



## Auditors and Directors Found Negligent for Failures to Spot Obvious Frauds

The Singapore Court of Appeal has recently issued two important decisions both dealing with the issue of the duties of auditors in carrying out a statutory audit. These two decisions, issued on the same day and covering similar issues, will clearly become important touchstones for determining the scope of duties and liabilities of auditors and directors where fraud has been perpetrated on a company. In brief, the Court of Appeal decided in both cases that:

- in carrying out a statutory audit, auditors have a duty to be alert to fraud and must assiduously investigate any suspicious matters; and
- the quantum of liability imposed on auditors should be reduced by 50% as the company's directors and management should have been able to catch the fraud but failed to do so due to negligence.

The two cases, *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)* and *PlanAssure PAC v Gaelic Inns Pte Ltd*, are examined in this update, which considers their significance and implications for both auditors and directors.

### **Facts of JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)**

The defendant was an accounting firm that provided audit services to the plaintiff during the financial years ("FY") 1999, 2000 and 2001. The plaintiff was the Singapore subsidiary of an American freight-forwarding company. It had two directors. One was based in Singapore, while the other resided in the United States and was also the head of the plaintiff's ultimate holding company.

*Singapore-based director siphoned off plaintiff's funds*

The Singapore-based director had overall control and responsibility of the plaintiff's day-to-day operations in Singapore and reported to the US-based director on all operational and business issues. It subsequently transpired that the Singapore-based director was engaged in a scheme to siphon off the plaintiff's profits for his own benefit. His defalcations were not picked up by the defendant, and

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they only came to light after one of the staff "blew the whistle" on him to the US-based director.

*Plaintiff alleged auditor negligent in not spotting fraud*

The plaintiff eventually sued the defendant for negligence in carrying out its audit duties. It alleged that the defendant had failed to pick up the fraud of the Singapore-based director in three principle areas:

- failure to verify the Singapore-based director's entitlement to remuneration;
- failure to report abuses by the Singapore-based director of his cheque signing limit; and
- failure to properly verify the renovation expenses of the plaintiff's warehouse in Singapore and of its Hong Kong subsidiary.

#### **Facts of PlanAssure PAC v Gaelic Inns Pte Ltd**

An update was issued on this case when the High Court released its decision (See "Auditors Liable for Failing to Warn Companies of Fraud". [Click here to go to update.](#))

*Finance manager engaged in teeming and lading*

The plaintiff was a company that ran a pub. Its finance manager had misappropriated company funds through teeming and lading. This process essentially involved delaying the banking of cash received on the day of sales in order to hide misappropriations. Hence, instead of banking the cash received from a particular day's takings into the company's bank account, the finance manager would use the cash for her own personal benefit. The cash used would be replaced subsequently with cash received from subsequent sales. The teeming and lading was carried out substantially over 2003 and 2004.

*Auditor did not follow up on large amounts of unbanked cash*

Sometime in February/March 2004, as part of its audit of the plaintiff for FY2003, the defendant audit firm obtained a copy of the plaintiff's bank reconciliation statement as at 31 December 2003. This was provided for the purpose of carrying out the audit of bank balances. From the statement, the auditor noticed that the amount of cash deposits which had not been banked into the plaintiff's bank account ("unlodged cash deposits") stood at more than S\$600,000. He then asked the group finance manager for the dates on which the cash deposits were cleared and lodged into the bank account. However,

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unsurprisingly, this information was not forthcoming. By May 2004, the amount misappropriated had increased to some S\$1 million.

*Plaintiff alleged auditor negligent for not warning it*

When the misappropriation was eventually discovered, the finance manager was charged and convicted. The plaintiff then commenced a suit against the auditor for negligence, asserting that he had been negligent in failing to spot the misappropriations and to warn management that the high levels of unlogged cash deposits indicated a risk of fraud. It asserted that if the warning had been made, management would have been alerted in good time to prevent further losses and to recover the misappropriated sums from the finance manager.

