The law relating to auditors' liability in Kenya with particular emphasis on third party liability.

By

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INTRODUCTION

The service offered by auditors involves examination and assessement of financial records and preparation of reports. The public and the institutions that employ these services rely heavily on these reports to make decisions. Auditors are therefore obliged to conduct their duties with diligence and integrity. Once the integrity of the auditor is compromised then he ceases being objective and his report is likely to contain negligent misstatements. There are several ethical issues that lead to compromised integrity and the main one is independence of the auditor.

> A member's objectivity must be beyond question if he (she) is to report as an auditor. That objectivity can only be assured if the member is, and is seen to be, independent"[1]

Research at Institute of Certified Public Accountants of Kenya (ICPAK)[2] has shown that cases of malpractice by the auditor are countless and this is shown by the numerous cases handled by the disciplinary committee and the number of complaints received by the committee. These will be discussed further in Chapter one. These are problems mainly dealing with the auditor's independence and the contravention of the Accountants' Act[3]

However even with the numerous displinary cases, there are few instances when clients institute legal proceedings against the auditor. Even more remote are the chances of a third party suing the auditor on grounds of negligence[4]. A third party in this case is a

[1] Association of Chartered Certified Accountants' Rules of professional conduct, statement 1. Similar to International Federation of Accountants Code of ethics for professional accountants section 1

[2] Statutory body established under the Accountants Act (Cap 503) with the responsibility of regulating the activities of the Accounting profession

[3] Cap 531 of the laws of Kenya section 28.

[4] An interview with John K. Njirani, Chief Executive ICPAK.

person other than the shareholder, meaning that he does not have a contract with the auditors.

While the above is true in Kenya, the scenario is different in the international scene. Here, auditors are being sued left, right and center for colossal amounts by third parties who were not privy to the contract for auditing services .The accounting profession has been subjected to large amounts of damages for professional negligence and it is estimated that the profession as a whole faces an estimated US $30 billion in damage claims[5]. There is an outcry by the auditors to have this liability checked.

The Kenyan auditor cannot afford complacency because what is happening in the developed world has already made a debut here. This is evidenced by the ongoing case of Trust Bank vs. KPMG Peat Marwick[6] where the auditors are being sued for negligence. Because the accountancy profession is characterized worldwide by its endeavour to achieve a number of common objectives and by its observance of certain fundamental principles[7], it can be assumed that the trend of third party liability claims will affect the profession in a similar manner.

The issue of third party liability poses serious difficulties for the courts. On the one hand, it is in the interest of justice that a wrong should be remedied. On the other hand, the courts find it impossible to grant relief in all cases. It is often felt that some injustices should go unremedied because an attempt to provide a remedy would open the

[5] Chairman of US firm Coopers and Lybrand on auditors' liability. See: http//www.pwcglobal.com
[6] Civil case No. 2155 of 2000.
[7] IFAC Code of ethics for professional accounts, in its introduction.

floodgates to litigation in unlimited capacity, which is likely to do more harm than good to the society. It is necessary for the law to draw a line somewhere [8]

Lord Denning goes further to explain how to draw these limits[9]

> "Sometimes it is done by limiting the range of the persons to whom the duty is owed. Sometimes it is done by saying that there is a break in the chain of causation. At other times it is done by saying that the consequence is too remote to be a head of damage. But ultimately, it is a question for the judge to decide".

Liability trends have changed with the times according to economic conditions by either widening or restricting the scope of liability of the auditor and some countries have even capped the limit to liability via statute.

A recent case of Caparo Industries plc V. Dickman and others[10] has narrowed the liability of the auditors to present shareholders only. According to the Caparo decision the purpose of the auditing, it seems is only to fulfil the requirements of the Companies Act[11] that companies must file audited accounts with the Registrar of Companies. The decision in Caparo has considerably narrowed the auditors' potential liability to 3rd parties. Is such a restricted view of the usefulness of audited accounts in the profession's long-term interests?

As Lord Denning said, it is necessary for the law to draw a line somewhere.

An interview with Prof. Eshiwani A. A,[12] opines that auditors' legal liability to third parties must be checked.

The auditors' problem is further compounded by the public's ignorance of the duties and responsibilities of the auditor. The expectations gap is widened, as there is a

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[8] Compania Finenciera "Soleada' S.A.V. Hamoor Tanker 'Corpin, the Borag (1981) I.W.L.R. 274
[9] Ibid.
[10] (1990) All England Reports 568.
[11] Cap 468 laws of Kenya, section 159(1)
[12] Director ICPAK and Lecturer, Faculty of Law, University of Nairobi

lot of mystery surrounding the work of the auditor. ICPAK needs to address this problem by demystifying the role of the auditor.

It is the purpose of this research to look into the law surrounding auditors' liability generally, with particular emphasis focusing on third party liability and how it has widened the quantum of damages awarded in cases of auditors' negligence and also how it has widened the parties to whom the auditor is liable and the implications of this wider scope to the Kenyan Auditor.

CHAPTER ONE

1.0 CAUSES OF AUDITORS' NEGLIGENCE AND THE PROBLEMS ARISING AS A RESULT OF THIRD PARTY LITIGATION.

In modern business environment, it is desirable that businesses, which are operated as companies with limited liability, should produce accounts, which will indicate how successfully they are operating. The owners of a business require more than accounts because the managers responsible for preparing them may either unintentionally or by deliberate manipulation produce accounts that are misleading. An independent examination of the accounts is needed so that the owners of the business can assess how well management has discharged their stewardship[13].

Auditing can be defined as an <u>independent examination</u> of the books of accounts of a business with a view of forming an opinion as to whether, these have been kept properly according to the Companies Act and as to whether the statements drawn therefrom portray a true and fair view of the company's state of affairs as at a given date.[14]

This definition is however restricted to limited companies only and a wider view needs to be taken.

The International Auditing Practices Committee's Glossary of terms defines an audit as follows:

> "The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared in all material respects, in accordance with an identified financial reporting framework."

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[13] Association of Chartered Certified Accountants study text 'The Audit Framework.BPP Publishing London(Sept 2000)

[14] Paul N. Manasseh, A textbook of principles of auditing McMore Accounting Books,Nairobi p 1

The underlined statements from the above definition need further explanation and expounding:

1.1 INDEPENDENT EXAMINATION

The audit should be conducted by a qualified accountant and must be independent of all parties with an interest in the company, including management, directors and third parties. The concept of independence is fundamental to the accountancy profession. It is an attitude of mind characterized by integrity and an objective approach to professional work.[15] He should be and be seen to be free in each professional undertaking of any interest that might detract his objectivity. He must be impartial and not allow prejudice or bias in his judgement.

An auditor's objectivity must be beyond question. That objectivity can only be assured if an auditor is, and is seen to be independent.[16]

It can be seen that the independence of an auditor is fundamental and if compromised, the report given by auditors is unlikely to reflect on the true position of the company's affairs. This requirement of auditors following code of ethics one of which is independence is provided for in Accountants Act, section 28. (Cap 503)

The independence is also a requirement of the Companies Act. (Cap 486)[17] which lists persons who cannot serve as auditors of a business entity.

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[15] Similar provision in IFACS code of ethics for professional accountant para 14.
[16] International federation of Accountants: code of ethics for professional accountants part A para 1.2.
[17] Section 161

The Institute of Certified Public Accountants of Kenya (ICPAK) in its code of ethics requires the independence of an auditor. The independence of an auditor is a fundamental requirement because without independence auditors' judgment is impaired and negligence is the likely outcome. This impairment can arise due to some of the reasons explained below. The auditor compromising his objectivity brings about most of the cases concerning accountant's liability.

Objectivity, integrity and independence of an auditor can be compromised in several ways and once compromised, negligence claims are likely to arise as a result.

1.1.1 Undue dependence on one client.[18]

It is recognized that a dependence on income from a particular client may impair objectivity. A firm which derives most of its income from one client for instance might find it difficult to make a stand on a particular issue as the loss of that client (through removal or resignation) would have a disastrous effect on the firms financial position.[19]

The very clear case that comes to mind is that of Enron. Enron was energy giant in the USA and for a long time had made major losses. However, the auditors (Arthur Andersen) having relied heavily on this one firm had their objectivity clouded and went along with the reported 'profits' running into $618 million. Enron was rated the number 7 global giant of 2001[20] based on these 'profits' yet in actual sense this company was

[18] International Federation of Accountants, Rules of Professional Conduct sectin 1 para 1.1
[19] The Economist, Jan 26th – Feb 1st 2002 edition vol. 326
[20] Fortune Magazine of 14th March 2001

making huge losses. Andersen continuously gave Enron a clean bill of health due to this dependance. Enron was Andersen's Golden Calf.[21]

1.1.2 Provision of other services to audit clients

Audit firms along with providing audit services provide non-related services to their clients. These other services include accountancy, financial advice, preparation of tax returns and consultancy. What this leads to is the auditor to auditing his own work in the long run. It starts by the auditor in his capacity as an auditor recognizes a problem within the company. He therefore offers to give advise on how to solve the problem. Therefore, what he does is to give advice on a problem and then go around and audit the same advice once the company has followed it. There is also the danger that the non-audit work is likely to bring in much more money than the audit work as it is considered more prestigious. It will therefore, be in the audit firm's best interest to give a clean bill of health in order to be appointed auditors at the next General Meeting. It has become obvious that shareholders only endorse the directors' choice of auditors and an auditor who pleases the directors is likely to be re-appointed. Arthur Andersen in 2001 alone earned $54 million from non-audit work given by Enron.[22] It was therefore in their best interest, to keep doing the audit work, which only gave meager earnings as compared to non-audit work. The only way to remain Enron's auditors was by going along with the fraud. You do not kill the goose that lays the golden eggs.

