Dear Sir/Madam,

The Quality and Effectiveness of Audit: Call for Views

I have recently completed my postgraduate studies in Corporate Governance & Law (LLM/GradICSA) at the University of Portsmouth and currently work as a Company Secretarial Assistant.

My initial interest in the audit market and audit regulation originates from my undergraduate studies in Accounting & Finance and the early stages of my career as an Accounts Assistant. I have been keen to develop an understanding of the legal and regulatory environment throughout my postgraduate studies and greatly enjoyed writing about auditing as my specialist subject for my postgraduate dissertation.

As part of my postgraduate studies I undertook a dissertation titled: -

"The Expectation Gap on Auditor's Liability"
Submitted on the 4th April 2019 to the University of Portsmouth.

I believe that my dissertation bears significant relevance to your recently published report titled: -

"The Future of Audit: Nineteenth Report of Session 2017-19"
Published on the 2nd April 2019 by authority of the House of Commons.

I would have relished the opportunity to incorporate the findings of the BEIS report into my dissertation prior to its submission, but unfortunately the deadline of my dissertation was too close to publication date of the BEIS report.

I appreciate that I am only 24 years old and a junior professional, but I hope you that find my dissertation proves to be an interesting read and is of some use towards the Brydon Review to reflect upon the quality and effectiveness of audit.

Should an opportunity ever arise to work for ARGA (Audit, Reporting and Governance Authority) or any other associated body then I would greatly appreciate your consideration.

Please find attached a copy of my dissertation (Two hard copies also posted on 03.05.2019).

Kind Regards,
Alexander Couter

U21706 – Legal Dissertation Postgraduate

Submission Title:

The Expectation Gap on Auditor's Liability.

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Supervisor: Dr Lee Roach

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Please Note:-

The Ethics Form & Research Proposal have been appended to the end of this online submission.

ii) Author’s Declaration

I declare that the work of this dissertation was carried out in accordance with the Regulations of the University of Portsmouth. The work is original except where indicated by reference in the text and appropriate citation in the footnotes and bibliography and no part of the dissertation has been submitted for any other degree.

I hereby grant permission for this dissertation to be reproduced and made available to persons or bodies that the University deems appropriate.

Any views expressed are those of the author and in no way represent those of the University of Portsmouth.

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	Print name	Signature
Student	Alexander Couter	

Date Signed: 4th April 2019

iii) Abstract

The audit expectation gap has proven to be a prominent issue for the auditing profession and remains subject to current debate following a string of recent corporate failures which have influenced societal perceptions of auditors. The purpose of this dissertation shall determine the nature of the expectation problem arising from the perceptual differences which exist between what society expects an auditor to achieve and what auditors are capable of accomplishing. The difference between the views of society and those held by the auditing profession with regards to the role and responsibilities of auditors is commonly regarded as the audit expectation gap. The legal analysis of the duty of care owed by auditors has attempted to identify those responsibilities which can be reasonably expected from auditors as it remains within the interests of the auditing profession to minimise litigation risks and ultimately reduce the extent of the audit expectation gap.

Keywords: Audit, Expectation Gap, Duty of Care

iv) Acknowledgements

I would like to express my gratitude to Lee Roach for his valuable advice and feedback given throughout the preparation of this dissertation. Furthermore, I am grateful to all my tutors, study support officers and staff members for their continual efforts and guidance.

I would also like to thank those who supported me throughout my studies, including my family, my girlfriend and my work colleagues for all of their encouragement, patience and support during my time at the University of Portsmouth.

v) Contents

I. List of Figures

II. List of Common Abbreviations

ACCA	Association of Chartered Certified Accountants
AIM	Alternative Investment Market
AQR	Audit Quality Review Team
Big Four	Deloitte, KPMG, Ernst & Young (EY), PWC
CA 2006	Companies Act 2006
FRC	Financial Reporting Council
ICAEW	Institute of Chartered Accountants of England and Wales
PIEs	Public Interest Entities

vi) Introduction

The Cadbury Report recognised auditing as a major cornerstone of corporate governance, serving as an external check when determining the truth and fairness of reported financial information.[1] Auditing provides an assurance service to the users of financial statements and maintains trust in the information reported within capital markets.[2] The auditor does not bear the ultimate responsibility to prevent corporate debacles, but when failures such as Carillion and Patisserie Valerie occur then the question often arises: 'Where were the auditors and did they shout loudly enough?'.[3] It is the prevalence of both historical and recent scandals which have led to public criticism of auditors exacerbating the litigation crisis surrounding the auditing profession.

The litigation crisis refers to an increasing number of lawsuits brought against auditors (discussed further in section 1.2 of this dissertation). One of the first academics to properly recognise the prominence of the litigation crisis was Harris Amhorwitz, who famously stated:

> 'Depending on the context, the global litigation crisis is characterised as one of professional competence, one of public confidence in the auditing profession or one of the profession's fears about its own vulnerability. Although the emphasis of these three characterisations differs somewhat, they all reflect a single underlying notion—that the auditing profession is somehow failing to adequately fulfil the role that society has come to expect it to play. Thus blooms the "audit expectation gap".'[4]

The audit expectation gap refers to the difference between what the general public and other financial statement users perceive the auditors duties and responsibilities to be and what the auditing profession and the auditors themselves believe their duties and responsibilities should entail.[5] Public misconceptions regarding the duties and responsibilities of auditors are a major cause of the litigation crisis surrounding the auditing profession.[6]

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[1] Sir Adrian Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (1st edn, GEE 1992), 35.

[2] Scott Knight, 'A Market Cap is the Quickest Way to Inject Some Competition Into Audit' (CityAM, 7th March 2019) <http://www.cityam.com/274297/market-cap-quickest-way-inject-some-competition-into-audit?fbclid=IwAR2uiwG-pQXM77VtQlAcIXyVaiKELd3ALc7Wnm_pQkNj2VuoUCdJjQHIdbA> accessed 31st March 2019.

[3] ibid.

[4] Harris Amhowitz, 'The Accounting Profession and The Law: The Misunderstood Victim' (1987) 163 Auditing Journal - Issue 5, 358.

[5] ICAEW – Audit Purpose Group, 'Audit Quality Forum Audit Purpose Working Paper' (2006) 2.

[6] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 147.

The Auditing Practices Board, the body responsible for issuing auditing standards and guidelines, states that 'the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with applicable financial reporting frameworks.'[7] In the UK, these frameworks comprise of the CA 2006 and International Financial Reporting Standards (IFRS) for all listed companies.[8] The external auditor appointed forms their objective professional opinion as to whether the financial statements prepared show a "true and fair" view of the entity.[9] The assurance provided by an external auditor reaffirms the confidence of financial statement users, including shareholders, investors and creditors that management has effectively discharged their stewardship responsibility and reported information remains free from bias, material errors or potential fraud which poses significant information risks when users are faced with economic decisions.[10]

On the 15th January 2018, a winding up order was made against the construction company Carillion plc.[11] Carillion serves as a recent reminder of how both past and present corporate collapses raise public critique towards the auditing profession.[12] The reputations of the Big Four accounting firms were subject to severe damage given that Deloitte acted as Carillion's sole internal auditor, KPMG served as external auditor and both EY and PWC were advisers to Carillion prior to its demise.[13] The robustness of KPMG's external audit of Carillion has come under public scrutiny and is currently being investigated by the FRC amidst mounting public pressure. KPMG stated that their audits were 'conducted appropriately and responsibly' and recognised Carillion as a going-concern for the 12 months following Carillion's accounting year which ended on the 31st December 2016.[14] Following the provision of the audit opinion, Carillion issued a disastrous profit warning which saw their Chief Executive step down with immediate effect.[15]

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[7] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 4.
[8] PWC, 'New UK GAAP or IFRS?' (2013) 1, 3.
[9] Kamal Gupta, *Contemporary Auditing* (6th edn, McGraw Hill 2004) 8.
[10] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 55.
[11] The Insolvency Service, 'Carillion Declares Insolvency: Information for Employees, Creditors and Suppliers' (Gov.uk, 15th January 2018) <https://www.gov.uk/government/news/carillion-declares-insolvency-information-for-employees-creditors-and-suppliers> accessed 9th April 2018.
[12] Tom Herbert, 'Carillion Collapse Raises Audit and Governance Questions' (AccountingWeb, 16th January 2018) <https://www.accountingweb.co.uk/business/financial-reporting/carillion-collapse-raises-audit-and-governance-questions> accessed 9th April 2018.
[13] Sebastian McCarthy, 'A Summer to Forget: KPMG Reputation Dealt Another Blow' (CityAM, 19th September 2018) <http://www.cityam.com/263291/summer-forget-kpmg-reputation-dealt-another-blow-after> accessed 28th September 2018.
[14] Christopher Williams, 'Carillion Auditor KPMG Faces Scrutiny for Approving Books Months Before Collapse' (The Telegraph, 15th January 2018) < http://www.telegraph.co.uk/business/2018/01/15/carillion-auditor-kpmg-faces-scrutiny-approving-books-months/> accessed 3rd May 2018.
[15] Conor Sullivan, 'Carillion Chief Quits and Shares Tumble After Profit Warning' (The Financial Times, 10th July 2017) <https://www.ft.com/content/4ca80d5a-6537-11e7-8526-7b38dcaef614> accessed 5th May 2018.

The collapse of Carillion highlights the two opposing viewpoints which emphasise the expectation gap in that auditors cannot predict future outcomes following the provision of their audit opinion and that the public may place unreasonable expectations on the duties and responsibilities of auditors for not raising the alarm in the first place. It is often the case that when poor corporate governance is exposed, usually as a result of fraud and mismanagement, that the auditor is subject to criticism in the media for not discovering and reporting the problem sooner.[16] However, this blame may be misplaced given that full investigations into potential causes can take many months and possibly even years to determine the parties responsible and the true reasons behind such failures.

A recent ACCA survey indicated that 41% of survey respondents expected the detection of all instances of fraud and misstatements.[17] This expectation is often unobtainable due to the inherent limitations of auditing which include time constraints due to the cost of the audit engagement to the client, sampling restrictions and the potential for concealed fraud which can prove difficult to detect.[18] The users of financial statements often fail to factor the inherent limitations of auditing into their expectations of auditors.[19] The auditor may have made every effort to ensure they carried out their role to a reasonable standard, but they may yet find themselves subject to blame and costly reputational damage should any financial irregularities be discovered following the provision of their audit opinion.[20] It is this perceived failure by the auditing profession to adequately fulfil society's expectations which gives rise to the expectation gap.[21]

The expectation gap arises from the fact that 'the users of financial statements have expectations which exceed the current practice of the profession'.[22] Since the auditor merely expresses their opinion as to whether the financial statements are presented fairly in all material respects, their opinion cannot be taken as an absolute guarantee that no fraud and errors are present due to the inherent limitations of auditing, especially considering that management has incentives to issue biased financial information as remuneration and bonuses are often linked to performance.[23] The public and other stakeholders

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[16] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 649.
[17] Pat Sweet, 'Only 25% of the Public Know the Role of an Auditor' (AccountancyDaily, 19th November 2018) <https://www.accountancydaily.co/only-25-public-know-role-auditor?fbclid=IwAR2hLFajzn8wUCqJrFQdNXdv1yIoc1JGro4Vqqrhe3KIAW1fNAWy1dLJT08> accessed 6th December 2018.
[18] Khor Hun, 'Don't Expect Too Much From Auditors – They're Watchdogs, Not Bloodhounds' (SCMP, 19th December 2011) <https://www.scmp.com/article/988139/dont-expect-too-much-auditors-theyre-watchdogs-not-bloodhounds> accessed 12th May 2018.
[19] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 59.
[20] Harris Amhowitz, 'The Accounting Profession and The Law: The Misunderstood Victim' (1987) 163 Auditing Journal - Issue 5, 358.
[21] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 58.
[22] ibid.
[23] Lee Roach, *Card and James: Business Law* (4th edn, OUP 2016) 562.

generally overestimate the role of auditors leading to a damaging expectation gap which continues to influence the debate about the future of auditing.[24]

I. Research Aims & Dissertation Structure

The aim of this research is to examine the relationship which exists between the expectation gap and the duty of care owed by auditors. The research conducted shall analyse how public perceptions have exacerbated the number of claims made against auditors and increasingly put pressure upon the audit-client relationship as the profession has struggled to keep pace with societal expectations.

It is important to establish the link which exists between the duty of care owed by auditors and the expectation gap surrounding their role and responsibilities. This dissertation shall identify the link between these two topics and determine a number of methods which can be used to narrow the expectation gap.

The project aim shall be accomplished by addressing the following research objectives throughout the chapter structure of this dissertation:

- **Chapter One:**
    - *Define and identify* the different components of the expectation gap.
    - *Analyse* the impact of the expectation gap on the number of lawsuits made against auditors.
- **Chapter Two:**
    - *Examine* the duty of care owed by auditors and how this differs from what the public typically expect.
- **Chapter Three:**
    - *Propose* a number of different solutions and methods to narrow the expectation gap.

[24] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 33.

Chapter One: The Expectation Problem – A litigation crisis?

In this chapter an overview will be provided of the structural components of the expectation gap and how this relates to the litigation crisis surrounding the auditing profession. The consequences of failing to address components of the expectation gap have resulted in perceptual differences between the level of assurance the public expect from auditors and the level of assurance auditors are capable of providing with regards to the veracity of reported financial information.[1] In cases where the level of assurance provided by an auditor fails to live up to the expectations of the users of audit services then there has been an increasing trend to target the auditors "deep-pockets" and blame them for failing to discover and report instances of fraud and misstatements. The attribution of responsibility for financial loss associated with the perceived failures of the auditing profession to deliver the level the assurance society has come to expect has led to an increasing number of lawsuits brought against auditors as the parties concerned have sought to recover their investment loss.

1.1 The Expectation Problem

The existence of the expectation gap is often regarded as an expectation problem by those who are familiar with the auditing profession. The primary cause of the expectation problem arises from public perceptions surrounding the responsibilities of auditors and to what extent the auditor owes a duty of care to parties who have suffered quantifiable loss.[2] In recent times, adverse media publicity concerning auditors and well-publicised corporate collapses have shaken public confidence towards the auditing profession and sparked new debate in relation to the expectation problem.

1.1.1. The Expectation Gap

In the European Union over two million audits are conducted annually in accordance with statutory requirements and regulatory frameworks.[3] At the time of writing, the UK remains as an EU Member State and continues to enforce the Audit Directive and Audit Regulation, but reliance is also placed upon national law which includes the CA 2006. The Audit Directive defines a statutory auditor as 'a natural person who is approved in accordance with the Audit Directive by the competent authorities of a

[1] David Hay et al., *The Routledge Companion to Auditing* (1st edn, Routledge 2014) 44.
[2] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 30.
[3] ibid 160.