### Overview of Decisions in Both Cases

*Court of Appeal held that auditors were negligent*

In both cases, the Court found negligence on the part of the auditors in carrying out their duties in performing a statutory audit:

- In *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the Court found negligence from the defendant's failure to obtain independent verification of the Singapore-based director's entitlement to remuneration.
- In *PlanAssure PAC v Gaelic Inns Pte Ltd*, the Court found negligence from the defendant's failure to rigorously investigate the possibility of fraud given the unusually large amount of the unlogged cash deposits.

*Quantum of liability reduced as management negligent*

Again, in both cases, the quantum of liability was reduced, and by the significant proportion of 50% in both cases. In broad terms, the Court decided to reduce the auditors' liabilities because it was of the view that the directors and management of the companies had themselves been negligent. However, the legal routes used to achieve this result differed:

- In *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the quantum of liability was reduced pursuant to section 391 of the Companies Act. This section allows a court to grant relief to auditors under the circumstances specified.
- In *PlanAssure PAC v Gaelic Inns Pte Ltd*, the Court found that the directors, executive and non-executive alike, had not looked at the company's accounts. If they had reviewed the accounts, even

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cursorily, the large amounts of unlodged cash deposits would have been immediately obvious and would have alerted them that something was amiss. This amounted to contributory negligence by the plaintiff.

The decision and reasoning of the Court in both of these respects will be discussed in greater detail below.

### Auditor's Duty of Care to Detect Fraud

The Court had to consider whether an auditor performing a statutory audit has a duty to detect and report fraud. The Court held that he does have such a duty. It explained that in carrying out a statutory audit, an auditor must exercise the reasonable care and skill of an ordinary skilled person embarking on the same engagement. In other words, his duty is to take reasonable care to ascertain that the company's accounts are substantially accurate.

*Auditors must approach audit with inquiring mind*

While it is not his duty to be wholly sceptical and suspicious, neither is he a mere professional mathematician. Rather, he must perform his duties with an attitude of professional scepticism where he is alive to the possibility of fraud. Accordingly, he must approach his task with an inquiring mind, and must make further inquiries where reasonable suspicion would typically be excited. The precise degree of scrutiny and investigative effort will depend on the facts of each individual case.

### *Auditor's Negligence in JSI Shipping (S) Pte Ltd v Teofoongwonglcloong*

*Signs of fraud were obvious but auditor failed to pursue issue*

In *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the Court took the following factors into account in determining that the auditor had failed to meet the requisite standard:

- It noted that the remuneration paid to the Singapore-based director was unusually high, amounting to some 6-9% of the plaintiff's total revenue. This was in itself a warning sign.
- The reluctance of the Singapore-based director to allow clear independent means of verification was another warning sign.
- The method suggested by the Singapore-based director and used by the defendant to obtain verification of his entitlement to

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remuneration was inadequate. It was not sufficient for the defendant to rely on the signing of the plaintiff's audit report by the US-based director as verification that the amount of the Singapore-based director's remuneration as stated in it was correct. This was all the more so as he had not alerted the US-based director that he would be relying on his signing of the audit report for this purpose.

- Independent verification could very easily have been obtained from the US-based director with no or little disruption to existing processes as the defendant was already in contact with him on other matters.

*However, no negligence where fraud not indicated*

The Court, however, held that it had not been negligent of the defendant to not pick up the frauds arising from the abuse of the cheque signing limits and the purported warehouse renovations:

- It noted that the defendant had carried out sample testing of the split cheques and the amounts had been verified against properly issued invoices. It was not necessary for the defendant to test all the cheques and invoices for the statutory audit.
- With respect to the warehouse renovations paid for on behalf of the plaintiff's Hong Kong subsidiary, it noted that the defendant had received confirmation from the subsidiary of the debt. However, it was not the defendant's duty to verify that the expenditure by the subsidiary had been proper. Accordingly, this was sufficient verification for the purposes of the statutory audit.