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[21] Supra note 18 pg. 126
[22] Supra note 18 pg. 125

The other threats to independence and objectivity could be mentioned in passing.

A firms objectivity may be threatened or appear to be threatened as a consequence of a family or other close personal or business relationship. The disciplinary committee of ICPAK has decided on various cases concerning this. An example is that of H.W Gichohi [23] in which the auditor was found guilty of misconduct by auditing books of a company in which his wife was a majority shareholder.

Beneficial interests in shares and other investments in the clients firm is likely to cloud the judgement of the auditor.

Influences from outside the practice. This could include pressure from associated practices, or organizations, or from other external forces such as bankers, advocates, the government, etc.

Guaranteeing clients' loans, accepting loans from the audit client or having the audit client guarantee a loan.

Providing overlapping work for two different clients. There is likely to arise a conflict of interest and probably violation of auditing standards when one firm performs work for two different clients and the work is related. Both clients need to be pleased and the auditor will do whatever it takes to ensure his clients satisfaction. Standards and ethics are likely to be compromised. PricewaterhouseCoopers (hereinafter PWC) has been implicated in the Enron scandal. The firm has been alleged to have been working for both Enron and debt-shielding partnerships LJM2. PWC was providing tax advice to help LJM 2 structure its deal, while advising Enron on the value of that deal. This obviously presents a problem of objectivity. The overlapping engagements violate accounting ethics, standards, which require firms to maintain a degree of objectivity while dealing with clients. Objectivity will always be compromised in such cases.

The above are just but a few instances where the independence and objectivity of an auditor is threatened and this threat if not removed can lead to cases of malpractice.

1.2 TRUE AND FAIR VIEW?

The term true and fair view is required to be stated by the auditor while giving his report and this term pauses some problems when it comes to the expectations of the users of the financial statements. It compounds the problem of unlimited litigation as it makes the auditors' report definitive and makes reliance on it almost sacrosanct.

The term true and fair view is not defined as such in any accounting or auditing standard neither has it been given any legal meaning.

This term has been included in the company legislation, that is, the law mandates that the report should state that the financial statements give 'a true and fair view' of things.'[24]

The International Accounting Standards Committee (IASC)[25] does mention true and fair view but not in very helpful terms.

> "Financial statements are frequently described as showing a 'true and fair view' of the financial position, performance and changes in financial position of an enterprise…the application of principal qualitative characteristics and of appropriate accounting standards normally result in financial statements that convey what is generally understood as 'true and fair view' of such information."

Even in legislation, the definition of true and fair view is not included. The 7th Schedule of the Companies Act[26] is far from being clear.

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[23] Case No.0588(2001)
[24] Companies Act (Cap 486) Section 162

Before the enactment of the Companies Act, these words used to read 'true and correct view' and had obvious loopholes in it. The expression true and correct indicated precision and exactness where in fact the financial statements are based on estimates. Due to these loopholes, the 'correct' was replaced with 'fair'. This hardly helps matters because the inclusion of truthfulness which to many users means that the accounts are risk free. These words make the report sacrosanct; reliance on it feels like obeying a covenant.[27]

It is on this basis of lack of understanding of the roles of auditors that lead to overzealous litigation against the auditor by third parties. Stating that the accounts present a true and fair view binds the auditor to guaranteeing the company's future.

What was intended by this phrase was to state that in preparing the financial statements the relevant accounting standards and conventions have been complied with.

But in the final end, the arbiter of whether or not the accounts are true is the court and not the accountant. The question of whether company accounts comply with relevant legislation can be authoritatively decided by a court of law, but compliance with accountancy standards and conventions cannot be decided by court of law since accounting standards and conventions have no legal effect. They are simply rules of professional conduct for accountants.[28]

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[25] Framework for the preparation and presentation of financial statements.
[26]It sets out samples of what should be contained in an auditor's report.
[27] The accountant, journal of the institute of certified public accountants July-September 1998 pg. 21.
[28] ACCA Study text, The Audit Framework BPP publishing ltd. London 2001.

The cryptic nature of this requirement of the auditor's reports tends to bind them to making their opinion definitive opening doors to litigation from all the parties that rely on them. The courts of law are also likely to be caught up with this difficulty.

Because of the fallacy of the concept and the risk of costly claims, some regimes have abandoned it or substantially watered it down.[29] Americans have adopted one that is safer legally and non-committal.

> "In our opinion, the financial statements referred to be above present <u>fairly</u> in all material respects, the financial position of company X as of (at) December 31st 19xx and the results of its operations and its cash flows for the year ended in conformity with generally accepted accounting principles."

This does not mention 'true', but 'fairly' which is likely to reduce damage. We also need to amend the Seventh Schedule of Companies Act[30]to a similar provision.

1.3 THE EXPECTATION GAP

While looking at auditors' liability it is worth noting something on the expectations gap – the difference between what people think auditors do and what auditors really do in practice. It is important to understand this, because liability claims are likely to arise due to these expectations. Judges who are not fully aware of the true duties of the

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[29] Supra note 26 pg. 24.
[30] Cap 486 Laws of Kenya

auditor are likely to find them liable to third parties. Even some 'financially aware' people do not look at the report of auditors of the company they are investing in.[31]

Auditors' responsibilities, powers and duties are very restricted by statute, ethics and auditing standards and many users of the financial records do not understand this. It is important to understand some principles applying to auditing in order to reduce the claims against them.

Many people believe that it is the duty of auditors to detect fraud, to act like the police, fighting for truth order and justice. The responsibility of detection of fraud is purely for the management.

When planning and performing procedures and in evaluating and reporting the results thereof, the auditor should consider the risks of material misstatements in the financial statements resulting from fraud and error.[32]

International Standards of Accounting referred to as (ISA) 240 makes it clear that the responsibility for prevention and detection of fraud and error rests with management through the implementation and continued operation of adequate accounting and internal control systems.

In planning the audit, the auditor should assess the risks that fraud and error may cause the financial statements to contain material misstatements and should inquire of management as to any fraud or significant error that has been discovered.[33]

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[31] ACCA Study text, The Audit Framework BPP Publishing London pg13.
[32] International Stand of Acting (ISA) 240
33 ibid.

It is clear from the above that the auditor should not be given the responsibility of detecting fraud but an audit is merely a deterrent to fraud. Where the auditor fails to defect fraud, without any proof of negligence and fraud, he should not be held liable.

Operational Guideline No. 19 on fraud and error[34] provides in a nutshell that where fraud is suspected, the auditor should take a professional role and not an investigatory one.

The auditor often is seen as a watchdog if not a bloodhound. When he arrives at the office, a chilling atmosphere descends, managers become friendly to subordinates; visitors are even served tea. All these are because of the misconceived role auditors. The mystery surrounding the auditor needs to be demystified.

The duty of confidentiality applies even to auditors. Even where the client has been breaking laws and regulations disclosure by auditors would only be acceptable when either required by statute or court of law or in the extreme cases of public interest e.g. trading with the enemy at war time.[35] The auditor reports and is liable to the shareholder only and disclosure should be with the client's express permission.

Another principle that should be understood is that, auditors only examine financial statements prepared by the company and their duty is not to ensure that the law and regulatory requirements are met by the company, that is entirely the management's duty.

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[33] Ibid..
[34] The Kenya Auditing Guidelines.
[35] Supra note 30 pg. 45.

The auditor's reports will be based on past information and not on future estimates and forecasts and therefore he can not be liable for events taking place after the report. They report on what has already happened and not future expectations.

Public concern of large companies failures has highlighted the problems with expectations gap. People assume that the auditor should have foreseen the failure but;

> "The role of auditors in corporate governance is widely acknowledged but the limitations of their role should also be recognized. Auditors are not an alternative to good governance."[36]

1.4 THE LIABILITY CRISIS

The auditing profession has been increasingly subject to damages for professional negligence. The chairman of the US firm coopers and Lybrand estimates that the profession as a whole faces an estimated US $30 billion in damage claims.[37]

These claims are mostly against the 'Big 5' (soon to be four) firms of auditors[38]. One of the largest claims has been made against Pricewaterhouse in respect of their audit work of the collapsed Bank of Credit and Commercial International (BCCI) (notoriously referred to as 'Bank of Criminals and Crooks International.)[39] The amount claimed was to the tune £8 billion.[40]

Such large claims and settlements are common in jurisdictions that follow the common law regime covering the tort of negligence.

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[36] Roger Davis, partner pricewaterhouse coopers (UK) on Company Law Review (http//www.pwcglobal.com).
[37] Paper presented at the 19th annual congress of European Accounting Association, Bergen Norway.
[38] The Big five include are: PricewaterhouseCoopers, KPMG, Deloitte and Touche, Earnst and Young and Arthur Andersen.
[39] Study text Accounting; Audit services and Assurance, BPP Publishing London (2001)
[40] Ibid.

Countries like France, Germany, Japan etc have the provisions, relating to auditor's negligence in their statutes. Other countries like Israel have remedies for the investors that do not involve the auditor and therefore do not have the problem of unlimited liability and the widened scope of third parties who can sue the auditor.

This problem is however not unique to the US and many countries that follow common law of torts are at risk of opening the door to large settlements for damages in negligence. Kenya follows the common law principles[41] and statute does not intervene to cap the liability of the auditor where negligence has been proved. An attempt to do so is statutorily void. The Companies Act[42] provides that, any provision in a company's Articles or in any contract with the company exempting the auditor from liability or seeking to indemnity him//her for such liability shall be 'void'.

This is a great danger. Even though this country has not witnessed a lot of third party litigation against the auditor, the wind of litigation from the west is definitely blowing in this direction.