Member State'.[4] The lack of a standard definition of a statutory auditor due to variations in the requirements and interpretations by the different competent authorities of each EU Member State add to many contributing factors which lead to a damaging expectation gap.[5]

The expectation gap was first applied to the role of financial practitioners by Liggio.[6] Liggio attempted to define the gap as 'the difference in the level of expected performance as envisioned by both the users of the financial statements and the independent accountant'.[7] The definition proposed by Liggio focused on the performance aspect of auditors and became known as the definition of a performance gap.[8] The Commission on Auditors' Responsibilities (CAR) expanded upon Liggio's definition to consider 'whether a gap may exist between what the public expects and what auditors can and should reasonably be expected to accomplish', otherwise known as the reasonableness gap.[9] The CAR recognised the expanded public expectations placed upon the role of auditors and tailored their definition to encompass numerous societal groups by referring to "the public" rather than merely "the users of financial statements".

Porter contended that these definitions failed to fully acknowledge the two separate components attributing towards the expectation gap.[10] Porter suggested that Liggio 'failed to recognise that auditors may not accomplish expected performance' and that the CAR definition only considers what auditors 'can and reasonably should expect to accomplish'.[11] Porter proposed that the performance gap and the reasonableness gap should be merged to form the modern-day definition of the expectation gap as 'the difference between society's expectations of auditors and their perceptions of the services which auditors actually deliver'.[12]

The expectation gap identified by Porter recognises that 'two major components exist:

i) **A reasonableness gap** – the gap between the responsibilities society expects auditors to perform and those responsibilities which are reasonable to expect of auditors;

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[4] EU Audit Directive (2006/43/EC), Article 2(2).
[5] Europa, 'Green Paper: The Role, The Position and The Liability of The Statutory Auditor Within The European Union' (1996) European Auditing, 4.
[6] Carl Liggio, 'The Expectation Gap: The Accountant's Legal Waterloo' (1974) 3 Contemporary Business Journal, 27.
[7] ibid.
[8] ibid.
[9] American Institute of Certified Public Accountants, 'The Commission on Auditors' Responsibilities: Report, Conclusion and Recommendations' (1978) Cohen Commission Report, xi.
[10] Brenda Porter, 'An Empirical Study of the Audit Expectation-Performance Gap' (1993) 24 Accounting and Business Research Journal, 49-68.
[11] ibid.
[12] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 786.

ii) **A performance gap** – the gap between the responsibilities society reasonably expects of auditors and those it perceives they deliver (or, more precisely, those it perceives they perform deficiently). This component comprises of:

a) **A deficient standards gap** – the gap which arises from both the limitations of law and responsibilities which can be reasonably expected of auditors and those which auditors are obliged to perform under statute or case law, regulations or other professional promulgations;

b) **A deficient performance gap** – the gap between the standard of performance of the auditors' existing responsibilities which are expected, and perceived to be delivered, by society.'[13] Otherwise known as the actual risk of an audit opinion being misleading in the audit report.

The structure of the expectation gap is shown below.

Figure 1 – The Audit Expectation Gap

Figure 1 demonstrates how the overall gap referred to by Porter can be broken down into its structural components. The analysis of the performance gap and reasonableness gap allowed Porter to identify three separate components which contribute towards the expectation gap (i.e. deficient performance, deficient standards and unreasonable expectations).

The performance gap includes the potential for deficient performance by auditors below the standard of their existing responsibilities and a deficient standards gap in that both existing laws and other regulations do not hold auditors accountable to a level which ought to be reasonably expected of them. The unreasonable expectations of society attribute towards the reasonableness gap as auditors cannot be expected to go beyond those responsibilities which are reasonably expected of them, despite societal expectations setting an unobtainable benchmark.

[13] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 786.

The purpose of the audit function adds to the credibility of reported financial information allowing users to feel more confident when they place their reliance on such information.[14] Limperg developed the theory of rational expectations which states that auditors ‘should be governed by the rational expectations of those who may use the financial statements’.[15] An auditor should remain prudent and not act in a manner that disappoints and undermines the expectations of those who may use financial statements, but the auditor should not arouse greater expectations from their opinion more than their examination justifies.[16]

The expectation gap threatens auditing as the credibility and legitimacy of the profession remains subject to discreditation by the users of financial statements.[17] The expectation gap reduces the perceived utility that audit services can deliver as the users of audited accounts mistakenly rely on the audit opinion as a form of guarantee of a company’s solvency, propriety and future viability.[18] The users of financial statements ought to understand what the audit opinion achieves and that it should not be considered as a guarantee of the veracity of the financial statements given that it would be impossible to promise they are fully accurate due to the inherent limitations of auditing.[19]

Numerous studies suggest considerable differences exist between what the public expects an audit to achieve and what the auditing profession believes the auditor can reasonably be expected to deliver. The expectation gap has existed for more than 100 years,[20] and has been the subject of countless studies in a ‘wide range of countries – for example, in Australia, Canada, China, the UK and the USA’.[21] These studies were conducted to ascertain whether an expectation gap existed and to determine the elements which contribute towards the expectation gap.[22] These studies universally concluded that the users of financial statements expected far more from auditors than it would be reasonable for auditors to deliver and that the users possessed little understanding of the role and responsibilities of auditors.[23]

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[14] Carol Adams & Richard Evans, ‘Accountability, Completeness, Credibility and the Audit Expectations Gap’ (2004) Journal of Business & Economics 97.
[15] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 9.
[16] Hans Blokdijk et al., ‘Reflections on Auditing Theory, A Contribution from the Netherlands’ (1995) 23-24.
[17] Claus Holm & Mahbub Zaman, ‘Regulating Audit Quality: Restoring Trust and Legitimacy’ (2011) Auditing Journal, 1.
[18] ibid.
[19] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 59.
[20] Roy Chandler & John Edwards, ‘Recurring Issues in Auditing: Back to the Future?’ (1996) 9 Auditing and Accounting Journal 2.
[21] David Hay et al., *The Routledge Companion to Auditing* (1st edn, Routledge 2014) 44.
[22] ibid.
[23] ibid.

1.1.2. ACCA Survey 2018 – Audit Perceptions

In 2018, the ACCA commissioned a survey of 1000 members of the general public to analyse societal expectations of auditing.[24] The ACCA selected a representative sample of the UK population, 'weighted evenly by gender and spread across age, education level and household income' to adequately reflect the views of society.[25] The preliminary results revealed an urgent need to address the legitimate concerns of the users of financial statements in order to understand what kind of future role the public expects from auditors and how the profession can seek to close the expectation gap.[26] An analysis of the results can be found below.[27]

Figure 2 – ACCA Survey Result (i)

Figure 2 recognises that 48% of the survey's respondents possess unreasonable expectations as they believe auditors are solely responsible for preventing corporate failures. A variety of reasons which the auditor is not responsible for can lead to corporate failures such as poor strategic decisions, intense competitive rivalry, external changes to the business environment, the potential for undetected fraud and poor oversight by the board of directors or senior management.[28] Extrapolating these results to

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[24] Maurice Richmond, 'New Research Reveals 48% of Public Believe Auditors Could Prevent Company Failures' (ACCA, 2018) <https://www.accaglobal.com/my/en/news/2018/november/audit-expectation-gap.html> accessed 6th June 2018.
[25] ibid.
[26] Pat Sweet, 'Only 25% of the Public Know the Role of an Auditor' (AccountancyDaily, 19th November 2018) <https://www.accountancydaily.co/only-25-public-know-role-auditor?fbclid=IwAR2hLFajzn8wUCqJrFQdNXdv1yloc1JGro4Vqqrhe3KIAW1fNAWy1dLJT08> accessed 6th December 2018.
[27] Maurice Richmond, 'New Research Reveals 48% of Public Believe Auditors Could Prevent Company Failures' (ACCA, 2018) <https://www.accaglobal.com/my/en/news/2018/november/audit-expectation-gap.html> accessed 6th June 2018.
[28] Stewart Hamilton & Alicia Micklethwait, *Greed and Corporate Failure: The Lessons from Recent Disasters* (1st edn, Palgrave Macmillan 2016) 27.

represent the views of wider society suggests that societal expectations far exceed the ability of the auditing profession. The courts have indicated that the responsibility for avoiding corporate failures would fall outside of the purview of an auditor's duty of care because it would result in a multitude of claims made against auditors with no restrictions on the scope of the claim brought against them.[29]

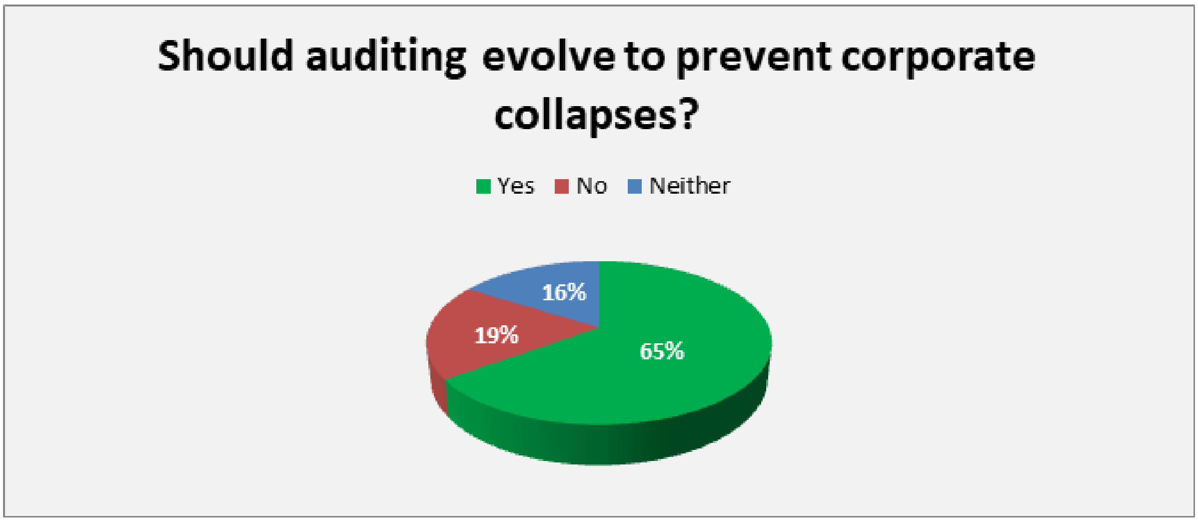

Figure 3 – ACCA Survey Result (ii)

Figure 3 highlights the widening expectation gap as the results suggest a growing need for the expansion of the auditors' existing responsibilities in order to meet the demanding expectations of society.

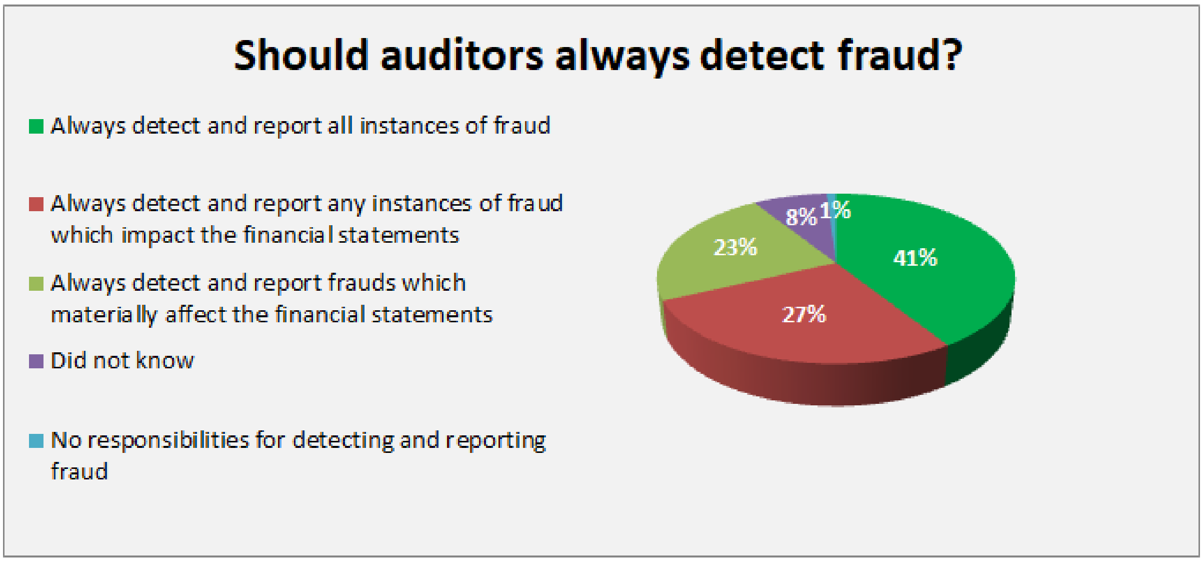

Figure 4 – ACCA Survey Result (iii)

Figure 4 recognises that 91% of respondents expected auditors to detect and report instances of fraud, but societal expectations varied in terms of the degree of fraud an auditor should be expected to detect. These results suggest that each group within society possesses their own set of expectations of what

[29] Cardozo CJ in Ultramares Corporation v Touche [1931] 255 NY 170 at 179.

auditors are capable of accomplishing.[30] Only 1% of respondents believed auditors should have no responsibilities for detecting and reporting fraud. The limitations of auditing and certain inherent risks, such as human error and the potential for concealed fraud will always prevent auditors from providing any more than their opinion on a set of financial statements. Auditors are incapable of providing a full guarantee that the financial statements will be free from all instances of fraud or misstatements. The courts have recognised that it would be unreasonable to expect such guaranties from auditors as the duty of care owed by an auditor does not include the detection of all instances of fraud and misstatements.[31]

History has shown that the auditors' responsibility with regards to the detection of fraud has changed significantly throughout time.[32] Leung *et al.* recognised that from the mid-1800s to the early 1900s, the objective of auditing had changed from 'fraud detection' to the 'verification and enhancement of the integrity and credibility of financial statements' meaning that the audit purpose was no longer primarily focused on the detection of fraud and misstatements.[33] It can be argued that this change has exacerbated the reasonableness gap and caused a significant degree of confusion over what can be reasonably expected of auditors.

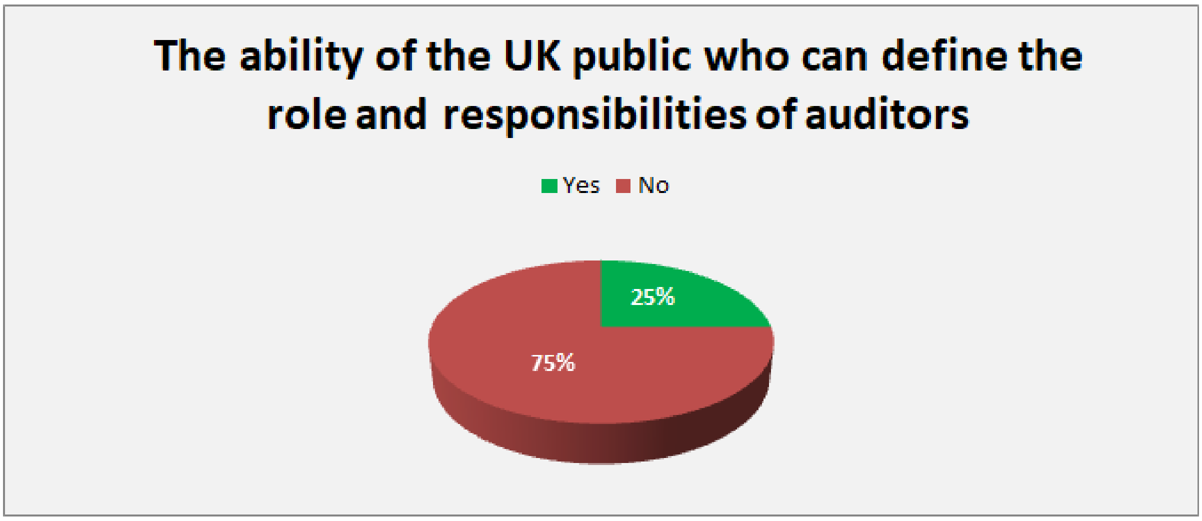

Figure 5 – ACCA Survey Result (iv)

Figure 5 demonstrates that 25% of respondents could identify the role and responsibilities of an auditor. It should be noted that no universal definition exists of the role and responsibilities for auditors as this is subjective dependent upon the circumstances, but this question was proposed to survey respondents in

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[30] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 58.
[31] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.
[32] ibid 51.
[33] Philomena Leung et al., 'The Audit Expectation Gap: A Review of the Contributing Factors' (2004) 4 Journal of Modern Accounting and Auditing 30.

line with the competency framework criteria for external auditors set by the ACCA.[34] Only 6% of respondents who were able to answer the question could accurately identify all of the different pieces of information contained within an audit report (audit opinion, materiality, key audit matters paragraph and the managerial responsibilities for an audit).[35] It is clear that some confusion exists regarding the purpose of an audit highlighting that the auditing profession must educate society on the role and responsibilities of auditors in order to proactively address the expectation gap.

