Gaelic Inns Pte Ltd v Patrick Lee PAC
[2007] SGHC 13

Case Number : Suit 531/2005

Decision Date : 29 January 2007

Tribunal/Court : High Court

Coram : Belinda Ang Saw Ean J

Counsel Name(s) : Philip Fong, Navin Joseph Lobo and Tan Ai Lin (Harry Elias Partnership) for the plaintiff; Cecilia Lee Hendricks and Russel Low (Kelvin Chia Partnership) for the defendant

Parties : Gaelic Inns Pte Ltd — Patrick Lee PAC

Tort – Negligence – Duty of care – Company employee perpetrating fraud on company over period of three financial years thereby causing company to suffer loss – Company's auditor failing to detect such fraud when auditing company's accounts – Whether such fraud rendered possible by neglect and want of professional skill of auditor of company – Whether auditor owing company duty of care to detect such fraud – Nature and scope of auditor's duty of care – Whether auditor breaching such duty of care – Whether company contributorily negligent for loss suffered

29 January 2007

Belinda Ang Saw Ean J:

1 In this action, the plaintiff, Gaelic Inns Pte Ltd ("GIPL"), claimed damages of close to $1 million for negligence in respect of audits carried out by the defendant, Patrick Lee PAC between 2002 and 2004. It was alleged that Denise Ang ("Denise"), the plaintiff's former group finance manager, was able to misappropriate the plaintiff's funds for her own benefit without detection and that was rendered possible by the neglect and want of professional skill of the defendant as auditor of the company.

2 On 15 December 2006, I delivered a lengthy oral judgment covering the main grounds of my decision for allowing the plaintiff's claim in the sum of $775,266.02 with interest thereon at the rate of 6% per annum from the date of the writ and costs. The defendant has appealed against my decision. I now set out in full the reasons for my decision.

The pleaded complaint and defence

3 The overall complaint by the plaintiff was that the defendant failed to detect Denise's cash misappropriations during the audit of the accounts for the financial years ending 31 December 2001 ("FY 2001"), 31 December 2002 ("FY 2002") and 31 December 2003 ("FY 2003"). As a result, Denise was able to misappropriate the plaintiff's monies without detection until the plaintiff was alerted of her misdeeds by Maggie Seah ("Seah"), the payroll and administration manager, who raised the alarm on 24 May 2004.

4 Specifically, the matters giving rise to the common law duty to exercise the care and skill of competent auditors in relation to the audit of financial statements were (at least primarily) those set out under paragraphs 3 to 6 of the Statement of Claim. The pleaded case in paragraph 7 of the Statement of Claim was that in preparing and purporting to audit the plaintiff's financial statements for the FY 2001, FY 2002 and FY 2003 respectively and in providing audit reports in respect of the FY 2001 and FY 2002, the defendant acted in breach of the duty of care which it owed to the

plaintiff. Particulars of the breach of duty included a failure to detect the cash misappropriations by Denise for the FY 2001, FY 2002 and FY 2003 respectively[note: 1]. In paragraph 7(c) of Statement of Claim, the plaintiff referred to the defendant's failure to raise any queries and/or make recommendations in respect of irregularities in the plaintiff's financial statements and accounting and other records, including but not limited to the failure to raise any queries about the inordinate time lapses between the receipt of cash and its lodgement with the bank. Paragraph 7(d) of the Statement of Claim was on the defendant's failure to raise any queries and/or make recommendations in respect of irregularities in the accounting, banking and/or cash practices thereby breaching the Singapore Standards of Auditing (SSA) including but not limited to SSA 6, 8, 21 and 25. Paragraph 7(e) of the Statement of Claim was on the defendant's failure to take care in and about auditing the plaintiff's accounts despite full knowledge that most of the plaintiff's business was transacted in cash, including but not limited to the failure to carry out physical verification of cash takings against the plaintiff's bank reconciliation statements. More generally, it was alleged that the financial statements for the FY 2001 and the FY 2002 respectively failed to show a true and fair view of the plaintiff's affairs; that contrary to the position represented in the auditor's reports, proper books of account were not kept and internal reporting systems and management controls had weakness.

5 According to the plaintiff, the misappropriations straddled three financial years beginning with the FY 2001 and continuing right through to the FY 2003 and beyond to 24 May 2004. The total amount stolen over this period of time was allegedly $1,006,115.19. Through teeming and lading, Denise was able to cover up prior cash misappropriations and to continue stealing in the manner explained in the further and better particulars filed by the plaintiff on 1 February 2006[note: 2]:

> [Denise] delayed banking cash received on the day of sales into the plaintiff's bank account and used the cash for her personal benefit. The cash used was replaced subsequently with cash received from the plaintiff's subsequent sales.