In Germany for example the extent of liability has been fixed at DM 500 000 for many years. There are now proposals to increase the limit to DM 8 million for listed companies and DM 4 million for unlisted companies, and this pressure for change comes from the accounting profession in Germany who believe that it is necessary in order to improve the image and standing of the profession[43]. France and Japan have similar provisions in their statutes and this s a welcome change for this country, which follows common law legal traditions to deal with auditors' negligence.

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[41] As adopted via section 3 of the Judicature Act (Cap 8)
[42] Cap 486, section 206

1.5 IMPLICATIONS OF THE LIABILITY CLAIMS

Auditors are now complaining as a result of the lawsuits facing them. The shareholder to whom the auditor has reported to for over a century and a half is no longer the only source of litigation. Third parties who include creditors, investors, suppliers, the government etc can now sue and get large sums of money in settlement. The auditors are either going to close down their business or cease to offer any auditing services at all.[44]

Many auditing firms have taken insurance against litigation for negligence. In practice many claims do not go to court because of the costs and the publicity. Settlements are made out of court from persons who insured the audit firms against damages arising out of liability to negligence claims. However, as the claims became larger and larger the insurers do not cover all the claims and the premiums payable have become very expensive.[45]

Many firms are no longer able to procure insurance because many insurers perceive auditors as high risks due to the size of damages. The audit business is like the matatu business in this country, they are no go-zones for many insurers and those who have insured them do so at large premiums.[46]

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[43] Supra note 39
[44] Supra note 38.
[45] Supra
[46]J. Njiraini, chief Executive ICPAK at seminar on 'Auditing Standards dream or reality', Strathmore college, 23rd March 2002.

The 'Big Five' in the UK have made a collective appeal to the government to remedy the situation before the audit firms cease to practice because of the size of the outstanding claims.

The auditors are likely to react by withdrawing from litigation prone industries. Some will refuse to do audit work completely and concentrate on consultancy or decline to give professional services in circumstances that are likely to increase their exposure to liability. This is what insurance companies do all the time by simply refusing to offer cover to certain persons or industries they consider obvious risks. The implication of this is that certain industries may be denied the essential audit services. This outcome is hardly in the interest of business development. The repercussions on the market place and the economy in general are multifarious.

1.6 THE KENYAN ACCOUNTANT (AUDITOR)

Accountants in Kenya can take a cue from the international effort and apply some of the remedies already formulated. This will be discussed later in the text. My main concern is civil liability and not criminal liability and therefore I shall not focus on fraud and liability in fraud as provided for in the penal code [47].

The Kenyan auditor can not afford complacency and ICPAK should lobby for amendments of certain statutes.

The Banking Act (Cap 488) through section 24, the Insurance Act (Cap 487) in section 56, Capital Markets Authorities Regulations 33 and 34 of 1992,the Income Tax Act have provisions that are stringent and gravely detrimental to the auditing profession. They only seem to reinforce the problem already being faced by the auditor through third party litigation. These are lethal and shall be given a closer view in the next chapter.

There is need to have negligence claims covered by statute law by first of all amending the already existing statutes and capping the liability of auditors.

The regulatory framework of the auditing profession is in need of strength and power. The auditing standards are mere guidelines. They are not enforceable in any court of law, they are imprecise and the enforcing body has no redress in case of any breach.

> "When the professional and legal standards applying to directors and auditors are certain, both parties will comply with such standards. Conversely, when these standards are sufficiently imprecise, compliance by either party is no longer guaranteed."[48]

The question is: "should these standards be made mandatory, i.e. through statute?"

The expectations gap needs to be closed and this can only be done by demystifying the role of auditors.

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[47] Cap 63 Laws of Kenya section 329.
[48] Precision in auditing standards: effects on auditor and director liability and the demand for quality audit services – paper presented at the 19th Financial Congress of the European Acting Association Bergen Norway.

CHAPTER 2

2.0 AUDITORS' LEGAL LIABILITIES

Liability of the auditor can be categorized under the following headings:

- Liability under statute; either civil or criminal
- Liability arising from negligence under Common Law
  - To clients under contract law
  - To third parties under law of tort

It is not the concern of this research to discuss liability under criminal law and therefore the penal code[46] provisions shall not be looked into.

The importance of liability under statute and that under common law differ from one jurisdiction to another. In jurisdictions with civil code legal traditions the former is more important whereas those with common law legal tradition such as Kenya, the latter is more important.

2.1 LIABILITY UNDER STATUTE/LEGISLATION.

2.1.1. The Companies Act (Cap 486).

The Companies Act[47] provides for appointment and remuneration of auditors. It also provides for auditors' liabilities in various sections[48]:

> '... Where a prospectus invites persons to subscribe for shares or debentures in a company; the following persons shall be liable to pay compensation to all persons who subscribe for any shares or debts on the faith of the prospectus for the loss or damage they may have sustained by reason of any untrue statement included therein'.

The section lists amongst others as any person who has authorized the issue of the prospectus. The Act includes an accountant as any 'expert' who gives consent to the issue of prospectus containing statement by him[49].

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[46] Section 329
[47] Section 159
[48] Section 45(1)
[49] Section 42(3)

Section 159(1) provides that every company shall at each annual general meeting appoint an auditor or auditors 'to hold office…'

This status of an auditor as an officer of the company should be eliminated. Because of this, courts have ruled that the auditor should be punished as such. This was the basis in R.v Shacter[50]. Many statutes provide for penalties against officers of the company and it would be completely unfair to regard an auditor as an officer of the company. The auditor is simply an appointee of the shareholder appointed to ensure that the company's accounts reflect the true affairs of the way the company is run. He is an independent person.

Section 162 read together with the seventh schedule[51] brings about the issue of true and fair view[52] which I have already discussed in the previous chapter and it needs to be amended accordingly in order to demystify the role of auditors and the extent of their liability.

The Companies Act expressly prohibits any attempts by the auditor to cap or limit the extent of his liability.

> '…any provision whether in the Articles of a company or in any contract with the company or otherwise for exempting …an auditor from or indemnifying him against any liability ……… 'shall be void' (emphasis added)[53].

The liability of the auditor under the Companies Act is unlimited. It cannot be limited by any agreement and limits the freedom of the auditor to negotiate the terms of his contract and the courts shall decide the quantum of damages if found liable.

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[50] (1960) All England Reports. 61
[51] Matters to be expressly stated in auditors report.
[52] Particularly rule 3(2)

[53] Section 206

This amount could be as varied as the courts deem fit and this is what has led to large damages being awarded against the auditors. It is this provision that the auditors are crying foul about as it has exposed them to claims of large settlements.

Section 206(ii) provides that a company may indemnity an auditor against the liability incurred in defending such a claim if judgement is in his favour or in which he is acquitted or in connection with any application under section 402 in which relief is granted by the court[54]. Section 402 gives the procedure to be followed by the auditor while making an application for indemnity under section 206(ii). This clearly limits the freedom of the auditors to negotiate the terms of their engagements and contract.

The expectations gap compels auditors on the one hand to report on fraud, good governance, future prospects and risks *etc* and yet if the scope of the audit does not go this far, clients may treat audits as irrelevant. On the other hand statute does not cover the auditors in any way against litigation considering the uncertainty of the matters on which they have to report[55]. Roger Davis, Partner PWC (UK) on company law review states:

> " Auditors are not an alternative to good governance. Allowing the auditors to limit their liability in a proportional way is the obvious quid pro quo if they are not to take the imaginable risks of financially underwriting every company's future. It would destroy the incentives of others with a responsibility for good governance".[56]

Good governance is the responsibility of management.

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[54] The Hong Kong companies ordinance has a similar provision in section 165© and 358 respectively, the UK companies Act (1985) s.310 provides the same.

[55] Prof. Eshiwani 'trends in Auditors' Legal liability in Kenya' The Accountant July-sept 1998.

[56] Http/www.pwcglobal.com

2.1.2 The Banking Act (Cap 488).

The section that deals with auditors' appointment is section 24(1).

> 'Subject to subsection 7, every institution shall appoint annually an auditor qualified under section 161 of the companies Act and approved by the Central Bank, whose duty shall be to audit and make report upon the annual balance sheet and profit and loss account …'
>
> "If an institution fails to appoint an approved auditor or to fill any vacancy for an auditor which may arise, the Central Bank may appoint an auditor and fix the remuneration to be paid by the institution to him[57]".

The Banking Act unlike the Companies Act does not make an auditor an officer of the institution.

An institution in this case means a bank or financial institution or a mortgage finance company.[58] The Central Bank of Kenya therefore takes over some element regulation of the audit practice. This can be inferred through various provisions of the Banking Act.

> The Central Bank may appoint an auditor and fix his remuneration should the institution fail to do so.

Section 24 (i) of the Banking Act gives the auditor further requirements for qualification, as the approval of the Central Bank is required. However, the criteria to be used by the Central Bank when granting or refusing approval has not been given.

Section 24(6) gives the auditor 'Whistle-blowing' duties and this seems to be the only one of its kind in our statute books. It states:

> 'If an auditor of an institution fails to comply with the requirements of this Act, the Central Bank may remove him from office and appoint another person in his place'.

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[57] Cap. 488 Section 24(2)
58 Section 2(i)(ii)

These requirements are listed in section 24(4)(a) to (e) of the Banking Act,

If the auditor of an institution, in the course of the performance of his duties under this Act is satisfied that:

> "There has been a serious breach of or non-compliance with the provisions of this Act, the Central Bank of Kenya Act or the regulations, guidelines or other matters prescribed by the Central Bank;
>
> a criminal offence involving fraud or other dishonesty has been committed by the institution or any of its officers or employees;
>
> losses have been incurred which reduce the cover capital of the institution by fifty percent or more;
>
> serious irregularities have occurred which may jeopardize the security of depositors or creditors of the institution; or
>
> he is unable to confirm that the claims of depositors and creditors of the institution are capable of being met out of the assets of the institution, he shall immediately report to the Central Bank."

