Chapter 2

The structure of the profession

Learning objectives

2.1 Identify the attributes of professional status and describe to what extent they exist in public accounting.

2.2 Describe the regulation of auditing and its subject matter.

2.3 Explain the impact of internationalisation on auditing.

2.4 Outline the characteristics of the professional bodies and accounting firms engaged in the auditing profession and describe the internal structure of an audit firm.

2.5 Identify the elements of quality control within audit firms and explain practice-monitoring programs.

2.6 Explain the concepts of reasonable care and skill, and negligence.

2.7 Explain the auditor's legal liability to clients.

2.8 Explain the auditor's liability to third parties

2.9 Describe alternative methods used to limit the auditor's liability.

Major chapter sections

Professional status of the auditor

Regulation of auditing and of the subject matter of audits

Internationalisation of auditing

Profile of the auditing profession and of audit firms

Quality control

Reasonable care and skill, and negligence

Liability to clients

Liability to third parties

Limitation of liability

Lecture plan

Since many students are interested in a career in public accounting, we normally spend some time covering the items in this section. In particular, we like to go over the status of auditing as a profession and the role of government and professional associations in the auditing and assurance services environment.

You should outline the learning objectives for this chapter, and also walk them through how this chapter fits into the flowchart of the overall auditing and assurance framework.

[Use slides 2-1 to 2-3]

LO 2.1: Professional status of the auditor

It is important that students realise that auditing is a profession and, therefore, like all professions, must exhibit the attributes of systematic theory, professional authority, community sanction, regulative codes and culture.

[Use slides 2-4 and 2-5]

LO 2.2: Regulation of auditing and of the subject matter of audits

It should be pointed out to students that the audit and assurance function is carried out in a complex environment, composed of interrelationships between government and professional organisations and individual auditors and audit firms. Students should be made aware of the main government and independent agencies that regulate auditing and the subject matter of audits, and the role played by the accounting bodies.

[Use slides 2-6 to 2-13]

LO 2.3: Internationalisation of auditing

Business is now conducted globally and this has contributed to the development of international auditing practices. Introducing students to the importance of the global environment at this early stage prepares them for considering this aspect in relation to client business risk later on.

[Use slides 2-14 to 2-16]

LO 2.4: Profile of the auditing profession and of audit firms

We review the three key professional accounting bodies that dominate the auditing profession in Australia. We then briefly review the structure of firms (e.g. sole trader, partnership or authorised audit company), the categorisation of firms (e.g. Big 4, national firms, regional firms and local firms) and the types of services (e.g. audit, tax, management consulting, internal audit, and accounting and insolvency services) that are offered by public accounting firms. We also give an example of the internal structure of an audit firm.

[Use slides 2-17 to 2-24]

LO 2.5: Quality control

Students should be made aware at this stage that quality control procedures are essential to ensure auditors meet their responsibilities. We discuss the overall requirements of ASA 220 (ISA 220), ASQC 1 (ISQC1) and APES 320 and the key quality control procedures used by the professional accounting bodies, including practice reviews and professional development.

[Use slides 2-25 and 2-29]

LO 2.6: Reasonable care and skill, and negligence

We usually start our discussion of this topic by referring to the agency or stewardship notions covered in Chapter 1. It is then easy to show the students how parties to the contract (principals and agents) should have recourse against the auditor if an inappropriate auditor's report is issued.

Students should realise that an auditor does not guarantee their work product. However, the auditor is required to perform professional services with due care. When the auditor fails to carry out contractual arrangements with the client, they can be held liable for breach of contract and/or negligence.

When discussing the concept of reasonable care and skill we use the quote from Lord Bridge in the *Caparo* case. When discussing the auditor's liability under common law for negligence, we discuss the elements for establishing auditor liability for negligence:

1. the duty to conform to a required standard of care
2. failure to act in accordance with that duty
3. actual loss or damage to client
4. a causal connection between the auditor's negligence and the client's damage.

[Use slide 2-30 to 2-32]

LO 2.7: Liability to clients

We point out that the auditor's liability for breach of contract arises from the obligations included in the engagement letter.