6 Separately, in or about May 2002, Denise passed false journal entries in the accounts to reduce the sales figure by $71,332.37 thereby reducing the cash that was supposed to be deposited into the plaintiff's bank account. Counsel for the plaintiff, Mr Philip Fong, confirmed that it was not the plaintiff's case that the defendant ought to have detected the unlawful journal adjustments. The complaint was the defendant's failure to detect Denise's cash misappropriations during the FY 2001 audit enabled Denise to misappropriate a further sum of $71,332.37. At the date of the writ, the plaintiff already succeeded in recouping from Denise the sum of $8,929 and an additional sum of $100,000 from its insurers. The plaintiff sought to recover from the defendant the remaining balance quantified at $968,508.56. The claim was advanced on the footing that for past losses, the plaintiff lost the chance of recovering from Denise the moneys misappropriated. In addition, if alerted of her misdeeds, further misappropriations would have been averted.

7 The defendant strenuously refuted all allegations of negligence. The defendant denied any negligence in signing the audit reports for the FY 2001 and FY 2002. The audits were carried out in accordance with the Singapore Standards on Auditing. The losses in the FY 2001, FY 2002 and FY 2003, if any, were not attributable to any negligence on the part of the defendant.

8 The defendant pointed out that the misappropriation of funds occurred from the period 29 March 2003 to 24 May 2004 and not earlier. As such, there were no losses in the FY 2001 and FY 2002. As for the FY 2003, the plaintiff terminated the defendant's services without formal representation before completion of the audit of the plaintiff's financial statements for the FY 2003. The defendant ceased to be the statutory auditor for the plaintiff on 11 October 2004. Prior to termination, the defendant was hindered in the performance of its duties and exercise of its powers

as statutory auditor. In particular, the plaintiff had effectively ignored the defendant's repeated requests for bank statements and information on the clearance dates of the sum of $672,253.94 being the amount of cash sales in the schedule to the plaintiff's bank reconciliation statement as at 31 December 2003 under the column headed "uncredited lodgements". Instead, the plaintiff instructed the defendant on 10 June 2004 to hold in abeyance the audit pending further instructions. All these matters forestalled discovery of Denise's cash misappropriations in the FY 2003. I should mention that the terminology "uncredited lodgements" related principally to cash sales items (prefixed CFS) followed by a number as distinct from "unpresented cheques" listed down under a separate column in the schedule to the plaintiff's monthly bank reconciliation statements. That much was clear. I interpose to mention that Lawrence Phong Wai Lee ("Phong"), the audit manager, in his affidavit of evidence-in-chief, referred to those CFS items as "unlodged cash deposits". As to what the terminology "uncredited lodgement" was meant to convey, it was capable of two interpretations. Some like Ian M Crowhurst ("Crowhurst"), the plaintiff's former managing director and the audit partner, Tow Juan Dean ("Tow") thought it represented cash sales deposited into the plaintiff's bank but not showed as credited as at 31 December 2003. Others like Seah and Phong, understood it to represent cash sales not yet deposited into the plaintiff's bank account as at 31 December 2003. I should mention that as the arguments developed (and I will explain later) it was not necessary for me to express a view as to which of the two interpretations was intended.

9 By way of counter argument, the defendant alleged that the plaintiff was negligent in failing to put in place internal controls to prevent or detect the cash misappropriations by Denise. The defendant contended that it was the plaintiff's responsibility to establish appropriate internal controls to, *inter alia*, ensure adherence to management policies, the safeguarding of assets including the prevention and detection of fraud and error in the company. In support of that assertion, the defendant relied on the experience and qualification of the directors and the engagement of specialist consultants to implement the plaintiff's internal control systems. Apart from that the defendant relied upon the representation letters issued by the plaintiff to the defendant whereby it was, *inter alia*, represented to the statutory auditor that there were no irregularities involving management or employee who had a significant role in the system of internal control; that the financial statements were free of material errors and omissions. Consequently, as pleaded in paragraph 16 of the Amended Defence, the loss and damage, if any, was caused solely by the plaintiff or, in the alternative, was contributed to by the plaintiff in failing to practise good corporate governance and to maintain effective management practices to prevent or detect the presence and perpetration of fraud by Denise.

10 I should mention at the outset that both parties referred to and in some instances relied upon the special reports prepared by Raffles Corporate Consultants Pte Ltd ("RCC"). Authenticity of the latter's reports was agreed between the parties but not the truth of the contents. Yet, nobody from that organisation was called as a witness. As such, I disregarded as hearsay aspects of the reports which the parties relied upon in support of the points they each made.