#### *Auditor's Negligence in PlanAssure PAC v Gaelic Inns Pte Ltd*

*Large amounts of unbanked cash a clear fraud risk*

In *PlanAssure PAC v Gaelic Inns Pte Ltd*, the Court took the following factors into account in determining that the auditor there had failed to meet the requisite standard:

- The amount of unlodged cash deposits—at more than S\$600,000—was highly unusual (it could not be that the company was physically keeping such large amounts of cash on its premises) and should have rung alarm bells.
- The company's practice of banking in cash twice a week was known to the defendant and was inconsistent with it holding onto such large amounts of cash.

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*However, auditor only went through the motions to check*

- The defendant himself had previously noted in a risk assessment review of the company that cash was a key concern.
- The defendant had only made a standard request for information on the subsequent clearance dates of the unlodged cash deposits. Given the risks involved, he should have done more (for example, he could have asked for copies of the bank reconciliation statements).

#### *Additional Observations on Auditors' Duties*

Generally speaking, the Court's decision on the auditor's duty of care is unremarkable in that it does not change the existing law set out in prior cases. Indeed, the Court was at pains to emphasise this, stressing that it was not establishing any new legal propositions or principles, but simply clarifying and restating the principles of professional liability relating to auditors.

Notwithstanding this, certain aspects of the Court's decisions should be highlighted:

*Contractual exclusion of duty to discover fraud not an excuse*

- In *PlanAssure PAC v Gaelic Inns Pte Ltd*, the defendant's engagement letter had expressly excluded a duty to discover fraud. It stated, "[O]ur audit should not be relied on to disclose fraud, defalcations or other irregularities." However, the Court held that it was not open to the defendant to exclude or limit its liability to the plaintiff for negligence or any other breaches of duty in this manner. Indeed, the Court suggested that it would be a rare case where it would permit an auditor to exclude his duty in this way.

*Low fees for audit not an excuse*

- The defendant in *PlanAssure PAC v Gaelic Inns Pte Ltd* had also sought to argue for a lower standard of duty on the basis that the fee paid to him for the audit was low and he therefore could not have been expected to engage in such a thorough review of the plaintiff's financial position. This was strenuously rejected by the Court, which held that this could not be used to excuse a lower standard. It stated, "...it would be wholly untenable from the viewpoint of policy and market discipline if the [defendant] were to be held to a lower standard simply on the basis that it had not been remunerated sufficiently for its services".

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*Auditors must be willing and ready to challenge management*

- In both cases, the Court was ultimately concerned with the tepidness of the follow-up, with both the defendants effectively backing down once challenged by the perpetrator of the fraud. While it was argued that the making of further inquiries would have jeopardised the defendants' relationships with their clients, the Court stressed that this was not a reason for auditors to resile from their independent role or to compromise corporate governance standards. It stated, "...[auditors] are not entitled or obliged to adopt an overly deferential view of their role for fear of offending management." More strongly, in *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the Court said, "It is of paramount importance that auditors are not readily cowed or deflected by senior management of a company. They should not allow themselves to become mere rubber stamps by adopting an undue degree of defence to management representations."

### **Negligence by Management**

As noted above, in both cases, the Court reduced the amount for which the auditors were found to be liable to the companies. The reason for this was, in both cases, negligence on the part of the directors and management which permitted the frauds to go undetected.

#### *Director's Negligence in JSI Shipping (S) Pte Ltd v Teofoongwonglcloong*

*US-based director trusted Singapore-based director*

In *JSI Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the Court noted that the US-based director never even looked at the plaintiff's audit reports. However, it is not clear from the judgment what this finding of fact is based on as only one incident is referred to. The Singapore-based director had sent the original sets of audit reports to the US-based director to be signed by him. In doing so, he stated that he had already signed the reports. The Court noted that this had been done in order to lull the US-based director into a false sense of security by implicitly representing that everything was fine. Separately, the Court also noted that the US-based director had been happy to rely on the perceived good work of the Singapore-based director in building up the business of the company, trusting him wholly and implicitly.