It is important that students realise that an auditor's liability to clients can arise both in contract and in the tort of negligence. We discuss the main cases that have led to the development of the auditor's liability to clients. Particular emphasis is placed on the *Pacific Acceptance* case, as this was the first time the court gave a decided indication of what was expected under reasonable care and skill.

We also discuss the development of the concept of contributory negligence here, emphasising the AWA case (1995), which establishes the principles of contributory negligence.

[Use slides 2-33 to 2-36]

LO 2.8: Liability to third parties

It is important for students to know that auditors' liability to third parties for negligence is very complex and that court rulings are not always consistent.

It is important for students to be aware of the history of the development of the current position regarding auditors' liability to third parties. Therefore, we go through some of the major cases, beginning with *Donoghue and Stevenson* and going through to *Esanda*, and discuss the concepts of special relationship, reasonable foreseeability and proximity. The amount of time spent here will depend on how much of this material students have already covered in business law subjects.

[Use slides 2-37 to 2-41]

We also point out to students that legal decisions have resulted in third-party requests for privity letters.

[Use slide 2-42]

Students should also be made aware that although the auditor's liability to third parties under the tort of negligence now seems very narrow and is limited to situations where the auditor induced the third party to rely on the auditor's report, the auditor may also have a potential liability under the Commonwealth *Competition and Consumer Act 2010* or the relevant state Fair Trading Acts and under the *ASIC Act*.

[Use slides 2-43 to 2-44]

Students should also be made aware of the fact that auditors may be subject to criminal prosecution, although this is rare.

[Use slide 2-45]

LO 2.9: Limitation of liability

We find that a useful way of introducing this topic is to refer to the substantial litigation against auditors over the past twenty years or so and refer to the claims made in cases in Australia, such as *Tricontinental,* the *State Bank of South Australia*, *Westpoint*, *MFS* and *Centro*. We also discuss the problems of operating as a partnership and of obtaining satisfactory professional indemnity insurance.

We then discuss the arguments for and against limiting the auditor's liability and the different schemes introduced through CLERP 9.

[Use slides 2-46 to 2-47]

Summary

We provide a summary slide of the main learning takeaways in this chapter.

[Use slide 2-48]

SOLUTIONS

REVIEW QUESTIONS

2.1 The essential attributes of a profession are systematic theory, professional authority, community sanction, regulative codes and a culture. The auditing profession satisfies these essential attributes as follows:

- *Systematic theory*: The underlying theory of the auditing profession consists of auditing theory and accounting theory. Knowledge of systematic theory can be achieved best through formal education and a tertiary education is considered a prerequisite for people entering the auditing profession. They are then required to complete the education program of one of the three accounting bodies (Chartered Accountants Program, CPA Program or NIA Program) and to undertake continuing professional development throughout their audit career.
- *Professional authority*: To be a registered company auditor a person must, among other things, be a member of one of the three recognised accounting bodies, each of which controls admission to their own organisation.
- *Community sanction*: In Australia only registered company auditors are permitted to render external auditor's opinions on the financial reports of companies.
- *Regulative codes*: Regulation of the auditing profession is directed at two areas: technical and ethical. Auditing standards govern the technical work of the auditor, while the ethical rules govern the auditor's ethical behaviour.
- *Culture*: Auditors are expected to behave in a way that is in accord with the Code of Ethics for Professional Accountants, including exhibiting integrity, independence, objectivity and confidentiality and acting in the public interest. New members of the profession must learn what is expected of them or they will not be accepted as colleagues by their associates.

2.2 The AUASB, which is an independent statutory body, develops and maintains auditing and assurance standards, which are applicable to all audits. For audits undertaken under the *Corporations Act 2001*, the standards have legal authority. Failure to observe these standards may expose a member to investigation and disciplinary action from the Australian Securities and Investments Commission (ASIC) through the Companies Auditors and Liquidators Board (CALDB).

For other audit and assurance engagements there is a mandatory obligation for members of the accounting bodies to follow the standards contained in APES 210 *Conformity with Auditing and Assurance Standards*, issued by the Accounting Professional and Ethical Standards Board (APESB). Failure to follow these standards in engagements can result in disciplinary action by the accounting bodies.