The law

The nature and scope of an auditor's duty

11 The plaintiff's action was an action in negligence and not an action for breach of contract. The skill of the auditor is in looking at the company's accounts and the underlying information on which they are or should be based and telling the shareholders whether the accounts give a true and fair view of the company's financial position (as per Laddie J in *BCCI v Price Waterhouse* [1999] BCC351 at [57]). As illustrated by the recent decision of *JSI Shipping (S) Pte Ltd v Messrs Teofoongwonglcloong* [2006] SGHC 223, generally, an auditor who adheres to the accounting

standards of the day to convey a true and fair view of the financial statements has a better chance of defending criticisms in the conduct of the audit as compared to an auditor who departs from them. Still, there is no assurance to speak of. At the end of the day, even though auditors in the profession may have done something differently, it is ultimately the court that has to decide whether, on the facts and circumstances of the case, a *prima facie* case of breach of duty has occurred. I can do no better than to reproduce the succinct observations of Justice Moffitt in *Pacific Acceptance Corporation Ltd v Forsyth* [1970] 92 WN (NSW) 29 at 75, which I adopt, to emphasis the point:

> When the conduct of an auditor is in question in legal proceedings it is not the province of the auditing profession itself to determine what is the legal duty of auditors or to determine what reasonable skill and care requires to be done in a particular case, although what others do or what is usually done is relevant to the question of whether there had been a breach of duty. It follows, if the auditing profession or most of them fail to adopt some step which despite their practice was reasonably required of them, such failure does not cease to be a breach of duty because all or most of them did the same.

12 It is important to note that the duty imposed on the auditor must not exceed the task undertaken. On the scope of duty, Lord Bridge in *Caparo Industries plc v Dickman* [1990] 2 AC 605 at 627 has this to say:

> 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.

In the same vein, Lord Oliver at 651 quoted from the judgment of Brennan J in *Sutherland Shire Council v Heyman* (1985) 60 ALR 1, who at 48 said:

> …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 any duty to avoid or prevent it.

13 Several years later, the same point was made by Lord Hoffman in *South Australia Asset Management Corp v York Montague* [1997] AC 191 at 211:

> Before one can consider the principle on which one should calculate the damages to which a plaintiff is entitled as compensation for loss, it is necessary to decide for what kind of loss he is entitled to compensation. A correct description of the loss for which the valuer [similarly an auditor] is liable must precede any consideration of the measure of damages. For this purpose it is better to begin at the beginning and consider the lender's cause of action … A duty of care such as the valuer [and similarly an auditor] owes does not, however, exist in the abstract. A plaintiff who sues for breach of a duty imposed by the law (whether in contract or tort or under statute) must do more than prove that the defendant has failed to comply. *He must show that the duty owed to him and that it was a duty in respect of the kind of loss which he has suffered*.
>
> [Emphasis added]

14 In the context of this case, the question before me was this: Did the auditor owe a duty of care to the company he audited to detect fraud or error? There is the category of cases (and this is one of them which may be said to fall on the side of the line in which it is well established that an auditor may be liable for losses suffered by the audited company) where an auditor negligently fails to detect fraud and was held liable for losses caused by the fraud continuing. This outcome stems from

the proposition that whilst an auditor is not expected to be a detective, the duty to audit carries with it an incidental duty to warn the appropriate level of management or the company's directors of fraud or irregularities uncovered during the course of the audit.

15 A case which is illustrative of this principle is *Sasea Finance Ltd (in liquidation) v KPMG* [2000] 1 All ER 676. The main complaint there was that the auditors had failed to timely warn the company of fraud by a senior employee. The appellate court observed at 681:

> When a firm of accountants accepts instructions to audit the accounts of a company for a fiscal year its primary obligation is within a reasonable time to exercise an appropriate level of skill and care in reporting to the company's members on the accounts of the company, stating, in their opinion, whether the accounts of the company give a true and fair view of the company's financial affairs. ... If for example, the auditors discover that a senior employee of a company has been defrauding that company on a grand scale, and is in a position to go on doing so, then it will normally be the duty of the auditors to report what has been discovered to the management of the company at once, not simply, when rendering the auditor's report, to record what has been discovered weeks or months later.

The basis of the decision was a matter of concession (rightly made) that "[i]f … auditors discover that a senior employee of a company has been defrauding the company on a grand scale, and is in a position to go on doing so, then it will normally be the duty of the auditors to report what has been discovered to the management of the company at once …". The concession in effect also answered the question on the scope of the auditor's duty (see p 682).

16 A related matter, which is of importance, is the time of the breach. A breach of the duty would have occurred at the time where, in the course of the audit, the auditors uncovered matters which reasonably require them to take further steps that would have uncovered or led them to uncovering of the fraud and they omitted to take those steps (see *Jackson & Powell* on Professional Negligence (Sweet & Maxwell, 5th Ed, 2002) at para 15-099). However, for the breach to be actionable, damage must be established.

Question of loss

17 With these principles in mind, I now turn to the dispute before me. I found it expedient to first look at the question of loss as it was an essential issue in dispute. As stated, the plaintiff's action was in negligence. It is trite law that a cause of action based on negligence does not accrue until damage is suffered. Hence, it is from that date, not the date on which the negligent act or omission occurred that the cause of action arises (see *Bell v Peter Browne & Co* [1990] 2 QB 495 at 502). It is a question of fact in each case whether actual damage has been established (as per Neill LJ in *Moore v Ferrier* [1988] 1 WLR 267 at 278 cited in *Knapp v Ecclesiastical Insurance* [1998] PNLR 172 at 177). So the critical question is when the damage happened and the burden of proof is on the plaintiff to establish that the defendant's act or omission caused the company loss.