The implications of these whistle blowing duties on the auditor are far reaching.

First, it alters the contractual relationship between the auditor and the shareholder who engages him. The shareholder hires while the Central Bank fires in cases where the CBK is dissatisfied with the auditor's performance. Shouldn't this be the shareholders' complete discretion? This is in view of the fact that the contract for audit services is between the auditor and the shareholder.

Secondly, this section tends to turn the role of the auditor into an investigatory one. He is supposed to carry on like the police department and not a professional, appointed by the owners of the institution to report to them on the financial statements prepared by the institution's management. The Central Bank has its own investigation teams that look into the compliance of the laws and regulations by the banks and it should utilize these as the extra duties on the auditor beyond his contractual duties only acts to burden him further. The auditor already has other conventional claims against him that are already overwhelming.

Thirdly, whistle-blowing duties are almost unorthodox. Besides making the auditor lose his clientele it offers no compensation for the loss of client or offer any replacement. While the CBK can fire, then it should be mandatory for it to hire in order to provide alternative engagement for the auditor who blows the whistle.

Fourthly, the duty of confidentiality imposed on auditors by IFAC code of Ethics for professional accountants[59] comes in conflict with this provision. Section 4.2 states that confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.

This legal duty has been given via section 24(4) and it tends to isolate the burdens put on the auditor from those of other professionals. A lawyer for example acting for the director who has been implicated in the same fraud is protected by the law from disclosing this information, so are doctors and other professionals, why target the auditor?

The case of <u>Republic v. F.T. Nyammo and others</u>[60] seems to be the first local case involving auditors. The company in question was a bank and the auditor was accused together with the directors of the bank of making, circulating or publishing or (concurring in any of the above) any written statement of account which in any material particular

[59]IFAC's Code of Ethics in Section 4 (paragraphs 1-9)
[60] MCI, Crc. No. 2801/96.

was, to their knowledge false with intent thereby to deceive or to defraud any member, shareholder or creditor of the company, whether a particular person or not.

Following the mention of the case a consultative meeting between CBK and ICPAK was held in August 1996. The two agreed on the "Role of External Auditors in Banking Institutions" and a number of guidelines were formulated by CBK (not ICPAK) and of greatest impact to the auditor is guideline No.9[61]. Some of the actions threatened to be taken by the CBK against negligent audit firms include blacklisting them from auditing banking institutions and instituting legal proceedings where the audit firm has been proven negligent. Notice of intention to prosecute routinely (NIP) has thus been given to auditors by the CBK.

It should be borne in mind that the auditor's work is not a social service like defence for example; he is a person in business selling his skills. Auditors have to bid for auditing services from banks and other institutions. While it is true that the shareholders appoint auditors it has become common practice that shareholders only endorse the directors' choice. Therefore asking the auditor to go beyond his contractual duties to the shareholder and report the very same people who select him is absurd to any businessperson. The publicity and loss of business alone is damaging to any profession. This is compounded further by the fact that the Central Bank of Kenya offers no compensation in such cases. In Hong Kong, auditors who report get police protection[62] and this hardly solves the economic problem facing the auditor. It is upon the Central Bank to put in place regulatory mechanisms in order to monitor banks' affairs.

[61] 'The role of External Auditors in Banking Institutions' paper presented at consultative meeting between CBK and ICPAK in August 1996.
[62] Gordon Oldham, partner in Oldham, Li & Nie (a Hong Kong audit firm) on Auditors' Liability.

Conventional claims on the auditor as it is are large enough without further obligations from the Central Bank of Kenya.

Section 24 is the main argument in Trust Bank Limited v. KPMG Peat Marwick[63] in which the depositors of Trust Bank Ltd. are suing KMPG, an accountancy and audit firm for a whopping Kenya Shillings 8 Billion. The plaintiffs Tarlok Singh Nandhira, Mahendra Patel, Dinesh Shah and Tajdin Jiwa are suing on their own behalf and on behalf of the depositors of Trust Bank Limited. They claim that their loss occurred because the auditors *inter alia* failed to perform their statutory duties under the Banking Act by failing to disclose to the plaintiffs the true and correct financial position of the bank, causing the plaintiffs to continue depositing the funds with bank, which bank was placed under liquidation with the consequences that they lost their deposits.

In December 2001, Justice A. Ringera in his ruling allowed the filing of a representative suit on behalf of all the depositors of Trust Bank. He argued that the named persons who sought to be represented were numerous persons who had the same interest in the suit.

Depending on how the matter is resolved, the case may open a floodgate of litigation against accountants and auditors[64]. The danger signs are already looming. The ruling has included into the suit numerous persons who are third parties or strangers to the contract for audit services.

It should be noted that I am not advocating for non-punishment of auditors who have been found negligent. Cases of malpractice are many and not just in the

[63] High Court, Civil case No. 2155 of 2000.
[64] The Daily Nation Wednesday, March 27, 2002

accountancy profession, some are even reported as they are settled out of court. It would be wrong to let them off the hook, or even to suggest total exoneration.

However, it is the extent of their liability seen through the litigation trends in the West that go beyond the boundaries of statute and contract that should be addressed. The courts have relied on the proximity and foreseeability principles to bring third parties within the liability cap. The amounts awarded by courts as damages are supernormal and the parties to whom they are liable are numerous. The BCCI case against PWC where the auditors were being sued for about US $ 8 Billion is an example[65]. The traditional shareholder to whom the auditor has always reported is no more and the scope of his liability has widened greatly.

Also at hand is the question as to whether they should be held liable for the share of losses caused by other defendants *i.e.* directors and management. The deep pockets syndrome[66] makes the litigants target the auditor.

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[65] ACCA Study Text :Assurance and Audit Services, BPP Publishing(London)2001

[66] The belief that auditors have more money and therefore they should be sued for large amounts since they are the ones in a position to pay or settle.

2.1.3 The Insurance Act (Cap 487)

In the UK, banks and insurance companies fall in a special category and rules relating to auditing their accounts are also special. In our statute books, this is also apparent. The insurance Act makes this clear.

Section 56 makes provision for the requirement of annual auditing of the accounts of every insurer. Insurer in this case is a person, whether registered under the Act or not, who carries on insurance business and includes reinsurer.[67]

The Insurance Act[68] requires the auditor to report on his satisfaction or otherwise on compliance by the companies of certain matters. This report should be in certificate and should state the following;

> The accounts and statements appear to be in accordance with the Act and give particulars of those matters that do not appear to be in accordance;
>
> the accounting records have been properly kept and explain the financial position of the insurer and give particulars of records that appear not to have been so kept;
>
> that he has obtained explanation and information that he requested and give particulars of that, that he did not obtain;
>
> he is satisfied that the accounts and statements agree with the accounting records of the insurer and appear to him to truly represent the financial position of the insurer and if they appear to fail to so represent the financial position, give particulars of the failure;
>
> amounts required by section 53 to be apportioned have been so apportioned and if they not, give particulars of the failure;
>
> all management expenses have been debited in the revenue account or profit and loss accounts as expenses and if not, give particulars of the amount not so debited;
>
> every reserve has been calculated in accordance with the method approved by the commissioner and if not, give particulars of the reserves not so calculated.

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[67] Section 2: (Cap 487)
[68] Section 56(2)

Section 178 provides for the penalty that will be imposed on the auditor for contravening the provisions of the Act. The Commissioner of Insurance may institute proceedings against the auditor just like the Governor of Central Bank has done by issuing Notice to Prosecute and going further to institute proceedings in the case of Republic v. F.T Nyammo and others.

The requirement of the auditor to report in certificate as in section 56(2) tends to make the auditor's report definitive. It is however not true that the things the auditor is required to report on can be in any way definitive. It cannot be said with certainty that for example that the reducing balance or straight line method of depreciating fixed assets is better than the other but whatever method is chosen the accounts will show a true and fair view. The company will most likely use one that will give a better profit figure.

This requirement by the Insurance Act[69] that the auditor report in certificate is as damaging as the companies Act "True and Fair" view requirement. Once the auditor has given his report in certificate reliance on it is almost like obeying a word of law. The circumstances surrounding the insurance industry will not be in the mind of a plaintiff when such a definitive report has been issued. The auditor is as good as having insured the insurance company himself. Insurance business and banking institutions are fundamental to the economy, it is argued, but so is the auditing profession. Requiring the auditor to give such a report on certainty of certain matters puts him in a vulnerable position from all manner of litigations.

[69] Section 56(2)

2.1.4 Capital Markets Authority Act.

The advent of capital markets led to the creation of the Capital Markets Authority (CMA)[70], a body to regulate the securities market. There are stringent measures and legal regulations to facilitate as well as regulate listed companies. One of the principal objectives of the CMA is the protection of investor interests.[71] The information with which the companies seek to attract investors is prepared by experts and consequences exist for those experts who give this information negligently and therefore cause losses to investors.

The minister may make regulations in respect of matters required by the Act to be prescribed or in respect of which regulations are authorised to be made.[72]

This power to make regulations by the minister has been exercised and CMA regulations of 1992 were the result .Of interests are regulations 33 and 34:

> 'The authority shall have the right to disqualify from giving professional opinion on matters related to listed companies or otherwise penalise any professional who in the opinion of the authority has given a professional opinion that is false or misleading or has omitted to give an opinion where such an omission is likely to be misleading in the circumstances in which the opinion is given or omitted as the case may be.'[73]

A professional in this case includes an accountant, financial analyst or investment advisor.[74] Under Kenyan law[75] no distinction is made between accountants and auditors. They are generally referred to as accountants. Auditors can therefore be assumed to be specialized accountants.

