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Forgery in the making of audit report: the liabilities and breach of professional duties

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Abstract

Forgery is a mechanism to commit fraud and involves the modification of original documents without valid authorization. This includes the process of making an audit report by the auditors. This paper will examine the liability of the auditor if he/she fails to identify the existence of forgery and fails to exercise due diligence in the making of audit report.

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1. Introduction

Forgery can be committed in various fields. In financial sector and corporate settings, forgery can occur in the financial statement and any other document related to the company account either related to liabilities and asset of

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the company (Todd, 2003). It is an offence under Malaysia law by virtue of section 463 of the Penal Code and also can be subject to civil litigation and criminal prosecution as clearly stated;

'whoever makes any false document or part of a document with intent to cause damage or injury to the public or to any person, or to support any claim or title, or to cause any person to part with property, or to enter into any express or implied contract, or with intent to commit fraud or that fraud may be committed, commits forgery'

Section 463 and 464 of the Penal Code stated the basic definition of *mensrea* and *actusreus* of the forgery. According to Rantanlal and Dhirajlal (2007), the *mensrea* can occur in circumstances where (i) intent to cause damage or injury to the public or injury to the public or any person; (ii) intent to support any claim or title (iii) intent to cause any person to part with property; (iv) intent to cause any person to enter into a contract; intent to commit fraud (vi) the fraud may be committed. This intention must be collaborating with *actusreus* and in the forgery cases it refers to making a false document with the intention to commit fraud.

According to Mohammed (2002) there must an intention to deceive and to defraud in order to constitute forgery. Mohammed (2002) further referred to the case of *Re London and Globe Finance Corporation Limited (1903) 1 Ch 728* when the court held:

'To deceive is, I apprehend, to induced a man to believe a things true which is false, and which the person practicing the deceit knows or believes to be false. To defraud is to deprive by deceit; it is by deceit to induce a man to act to his injury. More tersely it may be put, that to deceive is by falsehood to induce a state of mind; to defraud is by deceit to induce course of action.'

An audit is a systematic document to reflect the company financial statements (Feinman, 2003). Therefore, possibility of forgery may occur in relation to company documents that to be audited exist. However, the liability own by the auditor depends on his participation of the said activities. The concept of knowledge and intention is the key to determine the liabilities (Yusuf Ibrahim Arowosaiye, 2012). If the auditors have knowledge and participate in the making of the said document either by giving an advice or by directly making a false statement, it is an offence. In the event that he had no knowledge about the false statement but failed to exercise due diligence and applied professional skill and practice, it can be considered as professional negligence, which can be subjected under law of tort and law of contract,

In respect of company law, it is an offense for the officer of the company to produce or issue a false report including the report to the auditor. This was illustrated under section 364A Company Act when it stated;

An officer of a corporation who, with intent to deceive, makes or furnishes or knowingly and willfully authorize or permits the making or furnishing of, any false and misleading statement or report to: -

(a) a director, auditor, members, debenture holder or trustee for debenture holders of the corporation.

It is a statutory requirements for the company to be audited (Rachagan, Pascoe, and Joshi, 2005). Under section 9 of the Company Act, a company must appoint the company auditors to prepare an audit report according to the financial years to examine the financial standing of the company in question. The audit report is also considered as the evidence of the financial statement of the company. Section 366 (4) Company Act stated;-

Upon the trial of a charge for any offence against this section, the opinion of any properly qualified auditors of accountant as to the financial position of any company at any time or during any period in respect of which he made an audit of an examination of the affairs of the company according to the recognized audit practice shall be admissible, either for prosecution or for the defense of evidence of the financial position of the company at the time or during that period notwithstanding that the opinion is based in whole or part on book-entries, documents or vouchers or on written or verbal statements by other persons.

As the audit report is an important piece of evidence in court, the Penal Code further define the meaning of document under section 29 as: -

'any matter expressed, described or however represented, upon any substance, material, thing, or article including any matter embodied in a disc, tape film, sound track or other device whatsoever. In respect of audit report the reading of the section 29 (a) stated it includes letters, figures, marks, symbols, signals, signs, or other forms of expression, description or representation whatsoever.'

Auditors when making an audit report are based on accounting record of the company. The interpretation of accounting report is stated under section 4 Companies Act. Accounting records means invoices, receipts, order for payment of money, bill of exchange, cheques, promissory notes, vouchers or any other documents of prime entry

and also includes such working papers and other documents as are necessary to explain the methods and calculation by which account are made up. This is a document that is relevant for audit purposes.

This paper will discuss the liabilities of the auditors in the event of the document that has been audited and is a forged documents and as a consequence affect the validity of the audit report itself together with the duty owned by the auditors.

2. Creative Accounting

The question arise is whether creative accounting is amounted to forgery. The basis of the argument is the audit report does not reflect the actual financial standing of the company in question. This can be done through creation of certain documents which are not in reality exist to formulate a positive perception over the company's financial standing.

