ACCANTANCY FUTURES

Audit reform: aligning risk with responsibility

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ABOUT ACCOUNTANCY FUTURES

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The independent audit is the focus of intense international interest following the global financial crisis. There is developing interest in expanding the scope of audit work and increasing competition in the audit market.

Progress on these matters must be pursued in conjunction with a re-assessment of the auditor's exposure to liability.

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Introduction

The independent audit has for decades been a key element of the framework of measures that contribute to stakeholder confidence in individual companies and the capital markets in general.

While the global financial crisis has not thus far resulted in auditors being held culpable in any major corporate failures, the nature of the independent audit has been subjected to extensive re-examination by many different authorities around the world.

The primary concern here can be summed up quite simply – if it is true that auditors have generally performed their professional responsibilities correctly, even where client companies have failed within a short time of the audit, then the real issue must be whether those responsibilities need to be reformed and perhaps expanded so as to make the audit more 'useful' to primary and secondary stakeholders and to improve its ability to identify threats to business solvency, for the benefit of those who need to know about them. There is thus an interest in developing the role of the independent auditor to meet the new information needs of stakeholders.

A second significant aspect of the attention currently being paid to audit is concern about the apparent concentration of the market for audit services in the hands of a few very large international networks. There is a clear desire, at government and regulatory level, to achieve greater competition in the provision of audit services to the listed company sector. If this is to be achieved, smaller firms must feel prepared to assume the increased level of risk that accompanies the job of auditing large and complex entities. Of course they must, at the same time, satisfy themselves that they have the expertise and resources to conduct this work.

This focus of attention on the value of audit coincides with deeper scrutiny of the framework of corporate reporting more generally. Similar questions are being asked as to whether the present accounting and disclosure frameworks remain suitably transparent, reliable and informative, and whether stakeholder needs would be better served by the adoption of more radical models. These concerns about the wider reporting framework in themselves amount to a substantial issue but, given that the auditor acts in the context of that wider framework, they also have very significant implications for the assessment of the current role of the auditor and the debate about what that role should be in the future. Simply put, the issues are so interrelated that progress on the two agendas cannot be contemplated in isolation from each other.

Before any material evolution of the role of audit can occur, the possible implications for the auditor's exposure to liability must be understood. Achieving any increased involvement of smaller firms in the audit of listed companies, in the interests of healthy competition, must depend at least partly on whether their concerns on this issue can be resolved.

This paper argues that the liability issue needs to be addressed in order to achieve progress on both the development of the role of the audit and the encouragement of greater competition in the audit market.

Background

The aftermath of the global financial crisis has seen a series of inquiries into the way that different actors in the regulatory framework carry out their functions. The initial focus of the regulatory response was on the way that large companies – primarily the banks – were governed and supervised, and on the incentives they gave to their directors and executives. The scope of that response has since widened considerably. Naturally, the role played by auditors is one (among many) of the issues that have received attention from governments, regulators, academics and the auditing profession itself. As part of a re-examination of what the process of audit is supposed to achieve, answers have been sought to some fundamental questions, including the following.

- Why did some auditors not, apparently, identify the weaknesses that were to bring down their client companies so dramatically?
- Were they not looking for such weaknesses in the first place?
- Did they have concerns about their clients' preparedness to withstand severe financial shocks but feel unable, for whatever reason, to communicate them?

In short, some have questioned the very value of audit as it is currently structured.

Given the circumstances in which this re-assessment has taken place, it is striking that studies that have been carried out have revealed continuing high levels of support for the audit. Management, directors, investors, audit committees, governments, regulators and market analysts have all spoken up for the value that audit adds to their respective functions. There has, however, been a recurring theme in the research findings, which is that many stakeholders now say they want to see the audit do more. They agree that an independent audit conducted on the current model will add credibility to a set of financial statements. Furthermore, audit committee members say that they welcome the auditor's expertise in respect of accounting standards and policies. But many of them are now saying that they would also like the auditor to provide additional, specific assurance on such matters as the company's corporate governance structure and its arrangements for managing risk. There seems, accordingly, to be increasing support for the audit function to expand in scope in response to the evolving information needs of stakeholders.