2.3 A review of the Framework of Pronouncements indicates the following structure of auditing and assurance standards:

- The auditing and assurance standards issued by the AUASB are divided between assurance and no assurance standards.

- The assurance standards are governed by the Framework for Assurance Engagements, which provides a general framework for all assurance services, and defines and describes the elements of an assurance engagement.
- The assurance standards are split into three groups, comprising those relating to audits of historical financial information; reviews of historical financial information; and other assurance engagements.
- The assurance standards on historical financial information (financial reports) contain a detailed infrastructure of standards. These are the ASA (ISA) standards that cover issues such as client acceptance, planning, risk assessment, evidence gathering and reporting.

2.4 Sections 292–306 of the *Corporations Act 2001* require directors to prepare annually a financial report and any other information or explanation as is necessary to give a true and fair view in accordance with the accounting standards. Further, s. 295A requires the chief executive officer and chief financial officer to attach to the company's financial report a declaration that indicates whether or not, in their opinion, the financial report and notes to the financial report give a true and fair view. Section 295(4)(c) also requires the directors to state whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable. These representations by the directors are subject to audit.

The auditor's basic obligation under s. 308 of the *Corporations Act 2001* is to report to the members of the company on the financial report presented by the directors at the annual general meeting, and on the accounting and other records relating to that financial report. The specific responsibility of the auditor is to report an opinion as to whether the financial report is in accordance with the law, including compliance with accounting standards (s. 296), and provides a true and fair view (s. 297).

2.5 Globalisation of business has meant that there is a need for harmonisation of the working methods of auditors in different countries and the adoption of international auditing standards. Multinational clients want to be assured that, all over the world, members of the audit firm will be able to communicate easily on the outcomes of the audit and will apply one set of quality criteria to ensure the quality of the audit. Uniformity of the main elements of the audit process on an international scale also enables audit firms to increase the efficiency and effectiveness of the audit process worldwide.

IOSCO, which is the International Organisation of Securities Commissions, has pushed strongly for the adoption of international auditing standards for the audit of companies listed on world stock exchanges.

2.6 A member of the Chartered Accountants ANZ, CPA Australia or the IPA may be disciplined if they have:

- been guilty of any breach of their charter, constitution, by-laws or pronouncements;
- been guilty of dishonourable practices or conduct derogatory to the profession of an accountant or conduct that is not in the best interests of that body or its members;
- failed to observe a proper standard of professional care, skill and competence;

- become insolvent under administration;
- are declared of unsound mind or becomes incapable of managing their own affairs; or
- fail to pay any subscription or other sum payable.

The accounting bodies have disciplinary procedures that include the right to impose forfeiture of membership, suspension from membership, fines, censure or admonishment on any member found guilty of unprofessional conduct.

2.7 The largest international audit firms, consisting of PricewaterhouseCoopers, EY, KPMG and Deloitte, are known as the 'Big Four'. In the US, more than 90 per cent of the 'Fortune 500' companies and thousands of smaller entities are audited by the Big Four. In the UK, the Big Four account for two-thirds of the audit market. In Australia, the Big Four's annual revenues in 2013 averaged $1199 million, which was 3 to 4 times the size of the next largest mid-tier audit firm.

2.8 The quality control requirements for each audit engagement are set out in ASA 220.8-25 (ISA 220.8-25) as follows:

- *Leadership:* The engagement partner must take responsibility for overall quality control on each audit engagement.
- *Relevant ethical requirements*: The engagement partner must remain alert for evidence of non-compliance with relevant ethical requirements and take appropriate action if it occurs. Further, the engagement partner must form a conclusion on compliance with independence requirements for the engagement.
- *Acceptance and continuance of clients*: The engagement partner must be satisfied appropriate procedures have been followed regarding acceptance and continuance of the client.
- *Assignment of engagement teams*: The engagement partner must be satisfied the engagement team and any experts have the appropriate competence and capabilities for the engagement.
- *Engagement performance*: The engagement partner must take responsibility for the direction, supervision and performance of the audit.
- *Monitoring:* The engagement partner must consider whether the results of the firm's monitoring process affect this engagement.
- *Documentation*: The engagement partner must ensure that there is appropriate documentation of compliance with ethical requirements for the engagement; conclusions on compliance with independence requirements for the engagement; conclusions regarding acceptance and continuance of the engagement; and consultations undertaken during the engagement.

