1Chapter 2

Auditors' Legal Environment

Review Questions

2-1 Important changes include: the U.S. *Sarbanes–Oxley Act 2002*, which applies to all companies (and their subsidiaries) registered with the Securities and Exchange Commission (a requirement for listing securities on a US exchange: e.g. BHP Billiton, which is registered on the US Stock Exchange and needs to comply with *Sarbanes-Oxley*); The *Corporate Law Economic Reform Program* (CLERP 9) changes to the *Corporations Act 2001*; the establishment of Auditing Standards issued by the AUASB (under the FRC) as legislative instruments in 2003; limits to liability introduced with authorised audit companies and liability caps with passage of the *Treasury Legislation Amendment (Professional Standards) Act 2004*. Also in 2004, the *ASIC Act* and *Corporations Act* were amended to ensure that proportionate liability applies to claims for damages for economic loss arising from misleading or deceptive conduct (also reflected in the *Competition and Consumer Act 2010*). Students might also discuss ASIC's Auditor Surveillance program. CLERP 9 also provided for the Auditing Standards to become legally enforceable for financial reporting periods commencing 1 July 2006.

2-2 The main Commonwealth statutes are the *Corporations Act 2001* and the *Competition and Consumer Act 2010*. Students might also mention the *Crimes Act 1914* (or State criminal codes), but these are much less directly relevant to auditors.

2-3 ASIC can initiate prosecutions of auditors or refer them to the Companies Auditors and Liquidators Disciplinary Board (CALDB) for action. The CALDB can levy

sanctions ranging from fines to suspension or cancellation of an auditor's registration. Students might also discuss ASIC's Auditor Surveillance program.

2-4 Proportionate liability means that the various parties whose negligence contributed to a loss are liable for an appropriate share of the damages. This means auditors should not carry the full burden for losses resulting from a misstatement when other parties contributed to the level of losses incurred by failing to take adequate precautions. This was introduced by State legislation because there was a common perception that the courts were placing insufficient weight on the reasonableness of taking precautions to prevent or reduce the risks.

2-5 Vicarious liability means a person (or entity) is liable for the acts of a subordinate, agent or employee. This means an audit partner or firm (or AAC) can be liable for acts or omission by a person who is member, employee or agent of the firm. This requires the person to have acted within the actual or apparent scope of his or her authority or employment. (Also see question 2-8.)

2-6 The reasonable person concept states that a person is responsible for conducting a job in good faith and with integrity, but is not infallible. Therefore, the auditor is expected to conduct an audit using due care, but does not claim to be a guarantor or insurer of financial statements.

2-7 Groups for whose work a public accounting firm partner may be held liable include his or her partners, employees, other public accounting firms engaged to do part of the work, and outside specialists contracted to provide technical expertise. (Also see question 2-6.)

2-8 Contributory negligence means another person (usually the plaintiff) has contributed to his or her own loss by failing to take sufficient reasonable care. An example is the claim by the auditor that management knew of the potential for fraud because of weaknesses of internal control but refused to correct them. The auditor thereby claims that the client contributed to the losses caused by the fraud by not correcting material weaknesses of internal control structure. This was employed successfully in Australia for non-statutory audit work in *AWA Ltd v. Daniels* [1992]. Since then, various States have legislated requirements for damages to be apportioned according to a 'negligence calculus' that can recognise

the duties of parties additional to the auditor. This is known as *proportionate liability*.

2-9 An auditor's *legal liability to the client under common law* can result from the auditor's failure to properly fulfil his or her contract for services. The legal actions can be for breach of contract, which is a claim that the contract was not performed in the manner agreed upon, or it can be a tort action for negligence. An example would be the client's detection of an error in the financial statements, which would have been discovered if the auditor had performed all audit procedures required in the circumstances (e.g. misstatement of inventory account resulting from an inaccurate physical inventory not properly observed by the auditor).

Liability to clients under statutory law occurs under both the *Corporations Act* and the *Competition and Consumer Act*. The auditor has a duty to the corporation (such as to notify management of errors or problems) and to members of the corporation in the expression of an opinion in the audit report. Failure to detect and disclose a material misstatement is likely to render the auditor liable on this basis.

