditor and the Plaintiff, therefore no duty of care was established. However, upon appeal to the Court of Appeal, the High Court's decision was reversed, and the Court of Appeal laid down the correct test to be applied as follows:-

"(1) The court should apply the guidelines enunciated by Lord Bingham in Her Majesty's Commissioners of Customs and Excise v. Barclays Bank and accepted by the Federal Court when considering the issue of duty of care. The first test is premised on the 'assumption of responsibility'. Effectively this test means that: (a) reliance on the respondent auditor's report is no longer an essential ingredient to establish duty of care; (b) no anterior relationship between the appellants and the respondent is necessary to satisfy ingredients of foreseeability and proximity; and (c) the ingredient relating to proximity is satisfied so long as the assumption of responsibility may be inferred by reason of the existence of a special relationship. (paras 44 & 46)"

With regards to Caparo Tripartite Test, the Court had this to say:-

"[40] In our judgment, any examination of the tests to be applied in determining the existence of a common law duty of care in cases of economic loss must commence with the 'useful guides to courts among the Commonwealth when deciding how to approach a novel

situation in point of imposing a duty of care' (per Gopal 459 A B C Sri Ram JCA in KGV & Associates Sdn Bhd v. The Co-operative Central Bank Ltd [2006] 4 CLJ 241 representing a summary of the pronouncements by Lord Bingham in Her Majesty's Commissioners of Customs and Excise v. Barclays Bank [2007] 1 AC 181:

(a) *First, there are cases in which one party can accurately be said to have assumed responsibility for what is said or done to another. In this regard, the finding of an assumption of responsibility may obviate the need for further enquiry. Otherwise, further consideration is needed;*

(b) *Second, the assumption of responsibility test must be applied objectively, and is not based on what the defendant thought or intended;*

(c) *Third, the threefold tests in Caparo does not itself provide a straightforward answer to 'the vexed question' of whether, in a novel situation, a party owes a duty of care. As Lord Roskill had said in Caparo at p. 628, 'there is no simple formula or touchstone' in determining the existence of a duty of care in any given case;*

(d) *Fourth, the incremental test is of little value in itself, and is only helpful when used in combination with a test or principle that identifies the legally significant features of a situation; and*

(e) *Fifth, the majority outcome of the leading cases are in almost every instance sensible and just, irrespective of the test applied to achieve the outcome. In this regard, attention is concentrated 'on the detailed circumstances of the particular case and the particular relationship between the parties in the context of their legal and factual situation as a whole'."*

To sum it up, the Caparo Tripartite Test is not the only test to be applied in determining duty of care in a negligence case.

Whether an auditor owes a duty of care or not is a question of facts exclusive to each and every case. However, one thing for sure is that the audit report will certainly have some impact and bearing to the investing public, whether one likes it or not.

Impact of auditor's report – Lesson from Transmile

In 2007, the Malaysian investment public was shocked with the revelation of Transmile's audit scandal. It started when the company failed to adhere to the deadline in submitting its audited annual accounts for the financial year ended 31 December, 2006 to Bursa Malaysia for public release. It was to be within a period not exceeding four months from the close of the financial year, which was on or before 30 April 2007 as required by the Listing Requirements of the Exchange.

Matters took a turn for the worse when its external auditor, Deloitte & Touche via a letter to the Board of Directors (BOD) on 4 May 2007, declined to approve the annual accounts for lacking certain supporting documents. In response, on 7 May 2007, the BOD appointed Moores Rowland Risk Management to conduct a special audit on the issues raised by Deloitte & Touche. It was later found, amongst others, that the

revenues and profits had been materially overstated not only in the company's 2006 unaudited annual accounts but also in the 2004 and 2005 audited annual accounts. With the overstating figures taken into consideration, Transmile's profits for the effected years were reversed to losses instead.[iv]

The Transmile fiasco had sent reverberating shock waves to the investing public. As a result, the share price went down to around RM8 from its peak of around RM14 in early May 2007. According to Singapore Business Times, most of the selling came from disgruntled foreign investors. The price drop had resulted in substantial wipe out of its market capitalization.[v]

Undoubtedly, any report made by an auditor would have an impact on the shareholders and potential shareholders. It will be relied on to achieve sound financial analysis in the investment world.