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[70] Cap 485A of the laws of Kenya Section 5.
[71] Ibid, subsection ii
[72] Ibid, Section 36.
[73] Capital Markets Authority Regulation 33
[74] CMA Regulation 34
[75] Accountants Act (Cap 531), laws of Kenya

The implication of Regulation 33 is to deny auditors clientele through disqualification. Although the consequences of negligent advise are far and wide, the danger in regulation 33 is the numerous number of parties the auditor is likely to be liable to and who are consumers of the information in question. The Kenyan capital markets were for a longtime controlled but with liberalization in the 90's[76] foreigners come into the list of possible claimants under the title of investors. Capital markets are not nation specific and investors would go beyond the national boundaries. This clearly shows expanded list of the likely claimants under the Capital Markets Authority and it further expands the third parties the auditor would be liable to outside his contract with the shareholder.

[76] Class notes: Strategic Financial Management (ACCA Part 3) Strathmore College

2.1.5 The Income Tax Act.

The Income Tax Act[77] puts an obligation on an accountant. The leading tax experts in this country are accountants as opposed to any other professionals, say lawyers. Accountants assist and advice on preparation of accounts from which tax returns are made.[78]

> 'A person who makes a fraudulent claim for the repayment of tax or who, with intent to evade tax, prepares or maintains, or authorises the preparation of maintenance of, false books of account or other records or falsifies or authorize the falsification of books of account or records'[79]

This section proves to be even more lethal in subsection (3) where it is presumed that a person in any of the above categories is guilty until proved innocent. It states:

> "...person making the false statement of entry shall be presumed, until the contrary is proved, to have made the false statement or entry with intent to evade tax or to assist or enable that other person to evade tax".

In this section the rule of law that every person shall be presumed innocent until proven guilty does not apply. This is a crime of strict liability[80] and the intent or mens rea does not need to be proved. The burden of proof has been shifted to the auditor who should under any normal circumstances be preparing a defense.

The penalties for this offence are provided as a fine not exceeding ten thousand shillings or double the amount of tax for which he's liable under this Act

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[77] Cap 470 Laws of Kenya
[78] Class notes: Tax Law: UON Faculty of Law
[79] Supra, Section 111(1)(a)
[80] The rule in Rylands V. Fletcher

for the year of income in respect of which the offence was committed whichever is the greater, or imprisonment for a term not exceeding two years or both[81]

This also tends to burden the auditor even further. Beyond the costs of proving his innocence he can face the possibility of a fine or even imprisonment. This Act in no way helps the situation the auditor is already facing of numerous claims by third parties.

[81] Supra 80 Section 111(1).

2.2 LIABILITY UNDER COMMON LAW

2.2.1 To clients under contract law.

The law of contract provides that the common Law of England relating to contract as modified by doctrines of Equity, Acts of parliament of the UK is applicable to Kenya[82] The effect of this is that the common law as modified by doctrines of Equity and Acts of parliament of the UK as at 12th August 1897[83] are of binding force in Kenya. Kenyan courts, where circumstances allow and if it is in the interest of justice shall apply the above. With the view of the fact that the Kenyan case law in relation to the liability of accountants to their clients is underdeveloped, I shall discuss common law decisions of the UK.

By his contract with his client, an auditor owes a duty to perform the audit, report to the client exercising reasonable care. This contract sets out conditions of and the scope of the auditor's work.

The auditor cannot be found liable if he fails to carry out work not specified in the contract. In Maritime Insurance Co. v Fortune and Son[84] an auditor was engaged only to certify a return which was made by a branch office of an insurance company but not to audit the books. He was found not liable for failing to detect fraud of employees at the branch office as this was beyond the terms of the contract.

The duty of care owed to the client by the auditor is that of a prudent man. It is unlikely to be clearly spelt out in any contract setting out the terms of an auditors' appointment, exactly how they should discharge this duty of care.

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[82] Law of contract Act (Cap 23) Section 2

[83] Judicature Act (Cap 3) section 3.

[84] (1931) 414 LR 16

The duty of care has been defined as doing the things that a prudent man would do in the circumstances and refraining from those he would not do. In the case of an auditor engaged to audit a company's accounts, this presumably means that the audit will be conducted in accordance with accepted accounting standards and standards of audit practice[85] In Lloyd Cheyham v. Littlejohn de Paula[86], it was held that a thorough audit[87] was a good defense against claims of negligence.

When Lopes LJ considered the degree of skill and care required of an auditor in Re: Kingston Cotton Mill[88] he declared:

> ".... 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 care, skill and caution must depend on the particular circumstances of each case."

There is no question that the duty of care is owed to the client company by the contract itself and where this duty is breached the shareholders are entitled to sue as of right. However the only issue that complicates the matter is the issue of expectations gap. This is the disparity between the duty of the auditor as required under law and his duties as understood by his clients. This problem brings about of lack true understanding of an audit report and therefore leading to uncontrolled litigation. I have already looked at the expectations gap but for the purpose of explanation I shall revisit it.

Many shareholders and users of the financial records believe that the auditors' duty is to defect fraud. Where an auditor fails to detect fraud after having taken all

[85] Supra note 84
[86] (1985) All ER 368
[87] Includes inter alia following auditing standards and accounting standards, good documentation through working papers etc.
[88] (1896) 2 CH 279

reasonable steps he is not liable for any damage. On this issue Loper LJ goes further in the case of Re Kingston Cotton Mills[89] by saying that,

> '...an auditor is a watchdog not a detective, unless suspicions are aroused. He is a watchdog, but not a bloodhound".

Lord Denning in the case of Fomento (sterling area) Ltd v Selsdon Foundation pen Co. Ltd[90] sought to explain auditors' proper approach to his work by saying:

> ...he must come to it with an inquiring mind - no suspicious of dishonesty ... but suspecting that someone may have made a mistake somewhere and a check must be made to ensure that there has been none".

This is the same requirement of ISA 240[91] on fraud and error on the attitude of professional skepticism.

If the auditors' suspicions are aroused, they must conduct further investigations until such suspicions are either confirmed or allayed. In some cases, the courts have held on the strength of the facts presented that the auditor ought have been put upon inquiry[92] and gone further to investigate the matter until his suspicions have been allayed.

In Re Thomas Gerrard & Son[93] a managing director of a company had falsified the accounts to conceal company losses causing dividends to be paid either wholly or partially out of capital over a number of years. He had done this by including non-existing stock and altering invoices, which the auditors discovered and pursued no further. The discovery of the altered invoices put the auditors on inquiry, they were no longer entitled to rest content with the assurances of the officers of the company. Their

[89] Ibid.
[90] (1958) All ER 11
[91] International Statements of Auditing (ISA) are fully operational in Kenya since 2000 after scrapping the Kenya Auditing Guidelines.
[92] Supra note 37 page 388
[93] (1968) All ER 282.

suspicions should have been aroused and inquires should have been made from suppliers to verify those assurances. They were therefore negligent.

Many people believe that the auditor should be doing investigatory work to detect fraud; others do not even read the auditors' report leave alone looking at the financial statements on which the auditor reports. This is a call on ICPAK to educate the masses in order to save one of their own from unnecessary litigation. Even if the auditor is found not negligent, the cost of defending the suits can be quite prohibitive especially where the claims are numerous.

Demystification of the auditors is a must and capping their liability would go along way in saving the profession because even where negligence has been proved, the quantum of damages remains a subjective decision of the judge.

2.2.1 Liability to third parties under tort.

This is the most problematic head of liability. Under this head, third parties who are not privy to the contract are owed duty of care depending on causation, proximity and foreseeability.

A third party (a person who has no contractual relationship with the auditor) may claim for negligence arising out of the law of torts. In the tort of negligence, the third party must prove that the defendant *ie* the auditor owes a duty of care and that the defendant has breached that duty *ie* has been negligent and that the plaintiff has suffered loss as a direct result of the defendant's breach[94]

The issue of third party liability poses serious difficulties for the courts. On the one hand, it is in the interest of justice that where there is a wrong, a remedy should be given and on the other it is often felt that some injustices should go unremedied because an attempt to provide a remedy would open the floodgates to litigation in unlimited capacity which is likely to do more harm than good to the society.

Most of the litigation concerns not whether the auditor has in fact been negligent but whether a duty of care is owed in the first place as if no duty is owed it cannot be beached.[95]Duty of care is a question of both law and fact on whether it exists or not.

The initial matter is whether a duty of care exists. Legal decisions vary among countries .In the USA, until 1931 as in Ultramares Corporation v. Touche, Niven & Co.[96] it was

[94] Baven J, Negligence in law 4th ed by Byrne W.J. Gibb A.D, London sweet and Maxwell, 1928,1321.
[95] Ibid
[96] Supra

held that there could be no automatic liability to third parties generally but that he could be liable if he knew that the audit was for the primary benefit to the client.

In the Ultramares case, a banker advanced loans to a company on the strength of a balance sheet signed and approved by the auditor. Later this balance sheet proved to be defective and fraudulent and as such the lender lost his money and thereafter sued the auditor for damages. The court was of the view that it was wrong to expose the auditor to a potential liability of indeterminate amount for indefinite period to an indefinite class of people. Privity of contract was used to protect the auditor against third party liability. The Ultramares doctrine therefore states that the auditor has a duty to known users only.

In England prior to 1963 actions for third party liability were always unsuccessful. In Candler v. Crane, Christmas & Co,[97] Candler sued the accountants, Crane Christmas when he lost money he had invested in a company. The court ruling was that although the accounts were negligently prepared, Candler could not recoup his losses from the accountants because he did not have a contract with them. There was therefore no duty of care owed to third parties.

However in 1963 the case of Hedley Byrne v. Heller and Partners[98] changed this perception. The House of Lords decided that the decision in Candler was wrong and although Hedley Byrne did not have a contract with bank, Heller & Partners could recoup their losses due to negligence and loss involved. However the bank did not have to pay any damages due to a general disclaimer.

