AUDITING FUNDAMENTALS

Marlene Davies
John Aston

FT Prentice Hall
FINANCIAL TIMES

AUDITING FUNDAMENTALS

AUDITING FUNDAMENTALS

Marlene Davies and
John Aston

Financial Times
Prentice Hall
is an imprint of

PEARSON

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Singapore • Hong Kong
Tokyo • Seoul • Taipei • New Delhi • Cape Town • Madrid • Mexico City • Amsterdam • Munich • Paris • Milan

Pearson Education Limited
Edinburgh Gate
Harlow
Essex CM20 2JE
England

and Associated Companies throughout the world

Visit us on the World Wide Web at:
www.pearsoned.co.uk

First published 2011

ISBN: 978-0-273-71173-5

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data
Davies, Marlene.
Auditing fundamentals / Marlene Davies and John Aston.
p. cm.
ISBN 978-0-273-71173-5 (pbk.)
1. Auditing. I. Aston, John, MBA II. Title.
HF5667.D384 2011
657'.45—dc22

2010026549

10 9 8 7 6 5 4 3 2 1
14 13 12 11 10

Typeset in 9.5/12.5 pt Stone Serif by 73
Printed by Ashford Colour Press Ltd, Gosport

Dedication

This book is dedicated to the late Evelyn and Harry Aston, my mother and father, to whom I owe everything.

I also dedicate this book to my wife, Diane, who is a great source of encouragement and support to me. I am in her debt.

John Aston

This book is dedicated to my parents, the late Morwenna and Hugh Jenkins who were an inspiration to me.

I also dedicate this book with all my love to my husband, Frank, and daughters, Catherine and Helen.

Marlene Davies

This page is intentionally left blank.

Brief contents

Contents

Preface

This textbook will provide a fundamental introduction to the principles and practices of auditing and has been written and designed for anyone who has an interest in the science. Traditionally, many textbooks on this subject tend to specialise in external audit, often at the expense of internal audit. In fact, history often suggests that internal audit is a 'Cinderella' of all the finance functions. The development of corporate governance, social responsibility, risk evaluation, the need to review our main systems and the continuing requirement to maximise value for money all mean that internal audit has an important and growing role within the organisation. The recent problems of toxic debt management portfolios within the banking system, contemporary worries of identity theft and weaknesses within the chip and pin system all add up to the growing stature of internal audit within the profession, reporting to the highest level of management. It is only hoped that senior management listens and can evaluate and understand the advice on offer. It is also hoped that the role of external audit will continue to develop in such a way that their reporting will be of importance to shareholders, both present and future. Many contemporary problems of corporate governance within our banking system suggest that there is still work to be done to benefit the external audit function.

The primary aim of the book is to provide a straightforward and comprehensive approach to enhance an understanding of auditing. It takes both theoretical and practical approaches. Then, taking this a step further, it integrates theory into practice in a pragmatic and applied manner. Students of accounting and finance will certainly find this book useful. Professional bodies such as ICAEW, ICAS, ICA, ACCA and CIPFA will find elements of the book useful as will students of the IIA and AAT. In many universities, both traditional and new, accounting and finance are vibrant subjects providing vocational degrees leading to good jobs. Whilst aspects of this book are core to any undergraduate course, it can be used alongside other material for postgraduate students, many of whom are studying risk assessment and modelling, uncertainty and control as part of financial resource management studies. In fact this book is suitable for any aspiring professional who wants to understand the fundamentals of auditing.

One thought which became clear to both of us whilst writing this book is that anyone employed in the area of auditing 25 or 30 years ago would find contemporary techniques almost unrecognisable. Internal audit, in particular, is now a vibrant and fully developed profession. However, there is still much research to be done to develop the science further.

This book may well mean many things to many people. It has the potential to become one of the market leaders in its field. The greatest selling point of this book is that it concentrates on both external and internal audit. In the global environment where many developing countries are looking to grow their financial infrastructure, it is likely that this publication will have international appeal and we have therefore incorporated details of the revised (2009) International Standards on Auditing (ISAs) produced by the Auditing Practices Board (APB), itself part of the Financial Reporting Council (FRC), and which is fully committed to the worldwide harmonisation of auditing standards.

