AUDIT MARKET INVESTIGATION

Development of the statutory financial audit

Introduction and summary

1. This paper considers the development of the statutory financial audit of companies from their origins in Victorian legislation to the present day.

2. The development of the statutory financial audit is linked both to the development of company law and to the establishment (and subsequent growth in power) of audit firms.

3. The common law principles established by Victorian case law have remained unchanged in modern times. Many of the statutory arrangements also were first set out in Victorian legislation. However, after 1970 auditing and accounting standards have played an increasingly important role in auditing.

4. Landmark dates are:

1844	mandatory financial auditing provisions first appeared.
1856	the policy decision was taken to make auditing arrangements optional.
1895/96	the *London and General Bank* and *Kingston Cotton Mill Company* cases were decided.
1900	auditing provisions were once more made mandatory.
1948	audit firms were given a monopoly of auditing.
1970	Accounting Standards Steering Committee created.
1978	4th Council Directive on annual accounts.
1981	Companies Act gives effect to 4th Directive.
1983	7th Council Directive on consolidated accounts.

1984	8th Council Directive on approval of persons responsible for statutory audits.
1989	Act recognizes accounting standards; auditors required to disclose fees paid for non-audit work; audit firms could become limited liability companies.
1990	*Caparo Industries plc v Dickman* case decided (duty of care of statutory auditors).
2000	audit firms could become limited liability partnerships.
2006	Directive on statutory audits.
2006	the current consolidating Act was passed, giving effect to Directive 2006/ 43/EC; making it a criminal offence knowingly to issue a misleading audit report, but enabling auditors to agree a cap on liability with the company.
2008	the Banking crisis.
2011	European Commission proposal for a regulation to increase the quality of audits of public-interest entities, and for a directive to enhance the single market for statutory audits.

1844 to 1900

5. Modern statutory audit provisions derive from Victorian Companies legislation. Prior to 1844, the creation of a corporate body required a Royal Charter[1] or an Act of Parliament. However, this was unsuited to providing support and funding needed for the industrial revolution, as support for obtaining a Royal Charter often, in practice, involved payments being made to the Crown,[2] and private Acts of Parliament were expensive and required Parliamentary time to be available.[3]

[1] The East India Company is a well-known example of such a body. Originally, Royal Charters were in the exclusive gift of the Crown, but the Statute of Monopolies 1623 (c.3) prohibited such Charters unless allowed or confirmed by Act of Parliament.
[2] For example, by the Bubble Act 1720 (6 Geo 4 c.91), Lord Onslow was granted a Charter for The Royal Exchange to write marine insurance, but only after he had offered £300,000 towards the King's Civil List debts.
[3] This was especially so for railway and waterway development. In 1846, Parliament passed 272 Railway Acts.

6. Unincorporated joint stock companies with transferrable shares, but based on partnership, were an alternative way of raising finance through shares. The Bubble Act 1720 had been passed to prohibit such unincorporated joint stock companies. However, it was unclear from the drafting whether this was a total prohibition, or a prohibition only on such companies whose objects were not in the public interest, and unclear whether such joint stock companies were contrary to common law.[4] Following repeal of the Bubble Act in 1825[5] the number of such joint stock companies increased, but this led to claims of fraud and financial irregularities.

7. A select committee (chaired by the President of the Board of Trade, William Gladstone) was appointed to inquire into the law relating to bubble companies in view of *the circumstances of fraud and mismanagement in the conduct of such companies* and the report of this Committee in 1844,[6] led to the enactment of the Joint Stock Companies Act 1844. This Act created the office of Registrar of Joint Stock Companies, and enabled companies to be incorporated by registration of a deed of incorporation.

8. The main concern of the Select Committee was whether incorporation of companies by registration would reduce fraud and mismanagement, or encourage it. The Committee considered that the problem of mismanaged companies could be addressed by:

> the periodical balancing, audit and publication of accounts and by making the directors and officers more immediately responsible to the shareholders ... Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern and ... parties

[4] In *Kinder v Taylor* (1825) 3 LJ Ch 68 Lord Eldon had held that it was contrary to common law in England 'to act as a corporation, not being a corporation' (the position appears to have been different in Scotland) but the provisions of section 18 of the Bubble Act were unclear and unincorporated joint-stock companies with transferable shares, based on partnership, were common.
[5] By the Bubble Companies etc Act 1825 (6 Geo 4 c.91).
[6] Report of the Select Committee on Joint Stock Companies (P.P. 1844, VII).