The audit profession seems to be generally well disposed to the idea of this happening. ACCA's own paper *Restating the Value of Audit*, published in February 2010, proposed that the auditor should in future report not only on risk and corporate governance but on the financial assumptions that underlie the client's business model. But the expansion of the scope of audit into new areas such as this must recognise the cost implications of conducting additional professional work (including the cost of insurance), the skills that audit firms would need in order to perform any new tasks, and, not least, the implications for audit firms' exposure to liability. (With regard to the latter, while as yet no major litigation against auditors has reached the courts, there is some evidence of an increase in litigation against accountancy firms and professional advisers generally).

The stakeholder's view of audit

WHY DO SHAREHOLDERS NEED AN AUDIT?

It is worth recalling why stakeholders might want an audit to be carried out in the first place. This question was considered by Wanda Wallace in 1980.[1] She identified three ways in which audit meets the economic demands of shareholders. The first of these is related to agency theory – because shareholders delegate so much power to make decisions on their behalf to the company's directors, their interests and those of the directors may conflict. Hence shareholders may feel they have to take additional action to protect their interests: independent audit helps to reduce the 'agency costs' inherent in this situation. A second feature of audit is that it helps to redress the problem of information asymmetries, in other words the lack of inside information that shareholders may have on what is going on inside their companies. By appointing an auditor who is thought to be competent and independent, the directors indicate their willingness to be open about their record of stewardship of their company's affairs. The third purpose is that the audit plays an insurance role in that the auditor's exposure to liability (and in practice his insurance cover) provides a means of indemnifying investors against losses that they may incur.

These three factors have a bearing on the level of interest in and reliance placed on audit reports by shareholders and others. Wallace suggested that the higher the agency costs, the greater will be the information asymmetries, and this is likely to enhance the shareholders' keenness to protect their interests via the audit. And the greater the risk of financial losses in a company, the greater will be the need for audit 'quality'. These pressures can be seen as converging to create the present interest in expanding the auditor's role.

THE FUTURE OF AUDIT – FEEDBACK FROM STAKEHOLDERS

Expansion of the scope of the audit has been promoted in the recent past by a number of influential parties. In 2009, the UK House of Commons Treasury Committee said (albeit in a comment which perhaps should have been aimed at the process of corporate reporting more generally) 'the current audit process results in tunnel vision where the big picture that shareholders want to see is lost in a sea of details and regulatory disclosures'. The UK Financial Reporting Council announced a high-level review of the scope of the audit in early 2010, and has floated in particular the idea that the audit report needs to say more about risk. The European Commission, in its Green Paper on audit issued in October 2010, suggested that audit should 'go back to basics' and concentrate more on substantive verification of the balance sheet than on compliance and systems work.

A report published in 2010 by Maastricht University's Accounting Research Center (MARC), *The Value of Audit*,[2] which was commissioned by the Global Public Policy Group of the six biggest international firms, found that the audit was still viewed as a tool which increased confidence in a company's financial statements and met the key expectations of stakeholders. On a scale of 1 to 10, where 1 meant no value and 10 meant excellent value, the overall score given to audit by the stakeholders consulted – chief financial officers (CFOs), members of audit committees and market analysts – was 7.3. Nevertheless, the stakeholders consulted were all in favour of a less compliance-driven audit that would offer a broader, more holistic view of the business. They also said they would like to see more reporting by the auditor on the company's risk management and internal controls, as well as some perspective on the 'big picture'.

1. Wanda Wallace, *The Economic Role of the Audit in Free and Regulated Markets*, 1980.

2. *The Value of Audit*, Maastricht University Accounting Research Center, 2010. http://www.maastrichtuniversity.nl

ACCA's proposals, made in *Restating the Value of the Audit*,[3] that auditors should additionally report on the assumptions underlying an entity's business model, and its likely sustainability, received wide support in the series of round-table meetings that ACCA held around the world during 2010. These were summarised in the paper *Reshaping the Audit for the New Global Economy*.[4]

It seems, therefore, that there is a growing feeling that the evolving information demands of market participants should in future be reflected in the scope of the audit. Many consider, in particular, that the responsibilities of auditors, as they currently stand, are prescribed too precisely and too narrowly, leading to the perception that auditors' focus is too often on the detail rather than on giving stakeholders a view of the wider picture.

