

MODULE 1

Topic 2. Introduction to audit

Audit regulation
Structure of the profession
Legal liability
Client acceptance and continuance

Module 1 – Topic 2.1

Audit regulation

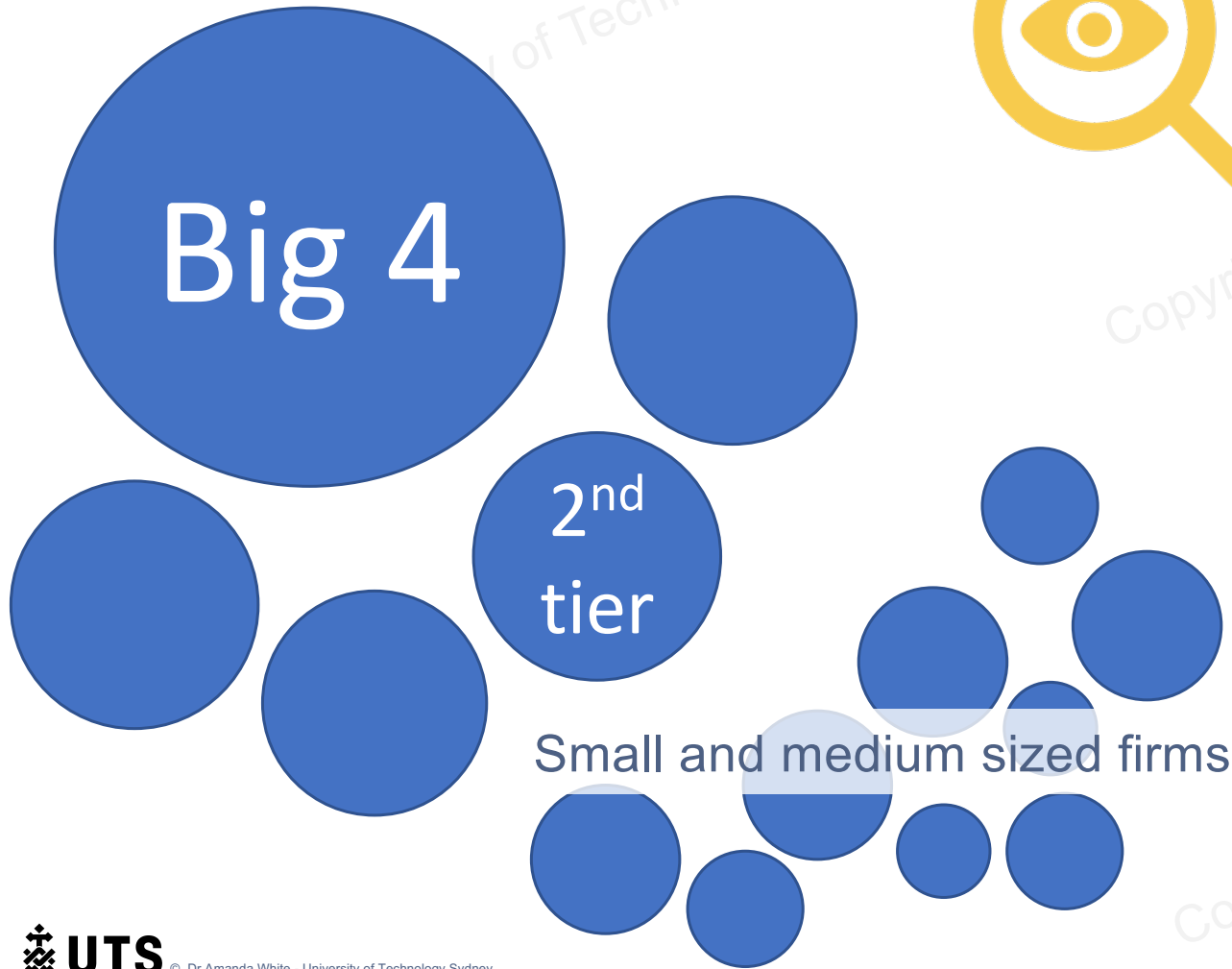
The Corporations Act

- We already know that auditors have to
 - Follow the auditing standards (ASAs)
 - Follow the ethical code
 - Maintain their independence
- Auditors will be inspected by ASIC
- Have been called to the parliamentary enquiry to testify on audit quality, the independence of audit firms and the provision of non-audit services
- ASIC is moving to prosecute auditors for breaches