Finally, our thanks go to our families and colleagues who have been a great source of wisdom, support, encouragement and patience.

We hope you enjoy reading this as much as we look forward to developing it over the years.

Marlene Davies
John Aston

About the authors

Marlene Davies is Divisional Head for Accounting and Finance at the University of Glamorgan Business School. Marlene's area of expertise is in audit and corporate governance, having worked in the public sector prior to becoming an academic. She has taught extensively in Europe and in Hong Kong and been an external examiner for CIPFA and IIA, UK and Ireland. More recently she has been involved in developing modules in forensic audit and accounting. She is a regular commentator on public finance and local government issues for BBC Radio Wales and S4C.

John Aston was Subject Head of Business Studies at Brunel University. He has extensive experience in both the public and private sectors. He is a former Head of Audit and External Examiner for The Chartered Institute of Public Finance and Accountancy. He is an experienced tutor who has taught overseas in 10 different countries and for major organisations such as IBM, DHL, InterContinental Hotels, Cable and Wireless and National Savings. John is a visiting associate at Henley Business School, The College of Estate Management and The London School of Commerce. He is a licensed Lay Minister for the Church of England.

Acknowledgements

We are grateful to the following for permission to reproduce copyright material:

Figures

Figure 10.2 from The Passport Office, Crown Copyright material is reproduced with permission under the terms of the Click-Use Licence; Figure 12.3 from *Understanding Organizations,* 4th ed., Penguin (Handy, C.B. 1993), Reproduced by permission of Penguin Books Ltd.

Tables

Table 5.1 adapted from a table by David Geatrell.

Text

Extracts on pages 14–16, page 17, pages 17–18 after *APB Guidelines for Internal Audit,* Auditing Practices Board, © Financial Reporting Council (FRC). Adapted and reproduced with the kind permission of the Financial Reporting Council. All rights reserved. For further information please visit www.frc.org.uk or call +44 (0)20 7492 2300.

In some instances we have been unable to trace the owners of copyright material, and we would appreciate any information that would enable us to do so.

Chapter 1

Introduction to audit

Contents

Objectives

After reading this chapter you will be able to:

- understand the background and purpose of auditing;
- appreciate the need for audit;
- understand the auditors' objectives;
- know the difference between external and internal auditors.

Introduction

The word 'audit' is from the Latin *audire,* meaning to hear. Its roots go back to a time when financial affairs were reported by word of mouth and the auditor would give an independent account that the steward who had managed the situation was accurate in their report.

Many of the people who invested funds knew little, if anything, about the business they were investing in and therefore could not be sure how credible the account was. This was solved by appointing an independent third party to investigate and examine, where necessary, in order to give an opinion as to its reasonableness. The account was given orally, and after hearing it, respected listeners would report their opinion. Such people became known as **auditors**. As business expanded and became more sophisticated, the oral account became a written one, but the name auditor (the hearer) remained.

Demand for auditors grew, as did the skill and expertise in investigating the accounts and reporting. Financial statements may contain errors, or could be misleading or even contain a substantial fraud. Of course, many financial transactions may contain some degree of error or mistake. Minor errors can be easily covered up, particularly if the system is large. This is why the auditor only concentrates on material items. In the world of accounting and finance, materiality means size. Potential investors and lenders must be able to rely with reasonable assurance on the reasonable accuracy of the financial statements. This degree of reasonable accuracy is known as a true and fair view. It is not possible for the auditor to confirm that the accounts are 100% because the cost and time involved in examining every transaction down to the very last penny would be prohibitive and uneconomic. The terms true and fair have never been defined in law but a sensible way of defining them would be that the financial statements are intellectually honest. If the figures have been measured correctly, for example equipment was purchased on 1 March 2008, then the accounts are presented truthfully. If the value is written down by 25% over the next year to present, for example, the net book value then the decision to depreciate by that amount is a fair one.