These concerns about the remit and structure of the audit are valid. For the independent audit to maintain and enhance its value over the long-term, it needs to satisfy the information needs of investors and, less directly, of other stakeholders. This may mean that auditors will have to take on new responsibilities for key areas of stakeholder concern such as risk, and provide forward-looking rather than solely retrospective information. Ultimately, whether reform is likely to maintain or enhance the value of audit in the eyes of shareholders and other stakeholders is key to the whole debate about the future of the audit. Both sides have a direct interest in achieving this outcome.

As stated earlier, the audit profession seems, in principle, to be well-disposed to the basic idea of providing stakeholders with what they want: after all, auditors are in the business of providing a service to clients and it is in their interests for that service to be as useful as possible.

Aside from the technical issues in framing and imposing any new responsibilities, and the associated training issues, an essential consideration is how any expansion of scope will affect auditors' exposure to liability. Like any professional advisers, auditors are keenly aware of their exposure to litigation, and likely to react with some caution when faced with the prospect of entering into new areas of work, given that by doing so they risk not only increasing the scale of their exposure but the cost of their professional indemnity insurance.

The pervasive threat of litigation, it has long been claimed, leads to so-called defensive auditing, accusations of 'boiler plate' opinions and a reputation for the profession as being excessively cautious and conservative.

The risk that one of the large audit firms will fail as the result of a catastrophic damages claim is also now widely accepted to be a major systemic risk to the capital markets: it is feared that this risk has been exacerbated by the events of the financial crisis. Liability risk is sometimes cited as reinforcing the domination of the listed company audit market by the big firms: the existence of this risk can be one factor (among several) that may deter mid-tier firms from entering that market. An additional argument for addressing the issue of liability is, therefore, to encourage the involvement of smaller firms in higher-risk work and thereby to promote the public interest goal of increased competition in the audit market.

In practice, however, whether expanding the scope of the audit would lead directly to an extension of the auditor's liability will depend on the consequences for his duty of care.

3. *Restating the Value of the Audit*, ACCA, 2010. http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/pol-pp-rva2.pdf

4. *Reshaping the Audit for the New Global Economy*, ACCA, 2010. http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/pol-af-rtf2.pdf

The implications of reform for auditors' liability

THE AUDITOR'S DUTY OF CARE

In legal systems based on the common law, the duty of care of professional advisers is rooted in the civil law of negligence. This provides that, where specified conditions exist, an adviser can be made liable to pay compensation to a plaintiff for economic loss that the latter suffers. The conditions that trigger liability for negligence under current English law, and most parallel systems, are that:

- the defendant must owe a duty of care to the plaintiff (this means that the defendant must have been able to foresee that the plaintiff would suffer by his negligence and there must be a relationship of 'proximity' between the two)
- the defendant must be in breach of this duty of care
- the breach must cause the plaintiff loss
- the loss must be foreseeable (by the defendant).

Where an auditor is found to have been negligent in performing his duty, he can be sued by a plaintiff for damages, which represents the economic loss stemming from that negligence.

It is fair to say that, in most jurisdictions where these principles apply, the courts have in recent years been reluctant to extend the circumstances in which the duty of care applies. The key UK case of *Caparo* v *Dickman* (1990) laid down two very important constraints on actions against auditors. The first was that for a duty of care to be owed there had to be a pre-condition of a relationship of proximity between defendant and plaintiff. This means essentially that there must be a nexus or relationship between the two parties that will usually involve an assumption by one party of a responsibility to take care. In the case of the audit of a company's accounts, that relationship is held to exist only between the auditor and the company's body of shareholders. The second constraint identified was that auditors, when auditing a set of financial statements, owed no duty of care to persons who made financial decisions on the strength of their work (unless auditors gave separate undertakings to other persons or provided some sort of acknowledgement of proximity). Subsequent cases (eg *Moore Stephens* v *Stone & Rolls*) have reaffirmed the limited responsibility that auditors have for detecting fraud. The cautious approach of the courts, at least since the 1970s, has admittedly prevented the realisation of fears about a flood of successful litigation against professional advisers.