to mismanagement may be made more amenable for acts of fraud and illegality.[7]

9. Accordingly, the 1844 Act introduced the following requirements as regards audits. As these are broadly similar to the duties that apply today, they are worth summarizing:

- One or more auditors must be appointed in the formation deed (section VII).
- The directors must *cause the Books of the Company to be balanced, and a full and fair Balance Sheet to be made up* (section XXXV).
- Company to appoint auditors annually at a general meeting (section XXXVIII).
- At least one auditor must be appointed by the shareholders (section XXXVIII).
- Board of Trade to appoint auditor if none appointed by the shareholders (section XXXVIII).
- Directors to deliver the accounts and balance sheet to the auditors at least 28 days before the relevant ordinary meeting for examination (section XXXIX).
- Auditors to report within 14 days to the directors (not the shareholders) and either confirm the accounts or, *if they do not see proper to confirm such accounts, report specially thereon* (section XLI).
- Directors to send a printed copy of the balance sheet and auditor's report to every shareholder 10 days before the ordinary meeting, and to read the report at the meeting together with the report of the directors (section XLII).
- Auditors authorized to inspect the books at any reasonable time and to receive assistance from the officers and staff of the company (section XL).
- A copy of the balance sheet and of the auditors report to be filed at the Registry (section XLIII).

[7] Report of the Select Committee on Joint Stock Companies (1P.P. 1844) page v.

10. The Act did not work well in practice[8] and the audit provisions were ineffective. For example, shareholders were provided with information as to the accounts, but the quality of that information was uncertain, as the requirement for the shareholders to appoint at least one of the auditors did not ensure either the independence or the competence of the auditors.

11. Nevertheless, the policy aim appears to have been to use a compulsory statutory financial audit as a means of safeguarding against mismanagement and fraud.

12. An important development in company law was the passing in 1855 of the Limited Liability Act[9] giving protection from liability to shareholders, and further distinguishing companies from partnerships.

13. The 1844 Act was replaced by the Joint Stock Companies Act 1856. A different policy, of laissez faire, which placed the minimum cost and restriction on business, now motivated the legislation. In introducing the Bill, Robert Lowe (Vice President of the Board of Trade) stated that 'the principle we should adopt is this—not to throw the slightest obstacle in the way of limited companies being formed'.[10]

14. The 1856 Act introduced the now familiar arrangements for incorporation of submitting a signed Memorandum of Association and Articles of Association to the Registrar for registration. Model articles of association were in a schedule to the Act, but as Robert Lowe stated:

> When those articles appear to the persons who have signed the articles of association to be applicable to the company, they may be adopted bodily without any expense; but if it should turn out that those rules are

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[8] Largely because its procedure of provisional registration, followed by complete registration, was exploited by some companies, which failed to complete the formalities but held themselves out as being backed by statute and full registration.
[9] The Limited Liability Act 1855 (18 & 19 Vict c 133).
[10] HC Deb 01 February 1856 vol 140 cc131.

> not applicable to a particular company, the company will have the power of filing a document with their memorandum of association, either specifying the whole code which they have agreed upon, or enumerating such of the rules as they do not adopt, and giving those which they substitute for them. There is no compulsion, therefore, in the matter. We leave companies to form their constitutions as they please; but if the constitution provided by the Act be suitable to the promoters, they will have the advantage of being able to adopt it without expense.[11]

15. The audit arrangements were, therefore, moved to a Schedule and formed part of 'Table A—regulations for management of a company limited by shares'.

16. The model articles as regards audit were similar to those which were in the 1844 Act. In some respects, however, the model provisions were improvements. For example, the auditors must state to the shareholders '*whether, in their opinion, the balance sheet is a full and fair balance sheet'* (the 1844 Act required directors to cause a full and fair balance sheet to be drawn up, and the auditors confirmed the accounts). In the 1856 Act, the auditor '*may, at the expense of the company, employ accountants or other persons to assist him in investigating such accounts, and he may in relation to such accounts examine the directors or any other officer of the company'.* However, companies were not required to use the model articles, and so the major weakness was that these arrangements did not apply to many, perhaps most, companies.