It is worth making clear at this point three essential facts:

- The responsibility for the preparation and accuracy of the financial statements rests with the management of the business.
- The responsibility for ensuring that systems of internal control exist rests with management.
- The auditor does not seek to uncover all fraud and error.

However, the auditor is expected to carry out tests of the records supporting the financial statements in such a manner that there is a reasonable expectation of uncovering a major fraud or error, should either exist.

In the UK there are a large number of different accountancy, or accountancy-related, institutes and associations, including the following:

- Institute of Chartered Accountants in Ireland (ICI);
- Association of Chartered Certified Accountants (ACCA);

- Institute of Chartered Accountants in England and Wales (ICAEW);
- Chartered Institute of Management Accountants (CIMA);
- Association of Accounting Technicians (AAT);
- Chartered Institute of Public Finance and Accounting (CIPFA);
- Institute of Chartered Accountants of Scotland (ICAS);
- Institute of Internal Auditors (UK & Ireland) (IIA).

All these bodies vary from each other, depending on the nature of their aims and the specialism their members wish to attain. They are all, however, characterised by various attributes common across the accounting profession:

- stringent entrance requirements (examinations and practical experience);
- strict codes of ethics;
- technical updating of members and a commitment to keep up to date by continued professional development.

Membership of a professional accountancy body is essential for any auditor who has attained and maintained a professional qualification. There is one body that specialises in internal audit only, the Institute of Internal Auditors (IIA). This body is big in the USA and Canada and fairly small in the UK by comparison. Nevertheless, its members specialise as internal auditors in both commercial and public sector bodies and provide a valuable service to management.

There are two different types of audit, external audit and internal audit, and it is important to have an early appreciation of their different roles.

External audit

The majority of external audits undertaken in the private sector are statutory audits of limited companies under company law. Auditors are appointed by the shareholders, as the owners of the company, and have a duty to carry out such investigations that will enable them to form an opinion. Every company that has a turnover greater than £5.6 million is subject to a statutory audit, which is the maximum level permitted under a Companies Act 1989 requirement. Any company that has a turnover exceeding £5.6 million that is a public limited company must submit themselves for audit.

Companies entitled to an audit exemption must deliver accounts to the Registrar of Companies. Unaudited accounts must include, on the balance sheet, a director's signature and a statement that says the following:

- The company is entitled to an exemption for that financial year.
- There is no notice from members requiring an audit.
- The company keeps proper accounting records.
- The directors acknowledge their responsibility for preparing accounts that give a true and fair view.
- All relevant accounting standards have been complied with.

Most external auditors are qualified accountant members of a supervisory body. In the vast majority of cases, these tend to be the ICAEW, the ACCA and their

Scottish or Irish equivalents, ICAS or ICI. When a partnership is appointed, it is the firm and not the individual employee that is regulated. Under the Companies Act 1985 the auditor must be totally independent of the company. Auditors are ineligible for appointment if:

- they are an officer of the company;
- they are a partner or employee of such a person;
- the company is a partnership in which such a person is a partner;
- they are ineligible by virtue of the above for appointment as auditor of any parent or subsidiary undertaking;
- there exists between them or any associate (of his or hers) and the company (or company as referred to in above) a connection of any description as may be specified in regulations laid down by Secretary of State.

It should be noted that the legislation does not prohibit the appointment of an auditor who owns shares in the company or who is a creditor or debtor. It also does not disqualify a close relative of an employee of the business. The key to all of this is that the auditor or the practising firm should be totally independent of the company.

The external auditor's duties are as follows:

- to form an opinion as to whether the financial statements are true and fair;
- to ensure the company has kept proper accounting records;
- to ensure the records agree with the financial statements;
- to ensure the statements comply with statutory and stock market requirements;
- to ensure that appropriate accounting policies have been applied consistently.