That is not to say, however, that this restrictive interpretation will continue indefinitely. While the focus of *Caparo* and subsequent cases was on the auditor's responsibility to report on essentially financial information, the auditor has already been called upon, in many countries, to report on information that is not directly connected with the company's financial statements, such as the company's corporate governance arrangements. As has already been discussed there are calls, post-crisis, for this trend to continue and expand.

The other important assumption made by the courts about the function of the auditor, ie to report to the body of shareholders on the directors' stewardship of their company (and not to provide a basis for individual shareholders' decisions), has always been seen by some commentators as illogical and unsustainable (not to say contrary to the original intention of the relevant legislation). The International Accounting Standards Board's conceptual framework for the preparation and presentation of financial statements is clear that the objective of general-purpose financial statements is to provide information on an entity's financial position that will be useful to both existing and potential investors and creditors in making economic decisions in relation to the reporting entity. While International Standards on Auditing (ISAs) make it abundantly clear that an audit of financial statements does not relieve management or directors of their own responsibilities, and stress that the assurance an auditor gives cannot be absolute, they do at the same time provide that, in some respects at least, the auditor has to be mindful of the economic decisions that users might take on the basis of the financial statements.

Given this potential for divergence between the technical purpose of the accounts and the legal purpose of the audit, any extension of auditor's duties to include specific new functions must take into account how auditors' assurances on those matters could be interpreted by shareholders and even prospective shareholders for their own decision-making purposes.

THE DUTY OF CARE IN RESPECT OF OTHER FORMS OF ASSURANCE AND UNDERTAKINGS

Auditors' exposure to liability will not be confined to the opinion set out in their audit reports on general-purpose financial statements. Any ad hoc responsibilities and undertakings will also be relevant. In the UK, for example, it is clear that direct statements by auditors to individual shareholders can have the effect of establishing the necessary relationship of proximity and thereby triggering a duty of care. In Australia, reforms made to enhance the governance rights of shareholders now require auditors to attend company AGMs and to answer any relevant questions posed by members about the audit opinion and the conduct of the audit, either orally or in writing. Answers given in response to direct questions posed by individual shareholders may also establish the required relationship of proximity, thereby increasing the auditor's potential exposure.

JOINT AND SEVERAL LIABILITY

Any change in auditors' responsibilities that affected the duty of care would draw even more attention to the other highly relevant aspect of the common law on negligence, namely the rule on joint and several liability, which applies generally to actions for torts/civil wrongs. Where a person suffers loss as the result of tortious acts committed by two or more 'several' or 'concurrent' wrongdoers, then the plaintiff will be entitled to sue any or all of the wrongdoers for the full amount of his loss. Accordingly, where a set of audited accounts contains misstatements that are due to fraud or management error, a plaintiff will have the choice of suing the company's directors, the auditor and/or any other party who has been negligent in the case on a joint basis; alternatively he may choose to sue the auditor alone. This has led directly to the long-standing phenomenon of 'deep pockets syndrome', whereby auditors are singled out for attention for the perverse reason that they are so well regulated that they are known to carry substantial amounts of professional indemnity insurance.

The virtue of the 'joint and several' rule is that it maximises the likelihood that a deserving plaintiff will recover his loss. Without it, a plaintiff whose interests have been harmed by two parties might be worse off than if he had been harmed by only one. There is also the moral hazard argument that a party who is negligent would be in a better position in litigation if there were another negligent party who could shoulder the blame: in such circumstances the onus on the first party to do a thorough job might decrease accordingly. The counter-argument is that joint and several liability imposes a heavy, and arguably unreasonable, burden on a well-resourced defendant to cover for mistakes made by other parties. Simply put, can it be right that one party assumes 100% of the blame when he may be only partly responsible for the loss that has been incurred?

MEASURES THAT HAVE BEEN TAKEN TO ADDRESS LIABILITY CONCERNS

In fact, the argument for reforming the liability rules has been widely accepted, at least in principle, and much remedial action has been taken in the recent past to try to protect auditors and, as a consequence, to increase competition in the audit market.

