

Undermining the Statutory Audit

The damaging effects of adopting IFAC-IAASB standards on auditing (ISAs)

(June 2005)

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Undermining the Statutory Audit

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Introduction

1. In the aftermath of recent corporate scandals and related audit issues, it has become apparent that shareholders and the wider public currently face a serious threat to the future quality of audits (reducing the safeguards against future corporate scandals). Changes are being made to the nature of audits that will reduce their scope and rigour and materially weaken this key safeguard. This threat has arisen and is being pursued at an accelerated pace, without proper public debate, almost unnoticed and certainly not widely understood.¹
2. The context in which this is happening is the move to create an international framework of auditing standards, with the objective of:
 - (i) giving users confidence in audit practices, regardless of the jurisdiction; and
 - (ii) enhancing the reputation and credibility of the auditing profession, as well as helping to restore public confidence in it.
3. We have no issue with these broad objectives. However, these objectives are being pursued by means of the US derived IFAC-IAASB² standards (ISAs), on the claims that they offer better standards and will deliver better audits – **we strongly disagree.**

This approach will fundamentally change and undermine the “true and fair view” basis of audits established under the Companies Act, a process started by the Auditing Practices Board (APB), which will be completed through the proposed 8th Company Law Directive that is being fast-tracked through the EU.

Aim of this paper

4. This paper seeks to explain:
 - why there must be a real concern for shareholders and the public more generally from the changes being made to the UK’s audit framework;
 - what the perceived risks and effects of adopting the IFAC-IAASB standards are, particularly if they are given a statutory footing, as is envisaged in the proposed 8th Company Law Directive that is being fast-tracked through the EU; and
 - the opaque process³ being used to embed this US derived framework, which has not allowed proper public debate of the nature and effect of these reforms.

¹ : see paragraphs 8-16 and 20-27 below

² : IFAC: the International Federation of Accountants (“the global organization for the accountancy profession”).
IAASB: the International Auditing and Assurance Standards Board (“functions as an independent standard setting body under the auspices of IFAC”). Under new proposals, whose nature and merits have yet to be assessed, the IAASB is being placed under the oversight of a new body called the PIOB or Public Interest Oversight Board.

³ : see paragraphs 8-16 below

Summary of Concerns

5. Regardless of the merits of the high level objectives noted in paragraphs 2(i) & (ii) above, the effect in the UK of pursuing them by means of the IFAC-IAASB standards will be to:
- (i) reduce the scope of UK audits;⁴
 - (ii) reduce the rigour and tests applied in UK audits;⁵
 - (iii) shift away from the public interest/shareholder audit to a process driven, technical-compliance assurance: the end of ‘true and fair view’ audits as we know them;⁶
 - (iv) have the principal effect of reducing the scope of the auditor’s role and exposure to risk⁷ by means of imposing a procedural, compliance orientated framework of limited scope.⁸
 - (v) extend the process of internalising audit accountability that began in the early 90s, making the directors/management the ‘client’ instead of shareholders;⁹
 - (vi) transfer additional responsibility and risk to non-executive directors, who will no longer have the same, established common law reliance on the audit and auditor;¹⁰ and
 - (vii) harmonise audit standards under a US derived framework that suits the approach of the US side of some of the larger global accounting firms.¹¹
6. In addition, as part of the wider debate, there is a move to discuss extending responsibility for, effectively, determining the audit opinion onto third party advisers (e.g. lawyers and bankers), even though such parties undertake a clearly different role as contracted advisers to management as opposed to statutory auditors with a duty of care to shareholders.¹²

A broader perspective

7. Our concerns about the nature of the IFAC-IAASB standards are not isolated ones, nor are they just UK ones. For example, on the nature of IFAC-IAASB standards, the views of Germany’s professional accounting body, the Institute Der Wirtschaftsprüfer (IDW), illustrate one element¹³ of this (7 January 2005 letter to IFAC-IAASB):

“We do not believe that the increasing complexity of, and detail in, the ISAs, with more requirements and the consequent reduction in the room left for professional judgement actually improves audit quality. In fact, we believe that the reduction in the room for professional judgement due to increasingly complex and detailed standards endangers the quality of audits.”

⁴ : see paragraphs 17-19 below and Appendix 1

⁵ : see paragraphs 17-19 below and 34-38 below and Appendix 1

⁶ : see paragraphs 17-19 below and 34-38 below and Appendix 1

⁷ : see Appendix 2

⁸ : i.e. protecting the auditor rather than the shareholder or wider public (e.g. see paragraph 34-38 below)

⁹ : see Appendix 1 (section on ‘purpose’ and on ‘the client’)

¹⁰ : see paragraphs 28-30 below

¹¹ : see paragraphs 20-27 and 43-46 below

¹² : see paragraph 31-33 below

¹³ : see paragraphs 34-38 below

“In our view principles-based international standards that encompass the objectives that requirements are to achieve have a greater potential to influence auditor behaviour in a global environment than detailed rules that are followed slavishly, possibly irrespectively of whether they meet the objectives. The issue here is whether [IFAC-IAASB] wants standards to control auditor input or out-put. We believe that controlling auditor output (the objectives to be achieved) using a principles based approach is more effective, efficient and robust ... than trying to control auditor input (procedures to be performed) by means of detailed rules.”

Imposition of IFAC-IAASB standards in the UK – how did it happen?