The ACCA survey results support the historical findings of Humphrey who conducted a similar survey to ascertain the perceptions of the UK public with regards to the expectation problem. Humphrey's survey indicated that the expectations of the users of financial statements exceeded the ability of the auditing profession to deliver the services expected of them and that these users failed to fully understand the role of auditors.[36] The weight of expectation which society places upon auditors suggests that auditors are expected to play a crucial role in corporate safeguarding, assuring the confidence of financial statement users.[37]

1.2 The Litigation Crisis

The litigation crisis faced by the auditing profession is indicative of the expectation gap as different parties seek to hold auditors responsible for perceived audit failures by demanding a higher duty of care than the existing responsibilities required of auditors.[38] The demanding weight of societal expectation to prevent corporate failures and detect all instances of fraud and misstatements sets a benchmark which auditors are incapable of satisfying as the courts have recognised that these expectations are generally considered unreasonable. Judicial systems have attempted to address the reasonableness gap indicating that auditors are only capable of achieving the duties which can be reasonably expected from them given the circumstances of the case.[39] The limits to what extent an auditor owes a duty of care when there is a

[34] ACCA, 'Competency Framework – External Auditor' (ACCA, 2018) <https://www.accaglobal.com/uk/en/qualifications/why-acca/competency-framework/job-profiles/advisory-audit-risk-and-assurance/external-auditor.html> accessed 31st March 2019.
[35] Maurice Richmond, 'New Research Reveals 48% of Public Believe Auditors Could Prevent Company Failures' (ACCA, 2018) <https://www.accaglobal.com/my/en/news/2018/november/audit-expectation-gap.html> accessed 6th June 2018.
[36] Christopher Humphrey et al., 'The Audit Expectations Gap in Britain: An Empirical Investigation' (1993) 23 Journal of Accounting and Business Research, 4.
[37] Maurice Richmond, 'New Research Reveals 48% of Public Believe Auditors Could Prevent Company Failures' (ACCA, 2018) <https://www.accaglobal.com/my/en/news/2018/november/audit-expectation-gap.html> accessed 6th June 2018.
[38] Ping Zhang, 'The Impact of the Public's Expectations of Auditors on Audit Quality and Auditing Standards Compliance' 24 Contemporary Accounting Research 2, 631.
[39] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.

perceived audit failure highlights the expectation gap as auditors currently bear the level of responsibility of their existing duties, but claimants typically seek to hold auditors responsible to higher standard as a result of societal over-expectation. Public misconceptions regarding the perceived duty of care owed have exacerbated the amount and severity of litigation claims brought against auditors resulting in the litigation crisis faced by the auditing profession.[40]

1.2.1. The Legal Environment

The legal environment with regards to the auditing profession is one which continuously evolves due to changes in auditing standards, practices and societal expectations.[41] The ever-changing nature of the legal environment means that it is very difficult to accurately identify fixed points on the expectation gap model.[42] Furthermore, many important aspects of auditing are not subject to precise rules or legal definitions, for example, the courts have been unable to precisely define what "true and fair" actually means as this definition depends upon the circumstances of each case.[43] The courts consider the interests of society when determining the duties required of auditors, but to date no court has been able to 'prescribe a complete, precise and authoritative definition' to encapsulate all of the duties required of auditors.[44]

The estimated value of lawsuits made against auditors increased significantly from $2 billion in 1980 to $50 billion in 2004, representing outstanding claims made against the Big Four firms alone.[45] The expectation problem has been exacerbated following the 2008 financial crisis and the subsequent recession.[46] An increased risk of corporate insolvency exists during recessionary periods, leading to corporate failures and the incentivisation for managerial bias, as difficult times can 'lead to inappropriate shortcuts being taken ultimately damaging corporate reputations'.[47] The work of an auditor will typically

[40] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 147.
[41] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 472.
[42] Christopher Humphrey, 'Audit Expectations' (1991) 3 Auditing Journal, 21.
[43] Francis Palmer, *Palmer's Company Law* (3rd edn, Stevens 1987) 6302.
[44] Customs and Excise Commissioners v Barclays Bank [2006] 4 All ER 256 HL.
[45] The Economist, 'The Future of Auditing: Called to Account' (The Economist, 18th November 2004) <https://www.economist.com/special-report/2004/11/18/called-to-account> accessed 4th July 2018.
[46] Klaus Ruhnke & Martin Schmidt, 'The Audit Expectation Gap: Existence, Causes and the Impact of Changes' (2014) 44 Accounting and Business Research Journal – Issue 5, 573.
[47] Jonathan Hunt et al., *The Effective Audit Committee: A Challenging Role* (1st edn, ICAEW 2001) 9.

be used to support or promote the business to financial statement users who rely on the audit opinion as a form of assurance.[48]

The FRC recognised the dominance of the Big Four as they 'audit 97% of FTSE 350 companies'.[49] The recessionary period following the 2008 financial crisis led to criticism of the Big Four for failing to provide warning signs of the impending crisis.[50] The 2008 financial crisis revealed large scale losses by financial institutions despite a clean bill of health from audit reports.[51] The House of Lords referred to auditors as 'the dogs which didn't bark' as Lord Forsyth found it difficult to believe that auditors failed to raise the alarm.[52] The dominance of the Big Four reduces the choice of auditors for large companies and according to the Competition Commission can result in higher prices and lower audit quality.[53] Deloitte and PWC disputed the findings of the Competition Commission and claimed that the Big Four were not collectively failing shareholders and that competition remains fierce.[54] The FRC supported the Big Four by stating that 'a market with four participants would see competition against one another on price, quality and innovation'.[55] The FRC contended that if a Big Four firm were to fail then this 'would restrict competition to an unacceptable extent and undermine public and investor confidence in financial statements'.[56] It is generally agreed that audit market concentration is considered to have undesirable consequences which ultimately impacts upon audit quality.[57]

The auditing profession has experienced a low percentage of audit failures compared to the total number of audits conducted.[58] Cosserat and Rodda recognised that the volume and cost of litigation related to alleged audit deficiencies have increased in recent years proving to be a cause of concern for the auditing profession.[59] The threat of litigation has exposed a vulnerability in the confidence of the profession as auditors tend to adopt a cautious approach by conducting more work to reduce risk, ultimately serving to increase the audit fee charged to clients.[60] The Big Four adopt a cautious approach

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48 FRC, 'Stephen Haddrill at the International Auditor Regulatory Institute' (FRC, 3rd December 2013) <https://www.frc.org.uk/news/december-2013/speech-by-stephen-haddrill-at-the-pcaob-s-internat> accessed 13th July 2018.
49 FRC, 'Developments in Audit 2016/17' (2017) Summary Report 6.
50 Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 798.
51 Brenda Hannigan, *Company Law* (4th edn, OUP 2016) 469.
52 House of Lords Select Committee on Economic Affairs, 'Auditors: Market Concentration and their Role - 2nd Report of Session' (2010) 1 Select Committee Report - para 167.
53 Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 816.
54 Beth Abel, 'Big Four Dismiss Claims They Are Failing Shareholders' (AccountancyAge, 22nd February 2013) <https://www.accountancyage.com/aa/news/2250149/big-four-dismiss-claims-they-are-failing-shareholders> accessed 20th July 2018.
55 FRC, 'Response to Green Paper - Audit Policy: Lessons from the Crisis' (2010) – para 2.18.
56 ibid.
57 Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 818.
58 Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 112.
59 ibid.
60 Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 391.

when accepting high-risk clients due to the threat of litigation and smaller audit firms are only capable of serving a few low-risk clients as they do not have the risk capacity to tackle large-scale audit engagements.[61] The threat of litigation has begun to erode the confidence of the auditing profession causing some audit firms to resign from high-risk clients and deterring many new graduates from entering into public practice.[62]

When an economic climate experiences a recession and pressure is placed upon the business environment there is generally an increase in the amount of professional negligence lawsuits brought against auditors.[63] The Conference Board has suggested that the British economy could shrink in 2019 as the UK faces a high risk of recession.[64] The uncertainty around Brexit has made it difficult for businesses to strategically plan which investments they ought to pursue and this uncertainty could lead to inaction intensifying the risk of a recession.[65] On this basis, it seems inevitable that another corporate debacle will occur which shall once again place pressure upon the auditing profession. The uncertain nature of a post-Brexit Britain may give rise to the perfect storm of corporate failures further exacerbating the litigation crisis faced by the auditing profession.

1.2.2. Audit Quality Review

In the wake of former accounting scandals at companies like Carillion and Patisserie Valerie, the Department for Business, Energy and Industrial Strategy (BEIS) have commissioned an independent review into the quality and effectiveness of the current audit market as part of the Brydon Review due to take place throughout 2019.[66] The performance of audits to a high standard helps reassure the confidence of the users of financial statements reinforcing that auditors have performed their role to an appropriate standard satisfying societal expectations and serving to protect audit firms against the damaging litigation claims brought against them.[67] One of the key reasons why a significant proportion of society expects the detection of all instances of fraud and misstatements is due to the fact that auditors are regarded as the only independent professional who routinely visits companies and checks the

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[61] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 113.
[62] ibid.
[63] Matthew Lawson, 'Litigation: Auditors Get the Blame' (AccountancyAge, 26th March 2009) <https://www.accountancyage.com/aa/feature/1761924/litigation-auditors-blame> accessed 24th July 2018.
[64] Ilaria Maselli, 'The Risk of a UK Recession is Growing' (The Financial Times, 18th September 2018) <https://www.ft.com/content/07f500bc-ba97-11e8-8dfd-2f1cbc7ee27c> accessed 25th October 2018.
[65] ibid.
[66] Louis Ashworth, 'Grant Thorton and the Fraudian Slip' (CityAM, 8th February 2019) <http://www.cityam.com/272955/grant-thornton-and-fraudian-slip?fbclid=IwAR0KCeeWXnHq8CqImf0ETBptrhidgBbrCw-T18auqEjURLJTaPh5MCsJ0SU> accessed 9th February 2019.
[67] Graham Ward, *A Practitioner's Guide to Audit Regulation in the UK* (1st edn, City & Financial Publishing 2004) 201.

processes and information used to produce the accounts.[68] The auditor has a general right of access to the company's books, accounts and the ability to request any information necessary to perform his duties.[69] It is generally accepted that it would be unreasonable to expect auditors to detect all minor frauds or very ingeniously concealed fraud.[70] The degree of fraud detection required remains open to interpretation as different members of society possess different opinions as to what it is reasonable to expect from auditors.[71]

A study conducted by Crowe Clark Whitehill and the University of Portsmouth's Centre for Counter Fraud Studies estimated that the total impact of all recorded UK frauds when applied to the average loss rate of UK GDP in 2016 implied that total losses amounted to £110 billion.[72] PWC indicated that 18% of all recorded instances of fraud in 2016 resulted from those categorised in relation to business conduct which includes both 'the manipulation of accounting records and the deliberate overcharging of customers'.[73] The results of these surveys suggest that frauds categorised in relation to business conduct resulted in total estimated losses of £19.8 billion to the UK economy in 2016. As a consequence, it is no surprise that legislative pressure has been placed upon a number of regulatory bodies to enhance the role of auditors to address this issue, especially as the number of reported cases of fraud and accounting scandals has increased significantly in recent years.[74]

The European Parliament and the Council of the European Union recognised the severity of the issue and sought to address the deficient standards component of the expectation gap by introducing audit reform measures. The Audit Directive introduced the requirement for audit firms of PIEs to publish annual transparency reports which must contain 'a description of internal quality control systems and a confirmation of its effectiveness by the management of the audit firm'.[75] Furthermore, the Audit Regulation introduced the requirement for regulatory bodies to inspect the work performed by auditors

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68 Brenda Porter, *Current Issues in Auditing - Auditors' Responsibilities with Respect to Corporate Fraud – A Controversial Issue* (3rd edn, Paul Chapman Publishing 1997) 47.
69 CA 2006, s.499.
70 Brenda Porter, *Current Issues in Auditing - Auditors' Responsibilities with Respect to Corporate Fraud – A Controversial Issue* (3rd edn, Paul Chapman Publishing 1997) 44.
71 ibid.
72 Jim Gee & Mark Button, 'The Financial Cost of Fraud 2018' (Crowe Clark Whitehill, 30th May 2018) <https://www.crowe.com/uk/croweuk/-/media/Crowe/Firms/Europe/uk/CroweUK/PDF-publications/Financial-Cost-of-Fraud-2018.ashx?la=en-GB&hash=F3D9DED968C59B2469729C7FDCDDFF9B481C65BC> accessed 2nd September 2018.
73 Fran Marwood et al., 'PwC's Global Economic Crime Survey 2018: UK Findings Pulling Fraud Out of the Shadows' (PWC, 3rd April 2018) <https://www.pwc.co.uk/forensic-services/assets/gecs/global-economic-crime-survey-2018-uk-findings.pdf> accessed 11th September 2018.
74 Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 32.
75 Graham Ward, *A Practitioner's Guide to Audit Regulation in the UK* (1st edn, City & Financial Publishing 2004) 208.

of PIEs to address the performance gap and bring auditors existing responsibilities in line with those which ought to be reasonably expected from an audit engagement.[76]

The FRC was designated as the competent authority for the Audit Regulation whose responsibilities led to the establishment of the Audit Quality Review (AQR) team. The role of the AQR is to monitor the quality of audit work performed by the auditors of PIEs on an annual basis for larger firms, while others are generally inspected once every three years.[77] The AQR publishes annual reports based on the scope of their work for entities whose audits are conducted under UK company law.[78] Although the AQR provides an important function with regards to monitoring the effectiveness of audits, it is worth noting that the review of audit work could occur to infinite regress since an inherent risk for human error remains no matter how many times the work of an auditor is reviewed. The extent to which an auditor's work is reviewed depends upon a cost-benefit analysis of the perceived value added by the review work.