Module 1 – Topic 2.2

Structure of the audit profession

All the players in the game

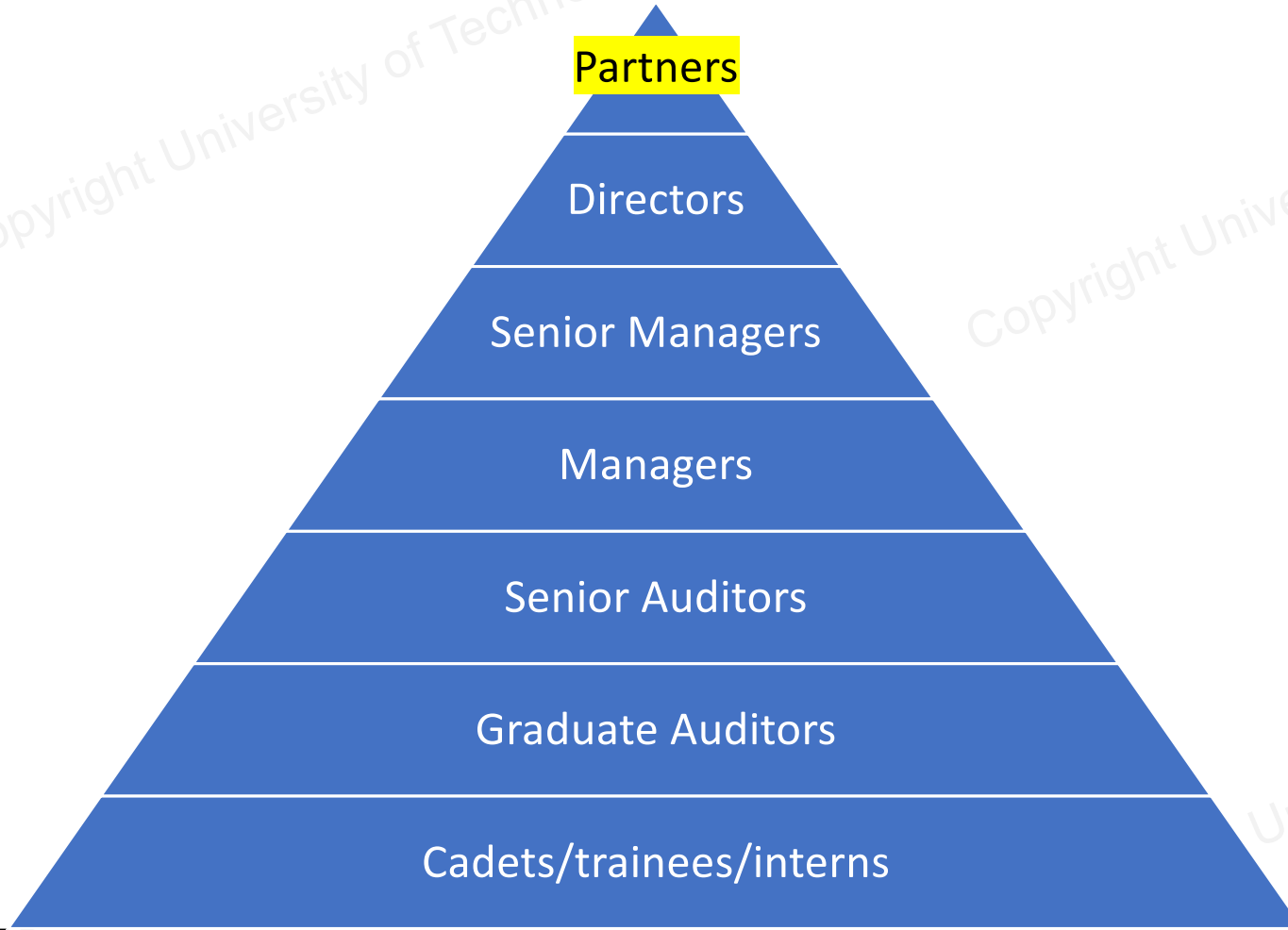


ASIC



Chartered Accountants + CPA Australia + IPA

What is the inside of the firm like?



Module 1 – Topic 2.3

Legal liability – part 1

Auditor's Legal Liability

Sydney Morning Herald, 20/11/2012

PwC auditor sidelined until 2015 for \$2.1b Centro debt bungle

November 20, 2012

☆ Read later

PwC partner Stephen Cogle has agreed to a temporary ban on auditing work following his involvement in approving Centro's misleading financial accounts in 2006-07.

The accounts wrongly classified \$2.1 billion worth of debt as non-current when in fact it was current. Centro came close to collapse when it was unable to refinance the debt during the global financial crisis.

Mr Cogle led the team that audited Centro. He has promised the corporate watchdog he will not practise as a registered auditor until June 30, 2015, and has agreed to additional training, and to submit his first three audits after the suspension for checking by another auditor approved by the Australian Securities and Investments Commission.



How are auditors exposed to legal liability?