[97] (1951) I Ch 407.
[98] (1964) AC 465.

Hedley Byrne is the most striking decision in the field of negligence. Where there is a special relationship between parties, and one party relies on the information and suffers a loss, then liability could exist. The reliance must be foreseeable.

In Mutual Life Citizen Assurance Co. v Evatt[99] it was held that a duty of care exists if third party relied on the advice of skilled persons. These skilled persons could include auditors.

The issue of third party liability has gone through various developments since Hedley Byrne. Scott Group Ltd v. Mcfarlane[100] involved a takeover bid and the plaintiffs relied on the unqualified report[101] by the defendants to acquire the company. It was later discovered that the bank overdraft was understated and reserves were overstated. The auditors did not deny the error or their responsibility to detect it but denied any knowledge of the bid. The court held that they should have contemplated such a bid[102] and were therefore held liable.

Jeb Fasteners Ltd v Marks Bloom & Co[103]. Jeb Fasteners acquired the entire share capital of another company and then suffered substantial loss because of inflated stock figures. They sued Marks Bloom who had audited the company's accounts on which they relied. Mr. Justice Wolfe held that the appropriate test was whether the auditors knew or reasonably should have foreseen at the time at which the accounts were audited that a person might rely on them for the purpose of deciding whether or not to take over the Company. In this case it was proved that the plaintiffs would have bought the share

[99] (1968) 1 Ch 487
[100] (1978)AC 728
[101] A report stating that the accounts show a true and fair view of the affairs of the company.
[102] C.F Tomax V.Dickson, Mcfarlane and Robinson (1983) also based its decision on forseeability.
[103] (1981) 3 ALL ER 289

capital whatever the accounts had said. Whether duty of care existed was irrelevant to the decision.

In Lloyd Cheyham v. Littlejohn de Paula[104], it was held that a thorough audit[105] was a good defense against claims of negligence. A change can be found in Al Saudi Banque & others v. Clark Pixley.[106] In this case ten banks lent money to Gallic Credit Ltd. Seven were creditors at year end and the three continued lending. They relied on auditors' report to continue the lending. The company was wound up and the creditors sued the auditors. It was held that no duty of care was owed to the three banks due to lack of proximity and no duty to the seven either because the auditors did not report to them, nor did the banks appoint the auditors, hence to duty to report to them.

In recent holdings and the courts are moving away from the numerous people who are owed a duty of care by the auditors. A landmark case demonstrating this is the House of Lords holding in Caparo Industries PLC v. Dickman and Touche Ross & Co[107]. In this case, Caparo Industries purchased Fidelity PLC's shares whose accounts had been audited by Touche Ross. Caparo alleged that the accounts had overstated the profits of Fidelity PLC and that its purchase of shares and takeover bid were all made on reliance on the audited accounts.

The House of Lords concluded that the auditors of a public company's accounts owed no duty of care to members of the public at large who relied upon the accounts in deciding to buy shares in the company. And as a purchaser of further shares, while

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[104] Supra note 86
[105] Supra note 87
[106] (1989) 2W.L.R. 344
[107] (1990) All E.R. 568.

relying upon the auditors' report a shareholder stood in the same position as any other member of the investing public to whom the auditors owe no duty.

This holding was justified with regard to the lack of proximity between auditor and potential investor and the fact that it would not be just and reasonable to impose a duty on the auditor to such investors.

In the above case the House of Lords identified the auditors' functions as being to protect the company itself from errors and wrongdoing and to provide shareholders with information such that they can scrutinize the conduct of the company's affairs and reward or remove those responsible *ie* directors.

The Caparo decision has considerably narrowed the auditors' potential liability to third parties. This decision may have brought a sigh of relief from the auditing profession but it needs a closer look. There are likely to be far reaching implications for such restricted view of the usefulness of the audited accounts. Is such a restricted view of the usefulness of audited accounts in the profession's long term interests?

It seems from Caparo that the purpose of an audit is simply to fulfil the requirements of the Companies Act[108]. It is true that there are various user groups who make use of audited accounts. They could include creditors, potential investors, the government, suppliers, lenders *etc.* These people place heavy reliance on audited accounts and limiting the liability of the auditor to the current shareholder[109] only could have disastrous results to the business conduct and the relevance of audited accounts. It

[108] Cap 486 Laws of Kenya, Section 159.
[109] Even a present shareholder intending to purchase further shares would not be protected according to Caparo.

would be a fallacy to assume that the auditing and filing of company accounts with the registrar[110] is the sole reason for performing an audit.

Several decisions coming after Caparo are in the same line of thought. In Esanda Finance Corporation v. Peat Marwick Hungerfords[111] a decision was made upholding Caparo and the court stated that the holding in Columbia tea and coffee property Ltd v. Churchill[112] which had extended the liability of the auditor beyond the Columbia shareholders was wrong.

This trend by the courts goes against the rules of negligence. If duty of care has been established and there is proof that this duty of care has been breached and as a result of this breach, damage has resulted, then liability should be imposed. However caparo seems to have taken different view. Negligence is negligence regardless of the profession involved why then give special treatment to auditor?

It is my view that the court should act as a regulator. Where there is likely to be a crisis the courts should step in and regulate the situation. With past legal decisions the audit profession has almost faced extinction due to large settlements and numerous litigation. The larger audit firms have continuously threatened to stop offering audit work altogether or do auditing on selective basis for those industries considered less risky to litigation.

Such a result is not a desirable one to the investor confidence and the economy at large. The courts had to step in to curb such a result.

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[110] Ibid.

The Caparo judgement also does not uphold our own statutory provisions. It limits liability only to the current shareholder. Our statutes as already discussed have tended to expand this liability to third parties. The Capital Markets Authority Act for example expands to investors who the Caparo judgement does not cover.

It goes further to spell out the functions of the auditors and these are only to the shareholder and not any regulatory bodies or third parties. The provisions of the Banking Act are therefore not covered and if caparo sets precedent, then they are in need of review

The question of who is owed a duty of care still remains one for the courts to grapple with and so is the quantum of damages. Our statutes do not in any way deal with these issues and it seem of paramount importance for them to be addressed.

In the USA, the practice varies among states. The Ultramares principle is followed in many states, but in others a wider definition has been given. In a New Jersey case, H.Rosenblum Inc v Alder[113] it was held that auditors could be liable for ordinary professional negligence to any foreseeable party relying on it. This is known as The New Jersey Rule, and many states also apply it.

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[111] (1994) All ER 876
[112] (1992)AC 456
[113] Supra note 94 page 123

CHAPTER 3

3.0 RECOMMENDATIONS AND CONCLUSIONS.

3.1 SUGGESTED SOLUTIONS FOR THE AUDITORS.

Many large auditing firms in other countries in the west have adopted many measures to limit their liability to third parties mentioned below. Kenyan auditors need not reinvent the wheel. They can simply take a cue from the international effort and apply some of the remedies already formulated.

3.1.1 Insurance

Many of the claims against the 'Big 5' firms of auditors do not come to court because of costs and possible bad publicity resulting to audit firms. Settlement have been made for a reduced sum of damages with most of the money coming from the persons who insured the audit firms against damages arising out of liability to negligence claims[114]. In the beginning this was regarded as the solution as a part of the gross income of the auditing firms was paid to insurers as professional indemnity insurance.

However with the increasing trend of claims for larger and larger amounts, the insurers do not cover the claims and the premiums payable have become very expensive[115]. Insurance firms can make a choice of those businesses they want to cover and those they canno[1] ACCA study text: Audit and Assurance Services, London BPP

[114] ACCA study text: Audit and Assurance Services, London BPP publishing Ltd 2002
[115] Ibid.

publishing Ltd 2002t. Audit businesses have become a no go zone for many insurance companies due to the large settlements awarded by the courts.

Mr. John Njiraini equates this profession to the matatu industry in Kenya where insurers have rejected covering matatus or doing so at very high premiums[116].

Another angle is that the auditor may require that the directors of the company purchase for the auditor professional liability insurance covering the auditors engagement. Although this approach has not been tested, it would appear that the policy should be assigned absolutely to the auditors prior to the audit[117].

3.1.2 **Indemnification.**

The companies Act expressly prohibit any attempts by the auditor to cap or limit the extent of his liability.

> "... Any provision whether in the articles of a company or in any contract with the company or otherwise for exempting ... an auditor from or indemnifying him against any liability... Shall be void"[118].

The Act provides circumstances in which the auditor may get indemnification. The company may indemnify an auditor against the liability incurred in defending such a claim if judgement is in his favour or in which he is

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[116]CEO of ICPAK in his speech given at a seminar on 'Ethical Accounting' at Strathmore College 23rd March 2002.
[117] Gordon Oldham. Partner in Oldham, Li & Nie (Hong Kong Audit firm) on Auditors Liability.
[118] Cap 486, section 206

acquitted[119] or in connection with any application under section 402[120] in which relief is granted by the court[121].

Therefore, unless company law review is taken an auditor can only request an agreement from the company which provides for indemnity action of costs and damages in the following circumstances.

- The claim arises out of an audit but is made by a third party for damages not in relation to the company[122].
- The claim relates to the company but judgement is in favour of the auditor.
- The claim relates to the company but the auditor obtains relief for all or a portion of the claim under section 402.

3.1.3 Incorporation.

The first development was the decision by KPMG to incorporate its UK audit practice. The incorporation is allowed under companies legislation in the UK and KPMG was the first to go ahead with the idea[123].