The FRC has a vested interest in upholding their reputation by pressurising audit firms to continuously improve audit quality as this improves the overall performance of the audit market.[79] The FRC comes under scrutiny by the media if they appear to apply an overly soft-touch towards audit firms.[80] In 2018, the BEIS commissioned an independent review of the FRC by Sir John Kingman to determine whether the FRC has been performing its role effectively and whether their transparency and independence remains fit for the future.[81] The results of the Kingman Review have been welcomed by the FRC following a scathing analysis which has called for their immediate replacement by a new public oversight body, namely the Auditing, Reporting and Governance Authority (ARGA), who would possess new statutory powers to regulate against major audit firms and enforce a stronger audit regime in the UK.[82]

Stephen Hadrill, CEO of the FRC, stated:

> 'At a time when public trust in business and audit is in the spotlight, the Big Four must improve the quality of their audits. They must urgently address several factors which are vital to audit,

[76] Liz Loxton, 'Keeping Tabs on Audit' (ICAEW, 3rd June 2015) <https://economia.icaew.com/features/june-2015/keeping-tabs-on-audit> accessed 15th September 2018.
[77] FRC, 'Audit Quality Review' (FRC, 18th June 2018) <https://www.frc.org.uk/auditors/audit-quality-review> accessed 16th September 2018.
[78] FRC, 'Scope of Independent Inspections' (FRC, 2013-2017) <https://www.frc.org.uk/auditors/audit-quality-review/scope-of-independent-inspections> accessed 16th September 2018.
[79] Patrick Collinson, 'Accounting Watchdog Could Ban Auditors from Consultancy Work' (The Guardian, 8th October 2018) <https://www.theguardian.com/business/2018/oct/08/accounting-auditors-consultancy-frc-kpmg> accessed 10th October 2018.
[80] ibid.
[81] Simon Jack, 'UK Accountancy Firms Face Major Overhaul Under New Plans' (BBC, 18th December 2018) <https://www.bbc.co.uk/news/business-46591575> accessed 6th January 2019.
[82] James Bunney, 'Kingman Calls for Abolition of FRC as Audit Regulator' (AccountancyDaily, 18th December 2018) <https://www.accountancydaily.co/kingman-calls-abolition-frc-audit-regulator> accessed 6th January 2019.

including the level of challenge and scepticism by auditors. Firms must renew their efforts to improve audit quality to meet the legitimate expectations of investors and other stakeholders'.[83]

The significance of this comment sets out the expectations which the FRC demand of the auditing profession reinforcing the need for audit firms to improve audit quality. The FRC can publically criticise audit firms by naming and shaming them following the publication of AQR reports directing pressure upon audit firms whose reputation may suffer as a result of poor performance. Soltani recognised that the threat of reputational damage encourages audit firms to produce higher quality work as reputational effects can increase or decrease the demand for audit services.[84] The brand value of an auditor attributes towards the perceived value of an audit and should the reputation of an audit firm suffer then fewer clients will demand their services.[85]

Auditors devote effort towards upholding their reputation as it can be 'used as a control device in the shareholder-manager-auditor relationship motivating the auditor to supply high-quality audit services'.[86] Shareholders rely upon the audit services provided and believe that high-quality audits are only produced by reputable auditors.[87] Management will want to appease the demands of their shareholders by appointing a reputable auditor and may reward the auditor by placing a stable and continued demand for their services should they deliver high-quality cost-effective audits.[88] As a result of managerial incentives to issue biased financial information, auditors must exercise professional scepticism due to the potential for concealed fraud as management may have ulterior motives despite the guise of their legitimate interests.[89]

It is widely known that audit quality and performance can vary on an annual basis. In 2018, the FRC highlighted how the Big Four need to improve their performance to achieve audit quality targets.[90] KPMG were publically criticised by the FRC in 2018 following the AQR results which indicated that 50% of KPMG's FTSE 350 audits 'required more than limited improvements, compared to 35% in the previous year'.[91] As a result, the FRC will place greater scrutiny on the work of KPMG, inspecting 25% more KPMG audits over the 2019 audit cycle and will closely monitor the implementation of KPMG's Audit Quality

[83] FRC, 'Big Four Audit Quality Review Results Decline' (FRC, 18th June 2018) <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline> accessed 7th January 2019.
[84] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 198.
[85] ibid.
[86] ibid 588.
[87] ibid 588.
[88] ibid 588.
[89] Lee Roach, *Card and James: Business Law* (4th edn, OUP 2016) 562.
[90] FRC, 'Big Four Audit Quality Review Results Decline' (FRC, 18th June 2018) <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline> accessed 9th January 2019.
[91] ibid.

Plan.[92] The fact that the FRC sets targets for audit quality suggests auditors can never be expected to achieve perfection otherwise there would be no need to set audit quality targets as perfection would always be demanded from auditors.

If an audit firm experiences a significant decline in audit quality or takes part in unethical practice, auditors should be held to account for their actions and any reputational damage incurred resulting from adverse public opinion may be justified.[93] A number of historical cases illustrate situations where an auditor has been held responsible for their actions, such as the involvement of Arthur Andersen in the Enron scandal.[94] Arthur Andersen was initially appointed as Enron's auditor in 1985 and was globally revered as a "Big Five" accounting firm.[95] In 2002, Enron concealed its real level of debt through inflating profits and off-balance sheet financing resulting in approximate shareholder losses of $70 billion.[96] The US Justice Department found Arthur Andersen guilty of altering an internal memo which was crucial to Enron's earnings release along with an obstruction of justice following the shredding of thousands of documents which tied the firm to the audit before the arrival of investigators.[97] The reputation of Arthur Andersen was severely damaged in the wake of their involvement and saw the surrender of their CPA (Certified Public Accountant) licence in the United States, precipitating their global collapse.[98] The loss of public trust in Arthur Andersen saw their audit client list diminish prior to their ultimate demise.[99]

In some cases an auditor may be unfairly criticised prior to an FRC investigation or the results of an AQR report. This can have damaging effects for the reputation of audit firms who are blamed despite the fact they might have carried out their duties to a reasonable standard. In most circumstances, such as Carillion, lengthy investigations are often required in order to find out whether the auditor was actually to blame for their perceived audit failure.[100]

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[92] FRC, 'Big Four Audit Quality Review Results Decline' (FRC, 18th June 2018) <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline> accessed 9th January 2019.
[93] Gordon Smith, 'Enron's Lesson: Rebuild Internal Auditing Now!' (2002) 13 Journal of Accounting 4, 13.
[94] J Edward Ketz, 'Can we prevent future Enrons?', (2002) 13 Journal of Corporate Accounting and Finance 4, 7.
[95] George Russell, 'Andersen, Auditing and Atonement – The Accounting Profession 10 years After Enron' (GAA Accounting, 24th April 2012) <http://www.gaaaccounting.com/andersen-auditing-and-atonement-the-accounting-profession-10-years-after-enron/> accessed 9th January 2019.
[96] Iain Gray, *The Audit Process: Principles, Practice and Cases* (5th edn, Cengage Publishing 2011) 2.
[97] Cathy Booth, 'Called to Account' (Time, 18th June 2002) <http://content.time.com/time/business/article/0,8599,263006,00.html> accessed 10th January 2019.
[98] George Russell, 'Andersen, Auditing and Atonement – The Accounting Profession 10 years After Enron' (GAA Accounting, 24th April 2012) <http://www.gaaaccounting.com/andersen-auditing-and-atonement-the-accounting-profession-10-years-after-enron/> accessed 10th January 2019.
[99] Penelope Patsuris, 'Andersen Client Loss Could Pile Up' (Forbes, 7th March 2002) <https://www.forbes.com/2002/03/07/0307andersen.html#38e761ea5001> accessed 10th January 2019.
[100] James Moore, 'Carillion Collapse: Will Bosses, Auditors Pay a Meaningful Price for What Has Happened?' (The Independent, 15th January 2018) <https://www.independent.co.uk/news/business/comment/carillion-collapse-will-bosses-auditors-pay-a-meaningful-price-for-what-has-happened-a8159876.html> accessed 10th January 2019.

1.2.3. “Deep-Pockets” Argument

When the level of assurance provided by an auditor is perceived deficiently following a corporate failure there is a trend to target the auditors “deep-pockets” and blame them for failing to discover and report instances of fraud and misstatements. Auditors are typically regarded as a form of insurance by investors as they are considered to be lucrative targets as a source of financial recovery.[101] The requirement for auditors to hold a practising certificate stipulates that auditors should carry professional indemnity insurance, thus creating a perception that auditors have “deep-pockets” to indemnify loss.[102]

The “deep-pockets” argument has concerned the auditing profession as it encourages claimants and their legal representatives to target auditors, even when the auditor may not be responsible for the damage incurred.[103] Auditors are generally considered to be one of the most financially stable and solvent parties from which to recover loss as there is a tendency to target the party whose professional liability has been insured.[104]

1.2.4. The Blame Game – Attribution of Responsibility for Loss

Auditors seek to carry out their work in accordance with professional standards in order to provide their audit opinion.[105] An overreliance may be placed upon the audit opinion as the expectations of the users of financial statements exceed what can be reasonably expected of the auditor.[106] It is often the case that auditors are subject to criticism as certain users of financial statements fail to properly understand the role and responsibilities of auditors.[107] If an auditor provides their opinion assuring an entity as a going-concern and the organisation fails as a result of fraud or mismanagement, there is tendency to blame the auditor for not discovering the problem and providing a warning sign to investors, particularly if the issue attracts media attention.[108] When corporate debacles occur, it is those who suffer loss who pose the question: “Why didn’t the auditor warn us?”.[109] These questions critique the level of assurance

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[101] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 53.
[102] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 112.
[103] ibid.
[104] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 473.
[105] Petri Mantysaari, *Comparative Corporate Governance: Shareholders as a Rule-Maker* (1st edn, Springer 2005) 199.
[106] Stuart Weinstein & Charles Wild, *Smith & Keenan’s Company Law* (16th edn, Pearson 2013) 542.
[107] Christopher Humphrey et al., ‘The Audit Expectations Gap in Britain: An Empirical Investigation’ (1993) 23 Journal of Accounting and Business Research, 395.
[108] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 31.
[109] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 785.

provided by an audit engagement and reinforce the failure of the auditors to adequately deliver the level of service which society expects from them.[110]

On account of the global nature of the expectation gap there are numerous benefits from the assessment of the views of different international bodies when evaluating its impact. The former vice-president of the AICPA (American Institute of Certified Professional Accountants) once stated:

> 'As long as investors suffer losses from a sudden and drastic drop in earnings or the bankruptcy of an organisation which was widely regarded as a good investment, the [auditing] profession is going to be criticised in the media. And since such situations are unlikely to disappear completely, we ought to become more mature in our reactions to criticism and recognise that this is an inescapable part of [an auditor's] life'.[111]

Auditors often find themselves as the recipients of negative publicity despite the fact that they may not be the one to blame. Olson recognised that when instances of undetected fraud or misstatements are discovered after the provision of the auditors' opinion, the users of financial information are quick to assume that because the auditor did not prevent or detect the fraud or misstatement that the auditor bears some responsibility for their loss.[112]

It is the fiduciary duty of directors to exercise reasonable care, skill and diligence when acting in the interests of both the company and its shareholders.[113] The directors of the company retain the primary responsibility to prevent, detect and investigate all instances of fraud and errors.[114] When directors neglect this duty and the company suffers as a result, society can view auditors as convenient and vulnerable scapegoats.[115] It is therefore vital auditors take appropriate actions to minimise litigation risks and understand the extent of their liability, otherwise auditors may find themselves subject to lawsuits brought against them by the client company or third parties.[116]

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[110] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 785.
[111] Teck Lee & Ali Azham, 'The Audit Expectation Gap: A Review of the Contributing Factors' (2008) 4 Journal of Modern Accounting and Auditing, 30.
[112] Olson (1993) cited in Teck Lee & Ali Azham, 'The Audit Expectation Gap: A Review of the Contributing Factors' (2008) 4 Journal of Modern Accounting and Auditing, 30.
[113] CA 2006, s.174.
[114] Greg Pound & John Courtis, 'The Auditor's Liability: A Myth?' (1980) 39 Accounting and Business Research, 299.
[115] Jane Croft, 'Negligence Actions Against Auditors Rise' (The Financial Times, 28th March 2010) <https://www.ft.com/content/77c829cc-3abd-11df-b6d5-00144feabdc0> accessed 15th January 2019.
[116] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 474.

Chapter Two: Auditor Liability - The Legal Duty of Care

In this chapter the liability of auditors will be examined focusing specifically on the duty of care owed by auditors under contract law and in tort. It is important to determine the extent to which an auditor owes a duty of care to both the client company and third parties in order to analyse how the duty of care owed compares to the misperceived level society has come to expect and fully understand how the courts have attempted to bridge the performance gap component of the expectation gap. The provision of audit services relies upon the level of assurance an auditor is capable of providing with regards to the veracity of reported financial information. Should the users of audit services fail to derive any comfort from the audit opinion then the purpose of audited information becomes worthless.[1] Audit firms rely upon the strength of their reputations to maintain trust in the profession and have favoured the use of out-of-court settlements as a means to avoid reputational damage ensuing from the court actions brought against them.

2.1 Duty of Care

The auditor's duty of care was defined by Lopes LJ in *Re Kingston Cotton Mill (No 2)* who stated that 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 careful, cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.'[2] The degree of skill and care owed has since been subject to judicial interpretation as the courts must take into account what can be reasonably expected of auditors.[3] To determine whether an auditor owes a duty of care, a three-fold test was established by the House of Lords in *Caparo Industries plc v Dickman & Ors* following their review of the various cases discussed within this chapter.[4] In order for a duty of care to exist between the claimant and the defendant auditor, there must be:

1) Reasonable foreseeability of the damage caused;
2) Sufficient proximity between the claimant and defendant auditor; and
3) The duty of care imposed should be fair, just and reasonable in all circumstances.[5]

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[1] KPMG, 'The Importance of Confidence and Trust: Stakeholder Perspectives' (KPMG, 11th April 2018) <https://home.kpmg/xx/en/home/insights/2018/04/confidence-and-trust-stakeholder-perspectives.html> accessed 2nd April 2019.
[2] Re Kingston Cotton Mill (No 2) [1896] 2 Ch 279 - para 288-9.
[3] David Gwilliam, *A Survey of Auditing Research* (1st edn, ICAEW 1987) 137.
[4] Caparo Industries plc v Dickman & Ors [1990] 1 All ER 568.
[5] Brenda Hannigan, *Company Law* (4th edn, OUP 2016) 472.