Auditors report their opinion formally in an audit report. This report is presented to the members of the company (normally the shareholders) and, to aid communication, should be placed before the financial statements.

The duties of the external auditor of a limited company are onerous. To help auditors carry out these duties, the Companies Act accords them certain powers, including the following:

- a right of access at all times to the books, accounts and vouchers of the company;
- the right to obtain from officers (including directors) of the company such explanation and information that is required;
- the right to receive notice of and attend meetings and to report on any matter that concerns the auditor;
- the right to make a report to the members on their findings, including failure on the part of the officers of the company to supply all the information and explanations.

To summarise, auditors must carry out a sufficient level of work to form a reasonable basis for their opinion that the financial statements show a true and fair view. Alternatively they may have carried out a sufficient level of work to have a reasonable chance of finding any material misstatement, error or irregularity. The external auditor will normally submit an unqualified audit report when the financial statements are true and fair. There are instances when the auditor's opinion is such that it needs to be qualified.

Internal audit

Internal audit is a part of the financial structure of very large organisations. Internal auditors are employees of the organisation and work exclusively for it. Their responsibility is to the management of the organisation, to whom they report. In the past, the internal audit division reported to the finance director, or to the chief executive, but due to codes of best practice in corporate governance many internal auditors new report directly to the Audit Committee of the organisation.

Internal audit is defined in the Auditing Practices Board's auditing guideline, *Guidance for Internal Auditors,* as:

> . . . an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.

The key to this is that despite the fact that internal auditors are employees of the company, they must maintain their independence and be able to report to the highest level of management unedited in their own name. This means they have the same right of unrestricted access to records and employees as the external auditor. They determine their own priorities but that is done in consultation with the Audit Committee On occasions they are given a remit to carry out a particular study, for example into the high level of telephone or heating costs. They have the right to report to all levels within the organisations. The internal auditor is not a part of any financial system and should not be employed to keep accounting records. If internal auditors are used for non-auditing duties, it could jeopardise their independence.

A considerable proportion of the duties of an internal auditor are directed towards a systems-based approach and internal control evaluation and testing. Systems-based audit (SBA) is essential for management to ensure that the controls within an organisation's systems provide an assurance of sound quality control. According to the Auditing Practices Board, in their *Internal Audit Guidelines* (1990):

> To achieve full effectiveness the scope of the internal audit function should provide an unrestricted range of coverage of the organisation's operations, and the internal auditor should have sufficient authority to allow him access to such records, assets and personnel as are necessary for proper fulfilment of his responsibilities.

It is a management responsibility to determine the extent of internal control in the organisation's systems, and it should not depend on internal audit as a substitute for effective controls. Internal audit, as a service to the organisation, contributes to internal control by examining, evaluating and reporting to management on its adequacy and effectiveness. Internal audit activity may lead to the strengthening of internal control as a result of audit evidence and management response. One of the objectives of internal auditing is to assist management in the pursuit of value for money. This is achieved through economic, efficient and effective use of resources. Internal audit also has a role to play in risk management, where it can act in an advisory role to management.

It is a management responsibility to maintain the internal control system and to ensure that the organisation's resources are properly applied in the manner, and to the activities, intended. This includes a responsibility for the prevention and detection of fraud and other illegal acts. The internal auditor should have regard to the possibility of such malpractice and should seek to identify serious defects in internal control which might permit the occurrence of such an event. An internal auditor who discovers evidence of, or suspects, malpractice should report firm evidence, or reasonable suspicions, to the appropriate level of management. It is a management responsibility to determine what further action to take.

Summary

This chapter introduces the reader to the world of auditing. As well as considering the background and purpose of auditing, it splits the audit function into two very different approaches, namely external and internal audit. External audit is a statutory function and an integral part of the regulation process. In some organisations, such as local government, an internal audit section is a legal requirement. (NB Accounts and Audit Regulations.) However, in the commercial sector it is a discretionary service – highly recommended and very desirable yet discretionary. However, there is momentum for change because corporate governance requirements in the UK have driven management to assess risk, materiality and internal control. It is clear they need a strong internal audit section to help them achieve their objectives.