2.9 Audit firms have internal reviews of audit engagements to ensure that office policies are adhered to with regard to control over the quality of work, including adherence to auditing standards and auditor independence. Under the process of internal review, auditors may have their engagements periodically reviewed by another auditor from within the same firm or office. ASQC1.48 (ISQC1.48) and APES 320.106 require inspection on a cyclical basis of at least one completed engagement for each engagement partner.

2.10 Reasonable care and skill is the standard of skill and care appropriate to the auditor's professional status, which is considered reasonable in the circumstances as they then exist. Auditing standards provide a guide as to what is meant by reasonable care and skill. However, the courts, in cases such as *Pacific Acceptance*, have indicated that compliance with professional standards will provide persuasive rather than conclusive evidence of reasonable care and skill. The courts will assess the reasonableness of the standards under specific circumstances, and therefore the courts will determine what is reasonable care and skill. Further, professional standards and practice must reflect changes in the economic and business environment if they are to be used as a guide to what constitutes reasonable care and skill.

2.11 The matters that must be proved to the satisfaction of a court before a claim of negligence can succeed are that:

- a duty of care was owed to the plaintiff (that is, that there was reasonable foreseeability and proximity)
- the auditor was negligent (that is, that reasonable care and skill were not exercised by the auditor)
- the plaintiff relied on the auditor
- the plaintiff suffered a quantifiable loss as a result of the auditor's negligence
- the loss was suffered as a result of relying on the auditor (that is, causation).

2.12 Auditors have a duty of care to their clients and therefore are liable to their clients for their audit work, as there is a contract between the client and the auditor that has an implicit term that the auditor will exercise reasonable care and skill in undertaking the audit. In addition, there is a duty of care under the tort of negligence, due to the proximity between the auditor and the client.

2.13 The AWA case established for the first time in Australia that contributory negligence by the client is acceptable as a reason for reducing the damages attributable to an auditor. For contributory negligence to apply, there must be a failure by the plaintiff to meet the standard of care required for its own protection, which contributed to bringing about its loss.

2.14 The best defence available to auditors against any suits brought under common law by third parties would be that a duty of care was not owed to the third party. If it were held that a duty of care did apply, then the best defence would be to ensure that the work performed had been completed in a professionally competent manner and in accordance with Australian Auditing Standards. A strong quality control system within the audit firm is also a major defence.

More specifically, the following defences would be available to auditors:

- a duty of care was not owed to the plaintiff (i.e. there is no reasonable foreseeability and proximity)

- the auditor was not negligent (i.e. reasonable care and skill was exercised by the auditor)
- the plaintiff did not rely on the auditor
- the plaintiff did not suffer a quantifiable loss as a result of the auditor's negligence
- the loss was not suffered as a result of relying on the auditor (i.e. causation)
- the plaintiff (client) failed to meet the standard of care required for its own protection, which contributed to bringing about its loss (contributory negligence).

2.15 Section 18 of the *Commonwealth Competition and Consumer Act 2010* and similar provisions in each of the state Fair Trading Acts prohibit misleading and deceptive conduct. Auditors may be sued under these provisions if it is considered that the auditor's report is misleading or deceptive. An application by the auditors in the Esanda case for the plaintiff's claim under the South Australian *Fair Trading Act 1987* to be dismissed, on the basis that the legislation does not apply to auditor's reports, was rejected.

Also, s. 50 of the *ASIC Act 2001* enables ASIC to take legal action for damages in the public interest. This may include actions against auditors and directors where losses were suffered by investors due to negligent or illegal behaviour.

