THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

AUDITING
INTO THE
TWENTY-FIRST
CENTURY
AUDITING
INTO THE TWENTY-FIRST CENTURY

A Discussion Document by the Research Committee of The Institute of Chartered Accountants of Scotland

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Foreword

This discussion document is the result of a major research project undertaken by the Research Committee of The Institute of Chartered Accountants of Scotland. The Committee is grateful to the Scottish Chartered Accountants Trust for Education for funding the project.

In recent years, external auditing has been subject to a great deal of criticism. As a result of that criticism the Research Committee decided in the summer of 1991 that it should carry out a research project which would investigate how the expectations gap in auditing might be reduced in the most effective manner. The Committee explored its perceptions of the public's expectations today concerning the reassurances provided by external audits and in regard to the independence, accountability and legal liability of external auditors. The Committee's proposals are aimed at satisfying those expectations that it believes to be reasonable. The proposals relate only to listed companies.

During 1992 two major reports were published which are relevant to this project. The first was the Cadbury Report on the financial aspects of corporate governance and the second was the Auditing Practices Board's paper on the future development of auditing. The Research Committee considered these two reports during its deliberations. Our proposals have features in common with these two reports and reference is made to them where appropriate.

There appears to be much confusion in the public's mind as to the respective responsibilities of directors and external auditors. For instance, it does not appear to be clear to the public that it is the responsibility of the board of directors to prepare financial statements which give a true and fair view and that it is the responsibility of the auditors to express an independent opinion thereon. Our proposals aim to clarify their respective responsibilities.

One of the Research Committee's proposals is that to enable a board of directors to fulfil its responsibilities, each company would require a strong team of internal auditors led by a Chief Internal Auditor. We envisage an
internal audit team that is capable of carrying out much of today’s external audit.

As a result of the internal auditors carrying out much of the detailed audit work, the work required to provide an independent opinion will be, to a significant extent, judgmental in nature and will therefore have to be carried out by individuals of considerable experience whom the Committee renames *external assessors*. These proposed changes would have a major effect on the structure of the accountancy profession and on the education and training of accountants.

The Committee sees the issue of the independence of external assessors from boards of directors as being of crucial importance. We propose that each company should have an *Audit Review Panel* of three capable and independent individuals who would have responsibility for supervision of the assessment process on behalf of the shareholders or primary stakeholders and who would be responsive to the needs of other stakeholders. Such fundamental changes to the present system of corporate governance would require government legislation.

Although the Committee’s main focus has been on satisfying public expectations today particularly regarding truth and fairness, fraud, illegal acts and the ability of the company to continue in business, it recognises that these expectations may develop further in the twenty-first century. Concern that boards of directors have fulfilled their responsibilities in regard to environmental and societal matters is likely to increase. It may be that multidisciplinary teams will be required to provide an independent opinion on these matters. There are likely to be further developments in information technology so that much of the information presently provided in hard copy will be in screen form and there will be an expectation from users of that information that its reliability can be validated on an ongoing basis.

We are aware of the strides forward that have taken place in recent years by auditing firms in updating their techniques and developing high standards of external audit performance. However, this is not a time for complacency. We commend our proposals to all those concerned about improving the effectiveness of auditing. In particular, we commend our proposals to the Auditing Practices Board as it considers the future development of auditing and to the Government as it considers changes in company legislation.

We are grateful to Dr Bill McInnes, the Institute’s Director of Research, for his tremendous achievement in pulling together the various threads that
emerged from the Committee’s numerous discussions on this subject; to Aileen Beattie, the Institute’s Director, Accounting and Auditing, for valuable contributions at various stages of the project; and to Isobel Webber, Personal Secretary to the Director of Research for the patience and care with which she has typed and retyped successive versions of this document. We are also grateful to members of the Council of The Institute of Chartered Accountants of Scotland for allowing us to publish this document.

Professor Ian Percy
Convener
Research Committee
The Institute of Chartered Accountants of Scotland
May 1993
The Research Committee and the Editor

This discussion document was prepared by the Research Committee of The Institute of Chartered Accountants of Scotland which, for the purposes of this project, consisted of:

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Acknowledgments

The Research Committee would like to express its thanks to Professor Tom Lee, Hugh Culverhouse Endowed Chair of Accounting, University of Alabama, for commenting on various drafts of the discussion document.

The Committee is also grateful to all those, including the Office Bearers of the Institute, who provided comment and advice at various stages of the project.

We know that not one of them would agree with every aspect of the final document. Their primary role was to challenge the Committee’s thinking. This they did and we are grateful to them all.
CHAPTER 1

INTRODUCTION

The directors of ... companies, ... being the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own. (Adam Smith, 1776, Wealth of Nations, Book V, Chapter 1, part III.)

The term ‘audit’ is widely used to mean very different things. There are quality audits, efficiency audits, academic audits, operational audits, value-for-money audits, management audits, safety audits, environmental audits, social audits etc. The Auditing Practices Committee (APC) (1989) defined an audit as an ‘independent examination of, and expression of an opinion on, the financial statements of an enterprise’. This discussion document focuses on the form of audit encapsulated by that definition.

Such a ‘financial audit’ or ‘external audit’\(^1\) is intended to provide primarily shareholders, but also lenders, customers, suppliers and other interested members of the public with confidence in the truth and fairness of the financial statements published by a company’s board of directors. In the case of listed companies, such an audit is also important because the efficient functioning of capital markets is dependent upon capital market participants

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\(^1\) Throughout the document we use the terms ‘financial audit’ and ‘external audit’ interchangeably to refer to the form of audit defined by the APC (1989).
having confidence in the truth and fairness of each company's financial statements.

External auditing has been subject to a great deal of criticism in recent years. In this report we assess these criticisms in some detail and provide our own proposals for making the audit function more effective in providing the public with the reassurances they expect in regard to the truth and fairness of each company's financial statements. Our arguments and proposals relate only to listed companies.

In 1991 we recognised the need to consider the effectiveness of the external audit of listed companies and towards the end of that year began our discussions on which this report is based. During 1992 the Committee on the Financial Aspects of Corporate Governance (hereinafter referred to as the Cadbury Committee, 1992) published a report that includes a substantial section (pp 36-47) on auditing, and the Auditing Practices Board (APB, 1992c) published a report entitled *The Future Development of Auditing: A Paper to Promote Public Debate*. In the chapters that follow we make reference where appropriate to these two reports. Whilst we agree that there will be benefits from many of the recommendations made in these reports, our analysis indicates that changes of a more fundamental nature are required to improve the effectiveness of auditing in providing reassurances to the public.

Listed companies have a major effect on the economy and we believe, therefore, that there is a need to consider the external audit of these organisations from a public interest perspective. In chapter 2 we explore what we believe to be the public's expectations in regard to the reassurances sought from present-day external audits of listed companies. We give our opinion on the extent to which the provision of these reassurances is the responsibility of boards of directors, the extent to which it is the responsibility of external auditors and the extent to which these reassurances cannot be provided by either boards of directors or external auditors. In chapter 3 we explore what we believe to be the public's expectations in regard to the independence, accountability and legal liability of external auditors within the present corporate governance framework. We give our opinion of the deficiencies of that framework from an external auditing perspective. Our detailed proposals are set out in chapter 4. We describe our proposals for providing the public with more reassurances than are provided at the present time as to whether boards of directors have fulfilled their stewardship responsibilities. We also
describe how we propose that the corporate governance framework should be changed to overcome the present problems relating to the independence, accountability and legal liability of external auditors.
CHAPTER 2

PUBLIC EXPECTATIONS TODAY: REASSURANCES SOUGHT FROM EXTERNAL AUDITS

This chapter explores our perceptions of the public's expectations regarding the reassurances sought from the present-day financial audits undertaken by external auditors. Our perceptions of the public's expectations are based on our own discussions and on investigations and discussions by others, such as the Macdonald Commission (1988), Steen (1989), Humphrey (1991), Porter (1991), Humphrey et al (1991, 1992), The Institute of Chartered Accountants in Ireland (1992), Sikka et al (1992), the Cadbury Committee (1992) and the APB (1992c). In our discussions we took into account relevant newspaper reports and editorials, as we believe these both reflect and influence the public's expectations.²

We deliberately express these expectations primarily in lay person's terms, avoiding the use of technical language. The language of a person who does not have a specialised knowledge of a subject tends to be imprecise, and in the course of our discussion we re-express the demands, where necessary, in more technical language.