The auditor's liability *to third parties under common law* results from any loss incurred by the claimant due to reliance upon misleading financial statements. An example would be a bank that has loans outstanding to an audited company. If the audit report did not disclose that the company had contingent liabilities that subsequently became real liabilities and forced the company into bankruptcy, the bank could proceed with legal action against the auditors for the material omission —the bank would have to establish that it enjoyed sufficient proximity and its reliance was reasonably foreseeable.

Liability to third parties under statutory law is most likely to arise under the Fair Trading legislation regarding misleading or deceptive statements. Because silence can be construed as misstatement, this may leave auditors exposed to third-party claims for failure to detect and report misstatements. However, this is yet to be tested in court. Where it can be established that a third party has privity of contract then they will be able to take action on a similar basis to the embers of the corporation.

2-10 Liability to clients under common law has remained relatively unchanged for many years. If an auditor breaches an implied or expressed contract with a client, there is a legal responsibility to pay damages. Traditionally, the distinction between

privity of contract with clients and lack of privity of contract with third parties is essential in common law. The lack of privity of contract with third parties means that third parties have no rights with respect to auditors except in the case of gross negligence. Liability to third parties under common law has been restrictively defined in the High Court's decision in *Esanda* to accord with these notions of privity by employing a combination of *proximity* and *foreseeability* tests.

2-11 The auditor should assess the risk that errors and irregularities may cause a client's financial statements to contain a misstatement. Based on this assessment, the auditor should design the audit to provide *reasonable assurance* of detecting errors and irregularities that are material to the financial statements. Because of the nature of irregularities (including defalcations), properly designed and executed audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of material misstatement due to fraud. The decision in the *Pacific Acceptance* case confirmed the auditor's duty to audit with due care and skill, *including* a duty to design the audit with due regard to the possibility of fraud. *WA Chip and Pulp* highlighted the irrelevance of materiality in considering the need to further pursue indicators of fraud. The Auditing Standards establish the minimum level of competency expected of the auditor during the conduct of the audit.

2-12 Some of the ways an auditor can reduce liability in auditing are:

- *Deal only with clients possessing integrity:* A firm needs procedures to evaluate the integrity of clients and should dissociate itself from clients found to be lacking in integrity.
- *Employ qualified personnel, and train and supervise them properly:* It is important that young professionals be qualified, well trained and supervised by experienced and qualified professionals.
- *Follow the auditing standards assiduously:* Audit firms and AACs must have procedures to ensure all personnel understand and follow the standards.
- *Maintain independence:* Independence-in-fact is more than merely following the statutory requirements. It requires an auditor to maintain an attitude of responsibility separate from the client's and management's interests.

- *Exercise professional scepticism:* Auditors must maintain a healthy level of scepticism and be alert to potential misstatements.
- *Understand the client's business:* Lack of knowledge of industry practices and client operations can lead to an auditor failing to uncover errors.
- *Perform quality audits:* Quality audits require obtaining appropriate evidence and making appropriate judgments about the evidence.
- *Document the work properly:* The preparation of good working papers helps in organising and performing quality audits. Quality working papers are essential if an auditor needs to defend an audit in court.
- *Obtain an engagement letter and a representation letter.* An engagement letter and a representation letter are essential in defining the respective obligations of the client and the auditor.
- *Carry adequate insurance:* This is also a legal requirement for AACs and is covered by the professional bodies' rules for all auditors.
- *Seek legal counsel:* Whenever serious problems occur during an audit or the event of potential or actual legal action, the auditor should immediately seek appropriate legal advice.

Multiple Choice Questions

2-13	a. (4)	b. (1)	
2-14	a. (2)	b. (2)	c. (1)
2-15	a. (4)	b. (1)	

Discussion Questions and Problems

2-16 a. Crosden & Sykes should use the defences of meeting generally accepted auditing standards and contributory negligence. The fraud perpetuated by Posh Manikins Ltd was a reasonably complex one and difficult to uncover except by the procedures suggested by Crosden.

