

IN THE HIGH COURT OF THE REPUBLIC OF SINGAPORE

[1992] SGHC 171

Suit 4935/1986

Between

Ikumene Singapore Pte Ltd
Another

... Plaintiff

And

Leong Chee Leng

... Defendant

And

Foo Huat Kim
Another

... Third Party

GROUND OF DECISION

Companies — Auditors; Professions — Accountants; Tort — Negligence —
Duty of care

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**Ikumene Singapore Pte Ltd and Another v Leong Chee Leng
(Foo Huat Kim and Another, Third Parties)**

[1992] SGHC 171

Suit 4935/1986
Goh Joon Seng J
22 June 1992

1 Cur Adv Vult

2 The second plaintiff was formerly the managing director of some subsidiaries within the Inchcape group of companies in Singapore. He retired and returned to the United Kingdom in 1973. Whilst in retirement, he was requested by three persons, one of whom was James Kwok Hoi Thin (`James Kwok`), the second third party, to join them in setting up a company to trade in medical and surgical equipment. James Kwok was the second plaintiff's former subordinate in the Inchcape Group. He enjoyed the confidence and trust of the second plaintiff. Thus, Ikumene Singapore Pte Ltd (`Ikumene`), the first plaintiffs, was incorporated on 29 December 1978 with the second plaintiff holding 47,000 (ie 94%) of the 50,000 issued shares of \$1 each.

3 The second plaintiff thus provided the working capital through his holding of 47,000 fully-paid shares. He also executed a guarantee in favour of Far Eastern Bank Ltd (`the bank`) relating to the overdraft and other facilities extended to Ikumene. By way of security for the facilities granted by the bank

to Ikumene, he executed a memorandum of charge in favour of the bank on his fixed deposit of \$200,000 with the bank.

4 On 19 October 1981 the defendant was appointed auditor of Ikumene. Presumably the defendant had started auditing before her appointment because the audited accounts of Ikumene for the year ended 31 December 1979 contained the auditor's report of 20 October 1981.

5 On 12 February 1982 the audited accounts for the year ended 31 December 1980 were completed with the auditor's report of 12 February 1982. On 30 October 1982 the audited accounts for the year ended 31 December 1981 were completed. Accompanying the said accounts was the auditor's report of 4 November 1982.

6 In respect of these three sets of audited accounts, the auditor's reports stated that the accounts were properly drawn up in accordance with the provisions of the Companies Act (Cap 185, 1970 Ed) (‘the Act’) so as to give a true and fair view of the state of affairs of Ikumene for the respective years and that the accounting and other records had been properly kept in accordance with the Act.

7 The 1979 audited accounts showed a loss of \$10,371. This was adjusted in the 1980 accounts upward to \$25,850. The 1980 audited accounts showed a loss of \$28,788, resulting in an accumulated loss of \$54,638. However, the 1981 audited accounts showed a profit of \$20,332, thereby reducing the accumulated losses to \$34,306. Following the favourable results shown in the 1981 accounts, James Kwok, who was appointed the managing director shortly after the incorporation of Ikumene, was congratulated by the second plaintiff at a board

meeting on 30 December 1982 on the results and the turn-around to profitability of Ikumene.

8 On 18 August 1983 Ikumene received a letter from the bank with a copy to the second plaintiff demanding payment of \$193,623.98 within 14 days, failing which the same would be set off against the second plaintiff's fixed deposit with the bank.

9 On 8 February 1984 a further letter of demand was sent by the bank to the second plaintiff for payment under his guarantee of the sum of \$198,215.12, being the amount due from Ikumene with interest to date of payment.

10 On 5 March 1984 the bank exercised its rights as pledgee of the moneys under the second plaintiff's fixed deposit which then stood at \$250,801.68 inclusive of accrued interest. Of this sum, \$201,338.61 was set off by the bank against the amount due from Ikumene.

11 In the meantime, on receipt of the bank's letter of 18 August 1983 referred to above, the second plaintiff instructed a firm of professional accountants, Kwan Wong Tan & Hong ('Kwan Wong') to conduct full investigations into the accounts of Ikumene. On 20 March 1986 Kwan Wong gave a report on their investigative work on the accounts of Ikumene for the three years ended 31 December 1979, 1980 and 1981 audited by the defendant.