²Press comment probably occurs most often when some group with which the public can identify (eg pensioners or shareholders) has had its interests damaged and it is alleged that the auditors have in some way failed to fulfil their responsibilities.
We believe that the public expects external auditors to have a role in protecting the interests of shareholders, creditors, pensioners, employees and the public generally by providing them with reassurances that:

1. the financial statements are right;
2. the company will not fail;
3. there has been no fraud;
4. the company has acted within the law;
5. the company has been competently managed; and
6. the company has adopted a responsible attitude to environmental and societal matters.

This chapter explores each of these expectations in the context of the arrangements for the present-day financial audits undertaken by external auditors. Our general view is that an expectation is reasonable if:

(a) there are stakeholders\(^3\) who are willing to pay for the service (i.e. there is an effective demand); and

(b) someone is willing to supply it (for a price bearing in mind the risk involved) and is competent to do so.

What external auditors can supply will depend not only on what clients are willing to pay but also on the auditors’ technical skills and attitude to risk. Some of the demands placed on auditors may be unreasonable in that they cannot be expected to possess the skills necessary to do the work, for example, the assessment of management competence. Some services demanded of auditors, such as the seeking out of fraud, may be reasonable only if the clients are prepared to pay the very high costs involved and auditors are willing to bear (or can find an insurer to bear) the high consequences of failure.

For each of the expectations identified above, we believe that boards of directors, as well as external auditors, may have responsibilities for providing reassurances to the public. In each section of this chapter we discuss the respective responsibilities of boards of directors and external auditors.

\(^3\)A classification of stakeholders is provided in chapter 3, p 29-30.
1. The financial statements are right

There are two misconceptions inherent in this expectation. The first is that it is possible to prepare financial statements that are ‘right’ and the second is that the financial statements are the responsibility of the auditors.

It is generally agreed among those who are well informed about accounting that financial statements cannot be ‘right’ in the sense that there is only one set of figures that expresses the results of a company’s operations and its financial status. The inherent complexity of enterprise operations and the uncertainties implicit in management decision-making defeat any attempt to develop a set of financial statements that all informed observers would regard as ‘right’. In view of the many judgments that must be made when preparing the annual financial statements, a range of possible outcomes - all coming within the bounds of accepted practice - is to be expected.

In the UK, legal recognition that no set of financial statements can be uniquely ‘right’ is embodied in the concept that financial statements should be ‘true and fair’ and this phrase has been a legal requirement since the Companies Act 1948. It has also been incorporated into the Fourth and Seventh Company Law Directives of the EC. The strength of the true and fair requirement is that it allows for the inevitably judgmental nature of many accounting figures. A consequence of these judgments, of course, is that the expectation that ‘the financial statements are right’ is ill-conceived.

The second misconception is that the financial statements are the responsibility of the external auditors. It is the board of directors and not the external auditors that has the responsibility to prepare financial statements which give a true and fair view. It is the directors and not the auditors who determine the accounting treatment and disclosure practices adopted in the financial statements. The role of the auditors is to give an opinion on whether the financial statements give a true and fair view and have been prepared in accordance with the requirements of company law.

A further problem with the expectation that ‘the financial statements are right’ is that many members of the public do not distinguish between the audited and unaudited sections of a company’s annual report and accounts. As the APB (1992c, para 3.11) has pointed out, a growing proportion of corporate financial information is communicated outside the audited section, for example in the Chairman’s Statement, the Financial Review by the
Finance Director and the Review of Operations by the Chief Executive. We believe it is the responsibility of the board of directors to ensure that the unaudited sections of the annual report and accounts do not contain any information that is inconsistent with that in the audited section. We further believe the external auditors should check that there is no such inconsistency.4

In principle the true and fair concept is a powerful one in that it requires both boards of directors and external auditors to consider the substance of an enterprise. This requires not only judgments about whether the figures in the financial statements and the notes of explanation are true but also judgments about whether they are fair. Whilst accounting rules and regulations are necessary it is possible that strict adherence to such rules can, in exceptional circumstances, not give a fair presentation. As Flint (1982, p 29) points out:

Whatever may be the extent of prescription [of accounting rules], an overriding requirement to give ‘a true and fair view’ is, at the lowest level of its utility, a safety valve protecting users from bias, inadequacy or deficiency in the rules; a fail-safe device for the unavoidable shortcomings of prescription.

From its inception the Financial Reporting Council accepted the true and fair view concept as the overriding requirement (Financial Reporting Council, 1991, para 3.1) and at the present time the Financial Reporting Review Panel assesses, on this basis, the financial statements submitted to it for review.

However, there have been difficulties with the true and fair concept. It has never been defined authoritatively by either accountants or lawyers and it can be claimed that this has given ample opportunity for ‘creative accounting’, ie the manipulation of accounting practices in order to report the level of profits, gearing, etc desired by the directors [examples are provided in Griffiths (1986), Jameson (1988), Smith (1992)].5 It might be argued that

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4Auditors are already expected to comment in the audit report if the information in the Directors’ Report is not consistent with that in the audited accounts.

5It has recently been argued that bad accounting practice unchecked in one company over time becomes acceptable practice by other companies (David Tweedie, Accountancy Age, 4 February 1993).
this is possible because the requirements of company law and accounting standards do not provide unambiguous directions to a company's directors on the bounds of their discretion to make accounting choices. Some boards of directors appear to have pushed this discretion to unscrupulous lengths.

A possible solution is to make the rules ever more comprehensive and restrictive. This 'rule book' approach (Tweedie, 1988), however, is unlikely to succeed. There is no way by which any set of rules can cover every eventuality in every type of business, and some directors have - with the help of their legal and financial advisers - shown great skill at 'creative compliance' (McBarnet and Whelan, 1991), ie structuring transactions in such a way that, while conforming with the letter of the rules (or law), they subvert their spirit. For instance, Rutherford (1988, p 37) reports the development of grey leases to satisfy the technical requirements of Statement of Standard Accounting Practice 21 [Accounting Standards Committee (ASC), 1984]. Financial statements therefore not only need to be in accordance with the rules but also must be 'fair' in the sense that they are not misleading and do not misrepresent the economic substance of the company.

The role of external auditors is to report that the financial statements are fair as well as true and there has been considerable criticism of them for not taking a stronger line when dealing with financial statements that creatively comply with the rules. Proposals on how auditors should deal with the problems of creative accounting are included in the APB's (1992a) Exposure Draft entitled Auditors' Reports on Financial Statements. In that Exposure Draft the APB clearly sets out that when, in the auditors' opinion, the financial statements are misleading as a result of the directors' accounting choices and disclosure practices, the auditors should issue a qualified opinion that states clearly all the factors giving rise to the disagreement, the

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6Statement of Standard Accounting Practice 21 distinguishes between finance leases and operating leases. A finance lease is defined (para 15) as a lease that transfers substantially all (normally 90%) of the risks and rewards of ownership of an asset to the lessee. A grey lease transfers fractionally less than substantially all the risks and rewards of ownership to the lessee. Thus, if only 89% of the risks and rewards are transferred this appears to satisfy the requirement of an operating lease which unlike a finance lease does not have to be recognised on the balance sheet. Thus, a lessee who wants to have the advantages of a finance lease but who does not wish to increase gearing has incentives to use a grey lease.
implications for the financial statements and, whenever practicable, a quantification of the effect on the financial statements. The APB further proposes that when the auditors consider that the effect of the disagreement is so material or pervasive that the financial statements as a whole are misleading, they should issue an adverse opinion.