2.16 The changes to limit the auditor's liability that were implemented through CLERP 9 and the professional standards legislation include the following:

- *A statutory cap*: This is where a statutory limit is placed on auditors' liability. This has been introduced by the professional standards legislation with a cap of 10 times the audit fee, up to a maximum of $75 million.
- *Incorporation:* This involves letting audit firms incorporate and operate as authorised audit companies. This allows members of the audit firm, other than the auditor signing the report, to have their liability limited to their capital invested in the firm.
- *Proportionate liability*. This means that the auditor is liable only for the proportion of the loss suffered by the plaintiff that was the responsibility of the auditor.

These reforms were introduced because it was argued that unlimited liability was unfair and meant that auditors were reluctant to carry out audit-related engagements that were in the public interest, for fear of litigation. Also, unlimited liability and escalating claims had resulted in public liability insurance for auditors becoming extremely expensive and sufficient cover impossible to obtain. Further, limited liability reforms such as incorporation and proportionate liability had already been introduced in the UK, the US and Canada.

DISCUSSION PROBLEMS AND CASE STUDIES

2.17 (a) All members of Chartered Accountants ANZ and CPA Australia are required to satisfy a minimum of 120 hours of structured Training and Development (T&D) or

Continuing Professional Development (CPD) averaged over three years, with a minimum of 20 hours to be undertaken annually.

(b) These T&D or CPD obligations are intended to:

- maintain and improve technical knowledge and professional skills, including keeping up with the pace and volume of changing technology and knowledge
- provide reasonable assurance to the community that members have the technical knowledge and professional skills to perform the services they provide.

2.18 ASIC is the administering authority for the *Corporations Act 2001* and undertakes audit inspections to determine whether auditors are complying with the auditing standards. The CALDB determines whether a registered auditor has failed to carry out his or her duties properly or is not a fit and proper person to be registered. ASIC may make applications to the CALDB to determine whether auditors have breached the *Corporations Act 2001*. The CALDB has the power to impose penalties if it determines that registered auditors have failed to carry out their duties properly or are not fit and proper persons to be registered. Penalties may include suspension or cancellation of the auditor's registration, the imposition of restrictions on conduct or an admonition.

In addition, Chartered Accountants ANZ, CPA Australia and the IPA conduct quality review programs. The reviewers consider the policies and procedures established by the member to ensure compliance with professional standards and review client files. Failure to comply with auditing standards could result in the accounting bodies applying their disciplinary provisions, which include forfeiture of membership, suspension from membership, fines, censure or admonishment.

2.19 The globalisation of business and increased international trade have contributed to the development of international auditing practices. There is a worldwide move towards harmonisation and convergence of international accounting and auditing standards.

Most countries carefully consider the International Standards on Auditing (ISAs), issued by the International Auditing and Assurance Standards Board (IAASB), when developing their own standards. IAASB is an independent body that develops standards and guidance for audit and assurance services. In Europe and Australia, international accounting and auditing standards have been adopted since 2005.

The International Federation of Accountants (IFAC) supports IAASB and guides efforts to develop technical (accounting and auditing) and ethical standards. Members include 179 accounting bodies (including the Chartered Accountants ANZ, CPA Australia and the IPA) in 130 countries. It has made considerable progress towards the adoption of the international auditing standards by member bodies.

IFAC has been supported in this role by the International Organization of Securities Commissions (IOSCO). Endorsement from IOSCO will mean that securities exchanges around the world will accept financial reports and other documents that have been prepared and audited in accordance with international standards.

2.20 (a) The auditing standards apply in the same manner to members of the accounting bodies whether they work for a small local audit firm or for a major audit firm.

(b) The fundamental principles of APES 110 are applied the same to all members, whatever type of organisation they work for, and are set out in part A of APES 110. Due to the different types of work, relationships and conflicts that members may face, depending on whether they work for a professional accounting firm or in business, APES 110 has section B that applies to Members in Public Practice and Part C that applies to Members in Business.

2.21 This team structure approach is used, as overall it is the most efficient way of doing the audit, with the advantages outweighing the disadvantages.

Advantages of using a team structure include the following.

- It is efficient, as less complex tasks can be delegated to more junior staff, allowing partners and managers to concentrate on areas of high risk.
- It ensures that the final opinion is supportable, as evidence is often considered by a number of individuals prior to determining the auditor's opinion.
- It allows for onsite training of staff.
- It ensures proper supervision of staff.