12 On the 1979 audited accounts, Kwan Wong referred to an oversight by the defendant in the accounts in not having included an item of purchase, thereby understating the loss by \$15,479, and the adjustment made by her in the 1980 audited accounts. On the adjustment, the defendant, in her notes which were to be read as an integral part of the accompanying accounts, stated:

The accounts for 1980 have been restated to correct an understatement in loss due to an oversight in not having included an item of purchase but have accounted for in closing stock. The effect of the inclusion in the 1979 accounts is to increase losses by \$15,479.

13 In the opinion of Kwan Wong, the 1979 accounts with such understatement did not show a true and fair view:

As the adjustment of \$15,479 represents 39% of sales for 1979 and 149% of the reported loss for 1979, before adjusting for this prior period item, we are of the opinion that this amount of \$15,479 is material to the 1979 accounts and accordingly the said accounts does not show a true and fair view.

14 Kwan Wong's views were supported by PW3, one John Curran, who testified as an expert on accounting matters. This is what he said in answer to questions from counsel for the plaintiffs (see notes of evidence at p 51):

Q: See 1AB48-49 on the adjustment of \$15,479?

A: I agree with Kwan Wong's view that the 1979 accounts did not show a true and fair view ... \$15,479 represents 30% of the stock value of \$50,899.

15 PW3 also found these deficiencies in Ikumene's accounting records:

(i) the purchase ledger was not properly maintained. The totals for 1979 and 1981 did not agree with purchase accounts in the general ledger and were not written up contemporaneously;

(ii) the purchase accounts in the general ledger were not written up contemporarily with large proportion by value of adjustment at year-end by auditors;

(iii) the stock cards for 1979 and 1980 had no cross-references to purchase and sale sources, no value balances for reconciliation to a stock control account in the general ledger which had no such account. There is no indication that the balance of stock shown on the cards had been checked with physical stock, some stock cards included a mix of different

stock items. There was no index reference on the stock cards that could detect loss of stock card and which could be used to indicate on a purchase or sale invoice that a stock card entry had been made. There was no clear distinction between stocks held for own account and stocks held on consignment. For 1981, no stock cards were sighted;

(iv) there was no debtors ledger, no individual account for each debtor and receipts were not always issued for payments received;

(v) the cash book showed receipts improperly analysed to sundry income instead of debtors and payments improperly analysed to purchases instead of creditors.

16 In PW3's view, proper accounting records had not been kept by Ikumene and it was not possible to say whether the accounts based on those accounting records gave a true and fair view. In answer to questions from counsel for the defendant on his report tendered as PB1-11, PW3 said (see notes of evidence at p 54):

Q: PBI "auditors could not have been in a position to know whether or not the accounts showed a true and fair view". You are not saying by this statement that the audited accounts for 1979-81 did not show a true and fair view?

A: Yes, that is correct. But it was impossible for the auditors to determine whether or not the accounts show a true and fair view.

17 At the end of the plaintiffs' case the defendant elected not to adduce evidence but chose to submit that she had no case to answer. I therefore accept the views of PW3 that no proper accounting records had been kept by Ikumene, and that based on those records and on the defendant's working papers which do not show that adequate checking or verification had been done, the defendant could not say if the accounts gave a true and fair view of the state of affairs of Ikumene (not that the accounts did not in fact give a true and fair view of the

affairs of Ikumene other than the 1979 accounts which understated the loss by \$15,479).

18 But does this give rise to a cause of action to the plaintiffs? To do so, the defendant must have owed a duty to the plaintiffs, there must have been a breach of that duty, and that breach caused the loss giving rise to the claim.

19 The defendant was appointed the auditor by Ikumene pursuant to a directors' resolution of 19 October 1981. The defendant therefore owed a duty to Ikumene arising from the appointment. Under s 207 of the Act, the auditor has to report to the members on the accounts required to be laid before the company in general meeting and on the company's accounting and other records relating to those accounts. The auditor, in his report, has to state whether the accounts, in his opinion, have been properly drawn up in accordance with the provisions of the Act so as to give a true and fair view of the company's affairs, and whether the accounting and other records required to be kept by the company have been properly kept in accordance with the provisions of the Act. The defendant, therefore, also owed the second plaintiff a duty arising under s 207 of the Act.