We support these proposals by the APB and recommend that auditors both individually and collectively (by not succumbing to directors gathering opinions from competing firms of auditors) be bold enough to use them to indicate to stakeholders the extent to which they believe the financial statements do or do not give a true and fair view.

We believe that it should be made clear in each company’s annual report and accounts that it is the responsibility of the board of directors to prepare financial statements which give a true and fair view and that it is accordingly their responsibility to choose appropriate accounting treatments and disclosure practices. This belief is consistent with recent recommendations by The Institute of Chartered Accountants of Scotland (1992) and the Cadbury Committee (1992).

In our view, there is an effective demand for external auditors to give an opinion on whether the financial statements give a true and fair view and have been prepared in accordance with the requirements of company law, as we believe stakeholders expect such an opinion. The auditing profession is willing to provide this service and is capable of doing so. However, doubts have been expressed in recent times that auditors are not tough enough with directors who prepare financial statements that creatively comply with the rules. It is up to the auditing firms to reverse this perception and up to the regulators of the auditing profession to deal strongly with auditors who continue to condone creative accounting by boards of directors.

2. The company will not fail

Both Decima Research Limited (1986) in a survey conducted in Canada for the Macdonald Commission (1988) and Steen (1989) in a survey conducted in the UK for KPMG Peat Marwick McLintock found that there is an expectation by a significant proportion (25% and 37% respectively) of the general public that the external auditor guarantees the financial soundness of a company.
It is sometimes alleged that the problem that external auditors face is that continuance of a company may depend upon the rest of the world not knowing that its status as a going concern is open to any doubt. If, for example, auditors report that a company will continue as a going concern only if the bank continues to roll over its loans and its suppliers continue to grant normal periods of credit, this may result in the bank insisting on immediate repayment and the suppliers insisting on cash on delivery. On the other hand, some companies might still be in existence and shareholders' and creditors' money saved if the problem had been identified earlier. Indeed, there are examples of companies that are able to continue trading despite it being public knowledge that they suffer from liquidity problems and are subject to discussions about financial reconstruction. Furthermore, a study by Citron and Taftler (1992) which compared a set of companies having a going concern qualification with a matched set having no qualification, found that survival rates were indistinguishable.

It is a requirement of company law and one of the fundamental concepts of Statement of Standard Accounting Practice 2 (ASC, 1971) that financial statements should normally be prepared on the assumption that the company is a going concern. However, there are, at present, no specific requirements for either directors or external auditors to satisfy themselves that this assumption is reasonable.

Recent proposals by the APB (1992b) and by the Cadbury Committee (1992) focus on this issue. The APB proposes that directors should provide auditors with a written statement confirming that, in their view, the company will remain a going concern for the twelve months from the date the directors approve the financial statements. The directors should provide the auditors with evidence to support that view. Auditors will have a responsibility to perform procedures specifically designed to test the directors' view that the company is a going concern. The Cadbury Committee proposes that directors should be required to satisfy themselves that the going concern assumption is reasonable and that they should report accordingly to shareholders. Auditors should have a responsibility to test the directors' view that the company is a going concern and to give their opinion on the matter.

In our opinion, neither the directors nor the external auditors can guarantee the financial soundness of a company. However, we believe that it is reasonable to expect the directors to state publicly whether in their
judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the date the directors approve the financial statements. We also believe that it is reasonable to expect the auditors to carry out procedures aimed at testing the directors’ stated judgment and to report publicly the result of such tests.

Despite the concerns outlined in the second paragraph of this section, we believe that the fulfilment of the directors’ and auditors’ responsibilities in this area will lead to improved financial reporting and could lead to improved financial management in companies where this was not previously strong.

3. There has been no fraud

The detection of fraud was seen by external auditors and their clients as one of the main purposes of an audit until the 1940s (Brown, 1962). Since that time, the pronouncements of professional auditing bodies throughout the world have tended to concentrate on the objective of reporting on the truth and fairness of a company’s financial statements (Humphrey, 1991, p 11). In the UK, Companies Acts since 1948 have required auditors to report on the truth and fairness of the financial statements. Since 1967 UK audit reports have made no explicit reference to the keeping of proper books of accounts. The accounting records have become subsidiary to the financial statements prepared therefrom. Audit procedures are designed to discover fraud only to the extent that it has a material impact on the figures in the financial statements.

The reasons for the change in audit objectives (Lee, 1986, p 23) included: the increased awareness of the needs of capital market participants for independently verified financial reports; the increased acceptance by company management of its responsibility for the prevention and detection of fraud and error; and the increase in the volume of business transactions which meant that, for economic reasons, the audit of large companies could be carried out only on a test basis. However, as Willingham (1975, p 19) rightly notes, the detection of fraud has ‘been removed as an [audit] objective by the profession rather than by a change in the demand of clients of accounting firms. A solicitous consuming public could reinstate it’. 
The evidence suggests that most members of the public have yet to recognise that a change in audit objectives has taken place. In the UK Steen (1989) found that 75% of the general public, including the majority of financially knowledgeable people, think that it is the external auditors' responsibility to detect fraud of all kinds. This study also found that 61% of the general public think that it is the responsibility of the auditors actively to search for fraud. Another UK study by Humphrey et al (1991) found that the detection of fraud is seen as the responsibility of auditors by 86% of users, 62% of financial directors and by 53% of auditors. An investigation by The Institute of Chartered Accountants in Ireland (ICAI) (1992) found that there is a wide difference between the expectations of users and the views of auditors in regard to the detection of material fraud. The ICAI reported that:

A majority of users of annual accounts, and some auditors, do not accept (or do not appreciate) that an auditor who plans and carries out his examination in a reasonably competent and professional manner may not necessarily detect material fraud ....

In Canada, the survey by Decima Research Limited (1986) found that 47% of readers/investors believe that auditors should actively search for fraud.

In the UK, in 1984 the Minister for Corporate and Consumer Affairs 'invited' the auditing profession to review its role in regard to the detection of fraud (Accountancy Age, 25 October 1984, p 4). As a result of the complex and controversial nature of the topic it was not until 1990 that the Auditing Practices Committee (APC, 1990a) issued an auditing guideline entitled The Auditor's Responsibility in Relation to Fraud, Other Irregularities and Errors. The guideline specifies the respective responsibilities of management (para 8) and external auditors (para 9). Management has primary responsibility for the detection of fraud, other irregularities and errors. This responsibility is seen as part of management's stewardship role. The auditor's responsibility is:

to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the annual accounts, whether they are caused by fraud, other irregularities or errors.
However well designed and executed, an audit can never guarantee to detect all fraud. Accordingly, the guideline recommends that the engagement letter should indicate to management that the audit should not be relied upon for this purpose (para 10).

The guideline recommends that if, during the course of the audit, the external auditors begin to suspect fraudulent activity, they have a responsibility to investigate until their suspicions are either allayed or confirmed (para 16). This recommendation is consistent with case law. In the absence of any statutory provisions requiring auditors to detect fraud, the auditors’ legal responsibilities in relation to fraud are determined by case law. The courts determine whether auditors have carried out their duties with ‘reasonable skill and care’ and if auditors have done so they cannot be found negligent in failing to detect fraud. As long ago as 1896 these principles were outlined by Lord Justice Lopes in the Kingston Cotton Mill case as follows:

It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective ....

He is a watchdog, but not a bloodhound. ... 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 ... .

Also consistent with case law (H E Kane v Coopers & Lybrand, 1985; W A Chip and Pulp Co Pty Ltd v Arthur Young, 1987) the guideline recommends (para 21 to 23) that external auditors should promptly report to senior management all fraud detected during the audit, even if the effect of the fraud is not material in the context of the company’s financial statements. The only circumstances in which auditors should not so report is when they suspect senior management is involved in the fraud (para 23). In these circumstances the auditors can report the suspected fraud to a third party in the public interest (para 31). We discuss the auditors’ responsibility to report to a third party in the next chapter.
If the fraud is material, external auditors need to ensure that the financial statements reflect the effect of the fraud and that all necessary details are disclosed (para 17). Provided the auditors are then convinced that the financial statements give a true and fair view it is not necessary to qualify the audit report (para 25). If the fraud is not material in the context of the financial statements it is the responsibility of the directors to decide whether disclosure is necessary (Tweedie, 1991, p 30).