Disadvantages of using a team structure include the following:

- The full review process might add little value to the audit evidence, as research suggests that the majority of points raised at the assistant to senior level were of an administrative nature.
- Many of the issues are now too complex for staff with little experience to understand. (However, this is a Catch-22 argument, as staff only get the experience by doing the work.)

2.22 You would need to look at policies and procedures for the following areas that APES 320.10-11 and ASQC 1.16-17 (ISQC 1.16-17) require all audit firms' systems of quality control to address:

- *Leadership responsibilities for quality within the firm*: Is there promotion of an internal culture recognising that quality is essential in performing engagements, including requiring the audit firm's CEO or managing board of partners to take responsibility for the firm's system of quality control?
- *Relevant ethical requirements*: Are there policies and procedures that provide reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including independence?
- *Acceptance and continuance of clients*: Are there policies and procedures covering the matters to consider when deciding on whether to accept or continue with a client?
- *Human resources*: Are there policies and procedures that provide reasonable assurance that the firm has sufficient personnel with competence, capabilities and commitment to ethical principles to perform engagements and enable the issuing of appropriate reports.
- *Engagement performance*: Are there policies and procedures that provide reasonable assurance that engagements are performed in accordance with auditing standards, ethical rules and legal and regulatory requirements and that engagement

partners will issue appropriate reports? This will include establishing policies and procedures for appropriate engagement quality control review.

- *Monitoring*: Are there policies and procedures that provide reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively? This will include internal reviews.
- *Documentation*: Is appropriate documentation required to provide evidence of the operation of each element of its system of quality control?

2.23 Under ASQC 1.18 (ASQC 1.18) and APES 320.16(a), for a firm to promote an internal culture based on quality, the audit firm's CEO or managing board of partners is required to take ultimate responsibility for the firm's system of quality control. Buckley & Howard has given sole responsibility for quality control to a new professional practice manager.

Under ASQC 1.A28 (ISQC1.A28) and APES 320.52, the establishment of policies and procedures that address performance evaluation, compensation and promotion (including incentive system) with regard to its personnel, is required to demonstrate the firm's overriding commitment to quality. Buckley & Howard does not have a formal performance management appraisal system or policy, and appraisals are very infrequent.

Under ASQC 1.A26 (ISQC 1.A26) and APES 320.50, the continuing competence of an audit firm's personnel depends to a significant extent on staff receiving an appropriate level of continuing professional development, so that they maintain their knowledge and capabilities. Effective policies and procedures should emphasise the need for continuing training for all levels of the audit firm's personnel, and should provide the necessary training resources and assistance to enable personnel to develop and maintain the required competence and capabilities. While Buckley & Howard encourage staff to improve their technical ability, they are not providing any staff training to assist them.

Under ASQC1.48 (ISQC1.48) and APES 320.106, inspection is required on a cyclical basis of at least one completed engagement for each engagement partner. The length of the review cycle is not set and depends on many factors, including the size of the firm, the complexity of the firm's practice and the risks associated with the firm's clients. However, an example given in ASQC1.A66 (ISQC1.A66) and APES 320.109 is a three-year cycle. Buckley & Howard is only reviewing a sample of engagements and is not specifically reviewing each engagement partner. Also, completing the reviews every five years is longer than the example given in the standard and appears to be too infrequent.

2.24 Under ASQC 1.43–44 (ISQC 1.43–44) and APES 320.89–90, the audit firm must establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, and where necessary discussing them with the engagement quality review partner. Further under ASQC 1.37 (ISQC 1.37) and APES 320.73, all significant matters should be discussed with the engagement quality review partner. John Little did not discuss the issue, which is a significant audit issue and the subject of a disagreement between members of the audit team, with anyone before making his decision.

Under ASQC 1.30-31 and APES 320.54-57, the firm should consider the procedures for the assignment of an engagement team and consider the requirements for independence set out in ASQC 1.21 and APES 320.24. The close friendship between John Little and Sam Harris creates a familiarity threat to independence and safeguards should be put in place to ensure that there is no breach of independence, such as not having John Little as part of the audit team for the audit of Vacation Pty Ltd.