In most circumstances it would not be necessary to physically count all inventory at different locations on the same day. Furthermore, the president of the company contributed to the failure to find the irregularity by refusing to follow Crosden's suggestion. There is evidence of that through his signed statement.

b. There are two defences Crosden & Sykes should use in an action by National Commercial Bank. First, there is a lack of privity of contract. Although this was a known third party, it does not mean that there is any duty to that party in this situation (see *Esanda*). This defence is very likely to succeed if it is an audit under the *Corporations Act*. The second defence is that the auditor followed appropriate auditing standards in the audit of inventory, including the employment of due care. Ordinarily it is unreasonable to expect an auditor to find such an unusual problem in the course of an ordinary audit. The fact that the auditor did not uncover the fraud does not mean the auditor has any responsibility for it.

c. The auditor is more likely to be successful in her defence against the client using contributory negligence defence if it is a non-statutory audit. But the failure of the plaintiff to take appropriate reasonable steps is considered in the calculus. The company has responsibility for instituting an adequate internal control structure. The managing director's statement that it was impractical to count all inventory on the same day because of personnel shortages and customer preferences puts considerable burden on the company for its own loss.

It is also unlikely that National Commercial Bank will be successful in an action. The court is likely to conclude that Crosden & Sykes followed due care in the performance of their work. The fact that there

was not a count of all inventory on the same date is unlikely to be sufficient for a successful action.

d. The issues and outcomes should be essentially the same if the action is brought under the *Competition and Consumer Act 2010*, except the contributory negligence defence may be less persuasive.

2-17 It is likely the auditor will be liable to the shareholders and the company. Because the financial statements were fraudulently prepared, liability may run to third parties under Fair Trading legislation. Fraud can be either actual or constructive. Here, there was no actual fraud on the part of Ji or the firm in that there was no deliberate falsehood made with the requisite intent to deceive. However, it would appear that constructive fraud may be present. Constructive fraud is found where the auditor's performance is found to be grossly negligent. That is, the auditor really had either no basis or so flimsy a basis for his or her opinion that he or she has manifested a reckless disregard for the truth. Ji's disregard for standard auditing procedures would seem to indicate such gross negligence and, therefore, the firm may be liable to third parties who relied on the financial statements and suffered a loss as a result. A contributory negligence defence may succeed if it is not the statutory audit.

2-18 The answers provided in this section assume the traditional legal relationship exists between the audit firm and the third-party user; that is, there is no privity of contract, the known versus unknown third-party user is not a significant issue, and clear negligence is required before there can be liability.

a. False. Gross negligence (constructive fraud) will probably be treated as actual fraud in determining who may recover from the firm.
b. False. There was no privity of contract between Spitz & Resuello and Ditipu. Therefore, negligence will not be sufficient for recovery. An action under Fair Trading legislation might succeed.
c. False. Ditipu is an unknown third party and will probably be able to recover damages only in the case of fraud.
d. True. See b.

2-19 a. The over-valuation of Sydney inventory would probably have been discovered using standard audit procedures for valuing inventory. Auditors have an obligation to see for themselves, and so should have verified the Bathurst inventory—especially given its materiality. The auditor is unlikely to be liable to the client for subsequent losses even though they appear to have been negligent.

b. The principle defence is lack of privity of contract. A secondary defence based on contributory negligence (which would only affect the auditors' share of Cornerd's losses) could be used as a fallback should they be unsuccessful with the lack of privity defence.

Case

2-20 a, b. For the charge of fraud to prevail, NuWave must show that Dell Dingle & Pritchard had knowledge of fraud or had recklessly disregarded the truth (to establish that the auditors acted with scienter).