8. With that view from the IDW in mind its worth remembering that ISAs have already been unilaterally imposed in the UK by the Auditing Practices Board, after it announced in March 2004 that it had “decided that these new standards shall apply in the UK and Republic of Ireland to audits of accounting periods commencing on or after 15 December 2004”.
9. As an interested party we have to ask what the ‘due process’ behind this was? Surprisingly it is, at best, not clear. The following overview is extracted from the APB minutes and press releases:¹⁴
 - **24 February 2004:** APB meeting. After a discussion was introduced about adopting ISA standards, it was agreed that the IFAC-IAASB ISAs on audit risk, fraud and quality control should be adopted but that ‘it might be better to issue’ them after an all day meeting on 5 April 2004, so that members of the board could consider them further.
 - **4 March 2004:** APB Press Release. Adoption of six new IFAC-IAASB standards (ISAs) announced.
 - **30 March 2004:** APB meeting. “The Chairman noted the recent APB press release concerning the adoption of ISAs”.
 - **5 April 2004:** no APB meeting minuted.
 - **26 April 2004:** APB meeting: “a draft consultation document to accompany exposure drafts of the ISAs” was distributed, which it was planned would be issued in June.
 - **6 May 2004:** Press release announcing the adoption of all ISAs issued, in place of existing UK standards (something no reader of its previous minutes could have anticipated).
 - **21 June 2004:** Exposure document issued on the 28 ISAs being adopted for the UK and Ireland.
10. In the space of the period outlined above, it appears that the APB reviewed, assessed and agreed the complete replacement of the UK’s auditing framework with the IFAC-IAASB standards for the UK and Ireland.
11. To compound this ‘process’, whilst the APB recognised in its June 2004 ‘consultation’ document that the adoption of the IFAC-IAASB standards was a significant step (having already indicated that they would require some audit firms – presumably UK Companies Act focussed firms rather than some heavily US orientated firms - to make significant changes to their audit approach), the following specific statement accompanied what was the first public consultation around the full adoption of the IFAC-IAASB framework:

“The APB has already made and announced its decision to adopt the complete suite of ISAs....The purpose of this consultation is not to seek views on this approach”.

¹⁴ : <http://www.frc.org.uk/apb/about/agenda.html> and <http://www.frc.org.uk/apb/press/>

12. This process and approach was not consistent with Government policy. The UK Government's Better Regulation Taskforce guidelines¹⁵ are clear about the need for both consultation and regulatory impact assessments of decisions by independent regulators, which applied to the FRC as it then was:

"The Government is committed to consulting the public on policies and using the responses to develop more informed and focussed decisions. Following a recommendation from the Better Regulation Task Force, the Government introduced, in November 2000, a minimum 12-week consultation period. This was published in a Code of Practice on Written Consultation."

"The Prime Minister has stated that "no proposal for regulation which has an impact on business, charities or voluntary bodies, should be considered by Ministers without a regulatory impact assessment [RIAs] being carried out." RIAs set out the costs and benefits of the proposal, and the options for delivering the outcome. They are a central and crucial part of the Government's drive to improve policymaking."

13. It is not clear, or easily understandable, why the APB moved to replace the whole UK auditing framework with the IFAC-IAASB in this way, ahead of any need to do so and at a time when companies and auditors were already having to grapple with the transition to IFRS. Why did this happen well ahead of any agreement on an appropriate EU framework or indeed its implementation? We find this particularly problematic given investor criticisms at the time, which were known to the APB. The APB, as a quasi-regulatory body, was changing the framework in a way that arguably runs counter to the objectives and intentions of Parliament and the Companies Act. These legal objectives have been expressly defended by the Courts where attempts to change audit practice have resulted in audit failures (this theme is expanded on below in the section on 'making the expectation gap a reality').¹⁶

The damaging effects of the proposed EU 8th Company Law Directive

14. While the APB has unilaterally imposed the IFAC-IAASB standards' framework in the UK, without proper public debate or consultation, the full effects of this may only, in fact, be realised once those standards are given a legislative footing, overriding and redefining the current Companies Act requirements and principles. The implications and issues arising from such an approach are already beginning to become apparent in Australia, where something similar has been done.¹⁷
15. This further step appears likely to happen as a result of the EU's proposed 8th Company Law Directive (ECOFIN draft, Dec 2004: Article 26), which is currently being fast-tracked through the EU system. We are profoundly concerned that, by giving the IFAC-IAASB standards a legislative basis, they will have the necessary force to give effect to fundamental (negative) changes to the UK statutory audit. Most significant amongst these is the overriding of the Companies Act "true and fair view" basis for audits (see paragraphs 17 to 19 below). While it has been suggested that the framework will allow national arrangements to be accommodated, there is no sustainable derogation available to allow that. On the flexibility available, the ECOFIN draft appears to be explicit:

"Art.26(4) Members states can impose additional requirements relating to the statutory audit of annual and consolidated accounts for a period of two years after the transposition period..."

¹⁵ : <http://www.brtf.gov.uk/docs/pdf/independent.pdf>

¹⁶ : see paragraphs 20-27 below

¹⁷ : see paragraph 16 below

16. The legal problems of codifying **any** auditing standards in law are already having to be discussed in Australia, which has a very similar Companies Act jurisdiction to the UK, far more comparable than the UK and US. The following extract is from a statement by the Australian Auditor General in August 2004, about issues arising from Australia's move to turn the existing Australian standards from guidelines into law:

"In Australia, there is debate about the legal status of auditing standards. While accounting standards have the legal backing of the Corporations Act 2001, previously the auditing standards did not. CLERP 9 redressed this issue, but in doing so has engendered concerns about the practicality of requiring legislative adherence where there is often an exercise of professional judgement. We would agree with the American Assembly that "auditors' best professional judgement must play a greater role" in audits of financial statements."

"Australia currently prides itself on its sound conceptual frameworks for accounting and auditing. However, as a result of auditing standards becoming law, they may potentially be subject to interpretation by the courts. In doing so, precedents could be made resulting in a quasi-rules based environment which may actually limit the exercise of professional judgement and/or create possible inconsistencies and contradictions which would simply add to the uncertainty rather than alleviating it."