The first element is relatively easy to establish because if a set of accounts was negligently audited then it is likely that damages will be reasonably foreseeable. The second element shall be examined throughout this chapter as it has caused the most confusion in law as to whether a relationship of sufficient proximity exists between the auditor and potential claimants. The third element was imposed by the courts in *Ultramares v Touche* in order to allow for judicial discretion to restrict an auditor's liability to protect auditors against claims for an 'indeterminate amount for an indeterminate time to an indeterminate class'.[6]

Professional accounting and auditing standards will be considered by the courts when determining whether the audit work conducted has been adequately performed with due care and skill.[7] Worthington recognised that societal expectations have progressively called for increases in the standard of care required from auditors and much of this influence has been fostered by different accounting bodies through revisions to their ethical codes of practice.[8]

The ACCA states within their ethical code that their members are expected to act with:

> 'Due skill, care and diligence with proper regard to the technical and professional standards expected of them as members'.[9]

Furthermore, the ICAEW expects their members to embody "professional competence" within their ethical code of practice:

> 'The principle of professional competence and due care imposes the following obligations:
>
> (a) To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional services; and
> (b) To act diligently in accordance with applicable technical and professional standards when providing professional services'.[10]

The auditing profession has clearly attempted to reinforce this duty of care to auditing professionals. Nevertheless, the courts have frequently referred to the duty of care principle in many cases which shall be discussed throughout this chapter.

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[6] Cardozo CJ in Ultramares Corporation v Touche [1931] 255 NY 170 at 179.
[7] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 114.
[8] Sarah Worthington, *Sealy and Worthington's: Text, Cases and Materials in Company Law* (11th edn, OUP 2016) 485.
[9] ACCA, 'ACCA Code of Ethics and Conduct' (ACCA, 2018) <https://www.accaglobal.com/uk/en/about-us/regulation/ethics/acca-code-of-ethics-and-conduct.html> accessed 15th January 2019.
[10] ICAEW, 'ICAEW Ethical Code of Practice' (ICAEW, 2018) <https://www.icaew.com/membership/regulations-standards-and-guidance/ethics> accessed 15th January 2019.

2.2 Negligence

Negligence can be defined as 'the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do or doing something which a prudent and reasonable man would not do'.[11] If an auditor commits a negligent act and fails to adequately perform their role then a breach of their duty of care will have occurred.[12] The auditor may rely on the work carried out by assistants, but the auditor should ensure that the assistants have not been negligent and that the audit is conducted with due care and skill.[13]

To bring a successful negligence claim, the claimant must prove all of the following requirements:[14]

1) The defendant owed a duty of care to the claimant;[15]
2) A breach of the duty of care occurred following a negligent act by the defendant;[16]
3) The claimant suffered a quantifiable loss or damage caused by their reliance on the negligent acts of the defendant following the breach of their duty of care.[17]

If an auditor can disprove any one of the above requirements then it is likely they will succeed in court.[18] In relation to the third requirement, the courts have now decided in recent cases to absorb arguments of causation and remoteness when contemplating whether a duty of care was owed.[19] Civil law recognises that an auditor can be sued for negligence through contract law or tort.[20] A contractual action against an auditor may only be brought by the client company as privity of contract exists between these two parties, but tort actions may be brought by any third party who has suffered loss as a result of the auditor's negligence.[21] Should the auditor be found liable then they may have to pay compensatory damages (or special damages if prevailing circumstances existed) for any direct loss suffered by the claimant resulting from the auditor's negligence.[22] In certain circumstances, damages may be offset through cross-claims against other negligent parties, such as contributory negligence.[23]

[11] Blyth v Birmingham Waterworks Co (1865) ii Ex 781 (Alderson J).
[12] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.
[13] Kamal Gupta, *Contemporary Auditing* (6th edn, McGraw Hill 2004) 28.
[14] Lucy Jones, *Introduction to Business Law* (2nd edn, OUP 2013) 347.
[15] Donoghue v Stevenson [1932] AC 562.
[16] Haley v London Electricity Board [1965] AC 778.
[17] Barnett v Chelsea & Kensington Hospital [1969] 1 QB 428.
[18] Lee Roach, *Card & James' Business Law: For Business, Accounting & Finance Students* (2nd edn, OUP 2012) 577.
[19] Johnson v Gore Wood & Co [2003] EWCA Civ 1728 – para 91.
[20] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.
[21] Brenda Hannigan, *Company Law* (4th edn, OUP 2016) 470.
[22] Paul Davies & Sarah Worthington, *Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 835.
[23] AWA Ltd v Daniel t/a Deloitte Haskins & Sells & Ors [1992] 10 ACLC 933.

2.3. Auditor's Duty of Care Under Contract Law – Client Company

The company and its auditor have a contractual relationship with each other.[24] If the auditor has breached their duty of care then they may be liable for breach of contract.[25] Lindley LJ famously recognised in *Re London and General Bank (No 2)* that the auditor's business is to:

> 'ascertain and state the true financial position of the company at the time of the audit and [the auditor's] duty is confined to that… [The auditor] must be honest – that is he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true'.[26]

As a consequence, an implied contractual term now exists between the auditor and the client company to ensure that the auditor performs their duties with reasonable care and skill.[27] Should an auditor breach their duty of care then any action for breach of contract must be brought by the client company as no privity of contract exists between auditors and third parties.[28]

Judicial systems have attempted to address the expectation gap by recognising that the detection of all instances of fraud and misstatements cannot be reasonably expected of auditors.[29] It would an unreasonable expectation to demand such guarantees from auditors as their existing legal duties extend so far as the provision of their professional audit opinion.[30] This is apparent in the famous dictum of Lopes LJ in *Re Kingston Cotton Mill (No 2)*:

> 'An auditor is not bound to be a detective… He is a watchdog, 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 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'.[31]

The significance of *Kingston Cotton Mill (No.2)* established the "watchdog" notion and the duty of care principle.[32] This statement by Lopes LJ recognised auditors are incapable of providing a full guarantee

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[24] Lee Roach, *Card and James: Business Law* (4th edn, OUP 2016) 565.
[25] Alix Adams, *Law for Business Students* (9th edn, Pearson 2016) 533.
[26] Re London and General Bank Ltd (No 2) [1895] 2 Ch 673.
[27] Supply of Goods and Services Act 1982, s.13.
[28] Alix Adams, *Law for Business Students* (9th edn, Pearson 2016) 533.
[29] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.
[30] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 59.
[31] Re Kingston Cotton Mill (No 2) [1896] 2 Ch 279 - para 288-9.
[32] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.

that a set of financial statements shows a "true and fair" view as it would be unreasonable to expect this level of assurance from an auditor.[33] Cosserat and Rodda recognised this decision received some criticism as auditors sought to rely upon this principle of law knowing that even if they performed deficiently that they were still unlikely to be held liable.[34] Lopes LJ indicated that auditors are also obliged to investigate when they encounter suspicious circumstances.[35] In *Fomento (Stirling Area) Ltd v Selsdon Fountain Pen Co. Ltd*, Lord Denning observed that an auditor should approach the audit engagement with 'an enquiring mind – not suspicious of dishonesty… but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none'.[36]

Should an auditor encounter suspicious circumstances and proceed to dismiss their duty to investigate then they will be held liable for breach of contract.[37] In *Thomas Gerrard & Sons Ltd*, the managing director of a company falsified inventory figures by altering invoices to conceal losses.[38] The altered invoices were discovered by the auditor but no further investigation was carried out because the auditor placed trust in the managing director.[39] The auditors sought to rely on the judgement of Lopes LJ in *Kingston Cotton Mill (No.2)* claiming that they were 'justified in believing the tried servants of the company in whom confidence is placed by the company'.[40] The courts held that the auditor committed a negligent act and was liable for breach of contract as they failed to exercise reasonable skill and care to investigate this matter further upon discovery of the altered invoices.[41] Once the suspicions of an auditor are raised, then they should investigate the matter thoroughly to uncover the fraud.[42] In *Sasea Finance Ltd v KPMG*, the Court of Appeal held that the auditor must immediately report the discovery of fraud to the management of the company and not merely when rendering their report at the end of the audit.[43]

The technical ability of a qualified auditor suggests that the courts should apply a higher standard of care when determining what can be reasonably expected from a suitably qualified professional. Pennycuick J, in *Thomas Gerrard & Sons Ltd*, observed that the standards of reasonable skill and care have developed over time and are 'more exacting today than those which previously prevailed'.[44] Since the 1960's, the auditing profession has implemented many new professional standards which have enhanced the

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[33] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 117.
[34] ibid.
[35] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 301.
[36] Fomento (Stirling Area) Ltd v Selsdon Fountain Pen Co. Ltd [1958] 1 WLR 45 (HL).
[37] John Lowry & Arad Reisberg, *Pettet's Company Law: Company Law & Corporate Finance* (4th edn, Pearson 2012) 199.
[38] Thomas Gerrard & Sons Ltd [1967] 2 All ER.
[39] ibid.
[40] Re Kingston Cotton Mill (No 2) [1896] 2 Ch 279, para 288-9.
[41] Thomas Gerrard & Sons Ltd [1967] 2 All ER.
[42] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 385.
[43] Sasea Finance Ltd v KPMG [2000] 1 BCLC 236.
[44] Thomas Gerrard & Sons Ltd [1967] 2 All ER 536.

responsibilities of auditors in an attempt to address the performance gap. The introduction of ISA 240 (*The Auditors' Responsibility to Consider Fraud in an Audit of Financial Statements*) has encouraged auditors to adopt an approach based upon professional scepticism as auditors ought to remain reasonably cautious since the potential for concealed fraud exists.[45] The existence of professional standards will be taken into consideration by the courts when determining what ought to be reasonably expected of auditors as they provide 'very strong evidence as to the proper standard which should be adopted'.[46]

In summary, the auditor owes a duty of care through their contractual relationship with the client company and that upon 'entering into a contract, [the auditor] promises to perform certain tasks using a degree of skill and care as is reasonable in the circumstances as they exist'.[47] The implementation of new auditing standards and practices can help improve audit quality and address the performance gap by reinforcing that auditors are legally required to exercise professional scepticism and investigate suspicious circumstances in order to meet the duties which can be reasonably expected from them.

2.4. Auditor's Duty of Care In Tort – Third Parties

The auditor may be liable in tort for negligent misstatements which are relied upon by third parties, including creditors, investors and shareholders (discussed as a sub-category of third parties - see 2.4.1).[48] Millichamp contended that this area of auditor's liability has troubled the auditing profession and the courts as different precedents have developed sporadically throughout time in a number of different jurisdictions.[49] The existence of a duty of care to third parties often depends upon the subjective and contentious question of whether a relationship of sufficient proximity exists between the parties.[50] The development of the *Caparo* three-fold test led the courts to recognise the importance of determining whether a relationship of sufficient proximity exists as this element enabled the courts to exercise their discretion when setting limits on the situations and relationships under which an auditor could be held liable to third parties.[51]

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[45] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 385.
[46] Lloyd Cheyham & Co Ltd v Littlejohn and Co [1987] BCLC 303 (QB) 313 (Woolf J).
[47] Pacific Acceptance v Forsyth [1970] 90 WN (NSW) 29 at 60.
[48] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
[49] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 385.
[50] Lee Roach, 'Auditor Liability: The Case for Limitation' (The Company Lawyer, 2010) <https://www.academia.edu/1331846/Auditor_Liability_The_Case_for_Limitation> accessed 20th January 2019.
[51] ibid.

In the landmark case of *Donoghue v Stevenson*, the courts held that a duty of care was owed to third parties in the event of damage or loss to the claimant.[52] The judgement provided by Lord Atkins recognised that a duty of care existed to third parties as reflected in his landmark statement below:

> 'You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. Who, then, in law is my neighbour? The answer seems to be persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question'.[53]

It is clear from this decision that a duty of care should be owed to third parties for the performance of negligent acts.[54] However, despite this judgement no duty was owed to third parties by professional accountants and auditors.[55] In *Candler v Crane Christmas & Co*, the accounts prepared by Crane Christmas were inaccurate and were relied upon by the claimant who decided to invest in the company based upon representations made in the negligently prepared accounts.[56] The courts held that because no contract existed between the investors and Crane Christmas that no duty of care was owed to third parties even though the accounts were negligently prepared.[57] An interesting observation was made by Lord Denning as he dissented against the judgement of this case:

> '[Auditors and accountants] owe a duty, of course, to their employer or client, and also, I think, to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts so as to induce him to invest money or take some action on them. I do not think, however, the duty can be extended still further to include strangers of whom they have heard nothing and to whom their employer without their knowledge may choose to show their accounts. Once the accountants have handed their accounts to their employer, they are not, as a rule, responsible for what he does with them without their knowledge or consent'.[58]

The position on the duty of care of auditors to third parties was overruled in *Hedley Byrne & Co Ltd v Heller & Partners Ltd* by the House of Lords as they upheld Lord Denning's minority judgement in *Candler v Crane Christmas & Co*.[59] Hedley Bryne lost money when they relied on a negligently prepared bank

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52 Donoghue v Stevenson [1932] AC 562.
53 ibid – para 580.
54 Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 122.
55 Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
56 Candler v Crane Christmas & Co [1951] 2 KB 164.
57 Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 385.
58 Candler v Crane Christmas & Co [1951] 2 KB 164 – para 179.
59 Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 123.

reference on a client provided by Heller.[60] The courts held that although no contract existed between the two parties, Heller was liable to pay damages to Hedley Bryne as a result of their negligence.[61] Heller managed to escape liability because of a disclaimer of liability clause, but the key ratio recognised that a third party could claim damages if they could successfully prove they relied on the negligently prepared work of another party (e.g. an auditor).[62] In his judgement, Lord Reid proposed a limit to the extent of this duty to 'those relationships where it is plain that the party seeking information or advice was trusting the other to exercise such a degree of care… and where the information or advice when he knew or ought to have known that the inquirer was relying on him'.[63] The ICAEW and the auditing profession breathed a sigh of relief knowing that the extent of their liability was not to society as a whole, but was limited to third parties who the auditor specifically knew would rely upon the audited accounts.[64]

In *JEB Fasteners v Marks Bloom & Co*, the courts considered adopting a much broader view towards the extent of an auditor's liability to third parties.[65] JEB Fasteners read the negligently audited accounts which severely overvalued the company prior to their takeover bid.[66] The auditors were aware that JEB Fasteners were interested in the company, but not that the negligently audited accounts would be relied upon for a takeover bid.[67] The courts held that a duty of care was owed to the claimant, but that the auditors were not liable because the actions of JEB Fasteners would not have changed whatever the accounts had said considering that a price had already been agreed for the takeover.[68] The significance of the *JEB Fasteners* case recognised that an auditor could owe a duty of care to an unknown third party who read the audited accounts and then made an investment decision based upon their reliance on those accounts.[69] In the *JEB Fasteners* case, Woolf J initially began to define elements of the *Caparo* three-fold test as to whether an auditor owes a duty of care to third parties, recognising that a duty of care exists when:[70]

- "Reasonable Foreseeability"

1) The auditor knew or should have reasonably foreseen when the accounts were audited, that the claimant might rely on the audited accounts; and

[60] Hedley Bryne & Co Ltd v Heller & Partners Ltd [1964] AC 465.
[61] ibid.
[62] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 386.
[63] Hedley Bryne & Co Ltd v Heller & Partners Ltd [1964] AC 465.
[64] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
[65] JEB Fasteners Ltd v Marks Bloom & Co [1983] 1 All ER 583.
[66] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
[67] ibid.
[68] Alan Millichamp et al., *Auditing* (9th edn, Thomson Learning 2008) 386.
[69] ibid.
[70] ibid.