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The Court then relied on section 391 of the Companies Act to grant relief to the defendant. As noted above, this section empowers the court to relieve a person either wholly or partly from his liability for negligence if certain conditions are satisfied. These conditions are:

- he has acted honestly and reasonably; and
- having regard to all the circumstances of the case, he ought fairly to be excused for the negligence.

*Director failed to perform own obligations to company*

It was accepted that the defendant had acted honestly. As to whether his actions had been reasonable, the Court held that reasonableness for the purposes of section 391 encompassed wider considerations, and could include the conduct of the company's directors. Here, the Court characterised the US-director's conduct as a "general indifference, laxity in management and failure to properly carry out his fundamental obligation to oversee and monitor the [plaintiff-company]".

*Court excused auditor and also found no causation*

It should also be highlighted that this alleged indifference and laxity was also relied on by the Court to decide that the auditor's negligence had not caused certain losses. In making a claim for damages, the plaintiff had claimed that but for the defendant's negligence, it would have discovered the frauds relating to the split cheques and warehouse renovations. However, the Court noted that the US-based director had been content to leave everything to the Singapore-based director, and that even after he had been notified of the possible fraud, he took such a long time to react that the Singapore-based director had been able to abscond. Accordingly, the Court held that these omissions broke the chain of causation linking the defendant's negligence to the plaintiff's losses in these two respects.

#### *Directors' Negligence in PlanAssure PAC v Gaelic Inns Pte Ltd*

*High Court had excused non-executive directors*

In *PlanAssure PAC v Gaelic Inns Pte Ltd*, the Court relied on the concept of contributory negligence to reduce the quantum of damages for which the defendant was liable. It is important to note that the High Court had excused the non-executive directors of contributory negligence, but found the managing director negligent in failing to even look at the monthly bank reconciliation statements

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which he received. The Court of Appeal indicted all three of negligent behaviour.

*Court of Appeal finds them negligent in failing to review accounts*

In doing so, it did not rely on whether the directors received or even reviewed the bank reconciliation statements. It noted that as directors, it was incumbent on them to at least perform a minimal degree of oversight in relation to the plaintiff's accounts and seek to be regularly apprised of its financial affairs. While they were not obliged to delve into minute irregularities in the accounts, they were obliged to broadly discern if any irregularities existed on their face. The Court also noted that even a cursory monitoring of the bank statements would have immediately revealed that something was seriously amiss in relation to the banking in of collections from customers.

*Accounts manager also negligent*

The Court also found the company to have been contributorily negligent from the acts and omissions of the accounts and payroll manager. It noted that she had prepared the monthly bank reconciliation statements and had regarded the increasing amounts of unlogged cash deposits as suspicious but failed to do anything about it.

#### *Additional Observations on Directors' Duties*

The following observations of the Court on the responsibility of directors and management should be highlighted:

*All directors responsible for preparation of financial statements*

- It clarified that non-executive directors are not exempted from the need to exercise a modest level of scrutiny of the companies on whose boards they sit.
- While directors cannot be made to bear personal responsibility in all cases for the accuracy and integrity of all of a company's financial statements, both executive and non-executive directors cannot nonetheless shy away from the fundamentals of putting in place prudent arrangements to oversee the preparation of such statements. In this respect, it should be noted that the Court held, in *PlanAssure PAC v Gaelic Inns Pte Ltd*, that the non-executive directors were not entitled to wholly rely on the finance manager to ensure that the accounts were in order, and that, in this regard, it was irrelevant that they lacked accounting expertise.
- The duties of auditors and directors to check on management are

*Duties of auditors*

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*and directors overlap*

not wholly distinct and separate, the one beginning where the other ends. Instead, these duties are overlapping, and auditors and directors share a dual responsibility to ensure their discharge. Importantly, the Court noted that effective corporate governance requires both sets of professionals to assiduously discharge their responsibilities

### Significance and Implications for Auditors

*Not so much a duty to discover fraud*

While the decisions may give rise to some concern in the auditing community, they can perhaps be understood in the context of the following underlying fact: In both cases, the Court clearly felt that the accounting discrepancies were readily apparent (perhaps even strikingly so) on the face of the accounts. It did not, hence, require any in-depth investigation to uncover the frauds. Indeed, the defendants in both instances had noted the discrepancies. Crucially, however, they had failed to pursue and investigate the matter. Instead, they allowed themselves to be fobbed off by what the Court considered to be inadequate representations and responses.