However, under the Kenyan Companies Act, incorporation is technically disallowed. The Companies Act lists those people not permitted to carry out an audit of a company as a director or a partner of the company, employee of the

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[119] Section 206 (ii)
[120] This section provides the instances in which the auditor can be indemfied by the company. This include costs or his suit if he wins the case against him and any settlements he had paid thereto.
[121] The Hong Kong companies ordinance has similar provisions in sections 165© and 358 respectively. The UK companies Act (1985) section 310 provides the same.
[122] Supra note 114.
[123] ACCA study text: 'The Audit Framework' London, BPP publishing Ltd 1998.

company and a body corporate[124]. This is because corporate bodies have limited liability status and if allowed to be auditors this will expose the client to limited liability defense occasioning him losses. Also auditors are expected to give their personal opinion as stated in the Companies Act, which a company cannot[125]. This is therefore an area that needs reform to enable audit firms to operate as limited liability companies and benefit from the advantages of limited liability companies. All audit practices in Kenya must operate as partnerships.

Close to limited liability companies is the creation of limited liability partnerships. The possibility of setting up limited liability partnerships in the UK has been discussed and draft proposals were made as early as 1996 and only awaiting UK parliamentary and Privy Council approval. As at 1999, the law was applying in Jersey[126].

This law would then protect individual partners' personal assets from large damages awards against their firm. Only the partnership assets and those of partners directly involved in the legal action would be vulnerable.

In America, it is possible to set up some kind of limited liability partnerships in the states of Delaware and New Jersey[127]

Kenya needs to amend the Companies Act section 161(2) to allow for incorporation to give the auditor some kind of protection through limited liability status.

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[124] Section 161 (2)
[125] Manas'sen N. Paul: A Textbook of principles of Auditing ,Nairobi McMore Accounting Books 1990
[126] Supra note 119 page 395.
[127] The Economist special report on company Accounts May 2002.

3.1.4 Disclaimers.

An auditors' duty of care to third parties may arise when an auditor does not know that his work will be relied upon by a third party, but only knows that it is work of a kind which is liable in the ordinary course of events to be relied upon by a third party[128]. An auditor may also be informed that a third party will rely upon the results of the audit. For example, an auditor would be instructed to prepare a report to be relied upon by a potential purchaser or potential creditor to the business. In this case it would be prudent to assume that he will held to owe a duty of care to the third party.

One way the auditor may seek to limit liability to third parties is to limit access to his work or reports.

The House of Lords in Caparo Industries PLC v. Dickman and Touche Ross & Co.[129] admitted the possibility of a disclaimer in the audit report itself.

This could be something like;

> 'While every care has been taken in the preparation of this document, it may contain error for which we cannot be held responsible[130].

The auditor could also include a clause in his report recording that the report as statement is confidential and has been prepared solely for the private use

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[128]The forseeability principle was upheld in Scott Group Ltd V. Mcfarlane (1978) AC 728 and C.F Twomax v. Dickson Mcfarlane and Robinson (1983).
[129] (1990) All ER 568
[130] Supra note 119.

of the client and should only be disclosed to third parties with the auditors consent. Any disclosures without this consent will not amount to liability by the auditor due to prior warning, for example;

> 'The report is submitted for the private use of x (client) only and may not be disclosed to any third party without the prior written authorisation of Y(auditors). No third part is entitled to rely on this report for any purpose whatsoever. Y auditors specifically declines responsibility for the use of this report by any other person other than x or for any purpose other than for which it was submitted.'[131]

There can be no assurance that such a clause would serve its purpose but it is likely to mitigate the auditor's case and therefore would not hurt to include it.

3.2 LEGISLATIVE REFORMS.

3.2.1 Financial Cap on Liability.

In the Kenyan legislation[132], the liability of the auditor is unlimited and any

attempts to limit his liability via agreement is statutorily void.

In many countries the amount of this liability is statutorily restricted to a fixed monetary amount. In Germany for example that amount has been fixed at DM 500,000 for many years. There are now proposals to increase the limit to DM 8 million for listed companies and DM 4 million for unlisted companies; and this pressure for change comes from the accounting profession in Germany who

[131] Supra note 114 page 396.
[132] Companies Act Section 206.

believe that it is necessary in order to improve the image and standing of the profession[133].

France and Japan have similar provision in their statutes and auditors' third party liability is governed by statute.

This situation is rare in countries that have common law traditions which deal with auditor's negligence through case law. (Such include UK, USA, Australia, and Hong Kong, Kenya etc).

ICPAK and stakeholders in the profession need to lobby for financial cap on liability, an amount which should be reviewed constantly as need be. This could be a provision in the Companies Act for example providing the top ceiling for the amount of damages the court can award where negligence has been proved. Lawyers for example have an amount to be paid by those found guilty of malpractice set at a particular amount[134] and such could be extended to the auditors.

3.2.2 Incorporation.

The Companies Act outlaws incorporation of audit firms. As stated in section 3.1.3 of this text, advantages of incorporation should be allowed to accrue to auditors too.

Limited liability partnerships are also a welcome inclusion in our statute books, as they will enable the auditors to limit their liabilities in a substantial way.

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[133] Supra note 111 page 27.
134 The Advocates' Act section 57.

3.2.1 True and fair view

The phrase 'true and fair view' has been discussed before in this text and this statement needs to be reformed. This term has been included in the company legislation, that is, the law requires that the report should state that the financial statements give a true and fair view of things[135].

The International Accounting standards committee does mention true and fair view but not in very helpful terms. Even in legislation definition of true and fair view is not included.

The phrase tends to bind the auditors to making their opinion definitive opening doors to litigation from all parties. It is also on this basis of lack of understanding of the role of auditors that lead to overzealous litigation against the auditor by third parties.

Because of the fallacy of the concept and the risk of costly claims, some regimes have abandoned it or substantially watered it down. Americans have adopted one that is safer legally and non-committal[136].

> "In our opinion, the financial statements referred to above present fairly in all material respects, the financial position of company x as of (at) December 31st 20xx and results of its operations and its cash flows for the year ended in conformity with generally accepted accounting principles".

[135] The Companies Act section 162 read together with the 7th schedule.
[136] The Accountant, Journal of the Institute of certified Public Accountants, July September 1998 pg 21.

The term 'true' which is absolute is eliminated and instead the term fairly' is used and this term being subjective and change the way accounts users view them.

The amendment of the seventh schedule of the companies Act is also necessary and ICPAK should push for this.

3.2.2 Whistle blowing duties

These duties are imposed on the audit by the Banking Act (Cap 488) and the implications of this requirement have already been discussed in chapter 2. This should be eliminated from legislation and let the auditor report to the shareholder who appointed him. It is detrimental to the auditor to require him to report to other parties whom he has no contractual relationship with at the risk of being fired. The CBK does not appoint, neither does it remunerate the auditor and it should therefore come up with its own mechanisms of ensuring compliance within the industry without sacrificing the auditor

3.2.3 Others

- **Joint or several liability**

This principle needs modification. In many countries, Kenya included, auditors are jointly and severally liable with directors where negligence claims are made either under legislation or under case law[137]

Generally, concurrent wrong doers causing the same damage will be held to jointly liability whereas concurrent wrong doers causing separate damage will be held only severally.[138]

Over the years, directors and auditors have been responsible together for the issue of negligently prepared and audited financial statements. The result is that, if for example the auditors are 10% at fault and directors 90% to blame (because the directors concealed audit evidence, and auditors failed to detect it). The auditor may bear all the costs if the directors have no resources to pay (in other words, they are judgement proof). This principle has the objective of protecting the plaintiff and maximising his chances of recovery. It is reported that the former directors of Enron have no assets in their names[139] and any plaintiff will have to recover from the auditors because they are insured.

This principle should be modified whereby, if directors facilitate fraud over time and the auditors later fail to uncover it, it can be argued that the damages are separate and the liability should be several but not joint. The

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[137]Supra note 110 page 33.
[138] Baven J. Negligence in Law 4th ed. By Byrne W.J. Gibb A.D.n London Sweet and Maxwell 192833
139The Economist, 26 Jan 2002 Vol. 326

difference is that the auditors who may be 10% responsible are not responsible for the balance. This was the result in a recent decision in Daniels & Others V. AWA Ltd.,[140]

- **Indemnification.**

Legislation at the moment forbids the auditor from limiting his liability via agreement or contract with the company. This provision however needs to be modified to allow the auditor to share the liability falling on his shoulders with the company who contribute largely to this negligence. Good governance is purely a matter for the management and directors of the company and where this has failed, the management should bear the costs to the shareholders and those who rely on the company's financial statements.

- **'Officer of the company' status.**

This status should be eliminated. It is provided in section 159 (I) and because of this courts have ruled that the auditor should be punished as such. The status of officer of the company puts an extra responsibility on the auditor beyond those in his contract.

3.3 REFORMS FOR AUDITING REGULATORY SYSTEM.

[140] A decision of the New South Wales full court reported by A. Lymer at http://www.AMLymer.ac.uk.

With the ever-increasing trend of claims for larger and larger amounts, the original reaction of the auditing profession to the problem was to improve quality and deal with the problem of independence. This was felt to be a solution in the sense that no negligence therefore arises in the first place.

3.3.1 The independence of the Auditor.

It has been suggested that auditor independence has been eroded beyond repair in many cases and various proposals have been put in place to ensure independence.[141] These are not statutory requirements but merely codes of ethics required of the auditor.

- **Rotation of auditor appointments**

It has been argued that the long term nature of company audit engagements tend to create a loss of auditor independence, due to increasing familiarity with the company's management, staff and this is likely to be against shareholders interests. There have been suggestions that there should be a rotation of the audit appointment every few years.

However, this may not be very popular in practice because of disadvantages of upsetting the client company with continual changes, the high costs of recurring first audit.

[141] Supra note 119 page 45.