- "Fair, Just & Reasonable"

2) In all circumstances, it is reasonable for a person to place their reliance on the audited accounts for that particular purpose.[71]

The development of the third element of the test, known as sufficient proximity, would later be defined in *Caparo Industries plc v Dickman & Ors* – see 2.4.1 for case summary. In *Caparo,* the House of Lords stated that in order to establish a sufficient degree of proximity, the third party must prove a "special relationship" existed by demonstrating these four factors: [72]

1) The audited accounts were required for a purpose, made known to the auditor;
2) The auditor knew that for the purpose made known, the audited accounts would be communicated to the third party, either specifically or as part of an ascertainable class;
3) The auditor knew that the third party was likely to act on the audited accounts when they were published; and
4) The third party acted on the audited accounts to their detriment.[73]

The clarification provided by the House of Lords narrowed the view of proximity with regards to an auditor's liability to third parties.[74] However, the court may still exercise their discretion and decide that a duty of care should not be imposed based upon the individual facts of the case and the grounds of fairness and reasonableness.[75]

If a third party can satisfy all of the requirements of the *Caparo* three-fold test to successfully prove that the auditor owed a duty of care, the courts must determine whether the negligent act of the auditor caused the claimant to suffer a loss due to their reliance upon a negligently prepared report.[76] Should the claim of a third party progress to this stage, then the courts must determine whether the quantum of loss of the claimant can be established in order to decide whether or not the auditor should be held liable.[77] Bourne recognised that the courts have typically relied upon two contrasting foreign cases when determining whether the quantum of loss of the claimant can be established.[78]

In *Scott Group Ltd v McFarlane*, the New Zealand appeal court held that although the auditor owed a duty of care to the claimant who relied upon the inaccurate work of the auditor, that in this case, the

[71] JEB Fasteners Ltd v Marks Bloom & Co [1983] 1 All ER 583.
[72] Lee Roach, *Card and James: Business Law* (4th edn, OUP 2016) 567.
[73] Caparo Industries plc v Dickman & Ors [1990] 1 All ER 568.
[74] Stephen Girvin et al., *Charlesworth Company Law* (18th edn, Sweet & Maxwell 2010) 501.
[75] Lee Roach, *Card and James: Business Law* (4th edn, OUP 2016) 567.
[76] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 124.
[77] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 124.
[78] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.

quantum of loss suffered by the claimant could not be established.[79] As a result, the courts held that the auditor was not liable to pay damages because evidence suggested that Scott Group paid less than the actual net worth of the company acquired and therefore did not suffer any financial loss as a consequence of their reliance on the work of the auditor.[80]

On the other hand, in the Scottish case of *Twomax Ltd and Goode v Dickson, McFarlane & Robinson* the auditors were held liable to pay damages to the claimant.[81] Twomax placed their reliance on a set of negligently audited accounts and suffered a quantifiable financial loss following their purchase of shares in Kintyre Knitware Ltd.[82] Lord Steward referred to the earlier decision in the *JEB Fasteners* case as he recognised that the auditors breached their duty of care and that their deficient performance and failure to inform the claimant of the desperate financial situation of Kintyre Knitware Ltd directly caused the financial loss sustained by Twomax.[83]

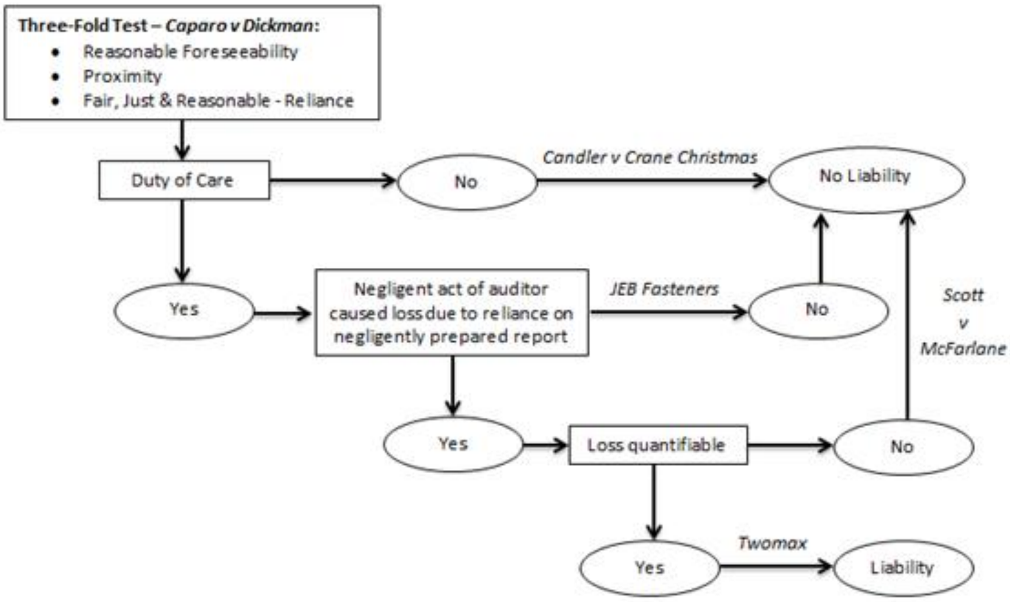

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Figure 6 – Auditor's Liability to Third Parties Flowchart

[79] Scott Group Ltd v McFarlane [1978] 1 NZLR 553.
[80] ibid.
[81] Twomax Ltd and Goode v Dickson, McFarlane & Robinson [1982] SC 113.
[82] ibid.
[83] ibid.
[84] Graham Cosserat & Neil Rodda, *Modern Auditing* (3rd edn, Wiley Publishing 2009) 124 – (Adapted).

In the absence of mechanisms imposed by the courts to restrict third party claims brought against auditors, there would be no floodgate measures to prevent claims from totally unknown and unforeseeable third parties who suffered loss. The most extreme example of this scenario occurred in the United States, in *Zelda Panzirer v Emanuel L Wolf et al*.[85] Mrs Panzirer suffered the loss of her investment following the purchase of shares when acting upon a recommendation stated in the Wall Street Journal.[86] Mrs Panzirer and her broker failed to read the audited financial reports before purchasing the shares.[87] The American Court of Appeals initially held that the auditors owed a duty of care to Mrs Panzirer as the financial statements recognised the company as a going-concern and that the auditors were responsible for the quality of reported financial information which influenced the recommendation of the Wall Street Journal.[88] The bizarre nature of the claim brought against the auditors and not against the Wall Street Journal demonstrates the "deep-pockets" argument as the auditors were targeted as the most suable party.[89] The courts have now vacated this decision because reliance upon this precedent would leave auditors exposed to claims from all unknown, unforeseeable third parties.[90] The auditing profession fears the extension of their duty of care to third parties where a relationship of sufficient proximity does not exist. It seems inconceivable that a UK court would abandon the well-established elements of the *Caparo* three-fold test and impose a duty of care to potential investors under similar circumstances.

In summary, an auditor does not owe a duty of care to third parties in tort unless there is a special relationship based on foreseeability and proximity at the time the negligent conduct occurred. A relationship of sufficient proximity must exist and that, as a minimum, the auditor must have known the identity of the third party when carrying out their work and should have reasonably foreseen that the third party would rely upon their work, for a known purpose, under circumstances where it would be reasonable for the third party to do so. In the UK, the position of auditors whose negligent misstatements caused quantifiable losses to third parties with whom they did not have a relationship of sufficient proximity appears to be relatively secure.

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85 Zelda Panzirer v Emanuel L Wolf et al [1983] 663 F 2d 365.
86 Wunmi Bewaji, *Insider Trading in Developing Jurisdictions: Achieving an Effective Regulatory Regime* (1st edn, Routledge 2012) 255.
87 ibid.
88 ibid.
89 ibid.
90 Julie Heisel, 'Panzirer v Wolf: An Extension of the Fraud-on-the-Market Theory of Liability Under Sec Rule 10b-5' (1983) 32 Cath University Law Review 9 – Issue 3, 700.

2.4.1. Liability to Shareholders

Auditors are involved in an agency relationship where they are entrusted by shareholders to express their professional audit opinion.[91] Audit quality is not directly observable by shareholders which makes it difficult for shareholders to assess the performance of the auditor because they cannot determine the probability of whether the auditor will detect instances of fraud and misstatements.[92] There is no contractual relationship which generally exists between shareholders and auditors, so any claims in relation to a loss of investment must be brought against the auditor under tortious liability.[93]

In the landmark case of *Caparo Industries plc v Dickman & Ors*, the House of Lords considered the position of the claimant in their capacity as an existing shareholder and as a potential investor.[94] Caparo relied upon a set of audited accounts for a takeover bid which reported that the target company made a profit of £1.3m, but in reality the financial statements should have reported a loss of £0.46m.[95] Caparo alleged that the accounts were fraudulently prepared by the directors, and that the auditors had been negligent in their failure to detect and report instances of fraud and misstatements.[96] Caparo attempted to sue the directors of target company and the auditors.[97] The House of Lords considered the potential liability of the auditors and held that an auditor owes a duty of care to the company and not to individual shareholders.[98] The rationale for this decision was recognised by Lord Bridge, who stated that:

> 'the interests of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders… will be recouped by a claim against the auditor in the name of the company, not by individual shareholders.'[99]

In certain circumstances, an auditor's duty of care may extend to a parent company in their capacity as a shareholder of a subsidiary company.[100] In *Barings plc v Coopers & Lybrand*, the claimant sought to hold the auditors to account for their failure to detect and report the fraudulent activity of Nick Leeson's fraud in unauthorised futures trading carried out through their subsidiary business.[101] The auditors relied on the *Caparo* decision and argued that no duty of care was owed to Barings plc as a shareholder of the

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[91] Kamal Gupta, *Contemporary Auditing* (6th edn, McGraw Hill 2004) 8.
[92] Gregory Kane & Uma Velury, 'The Role of Institutional Ownership in the Market for Auditing Services: An Empirical Investigation' (2004) 57 Journal of Business Research, 977.
[93] John Birds et al., *Boyle & Birds' Company Law* (8th edn, Jordans 2011) 570.
[94] Caparo Industries plc v Dickman & Ors [1990] 1 All ER 568.
[95] Henry Cheeseman, *Business Law* (8th edn, Pearson 2007) 579.
[96] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
[97] Caparo Industries plc v Dickman & Ors [1990] 1 All ER 568.
[98] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 303.
[99] Caparo Industries plc v Dickman & Ors [1990] 1 All ER 568 – para 626.
[100] Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 304.
[101] Barings v Coopers & Lybrand [1997] 1 BCLC 427.

subsidiary company, and that any damages being claimed by Barings plc ought to have been claimed by the subsidiary themselves.[102] The Court of Appeal found the auditors liable as their negligence in failing to detect and report the frauds committed by Nick Leeson led to a quantifiable loss suffered by the parent company as a shareholder.[103] The court recognised that a duty of care existed as the auditors were aware that the negligently audited accounts of the subsidiary would be used by Barings plc to prepare the group accounts.[104]

In summary, in the absence of a parent-subsidiary relationship, an auditor does not generally owe a duty of care to shareholders.[105] Shareholder losses resulting from the negligence of an auditor may only be recovered if the company has also suffered a loss which it is able to successfully recover through contract law, on behalf of its shareholders.[106] The company can place their reliance upon the implied contractual duty of care which exists under the auditor's liability to the client company, and any damages which are recovered by these means will beneficially accrue to the shareholders, as the ultimate beneficial owners of the company.[107]

2.5. Out- Of -Court Settlements

In this chapter we have discussed to whom the auditor owes a duty of care when they are faced with lawsuits brought against them. Many auditors are heavily reliant upon the perceived strength of their reputations in order to align the expectations of the users of audit services by maintaining trust and credibility in the audit work performed and would rather avoid litigation risks by agreeing out-of-court settlements with the parties who seek to blame them for any investment loss sustained.[108] In numerous cases, auditors are reluctant to pay substantial legal fees to fight claims or account for the lost time and earnings of senior audit partners tied-up in court.[109] In 2001, PWC conceded their position in the case of the Barings Group and reached an out-of-court settlement for £65m as the reported legal costs were found to be in excess of £100m.[110] Hayes *et al.* recognised that financial risks resulting from lawsuits made against auditors threaten the viability of the auditing profession.[111] Senior auditors have

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102 Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 304.
103 Barings v Coopers & Lybrand [1997] 1 BCLC 427.
104 Nicholas Bourne, *Bourne on Company Law* (7th edn, Routledge 2016) 304.
105 John Birds et al., *Boyle & Birds' Company Law* (8th edn, Jordans 2011) 572.
106 Sarah Worthington, *Sealy and Worthington's: Cases and Materials in Company Law* (10th edn, OUP 2013) 475.
107 ibid.
108 Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 662.
109 ibid.
110 Larry Schlesinger, 'Coopers Paid £65m in Barings Case' (AccountancyAge, 18th June 2003) <https://www.accountancyage.com/aa/news/1786952/coopers-paid-gbp65m-barings> accessed 27th January 2019.
111 Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 57.

contended that a single claim in excess of '£300m would be enough to fatally wound one of the Big Four'.[112] The threat of litigation has left many audit firms and their indemnity insurers in a state of fear that a few successful claims of negligent auditing could cripple one of the Big Four and set a damaging precedent opening the floodgates to a litigation disaster for the auditing profession.[113]

Porter recognised that the threat of litigation has caused uncertainty for auditors with regards to what legal obligations could be imposed upon auditors by the courts and how their reputation could be irredeemably discredited following public critique.[114] It is widely acknowledged that an auditors' reputation plays a crucial role in providing assurance services, therefore it is no wonder why auditors wish to keep damaging allegations (whether justified or not) out of the public spotlight, even if the auditor would have been able to successfully defend themselves in court.[115] Indemnity insurance companies often pressurise audit firms to seek out-of-court settlements in order to avoid litigation risks and the high costs involved.[116] The repercussions of out-of-court settlements have led to adverse consequences for the auditing profession as indemnity insurance premiums have increased and further developments in this area of law have been stifled.[117]

The success of a few audit firms in court may deter some other auditors from seeking out-of-court settlements.[118] For example, in 2007, Equitable Life abandoned a £700m claim for damages against EY following their initial accusations of negligent auditing.[119] Equitable Life struggled to prove that losses sustained from ill-informed strategic decisions were directly caused by an audit failure.[120] In general, the courts have been reluctant to place an unfair burden on auditors and seek to 'impose liability only when and to the extent that, it is fair, just and reasonable to do so in the circumstances of a particular case'.[121] The auditing profession should take comfort from this notion as the courts are likely to recognise what can be reasonably expected from auditors, meaning that a significant possibility exists that cases will be decided in the auditor's favour.[122]

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[112] Philip Aldrick, 'For Auditors, See Hazardous Pursuits' (The Telegraph, 17th January 2004) <https://www.telegraph.co.uk/finance/2874192/For-auditors-see-hazardous-pursuits.html> accessed 27th January 2019.
[113] ibid.
[114] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 662.
[115] ibid.
[116] David Gwilliam, *A Survey of Auditing Research* (1st edn, ICAEW 1987) 138.
[117] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 662.
[118] ibid.
[119] Rupert Jones, 'Equitable Life Drops £700m Claim for Damages From Ernst & Young' (The Guardian, 3rd September 2005) <https://www.theguardian.com/money/2005/sep/23/equitablelife.business> accessed 27th January 2019.
[120] Equitable Life Assurance Company v Ernst & Young [2007] EWCA Civ 1114.
[121] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 663.
[122] ibid 662.