18 Notably, the claim amount of $1,006,115.19 (before partial recovery from Denise and the plaintiff's insurers: see [6] above) represented the losses for the period 29 March 2003 to 24 May 2004, thus coinciding with the exact same period and amount for which Denise was charged and convicted under s 408 of the Penal Code (Cap.224 1985 Rev Ed). Denise pleaded guilty to taking this amount of $1,006,115.19. By s 45A of the Evidence Act (Cap 97, 1997 Rev Ed) the charge, statement of facts and conviction were all admissible in evidence in civil proceedings. Having identified the same quantum of loss sustained as falling within the same stated period as those bank deposit slips for cash sales not deposited in the plaintiff's bank account and there being, on the plaintiff's pleaded

case[note: 3], no bank deposit slips for cash sales from the FY 2001 and FY 2002 not deposited into the plaintiff's bank account in existence, the plaintiff was, in my view, hard pressed to establish a separate loss for the FY 2001 and FY 2002 respectively. A separate loss for the FY 2001 and FY 2002 was decidedly contrary to the pleadings. Besides, no tests on the accuracy of the monthly sales reports to those of the point of sales records for the FY 2001 and FY 2002 were undertaken by the plaintiff or its expert Tay Swee Sze ("Tay"). Furthermore, there was no verification that all the cash sales transactions from points of sale records for the FY 2001 were checked against total cash sale bank deposits for 2001 and, similarly, for the FY 2002. Thus, counsel for the defendant, Mrs Cecelia Hendricks, submitted that the losses were assumed by the plaintiff. It was, in my view, fanciful as it was baseless in the circumstances to assert that the sum of $1,006,115.19 were accumulated losses which arose from monies misappropriated for the period spanning over three financial years and beyond to 24 May 2004[note: 4]. Even on the plaintiff's own case founded on teeming and lading and given the fungible nature of cash, the alleged misappropriations in the FY 2001 and FY 2002 would have been made good by teeming and lading, in which case there would be no loss in the FY 2001 and FY 2002 respectively. Following from that reasoning, a loss would start manifesting itself, so to speak, when teeming and lading stopped and it would have been on 24 May 2004 during the audit for the FY 2003. This was the position adopted by the defendant's expert, Seow Teng Peng ("Seow") who opined as follows[note: 5]:

> … it's …when the music stops, then the loss actually takes place and not earlier.

But in this case, I was mindful that Denise admitted to and was convicted of misappropriations in 2003 and 2004. That put a gloss on Seow's testimony.

19 I agreed with the defendant that the plaintiff had not established that there were losses from cash misappropriations in the FY 2001 and FY 2002. Mrs Hendricks argued that if there was a loss in the FY 2001, the defendant could not be liable because the defendant took over as statutory auditor from LTC Associates after 16 November 2001 and the audit itself was carried out in February/March 2002. The audit plan was prepared by Tow on or before 21 January 2002 and the materiality summary was prepared on 31 January 2002[note: 6]. I was not persuaded by Tay's testimony that the audit should have started at a preliminary level in September/October 2001. Tay did not give any satisfactory reason why it was necessary in this case to start the 2001 audit before the financial year end. In contrast, Mrs Hendricks urged that as the defendant did not rely on a test of internal controls due to the circumstances of the plaintiff being a small enterprise, there was no need to test and observe the internal controls and systems. I was satisfied that there was nothing to suggest that this case warranted a departure from the norm, which was to start the audit after the audit period. In fact, Tay's testimony on this area was found wanting. Tay was initially of the view that planning of the audit should have taken place in September/October 2001 and that the defendant should have attended at the plaintiff's premises as early as September/October 2001 to observe and test the internal controls of the company. After it was pointed out to him that the defendant took over as auditors from the firm of LTC Associates after 16 November 2001, he promptly contended that the audit ought to have started in November/December 2001. Again, he gave no reasons for this view which was expressed obviously to repair his earlier blunder. Realising this, to ameliorate the situation, he conceded that the defendant would not be liable for any loss in 2001 if the court adjudged that it was proper for the defendant to carry out the audit for the FY 2001 after the financial year end in February/ March 2002 and not before 31 December 2001. Tay's credibility as a witness in this area of cross-examination would have been preserved had he conceded the point and saved himself some embarrassment.

20 Besides, there was the defendant's unchallenged testimony that the "unlodged cash deposits" as at 31 December 2001 were cleared in January 2002 and they were cleared not with cash sales

collected in January 2002. Seow gleaned from the plaintiff's documents that about $120,000 of the "unlodged cash deposits" of $148,112.45 as at 31 December 2001 were cleared by 8 January 2002. Notwithstanding that sales generated up to 4 January 2002 amounted to $40,000, cash deposited in the bank by 4 January 2002 amounted to $80,000. Allowing for the normal time lag in banking of cash sales, all of the $120,000 would have been attributable to the "unlodged cash deposits" as at 31 December 2001. Even on the basis of a conservative assumption that sales up to 4 January 2002 of $40,000 were banked in immediately, the remaining balance of $80,000 still substantially represents the clearance of the "unlodged cash deposits" as at 31 December 2001. By extrapolation, a similar exercise was demonstrated by Mrs Hendrick for the FY 2002.