17. The Audit provisions of the model articles in the 1856 Act are as follows:

[11] See Note 8.

74 The accounts of the company shall be examined and the correctness of the balance sheet ascertained by one or more auditor or auditors to be elected by the company in general meeting.

75 If not more than one auditor is appointed, all the provisions herein contained relating to auditors shall apply to him.

76 The auditors need not be shareholders in the company: no person is eligible as an auditor who is interested otherwise than as a shareholder in any transaction of the company; and no director or other officer of the company is eligible during his continuance in office.

77 The election of auditors shall be made by the company at their ordinary meeting, or, if there are more than one, at their first ordinary meeting in each year.

78 The remuneration of the auditors shall be fixed by the company at the time of their election.

79 Any auditor shall be re-eligible on his quitting office.

80 If any casual vacancy occurs in the office of auditor, the directors shall forthwith call an extraordinary general meeting for the purpose of supplying the same.

81 If no election of auditors is made in manner aforesaid, the Board of Trade may, on the application of one fifth in number of the shareholders of the company, appoint an auditor for the current year, and fix the remuneration to be paid to him by the company for his services.

82 Every auditor shall be supplied with a copy of the balance sheet, and it shall be his duty to examine the same, with the accounts and vouchers relating thereto.

83 Every auditor shall have a list delivered to him of all books kept by the company, and he shall at all times have access to the books and accounts of the company: He may, at the expense of the company, employ accountants or other persons to assist him in investigating such accounts, and he may in relation to such accounts examine the directors or any other officer of the company.

84 The auditors shall make a report to the shareholders upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet, containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory; and such report shall be read, together with the report of the directors, at the ordinary meeting.

18. When the Companies Act 1862 consolidated company legislation,[12] the Table A model provisions as to audit remained broadly the same as in the 1856 Act. Members of the company (but not directors or other officers of the company) could be auditors, and it was sufficient for one auditor to be appointed.

19. The model articles provided that: 'Once at the least in every year the accounts of the company shall be examined, and the correctness of the balance sheet ascertained, by one or more auditor or auditors'[13] and 'Every auditor shall be supplied with a copy

[12] This was the Act under which the landmark case of *Salomon v A Salomon & Co Ltd* [1897] AC 22 was decided.
[13] Table A, paragraph 83.

of the balance sheet, and it shall be his duty to examine the same, with the accounts and vouchers relating thereto'.[14]

20. The 'full and fair' test continued to apply also:

> The auditors shall make a report to the members upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet, containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory; and such report shall be read, together with the report of the directors, at the ordinary meeting.'[15]

21. In the case of a company limited by guarantee (ie not having a capital divided into shares) such as would be the case for a mutual insurance company, the model articles in Table B of the1862 Act provided that: 'The accounts of the company shall be audited by a committee of five members, to be called the audit committee.' This 'audit committee' carried out functions similar to those carried out by the auditors of a company limited by shares, and had the duty under the model articles to 'report to the members upon the balance-sheet and accounts and ... state whether in their opinion the balance-sheet is a full and fair balance-sheet, containing the particulars required by these regulations of the company and properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs'.

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[14] Table A, paragraph 92.
[15] Table A, paragraph 94.

22. Among the major financial scandals of this period was the collapse of the bankers Overend, Gurney and Company in 1866 (with allegations of fraud and false statements made in the 1865 prospectus) and of the City of Glasgow Bank in 1878 (where massive losses had been hidden by falsified balance sheets and profit and loss accounts).

23. In two landmark cases in the 1890s (*In re London and General Bank* (1895) and *In re Kingston Cotton Mill* (1896)) the common law duties of an auditor were clarified. Lindley LJ stated these to be:

> to examine the books, ascertain that they are right, and to prepare a balance-sheet shewing the true financial position of the company at the time to which the balance-sheet refers ... an auditor is not an insurer, and that in the discharge of his duty he is only bound to exercise a reasonable amount of care and skill ... what in any particular case is a reasonable amount of care and skill depends on the circumstances of that case ... if there is nothing which ought to excite suspicion, less care may properly be considered reasonable than could be so considered if suspicion was or ought to have been aroused. These are the general principles which have to be applied to cases of this description.
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> *...*
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> Auditors are ... bound to see what exceptional duties, if any, are cast upon them by the articles of the company whose accounts they are called upon to audit. Ignorance of the articles and of exceptional duties imposed by them would not afford any legal justification for not observing them.
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> It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade on hand. In the case of a cotton mill he must rely on some skilled person for the

> materials necessary to enable him to enter the stock-in-trade at its proper value in the balance-sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by every one who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter.
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> ...
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> It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was.[16]

24. In the same case Lopes LJ said:

> It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care, and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their

[16] *In Re Kingston Cotton Mill Company (No. 2)* [1896] 2 Ch. 279.

> representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful.

1900 to 1948

25. The Companies Act 1900 was enacted 'with a view to the better prevention of fraud in relation to the formation and management of companies'[17] and this introduced a compulsory audit for most companies (but not banks) in terms similar to but identical with those that had been in Table A under the earlier Acts.

26. Directors and officers of a company could not act as auditor. Auditors reported to shareholders 'whether, in their opinion, the balance sheet [was] ... a true and correct view of the state of the company's affairs ... as shown by the books of the company'.

27. In 1918, Lord Wrenbury's Report on Company Law Amendment considered whether 'auditors must have some and what professional qualification', but made no recommendation as 'We have not traced any mischief which requires remedy in the matter'. The report also considered whether the auditor's opinion should be changed from 'a true and correct view of the state of the company's affairs ... as shown by the books of the company', to simply 'a true and correct view of the state of the company's affairs', but considered that 'it would be highly inexpedient indeed, we may say impossible, to require a certificate in that form' and that the London and General Bank case and the Kingston Cotton Mill case 'have delimited with great distinctness the extents and limits of the auditor's responsibility'.

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[17] Davey Committee report on *Amendments necessary in the Acts relating to Joint Stock Companies incorporated with limited liability* (June 1895) (C 7779).

28. The Greene Committee on Company Law Amendment reported in 1925. The report noted that: ‘Many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of a prohibition in an Act of Parliament, dies hard.’ As regards auditors it stated that ‘in general the law as it stands with regard to the powers and duties of auditors is satisfactory’.

29. Financial scandals in this period had included the *Royal Mail Steam Packet Case* in 1931 (falsification by Lord Kylsant of a trading prospectus). This case raised the issue of the practice of secret reserve accounting, ie boosting the declared profits by taking money from secret reserves without declaring this, so implying (or stating) that the profits had come from trading. The Companies Act 1947 made it clear that non-disclosure of this in an audit report was not compatible with the accounts giving a ‘true and fair view’ as the Act required.

30. The Companies Act 1948 consolidated the existing legislative provisions. These included the changes made by the Companies Act 1947, following the recommendations of the Cohen Report of 1945.[18] As regards auditing, the important changes were: to restrict eligibility for appointment as auditor to persons possessing recognized professional qualifications or having special experience; to require the auditor to report on the profit and loss account as well as the balance sheet; and to state whether the accounts give ‘a true and fair view’ (rather than a ‘true and correct view’) of the state of the company’s affairs and of the profit and loss for its financial year. This change of wording was as recommended by the Cohen report, but without comment or discussion of the reasons for the change.

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[18] *Report of the Committee on Company Law Amendment* (Cm 6695).

1948 to 1985

31. In 1963 the Rolls Razer collapse showed the limitations of the then current auditing arrangements to deal with the wide variations in accounting practices in use at that time. Rolls Razer was a large scale supplier of domestic washing machines, but went into liquidation with liabilities of around £3.2 million, despite the last accounts showing net assets of around £1.6 million and profits of £400,000. Similar issues arose in 1967, in the contested takeover of Associated Electrical Industries (AEI) by General Electric Corporation (GEC). As part of its defence, AEI had forecast profits of £10 million for the current year, but once GEC had gained control, it transpired that AEI had a loss of £4.5 million.

32. In 1970, the Institute of Chartered Accountants in England and Wales created the Accounting Standards Steering Committee (later to become the Accounting Standards Committee) which issued standards for financial reporting in an attempt to combat the wide variation in accounting treatments in use at that time.

33. The Companies Act 1976 introduced a provision which requires an auditor who is removed from post or who has resigned to make a statement setting out the relevant circumstances (or confirming that there were no relevant circumstances). This statement is not only to be brought to the attention of the members of the company, but also to the attention of the creditors of the company, and is to be deposited at Companies House (and so made public). This appears to be the first time audit provisions had been expressly directed towards the protection of interested third parties (ie not members of the relevant company).