Over the past few decades, a rise in amount of lawsuits brought against auditors has led to some audit firms being forced into mergers with larger rivals after they suffered reputational damage and considerable payouts, such as Binder Hamlyn and Spicer & Oppenheimer.[123] It can be argued that out-of-court settlements have merely allowed auditors to defer litigation risks and that the use of this method does not provide an effective long-term solution to the expectation problem. Should audit firms continue to hide behind out-of-court settlements and conceal the true details from the public then this demonstrates that auditors have accepted that their deficient performance played a role in the claims brought against them.[124] Porter argued that this could prove to be more damaging to the auditing profession in the long-run as it erodes public confidence in the reputation of auditors and exacerbates society's perceptions of an auditor's deficient performance, thus broadening the expectation gap.[125] The auditing profession must work towards narrowing the expectation gap by addressing its underlying components and not merely rely on short-term solutions to negate the expectation problem.

[123] Philip Aldrick, 'For Auditors, See Hazardous Pursuits' (The Telegraph, 17th January 2004) <https://www.telegraph.co.uk/finance/2874192/For-auditors-see-hazardous-pursuits.html> accessed 27th January 2019.
[124] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 662.
[125] ibid.

Chapter Three: Reducing The Expectation Gap

The final chapter shall examine the various methods used to reduce the expectation gap by aligning societal expectations with those of the auditing profession. The expectation problem has consistently proven to be a cause of concern amongst auditors and many attempts have been made to understand the nature of the problem indicating that auditors should reconsider the issue before deciding whether or not to apply the techniques discussed in this chapter.

3.1. Reducing The Expectation Gap – Method Used to Change Perceptions

Audit firms should attempt to uphold the reputation of the profession by minimising litigation risks and narrowing the expectation gap in order to reduce the number of lawsuits brought against auditors. Salehi recognised that the burden of narrowing the expectation gap primarily resides with auditors and to a certain extent with the other parties involved in the preparation and presentation of financial information.[1] The auditing profession views the expectation problem as an issue which it is determined to solve, but the very nature of the expectation gap suggests that due to inherent social conflicts, differences will always exist to a certain extent between the perceptions of the public and auditors as the profession struggles to keep pace with the expanding needs of society.[2] Koh and Woo stated that although it may prove impossible to fully eliminate the expectation gap, research supported by professional bodies indicates that the expectation gap may be narrowed through the use of various techniques discussed in this chapter.[3]

3.1.1. Extended Audit Reports

The extended audit report is a technique employed by auditors to provide a greater level of detail while using simpler terminology to convey their audit opinion to the users of financial statements.[4] Many complex terms are found in audit reports which can prove confusing for the lay person to understand considering that the user may possess a limited knowledge of various auditing concepts, for example, the

[1] Mahdi Salehi, 'Audit Expectation Gap: Concept, Nature and Trace' (2011) 5 Journal of Business Management 21, 8379.
[2] Prem Sikka et al., 'The Impossibility of Eliminating the Expectation Gap: Some Theory and Evidence' (1998) 9 Critical Perspectives on Accounting 3, 299.
[3] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 150.
[4] FRC, 'Extended Auditor's Reports: A Further Review of Experience' (2016) Report on the 2nd Year Experience, 8.

going-concern or materiality concepts.[5] If consistent efforts are made to use less complex terminology to facilitate the understanding of the users of audit reports, then it is believed that users could more accurately interpret the audit opinion taking into account the inherent limitations of auditing.

Nair and Rittenberg indicated that the use of extended audit reports had successfully influenced the perceptions of users aligning them with those held by the auditor and encouraging societal views to properly consider the responsibilities of auditors.[6] Kelly and Mohrweis supported these findings and sustained an appreciation for extended audit reports.[7] Furthermore, Miller *et al.* recognised extended audit reports 'were more useful and understandable than alternative short-form reports'.[8] Extended audit reports have since been acknowledged by the ICAEW and other studies which promote their use to reduce the reasonableness gap component of the expectation gap as they provide a better understanding of the scope, nature and significance of an audit, successfully influencing how the auditor is perceived by the users of audit reports.[9]

3.1.2. Structured Audit Methodologies

It is well known that the needs of society evolve and change throughout time, thus the techniques used by auditors need to adapt and improve as the processes, policies and procedures employed become more efficient and better structured.[10] Advancements in technology and the increased use of tools to assist decision-making help audit firms narrow the performance gap component of the expectation gap by enhancing audit quality which ultimately helps to reduce the number of lawsuits made against auditors.[11] Jennings *et al.* recognised that the use of decision-making tools assists with the collection and analysis of data samples helping to improve and maintain audit standards.[12]

The adoption of more efficient and structured audit methodologies can allow for higher quality audits, but it is important to recognise that the audit requirements may vary between different companies.

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[5] Sanjib Basu, *Auditing Principles & Techniques* (2nd edn, Pearson 2007) 452.
[6] Raghavan Nair & Larry Rittenberg, 'Messages Perceived From Audit Review and Compilation Reports: Extension to More Diverse Groups' (1987) 7 Auditing Journal of Practice and Theory 1, 16.
[7] Allin Kelly & Lawrence Mohrweis, 'Bankers and Investors Perceptions of the Auditor's Role in Financial Statement Reporting' (1989) 9 Auditing Journal of Practice and Theory 1, 88.
[8] Jeffrey Miller et al., 'The New Auditor's Report: Will It Close the Expectation Gap in Communications?' (1990) Professional Accounting Journal 60, 4.
[9] ICAEW, 'The Start of a Conversation: The Extended Audit Report' (ICAEW, 2017) <https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit-and-assurance-faculty/publications/extended-audit-report.ashx?la=en> accessed 2nd April 2019.
[10] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 150.
[11] ibid 151.
[12] Marianne Jennings et al., 'The Significance of Audit Decision Aids and Precase Jurists' Attitudes on Perceptions of Audit Firm Culpability and Liability' (1993) 9 Contemporary Accounting Research, 2.

Audit procedures should be adapted to address areas of concern and tailored towards key audit components which may prove to be crucial to that particular audit or industry sector. It is widely believed that technological developments will help to reduce inadequate performance and meet the ever-increasing expectations of society through real-time continual reporting of business information.[13]

3.1.3. Education

Amhorwitz contended that if the role of an auditor is misunderstood by society then there is a greater possibility society will blame auditors for corporate failures.[14] The span of the expectation gap is directly determined by the level of knowledge which society possesses as this influences their appreciation for the role and responsibilities of auditors. If the users of financial statements were familiar with the inherent limitations of auditing then these individuals would possess more reasonable expectations of what an auditor can feasibly achieve. Shields *et al.* recognised that a larger expectation gap exists between auditors and less sophisticated users because these individuals place a far greater level of responsibility on auditors compared to more informed users.[15] Eipstein and Geiger suggested that if the auditing profession tailored education materials towards improving society's knowledge and their appreciation of the role and limitations of auditing then the expectation gap could be narrowed.[16]

In Australia, Monroe and Woodliff conducted a study on 'the effect of education on students' perceptions of audit reports'.[17] On completion of the academic term, the outcome revealed that compared to other student groups, auditing students best understood the limitations of auditing and accepted that auditors possess a much lower level of responsibility than the students originally thought at the beginning of their course. It is important to recognise the limitations of this study as it seems infeasible that education systems would be able to easily incorporate the study of auditing into their current curriculums. On this basis, audit firms should collectively seek to enhance the publication of material which better communicates the limitations of auditing in order to educate society.[18]

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[13] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 602.
[14] Harris Amhowitz, 'The Accounting Profession and The Law: The Misunderstood Victim' (1987) 163 Auditing Journal - Issue 5, 358.
[15] Michael Shields et al., 'Effects of Audit Report Wording Changes on the Perceived Message' (1983) 21 Journal of Accounting Research, 355-370.
[16] Marc Eipstein & Marshall Geiger, 'Investor Views of Audit & Assurance: Recent Evidence of an Expectation Gap' (1994) 177 Journal of Accountancy, 64.
[17] Gary Monroe and David Woodliff, 'The Effect of Education on the Audit Expectation Gap' (1993) 33 Accounting and Finance, 1.
[18] ibid.

3.1.4. Expansion and Enhancement of Auditors' Responsibilities

Humphrey *et al.* proposed that stricter enforcement measures could reform auditing and narrow the expectation gap.[19] They suggested the establishment of a public body responsible for the appointment of auditors, the regulation of audit fees and the implementation of statutory provisions to extend the auditors' responsibilities to provide a more definitive outline of the extent to which an auditor owes a duty of care with regards to the detection of fraud and misstatements.[20] It is important to assess the costs and benefits of this solution as a complete reform of the auditing industry could prove costly and extremely time consuming. Even upon completion, these reforms could not prevent corporate failures from occurring and there would be no guarantee the expectation problem would be resolved.[21]

The expansion and enhancement of auditors' responsibilities or the implementation of new auditing standards seeks to reduce the deficient standards and unreasonable expectations components of the expectation gap by bringing the responsibilities reasonably expected of auditors more in line with societal expectations.[22] O'Malley recommended that additional responsibilities should be imposed upon auditors, but that this proposal carries risk as the expansion of auditors' responsibilities may only serve to increase the threat of litigation against auditors.[23] Puxty and Sikka questioned the purpose and usefulness of new auditing standards as the introduction of new standards may be perceived as a mere public relations tool serving to provide an impression that auditors act in the interests of the users of financial statements, but these standards ultimately benefit auditors and often fail to address the wider interests of society.[24]

Any expansion of the auditors' existing responsibilities would appear to transfer a greater degree of risk to auditors.[25] The auditing industry would be reluctant to accept these changes without sufficient insurance provided to them to protect against the increased risks of litigation. Knutson suggested that auditors should only be held accountable for 'what they should have known, and not what they could have known'.[26] Numerous problems arise out of increasing the auditors' existing responsibilities because

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[19] Christopher Humphrey et al., 'The Audit Expectations Gap in Britain: An Empirical Investigation' (1993) 23 Journal of Accounting and Business Research, 4.
[20] ibid.
[21] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 151.
[22] EY, 'The Future of Assurance: The Role of Audit in Society' (EY, 2015) 2. <https://www.ey.com/Publication/vwLUAssets/EY-financial-services-viewpoints-audits-role-in-society/%24FILE/EY-financial-services-viewpoints-audits-role-in-society.pdf> accessed 29th January 2019.
[23] Shaun O'Malley, 'Legal Liability is Having a Chilling Effect on the Auditor's Role' (1993) 7 Accounting Horizons, 82-87.
[24] Anthony Puxty et al., 'Mediating Interests: The Accounting Bodies Response to the McFarlane Report' (1997) 27 Accounting and Business Research, 326.
[25] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 151.
[26] Peter Knutson, 'In the Public Interest – Is It Enough?' (1994) 64 Professional Accounting Journal, 1.

conflicts of interest exist as auditors will argue it is unreasonable for society to demand perfection given that an auditors' legal responsibilities only extend to the provision of their audit opinion which is not considered to be a guarantee.

3.1.5. Addressing Public Critique

The expectation gap model identified by Porter suggests that auditors are able to analyse and address the rationale for public critique by successfully determining which component of the gap the critique best represents (i.e. deficient performance, deficient standards or unreasonable expectations).[27] Once the auditing profession has successfully identified which component is most relevant then they can tailor and implement solutions to resolve the issue and address public critique.[28] Should the auditing profession fail to take corrective action, then it is likely the expectation gap will continue to widen unless audit failures are promptly addressed.[29]

Over the past few decades, auditors have continued to diversify the number of services they offer as they have relied upon fee income from the provision of non-audit services, such as consultancy work for corporate finance and tax administration.[30] The 2018 AQR results revealed a general fall in audit quality by KPMG which led to public critique of their failure to show an appropriate level of scepticism when challenging the management of their clients.[31] KPMG have attempted to address public critique by tackling the deficient performance component of the expectation gap as they have committed to become the first audit firm to implement a voluntary restriction on the provision of non-audit services to FTSE 350 clients.[32] KPMG are determined to re-establish confidence in the quality of their audit services as they wish to reassure the public that they haven't yielded to managerial pressure from their clients to protect their lucrative consultancy services.[33] The significance of this landmark decision has been

[27] Brenda Porter, 'An Empirical Study of the Audit Expectation-Performance Gap' (1993) 24 Accounting and Business Research Journal, 49-68.
[28] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 151.
[29] Christopher Humphrey et al., 'The Audit Expectation Gap – Plus C'est la Meme Chose?' (1992) Critical Perspective on Accounting, 143.
[30] Francois Badenhorst, 'FRC Could Ban Big Four From Consultancy Work for Audit Clients' (AccountingWeb, 9th October 2018) <https://www.accountingweb.co.uk/business/finance-strategy/frc-could-ban-big-four-from-consultancy-work-for-audit-clients> accessed 29th January 2019.
[31] FRC, 'Big Four Audit Quality Review Results Decline' (FRC, 18th June 2018) <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline> accessed 4th February 2019.
[32] KPMG, 'UK Transparency Report 2018' (KPMG, 2018) 7.
[33] ibid.

ridiculed by some as a "high-profile gimmick",[34] nevertheless similar measures may yet be adopted by the other Big Four firms which could affect billions of pounds of revenue each year.[35]

3.1.6. Improve Audit Quality by Reducing Market Concentration

Audit market concentration and the dominance of the Big Four is generally considered to negatively influence audit quality as competition encourages audit firms to achieve higher quality audits.[36] Two proposals which seek to address the performance gap component of the expectation gap and improve audit quality are summarised below:

(i) Joint Audits

A joint audit is an audit conducted by multiple auditors who all participate and sign the audit report jointly.[37] Joint audits have been required in France for all listed companies since 1966 and encourage audit firms to actively monitor the activities of one another throughout an audit engagement.[38] Goundar supported this proposal and suggested that there is no evidence joint audits are more expensive and they only serve to improve audit quality.[39] On the contrary, the House of Lords remained unconvinced that joint audits would significantly improve audit quality and suggested they would only add to cost and bureaucracy.[40]

(ii) Limiting the Size of Audit Firms

If a limit was proposed to restrict the number of clients the Big Four could serve then this would allow mid-tier audit firms to compete on a more equal scale.[41] Grant Thornton reported that if the Big Four

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[34] Jasper Jolly, 'KPMG to Drop Non-Audit Services for its FTSE 350 Clients' (The Guardian, 8th November 2018) <https://www.theguardian.com/business/2018/nov/08/kpmg-to-drop-non-audit-services-for-its-ftse-350-clients> accessed 4th February 2019.

[35] Mark Kleinman, 'Accounting Scandals Prompt KPMG Ban on Non-Audit Work' (Sky News, 8th November 2018) <https://news.sky.com/story/accounting-scandals-prompt-kpmg-ban-on-non-audit-work-11547932> accessed 24th February 2019.

[36] Competition Commission, 'Audit Market Investigation Issues Statement' (2012) – para 29.