21 As the plaintiff must first establish damage before anything else (and this had not been done), liability for the loss of chance to recover the cash misappropriated by Denise in the FY 2001 and FY 2002 before their dissipation was an unviable proposition. In any case, the claim was speculative as no evidence was adduced by the plaintiff on the matter. If the chance was no more than negligible, it would be treated as nil. This was made clear in para 15-134 of *Jackson & Powell* on *Professional Negligence*:

> If the chance of the hypothesis being fulfilled is negligible, it will be treated as nil; conversely, if it is near certainty, it will be treated as certain.

It is a convenient juncture to mention that I came to the same outcome as regard the defendant's liability for misappropriations in the FY 2003 (see [38] below).

22 I should add that the claim for $71, 322.37 was not established and hence failed. Reliance was placed upon the RCC report which was inadmissible as hearsay since no one from the organisation came to testify.

Financial Year 2003

Was there teeming and lading in 2003

23 According to Seah, she stopped getting bank deposit slips. Instead, Denise prepared and provided Seah with handwritten daily cash sales lists. The lists were supposedly of cash sales not deposited into the plaintiff's bank account at the end of each month. Seah confirmed receiving such lists around March 2003[note: 7]. The timing of the unusual change in the bank recording procedure was significant and coincided with the steady and unabated increase in the amount of "unlodged cash deposits" appearing in the monthly bank reconciliation statements. As at 31 January 2003, the "unlodged cash deposits", namely the CFS items, added up to $203,916.36. The figure progressively increased each month to $210,726.91 in February, $219,808.69 in March 2003 and $258,715.19 in April. It went up to $313,845.15 in May. It was $408,825.61 in July before crossing the half a million dollar mark at $512,302.06 in August so much so that by November the figure jumped to $643,556.59 and to $672,253.94 by December 2003. By 31 January 2004, the figure stood at $756,095.66. It was $797,064.86 in February, $877,739.25 in March, $989.203.18 in April and by 24 May 2004, the "unlodged cash deposits" had ballooned to $1,006,115.19. This was clearly the "snow balling" effect of teeming and lading that Seow talked about. I should mention that although Seah in paragraph 23 of her affidavit of evidence-in-chief said that back in March 2001, she noticed that delays in the subsequent banking in of the daily cash sales receipts were getting longer and the amounts of uncredited lodgements were getting larger, there was no discernible pattern of consistent and unabated increases. In some months reductions could be seen as well. Accordingly, I found as a fact that Denise misappropriated the plaintiff's monies in 2003 and 2004.

24 Denise's mitigation plea contained statements on how her financial troubles caught up with her by March 2003 as a result of compound interest payable on her credit card bills and bank facilities. Her indebtedness escalated to $100,000 and she started receiving letters of demand from her creditors and that was when she committed the first offence to pay part of her debts just to cover her minimum monthly payments[note: 8]. Denise's statements in her mitigation plea that she had financial troubles by March 2003 was allowed to be put in evidence solely to prove her state of mind and not to prove her debts (see *Subramaniam v PP* [1956] 1 WLR 965 at 970). Her handwritten cash sales lists to Seah around the same time, the timing of the change in the bank recording procedure and the steady and unabated increase in amount of "unlodged cash deposits" all fitted in with her state of mind (see [23] above). Notably, the 1st charge (amended) covered the period 29 March 2003 to 31 March 2003 and the sum involved was $38,690.23.

The audit of FY 2003 financial statements in 2004

25 At the material time, Phong was the audit manager of the defendant who assisted Tow to carry out the audit of the plaintiff's financial statements for the FY 2001, FY 2002 and FY 2003 and he reported to Tow. As for the FY 2003 audit, he confirmed obtaining a copy of the bank reconciliation statement as at 31 December 2003 for the purpose of commencing the audit of bank balances[note: 9]. According to the plaintiff, this was given in February 2004[note: 10]. However, Phong said he received the December bank reconciliation statement on 9 March 2004 whereupon he noticed that the amount of "unlodged cash deposits"[note: 11] (*ie* CFS items as shown in the bank reconciliation statement) stood at $672,253.94. As it was a substantial amount, he requested from Denise and Seah the dates of subsequent clearance of the "unlodged cash deposits". Whilst waiting for this information, he continued "auditing other areas of the plaintiff's financial statements[note: 12]." He had also called Seah and Denise at various times between March and May 2004 for the outstanding information. He maintained that without this information he could not complete the sample sales testing nor trace the clearance of the "unlodged cash deposits" amounting to $672,253.94. In the circumstances, the defendant could not be liable for the losses in the FY 2003 and in 2004 as the audit was incomplete and the defendant's services were unceremoniously terminated. I pause here to make the point that the sole exercise of checking the bank statements was one thing but it would not have led to detecting teeming and lading activity itself without paying attention to the time it apparently took to clear the cash from sales through the bank.