Although there may be an expectation that external auditors give a guarantee that there has been no material fraud, it is probably not an effective demand, as it is unlikely that anyone would be willing to pay the very high costs of the detailed checking that would have to be undertaken by the auditors. In any event, even if auditors did check every transaction they could still not provide a guarantee that there had been no material fraud as they might still be deceived by collusion and the forging of documents. We are, therefore, of the opinion that it is not a reasonable expectation that auditors guarantee that there has been no material fraud.

In our opinion, it is, however, reasonable for the public to expect that the opportunities for fraud are minimised. We believe it is reasonable to expect the board of directors to take responsibility for setting up and maintaining systems of internal control that, *inter alia*, minimise the opportunities for fraud and that maximise the likelihood that any such fraud will be quickly detected.\(^7\) We believe that it is reasonable to expect external auditors to confirm in the audit report that these systems of internal control do minimise the opportunities for fraud and do maximise the likelihood that any such fraud will be quickly detected. We also believe that it is reasonable to expect auditors to support the directors in their attempts to prevent and detect fraud.

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\(^7\) In this document we are focusing on systems of internal controls that we believe would contribute to providing the public with reassurances in regard to certain aspects of a company’s activities. These systems of internal controls are subsets of the full range of internal controls for which directors, in their fiduciary capacity, are responsible to shareholders. According to the APC (1990c, para 60) the main objectives of these controls are: ‘(a) to ensure adherence to management policies and directives in order to achieve the organisation’s objectives; (b) to safeguard assets; (c) to secure the relevance, reliability and integrity of information, so ensuring as far as possible the completeness and accuracy of records; and (d) to ensure compliance with statutory requirements’. 
by reporting to the directors (a) any weaknesses they have identified in these systems of internal control and (b) any suspicions they may have in regard to fraud.

In recent years many of the larger frauds have been perpetrated by directors who have overridden systems of internal control. Consequently, we believe that auditors should plan their audits bearing in mind the risk of fraud by the directors of the company being audited. Such an approach is consistent with case law which indicates that the courts do not expect auditors to rely on the assertions of senior management and directors. The courts expect the auditors to obtain corroborative evidence, where possible, from sources external to the company (London Oil Storage Co v Seear Hasluck & Co, 1904; Re City Equitable Fire Assurance Company, 1925; Re Thomas Gerrard & Son Ltd, 1968; Pacific Acceptance v Forsyth & Ors, 1970; and H E Kane v Coopers & Lybrand, 1985).

4. The company has acted within the law

If the primary objective of an audit is to report on the truth and fairness of financial statements, external auditors are inevitably forced to consider the implications for those financial statements of a company’s failure to comply with the law. It is in this sense that auditors are concerned with illegal acts. They cannot be expected, qua financial auditors, to ascertain, and so to report, whether a company has complied with all the laws and regulations relating to, say, health and safety, or the protection of the environment.

Both the UK Auditing Practices Committee (APC, 1990b) and the International Auditing Practices Committee (IAPC, 1991) have issued exposure drafts on the auditor’s responsibility in relation to illegal acts. Both documents argue that the responsibility for the prevention and detection of illegal acts rests with management (APC, paras 4-6; IAPC, para 8). These documents adopt similar approaches to those described in the previous section in regard to the responsibilities of the auditor to prevent fraud. For instance, the IAPC (para 10) states that:

although an audit may contribute to preventing illegal acts, the auditor is not, and cannot be held responsible for preventing illegal acts.
And as regards detection the IAPC (para 11) states that:

procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. However, an audit in accordance with generally accepted auditing standards does not normally include audit procedures specifically designed to detect illegal acts.

The exposure drafts' recommendations in regard to the responsibility of external auditors to report to senior management all illegal acts detected during the audit and in regard to the responsibility of auditors relating to disclosure of illegal acts in the financial statements are similar to those relating to fraud outlined in the previous section.

Although there may be an expectation that external auditors give a guarantee that a company has not committed any illegal acts, it is probably not an effective demand, as it is unlikely that anyone would be willing to pay the very high costs of the investigations that would have to be undertaken either by the auditors or by lawyers on behalf of the auditors. We are, therefore, of the opinion that it is not a reasonable expectation that auditors guarantee that a company has not committed any illegal acts.

However, in our opinion it is reasonable to expect boards of directors to take responsibility for setting up and maintaining systems of internal control that, *inter alia*, minimise the opportunities for committing illegal acts in the name of the company and that maximise the likelihood that any such illegal acts will be quickly detected. We believe it is reasonable to expect auditors to confirm in their audit report that these systems of internal control do minimise the opportunities for committing illegal acts in the name of the company and do maximise the likelihood that any such illegal acts are quickly detected.

As part of their responsibility to prepare financial statements which give a true and fair view, we believe that directors must ensure that the statements reflect the financial implications of illegal acts detected if these implications are judged to be material.\textsuperscript{8} We believe that auditors, as part of their

\textsuperscript{8}A possible loss through fine, penalties or the award of damages is covered in the authoritative accounting literature on contingencies.
responsibility to give an opinion on whether the financial statements give a true and fair view, must confirm that the statements reflect the financial implications of any such illegal acts.

5. The company has been competently managed

Research shows that many users of published accounting information see an audit as an investigation of management competence. In the UK the study by Steen (1989) found that 46% of the financially knowledgeable respondents think that external auditors report on the efficiency, economy and effectiveness of the management process, while the study by Humphrey et al (1991) found that providing reassurance that the company is being run efficiently is seen as the responsibility of auditors by 62% of users, 42% of financial directors and by 27% of auditors.

The view that the audit function is designed to assess management competence does not look unreasonable when placed in the context of the external audit of the accounts of both local authorities and central government. For instance, the Local Government Finance Act (1982) requires external auditors to satisfy themselves that ‘the body whose accounts are being audited has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources’.

However, the assessment of management competence by external auditors is fraught with difficulties. Financial auditors do not, in the main, have the appropriate training or experience to undertake an audit of management competence. An audit of the full range of managerial activities would involve more work than is likely ever to be practicable for the auditors at any given point in time. An audit of management competence would need to include an assessment of management’s decisions. But decision making involves the exercise of choice, and it is only the consequences of the particular course of action decided upon that can be observed. The difficulties involved in ascertaining how the other rejected options would have turned out imposes a severe constraint on the ability to assess the quality of management decisions. Furthermore, in an uncertain environment it is impossible for even the most able and far-sighted managers to choose consistently those options that produce the optimal results. In our opinion, the audit of management competence is likely to be an extremely difficult undertaking only to be
undertaken by those with the necessary skills and not by those responsible for the financial audit.

In any event there seems to be less justification for including an assessment of the efficiency, economy and effectiveness of management in a private sector audit than in a public sector audit. Public sector bodies are not subject to the discipline of the capital markets. According to economic analysis, in the private sector only the more efficient managers are able to maintain their command over resources in the longer term. Even if competition in the product market fails to discipline incompetent managers the capital market will fulfil the same function. If sub-optimal use is made of existing resources, the company's share price will fall, thereby providing the opportunity for a takeover by some other firm that foresees the possibility of using the resources more effectively.

We believe it is the responsibility of a company's board of directors to monitor the competence of its management. In our opinion, it is unreasonable to expect financial auditors to assess the competence of management: as financial auditors do not have the appropriate training and experience; as economic analysis suggests that in the private sector incompetent managers will be unable to maintain their command over resources in the longer term; and as it is not clear that anyone is willing to pay the probably very high costs of auditors attempting to undertake this responsibility.