2.25 The concept of 'reasonable skill and care' has been discussed in a number of cases such as London and General Bank, Kingston Cotton Mills, Thomas Gerrard & Son and Pacific Acceptance. These cases have indicated that 'reasonable skill and care' is a dynamic concept that will be judged based on the skill and care that a 'reasonable auditor' would employ under the circumstances. For example, at the time of the *Kingston Cotton Mills* case in 1896, it was considered appropriate for an auditor to rely on the representations of management. However, by the mid-nineteenth century this was no longer considered adequate, as was indicated in *Thomas Gerrard & Son*.

Moffitt J in the *Pacific Acceptance* case, indicated that auditors have a duty to use reasonable care and skill. Moffitt indicated that reasonable care and skill included among other things that auditors:

- have a paramount duty to check and see for themselves—reliance on independent sources or the client's personnel is an aid to, and not a substitute for, the auditor's procedures
- should audit the whole year
- should closely supervise and review the work of inexperienced audit staff
- should properly document procedures in a written audit program which is amended when conditions change
- have a duty to warn and inform
- should take further action if their suspicion is aroused by the discovery of a large number of irregularities
- plan the audit such that if a material error or fraud exists the auditor has a reasonable expectation of discovering it.

Professional standards also provide a guide as to reasonable care and skill and ASA 500 (ISA 500) indicates that evidence is more reliable when it is obtained directly by the auditors themselves.

2.26 The following actions by Graham Young are likely to result in the court deciding that he did not exercise reasonable care and skill, as they represent breaches of accepted practice, as indicated in the auditing standards.

- Hiring two accounting students who have inadequate training and experience and not supervising or directing the work performed is a breach of quality control requirements (ASA220/ISA 220).
- Failing to gain the required understanding of the accounting system and related internal controls (ASA 315/ISA 315).
- Failing to ensure that the auditor obtained sufficient appropriate audit evidence—just checking mathematical accuracy and relying on client representations does not meet this requirement (ASA 500/ISA 500).

2.27 Auditors are obliged to exercise reasonable care and be competent in their undertakings. Failure to meet the relevant standards constitutes negligence and the auditor may be held liable to their client for the damages resulting from their negligence.

Sarah has a duty of care to her client, Sloan, under both the law of contract and the tort of negligence. Therefore, Sloan could sue and recover for the loss caused by the negligent performance of the engagement by Sarah.

2.28 (a) Tran & Associates has a duty of care to its client, Easyrider, under both the law of contract and the tort of negligence. Therefore, Tran & Associates would be liable to Easyrider if the loss was caused by the negligent performance of the audit engagement.

(b) In deciding whether the company was guilty of contributory negligence, the major issue to be determined is whether Easyrider failed to meet the standard of care required for its own protection—in this case, a sound internal control system—which contributed to bringing about its loss. The AWA case established for the first time in Australia that contributory negligence by the client is acceptable as a reason for reducing the damages attributable to an auditor.

2.29 The best defence against such litigation is to ensure that the work performed has been completed in a professionally competent manner, applying professional scepticism, and in accordance with the Australian auditing standards. A strong quality control system within the audit firm is a major defence.

However, in this case, Easy Credit is also likely to have difficulty proving that a duty of care is owed to it. Under the law of tort, an action for damages can be taken outside of the contractual relationship—that is, by a third party. However, in Australia, cases in which liability to a third party will be acknowledged are very limited and will occur only when it has been proved that the auditor has acted negligently and where there is proximity between the auditor and the third party.

To satisfy the test of proximity, all of the following must be proved.

- It was foreseeable by the auditor that the third party would suffer an economic loss as a result of their lack of due care.
- There was an intention to induce the third party to act in a certain way.
- It would be fair, reasonable and just, given all the circumstances, to impose a liability on the auditor for the economic loss.

The purpose of performing a statutory audit is ‘to ensure, as far as possible, that all the financial information as to the company’s affairs prepared by the directors accurately reflects the company’s position in order, first to protect the company itself from the consequences of undetected errors or possible wrongdoing (by, for instance, declaring dividends out of capital) and, second, 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 power to reward or control or remove those to whom that conduct has been confided’ (*Caparo Industries Pty Ltd v Dickman*).