The end of 'true and fair view' audits as we know them

17. While it is true that IFAC-IAASB standards acknowledge and even allow the use of the words 'true and fair view', their treatment of it is important to understand. IFAC-IAASB and its proponents have made considerable efforts to reassure people that the IFAC-IAASB framework accommodates specific national requirements and much has been made, in particular, about how they accommodate the 'true and fair view' concept in audits. However, regardless of these assurances, the reality is somewhat different. The standards make clear¹⁸ that the term 'true and fair view' will be interpreted and treated as being equivalent to the US based standard that IFAC-IAASB uses. They go on to make clear¹⁹ that despite any choice of words, it is the application of the IFAC-IAASB standards and procedures that will apply. Once you give this approach a legislative basis (particularly of the kind envisaged in the proposed EU Directive) what you end up with, despite any PR, is that the auditor would only have to:

- ***provide reasonable assurance that the accounts are fairly presented, in material respects, in accordance with GAAP/IFRS accounting standards.***

18. That is not, by any stretch of the imagination, the 'true and fair view' audit envisaged and set out in the Companies Act 1985. IFAC-IAASB's reasonable assurance of technical compliance and the process driven methodology behind it fall far short of the current Companies Act requirement. The Companies Act model we are loosing requires much more: the auditor

- ***gives an opinion on whether accounts give a true and fair view of the state of affairs of the business and its profit and loss, as well as addressing the other Companies Act requirements (e.g. on books and records).***²⁰

¹⁸ : ISA 200, 'Objective of an Audit', paragraph 2 (page 200, Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2005 edition (IFAC))

¹⁹ : ISA 200, 'Audit Risk and Materiality', paragraph 14 (page 202, Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2005 edition (IFAC))

²⁰ : see Appendix 1, sections on 'audit opinion' and 'audit approach'

19. The extent of the difference between the frameworks goes well beyond this²¹ and is illustrated further in **Appendix 1**. It is, however, worth emphasising this key difference in the US derived IFAC opinion as this cuts to the heart of the general understanding of and reliance on the audit.²² The UK ‘state of affairs of the business’ does not relate only to compliance with GAAP or IFRS. Both the audit of Barings²³ and Transtec²⁴ failed due to the auditors not detecting things that were hidden from immediate view. Enron would have been a clear audit failure under the current UK regime of “true and fair view of the state of affairs” without any need to refer to Accounting Standards, IFRS or otherwise, but the US/IFAC-IAASB model is different.

Making the audit expectation gap a reality

20. In effect the IFAC-IAASB standards are doing just what the title of this section says. Let me explain. Auditors commonly make reference to the audit “expectation gap”. The table in **Appendix 1** below illustrates perfectly the nature of that gap: the difference between what the IFAC-IAASB standards deliver and what UK legislation and the Courts currently hold UK auditors responsible for. The gap is, in fact, one of and in delivery.
21. We accept that there has been some lack of clarity in this area. However, the failure to clarify the purpose of audit has had more to do with the profession’s standard setters not pinning their colours to the mast properly, than it has to do with the various iterations of the Companies Act being clear about the purpose of the audit (which the Courts have defended, robustly).
22. This issue has re-emerged regularly after audit failures with, perhaps, the most significant, early instance seen in the Leeds Estate case in 1887. Here the court rejected the use of a formulaic approach based around an ‘arithmetic’ compliance checking of the numbers (deemed a ‘non-audit’). This effectively established the basis for the notion of a substantive, complete audit (as opposed to what has been referred to as a ‘biscuit and sherry audit’²⁵).
23. Lord Rigby highlighted the danger of focussing on technical compliance and reliance on management:

‘The words ‘as shewn by the books of the company’ seem to be introduced to relieve the auditors from any responsibility as to the affairs of the company kept out of the books and concealed A full and fair balance sheet must convey a truthful statement as to the company’s position’.

It seems that, with the IFAC-IAASB standards, the attempts to re-define the audit have not changed much, rather it could be said that IFAC-IAASB has continued a long and well established tradition.

24. Lord Rigby’s observations also highlight another element of the expectation gap. While the Audit Report is intended to provide reliable intelligence to shareholders,²⁶ it has been used in practice to contain ever increasing limitation and mitigation statements that reduce the scope of the auditor’s responsibility. A relatively recent example of this is illustrated in the Technical Release: Audit 1/03 ‘The Audit report and Auditors’ Duty of Care to Third Parties’²⁷ on the recommended wording to use to

²¹ : e.g. see paragraph 35 below

²² : see paragraphs 20-27 below

²³ : see Appendix 2

²⁴ : see paragraph 34 below

²⁵ : see ‘White Collar Crime in Modern England’ (1992) Robb, G. [p.129]

²⁶ : see Appendix 1 (section on ‘purpose’)

²⁷ : http://www.icaew.co.uk/index.cfm?AUB=TB2I_46648

in a disclaimer in the audit report to avoid the effect of the Bannerman judgement.²⁸ Again some things don't seem to change and the model Audit Reports that IFAC-IAASB has set out in its standards extend this approach.

25. It seems, therefore, that 'global' standards either by accident or by design are supporting the very things that UK Courts have repeatedly rejected for so long and, in doing so, are about to undermine the substance of audits as envisaged and articulated in the Companies Act and Courts.
26. In practice, we believe that the next iteration of the legislative process and reform should have been to address this problem by reinforcing the existing Companies Act principles²⁹ and incorporating the purpose of audit articulated by the Law Lords in the Caparo case,³⁰ through the forthcoming Company Law Bill.
27. It should hardly be surprising that shareholders find the situation bemusing and deeply concerning, particularly as this will compound the existing problems in audit practice.³¹