34. The Companies Act 1981 was enacted to give effect to the 4th Company Law Directive on the annual accounts of companies with limited liability.[19] The Directive requires company accounts to comprise a balance sheet, a profit and loss account and the notes to the accounts.

35. The introductory recitals state that:

> Whereas annual accounts must give a true and fair view of a company's assets and liabilities, financial position and profit or loss; whereas to this end a mandatory layout must be prescribed for the balance sheet and the profit and loss account and whereas the minimum content of the notes on the accounts and the annual report must be laid down; whereas, however, derogations may be granted for certain companies of minor economic or social importance.
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> Whereas the different methods for the valuation of assets and liabilities must be coordinated to the extent necessary to ensure that annual accounts disclose comparable and equivalent information.

36. Accordingly, Article 2 of the Directive provides that:

> 1. The annual accounts shall comprise the balance sheet, the profit and loss account and the notes on the accounts. These documents shall constitute a composite whole.
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> ...
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> 3. The annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss.
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> ...
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> 5. Where in exceptional cases the application of a provision of this Directive is incompatible with the obligation laid down in paragraph 3,

[19] 78/660/EEC of 25 July 1978, OJ (1978) L 222.

> **that provision must be departed from in order to give a true and fair view within the meaning of paragraph 3.** Any such departure must be disclosed in the notes on the accounts together with an explanation of the reasons for it and a statement of its effect on the assets, liabilities, financial position and profit or loss. The Member States may define the exceptional cases in question and lay down the relevant special rules. (Emphasis added.)

37. The 1981 Act also required auditors to review the directors' report to ensure that it was not inconsistent with the financial statements.

38. These provisions were subsequently consolidated in the Companies Act 1985.

1989 to 2006

39. The Companies Act 1989 gave the first UK statutory recognition to the existence of accounting standards. It inserted a new section 256 in the Companies Act 1985, and a new disclosure requirement in Schedule 4 to that Act. 'Accounting standards' were defined as statements of standard accounting practice issued by prescribed bodies; accounting standards applicable to a company's accounts were those which are relevant to a company's circumstances and to the accounts. Schedule 4, paragraph 36A, required companies to state by way of note whether the accounts have been prepared in accordance with applicable standards, and particulars of, and reasons for, any material departures. (There was an exception for small and medium-sized companies and certain small and medium-sized groups.)

40. The Accounting Standards Board was the prescribed standard-setting body for the purposes of section 256.

41. The 1989 Act also permitted auditing firms to incorporate as limited liability companies, as auditing firms had claimed that partnership structures were too unwieldy.

42. In 2000 the Limited Liability Partnership Act was passed, which allowed the audit firms to become LLPs. The circumstances in which this Bill was introduced were controversial. In debate on the Bill, Austin Mitchell MP said that:

> The legislation's origins are very murky indeed. I should like to detail those origins because they are not based solely on a process of consideration ... The fact is that the big accountancy houses got into a panic ... because, as they have deep pockets, they felt vulnerable. They were afraid that people would make huge claims against auditors.
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> The accountancy firms tried to panic the Conservative Government, who referred the issue to the Law Commission ... but it said that the firms could not have that special concession.
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> The big audit firms then began another devious manoeuvre. They were so anxious to secure limited liability that they went to the Jersey legislature and tried to buy legislation on their own terms. It was drawn up by Slaughter and May and financed by what was then Price Waterhouse and by Ernst and Young at a cost of £1 million.
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> That threat produced action. The Conservative Government began to draw up the legislation, we have continued with that. They did so under pressure from the big five and with a departmental civil service that works in what I would call close collusion—but let us say cahoots or a relationship—with the big accountancy houses.
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> ...the Bill is the result. [the 1989 Act] gave the accountancy houses the right to set themselves up as plcs if they wanted. They had been pressing for that, claiming that the fate of the accountancy profession depended

> on being given plc status. We gave them it, but only one accountancy firm took it up, converting its audit arm into a plc. Why do they not want to be plcs? Why do they want special limited liability partnership status? In 1991, the Institute of Chartered Accountants in England and Wales said that the obligation … to publish their accounts is perceived as a considerable drawback. In other words, the firms want to keep their business to themselves. They do not want the partners to have to reveal their income. They do not want to reveal anything beyond the firm's total fee income. That is why they did not want to take up the offer of plc status.[20]