[37] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 827.

[38] David Herbinet, 'Joint Audit Could Inject Some Competition Into the Market' (CityAM, 22nd January 2019) <http://www.cityam.com/271992/joint-audit-could-inject-some-competition-into-market?fbclid=IwAR08VnacvSpd1isdv_KaB8E-5lx-STSkmuS8eIB5yQ97xEqZNSuaincrTtc> accessed 12th February 2019.

[39] Santhie Goundar, '"Institutional Prejudice" Restricting Audit Market' (AccountancyAge, 3rd November 2010) <www.accountancyage.com/aa/news/1867640/institutional-prejudice-restricting-audit-market> accessed 12th February 2019.

[40] House of Lords Select Committee on Economic Affairs, 'Auditors: Market Concentration and their Role - 2nd Report of Session' (2010) 1 Select Committee Report – para 40.

[41] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 834.

allowed mid-tier firms to audit even 20% of their FTSE 250 clientele then this would increase the size of the mid-tier audit market by £25m to £30m.[42] However, it seems unlikely that the Big Four would submissively allow their clients to be poached by mid-tier firms, meaning that the success of this proposal relies on the Office of Fair Trading forcing the Big Four to divest their clientele to mid-tier audit firms.[43] If the audit market spreads the responsibility for auditing clients between themselves then it stands to reason they could provide higher quality audits and have a more dedicated focus towards their clients.

3.2 The Audit Expectation Cycle

The auditing profession has long spoken about the 'expectation problem and that previous efforts to close the expectation gap have failed'.[44] The expectation problem continues to thwart the auditing profession as it seems likely perceptual differences will always exist between the expectations of auditors and those of the rest of society, despite those efforts made by the auditing profession to fully eliminate the expectation gap. The expectation problem derives from an unsolvable conundrum as throughout time the auditing profession has continuously struggled to align societal views with those held by auditors as both parties think independently from one another making the expectation gap difficult to eliminate. On this basis, it would be reasonable for auditors to reconsider the expectation problem as an evolutionary step in the natural selection of new and improved auditing standards and practices.

The expectation gap model proposed by Porter portrays a linear depiction of how auditors can seek to align their performance with the expectations of society through their efforts to address the underlying components of the gap (i.e. deficient performance, deficient standards and unreasonable expectations). The third underlying component suggests that society's expectations are not static and may vary throughout time as individuals possess different expectations of what an auditor is capable of achieving, shown within Figure 4 (see 1.1.2).

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[42] Santhie Goundar, '"Institutional Prejudice" Restricting Audit Market' (AccountancyAge, 3rd November 2010) <www.accountancyage.com/aa/news/1867640/institutional-prejudice-restricting-audit-market> accessed 12th February 2019.

[43] Nick Huber, 'Big Four Break-Up Threat' (AccountancyAge, 26th January 2011) <www.accountancyage.com/aa/analysis/1939751/break-threat> accessed 2nd March 2019.

[44] Andrew Gambier cited by Maurice Richmond, 'New Research Reveals 48% of Public Believe Auditors Could Prevent Company Failures' (ACCA, 2018) <https://www.accaglobal.com/my/en/news/2018/november/audit-expectation-gap.html> accessed 4th February 2019.

The evolutionary theory of auditing derives from the impossibility of eliminating the expectation gap as a continual cycle of development occurs where societal pressure and public unrest demand that auditors are held to account for audit failures. As a means to address these audit failures, the auditing profession is pressurised by regulatory watchdogs, such as the FRC, into catalysing change which would ultimately force auditors to adopt new standards and practices to meet societal expectations.[45] Humphrey *et al.* recognised that the change in the expectations of society during periods of crises are usually pre-emptive indicators that auditing standards will soon adapt to meet society's expanded expectations of auditors.[46]

The adoption of new auditing standards and practices, as well as other methods used to reduce the span of the expectation gap can take a significant amount of time to implement which raises difficulties for the auditing profession as they continually struggle to keep pace with society's expanded expectations.[47] If the auditing profession adopted new standards and practices to appease even the least demanding expectations held by certain proportions of society, then these individuals are likely to develop revised expectations of what auditors are capable of accomplishing. The revised expectations of society in light of new standards and practices would hold auditors accountable to a higher duty of care than previously expected, thus creating a revised expectation gap resulting in a continual cycle of development.

In reality, the evolutionary theory of auditing would suggest that each iteration of the expectation gap as part of this developmental cycle would gradually decrease in size because the performance of auditors would become more closely aligned with societal expectations as the auditing profession strives towards perfection. If the auditing profession could instantaneously address societal expectations with minimal time delay and if auditors could guarantee that no instances of fraud or misstatements have affected the veracity of reported financial information then the expectation gap could theoretically be eliminated.

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[45] Rick Hayes et al., *Principles of Auditing* (3rd edn, Pearson 2014) 645.
[46] Christopher Humphrey et al., 'The Audit Expectation Gap – Plus C'est la Meme Chose?' (1992) Critical Perspective on Accounting, 137.
[47] Emile Woolf, *Auditing Today* (5th edn, Prentice Hall 1994) 456.

New Conceptual Theory: -

<u>The Audit Expectation Cycle</u>

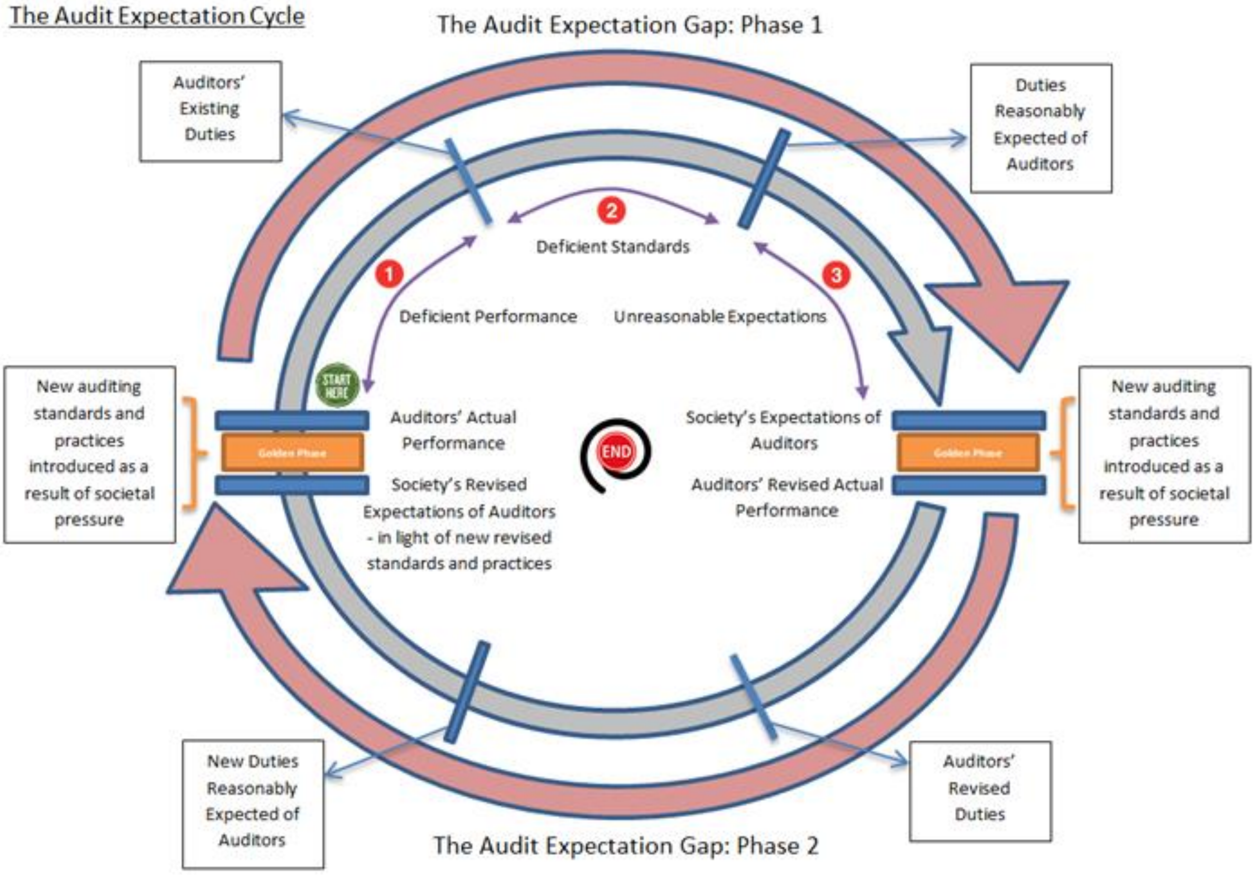

Figure 7 – The Audit Expectation Cycle (Author's own model)

In recent decades, it is clear that the expectation problem has exacerbated the number of lawsuits made against auditors and an expectation gap still exists despite numerous techniques utilised by the auditing profession to reduce the extent of the gap. Auditors must consider whether the use of such techniques will be worthwhile before they devote their efforts to chase societal expectations. Many of the methods used to narrow the expectation gap have helped to engender the confidence of society in the auditing profession and should not be disregarded unless 'they are being replaced by more effective approaches as part of expanding the role of the audit function to meet the ever-increasing needs of society'.[48]

[48] Hian Koh & E-Sah Woo, 'The Expectation Gap in Auditing' (1998) 13, 3 Managerial Auditing Journal 150.

ix) Conclusion & Recommendations

In conclusion, it is evident that the legal duty of care owed by auditors remains different to the perceived duty of care which society expects from the auditing profession. The expectation gap persists as an issue which continues to trouble both auditing and corporate governance professionals alike.[1] Society relies upon the auditing profession to provide assurance to the veracity of reported financial information.[2] However, often societal expectations exceed the level of assurance auditors are capable of providing as certain individuals misconstrue auditors as the party responsible for the preparation of financial statements and demand that auditors ought to provide an advanced warning of when an organisation is about to fail.[3] In most cases, this is an unreasonable expectation as several major companies have collapsed without any prior warning signs and yet the auditors were still publically criticised.[4] It is difficult to convince the public that a lack of due professional care is not endemic when high-profile corporate failures occur.[5]

The increasing level of transactions in capital market economies influences societal expectations towards the desire for continual reassurance that information remains free from instances of fraud and misstatements.[6] The large number of transactions makes it impossible for auditors to fully review a company's activities, thus preventing auditors from providing a higher level of assurance than their audit opinion justifies.[7] Munter highlighted that if auditors are to become "fraud police" then it would be necessary to expand the scope of audit engagements, resulting in additional costs that must ultimately be tolerated by the client company and their investors.[8]

In a continually changing business environment, audit firms are reliant upon maintaining the skills of auditors with a view to upholding the credibility of the profession. It is vital that audit firms and market regulators proactively apply the methods discussed in Chapter 3 to narrow the expectation gap and reinforce what society can reasonably expect of auditors.[9] It seems somewhat ironic that the word "audit" is derived from the Latin word "*audire*" which translates as "to hear", especially considering that the expectation problem is in essence a communication issue between society and auditors.

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[1] Barry Elliot & Jamie Elliot, *Financial Accounting and Reporting* (16th edn, Pearson 2013) 812.
[2] Krishna Palepu et al., *Business Analysis and Valuation: IFRS Edition* (3rd edn, Cengage Publishing 2013) 9.
[3] Andrew Thomas & Anne Marie Ward, *Introduction to Financial Accounting* (7th edn, McGraw Hill 2012) 101.
[4] Barry Elliot & Jamie Elliot, *Financial Accounting and Reporting* (16th edn, Pearson 2013) 812.
[5] ibid.
[6] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 602.
[7] Peter Atrill & Eddie McLaney, *Financial Accounting for Decision Makers* (8th edn, Pearson 2016) 451.
[8] Paul Munter, 'Will Technology Defeat Your Auditor?', (2002) 13 Journal of Corporate Accounting and Finance 4, 17.
[9] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 603.

The duty of care owed by auditors to the client company and third parties has been summarised at the end of the respective sections within Chapter 2 of this dissertation, but in general the courts have been reluctant to impose a duty of care to non-clients.[10] It is unlikely that the courts will find an auditor to be in breach of their duty of care if they have acted in accordance with professional standards and guidelines.[11]

The liability of auditors is greatly influenced by technological developments in a continuously changing business environment.[12] Technological developments and the ever-expanding expectations of society could eventually lead to real-time reporting of business performance.[13] The development of new technologies, including Artificial Intelligence (AI) could help the auditing profession solve the expectation problem.[14] It is widely believed that AI will be able to process vast quantities of data in short periods of time, streamlining audit processes and allowing for the recognition of anomalies, potential frauds and misstatements.[15] The implementation of AI could vastly improve the ability of the auditor to meet societal expectations as large quantities of data could rapidly be analysed in short periods of time, potentially eliminating the existing limitations of data sampling.[16] It is unlikely that such tools will render the role of an auditor redundant as the human element will always be required for higher level analysis when building a full picture of the organisation behind the data, as well as providing assurance on the AI systems themselves.[17] There are numerous benefits to the use of these systems, but developing and maintaining the functionality and security of AI systems will prove to be vital areas of concern for auditors as they seek to eliminate the expectation gap and ensure that new processes are more effective than the current methods employed.

It is apparent that the current audit model contains inherent conflicts which prevent auditors from delivering the level of service which society expects from the auditing profession.[18] The interests of audit firms are usually profit-orientated and this can prove to be contrary to both shareholder and wider societal interests.[19] The House of Lords once described the current system of regulating auditors as 'fragmented and unwieldly with multiple overlapping organisations and functions'.[20] The outcome of the

[10] Brenda Hannigan, *Company Law* (4th edn, OUP 2016) 470.
[11] Ewan MacIntyre, *Business Law* (8th edn, Pearson 2016) 498.
[12] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 472.
[13] ibid 602.
[14] Bill Brennan et al., 'Artificial Intelligence Comes to Financial Statement Audits' (CFO, 2nd February 2017) <http://ww2.cfo.com/auditing/2017/02/artificial-intelligence-audits/> accessed 7th February 2019.
[15] ibid.
[16] Bahram Soltani, *Auditing: An International Approach* (1st edn, Prentice Hall 2007) 602.
[17] ibid.
[18] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 841.
[19] ibid 840.
[20] House of Lords Select Committee on Economic Affairs, 'Auditors: Market Concentration and their Role - 2nd Report of Session' (2010) 1 Select Committee Report – para 110.

Brydon Review into the quality and effectiveness of the current audit market alongside the recommendations of the Kingman Review should provide market regulators with the powers necessary to reform the current audit model.[21] If these inherent conflicts are resolved then auditors will have a greater chance of narrowing the expectation gap as each measure implemented in the wake of corporate debacles shall serve to enhance auditing standards and practices in order to align audit performance with societal expectations.[22]

[21] James Bunney, 'Kingman Calls for Abolition of FRC as Audit Regulator' (AccountancyDaily, 18th December 2018) <https://www.accountancydaily.co/kingman-calls-abolition-frc-audit-regulator> accessed 12th February 2019.
[22] Brenda Porter et al., *Principles of External Auditing* (4th edn, Wiley 2014) 841.

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