6. The company has adopted a responsible attitude to environmental and societal matters

There have been demands over recent years for companies to be subject to an audit of their social behaviour, most notably in respect of the physical environment but also in terms of employment practices, safety of operations, trade sanctions, product development policies and other issues of concern to particular interest groups.

To the extent that a company's behaviour in regard to these matters is regulated by the law we have already discussed the respective roles of boards of directors and external auditors in section 4 of this chapter. To the extent that environmental and societal matters are outside the existing law, each management will have to make judgments on the proper scope of its
company's public responsibility. It has been suggested that these judgments should be subject to some form of audit.

Without questioning the need for such an audit, it might be asked whether a company's financial auditors have appropriate qualifications and experience to provide it or whether it should be a separate exercise from the financial audit and be carried out by qualified experts in the area. In our opinion, it is unreasonable to expect financial auditors to make judgments on a company's attitude to environmental and societal matters.

As we stated in section 4 of this chapter we believe that external auditors have a responsibility to confirm in their audit report that boards of directors have set up and maintained systems of internal control that minimise the opportunities for committing illegal acts in the name of the company and that maximise the likelihood that any such illegal acts will be quickly detected. As part of this responsibility auditors should confirm that such systems of internal control have been established and maintained in regard to environmental and societal matters.

We also stated in section 4 that we believe that auditors, as part of their responsibility to give an opinion on whether the financial statements give a true and fair view, must confirm that the statements reflect the financial implications of any illegal acts detected if these implications are judged to be material. In our opinion this responsibility must include illegal activities in regard to environmental and societal matters.

Conclusions

This chapter has explored the various reassurances that we believe the public expects from external audits. Our analysis indicates our beliefs regarding the provisions of these reassurances: the extent to which they are the responsibility of boards of directors; the extent to which they are the responsibility of external auditors; and the extent to which they cannot be provided by either boards of directors or external auditors.

In our opinion it is reasonable to expect boards of directors to take responsibility for: preparing financial statements which give a true and fair view; stating publicly that in their judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least
twelve months from the date the directors approve the financial statements; setting up and maintaining systems of internal control that, *inter alia*, minimise the opportunities for fraud and other illegal acts and that maximise the likelihood that the directors will quickly detect any such irregularities. We also believe it is the responsibility of the board of directors to ensure that the company is competently managed and to ensure that the company adopts a responsible attitude to environmental and societal matters.

We believe it is the responsibility of the external auditors to *give an opinion*: on whether the directors have prepared financial statements which give a true and fair view; on the directors’ stated judgment that, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the date the directors sign the financial statements; and on whether the directors have set up and maintained systems of internal control that minimise the opportunities for fraud and other illegal acts and that maximise the likelihood that the directors will quickly detect any such irregularities. We believe that external auditors have a responsibility to plan and perform their audit work bearing in mind the risk of fraud and other illegal acts by directors.

In our opinion it is unreasonable to expect either boards of directors or external auditors to be able to provide *guarantees* that the financial statements are precisely right, that the company will not fail, that there has been no material fraud or that the company has not committed any illegal acts.
CHAPTER 3

PUBLIC EXPECTATIONS TODAY: INDEPENDENCE, ACCOUNTABILITY AND LEGAL LIABILITY

In addition to the expectations that we believe the public has in regard to the reassurances sought from present-day audits (explored in chapter 2) we believe the public has expectations regarding the independence, accountability and legal liability of external auditors within the present corporate governance framework.

We believe the public expects external auditors to be:
1. independent of the directors of the companies being audited;
2. responsible for reporting to a third party if they suspect that the directors are involved in fraud or other illegal acts;
3. accountable to a wide range of stakeholders; and
4. financially liable if they fail in any of their duties.

This chapter explores each of these expectations.

1. The external auditors are independent of the directors

In principle a company’s shareholders have the authority to appoint and dismiss that company’s external auditors. However, for the shareholders of most listed companies, as a result of their large numbers and transient nature, there is no effective mechanism for them to do so. It is usually the directors
who effectively appoint and dismiss the external auditors with the appointment or dismissal merely being ratified by the shareholders at the annual general meeting. A consequence of this reality is that external auditors have been subject to criticism that they are not independent of the directors. It is argued that, in disputes between directors and external auditors on issues such as accounting policy choices, the auditors have incentives to concede to the wishes of the directors. The auditors may be put in a particularly difficult position in such disputes if the directors have gathered opinions from competing firms of auditors.

It is argued that another result of the auditors being appointed by the directors is that, due to cost pressures, both parties have reduced the external auditors’ role to the minimum necessary to fulfil the legal requirements of company law as interpreted by the auditing firms themselves. It is argued that this has led to less attention being given by the external auditors to the assessment of the efficiency and effectiveness of companies’ internal control systems, which could lead to an increased incidence of fraud and other illegal acts.

The agreement of the external auditors’ remuneration with the directors creates a further problem. The audit fee is normally agreed in advance and is based on the usually valid assumption that the auditors will not find any evidence of malpractice. However, if, in the course of their work, the auditors become suspicious that there has been fraudulent activity that they feel should be subject to further investigation, they will have to agree with the directors a fee for this additional work. If the directors are involved in the malpractice the external auditors are in a very difficult situation.9

As the APB (1992c) document on the future of auditing points out, external auditors often see the directors of the companies they audit as clients. Audit fees, through the practice of ‘low-balling’ or ‘predatory pricing’, are perceived to be used increasingly as loss-leaders for more lucrative management consulting and tax services. Furthermore, it is alleged that

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9 The framework within which the external audit of local authorities is conducted is quite different from that in the private sector. For example, the Accounts Commission in Scotland appoints, dismisses, remunerates and reviews the quality of the work of the external auditors of local authorities in Scotland. This framework should ensure that the external auditors have a high degree of independence from the local authority being audited.
auditors act as ‘hired guns’ (Zeff, 1992) for their audit clients by helping them present their views to accounting standard setting bodies. It is argued that the public perceives that the desire to earn fees for non-audit work impinges upon the auditors’ independence of mind when carrying out the audit role.

Although we have no evidence that auditors have not acted independently we are of the opinion that the framework within which auditors conduct their audits is deficient as their independence is always going to be open to question for the reasons outlined above. We believe that it is reasonable for the public to expect that the independence of the external auditors not only exists but is seen to exist.

2. The external auditors will report to a third party if they suspect that the directors are involved in fraud or other illegal activity

In our opinion, there is legitimate public concern about the reporting responsibilities of auditors when they have reason to suspect that the directors are involved in fraud or other illegal activity. It is in these circumstances that auditors have the difficult task of deciding whether to report the suspected fraud to a third party such as the Police or appropriate prosecution authorities, the Department of Trade and Industry, the London Stock Exchange or the Securities and Investments Board. The APC (1990a) guideline argues that in exceptional circumstances auditors are not bound by their duty of confidentiality to their clients and can report the suspected fraud to an appropriate authority in the public interest (para 31). However, although the ‘public interest’ is a concept recognised by the courts, no definition has ever been given. Consequently auditors can be left with a difficult decision as to whether it is in the public interest to report a suspected fraud to a third party. The APC guideline (para 33) suggests that the auditor takes the following matters into account when considering this decision:

(a) the extent to which the fraud or other irregularity is likely to result in a material gain or loss for any person or is likely to affect a large number of persons;
(b) the extent to which the non-disclosure of the fraud or other irregularity is likely to enable it to be repeated with impunity;
(c) the gravity of the matter;
(d) whether there is a general management ethos within the entity of flouting the law and regulations; and
(e) the weight of evidence and the auditor’s assessment of the likelihood that a fraud or other irregularity has been committed.

The guideline suggests that the auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest. The difficulty for auditors is that normally they will have to make a decision based on their suspicions of fraud rather than on proven facts. If they report their suspicions to a third party and are subsequently unable to find evidence of fraud they may be liable to legal action.