Reasonable Care and Skill

- Overall, an Auditor has a duty to exercise the reasonable care and skill expected of a professional.
- Requires adherence to regulatory and professional standards in all aspects of an audit.
- *‘The professional man owes a duty to exercise that standard of skill and care appropriate to his professional status’ (Caparo, 1990).*

Negligence

Negligence can be defined as any conduct that is “*careless or unintentional in nature and entails a breach of any contractual duty or duty of care in tort owed to another person/s*”.

In the context of Auditing, an Auditor would be deemed to have been “**negligent**” where they made a judgement or error that a normal, **reasonable** Auditor would not have made in the same situation.

Claims for Negligence

To be successful in a claim for negligence, a **plaintiff must prove that:**

- 1) **A Duty of Care was owed** to the plaintiff by the defendant (i.e. the Auditor)
- 2) **There was a breach of the duty** of care as the Audit was **negligently** performed
- 3) **It resulted in an inappropriate Audit report** which was **relied upon by the plaintiff**
- 4) **Financial Loss or damage** was suffered by the plaintiff as a result

Note: A causal relationship existed between the breach of duty and the harm suffered by the plaintiff.

Liability to Clients

Liability to clients arises both in **Contract** and under the **Tort of Negligence**.

Key cases include:

- *London & General Bank Ltd (1895)*
- *Kingston Cotton Mill (1896)*
- *Thomas Gerrard & Son (1967)*
- *Pacific Acceptance (1970)*
- *Kirby v Centro Properties (2012)*

Pacific Acceptance (1970)

Auditors' duties and responsibilities are to:

- Use **reasonable** care and skill
- Check and see for **themselves**
- Audit the whole year
- **Appropriately supervise and review** work of inexperienced staff
- Properly **document** procedures
- Rely on satisfactory **internal controls**
- **Warn and inform** the appropriate level of management
- **Take further action where suspicion is aroused**
- **Structure plans and procedures** so that discovery of material error or fraud is reasonably expected
- **Be guided by professional standards**

Contributory Negligence

- Exists where the plaintiff fails to exercise reasonable care, thus **contributing** to the harm or loss suffered.
- The defence of “**contributory negligence**” by Auditors was first successful in the **AWA case (1995)** which involved considerable negligence by management which was recognised and considered in the court proceedings.

Module 1 – Topic 2.3

Legal liability – part 2

Liability to Third Parties

- A number of cases have considered the auditor's liability in relation to persons other than the immediate client.
- For such a case to be successful, the Plaintiff (third party) must establish and prove a **reasonable degree of proximity** existed between third party and auditor.
- ***Donoghue v. Stevenson [1932]***
Established the precedent that a **duty of care** could be owed to third parties.

Liability to Third Parties (continued)

Early test: Special Relationship

- A duty is owed to any third party to whom the auditor shows accounts or to whom the auditor **knows** the client is going to show accounts, so as to induce some action.
 - ***Candler (1951)*** (per dissenting judgement of Lord Denning)
 - ***Hedley Byrne (1963)***

Continued

Liability to Third Parties (continued)

Next test: Reasonable Foreseeability

- A duty is owed to a specific third party of whom the auditor was not aware, but who was part of a class of persons who they **should have been aware** would rely on their audit opinion – i.e. where the party's reliance on the client's financial report was **reasonably foreseeable**.

– ***Scott Group (1978)***

Liability to Third Parties (continued)

Current test: Proximity

- For a duty of care to exist, there must be circumstances establishing a **relationship of proximity** between the auditor and third party – i.e. The Auditor must have **encouraged, enticed or induced the party to **rely** on the report.**
 - *Caparo (1990)*
 - *R. Lowe Lippmann Figdor & Franck v AGC (1992)*
 - *Columbia Coffee (1992)* (very wide interpretation, later overturned in *Esanda*)
 - **Esanda (1997)**

Esanda (1997)

- The Australian High Court ruled that **for a third party to establish duty of care, they must show:**
 - The report was **prepared on the basis that it would be communicated to a third party**
 - The report was **likely to be relied upon by that third party; and**
 - The **third party ran the risk of suffering a loss** if the report was negligently prepared

Module 1 – Topic 2.3

Legal liability – part 3

Let's talk about privity letters

- Third parties can send a **Privity Letter** to the Auditor seeking formal acknowledgement of their reliance on the report, in an effort to **establish proximity**.
- Should auditors respond to a privity letter?

The Auditor's Response

- .11 In view of the circumstances associated with a request for a privity letter and the audit concerns noted, unless an auditor intends to accept responsibility to a third party, an auditor responds unequivocally to a request for a privity letter stating that the body of shareholders is the only group entitled to rely on the audit report.