According to Amat, Blake, and Dowds (1999) creative accounting can be defined as 'a process whereby accountants use their knowledge in accounting rules to manipulate the figures reported in a accounts of a business'. Certain ethical issues arise in this matter particularly pertaining to the validity and relevancy of the audit report. The most common ethical issues in preparing the audit report are client proposal to manipulate account, client proposal to tax evasion and conflict of interest (Amat et al., 1999). Other definition suggests that it refers to 'the use of the accounting knowledge to influence the reported figures, while remaining within the jurisdiction of accounting rules and laws and, so that instead of the actual performance or position of the company, they reflect what the management wants to tell the stake holder' (Shah, Butt and Tariq, 2011). However, this definition does not comprehensively address the meaning of within the law. To what extent does creative accounting can be accepted without violation of any law.

In *MMP GMBH v Antal International Network Ltd [2011] EWHC 1120 (comm)*, the court disapproves the concept of creative accounting by stated;

'the actual accounts for that year do not give an accurate picture of income and net profit since they contain some "creative accounting" that exclude staff costs and depreciation'

In *Vita Health Laboratories Pte Ltd and others v Pang SengMeng [2004] SGHC 158*, it is a duty of the directors to ensure that the company account is genuine and reflects the financial standing of the company. The failure of the directors of the company to comply with this rules amounted breach of fiduciary duty as a director. The judgment of this case illustrated, creative accounting amounted to fraudulent act the courts further address the issue of creative accounting as stated;

'A director, who causes accounts to be misstated, flagrantly abuses his position and breaches his corporate duties. Being in breach of his duties to the very company itself, he cannot evade his responsibility by attempting to hide behind the cloak of corporate immunity. Apart from this, he may also face issues of liability and or indemnities apropos his fellow directors, shareholders, auditors and third parties. In appropriate cases, the court will readily lift the cloak of corporate immunity. Creative accounting of a deceitful nature ought to be severely denounced as it strikes at the very heart of commercial intercourse, which depends upon the integrity of company accounts and financial statements.'

In the more serious issues, the court disapprove the corporation that practice creative account by giving aggravated damages to the claimant who suffered loss due to relying the false statement. In *Wishing Star Ltd v Jurong Town Corp [2008] 2 SLR 909* stated, the true principle is to justly compensate the claimant for all financial losses and/or damages flowing directly from the fraud is by (1) valuation (2) adding up the immediate and (3) consequential losses. The court further stated the 'creative accounting requires creative remedies'.

The concept of creative accounting was not acceptable by the court. The main reason is it can lead to deceive the prospect investors and manipulate the financial standing of the company. However, in the current competitive economics and business environment, there is a leniency of adaptation of this concept as long as it is just and fair.

3. Professional Duties

The professional duties are arisen in the case of *Bolam v Friern Hospital Management Committee (1957) 1 WLR 582*. Even though these cases are related to the clinical negligence, the fundamental aspects of professional negligence have been addressed by the court. The professional standard requires the practitioner on the profession in concern to exercise due diligences in the execution and in discharging his duties (Samanta and Samanta, 2003).

It is a requirement for the auditors to discharge the duties in accordance with the required standard approved by the common practice. In *Kua Kok Kim & Ors v Ernst & Young (Sued as a firm) [2000] 1 SLR 707*, the basis of the claim was an assertion of breach of a professional duty to exercise reasonable care and skill in valuation and assessing of shares. The court further evaluate the degree of negligence based on whether the auditor acting within the accepted principles and parameters of the common practice conducted by other auditors in the same circumstances.

In *Wong Kok Chin v Singapore Society of Accountants [1990] 1 MLJ 456*, it is agreed that the test determines the liabilities and professional duties of the auditors. The test is whether, if a reasonable person, on hearing what he had done, would had said without hesitation that as an accountant he would not done it. The court further held, the member of society (accountants) who have been found guilty for gross neglect in performance of his professional duties if, having regard to all surrounding circumstances at the time, he did not exercise his skill and care that reasonable client who have been entitled to expect from him. This case point out the duties as an auditor when stated;

'The auditor is not to be written off as a professional 'adder-upper' and subcontractor. His vital task is to take care to see that errors of computation, or errors of omission or commission, or downright untruth. In common with other professional men, the standard required of an accountant carrying out an engagement is that of reasonable skill and care of an ordinary skilled men carrying out the same engagement. Some recent authorities have generally recognized the more exciting nature of his standard in the light of modern conditions. The importance to be emphasized by considering default in the light of surrounding circumstances, having regard of the professional code of standards and guidelines and to evidence of general professional practice, in particular the court, which is determining a case, must guard against hindsight and only take into account knowledge available to the auditor at the time of the default.'

Furthermore, the contractual relationship exists between the auditors and client. In the event of default for failure to exercise their duty that being expected, the remedy of breach of contract can be granted by the court (Rachagan et al., 2005). Therefore, The auditors must comply with the professional requirements and standard as been expected from him. The negligence may occur if the auditors fail to comply with this standard in question.