The requirements of external and internal audit and the importance of their relationship are developed further in the next chapter.

? PRACTICE QUESTION

What are the purpose and objectives of both external and internal audit, and what kind of service do they supply to management?

Chapter 2

External and internal audit

Contents

Objectives

After reading this chapter you should:

- understand the role and function of external audit;
- be aware of key case law;
- understand the role and function of internal audit;
- be able to discuss how to measure the effectiveness of internal audit.

Introduction

This chapter builds on Chapter 1 but takes the issues of external and internal audit a step further and considers the importance of a good working relationship.

External audit

Accountancy bodies have a responsibility for inspecting and monitoring their registered auditors on a regular basis. This is undertaken by the Professional Oversight Board's Audit Inspection Unit. The following features should be transparent in each accounting/audit practice:

- recruitment of suitable staff;
- proper training, both academically and on the job;
- continuing professional development;
- quality control and supervision of work;
- proper planning and approach;
- appropriate fee-charging policy, which is based either on an hourly rate or a percentage of turnover;
- a commitment to ethical guidelines;
- internal peer review at appropriate intervals.

The visit during the monitoring process is substantive or compliance-based. The inspectors will assess a certain number of audit files selected at random, and also files from categories known to be high-risk. The substantive approach will seek to verify that:

- planning, recording, supervision and review work have been carried out to a satisfactory professional standard;
- the work recorded provides a sound basis for the audit opinion.

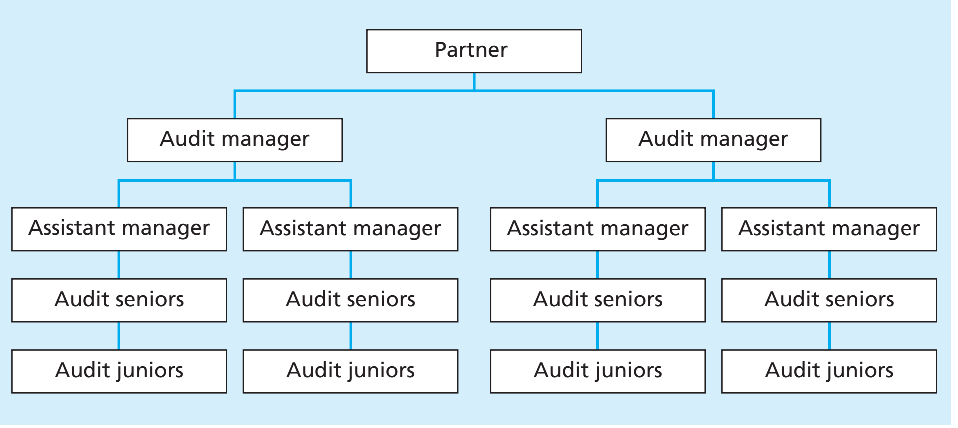
Each inspection ends with an interview, and the findings of the inspection are fully discussed together with any recommendations. If the inspection is not satisfied then the auditor or the firm will have their practising certificate withdrawn as a last resort.

The typical structure of an audit department in an audit firm is shown in Figure 2.1.

External auditor's reports to users and to management

Audit reports are the end product of the work and must be completed to the highest standard. They are governed by the 1985 Companies Act as amended by the Companies Act 1989 and 2006 and also by the international auditing standard ISA 700, *The Auditor's Report on Financial Statements*. The 1985 Act places a duty on auditors to examine the financial statements and to express an opinion on whether they show a true and fair view at the year end. The auditor should not express an opinion on the statements until they have been approved by the directors and the auditors have considered all available evidence.

Figure 2.1 Structure of an audit firm



There are two types of audit report, an unqualified report and a qualified report.