Transferring 'audit' responsibility and liability to the non-executive directors

28. Another issue that has been absent from the current debate, is the potential impact and effect on directors (particularly non-executive directors) from the introduction of IFAC-IAASB standards, in particular, in relation to their role, reliance on auditors and exposure to risk and liability.
29. It is worth touching on why there is this transfer of 'audit' responsibility and liability to the directors:
 - (a) In relation to auditors, if directors appoint a person of good repute and competence to audit the accounts, absent real grounds for suspecting that the auditor is wrong, the directors will have discharged their duty to the company. The directors are not required to look at the entries in any of the company's books of record, or verify the calculations of the company's accountants in preparing the financial statements or of the auditor himself. Directors are entitled to rely on the judgement, information and advice of the auditor (*cf In Re Denham & Co* [1883] 25 Ch.D. 752, 766; *Dovey v Cory* [supra] 486, 492).
 - (b) Reliance may properly be more complete where the auditor is acknowledged as being more knowledgeable, skilled and experienced in the particular matter in question than the directors or other auditors. Effectively, a director is entitled to expect the auditor to carry out its duties utilising that higher degree of knowledge, skill and experience. In such circumstances the auditor will be under an even higher duty of care than the standard of care of an auditor without such specialist knowledge, skill and experience (*In re Thomas Gerrard & Son Ltd* [1968] Ch. 455, 575; *Pacific Acceptance Corporation v Forsyth* (1970) 92 WN (NSW) 29, 74; *Haig v Bamford* [1977] 72 DLR (3rd) 68, 74; *Bartlett v Barclays Trust Co Ltd* [1980] 1 Ch. 515, 534).
30. The perceived issue for directors is that if you (i) reduce the scope of the audit and (ii) reduce the level of rigour and the tests that apply, directors can no longer place the same reliance on the auditors to show they have discharged their duty. In terms of

²⁸ : Royal Bank of Scotland v Bannerman Johnstone Maclay and others [July 2002]

²⁹ : section 236 of the Companies Act 1985 (dealing with the 'true and fair view') and related provisions

³⁰ : see Appendix 1 (section on 'purpose')

³¹ : see 'Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)' (Feb 2004)

the extent to which auditors responsibilities and, hence, exposure to liability may be reduced, see Appendix 2. The significant reduction suggested in auditors' exposure to liability falls back solely to the directors.

Transferring 'audit' responsibility and liability to lawyers and bankers

31. As indicated in paragraph 6 above there is now also debate about, effectively, extending responsibility for determining the audit opinion onto third party advisers (e.g. lawyers and bankers). It is worth pausing for thought on this issue though. This is an extension of the debate about how much reliance auditors have placed on the face value of statements made to them.³² Is this appropriate? And, if so, in what context?
32. The first question has been discussed before. While this paper will not seek to pursue it in detail, the views of Lord Denning in this area³³ are of interest:

"There is a great difference between the lawyer and the accountant. The lawyer is never called on to express his personal belief in the truth of his client's case, whereas the accountant, who certifies the accounts of his client, is always called upon to express his personal opinion...and he is required to do this not so much for the satisfaction of his own client, but more for the guidance of shareholders...who may have to rely on the accounts in serious matters of business."

33. The second question does, however, raise some interesting issues in the context of this paper's theme. Given the recourse through contractual liability to the company/management, the only logical reason for considering an extension of accountability to management's advisers, would be to address the kind of actions that have been criticised by, say, DTI inspectors. One example of this is found in the House of Fraser plc case:³⁴

'The lies which the Fayeds were telling about themselves and their resources were given a credibility they would not have otherwise attained when they were repeated by their very reputable advisers.'

'Their advisers accepted at face value what they were told by the Fayeds. In our opinion they did not take sufficient steps to check the accuracy of what they were told.'

'The Secretary of State saw no practical alternative but to accept the representations and assurances which were made to him, and in particular those which he and his officials saw as having been made by the Fayeds, Kleinworts and Herbert Smith....'

Prescriptive, process based standards

34. This problem has a direct corollary in relation to auditors and audit failure. It highlights one the concerns we have about the potential effects of the IFAC-IAASB standards. In term of audits, the equivalent problem was seen in the Parmalat case and has also been highlighted by DTI Inspectors. An illustration of this issue is found in the TransTec plc case,³⁵ where the inspectors were:

³² : see paragraphs 34-35 below and Appendix 1 (section on 'scope and quality of information')

³³ : Candler v Crane Christmas & Co [1951] 1 All ER 426

³⁴ : "House of Fraser Holdings plc" (1990) Investigation under Section 432(2) of the Companies Act 1985, HMSO: ISBN 0 11 514652 0

³⁵ : "TransTec plc - Investigation under section 432(2) of the Companies Act 1985" (2003) TSO, ISBN 0-11-515502-3

“firmly of the view the audit of TransTec’s accounts for the year to 31 December 1998 was inadequate. The way in which PwC satisfied themselves as to the evidence on certain transactions was, and is, unimpressive”.

35. The aspect of the IFAC-IAASB standards that causes concerns in this regard is ISA 240:³⁶

“An audit performed in accordance with ISAs rarely involves the authentication of documents Unless the auditor has reason to believe the contrary, the auditor ordinarily accepts records and documents as genuine.”

Righteous by process? Pareash Samet of Croner Consulting summed up the problem.³⁷

“The days when the auditors used to carry out stringent checks are well gone. These days the auditors ask questions to the company accountant and accept their word”

36. Extending this theme, it is worth noting that, under the IFAC-IAASB model, many of the practices used and criticised in other cases (e.g. Parmalat³⁸) would be taken outside the auditor’s role or normalised and made acceptable under the procedural approach of their US style standards. As ably put by the Association of Chartered Certified Accounts (ACCA):

“US influenced audit standards are heavily influenced by the ‘tick box’ approach which has the aim of demonstrating that the auditor has not been negligent. In our view, this reduces the essential technical quality of an audit”³⁹

37. This theme is also illustrated in paragraphs 7, 22-24 above and 43-46 below. The process orientated IFAC-IAASB standards create a detailed rules based framework that will also be hard to maintain effectively:

“It is a brave standard setter indeed who can be certain to have covered every possible situation, both current and potential, and to have provided a detailed rule for it. A set of principles⁴⁰ can cover every situation whether foreseen or unforeseen. As I said in my earlier talk, rules encourage avoidance, whereas principles encourage compliance.”⁴¹

38. Another illustration of the effect of prescriptive, process driven standards can be found in Lord Penrose’s report of the Equitable Life inquiry. While Lord Penrose was clear that it was not for the inquiry to enter into the debate on the formulation of appropriate standards, he deemed it appropriate to comment on some of the problems standards can create. One example of this related to SAS 620:

“76. The auditor’s independent obligation to report to the regulator could, in appropriate circumstances, involve investigations into the reserving policies and practices of the actuary. But the obstacles in the way of the auditor have at all material times been significant.”