26 This leads me to the question whether or not in the circumstances of the case the contention that the audit was not complete was a defence that availed the defendant. On the evidence before me, it was not necessary to determine whether or not the FY 2003 audit was completed at the material time since (and I shall elaborate below) the outcome would be the same even though the audit was not completed.

27 At the risk of repetition, if an auditor in the course of the audit comes across apparent irregularities before he completes the audit, he has a duty to make inquiries and to take steps to look into the irregularities that concern him as an auditor. A breach of duty occurs at the time he did not take the reasonable and necessary steps that would have uncovered or led him to the uncovering of a fraud. Significantly, given the nature of the asset (*ie* cash) and what Phong knew as at 9 March 2004, there were serious inherent and audit risk implications that now seem grave.

28 In my view for the reasons stated below, the breach in this case occurred certainly at the latest by 10 March 2004. This date took into consideration Phong's testimony that he saw the December bank reconciliation statement on 9 March 2004, noticed the substantial amount of "unlodged cash deposits", asked for bank clearance dates and then waited.

29 As stated in the FY 2003 audit plan, one of the objectives of the audit was to ensure that all cash sales have been deposited in the bank. Unlike Tow, Phong clearly knew that "uncredited lodgement" as appearing in the plaintiff's bank reconciliation statement as at 31 December 2003 and schedule thereto meant cash from sales not yet banked into the plaintiff's bank account as at 31 December 2003. Hence, his use of the expression "unlodged cash deposits". It did not matter that Tow, on the other hand, thought that "uncredited lodgement" meant cash from sales deposited into the plaintiff's bank account but not yet credited due to normal timing differences. Reverting to what Phong knew, from the previous two audits he was aware that there were "unlodged cash deposits" as at 31 December. Going by the bank reconciliation statement as at 31 December 2001 and 31 December 2002 respectively, the figures he was used to seeing were $148,112.45 for the FY 2001 and $160,846.78 for the FY 2002 and there was to him nothing untoward in those figures despite delays in banking in the cash receipts. At those levels, the amount of "unlodged cash deposits" to him was not disproportionate having regard to his assessment of the monthly takings of the pub and actual delays experienced in banking in the cash receipts due to staff strength, volume of work and the amount that could be deposited in the bank each time given the then sum insured under the plaintiff's money in transit policy. These were mitigating reasons afforded by the defendant in support of the claim that there was nothing untoward happening. Mr Fong, however, did not think much of these so-called mitigating factors which he submitted were after-thoughts. Be that as it may, when confronted with a huge figure of $672,253.94, Phong was, as he admitted, put on inquiry. The bank reconciliation statement as at 31 December 2003 alerted him that a significant amount of cash was not banked into the plaintiff's bank account. His reaction to the situation was mechanical and woefully inadequate in the circumstances. He was content to wait for the bank statement as was his usual practice preferring to continue with the rest of his audit, behaving as if reconciling CFS items in the sum of $672,253.94 was normal for the company. It was not and if anything, was well outside the norm. For such a huge amount of "unlodged cash deposits", the delays in banking would have been inordinate. He was clearly put on inquiry and I did not think that he was then entitled to rest content with the assurances that Denise would provide him with the information, however implicitly he might have trusted her. He took a risk in waiting for the bank statement, clearance dates and allowing himself to wait for an inordinate amount of time for the information requested. In my judgment the duty which he undertook did not entitle him to take that risk. He should have investigated the irregularity straightaway in order to ascertain the reasons for the unusually long list of reconciling items. He should in the performance of his duty have reviewed all the 2003 monthly bank reconciliation statements from which a pattern of unabated increase in "unlodged cash deposits" would be discovered and by examining the irregularities, the fraud would have been uncovered. This omission occurred, at the earliest, on 10 March 2004. The omitted step was reasonably required of him and would have led him to the uncovering of Denise's fraud. In my judgment, Phong did not exercise a reasonable amount of care and skill expected of someone with his experience and qualification.

30 A closer look at the bank reconciliation statements since January 2003 up to December 2003 showed the following: (i) the amount of "unlodged cash deposits" was progressively increasing in terms of dollar value numbers and length of time outstanding from $203,916.36 in January to $672,253.94 in December 2003; (ii) of the reconciling CFS items outstanding at December 2003, $410,194.49 representing 61% of CFS were not banked in for more than two months or more. In addition, CFS 134/03 to 136/03 – amounting to $38,690.23 outstanding since March 2003 – remained undeposited even as at May 2004 (14 months old). This exercise could easily have been undertaken by Phong and he would have discerned the same thing as I, by simply looking at the monthly bank reconciliation statements for 2003. The circumstances disclosed would certainly have given rise to real ground for bringing the matter up to the board of directors of the company.