Unqualified reports

This is the most common report issued with the financial statements. It is known as a clean report. The auditing standard ISA 700 states that 'An unqualified opinion on financial statements is expressed when in the auditor's judgement they give a true and fair view and have been prepared in accordance with relevant accounting or other requirements.' This judgment concludes:

- The financial statements have been prepared using appropriate accounting policies which have been consistently applied.
- The financial statements have been prepared in accordance with relevant legislation regulations or applicable accounting standards (and that any departures are adequately explained in the financial statements).
- There is adequate disclosure of all information relevant to the proper understanding of the financial statements.

Qualified audit reports

There are three types of qualified report, which become appropriate depending on the circumstances. These reports will contain:

- an 'except for' opinion
- an 'adverse' opinion
- a 'disclaimer of' opinion.

This type of reporting is covered in Chapter 17.

Management representation letters

As part of the completion stage of the audit, a letter is prepared by the auditor on behalf of the management of the company to remind the directors that the responsibility for the preparation of the financial statement is theirs. Because the auditor frequently has to rely on information provided by management, it is usually good practice to confirm this in writing. The content of such a letter is as follows:

- Directors acknowledge their responsibilities under the Companies Acts.
- Issues arising from the audit where management judgment and opinion are noted.
- The draft financial statements do not need to be revised because of post balance sheet events known to the directors but not reported to the auditors.
- There are no significant fixed assets held off the balance sheet which would necessitate its revision.
- There are no liabilities of a material nature not included in the balance sheet.
- There are no contingent liabilities of a material amount for which provision has not been made.

This letter of representation is signed by the chairman and company secretary and minuted by the board of directors.

The management letter

An effective written report to the board of directors preceded by an executive summary is an essential part of communication. Auditors will report on matters that have come to their attention during the course of the audit. These will include:

- changes in risk assessment which are an issue;
- weaknesses in internal controls;
- weaknesses within management information systems;
- comments on the work and reliance of internal audit;
- issues that relate to the financial statements;
- recommendations for change.

Management letters are private communications which the board may well delegate to the Audit Committee. They are considered by all parties to be important and fundamentally useful.

External audits in the public sector

External audit reports of central government departments and quangos are undertaken by the Comptroller and Auditor General (C&AG) who is not a civil servant but an officer of the House of Commons. The C&AG is responsible for the National Audit Office, with a duty not only to carry out value-for-money reviews but also to audit the government's appropriation accounts. The C&AG is required to give an opinion that sums expended have been applied for the purposes authorised by parliament and that the account properly presents the expenditure and receipts for the year.

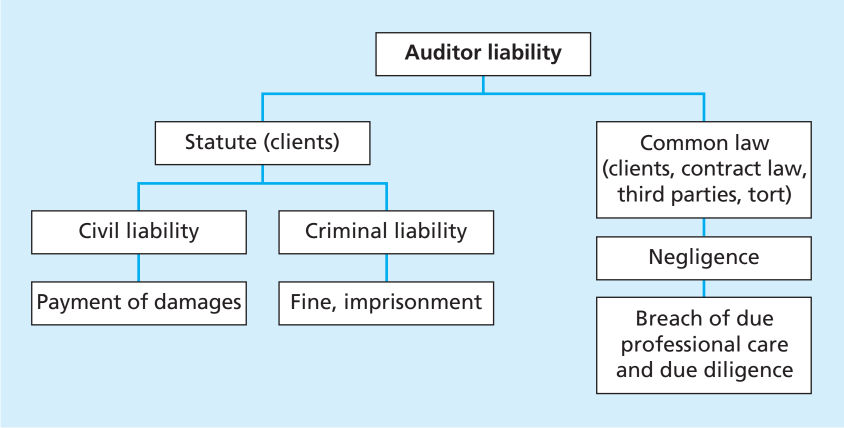
Audits in local government and the National Health Service are carried out by the Audit Commission in England, a body that controls the audit and inspection process of these public sector bodies. The Audit Commission is an independent body made up of the District Audit Service, comprising civil servants with a financial background and the large firms of chartered accountants that apply for this type of work. One significant feature in this area is that the audit is rotated and fees are paid by the Audit Commission itself. It is a commonly stated view that this system promotes audit independence and should be used by the private sector. However, this was considered by the Smith Report in January 2003 (see Chapter 5 for a discussion of this report) and rejected as inappropriate, which some might argue was a missed opportunity. (The Smith Report is now incorporated into the Financial Reporting Council's combined code.)