20 The duty of an auditor is to exercise reasonable care and control. See the classic statement by Lopes LJ in *Re Kingston Cotton Mill Co (No 2)* 1 at pp 288-289:

*But in determining whether any misfeasance or breach of duty has been committed, it is essential to consider what the duties of an auditor are. They are very fully described in **Re London and General Bank** [[1895] 2 Ch 673], to which judgment I was a party. Shortly they may be stated thus: It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution*

must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

21 Having regard to the deficiencies in the accounting records of Ikumene, it is my view that the defendant had not exercised reasonable care expected of her when without adequate checking or verification, she certified that Ikumene's accounts gave a true and fair view of the state of affairs of Ikumene and that the accounting and other records had been properly kept in accordance with the Act. But the duty is only to Ikumene and its shareholders in respect of their interest as shareholders.

22 In **Caparo Industries Plc v Dickman & Ors**,² the respondents owned shares in a public company, Fidelity PLC, whose accounts for the year ended 31 March 1984 showed profits far short of the predicted figure which resulted in a dramatic drop in the quoted share price. After receipt of the audited accounts for the year ended 31 March 1984, the respondents purchased more shares in Fidelity PLC and later made a successful take-over bid for the company. Following the take-over, the respondents brought an action against the auditors of the company, alleging that the accounts were inaccurate and misleading in that they showed a pre-tax profit of some o1.2m for the year ended 31 March 1984 when in fact there had been a loss of over o400,000, and that the auditors had been negligent in auditing the accounts which the respondents relied on to purchase further shares and made their take-over bid. The House of Lords held that an auditor owes no duty of care to an individual shareholder in the company

who wishes to buy more shares in the company. In delivering his judgment, Lord Bridge said, at pp 579-580:

The position of auditors in relation to the shareholders of a public limited liability company arising from the relevant provisions of the Companies Act 1985 is accurately summarized in the judgment of Bingham LJ in the Court of Appeal ([1989] 1 All ER 798 at p 804, [1989] QB 653 at pp 680-681):

*'The members, or shareholders, of the company are its owners. But they are too numerous, and in most cases too unskilled, to undertake the day-to-day management of that which they own. So responsibility for day-to-day management of the company is delegated to directors. The shareholders, despite their overall powers of control, are in most companies for most of the time investors and little more. But it would, of course, be unsatisfactory and open to abuse if the shareholders received no report on the financial stewardship of their investment save from those to whom the stewardship had been entrusted. So provision is made for the company in general meeting to appoint an auditor (s 384 of the Companies Act 1985), whose duty is to investigate and form an opinion on the adequacy of the company's accounting records and returns and the correspondence between the company's accounting records and returns and its accounts: s 237. The auditor has then to report to the company's members (among other things) whether in his opinion the company's accounts give a true and fair view of the company's financial position: s 236. In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client. But he is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment. Vaughan Williams J said in **Re Kingston Cotton Mill Co** [1896] 1 Ch 6 at 11: "No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them." The auditor's report must be read before the company in general meeting and must be open to inspection by any member of the company: s 241. It is attached to and forms part of the company's accounts: ss 238(3) and 239. A copy of the company's accounts, including the auditor's report, must be sent to every member: s 240. Any member of the company, even if not entitled to have a copy of the accounts sent to him, is entitled to be furnished with a copy of*

the company's last accounts on demand and without charge: s 246.

No doubt these provisions establish a relationship between the auditors and the shareholders of a company on which the shareholder is entitled to rely for the protection of his interest. But the crucial question concerns the extent of the shareholder's interest which the auditor has a duty to protect. The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholder ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders, eg by the negligent failure of the auditor to discover and expose a misappropriation of funds by a director of the company, will be recouped by a claim against the auditor in the name of the company, not by individual shareholders.

23 I find it difficult to visualize a situation arising in the real world in which the individual shareholder could claim to have sustained a loss in respect of his existing shareholding referable to the negligence of the auditor which could not be recouped by the company.

24 Both the plaintiffs are claiming damages. The second plaintiff has particularized his claim as being loss of \$201, 338.61, being part of his fixed deposit and accrued interest pledged by him to the bank to secure the facilities granted to Ikumene and guaranteed by the second plaintiff, and \$47,000, being loss of his investment in the capital of Ikumene. Thus, the second plaintiff's claim arose from his being:

(1) a guarantor under the guarantee dated 30 March 1981 in favour of the bank, and

(2) a member of Ikumene holding 47,000 shares of \$1 each at par value.