The proximity test—that is, that a statutory audit is not intended to advise or induce potential investors or lenders to either act or refrain from acting in a particular way—was considered and upheld by the full High Court in the Esanda case.

Even if the auditors of Crown were negligent in relation to the 2015 audit, it is unlikely, given recent court decisions, that the proximity test in relation to inducing Easy Credit to act in a certain way (that is, to lend Crown the funds) could be proved, and therefore Easy Credit is unlikely to be successful in its litigation.

In the unlikely event of a duty of care being established, Easy Credit would also need to demonstrate that there was a breach of the duty of care and that a quantifiable loss was incurred as a direct result of that breach, in order to succeed in a negligence action. These requirements make such a case extremely difficult for Easy Credit to win. However, Crown might still be liable to Easy Credit under the *Competition and Consumer Act 2010* or the relevant state Fair Trading Act, although this is yet to be tested.

2.30 (a) Following the rulings in recent cases, such as AGC, Caparo and Esanda, the test of proximity needs to be satisfied to determine a special relationship.

To satisfy the test of proximity the following must be proved:

- it was foreseeable by the auditor that the third party would suffer an economic loss as a result of their lack of due care;
- there was an intention to induce the third party to act in a certain way; and
- it would be fair, reasonable and just, given all the circumstances, to impose a liability on the auditor for the economic loss.

In this case, there is no indication that Crew induced Quick Money to rely on the audited financial report of Poultry. Therefore it does not appear that Crew owes Quick Money a duty of care

(b) Crew's defence was that they relied on information from Poultry's management. *Pacific Acceptance* (1970) confirmed the standards of reasonable care and skill, which includes that auditors have a duty to check and see for themselves. To rely on client's personnel and/or management is an aid, but not a substitute for auditor's procedures. Therefore, if a duty of care did exist, this would not be a valid defence.

2.31 Methods of limiting an auditor's liability are as follows:

- *A statutory cap*: This is where a statutory limit is placed on auditors' liability. This has been introduced by the professional standards legislation with a cap of 10 times the audit fee, up to a maximum of $75 million.
- *Incorporation*: This involves letting audit firms incorporate and operate as companies. This is now permitted as a result of CLERP 9 through authorised audit companies. This will mean that, where audit firms incorporate, members of the audit firm other than the auditor signing the report, will have their liability limited to their capital invested in the firm.
- *Proportionate liability*: This means that the auditor will be liable only for the proportion of the loss suffered by the plaintiff that was the responsibility of the auditor. This was also implemented through CLERP 9.

It can be argued that limiting the auditor's liability is fair to auditors, as unlike many other professionals, an auditor generally cannot just resign or restrict the scope of their engagement and therefore, an auditor needs some protection in order to ensure the audit function is still able to be fulfilled. Auditors were previously personally liable to an unlimited extent for their professional services. This unlimited liability put the auditor's personal assets at risk in the event of a legal claim and resulted in the 'deep-pockets syndrome', in which auditors were perceived to be the best course for redress when companies failed. Professional indemnity insurance has become very expensive and before the introduction of the limited liability legislation, audit firms found it very difficult to obtain the amount of coverage they needed to protect themselves against potential bankruptcy.

It can be argued that limiting the auditor's liability is fair to users, as auditors perform a vital public service and without protection, practitioners may no longer be willing to accept the risks involved and the assurance provided by the auditor may no longer be available. Also, audit firms are required to have adequate professional indemnity insurance under the statutory cap legislation. The importance of professional indemnity insurance is that it provides coverage for damages awarded in negligence cases. Provided that sufficient insurance is maintained, it protects parties who might have suffered loss as a result of the auditor's negligence. Prior to this legislation, some partners in audit firms were stripping themselves of personal assets and 'running bare' with only their insurance to cover claims and even this coverage was not always adequate. On the other hand, some would argue that the amount of the statutory cap has been set too low when compared to the amount of losses that may be suffered.

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