*However, a duty to investigate once alerted*

The cases should therefore not be seen as imposing a duty on auditors performing a statutory audit to discover and root out fraud in all cases. Perhaps a better way to characterise the duty imposed in these cases is to see it as a duty to investigate thoroughly once red flags have been raised. It is hence for auditors, using a measure of professional detachment and scepticism, to ensure that any apparent accounting anomalies and discrepancies are satisfactorily explained by independent evidence, and if not, to qualify the accounts appropriately. However, if there is no apparent cause for concern, auditors should be able to take comfort in the fact that they will not be required by the courts to act as *de facto* policemen.

### Significance and Implications for Directors

*50% reduction a signal of joint responsibility?*

Companies, directors, and management will wish to take particular note of the Court's reduction in the quantum of the defendants' liabilities. It is worthwhile noting that in both cases, liability was reduced by 50%. This was perhaps intended to send a signal that

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responsibility between auditors and directors for financial statements is shared equally between both parties.

*Directors must engage at least in a minimal review*

More importantly, by characterising the responsibilities of auditors and directors as overlapping, the decisions suggest that directors, executive and non-executive alike, cannot just rely on auditors but must exercise some degree of supervision and oversight in reviewing the company's accounts. At the very least, they should review them to ensure that there is nothing that, on its face, demands greater scrutiny. Again, it is worthwhile pointing out that the Court seemed to view the frauds as being readily apparent, and would have leapt out at anyone making even a cursory examination of the accounts.

*Risk of finding of contributory negligence*

The implications for a failure by directors in this regard can be severe, not only for the company but for the directors themselves. In *JS/ Shipping (S) Pte Ltd v Teofoongwonglcloong (a firm)*, the Court noted that the defendant had not sought to rely on contributory negligence and characterised its defence in this regard as "sorely lacking". It should be noted that, as a company can only act through its human agents, if contributory negligence is found, it can only have arisen from negligence by its agents. This can only be the directors, managers, or employees. This in turn gives rise to a risk that the director, manager, or employee may in turn be found liable to the company for this negligence.

*Directors also at risk of being found liable to company*

In a case decided earlier this year, *Nagase Singapore Pte Ltd v Ching Kai Huat & ors*, the High Court held that while a court would be reluctant to fault a director who had in good faith delegated his functions or powers to competent subordinates, this did not mean that the director could never himself be held negligent because the loss complained of resulted from the negligence of his subordinates whom he bona fide believed to be competent. Even if they had proved themselves to be competent, a director or senior manager must have in place a proper system of ensuring that his subordinates do not make serious mistakes and that such mistakes, if committed, are quickly spotted and rectified.

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*Practical best  
practice steps that  
can be taken*

It is likely that the issue and extent of proper delegation and supervision will become an increasingly important issue for directors in the near future. These recent decisions suggest a trend by the courts to impose strict duties of supervision on management and directors (executive and non-executive). As a practical measure to avoid liability, and as a best practice, parties may wish to consider setting up systems of checks and review, and to adhere scrupulously to such systems on a continuing basis. Any such adherence should be documented in order to maintain a record of steps followed.

If you would like more information on this or any other area relating to auditors' or directors' duties, or corporate governance generally, you may wish to contact the lawyer at WongPartnership that you normally deal with or contact the following partners from the Corporate Governance Practice:

**JOY TAN**

DID: +65 6416 8138

Email:

[joy.tan@wongpartnership.com.sg](mailto:joy.tan@wongpartnership.com.sg)**ANNABELLE YIP**

DID: +65 6416 8249

Email:

[annabelle.yip@wongpartnership.com.sg](mailto:annabelle.yip@wongpartnership.com.sg)