Accountants and auditors require complying with certain requirements. The basic requirements were highlighted in *Ultramares Corp v. Touches 174 N.E 441 (1932)*, known as Ultramares principles. The conditions that must be fulfilled in order to satisfy the test are;

- (a) The accountants must have been aware that the financial were to be used for particular purpose or purposes;
- (b) In the furtherance of which known party or parties was intended to rely; and
- (c) There must be some conduct on the part of accountant linking them to that party or parties, which evinces the accountants understanding that party reliance

This test suggests that the elements of knowledge and reliance are important to determine the degree of liabilities. The question is whether or not the third party relied upon the statement when making a decision. If the audit report shows in increase prospect of the company but the document used in the process of making the audit report are not genuine, therefore, the liability may occur but subject to circumstances. The question of assessing the liabilities of auditors in corporate is difficult with the reason of in the reality of business; audit has been performed in client-controlled environments. This is because, the auditors must comply with various sets of rules and regulation to make a judgment and decision based on their interpretation (Dean and Clarke, 1997).

In *Caparo Industries Ptd v Dickman [1990] A.C 605*, the court ruled that in order to prove negligence, it must be proven within foresee ability, proximity and whether a duty of care is fair, just and reasonable in the circumstances. In this aspect, the auditor can be held liable breach it professional duties when making the audit report based on

forge documents. This is because of the fact that said audit document is a medium for the future or prospect investors to invest in the company in questions. If that is the case, the reliance principle as stated in the case of *Ultramares* can be applied in determine the liabilities owed.

The liabilities can be either criminal or civil action (Gottschalk, 2010; Rantanlal and Dhirajlal, 2007). If the injured party intent to claim losses due to the forgery, the claimant must institute a civil proceeding against defendants and the prosecutor can commence a criminal proceeding for those who alleged to commit forgery and can be punished under section 465 Penal Code (Rantanlal & Dhirajlal, 2007). Both proceeding can be instituted simultaneously. As far as criminal law is concerned, the prosecution must prove beyond reasonable doubt in order to establish prima facie (Sindhu, 2011).

In civil claim, the person who suffered loss due to relying on false audit report must prove the case within balance of probabilities (Ng, 2001). In *Lim Tai Ming & Son Credit Sdn.Bhd. v Lim Tuck Thien [2001] 1 MLJ 57* the court held:-

'Now, there is a great distinction between a civil and a criminal case, when a question of forgery arises. In a civil case the onus of proving the genuineness of a deed is cast upon the party who produces it, and asserts its validity. If there be conflicting evidence as to the genuineness, either by reason of alleged forgery, or otherwise, the party asserting the deed must satisfy the jury that it is genuine. The jury must weigh the conflicting evidence, consider all the probabilities of the case, not excluding the ordinary presumption of innocence, and must determine the question according to the balance of those probabilities. In a criminal case the onus of proving the forgery is cast on the prosecutor who asserts it, and unless he can satisfy the jury that the instrument is forged to the exclusion of reasonable doubt, the prisoner must be acquitted.'

Section 302 Companies Act provides a penalty for falsifying of books. This includes financial statement and any document related to the company assets and liabilities. It stated;

'Every officer or contributory of any company being wound up who destroys, mutilates, alters or falsifies any books, papers, securities, or makes or in privy to the making of any false or fraudulent entry in any register or book of account or document belonging to the company with intend to defraud or deceive any person shall be guilty of offence under this act'

The word contributory under this section refers to the outsider or third party. This includes auditor who participate in forgery activities either directly or indirectly. The person who found guilty under this section should be subject to imprisonment of five years or fine if any the court direct.

4. Conclusion

In the event of the auditors fail to exercise reliable standard of practice, they can be held liable for professional negligence. This includes the failure to identify the authenticity and genuineness of the financial documents during the currency of making the audit report. Therefore, it is an offence to make a false document in the process of making altered audit reports.

The main problem in detecting forgery is the audit process has been conducted within client premises. It is quite difficult to remain independent and able to conduct the audit process without the presence of bias. Whether or not the audit report is done professionally is not an issue but the matter of 'controlled' seemed to be materialized. There is a principle under the law that stated 'justice must seen to be done'. If this principle is applied in the audit process, it can be said that, 'it is not seen to be done independently'

In term of liability, the auditors can be held liable if he/she has knowledge over the forgery matter. It can be either criminal or civil action taken against them. The third party or stakeholder can commence a legal action either for the breach of contract, and professional duties by the reason of failure to exercise due diligence in discharging his duty within reasonable expectation.

However, in current economic competitiveness and development of business rivalry in corporate world, it is difficult to avoid this problem comprehensively. Therefore, there must be a reliable set of rules and regulation in respect of forgery issues and not limited to fraud alone. The extensive methods together with responsive measure to

reduce liability, fault and mechanism can be practiced by the auditors if they know and have knowledge about the company officers who commit forgery.

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