25 On the second plaintiff's claim arising as a result of his being the guarantor, on the authority of **Caparo**'s case² this head of the claim is not within the scope of duty owed by an auditor to a shareholder of the company as it is a wholly independent transaction, having no connection with the second plaintiff's shareholding in Ikumene. Lord Bridge in **Caparo**'s case² said, at p 581:

... the loss in the case of the sale would be of a loss of part of the value of the shareholder's existing holding, which, assuming a duty of care owed to individual shareholders, it might sensibly lie within the scope of the auditor's duty to protect. A loss, on the other hand, resulting from the purchase of additional shares would result from a wholly independent transaction having no connection with the existing shareholding.

26 I believe it is this last distinction which is of critical importance It is never sufficient to ask simply whether A owes B a duty of care. It is always necessary to determine the scope of the duty by reference to the kind of damage from which A must take care to save B harmless:

'The question is always whether the defendant was under a duty to avoid or prevent that damage, but the actual nature of the damage suffered is relevant to the existence and extent of the duty to avoid or prevent it.'

(See **Sunderland Shire Council v Heyman** [1985] 60 ALR 1 at 48 per Brennan J.)

27 Assuming for the purpose of the argument that the relationship between the auditor of a company and individual shareholders is of sufficient proximity to give rise to a duty of care, I do not understand how the scope of that duty can possibly extend beyond the protection of any individual shareholder from losses in the value of shares which he holds.

28 On the second plaintiff's claim for the loss of value of his investment through the 47,000 shares in Ikumene, his interest is, in the words of Lord Bridge, 'indistinguishable from the interest of the company itself and any loss suffered by him will be recouped by a claim against the auditor in the name of the company, **not by individual shareholders**' (emphasis added). Thus, this head of the claim should be recouped by a claim through Ikumene. Ikumene, in turn, has to prove that its loss was due to the defendant's breach of duty.

29 In *JEB Fasteners Ltd v Marks, Bloom & Co (a firm)*,³ the defendants, in 1975, prepared an audited set of accounts for a manufacturing company for the year ended 31 October 1974. The company's stocks which had been purchased for o11,000 was shown as being worth o23,080, which was the company's own valuation of the net realizable value of the stock. But the defendants described it as being valued at lower of cost and net realizable value. On the basis of the inflated stock figure, the accounts showed a net profit of o11.25, whereas if the stock had been included at cost with a discount for possible errors, the accounts would have shown a loss of over o13,000. The defendants were aware when they prepared the accounts that the company had liquidity problems and was seeking outside financial support from, amongst others, the plaintiffs. The plaintiffs who manufactured similar products and to whom the accounts were made available had reservations about the stock valuation. But they took over the company for a nominal amount because they would thereby obtain the services of the company's two directors who had considerable experience in the type of manufacturing carried out by the plaintiffs. The plaintiffs' take-over proved less successful than they had anticipated and they sued the defendants for negligence in the preparation of the audited accounts. The plaintiffs' claim was dismissed on the ground that even though they had relied on the accounts, they would not have acted differently

had they known the true position. Their reason for the take-over was to obtain the services of the two directors.

30 In the matter herein, the defendant, in respect of the accounts for the years 1979 to 1981, gave unqualified reports. But the plaintiffs have not shown that the losses were due to their relying on the reports. Neither have they shown that if qualified or adverse reports had been given, the losses could or would have been avoided.

31 See the second plaintiff's evidence at p 9 of the notes of evidence:

Q: See 2AB33, these were prepared by defendant for up to December 1981 showing a profit of \$20,332. See 1AB19 1 item you were happy that the company had turned around?

A: Yes.

Q: What would you have done if company for year ended 1981 did not make profit?

A: I would have caught the first plane to Singapore.

Q: These accounts were made available in November 1982 or October 1982?

A: In November 1982.

Q: What would you do if you had come out to Singapore?

A: I would go through the running and control of the business to see what was wrong.

...

Q: In relation to decisions you would make, what decision would you have made?

A: No, it is not quite possible for me to say that. The whole situation is hypothetical.