An important difference between local government and the private sector is that financial statements and appropriate supporting documents are put on public view for inspection and query. Members of the public on the electoral roll may take this further by raising objections if they feel expenditure or income is unlawful and the local authority or its employees or elected members have acted with culpable neglect. The auditor has the power to issue a 'certificate of loss', which is a surcharge requesting the return of public money from an individual. The most famous case involved the surcharge issued to Dame Shirley Porter who was leader of Westminster City Council. She faced accusations of 'gerrymandering', resulting from several major housing construction projects aimed at importing affluent voters to London's Westminster constituency. Dame Shirley later faced a surcharge of £27 million after being accused of selling houses for votes by the Audit Commission. She eventually settled in 2004 with a payment of £12m. Once again the auditor must provide an opinion which if unqualified would state that the statement of accounts presents fairly the financial position of the Council for the year end.

Auditor liability

A major error or oversight by the auditor can result in an incorrect opinion. If this happens, the auditor then has a liability to parties who suffer a loss. There are cases of early law which are covered here but the most recent influential contemporary case was the House of Lords' ruling in the Caparo case in 1990. Some of the early case law is considered briefly as this is a major subject area. Figure 2.2 outlines the auditor's legal position.

Figure 2.2 Auditor liability – legal aspects



Re London and General Bank (1895)

In this case the company had taken credit for interest accrued on loans which were never likely to be repaid. Many of these loans were statute barred (i.e. uncollectable). The auditor was aware of the problem and reported only to the directors and not to the shareholders. Subsequently the financial statements did not show a true and fair view. In summing up, the judge stated that the auditor had a duty to shareholders to report any dishonest acts that had occurred. He said the auditor could not expect to find every error but had a duty to use due care and skill.

Re Kingston Cotton Mill Co. Ltd (1896)

In this case the accounts had been falsified to a very considerable extent by the managing director, by extensive overvaluations of stock. In this instance the auditors were deceived, and although they acted with due care, they had understandably missed the deception. Lord Justice Lindley stated that the auditor is not bound to be a detective; he is a watchdog and not a bloodhound. In this instance the directors are liable to the shareholders for fraud.

Both this case and *Re London and General Bank* represent a cornerstone for auditor liability.

What are the auditor's duties?

The Companies Acts do not expressly state how an auditor should discharge their duty of care. L. J. Lopes, in *Re Kingston Cotton Mill*, stated.

> It is the duty of the auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.

Donoghue v. *Stevenson* (1932)

This case established that a duty of care is owed to parties outside a contractual relationship. This case refers to the sale of goods and relates to a situation where a customer was sold a bottle of drink with a slug at the bottom. It established the principles of duty of care.

Candler v. *Crane Christmas* (1951)

Although the court confirmed that no duty of care is owed to third parties outside a contractual agreement, the dissenting judgment of Lord Denning signalled the way the law would develop in the future by stating that the accountant owes a duty to any third party who sees the accounts and invests money but that this duty cannot be extended to include strangers.

Hedley Byrne & Co. Ltd. v. *Heller & Partners* (1963)

The court accepted the Denning reasoning that a duty of care is owed to third parties where it can be shown that a special relationship exists. The counsel's opinion was that there is a duty of care only if:

- It is clear that the financial loss is attributable to reliance upon the negligently prepared document and no other cause.

- The party issuing the document knew the purpose for which it was being prepared and knew (or ought to have known) that it was to be relied upon in that particular context.

Therefore, there was no duty of care to individual shareholders who place reliance on the audit report for investment decisions. The financial statements and the audit report are prepared for the purpose of stewardship and not for future investors.