In the financial sector, auditors’ responsibilities in this regard have been clarified by legislation. The Financial Services Act 1986, the Building Societies Act 1986 and the Banking Act 1987 all release auditors from their obligations of confidentiality to their client organisations and give them the right but not the obligation\(^\text{10}\) to report to a regulatory body when they are satisfied that it is necessary to do so in order to protect the interests of shareholders or depositors. Thus in the financial sector auditors are to some extent emerging as agents of the regulatory body. Although this marks an important change in the relationship of auditors both to clients and to the state in the UK, the concept of auditors acting on behalf of regulatory agencies as well as shareholders is a familiar one in France. Furthermore, in the UK public sector, auditors of local authorities report to the Accounts Commission in Scotland or to the Audit Commission in England.

We believe that it is reasonable for the public to expect that auditors will report to a third party when they suspect that directors are involved in fraudulent activities or other illegal acts. The present arrangements outlined above mean that when auditors have such suspicions it is difficult for them to decide whether or not to report these suspicions to a third party.

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\(^{10}\)In March 1993, HM Treasury and the Department of Trade and Industry (1993) issued a Consultative Paper seeking views on the Government’s proposal that auditors of banks, building societies, investment businesses authorised under the Financial Services Act 1986, insurance companies and friendly societies should be under a statutory duty to report certain matters to the relevant regulators.
3. The external auditors are accountable to a wide range of stakeholders

The activities of listed companies are of interest to a wide community of stakeholders. We classify stakeholders into three groups - primary, secondary and tertiary. The membership of all three groups is, for many listed companies, continually fluctuating and it therefore becomes necessary to take account not only of actual stakeholders but also to recognise the needs and interests of potential stakeholders. Within each of these groups of stakeholders there is likely to be a wide range of ability to understand and interpret accounting policies, practices and reports.

*Primary stakeholders* are those with an ownership interest in the company which, under UK company law, gives them the formal right to appoint, and to receive reports from, the directors of the company. The primary stakeholders are thus the equity investors. They may be classified into two groups: private investors, who often lack a good knowledge and understanding of accounting matters and do not have ready access to persons who do; and institutional investors, who should have such knowledge and understanding.

*Secondary stakeholders* are those with a financial but not an ownership interest in a company. They include loan creditors, employees, business contacts (customers and suppliers) and the authorities responsible for the assessment and collection of direct and indirect taxes.

*Tertiary stakeholders* are those without a direct financial interest in the company but who are affected, or believe themselves to be affected, by the way in which the company’s resources are managed. They differ from other stakeholders in that they do not have a direct financial stake. Tertiary stakeholders often wish to receive information on what economists call ‘externalities’, *ie* costs (*eg* atmospheric pollution caused by a smoking chimney) and benefits that are not borne or received by the company responsible for them and that do not appear in the company’s routine accounting records.
The mechanisms used in major listed companies to monitor and report on the performance of company managements still largely reflect the historical position of a company accountable only to its primary stakeholders. Both the directors’ report and the audit report for instance are formally addressed to ‘the shareholders’ or ‘the members’.

However, the notion of corporate accountability appears to have evolved beyond this traditional concept. The obligatory filing of various reports with the Registrar of Companies establishes the most practical route to ensure the availability of information to the generality of secondary and tertiary stakeholders, as well as to those who are evaluating whether to take an explicit stake in a company. Recent Companies Acts have progressively required directors to include in the directors’ report matters of more immediate concern to secondary and tertiary stakeholders than to the primary stakeholders eg political and charitable donations, policy on employment of disabled persons, action regarding consulting, informing and involving employees.

The formal function of external auditors in the UK entails duties and obligations to primary stakeholders based on a contractual relationship between the auditors and the company. External auditors are, in addition, seen as providing reassurances to secondary and tertiary stakeholders although external auditors do not have any legal responsibility towards them.

We believe that the public expects external auditors to accept that they should have regard to the interests of secondary and tertiary stakeholders as well as to the interests of primary stakeholders. However, we recognise that auditors will be unwilling to accept that they have responsibilities to secondary and tertiary stakeholders until questions relating to the legal liability of auditors are clarified.

4. **The external auditors are financially liable if they fail in any of their duties**

The underlying contractual relationship in a company audit is between a company and its auditors. To achieve satisfactory performance of this contract, auditors are required to exercise reasonable skill and care. If auditors fail to exercise reasonable skill and care they can be sued by the company for failing to fulfil the terms of the contract.
The main focus of the highly controversial case of Caparo Industries plc v Dickman (1990) was on the auditors' duty of care to the company, to the shareholders and to other groups. The principles established in that case were outlined by the Cadbury Committee (1992, Appendix 6) as follows:

The case has established that in the absence of special features, auditors are not regarded as owing a duty of care to prevent loss to anyone relying on their report except (a) the company, and (b) the shareholders as a body. In the absence of special features, no duty of care is owed in particular to individual shareholders, subscribers to new shares, purchasers or intended (sic) purchasers of shares from third parties including those conducting takeover bids, bankers or other lenders to the company, or persons doing business with the company.

Within the context of this study the main consequence of the Caparo judgment is that, although auditors are financially liable to the primary stakeholders as a body, auditors do not have a legal liability to individual primary stakeholders or to secondary or tertiary stakeholders.

We believe that it is reasonable for the public to expect that auditors are financially liable if they do not conduct their audits with reasonable care and skill. However, in certain circumstances, auditors can find themselves liable to pay 100% of a claim even if they were only, say, 10% at fault. We believe that some means must be found of limiting the claims against auditors to amounts that reflect their degree of negligence.

Conclusions

In our opinion the corporate governance framework within which external auditors operate is deficient. We believe it is reasonable for the public to expect that external auditors are independent of the directors of companies being audited. Within the present corporate governance framework it is not clear that this is the case.

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11It is assumed that the word 'intended' should read 'intending' and refers to prospective purchasers.
We believe it is reasonable for the public to expect that the external auditors will report to a third party if they suspect that the directors of a company are involved in fraud or other illegal activities. Within the present corporate governance framework the external auditors have a very difficult decision to make when they have such suspicions.

In our opinion it is reasonable for the public to expect that external auditors have regard to the interests of a wide range of stakeholders. Within the present corporate governance framework it is not clear whether this is the case or whether they need only have regard to the interests of primary stakeholders.

We believe it is reasonable for the public to expect that external auditors will be financially liable if they fail in any of their duties. We also believe it is reasonable that the legal liability of auditors should be limited to amounts that reflect their degree of negligence.
CHAPTER 4

OUR PROPOSALS

This chapter sets out our proposals for improving the effectiveness of financial audits in providing reassurances to the public. These proposals relate only to listed companies and are aimed at satisfying the public expectations that we considered to be reasonable in chapters 2 and 3. The first section of this chapter provides a summary of our proposals. In the second section we set out our proposals for addressing the reassurances expected by the public as discussed in chapter 2. The third section sets out how we propose to address the independence, accountability and legal liability issues discussed in chapter 3. Conclusions are provided in the final section.

A summary of our proposals

Our analysis in chapter 2 suggests that in regard to certain aspects of the monitoring of a company’s activities it is reasonable for the public to expect a greater degree of reassurance than is currently provided. To achieve this we believe that boards of directors will have to provide more reassurances to the public than they do at present.

We believe that each board of directors should report:
(a) whether it has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to provide the board with (i) the information necessary for the
preparation of financial statements which give a true and fair view, and with (ii) reassurances that, inter alia, the opportunities for fraud and other illegal acts are minimised;

(b) whether the financial statements give a true and fair view of the state of affairs of the company at the period end and of the profit or loss for the period then ended and have been properly prepared in accordance with company law; and

(c) whether in the board’s judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the board approved the financial statements.

To provide a board of directors with reassurances that its management information systems and internal control systems are sufficiently reliable and relevant, we believe each company should establish and maintain a strong internal audit function under the direction of a Chief Internal Auditor. We envisage an internal audit team that is significantly stronger than is typically found in UK listed companies at the present time. As the internal auditors will be carrying out their work on a continuous basis and as they should have a sound understanding of the range of activities in which a company is involved, the Chief Internal Auditor should be in a strong position to provide a board of directors with reassurances regarding the reliability and relevance of the systems being operated within that company.