32 See the second plaintiff's evidence at pp 14-15 of the notes of evidence:

A: (To a question by the court): I myself cannot identify the period in which these losses occurred which would have been disclosed by a proper audit. But the experts may be able to do so.

Q: Do you not agree that even if these accounts were accurate, you might still have suffered loss?

A: I don't agree. A profit has been shown in the 1981 accounts and forecasts in 1982 and 1983 showed increase in business.

Q: So you cannot tell if the losses were attributable to inaccurate accounts?

A: I cannot say that. But I do say that if the accounts had shown the true position I would have taken certain courses of action earlier. The real position of the company only became apparent when I received the letter from Far Eastern Bank. This was terminal. There was nothing I could do.

Q: I put it to you that whatever actions you might have taken if you had known the accounts were inaccurate might have no bearing on the loss?

A: I do not know because I relied entirely on the accounts being accurate. I do not know what I would have done in 1979 if I had known the accounts to be inaccurate.

...

Q: You are in no better position now than what you would have been in 1982 if you had known what the actual profit figure was?

A: I agree.

33 Set out below are the extracts of the accounts for the years from 1981 to 1984:

Comparison - balance sheet & profit/loss

1981 1982 1983 1984

\$ \$ \$ \$

Current assets 168,435 347,952 177,831 152,518

Total assets 192,991 366,253 196,135 170,822

Current liabilities 177,297 377,521 311,890 314,837

Accumulated profit/(loss) (34,306) (61,268) (165,755) (194,015)

Net profit/(loss) 20,332 26,962 104,487 28,260

34 A perusal of the comparison will show that Ikumene continued to sustain losses even after the defendant ceased to be their auditor.

35 In ***Alexander & Ors v Cambridge Credit Corp Ltd & Anor***,⁴ the auditors of Cambridge Credit Corp Ltd in their annual audit certificate in 1971 failed to note that the balance sheet and other accounts did not show provisions which should have been made. Had the appropriate note been made, it was highly probably that a receiver would have been appointed. The company was put into receivership in 1974. In proceedings for damages against the auditors for breach of contract, Rogers J found that but for the breach of contract by the auditors, the company would have gone into receivership in 1971. He therefore awarded the company \$1.45m being the increase between 1971 and 1974 in the deficiency of assets required to meet liabilities. The appeal by the auditors was allowed by the Court of Appeal on the ground that there was no causal connection between the breach of contract and the damage. McHugh JA said, at p 359:

Moreover, Cambridge did not seek to prove that particular losses in respect of particular transactions were caused by the auditors' certificates. It asserted that from the moment that the trustee acted on the auditors' certificates and as a consequence, did not put Cambridge into receivership, the auditors became the insurers of Cambridge's trading fortunes. The argument went so far as to maintain that even though Cambridge may have prospered for years, the auditors, subject to the Limitation Act 1969, were liable for any ultimate loss made by the company.

36 In the proved circumstances of this case, I do not think that the issue of the certificates by the auditors constituted a cause of Cambridge's loss of \$145m. The existence of a company, as counsel for Cambridge conceded,

cannot be a cause of its trading losses or profits. Yet that is what the case for Cambridge comes to. Except in the sense that the issue of the certificates induced the trustee not to take action against Cambridge and thereby permitted Cambridge to exist as a trader, the issuing of the certificates was not one of the conditions which were jointly necessary to produce the loss of \$145m. To assert in these circumstances that the issue of the certificates was a cause of the loss in my opinion is to depart from the common sense notion of causation which the common law champions.

37 The plaintiffs have not shown that the loss was due to the defendant's breach of duty, neither have they shown that the loss could have been avoided but for the breach. In fact, even after the letter of demand of 18 August 1983 from the bank for payment of \$193,623.98, Ikumene carried on trading. It has not even been satisfactorily established that the losses claimed for were attributable to the period for which the defendant owed a duty as the auditor of Ikumene.

38 Accordingly, I dismiss the plaintiffs' claim with costs.

39 **Outcome:**

Goh Joon Seng J

Lim Chor Pee and Loy Wee Sun (Chor Pee & Co) for the plaintiffs
Ronnie Quek and Teo Lip Hua (Allen & Gledhill) for the defendant

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Michael Kuah (Lee & Lee) for the first third party
The second third party did not enter an appearance