Hedley Byrne v. *Heller and Partners* (1963)

In this case it was determined that the judgment in *Candler* v. *Crane* was wrongly decided. Hedley Byrne were advertising agents who wished to extend credit to the company Easipower Ltd. They asked Heller, as the company's bankers, for a reference in relation to the company's creditworthiness. The reference was given that the company was respectable but the reference included a disclaimer on the part of the bank if the information was relied on for any investment or business decisions. The advertising agency lost money and sued the bank for negligence.

The case was dismissed because of the disclaimer; however, the judge in this instance held that there was a duty of care even though no contractual or fiduciary relationship existed.

Jeb Fasteners Ltd v. *Marks, Bloom & Co.* (1981)

In this instance, the auditors conducted an audit for a company facing solvency difficulties. They were also subject to a takeover. The assets in the balance sheet were seriously overvalued, hence forcing the company to be taken over at an artificial price. Lord Justice Woolf said that the auditors could reasonably foresee that a takeover company would rely on the audited accounts and therefore suffer a loss if they were inaccurate.

Caparo Industries plc v. *Dickman & Others* (1990)

In 1984 Caparo Industries acquired a company called Fidelity on the basis that the company profits were in excess of £1 million. After the takeover, Caparo claimed that the accounts were inaccurate and the reported profit should have been a substantial loss. Caparo claimed that the auditors Touche Ross owed a duty of care to investors and sued them. They claimed Touche Ross should have seen the vulnerability of the company and therefore foreseen the likelihood of a takeover. However, the Law Lords were unanimous that auditors do not have a duty of care to individual shareholders or future investors. They also came to the conclusion that some previous cases, including *Jeb Fasteners* v. *Marks Bloom & Co.*, had been decided wrongly. However, Caparo went on to successfully pursue their action for damages against the directors of Fidelity, namely the Dickman brothers.

In relation to the Caparo judgment, Lord Bridge laid down the following circumstances in relation to proximity: the auditor will only be liable to the third party if the following circumstances are met:

1. The auditor is aware of the nature of the transaction which the third party is contemplating.

2. The auditor knows that the report will be communicated to the third party either directly or indirectly.
3. The auditor knows that the third party is likely to rely on the report in deciding whether or not to engage in the transaction in contemplation.

The Caparo judgment is a significant one since the courts are clearly reluctant to impose an unacceptable burden on auditors. Yet given the costs involved in lengthy court cases, it is not a surprise that so many cases in recent years, such as Barlow Clowes, BCCI, Maxwell Enterprises and Polly Peck, have been settled out of court.

In recent years the collapse of Enron and WorldCom in the USA and the consequences for the auditors Arthur Andersen, who were implicated in the scandal, resulted in the USA introducing the Sarbanes Oxley Act 2002. In the UK the courts have been concerned about the burden placed on external auditors since the Caparo case. In order to limit this burden, some auditors have formed limited liability companies; in other cases limited liability partnerships were created as an alternative.

Relationship between external and internal audit

During the course of their planning, the external auditors should perform a preliminary assessment of the internal audit function, when it appears that certain internal audit work is relevant to their external audit. A favourable assessment might allow the external auditors to modify the nature, timing and extent of external audit procedures.

External auditors may make use of the work of internal audit in forming their opinion. During the course of their work they will want to measure the effectiveness of internal audit. They do this against the *Internal Audit Guidelines* approved by the Auditing Practices Board (APB) in 1990.

However, it must be stated that external auditors have sole responsibility for their statutory responsibility to provide an audit opinion.

Internal audit

The Institute of Internal Auditors define internal audit as an independent assurance and consulting activity designed to add value and improve the organisation's objectives. It also helps an organisation accomplish its objectives, and it improves the effectiveness of risk management, control and governance processes. Figure 2.3 for the typical structure of an internal audit department.

Internal audit is defined by the APB in its 1990 *Internal Audit Guidelines* as an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a proper, economic, efficient and effective use of resources. The essential features of an effective internal audit department are as follows:

- independence
- appropriate staffing and training