Many countries now allow audit firms to incorporate, with the result that individual 'partners' are able to separate their personal assets from the assets of their firm. This is not a comprehensive solution to concerns over liability, since incorporation only acts to protect the individual partners from the liabilities of their firm: catastrophic damages awards, or trading losses, can still bring down the firm itself.

In 2006, UK law changed to allow audit firms and their corporate clients to enter into voluntary liability limitation agreements. These amount to bilateral contracts between company and auditor that specify the limit of any damages that the client company may claim against its auditor in respect of negligent audit work. To date, the use made of this reform has not been high, owing to a combination of shareholder reluctance to forgo their rights to claim and the unfavourable attitude of some market regulators towards contracts of this kind.

Some countries have for many years had in place statutory caps on the liability of auditors for negligent work for which they might be responsible. For example, Germany currently imposes a basic cap of 4 million euros in respect of audits of listed companies.

The EU issued a formal Recommendation to member states in 2008 to encourage them all to put in place limitations on liability for audit work – this followed a review which concluded that there was no evidence that limitation of liability, either by statutory caps or other means, had any detrimental effect on the quality of audit work.

Some common law jurisdictions have moved away from the traditional rule of joint and several liability altogether, towards a system where financial responsibility is apportioned by reference to a defendant's share of blame for loss caused – usually referred to as 'proportionate liability'. Under this system, the plaintiff is entitled to sue each wrongdoer whom he considers bears some responsibility for the loss he has suffered, and each wrongdoer will be liable only for that share of the plaintiff's loss that arises from his own negligence, as decided by a court.

Since the year 2000, Australia has reformed the whole basis of its federal law on civil liability. In the wake of a national crisis over the availability and cost of professional indemnity insurance (which saw audit firms' premiums rise by up to 400% in some cases), it has replaced the principle of joint and several liability (at least in cases involving economic loss and damage to property) with a general principle of proportionate liability. This new system applies to the work of company auditors via changes made to the federal Corporations Act.

Proportionate liability under the Australian model does not provide wholesale exemption from liability. It does not apply where a party's conduct is deemed to have been fraudulent or intentional. If a court considers that an auditor has been 100% to blame for shareholders' loss, the auditor can be sued for the whole of that loss, as happens under joint and several liability. In some states, proportionate liability can even be contracted out of and overridden by indemnities. There is accordingly no cause to conclude that an auditor's ultimate financial responsibility has decreased as a result of the general move towards proportional responsibility. This solution also addresses the concerns, referred to above, that deserving plaintiffs might be unable to recover the whole of their loss from a negligent adviser, at least in cases where that adviser is solely to blame. This approach is also, arguably, consistent with the professional impetus to safeguard audit quality.

The move towards proportionate liability in federal civil cases is in addition to legislation now in force in some Australian states that allows for the statutory capping of professionals' liability. In New South Wales, for example, the liability of an auditor is capped at ten times the audit fee for the assignment concerned.

In the US, meanwhile, a measure of proportionate liability applies in class actions by virtue of the Private Securities Litigation Reform Act 1995. Under the rules of the Securities and Exchange Commission, investors may bring class actions against companies and their auditors where share prices have fallen. Nonetheless, even where a defendant is successful, there is no provision for recovery of costs, meaning that companies and auditors have faced increasing pressure to settle cases out of court. The Reform Act was passed following a huge increase in class actions during the 1980s, as a result of which the 'Big Four' firms had to pay a reported $650 million, or 12% of their gross revenues, in legal costs by 1993. The Reform Act restricts class action claims to a proportionate liability basis, although joint and several liability remains where a criminal offence has been committed (other assurances are additionally demanded of auditors).