- **Appointment by an independent body (Agency).**

It has been suggested that appointment by shareholders implies a certain lack of independence because it ignores the interests of other users of financial accounts and also because, the shareholders merely endorse prior recommendations by the management. It has been argued that auditors should be appointed by an independent body because they will have security of employment and leave them free to give a totally objective opinion on the financial statements. This would reduce cases of negligence and hence less claims.

This suggestion would however be difficult to administer and might be a step towards nationalising the accounting profession and it is well known that nationalisation of any profession has numerous disadvantages.

- **Peer reviews.**

Some suggestions have been made for a system of auditing the auditors' and there have been such reviews being carried out on a mandatory basis in the USA[142]. The idea would be establishing a panel of experts to review and report on the practices and procedures of firms of auditors or another independent firm of auditors' carrying out the review[143]

Kenya has the same suggestion and ICPAK plans to introduce quality reviews by January 2003 but the Institute itself will carry out the reviews[144].

- **Divestiture**

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[142]Beth Belton, Business week (May 2002) '21st Century Accounting Rules'
[143] ibid.

Even causal readers of business news know that changes are coming in accounting practices in the wake of Enron. Among the reform proposals is a requirement that accounting firms divest their consulting operations[145]. Following the fall of Enron, the United States Securities and Exchange Commission passed a recommendation that auditors should only provide audit work and not any other non-audit related services[146]. However, the industry lobbied strongly against this decision and although not yet passed as law, it is a requirement that audit firms operate separately where non-audit work is given.

In Kenya several firms have followed suit and KPMG peat Marwick is presently, KPMG Kenya and KPMG consultancy. Deloitte & Touche intends to form two separate companies by May 2002[147].

This could solve the problem of independence. It is assumed that there are "Chinese walls" operating between the two companies

- **Audit Committees**

This was an American innovation and the Security and Exchange Commission[148] has made it compulsory for all listed companies. The audit committee consists entirely of non-executive directors, majority of whom are independent of the company. They should have absolute authority to investigate any matters within their terms of reference.

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[145] Business Week; 'The Reluctant Reformer' on 25th March 2002.
[146]The economist; profession under a cloud' 26th January 2002.
[147] Mr. Kiarie, head of constancy division at Deloitte & Touche at a seminar on Ethical Accounting 23rd mar 2002.

148 This is the main regulatory body of the acting profession in the United States of America.

This proposal arises mainly from the difficulty auditors have in instances where the executive directors of a company are determined to mislead them by perpetrating trade. The audit committee drawn from non-executive directors of the client company would provide liaison between the Board and the auditors.

This is likely to increase confidence and credibility of financial reports and the committee provides an impartial body for the auditors to consult. Although it may be difficulty in selecting non-executive directors with necessary competence, it improves the quality of reports by the auditor.

In UK, audit committees have been made compulsory under Stock Exchange Rules.[149]

3.2.1 Review Board

A good number of reforms in the international scene can be emulated in Kenya. However, Kenya must undertake its own measures given its legislative peculiarities and the uniqueness in sources of danger presented by its legal regime. The Accountants' Act[150] has established various statutory bodies to deal with the regulation of the accounting profession. The Institute of Certified Public Accountants of Kenya and the Disciplinary Committee are the bodies established here. Nowhere, in the Act is there an establishment of a Review Board as a statutory body.

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[149] The Accountant; Journal for ICPAK, May 2000 Edition.
[150] Cap 531 Laws of Kenya

The function of this body would be to influence new company legislation and to formulate National Accounting and Auditing Policy. Changes in the auditing profession are always occurring and although they may be welcome, they are not always universally applicable to every economic and legal situation. Kenyan auditing profession is in need of such a body.

IFAC, in its code of ethics provides that its provisions are of general application and each country needs to review them to suit its own cultural, economic, social and political differences.[151]

3.3.3 Audit Teams

The Banking Act puts some extra duties on the auditor, which widen his scope of liability. These are the whistle blowing duties in section 24 and the penalties threatened by the Central Bank of Kenya.

The Central Bank of Kenya has given notice to prosecute and blacklisting any auditor who does not report to them where certain matters have been discovered. Also any auditor intending to do audits for financial institutions should have the approval of the Central Bank of Kenya. The CBK having these stringent measures should find away to reward such auditors who blow the whistle or protect them from losing future business.

One of the suggestions for this is that the CBK could probably have its own audit team like the office of the Auditor-General. This will eliminate the conflict of interest the auditor has to face between the management's interests and

[151] IFAC's Code of Ethics in its introductory notes.

the CBK's interest. This option has to be weighed against the extra costs of having two audits one reporting to the shareholders and the other carrying out investigatory work and reporting to CBK.

An Auditing Board within the banking industry could be another view to be considered. This board's duties could be overseeing the appointment of auditors for financial institutions. The current situation where the shareholder hires while the CBK could fire is absurd. The Central Bank of Kenya does not even remunerate the auditor. It is argued that the banking industry is specialised and sensitive and therefor needs extra attention. This extra attention could only be given by the CBK taking over the appointment, remuneration and firing of auditors for financial institutions. This option has to be weighed against the disadvantages of institutionalisation, lack of freedom of the auditing profession to govern itself and likelihood of corruption during appointment.

3.3.4 <u>Expectations gap.</u>

Another problem leading to overzealous litigation against the auditors is the lack of understanding of the true role of the auditor and especially as regards fraud and error. This is a call on ICPAK to educate the shareholders on what to expect from an auditors report. This could be presentation before shareholders meetings or broadcasts or whatever it takes to educate the masses.

3.4 ACCOUNTING STANDARDS REFORM.

3.4.1 Precision

Until the 1960's standards were simple and based on broad principles. Audit firms however started demanding detailed, prescriptive standards when they were rejoined in class action suits against companies whose share prices had stumbled. In the US accounting standards have been criticised as being too detailed while at the same time containing several loopholes. In the US, the Financial Accounts Standards Board (FASB) is a private sector body staffed by accountants while in most European countries the government predominantly sets accounting standards[152]

Standard setters often face pressure from big businesses especially when seeking to introduce standards that will radically change the firms reported figures. This is usually done in collusion with the 'Big five' (now four) audit firms[153]

In a case such as this, should the auditors be sued if a company decides to exploit these loopholes to the detriment of shareholders?

Stakeholders in the industry are now calling for precise and simple accounting standards that will force companies to reveal far more economic reality in their accounts than they do at present.

> 'When the professional and legal standards applying to directors and auditors are certain, both parties will comply with such standards. When these standards are sufficiently imprecise compliance by either party is no longer guaranteed....'[154].

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[152]Joseph Berardino, former head of Arthur Andersen LLP in the Economist; 'many Accounts: Need for repair' May 4th 2002
153 Ibid.

[154] Precision in Auditing standards: Effects on Auditor and Director Liability paper presented at the 19th Annual Congress of the European Accounting Association, Bergen, Norway.

3.4.2 Beyond the numbers

Our society today has become obsessed by profits. A company that reports Kenya shillings 100 million as profits is perceived by any investor as a better investment prospect than that reporting Kenya shillings 10 million. Aren't there other ways of valuing a company?

The only statements heard at General Meeting are Net-operating profits, Return on Investment (R1) Asset returns; Earnings per share (EPS) etc. Although all these are important, they do not reveal the economic reality of the accounts.

Non-financial Performance Indicators (NPIs) are becoming important especially in a modern business environment. These for example could include a report on product quality, customer satisfaction, employee development, corporate responsibility etc. These should be combined with financial information to give a balance scorecard[155]

This is particularly important because financial reports are subject to manipulation as the accounting standards will allow different treatment of various entries and a company will most likely choose that which favour its financial position.

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155 ACCA study text; Performance Management BPP publishing Ltd Feb. 2001

For example a parent company operating in Kenya with subsidiaries in Uganda is allowed to apportion its management costs to the Ugandan subsidiary without breaking any accounting rules. This can be done for example to avoid the high taxation of corporate profits in Uganda or to show a higher profit for the parent company. Many international companies have always done this against their subsidiaries.

Such a companies reporting high profits cannot be said to be a better company to invest in on merits of efficiency and effectiveness or quality of products.

Another example is off-balance sheet financing. This is simply where a company acquires financing through special entities that do not have to be reported on the face of the balance sheet. Therefore anyone looking at the balance sheet to make an investment decision is likely to be misled about the real indebtness of the company. Many of the debts of the company are only included on the face or the balance sheet as an option. This practice is perfectly legal under US law but what it does is to disguise the company's real indebtedness. While Enron was reporting hundreds of millions in profits, it had established over 3,500 entities to take its debt off the balance sheet[156]. The auditor could only report that the accounts were presented 'fairly' according to the Accounting Standards.

[156] Jaindi Kisero:'Lessons from Enron for Kenyas'The Daily Nation, Wednesday March 27th 2002.

Take a company that is dumping toxic wastes into the river instead of recycling or treating. Recycling is a cost to the company and therefore it is likely to report a higher profit than another company that recycles but not because it is more competitive or efficient.

There is a need for a better and more informative way of reporting by auditors. Profits alone mislead the investors and lead to numerous litigation where the investor was not given a true picture of statements.

> "...Intangible assets like innovation, employee education, customer loyalty, research and development, corporate responsibility that generate much of stock market value ... are barely measured by the accounting system."[157]

There is a need to look beyond the numbers.

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[157] Robert Litan, Peter Wallison: 'The GAAP Gap :Corporate Disclosure in the internet age'

CONCLUSION

It is obvious from the foregoing that the law relating to this profession is in dire need of review. Trends in case law has over the years widened the scope of liability of the auditors and the quantum of damages has continued to expand. It is perhaps with this in mind that the Caparo decision was taken. The statutory provisions also need to take the same route in order to save a profession from extinction. Although this country has not witnessed large claims of damages, trends in the western countries need to be watched and any lessons taken. The case against KPMG is a debut and its decision should lay down proper foundation for the audit profession.

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