To ensure that the internal auditors have a significant degree of independence from the executives we propose that, in addition to reporting to the Chief Executive, the Chief Internal Auditor should report to a Financial Reporting and Audit Committee (FRAC) made up entirely of non-executive directors. The FRAC should approve the appointment, and the termination of the employment, of the Chief Internal Auditor. The Chief Internal Auditor should be free to communicate with the external assessors at any time.

We believe that the public will continue to expect an independent opinion of the reassurances provided by a board of directors. However, if each company has a strong team of internal auditors much of the detailed work in today’s external audit will have been done by them. There seems little point in repeating all of this detailed audit work. For this reason we propose a
change of name from external auditors to external assessors. We envisage that the work of the external assessors will be less procedural and more judgmental than the work carried out at the present time by external auditors.

The external assessors would have responsibility for reporting their opinion of:
(a) whether a board of directors has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to provide the board with (i) the information necessary for the preparation of financial statements which give a true and fair view and with (ii) reassurances that the opportunities for fraud and other illegal acts are minimised;
(b) whether the financial statements give a true and fair view of the state of affairs of the company at the period end and of the profit or loss for the period then ended and have been properly prepared in accordance with company law; and
(c) whether it was appropriate for the directors to state that in their judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the directors approved the financial statements.

To heighten the sense of commitment of the partner in charge of the external assessment, we recommend that the assessors’ report is signed in his or her own name on behalf of the firm of external assessors.

To ensure that the external assessors are independent of, and are clearly seen as being independent of, the directors of the companies they assess we propose that an Audit Review Panel (described in detail later in this chapter) should take responsibility for the appointment and the termination of the appointment, of the external assessors. The Panel would also take responsibility for agreeing the remuneration of the assessors. The Panel would be completely independent of the directors and would have responsibility for the supervision of the assessment process on behalf of the

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12 The term assessor rather than auditor was also used in another publication by the Research Committee of The Institute of Chartered Accountants of Scotland (McMonnies, 1988) entitled *Making Corporate Reports Valuable*. 
primary stakeholders and be responsive to the needs of the secondary and tertiary stakeholders. The Panel would have the responsibility of counselling the external assessors when the assessors suspect that the directors of a company are involved in fraud or other illegal activities which the assessors are considering reporting to a third party. Finally, we propose that external assessors should be financially liable only to primary stakeholders and only for damages that reflect the assessors' degree of fault.

Reassurances expected

In chapter 2 we explored our perceptions of the public's expectations in regard to the reassurances sought from present-day audits. Our analysis suggests that it is not possible to satisfy these expectations in their entirety within the financial audit. Nevertheless it is possible to provide the public with more reassurances about the monitoring of a company's activities than is provided at the present time. Our proposals for doing so are set out in detail in this section.

Responsibilities of boards of directors

We expressed the opinion in chapter 2 that it is reasonable to expect boards of directors to take responsibility for:
(a) preparing financial statements which give a true and fair view;
(b) stating publicly their judgment on whether, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the date the directors approve the financial statements; and
(c) setting up and maintaining systems of internal control that, inter alia, minimise the opportunities for fraud and other illegal acts and that maximise the likelihood that the directors will quickly detect any such irregularities.

Our recommendation that directors assume more responsibility for providing the public with reassurance in regard to financial reporting and auditing is consistent with paras 4.4 to 4.6 of The Code of Best Practice published by the Cadbury Committee (1992):
The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.\textsuperscript{13}

The directors should report on the effectiveness of the company's system of internal control.

The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

The explanatory note relating to para 4.4 recommends that the statement of directors' responsibilities should cover the directors' responsibility for preventing fraud and other irregularities. Thus paras 4.4 to 4.6 cover the same areas that we argued in chapter 2 are areas where it is the responsibility of boards of directors to provide reassurances to the public.

In order to provide the board of directors with the reassurances it requires on financial reporting and auditing matters the Cadbury Code of Practice recommends that each board should establish an audit committee of at least three non-executive directors, chaired by one of their number. We agree that such a committee of the board of directors should be set up with responsibility for financial reporting and auditing matters. This is likely to have the dual advantage of making use of the experience of the non-executive directors to enhance the internal monitoring of a company's activities and at the same time ensuring that the consideration that the board gives to financial reporting and auditing matters is well-informed as a result of the work of the committee. However, to underscore the breadth of its remit we are of the opinion that the title Financial Reporting and Audit Committee (FRAC) more aptly describes the responsibilities of this committee of the board.\textsuperscript{14}

We are of the opinion that the Cadbury Committee has not considered the full implications of its recommendation that each board should establish an audit committee with responsibility for financial reporting and auditing matters. We believe that companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to

\textsuperscript{13}In our proposals such a statement would be made by the external assessors.

\textsuperscript{14}Some boards of directors might wish to broaden the remit of their FRAC even further to include supervision of the audit of their companies' entire systems of internal controls.
fulfil its responsibilities. The scope of the work of the external auditors is unlikely to be adequate for this purpose. The timing of the external audit is unlikely to be appropriate for audit committee purposes given that most external audit work is done after the end of the financial year and is therefore likely to be of limited use for internal monitoring. Furthermore, the external audit is essentially a ‘snapshot’ at a particular point in time whereas assessment of the effectiveness of a company’s management information systems and systems of internal control should be undertaken on a continuous basis.\textsuperscript{15}

Consequently, we recommend that each company should appoint a Chief Internal Auditor to lead a strong internal audit team that is capable of providing the FRAC with sufficient information to fulfil its responsibilities on behalf of the board.\textsuperscript{16} In order to carry out this work each company would require a significantly stronger internal audit team than is typically found in such companies at the present time.\textsuperscript{17}

\textit{Internal audit function} As Shaw (1980, p 117) points out a fundamental difficulty in setting up and maintaining an effective internal audit department is the conflict between the need of the department for independence and authority and the need of the executives to exercise supervision and control

\textsuperscript{15}There are likely to be further developments in information technology as we move towards the twenty-first century. Each company is likely to have a financial database which will be drawn upon to provide information for internal use by management as well as for the interim and final financial statements. The internal audit of this database on a continuous basis is likely to provide a central element of a system of corporate governance.

\textsuperscript{16}An alternative approach would be for a company to appoint an outside firm of auditors to carry out the responsibilities of the internal auditors described in this section. If a company were to choose this approach a different firm would have to carry out the responsibilities of the external assessors.

\textsuperscript{17}Aid to Industry (1992) conducted a survey of internal auditing in UK listed companies on behalf of The Institute of Internal Auditors - United Kingdom. Of the 1185 companies replying to the survey only 24\% had an internal audit function. Of these 74\% were found to have fewer than 10 auditors.
over internal audit activities. Our proposals are aimed at achieving a balance between these needs.

We propose that the appointment and dismissal of the Chief Internal Auditor be subject to the approval of the FRAC. To ensure that the Chief Internal Auditor is as independent as possible from the executives we recommend that the Chief Internal Auditor should have no executive function in the company and should be debarred from accepting an executive position at the end of his or her term of office, except with the express permission of the FRAC. He or she should have sole responsibility for appointing the internal audit team and should have access at all times to the Chairman of the FRAC.

Chambers (1992, pp 23-24) recommends that the strategic planning of the activities of an internal audit function should be a team effort. An appropriate team might consist of the Chief Executive, the Chairman of the FRAC, the Chief Internal Auditor and a partner from the firm of external assessors. The budget for the internal audit department would be set by executive management on the basis of the estimated cost of the work agreed by the planning team.\footnote{Some boards of directors might wish to broaden the work of their internal audit departments to include the audit of the entire system of internal controls in their companies.} The budget would have to be approved by the FRAC.

The Chief Internal Auditor would have responsibility for ensuring that the internal audit team carries out competently and timeously the work agreed in the plan. The findings of each investigation should be reported by the Chief Internal Auditor, together with his or her recommendations, to the Chief Executive, to the FRAC and to the external assessors on a timely basis.