THE MERITS OF PROPORTIONATE LIABILITY AS A BASIS FOR LIMITING AUDITOR LIABILITY

Notwithstanding the crisis in the insurance market, which prompted the most recent liability reforms in Australia, the reform there was controversial. The same concerns over whether deserving plaintiffs should bear more of the risk associated with their claims have characterised the debate over the relative merits of proportionate versus joint and several liability wherever it has taken place, and will doubtless do so in future. But it is very arguable that the concept of a legally blameless plaintiff should not apply in cases involving commercial plaintiffs for whom business risk might be expected to be a fact of life. The cause of protecting deserving plaintiffs could also be helped by imposing mandatory (and tax deductible) insurance cover for company directors, with the aim of reducing the incentives for plaintiffs to pursue the auditors alone. But while no predetermined basis of limitation of professional liability can be said to achieve a completely satisfactory balance between competing dynamics, the concept of proportionate liability does offer a solution which reflects the reality of the auditor–client relationship but which still allows a plaintiff to recover the whole of his claim where the defendant is solely at fault.

THE ARGUMENTS AGAINST REFORMING THE RULES ON LIABILITY

As already mentioned, the reforms that have been made in this area have encountered significant opposition.

Opponents of reform query whether it is really needed, and also whether it would be in the public interest to provide more protection to auditors. They point out that the courts have in practice actively resisted the prospect of 'opening the floodgates' to litigation against auditors by taking a conservative line as to the circumstances in which auditors owe a duty of care, and hence expose themselves to liability for negligent work. They also point out that, where claims are brought, it is invariably not ordinary shareholders who do so but other professional firms bringing actions on shareholders' behalf (usually these are liquidators acting for failed companies). They also state, correctly, that many countries (though by no means all) now allow audit firms to incorporate, thereby allowing their partners to shelter their own personal assets behind the corporate 'shield'.

It should also be noted that in 1996 the UK's Law Commission undertook a thorough investigation into the merits of replacing the system of joint and several liability with proportionate liability. On that occasion, the Commission came down against making any such change, concluding that 'we regard the policy objections to joint and several liability to be at worst unproven and, at best, insufficiently convincing to merit a departure from the principle'.

Clearly, there will remain principled objections to reform. Nonetheless, the fact that several major jurisdictions have in recent years accepted that there is a workable alternative to joint and several liability suggests that it is possible to arrive at a formula that affords more protection auditors while at the same time serving the public interest by ensuring that audit quality is maintained. As this paper has argued, the current debate about innovation in the nature and scope of the audit invites a corresponding consideration of the basis and extent of the auditor's liability.

Conclusion

There is no strong evidence that the current audit model is 'broken'. Primary and secondary stakeholders alike have reaffirmed their trust and confidence in the independent audit of general-purpose financial statements. At the same time, there seems to be a widespread view, shared by regulators, investors, audit committees, businesses and auditors themselves, that the audit can and should contribute more to the goal of enhancing stakeholder and market confidence in individual businesses.

The re-assessment of the role of the audit that has followed the financial crisis presents both a challenge and an opportunity for auditors to prove their value to the business sector. But the adoption of more specific and investor-focused reporting responsibilities has the potential to create new uncertainty about the auditor's duty of care in those legal systems where the extent of the duty is defined by the courts. For this reason it is essential that the development of a progressive approach to the audit is not only aligned with developments in the structure of corporate reporting but is accompanied by recognition of the implications of expansion for auditors' exposure.

The assumption of responsibility for work carried out is a driver of quality in all professions. As a matter of principle, auditors must continue to accept responsibility for the work that they do and be prepared to defend themselves if necessary. But accepting responsibility for one's own work is one thing – doing so in respect of someone else's mistakes or deception as well is, arguably, something quite different. This point is especially relevant because audit, unlike other areas of professional advice, involves the giving of an opinion on a body of work, principally a set of financial statements, that has been prepared by another party. The special character of this situation means that, whatever its constituent procedures, audit will always have inherent limitations and will never be able to offer a complete guarantee of a client's financial health.

The audit profession must be prepared to respond to stakeholder needs and regulatory concerns by assuming new responsibilities. Expanding the range of matters that are subject to an auditor's attention is likely to be helpful in meeting the information and assurance requirements of stakeholders. But radical change must recognise the risk of exposing auditors to unreasonable levels of liability and prohibitive insurance costs. The reform agenda must proceed in tandem with a considered debate on what constitutes a fair liability framework in the new, post-crisis environment.

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