Enron

43. In 2001 it became apparent that the Enron Corporation in the USA had been using specialized accounting techniques and special purpose enterprises to overstate profits and hide massive losses off balance sheet. Enron subsequently filed for bankruptcy. The Report of the Permanent Subcommittee on investigations of the Committee on Governmental Affairs, United States Senate [2002][21] found that:

> In 1999, Audit Committee members were given a nine page presentation on mark-to-market and fair value accounting issues, and told how Enron divisions were expanding their use of fair value accounting which 'require[d] continuous revaluation of asset[s] and liabilities' on Enron's books
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> Andersen informed the Audit Committee members that Enron was engaged in accounting practices that 'push limits' or were 'at the edge' of acceptable practice. In the discussion that followed, Andersen did not advocate any change in company practice, and no Board member

[20] HC Deb 23 May 2000 vol 350 http://hansard.millbanksystems.com/commons/2000/may/23/limited-liability-partnerships-bill-lords.
[21] http://www.hsgac.senate.gov/download/the-role-of-the-board-of-directors-in-enrons-collapse.

objected to Enron's actions, requested a second opinion of Enron's accounting practices, or demanded a more prudent approach.

On paper, the Audit Committee conducted two annual reviews of LJM transactions in February 2000 and February 2001.[22] In reality, these reviews were superficial and relied entirely on management representations with no supporting documentation or independent inquiry into facts.

44. The report included findings that:

> The Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.
> The Board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.

WorldCom

45. On June 25, 2002, the US telecommunications company WorldCom announced that it intended to restate its financial results for all the quarters in 2001 and the first quarter of 2002 and filed for Chapter 11 bankruptcy protection the following month in what was the largest bankruptcy filing in the US to that date.

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[22] LJM were private equity funds which transacted business with Enron.

46. The US Securities Exchange Commission filed a complaint against the company for various breaches of the Securities Exchange Act of 1934 and claimed that WorldCom had misled investors from at least as early as 1999 through the first quarter of 2002, and that, as a result of undisclosed and improper accounting, WorldCom had materially overstated the income it reported on its financial statements by approximately $9 billion.

Sarbanes-Oxley

47. The response in the USA to these (and other financial scandals[23]) was adoption in 2002 of an Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes, sponsored by Senator Paul Sarbanes and Representative Michael G Oxley.[24]

48. The Act, among other things, created a private body with regulatory functions, the Public Company Accounting Oversight Board (PCAOB). Under section 101 of the Act the PCAOB has power (among other things) to:

- register public accounting firms that prepare audit reports for issuers;
- set auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by issuers;
- conduct inspections of registered public accounting firms;
- conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms (including fines of up to $100,000 against individual auditors, and $2 million against audit firms);
- perform such other duties or functions as the Board (or the SEC) determines are necessary or appropriate to promote high professional standards among, and

[23] Such as Tyco (where the former chairman and chief executive and the former chief financial officer were convicted of theft from the company, and Tyco settled a class action by agreeing to pay $2.92 billion, and its auditors agreeing to pay $225 million, to a class of defrauded shareholders).
[24] Public Law 107–204; Sarbanes-Oxley Act of 2002.

improve the quality of audit services offered by, registered public accounting firms and their employees; and

- sue and be sued, complain and defend, in its corporate name and through its own counsel, with the approval of the SEC, in any Federal, State or other court.

49. More generally, the stated aim of the PCAOB is to 'protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports'.

Regulatory developments

50. In the UK the Companies (Audit, Investigations and Community Enterprise) Act 2004, placed new requirements on the five recognized supervisory bodies of auditors[25] by making it a condition of recognition that they participate in independent arrangements for setting auditing standards relating to professional integrity and independence and setting technical standards; for monitoring audits of listed companies and other companies whose financial condition is of particular importance; and for investigating and taking disciplinary action in relation to public interest cases.

51. The Act also enabled funding to be provided to the FRC for setting accounting and audit standards (through the ASB and the Auditing Practices Board (APB)); for enforcement or monitoring (through the Financial Reporting Review Panel Ltd (FRRP), the Accountancy Investigation and Discipline Board (AIDB),and the audit inspection unit reporting to the Professional Oversight Board for Accountancy (POBA)); and for oversight of the major professional accountancy bodies (through the POBA).