Position in the US

In the US, audit scandals are quite commonplace. Scandals like Enron, Waste Management, Fortress Re, Tyco etc had revealed auditor's negligence to some extent. In *Waste Management's* case, the audit firm, Arthur Andersen was fined over USD7 million by the Securities and Exchange Commission ("SEC") for improper accounting practice of inflating the garbage-hauling concern's earning.

The same firm was also fined by SEC in *Enron's* case for disposing important documents.

In 1999, Ernst & Young was slapped with a negligence suit for malfeasance in the audit of a company named Cendant Corp. The misdeed involved inflated earnings of the company to the detriment of shareholders. The suit by shareholders was eventually settled by E&Y by making a huge payout of USD350 million to the shareholders.[vi]

In 2006, the accounting firm of Deloitte & Touche LLP paid almost USD250 million in settlement of a civil suit by Japanese Insurers in the case of Fortress Re.

Fortress Re, which was once the largest aviation reinsurer in the world, collapsed after the Sept. 11, 2001 terror attack which resulted in enormous losses to many investors. Based in Burlington, N.C., Fortress had managed its reinsurance business on behalf of a group of Japanese insurers, and its books were audited by Deloitte for years. Reinsurance is purchased by insurance companies to spread risks in case they are hit by large claims.

Two of the Japanese insurers and a related Bermuda entity later sued Deloitte in state court in Greensboro, N.C., claiming that the accounting firm improperly let Fortress hide liabilities that should have been on the books long before Sept. 11, 2001. The Japanese estimated their total losses at more than $3.5 billion. The suit was settled out of Court.

In 2007, PWC was sued by the shareholder of Tyco International Ltd for failure to spot a massive accounting fraud committed by the top executive of Tyco. PWC also settled the suit for USD250 million to avoid trial of a massive class action.

The above highlighted cases in US clearly indicate that an auditor has a duty of care towards shareholders of the company.

New perspective of liability?

From the above line of authorities in the UK, US and Malaysia, the inevitable conclusion is as follows:-

1. Auditor owes a duty of care to the shareholders;

2. Shareholders can take action against an auditor if the auditor is negligent in carrying out his duties in preparing the report;

3. Annual Report pursuant to Companies Act 2016 will be relied upon by the shareholders to decide on their investment;

4. The auditor has a duty of care to report any findings which go against statutory requirement or duty of a company to the regulator, failing which the auditor will be negligent in discharging its duty.

However, the suit filed by Serba Dinamik opened up a new perspective on the auditor's liability. Instead of an action taken by the shareholders of a company against the auditor for negligence in its audit finding, the company itself filed an action against the auditor for raising audit issues which cause substantial depreciation in market capitalization. It was reported in the media that the suit alleged that KPMG unreasonably raised audit issues without first having a discussion with the company to address the matter.

The question here is whether an auditor, apart from having contractual duties towards its client to give their professional service as well as having a duty of care towards the shareholders to diligently prepare the report which would be relied on by the shareholders, would also have a duty to protect its client from adverse market sentiments due to their own audit finding.

The auditor will certainly be in a dilemma between having to meticulously scrutinize the client's account and report potential misdeed to the regulator, and at the same time having to protect its client from adverse market sentiment by internally addressing the issue first before reporting it.

It is also interesting to see whether the auditor had complied with the statutory requirements, audit standard, the relevant corporate code as well as the Listing Requirements in making the audit finding and raising red-flag.

However, it is too early in the day for a conclusion. We are still waiting to read the Statement of Claim by Serba Dinamik and KPMG's reply to better appreciate the arguments and issues. Until then, we shall refrain ourselves from commenting on who is right and who is wrong.

Author



Yusfarizal Yussoff
Managing Partner
yusfarizal@yaz-law.com

Disclaimer: The contents do not constitute legal advice, are not intended to be a substitute for legal advice and should not be relied upon as such.

29 JUNE 2021

References

[i] https://www.bursamalaysia.com/market_information/announcements/company_announcement/announcement_details?ann_id=3162085

[ii] Caparo Industries PLC v Dickson [1990] UKHL 2

[iii] CIMB Investment Bank Bhd V. Ernst & Young & Another Appeal [2014] 6 CLJ 438

[iv] Nik Rosnah Wan Abdullah, Mohd Zahrain Bin Mohd Nor, Azwan Bin Omar. (2012). Case Study: Transmile Group Berhad. NIDA Case Research Vol. 4 No. 1 (January-June 2012) Journal

[vi] https://www.casemine.com/judgement/us/5914b3eaadd7b04934769161