³⁶ : ISA 240, ‘Professional Skepticism’, paragraph 26 (page 282, Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2005 edition (IFAC))

³⁷ : Accountancy Age, 6 November 2003.

³⁸ : see <http://www.post-gazette.com/pg/05118/495805.stm>

³⁹ : ACCA submission on the DTI consultation on ‘Director and Auditor Liability’ (March 2004)

⁴⁰ : see paragraph 26 above and 50(ii) below by way of example

⁴¹ : Peter Wyman, past President of the ICAEW, extract from a speech at the ICAEW/ICAI joint conference 2002.

In the preceding and subsequent paragraphs,⁴² Lord Penrose set out how the prescriptive drafting of the applicable standards and their thresholds and tests meant that the circumstances enabling an auditor to ‘justify’ reporting to the regulator were likely to be “extreme”.

Risk in relation to future Corporate Scandals

39. Outlined above (e.g. paragraphs 5,7,17-19 and 34-38) are some of the perceived effects/risks of the move to impose IFAC-IAASB standards. While we want reform to improve audits, a shift towards a process driven IFAC-IAASB framework, that is based on and derived from the US model of supporting market pricing and trading, will not achieve that. Nor will it enhance the credibility or reputation of the auditing profession.⁴³ An overview of the differences between the UK and US systems was provided in our earlier paper “Audit Reform: a focus on purpose and transparency”. It is also covered in more detail in a variety of published papers.⁴⁴ In essence the US has a very different system based around Securities Law, market pricing and regulation, while the UK has a system based around incorporation law, stewardship and governance. What may be appropriate in the US, given their reliance on the Securities Act 1933, is clearly not appropriate in the UK under the Companies Act and may be equally inappropriate in the EU.
40. Where is the evidence that the audits in EU corporate scandals would have been more effective under the US style audit that the IFAC-IAASB standards are derived from? The evidence suggests, rather, that the opposite is true and that we may well be importing the risks and problems of the US system.⁴⁵ At a time when scandals have been such a feature of the corporate landscape, any move to reduce the scope, nature and quality of the audit should be seen as a matter of considerable public interest and concern. The adoption of IFAC-IAASB standards and the provision of a legislative basis for them would be the most significant backward step since the audit was introduced into UK Company Law.
41. Shareholders and the public at large are facing a material reduction in a key safeguard against corporate scandals. Given that the IFAC-IAASB standards are based on the US model and these are being embedded in the very different UK and EU systems, there is a valid concern about the risks being created under the guise of global harmonisation. Why harmonise to what are clearly ‘lower’ quality standards both in practice and effect? The incidence of US corporate scandals under a comparable regime needs to be considered, as does the fact that many of the corporate scandals seen in the EU had their roots in the US (e.g. Vivendi, Ahold, Adecco etc).

Proposed UK auditor liability reform is not warranted

42. Given the context and situation outlined in this paper, we do **not** support proceeding with the proposed reform of section 310 of the Companies Act 1985, to allow auditors to secure proportionate liability by contract. Our willingness to accept the proposals was (and remains) specifically linked to re-asserting and consolidating the existing Companies Act principles and related Court rulings (see paragraph 26 above).

⁴² : “Return to an order of the Honourable House of Commons dated 8 March 2004 for the: Report of the Equitable Life Inquiry” The Rt. Hon. Lord Penrose, HMSO ISBN: 0-10-292688-3 (ref: Ch.11, paras 71-77, pages 375-7)

⁴³ : see paragraphs 20-27

⁴⁴ : “Divided by common language. Where economics meets the law: US versus non-US financial reporting models” (June 2005) T.Bush, (http://www.hermes.co.uk/pdf/corporate_governance/commentary/DBCL_proof_5A.pdf) or “How audit practices got muddled in the US and UK” (May 2005) S.Turnbull, Working Paper (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=608241)

⁴⁵ : see, for example, “A Theory of Corporate Scandals: Why the US and Europe Differ”, Prof. John Coffee, Columbia University Law School.

Pursuing liability reform, at the same time as materially reducing the scope and standard of the audit, in a way that Parliament has not scrutinised, can only exacerbate the problems that currently exist and result in an audit of significantly reduced value and standing. Bearing in mind the current Company Law proposal and given the concerns outlined in this paper, a key question has to be: proportionate liability of, and for, what responsibility?⁴⁶

Commercial Conflicts and the Global Firms

43. We are concerned about a possible alignment of interest between the move to adopt IFAC-IAASB standards and the commercial interests of global firms, particularly in the US. This reflects previous concerns that we have raised around the damaging trend in audits and the audit market.⁴⁷ These warrant re-emphasising in this context as being inextricably linked to the issue of US corporate scandals:

*“The Enron scandal is not an isolated accounting failure. Over the past five decades, accountants have changed from watchdogs to advocates and salespersons” Prof. Jay Lorsch, Harvard Business School.*⁴⁸

44. To illustrate the point though, in the Enron case, documents released by the US House of Representative’s Energy and Commerce Committee show how Andersen partner Carl Bass expressed concern and disagreement with accounting methods at Enron. This was long before Enron’s whistle-blower Sherron Watkins sent her memo warning that Enron “could implode in a wave of accounting scandals” in August 2001. After making repeated and strenuous objections to various accounting practices of Enron, Mr. Bass was removed from the Enron engagement at Enron’s request. The “client sees need to replace Carl,” reads one internal memo.⁴⁹ Similar events appear to have been seen at Parmalat.⁵⁰