AGS 1014 Privity Letter Requests – no longer in circulation

Managing Legal Liability

- Deal only with **clients possessing integrity**
- **Employ qualified personnel**, and train and **supervise them properly**
- **Follow the Auditing Standards** assiduously
- Maintain **independence**
- Understand the **client's business**.
- Perform **quality audits**
- **Document all work properly and thoroughly**
- Obtain an engagement and a representation letter
- **Carry adequate insurance**
- Seek legal counsel.

Liability under Consumer Law: *Competition and Consumer Act 2010*

Consideration needs to be given to the provisions of the Commonwealth ***Competition and Consumer Act*** and relevant state Fair Trading Acts:

- Acts prohibit **misleading and deceptive conduct**.
- It is possible that, in issuing an inappropriate auditor's report, an auditor might be guilty of conduct that is misleading or deceptive.
- Charges under this Act would often be brought by the **ACCC**.

Criminal Liability of Auditors

- Auditors can be subject to criminal prosecution under the *Crimes Act 1914*.
- This Act requires Auditors to **report any criminal offences** they discover the client has committed to the appropriate authorities.
- If the Auditor fails to report the crime, they may be deemed complicit in the act.
- Criminal actions against auditors are rare, but ASIC is looking to pursue auditors legally for breaches of the Corporations Act.

Changes to Auditor Liability

- Changes to the *Corporations Act 2001* as a result of **CLERP 9** helped to limit Auditor liability in the following ways:
 - Introduction of Professional Standards legislation to provide a **statutory cap to auditor's liability**
 - The ability for Auditors to incorporate and form **company structures with limited liability** (rather than having to operate as sole traders or in partnerships), with adequate and appropriate professional indemnity insurance
 - **Apportionment** between the plaintiff and defendant according to blame, and **proportionate liability** if there are two or more defendants.
(**Note:** Centro lawsuit was settled May 2012 for \$200 million, with PwC's share being \$67 million.)

Disciplinary Procedures

- Independent auditors are often mainly subject to the disciplinary provisions of their professional accounting bodies, either Chartered Accountants ANZ, CPA Australia or the IPA.
- **Sanctions can include:**
 - Exclusion from membership
 - Suspension from membership
 - Disbarment from practice
 - Being fined a sum not exceeding \$100,000
 - Having to pay costs and expenses of any investigation
 - Imprisonment (under Criminal Law).

Key take aways – legal liability

- Auditors are exposed to multiple sources of liability
- The best way to prevent getting sued is to conduct high quality audits
- Understand the concept of proximity in relation to auditor liability to third parties

Module 1 – Topic 2.4

Client acceptance and continuance

Who is
the
ideal
audit
client?



Image from "If you are the one shown" on SBS Australia

Quality Control Policies and Client Evaluation Procedures

- As part of **Quality Control**, audit firms must establish policies for:
 - Investigating and evaluating potential new clients and **acceptance of a new engagement**
 - Periodically reviewing **continuance of clients**.
- Policies and procedures for client acceptance and continuance are important as an audit firm will want to avoid association with a client who lacks **integrity** and can expose us to **legal liability!**

Portfolio
approach

Evaluation Procedures

- Procedures carried out before accepting a new client or continuing with an existing client include:
 - Obtaining and **reviewing available financial information** regarding the client
 - **Making inquiries of third parties**, such as solicitors and bankers
 - **Communicating with previous auditor** (only if client permission is granted)
 - **Evaluating the firm's independence and ability to serve the client**, including technical skills and knowledge of industry and personnel
 - Ensuring that accepting engagement will not violate the **Code of Ethics (APES 110/The Code)**.

Communication with the Previous Auditor

- This communication would allow the previous auditor to advise the prospective new auditor of any professional matters they should be aware of before accepting the engagement.
- But it is important to note that **APES 110/The Code** requires that:
 - The nominated incoming auditor should **request the client's permission** to communicate with the previous auditor
 - **If the client refuses** permission, normally **decline nomination**
 - **If permission is granted**, the nominated auditor asks the previous auditor **in writing for all information** necessary to decide whether the nomination should be accepted.

Engagement Letter

- After accepting the audit appointment, **ASA 210** requires that the auditor and entity **agree on terms** of the engagement in an **Engagement Letter**.
- This letter is from the auditor to the client and is intended to record the arrangements made with the client and **clarify matters that may be misunderstood**.
- Engagement letters should include the following:
 - Objectives and scope of the audit
 - Responsibilities of the Auditor
 - Responsibilities of Management
 - Identification of the applicable Financial Reporting Framework (i.e. **criteria** to be used to evaluate whether the subject matter is “true and fair”)

Key take aways

- We must assess clients carefully
- Must consider the potential profitability
- Independence is still key