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[25] ie ICAEW; ICAS; ACCA; ICAI; and the Association of International Accountants.

52. The Secretary of State was given power by the Act to make regulations addressing issues of independence, by requiring companies to publish more information about the types of services they and their associates have purchased from their auditors and associates. A loophole—that it was not a criminal offence for an officer of a company to fail to provide information or explanation to an auditor—was also dealt with. Further strengthening of audit arrangements was made by giving the FRRP power to have power to require information to be provided to it.

The Audit Directive

53. In 2006, to deal with the issues raised by Enron and WorldCom[26] and by the Parmalat scandal in Europe, the EU replaced its 8th Company Law Directive with a revised version of the Directive.[27] The Directive aims at a high-level (though not full) harmonization of statutory audit requirements. These provisions have been given effect by the Companies Act 2006 in the UK.

54. The Audit Directive expands and replaces the Eighth Council Directive on Company Law (which only dealt with the approval of statutory auditors) by clarifying the duties of statutory auditors, their independence and ethics; by introducing a requirement for external quality assurance; and by ensuring public oversight over the audit profession.

55. The Directives clarifies that a group auditor bears full responsibility for the audit report on the consolidated accounts of the company. As regards ‘public-interest entities’ (ie listed companies, banks and insurance companies) the Directive requires that the audit committee must monitor the effectiveness of the company’s internal control, internal audit (where applicable) and risk management systems. Also, only

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[26] In the USA this was done by the Sarbanes–Oxley Act of 2002 (Pub.L. 107–204, 116 Stat. 745).
[27] 2006/43/EC (replacing the Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents) OJ (2006) L 157/87.

non-audit practitioners can participate in the governance of the system of public oversight of the auditors of public-interest entities.

56. Auditors must have knowledge of international accounting standards (IAS) and international auditing standards (ISA). In the case of public interest companies, the audit committee must appoint the statutory auditor or audit firm, and the statutory auditor or audit firm must report to the audit committee on key matters arising from the statutory audit, particularly on material weaknesses of the internal control system. Any threats to the auditor's independence must be disclosed to and discussed with the audit committee, and the auditor must confirm his independence in writing to the audit committee.

57. Member States must set rules for audit fees that ensure audit quality and prevent 'low-balling' (ie offering the audit service for a marginal fee and compensating this with the fee income from other non-audit services).

58. Article 31 of the Audit Directive invited the European Commission to present a report on the impact of current national liability rules for carrying out statutory audits on European capital markets. Following an independent study[28] and a consultation, the European Commission published a recommendation in 2008[29] that the civil liability of statutory auditors, and of audit firms, arising from a breach of their professional duties should be limited, except in cases of intentional breach of duties by the statutory auditor or audit firm.

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[28] 'Study on the Economic Impact of Auditors' Liability Regimes', September 2006: http://ec.europa.eu/internal_market/auditing/liability/index_en.htm.

[29] Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms, OJ (2008) L162/39. http://eur-lex.europa.eu/JOHtml.do?uri=OJ:L:2008:162:SOM:EN:HTML.

The banking crisis

59. The banking crisis in 2008 highlighted that considerable shortcomings remained in the audit system. Notwithstanding serious intrinsic weaknesses in the financial health of the relevant companies, the audits of those companies, carried out immediately before, during and following the crisis, had resulted in 'clean' audit reports.

60. In November 2011, the European Commission issued a proposal for a regulation to increase the quality of audits of public-interest entities, and for a directive to enhance the single market for statutory audits. Key elements of these proposals are:

    (a) Mandatory rotation of audit firms: (audit firms required to rotate after a maximum engagement period of six years (with some exceptions). A cooling off period of four years is applicable before the audit firm can be engaged again by the same client. The period before which rotation is obligatory can be extended to nine years if joint audits are performed).

    (b) Mandatory tendering: (public-interest entities obliged to have an open and transparent tender procedure when selecting a new auditor; the audit committee to be closely involved in the selection procedure).

    (c) Non-audit services: Audit firms prohibited from providing non-audit services to their audit clients. In addition, large audit firms obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest.

    (d) European supervision of the audit sector: (coordination of auditor supervision activities to be within the framework of the European Markets and Securities Authority).