45. While this is not the main focus of this paper, the way it appears to be inextricably linked with the objectives of imposing IFAC-IAASB standards globally should not be ignored. As a taster of how perverse the situation can become:

*During 2000 and 2001, at a time when HealthSouth Corp.’s finances were spiralling into a \$2.7billion scandal, the company was paying its audit firm more to perform inspections of the cleanliness and physical appearance of HealthSouth’s facilities than it was to undertake its audit. \$2.6m compared to \$2.1m in fact. These are the same auditors who while they had been warned about the fraud back in 1998 had concluded that the “issues raised did not affect the presentation of HealthSouth’s financial statements”.*⁵¹

46. More detail on this theme and related issues, including published views and observations from the corporate sector were covered in our earlier paper “Bringing Audit Back From The Brink (Auditor liability and the need to overhaul a key investor protection framework)” (Feb 2004). As a result we have not sought to repeat them in this context.

⁴⁶ : see Appendix 1 and 2

⁴⁷ : “Bringing Audit Back From The Brink (Auditor liability and the need to overhaul a key investor protection framework)” (Feb 2004), Morley Fund Management

⁴⁸ : FT article, 10 April 2002.

⁴⁹ : see <http://www.tscpa.org/welcome/AcctWeb/acctweb40502.html#1> and http://energycommerce.house.gov/107/news/04022002_527.htm

⁵⁰ : see <http://www.post-gazette.com/pg/05118/495805.stm>

⁵¹ : see <http://www.tscpa.org/welcome/AcctWeb/acctweb111403.asp#1>

Conclusion and recommendations

47. In February 2004, we published our concerns about the state of audit⁵² as part of an ongoing attempt to highlight the seriousness of our concerns about audit given the DTI's focus on limiting auditor's liability. Given subsequent developments (see paragraphs 8-16) and the lack of debate, we published a set of more explicit recommendations⁵³ on the reforms that would be needed to give shareholders confidence in audit practices, and to re-establish the reputation and credibility of the auditing profession.
48. While the ICAEW and Audit Quality Forum are seeking to bridge the gap between UK users of accounts and audit practice (which we welcome), the most fundamental areas of this debate are not within their gift. Attempts to raise these issues and concerns with the DTI have met with no practical success.
49. If nothing is done to address the fundamental concerns outlined in this paper we will have reached a point of no return. The value of the statutory audit will have been undermined, effectively enabling the auditors to be 'righteous by process' with limited procedural audits, providing a reduced safeguard for shareholders and the public more widely. In particular it will have reduced a key safeguard against future corporate scandals.
50. As a result we recommend that:
 - (i) the DTI does not proceed with its Company Law White Paper proposal to reform section 310 of the Companies Act 1985 (allowing auditors to secure proportionate liability by contract);
 - (ii) the DTI should incorporate in its forthcoming Company Law Bill, as previously requested by investors, the purpose of audit articulated by the Law Lords in the Caparo Case (see Appendix 1, section on 'purpose') and reinforce section 236 of the Companies Act 1985 and related provisions (only then should the question of proportionate liability be addressed);
 - (iii) the DTI initiate a review of the APB's imposition of the IFAC-IAASB standards (ISAs) with a view to allowing a proper debate and consultation about their scope, nature and effects, in line with the Better Regulation Task Forces' guidelines; and
 - (iv) the EU should make substantive changes to or remove Article 26 and related provisions (e.g. paragraph 4(a) of the pre-amble) of the proposed 8th Company Law Directive, pending proper debate and analysis of the (detrimental) effects of the IFAC-IAASB standards.

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(June 2005)

Electronic copies of this paper and of "Bringing Audit Back From The Brink (Auditor liability and the need to overhaul a key investor protection framework)" (Feb 2004) and "Audit Reform: a focus on purpose and transparency", (Dec 2004) are available on request by e-mailing: iain.richards@morleyfm.com

⁵² : 'Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)' (Feb 2004)

⁵³ : 'Audit Reform: a focus on purpose and transparency' (Dec 2004)

COMPARISON OF THE UK COMPANIES ACT vs IFAC-IAASB FRAMEWORKS

- i. In our previous papers about audit we have highlighted our concerns about the risk of process driven auditing standards. This paper has sought to run through some of the related issues, developments and risks that the IFAC-IAASB standards create in this context.
- ii. Clearly, given the IFAC-IAASB Handbook of International Auditing, Assurance and Ethics Pronouncements (2005 Edition) runs to 974 pages, this paper can not provide a comprehensive analysis, which would probably require another tome, of equivalent or greater length. Rather it sets out an overview of the ‘users’ perception.
- iii. What the table below seeks to do is illustrate more clearly how some key aspects of the IFAC-IAASB framework are seen to differ from those of the UK’s Companies Act derived framework, in terms of their nature, focus and scope.
- iv. Clearly there is plenty of room for differences of interpretation and even semantics, much as has been seen around the assurance (presumably only ‘reasonable assurance’) that the standards incorporate and embrace the current ‘true and fair view’ concept. See below and paragraphs 17-19 of the main paper, for our understanding of the situation:

	UK CO. LAW FRAMEWORK	-VS-	IFAC-IAASB FRAMEWORK
Nature	<ul style="list-style-type: none"> Public interest and stewardship (s.236 of the Companies Act 1985) Principle and objective (output) based 	-vs-	<ul style="list-style-type: none"> Technical compliance assurance (Handbook of International Auditing, Assurance, and Ethics Pronouncements, 2005 edition (IFAC)) Rules and process (input) based
Purpose	<p>Law Lords ruling in Caparo Industries Plc v Dickman and others [1990] 1 All ER 568 [1990] 2 WLR 358:</p> <p>“It is the auditors’ function to ensure, so far as possible, that the financial information as to the company’s affairs prepared by the directors accurately reflects the company’s position in order:”</p> <ul style="list-style-type: none"> “first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital)” <p><u>and</u></p> <ul style="list-style-type: none"> “secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company’s affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.” 	-vs-	<p>IFAC-IAASB standards as set out in ISA200 as amended by ISA700 (revised):</p> <p>The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework:</p> <ul style="list-style-type: none"> a ‘reasonable assurance engagement’ as defined in the International Framework for Assurance Engagement (ISA 200) (the IFAE objective is stated as a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement) and with the audit plan developed in order to reduce audit risk to an acceptably low level. (ISA300) the auditor should communicate audit matters of governance interest arising from the audit with those charged with governance of an entity. (Board of directors as those entrusted with the supervision, control and direction of an entity). (ISA260)

	UK CO. LAW FRAMEWORK	-VS-	IFAC-IAASB FRAMEWORK
Principle or process	<p>Principle based:</p> <ul style="list-style-type: none"> The <u>overriding</u> requirement of the Act is that the financial statements must give a true and fair view of the state of affairs of the company / group (sections 228, 230 and 236). Accounting policies to be applied consistently from year to year (Sch 4, Pt.II); The amount of any item in the accounts must be determined on a prudent basis (Sch4, Pt.II). 		<p>Process based:</p> <p>The term “scope of an audit” refers to the audit procedures that, in the auditor’s judgement and based on the ISAs, are deemed appropriate in the circumstances to achieve the objective (see ‘purpose’ above) of the audit. (ISA200)</p> <p>The auditor should conduct an audit in accordance with International Standards on Auditing - ISAs contain basic principles and essential procedures (ISA 200)</p> <p>See also paragraph 7 of the main paper</p>
The client	<p>The current shareholders of the company (s.236(1) of the Act) and The “interest and protection of the public” (Parliamentary Debates, House of Lords, 18 Feb 1947 col. 745)</p>	-vs-	<p>The Board of Directors or the appropriate representative of senior management, with whom the auditor agrees the terms of engagement and any variation to it (ISA210)</p>
Audit Opinion	<p>section 236 of the Companies Act 1985:</p> <p>An absolute opinion based on the exercise of ‘skill and care’ as to whether the financial statements <i>give</i>:</p> <ul style="list-style-type: none"> a true and fair view of: <ul style="list-style-type: none"> (i) the state affairs of the company/group, and (ii) of the profit and loss of the company/group; and subject to the above, have been properly prepared in accordance with the Act. 	-vs-	<p>Provide reasonable assurance as to whether the financial statements <i>are</i>:</p> <ul style="list-style-type: none"> presented fairly, in all material respects in accordance with the applicable financial reporting framework (i.e. IFRS). <p><i>[IFAC-IAASB standards allow the words “true and fair view” to be used instead of the first bullet point but on the explicit basis:</i></p> <ul style="list-style-type: none"> <i>that under ISA it is deemed to be equivalent; and</i> <i>even if obliged to use the words “true & fair view” the actual responsibilities remain those in IFAC-IAASB’s ISAs.]</i>
Approach to audit	<p>It is the <i>duty of the auditor</i> to carry out such investigation as will enable them to form an opinion on:</p> <ul style="list-style-type: none"> Whether proper accounting records (broad definition in section 221) have been kept and proper returns; and that they and the financial statement are in agreement. Auditors must report additionally where they are not. <p>And to report if the accounts are not consistent with the information given in the director’s report (scope set out in section 235) - which must contain a fair review of:</p> <ul style="list-style-type: none"> (i) The development of the business of the company and its subsidiaries during the year; and (ii) Their position at the end of it. 	-vs-	<p>An audit involves “performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.”</p> <p>The procedures selected depend on the auditor’s judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.</p> <p>(see section on Fraud below)</p>

	UK CO. LAW FRAMEWORK	-VS-	IFAC-IAASB FRAMEWORK
Scope and quality of information required	<p>Obtain:</p> <ul style="list-style-type: none"> • <u>all the information and explanations</u> which, • <u>to the best of their knowledge and belief</u> • <u>are necessary</u> for the purposes of the audit. 	-vs-	<p>Obtain:</p> <ul style="list-style-type: none"> • <u>the evidence</u> that • is <u>sufficient and appropriate</u> • to <u>provide a basis</u> for the audit opinion. <p>An audit performed in accordance with ISAs rarely involves the authentication of documents and unless the auditor has reason to believe the contrary, the auditor ordinarily accepts records and documents as genuine (ISA240) (see paragraphs 34-35 of the main paper).</p> <p>If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit (ISA330)⁵⁴</p> <p><i>Consider the application of this framework in the context of a case like Barings. In the actual case the JDS appeals tribunal confirmed the view that:</i></p> <p><i>"We do not consider that C&L London performed sufficient tests to satisfy themselves that the controls over payments of margin and the associated accounting balances were operating effectively. In their testing, in December 1994, of the controls of the Futures and Options Settlements Department, managed by Granger, they undertook insufficient compliance testing and relied inappropriately on their perception of Granger's experience."</i></p> <p>http://www.castigator.org.uk/wordfiles/coopersappeal_tr.rtf</p>
Fraud	There is no exclusion on fraud	-vs-	<p>Although fraud is a broad legal concept, for the purposes of ISA, the auditor is only concerned with fraud that causes a material misstatement in the financial statements. (ISA240)</p> <p>Subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs as the audit test is "reasonable assurance". (ISA240)</p>

⁵⁴ : Consider the potential implications of only having to check some key control every three years in terms of corporate crisis and scandals such as AIG, Cable & Wireless or Parmalat. While a control may not have changed, the issue is more likely to be one of whether they are being operated and implemented effectively, particularly should a fraud arise.

