

Case study on tort of negligence in the Ims vs chuan associates case

[Business](#), [Company](#)



How this scenario relates to an area of law taught in Introduction to Business Law

The tort of negligence is the area of law which this scenario relates to. LMS has threatened to seek legal action against Chuan & Associates to recover damages for the harm suffered because of the approval of financial statements which had material misstatements by the audit firm. Everything 4 Less Limited (E4L) acquisition was a decision based on the information contained in those financial statements and LMS suffered financial loss by relying on them. The statements had overstated the value of the company's inventories, and this had increased the value of the company during the bid and subsequent acquisition.

The legally important facts in the scenario

LMS was offered the opportunity to conduct their own audit of the books of E4L before they made the actual acquisition and conduct all due diligence on the financial statements of the company. They however did not do this and instead opted to rely on the good reputation of E4L in the industry instead of hiring accountants and lawyers to conduct the due diligence.

It is legally important to note that LMS discovered the overstatement in inventories only after the acquisition had been finalised. LMS was offered an opportunity to conduct all due diligence on the accounts of E4L before making the actual acquisition, but they ignored this invitation and instead made the acquisition before conducting the audit. The audit and subsequent discovery of the discrepancies was discovered in an audit which was carried by LMS after the acquisition.

It is legally important to consider that by basing their decision to acquire E4L on the financial statements audited by Chuan & Associates and certified to be true and fair, LMS suffered financial harm.

The discrepancy in the valuation of the inventories of E4L in their financial statements was noticed by Julia who was in charge of the audit at E4L. She reported this to the senior partner of Chuan & Associates who advised her to ignore them.

The elements of the action that LMS must prove in order to win the case

LMS must prove to the court that it was owed a duty of care by Chuan & Associates from suffering financial harm by making a complete and diligent audit of the accounts of E4L. They must prove to the court that the financial harm they suffered was as a direct result of this breach of duty, that the breach was of duty was reasonably foreseeable and that the imposition of liability on Chuan & Associates for the harm suffered is fair, just and reasonable and that there exists a relationship of proximity between Chuan & Associates and LMS limited.

It must be proved to the court beyond reasonable doubt that there was indeed a breach of the duty of care that LMS was owed by Chuan & Associates in the auditing and signing off of the accounts of E4L limited as fair and absent of any material misstatements.

LMS must prove that the financial harm that they suffered was as a direct result of the overstatement in inventories of E4L in the accounts that Chuan & Associates had audited. LMS should prove to the court that they would not

have suffered any financial loss had they not relied on the accounts that were audited by Chuan & Associates.

Arguments that C&A could make in response to LMS's allegation

Chuan & Associates can argue that they did not owe any duty of care to LMS and thus cannot bear liability for the financial harm they suffered. They can argue that since they did not enter into any direct contract with LMS, they were not in any way obligated to LMS since their contract was strictly between them and E4L, not LMS.

Chuan & Associates can also argue that by LMS failing to hire lawyers and accountants to conduct all the due diligence on E4L accounts, they were contributory to the negligence and are thus also liable for the harm they suffered.

What should C&A should do to avoid liability in similar situations

A statement limiting the liability of Chuan & Associates should always be included in all the accounts that they audit. They should expressly indicate that their liability will only be limited to the harm that may be suffered by the firm with which they enter into a direct contract. They should also indicate in the accounts that it is upon any other party using the accounts to conduct its own due diligence on the accounts.

Any personal relationships with clients that may compromise the integrity of the audits that Chuan & Associates carries should be avoided by instituting strong internal control measures in the firm. Stiff penalties should be

imposed on those members of the Chuan & Associates who deliberately choose to ignore the misstatements in the accounts of clients due to personal relationships such as Chuan did by ignoring Julia's concern about the overstatement of inventories in E4L limited.

The audits carried out by Chuan & Associates for their clients should be counter checked by senior members if carried out by junior members of Staff. This will effectively ensure that any mistakes in the audits are discovered well in advance before the audited accounts are signed off back to the client and the stock market. This will reduce substantially the risk that the audit firm will be sued for liability due to negligence.

Letter instructing a solicitor

Parramatta Legal Aid Centre,

P. O. Box,

Sydney.

2nd May 2011.

Chuan & Associates,

P. O. Box,

Sydney, Australia.

Dear Sir,

RE: REQUEST FOR LEGAL ASSISTANCE IN LMS V. CHUAN & ASSOCIATES

We are an accounting firm based in Sydney, Australia operating under the name Chuan & Associates. On March 2011, our firm received official communication from LMS threatening to sue our firm for financial harm which they suffered and which LMS claims was occasioned by our negligence in conducting an audit for the accounts of Everything 4 Less Limited (E4L). They have claimed in their communication that by relying on those accounts to make a bid and a subsequent acquisition of E4L, they suffered a financial loss of \$ 5 million, the amount with which inventories in accounts were overstated. They have threatened to sue our firm for negligence resulting in financial harm if they are not compensated for the \$ 5 million loss.

No direct contract between Chuan & associates and LMS had been entered into. Our firm had only entered into a contract with E4L, the firm which was later acquired by LMS. After the announcement of the bid, the directors of E4L made available their accounts to LMS to conduct all the due diligence on the said accounts. The directors of LMS however chose not to hire lawyers and accountants to conduct the due diligence due to the Christmas holiday. They instead chose to rely on the good reputation that E4L enjoys in the industry, and the takeover was completed successfully in February 2011. A discrepancy in the valuation of the inventories of E4L in their accounts was only discovered after the takeover when an audit of the accounts of E4L was carried out.

In response to this serious accusation, our firm has made it clear to LMS that it cannot accept to bear the burden of liability for the financial harm that they suffered as a result of the overvaluation of inventories in the accounts of LMS. This is because no legal contract existed between our firm and LMS,

and thus our firm was not legally bound in any way to provide the accounts of E4L to LMS for the purposes of the takeover. Our firm's liability is thus only limited to the financial harm that may be suffered by E4L.

The directors of E4L made an express invitation to LMS to carry out all the due diligence on the accounts of E4L before the actual acquisition took place. LMS however chose to ignore this invitation and instead of hiring lawyers and accountants to conduct the due diligence, they relied on the accounts based on the good reputation enjoyed by E4L in the industry. LMS, by choosing to ignore this invitation, made themselves liable for any future harm, financial or otherwise, that may be occasioned by any misstatements in the accounts of E4L. This constitutes contributory negligence, and in effect clears our firm of any liability for the financial harm suffered as a result of the overvaluation of the inventories in the financial statements.

All the above facts and arguments for our firm's case are true and can be attested in a court of law. Chuan & Associates is not willing to bear any liability for the financial harm suffered by LMS as a result of their reliance of the accounts of E4L which were audited and signed off by our firm.

Chuan & Associates is seeking your legal assistance on this matter and this letter is meant to be a request for such.

I look forward to your timely reply regarding the matter.

Yours faithfully,

References

Deakin, S., Angus J. and Basil M., 2003. Markesinis and Deakin's Tort Law.

Oxford, UK: Oxford University Press.

Stuhmcke, A., 2001. Essential Tort Law, 2nd Ed. Sydney: Cavendish

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