The circumstances suggest NuWave was an intended third-party beneficiary of the audit contract. Depending on interpretation of the circumstances, they may enjoy privity, effectively creating a direct relationship between NuWave and the auditors. If a privity (or lack of proximity) defence failed, the auditors would best rely on an absence of negligence or a contributory negligence defence. For a negligence action to succeed, it is necessary to show that the auditors failed to take reasonable care and skill, or failed to accord with accepted auditing standards.

c. Sections pertaining to the position of officers of Megadon include s. 1308(9) (false or misleading statements/information) and 1311(2) (penalties). If fraud is involved, see also ss. 596 and 1307.

d. See the *Competition and Consumer Act 2010*.

e. See a. and b. above.

f. This would depend largely on the privity of contract defence—whether NuWave was the known and intended third-party beneficiary. If the auditors are unsuccessful in a privity defence, then Nu-Wave should be able to recover damages. The extent of their recovery from the auditors would then depend on the success of a contributory negligence defence by Megadon.

2-21 The accounting firm Watts & Ampage is potentially liable to its client because of the possible negligence of the partner in charge. Should there be a finding of negligence, liability would be limited to those losses that would have been avoided had reasonable care been exercised.

There being no evidence of the assumption of a greater responsibility, the partner's conduct is governed, as a minimum, by the profession's prevailing standards of conduct. The question arises as to whether the duty of reasonable care was breached when the partner failed to investigate further after being apprised by a competent subordinate of exceptions to 6% of the vouchers payable examined. Moreover, a question of causation arises; i.e. whether further actions by the partner would have disclosed the fraud. If both lack of due care and causation are established, recovery for negligence will be available.

2-22 a. The legal issues involved in this case revolve around the auditor's compliance with auditing standards and contributory negligence. Statements on Auditing Standards indicate that accounts receivable should be confirmed by the auditor. This procedure was employed in the case, and the legal issue is whether or not the auditor used due care in following up the confirmation replies received.

As a defence in the legal action, the auditor would claim to have followed generally accepted auditing standards by properly confirming accounts receivable. In addition, the auditor may defend him or herself by testifying that the company controller was responsible for investigating the reason for the differences reported on the confirmation replies. The auditor may state that he or she had a right to conclude that the controller had reviewed the explanations provided by the assistant accountant, and concluded they were correct. The auditor might also use the defence that there was contributory negligence. The controller should not have delegated the work to the assistant accountant and should have recognised the potential for intentional wrong-doing by the assistant accountant.

b. The auditor's deficiency in conducting the audit of accounts receivable was his or her failure to investigate and obtain evidence to substantiate the explanations provided by the assistant accountant. The auditor

should have investigated each of the timing differences, through which he or she may have discovered that no sales allowance had been granted to the customer, but in fact, the customer had mailed payment for the merchandise which the assistant accountant had stolen.

2-23 a. Yes. Smith was a party to the issuance of false financial statements (joint tortfeasor). The elements necessary to establish an action for common law fraud are present. There was a material misstatement of fact, knowledge of falsity (scienter), intent that the plaintiff bank rely on the false statement, actual reliance, and damage to the bank as a result thereof. If the action is based on fraud, there is no requirement that the bank establish privity of contract with the auditor. Moreover, if the action by the bank is based upon ordinary negligence, which does not require a showing of scienter, the bank may recover as a third-party beneficiary (an exception to the strict privity requirement), thus satisfying the proximity test. Thus, the bank should be able to recover its loss from Smith under either theory.

b. No. The lessor was a party to the secret agreement. As such, the lessor cannot claim reliance on the financial statements and cannot recover uncollected rents. Even if he or she was damaged indirectly, his or her own fraudulent actions led to his or her loss, and the equitable principle of 'unclean hands' precludes him or her from obtaining relief.

c. Yes. Smith had knowledge that the financial statements did not follow appropriate accounting principles and willingly prepared an unqualified opinion. The financial statements were not in accordance with accounting standards. That is a criminal act because there was intent to deceive.

2-24 West & North will argue they were not negligent. They will emphasise that the objective of the statutory audit is not fraud detection. They will have to show they had adequately planned and performed the audit; that there was no

apparent evidence of the fraud; and that their conduct was reasonable in the circumstances.

It is likely to be an important element of evidence as to whether the auditors had conducted reasonableness tests for rents and whether these tests should have or did reveal that rents for some centres were unusually low.