31 Interestingly, I noted that Tow in his written testimony stated that if the plaintiff's senior

management had reviewed the monthly bank reconciliation statements they would have detected the irregularities in the plaintiff's accounts and Denise's cash misappropriations[note: 13]. By the same token, had Phong reviewed the 2003 monthly bank reconciliation statements, he too would have noticed that there were irregularities. That is to say, he would have noticed that the total "unlodged cash deposits" increased unabatedly and substantially month after month in 2003.

32 Mr Fong referred me to the publication on *Cash Audits* by Kathreen Bagshaw, a guide for accountancy students. The author highlighted that if there is a delay between deposit and credit of more than a few days, suspicions of teeming and lading may arise. This kind of fraud is said to be common. The point taken was that Phong, an experienced audit manager, did not detect a common tell-tale sign of fraud. Elementary care would require the auditor to "enquire of management as to the reasons for the delay and corroborate any explanations" and "for each of the receipts on the bank reconciliation check the date stamped by the bank on the paying-in slip and ensure that it is on or before the end of the month in question" (see *Cash Audits* pp 27 and 29).

33 The long list of reconciling CFS items (*ie* "unlodged cash deposits") as at 31 December 2003 was unusual. As Tay opined, it would be unusual to have a long list of reconciling CFS items. At the most there should be only four reconciling CFS items in the bank reconciliation statement, *ie* four days of sales receipts as these were cash deposits with little or no bank clearing period required. The defendant was aware from previous audits that reconciling CFS items listed on the bank reconciliation statement as at 31 December 2001 took up to 11 days to clear and 21 days in the case of bank reconciliation statement as at 31 December 2002[note: 14]. However, the long list of reconciling CFS items as at 31 December 2003 suggested that it was taking a much longer time to clear. Tay further opined that not only should the defendant have enquired into the reasons for the long list of reconciling items, the defendant should have inquired into the reasons why cash sales had not been regularly banked into the bank account in accordance with the banking policy of the company. He opined that if there had been such inquiries, the irregularities underlying the bank reconciliation would have led to the uncovering of Denise's misappropriations which she had covered up by listing them as reconciling items in the bank reconciliation. Had the defendant discovered these matters, the defendant would have been obliged to report these matters to the directors of the plaintiff.

34 Once Phong was put on inquiry on 9 March 2004, he could still have carried out a cash count then coupled by a roll-back to verify the plaintiff's cash and bank balances as at 31 December 2003. In not so doing, the defendant failed to discover the irregularities underlying the December 2003 bank reconciliation statement.

35 Phong's excuse that he could not immediately form a judgment on the reasons for the long lists because bank reconciliation statements do commonly contain errors and he had to "approach the audit in a rational and logical manner" was simply untenable. Taking his excuse and reasoning to its logical conclusion, to avoid embarrassment he had simply asked for the subsequent clearance dates of the "unlodged cash deposits" to understand the significance of the long list. The concern that the figure of $672,253.94 in the bank reconciliation statement as at 31 December 2003 could be a mistake was the very thing that he was required to counter check. His excuse, even if it was true, did not justify his mechanical approach to an obvious and significant irregularity. He had merely mechanically noted the matter and neither he nor anyone else in the defendant considered its more serious implications.

36 It was next argued that without the information on the subsequent clearance dates of the "unlodged cash deposits", the defendant could not establish whether or not the plaintiff's cash sales receipt had been deposited. The defendant had no basis to inquire or investigate into the matter further and was thus not in a position to discover Denise's cash misappropriations during the 2003

audit. In essence it was said that the plaintiff had hindered the defendant from discovering the misappropriations by not providing the auditor with the information requested. I disagreed. As explained, Phong could have looked at the earlier monthly bank reconciliation statements instead of waiting indefinitely for the information. I have already explained that had Phong looked at the monthly bank reconciliation statements throughout 2003, he would have seen a pattern of continuing and unabated increase in the amount of "unlodged cash deposits". He would have seen the ballooning "unlodged cash deposits" and concluded that something serious was amiss. That would have prompted him to make further inquiries and ultimately to alert senior management. It was impossible to acquit the defendant of negligence in the audit for the FY 2003. I therefore found the defendant vicariously liable for Phong's failure to exercise reasonable care and skill. The defendant's negligence resulted in the plaintiff's senior management remaining uninformed of Denise's misappropriations. I was satisfied, on the balance of probabilities, that had the defendant discharged its duty of care, the plaintiff would have confronted Denise earlier than May 2004 and averted the financial detriment which it suffered in 2004. There was, in the circumstances, a causal connection between the breach of duty and the ultimate loss sustained by the plaintiff in 2004 for which the defendant had to bear.

37 I decided not to apportion the 2004 losses from 10 March 2004 onwards as Phong was aware from the previous audits that there would be cash sales which was not deposited in the bank as at 31 December and he ought to have informed Tow of the position so that a cash count of the "unlodged cash deposits" could be carried out on 2 January 2004. I therefore found the defendant liable for $775,266.02[note: 15] being the 2004 losses.