Auditor Liability – How the different models are structured and the outcomes

Introduction

Given the concern that a principal motivator and effect of the IFAC-IAASB framework seems to be the reduction of risk from undertaking audits, it is worth considering how the traditional UK system might compare to a US derived one. We have therefore outlined below an illustration of the difference in terms of traditional UK liability and the liability that would be created under a US type system on which IFAC-IAASB is based.

To illustrate this we have sought to model the broad effect of each system in relation an actual case – Barings. For those who want a more detailed insight into the case and the audit failing we recommend the case reports available on the Joint Disciplinary Committee's website: <http://www.castigator.org.uk/>

Background

Most people are aware of the broad nature of Barings case and Nick Leeson's actions. Barings collapsed in Feb 1995, due to the derivatives that Leeson was concealing creating a massive loss to the Bank. The board of the Bank appears to have assumed Nick Leeson was doing risk free arbitrage, as opposed to 'gambling' with derivatives.

The loss that resulted was the outcome of a chain of events that compounded each other up to the point of the Kobe earthquake. The Nikkei dived and the resulting derivative losses broke Barings, which could not pay the derivative settlements required.

Auditor liability

In relation to audit, in the UK, the Law looks at the consequential loss, from the point when a fraud that harms the company, had it been identified earlier by the auditor, could have been prevented. Against this, the focus of IFAC-IAASB ISA model is the same as that in the US, where the focus and scope of auditors' responsibility is only on "material misstatement in the financial statements", i.e. in terms of liability the focus is on the error in the signed off accounts, not the losses that result.

For the purposes of these scenarios we use the following:

- Barings' balance sheet contained a smallish but growing, material error at the time of being signed off for the year ended 31 December 1993, which later turned into a significant total loss of £828m, which broke the Bank.
- The "error" in Baring's last ever published, audited financial accounts (a mis-matched debtor obscuring Leeson's losses) was £23m as at 31 December 1993.
- The 1994 Accounts had been audited but were never signed-off (the effects of the Kobe earthquake brought everything to a head), but the error in the accounts due to Leeson's trading, as at 31 December 1994, had risen to £208m.
- The subsequent, additional losses to Barings that resulted were £805m

Scenario 1:

Current UK Model

(true and fair view, non-restrictive engagement letters, no IFAC-IAASB ISAs)

- Failure to detect the 'first loss' (£23m) creates potential (joint & several) auditor liability for the consequential loss to the company (£805m).
- The £23m loss behind the 1993 financial statements was not the responsibility of the auditor, but in failing to identify £23m in losses, it became the basis of an audit failure which allowed further losses to be 'incubated'.
- Therefore, while the error in the financial statement was 'only' £23m, the effect of that audit failure, in value terms, is the £805m consequential loss, two different things.
- Under the UK system the audit opinion on "the true and fair view of the state of affairs" and the auditor's duty to the shareholder body as a whole, is to prevent that consequential loss in the business itself, i.e. the auditor potentially becomes joint & severally liable for the £805m consequential loss, not the 'first loss'.

This dynamic creates a very strong incentive for the auditor to ascertain the facts behind the numbers (see paragraphs 34-36 and 44-47 of the main paper).

Scenario 2

US / IFAC-IAASB style model

(IFAC-IAASB ISA based standards, listed and registered in the US, engagement letters which limit the auditor's duty to the company, throwing it back onto the directors).

- The auditor has a more limited duty of care to the company for actual loss to the company when it fails to detect something.
- IFAC-IAASB have evolved around the requirements of s.12 (a) (2) of the 1933 Securities Act, which is only concerned with "material misstatement" in the accounts linked to the point when a security is exchanged (This is the basis on which the IFAC-IAASB standard "presents fairly in material respects" has been developed).
- The market "error" is only the misstatement error in the accounts at the audited balance sheet date (£23m, i.e. the IFAC-IAASB model cuts liability exposure by 97%).
- However, with the US style model this reduces even further as it is only those shareholders who:
 - (i) hold shares when the share price crashes; **and**
 - (ii) who bought them after the "wrong" balance sheet was signed off

who have an actual claim (say 10% of shareholders), i.e. potential exposure to liability is reduced to £2.3m.

- This can, perhaps, be reduced even further by the nature of the restrictive engagement letters and the exclusion of the scope of responsibility for fraud (under IFAC-IAASB its fraud in the financial statements not fraud in the business).

- Bear in mind also that the IFAC-IAASB standards specifically provide that the subsequent discovery of a material misstatement of the financial statements resulting from fraud does not, in and of itself, indicate a failure to comply with ISAs as the audit test is “reasonable assurance” (ISA240).

In this context, it should be apparent why there is a view that the promulgation of the IFAC-IAASB framework may be motivated by a desire to reduce responsibility, accountability and exposure to liability.

Additional defences for auditors

In either of the above scenario above, as matters currently stand in the UK, auditors are not without a range of existing protections, including:

- (i) The effect of Limited Liability Partnerships.⁵⁵
- (ii) The principle of contributory negligence, which enables auditors to make a defence based on the negligence of other parties.⁵⁶ (The ICAEW itself has acknowledged that this would have “a dramatic effect on limiting the effect of negligence”)⁵⁷
- (iii) The right of action by auditors against other parties.
- (iv) The existing right under the Companies Act to obtain relief from liability from the Courts.⁵⁸

Once you add proportionate liability, particularly under the IFAC-IAASB model, the effects on the extent of auditor liability are, potentially, astounding.

Thinking about Barings, ask yourself this: is getting reasonable assurance about compliance, in material respects, with IFRS, really what you would have been looking for and expecting from the Statutory Auditor?

⁵⁵ : See the ‘Limited Liability Partnerships (LLP) Act 2000’ and associated regulations, available in the Company Law and Investigations section of the DTI website (www.dti.gov.uk).

⁵⁶ : See House of Lords Judgement in Banque Bruxelles Lambert v Eagle Star Insurance (1997) AC 191

⁵⁷ : The Accountant, August 1996 (page 11)

⁵⁸ : Section 727 of the Companies Act 1985