Contributory Negligence

38 Lew and Shaw attempted to distance themselves from any management functions as they were non-executive directors. Their commitment was perceived to be to attend board meetings and discuss and resolve the matters there presented to them. In my view, they cannot protect themselves behind the label "non-executive director". Be that as it may, more importantly, the evidence showed that Lew and Shaw were not provided with monthly bank reconciliation statements. In that sense, their position was completely different from that of Crowhurst because no information came their way to suggest that anything untoward was taking place. Crowhurst as managing director was responsible for the day to day running of the company. He confirmed receiving monthly bank reconciliation statement but never bothered to look at them. Even on his own understanding of the term "uncredited lodgement" (*ie* that the cash had been deposited into the bank account but yet to be credited) he would have realised that it was taking a long time to clear through the banking system cash deposits and should have queried Denise. He had as much admitted to not monitoring the company's banking procedures which were breached over time. The fact that he trusted Denise (and there was over reliance), did not relieve or exonerate him from exercising supervisory control and review responsibilities. He was required to monitor and ensure that the company policies and procedures in the handling of the assets of the company, specifically cash, which has inherent and control risk implications, are complied with and any deficiencies rectified. Indeed there was ample justification for being critical of the management's shortcomings. I interpose to mention that the auditor came into this audit in 2004 after the loss in 2003 had taken place. Besides, there was no evidence of there being a chance of recovery from Denise before she dissipated the monies taken in 2003. In these circumstances, the company had itself to blame for the losses from 29 March 2003 to 31 July 2003 and, hence, could not claim those losses in 2003 from the defendant.

39 The findings on 2003 in [38] are separate and independent of any finding (which I was not required to make) of contributory negligence on the part of management for losses in 2004. This was because at the critical time, there were major management changes taking place in early 2004. The day to day running of the company was no longer the responsibility of Crowhurst. By way of

explanation, in January 2004 Crowhurst decided to step down as managing director to become a non-executive director and his responsibilities as managing director were relinquished to the executive committee whose members were Denise and Billy McDonald. Although the predetermined official date for his leaving was 1 July 2004, he seemed to have left much earlier. The day to day running of the company was taken over by the executive committee. Consequently, Denise's job scope as group finance manager was enlarged to include some of Crowhurst's monitoring and supervisory control and review responsibilities. Denise was given more authority to co-sign cheques of up to $10,000. That was on 24 February 2004. Denise took over and occupied Crowhurst's office room. It was unclear as to when he physically moved out of the Delphi premises. It could have been either in February or March 2004. There was some suggestion that Crowhurst was gone in February since it was Lew who explained to Denise in February her increased responsibilities. In any event, Crowhurst would probably have been out of the office soon after his letter of 4 March 2004 to Denise, but then again the letter could have been sent from his home. But for the changes in management during that relevant period which I found were critical and indeed differentiated the events in 2003 and 2004, I might have been inclined to find in respect of the losses which continued for a few months of 2004, some blameworthiness on the part of the company and Crowhurst, and that his negligence had contributed to some extent to the loss suffered by the company. That could have led to a reduction of the losses recoverable from the defendant. But as I said, I took the situation on the ground at that time into consideration and that made a difference to the outcome of the case. Of equal importance was the absence of evidence either way on whether Crowhurst was provided with monthly bank reconciliation statements after he ceased to be involved in the day to day running of the company. It would be speculative to say that he did receive them given his changed role and status in the company. After all, the evidence was that Lew and Shaw as non-executive directors were not provided with monthly bank reconciliation statements.

Conclusion

40 Having reached the conclusions above, it was not necessary for me to go into the other various areas of negligence alleged by the plaintiff. Accordingly, I entered judgment for the plaintiffs in the sum of $775,266.02 with interest thereon at the rate of 6% per annum from the date of the writ and costs.

[note: 1]Paragraph 7(a) of the Statement of Claim

[note: 2]Answer (i) to paragraph 7(a)(1) of the statement of claim at p15 of F&BP dated 1 February 2006

[note: 3]Page 6 of F&BP in answer to para 7(a) F&BP to the statement of claim filed 1 February 2006

[note: 4]Para 8 of Amended Reply filed on 24 February 2006

[note: 5]Transcript of evidence p 815 line 25

[note: 6]Transcript of evidence pp 997 to 998; 2AB 280-284

[note: 7]Transcript of evidence p 497 line 31

[note: 8]Mitigation plea paras 31 and 32 at 6AB 1381

[note: 9]Para 10 of Phong's affidavit of evidence-in-chief

[note: 10]Plaintiff's further and better particulars filed on 1 February 2006 at pp 29 & 30

[note: 11]Para 8 of Tow's affidavit of evidence-in-chief; Para 10 of Phong's affidavit of evidence-in-chief

[note: 12]Para 10 of Phong's affidavit of evidence-in-chief

[note: 13]Paragraphs 13 and 51 of Tow's affidavit of evidence-in-chief

[note: 14]2AB pp 287, 288 and 361

[note: 15]ie $884,195.02 (losses for the period between 16.2.04 – 23.5.04 which is the same period as the charges preferred against Denise and convicted) less $100,000 and $8,929.