These reporting responsibilities would be important in establishing and maintaining the independence and authority of the internal audit function. As a result of the reporting responsibility to the FRAC and the obligation to provide the external assessors with a copy of each report, the internal auditors should have considerable independence from the executives (including the Chief Executive). As a result of their reporting responsibilities to the Chief Executive and to the FRAC the internal auditors should have authority within the company.
The Chief Internal Auditor would have responsibility for checking that all the points raised in his or her report, *ie* the deficiencies identified in the management information systems and in the systems of internal control had been dealt with by the executives. Any matters that were not resolved by the executives would be reported by the Chief Internal Auditor to the FRAC with a copy being sent to the external assessors.

The Chief Internal Auditor and the partner in charge of the external assessment should attend all meetings of the FRAC. As financial reporting and auditing matters are the responsibility of the board as a whole, other members of the board should have a right to attend if they so desire except when matters relating to the performance of the executive directors are being discussed.

The Chief Internal Auditor should report whether management information systems and internal control systems have been established and maintained that are sufficiently reliable and relevant:

(a) to provide the information necessary for the preparation of financial statements which give a true and fair view;

(b) to contribute to the information necessary for the board to be able to make a judgment on whether, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the date the directors approve the financial statements; and

(c) to, *inter alia*, minimise the opportunities for fraud and other illegal acts and maximise the likelihood that the directors will quickly detect any such irregularities.

In addition, the Chief Internal Auditor should report whether the financial statements prepared by the Finance Director are in conformity with the accounting records and have been prepared in accordance with the requirements of company law and applicable accounting standards. This would include having responsibility for highlighting any matters that the board should take into account in assessing whether the financial statements give a true and fair view, including any aspect of the financial statements that might give rise to the directors being called before the Financial Reporting Review Panel.

The Chief Internal Auditor would take responsibility for ensuring that the internal audit team prepare full working papers that outline the internal audit
work done to provide opinions on the above matters. These working papers would provide a basis for the external assessment of the internal audit work. The work of the external assessors will be described later in the chapter.

As the Chief Internal Auditor and his or her internal audit team should have a pervasive understanding of the activities of the business and as they would be carrying out their audit work on a continuous basis, we believe that the Chief Internal Auditor should be in a strong position to provide the board of directors with reassurances on the above matters. We believe that each company’s board of directors should report in a Statement of Directors’ Responsibilities whether it believes that it has fulfilled these responsibilities. This statement should be included in each company’s annual report immediately before the financial statements. An illustration of such a Statement is provided below.¹⁹

¹⁹The Cadbury Committee recommends that the directors of listed companies should state in the report and accounts whether they have complied with the Code of Best Practice. Our illustration of a Statement of Directors’ Responsibilities focuses only on those responsibilities that are within the focus of this Discussion Document.
Statement of Directors’ Responsibilities

UK company law requires us, the directors of the company, to prepare financial statements which give a true and fair view of the profit (or loss) for each financial period and of its state of affairs as at the period end. We are required to maintain adequate accounting records which disclose with reasonable accuracy at any time the financial position of the company and which enable us to ensure that the financial statements comply with the Companies Act. Finally, we are required to safeguard the assets of the company and hence have responsibility for the prevention and detection of fraud and other irregularities.

Based on our own knowledge and on the reassurances given to us by our Chief Internal Auditor we believe that we have fulfilled these responsibilities in all material respects. We have established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to (a) provide the information necessary for us to prepare financial statements which give a true and fair view and (b) provide us with reassurances that, *inter alia*, the opportunities for fraud and other illegal acts are minimised.

The financial statements give a true and fair view of the state of affairs of the company at 31 December 1992 and of the profit (loss) of the company for the year then ended and have been properly prepared in accordance with company law.

The financial statements have been prepared on a going concern basis because in our judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date we approved the financial statements.

Chairman
Board of Directors

Chief Executive
15 March 1993
Some boards of directors may, in addition, wish to point out in their Statements of Directors’ Responsibilities that in preparing the financial statements: suitable accounting policies have been used and applied consistently; reasonable and prudent judgments and estimates have been made; and applicable accounting standards have been followed. In any event, a statement regarding conformity with applicable accounting standards is required by law to be made by the directors as a note to the accounts.

To emphasise further that the financial statements are the responsibility of a company’s board of directors, we recommend that each member of the board should sign the financial statements before publication as an acknowledgment of his or her responsibility and approval and that each set of published financial statements should record the signature of at least two members of the board. Some companies may decide to expand the number of signatories to include, for instance, the Chairman of the Board, the Chief Executive, the Finance Director and the Chairman of the FRAC.

**Responsibilities of external assessors**

We believe that the public will require an independent opinion on the above reassurances provided by boards of directors. However, if each listed company has an effective system of internal monitoring supervised by a FRAC and a strong internal audit function much of the detailed work in today’s external audit will not be required.\(^{20}\) For this reason we propose a change of name from external auditors to external assessors. We envisage that the work of external assessors would be less procedural and more judgmental than the work of external auditors at the present time.

To a considerable extent the external assessors would carry out their responsibilities by assessing the work of a company’s internal auditors. The Auditing Guideline *Reliance on Internal Audit* (APC, 1984, para 10) recommends that before deciding to place reliance on the internal audit

\(^{20}\) We have been informed that in the last 30 or 40 years a number of major companies in the Netherlands, including Philips, have had, for varying periods internal audit departments undertake full financial audits. Nonetheless, the external auditors continued to give an opinion on the published accounts based on the work of the internal auditors and their own additional work which was substantially reduced as a result of the larger role of the internal auditors.
function, external auditors should assess (a) the internal auditors' degree of independence from the executives, (b) the scope and objectives of the internal audit function, (c) the professional care with which internal auditors have carried out their work, (d) the technical competence of the internal auditors, (e) whether management responds and acts upon internal audit reports, and (f) whether the internal auditors have adequate resources to carry out their responsibilities. We envisage that our proposals would satisfy the criteria identified by the APC as follows:

Degree of independence: As already noted we propose that, in addition to reporting to the Chief Executive, the Chief Internal Auditor should report to a FRAC consisting entirely of non-executive directors. The FRAC should approve the appointment, and the termination of the employment, of the Chief Internal Auditor. The appointment of the internal audit team would be the sole responsibility of the Chief Internal Auditor. The Chief Internal Auditor should have no executive function in the company and should be debarred from accepting an executive position at the end of his or her term of office, except with the express permission of the FRAC. The Chief Internal Auditor should be free to communicate with the external assessors at any time. Furthermore the external assessors would be able to assess the extent to which the FRAC and the internal auditors are independent of the executives by attending all meetings of the FRAC and by discussing the matter with members of the FRAC and with the Chief Internal Auditor and senior members of his or her team.

Scope and objectives of the internal audit function: As already noted, we propose that the scope of the internal auditors' work should be aimed at enabling them to report whether management information systems and internal control systems have been established and maintained that are sufficiently reliable and relevant:
(a) to provide the information necessary for the preparation of financial statements which give a true and fair view;
(b) to contribute to the information necessary for the board to be able to make a judgment on whether, given the trading environment in which the company is operating and expects to operate, adequate financial resources
are available to enable it to remain a going concern for at least twelve months from the date the directors approve the financial statements; and (c) to, *inter alia*, minimise the opportunities for fraud and other illegal acts and maximise the likelihood that the directors will quickly detect any such irregularities.

The internal audit work should also include an assessment of whether the financial statements prepared by the Finance Director are in conformity with the accounting records and have been prepared in accordance with the requirements of company law and applicable accounting standards.

We believe that the above internal audit work should be of relevance to the external assessors.

*Due professional care:* We propose that the internal audit work be planned, controlled, recorded and reviewed with the same professional care as that currently expected of external audit work.

*Technical competence:* We propose that the individuals undertaking the internal audit work should have adequate training and experience. We envisage many of them being members of professional accountancy bodies. The qualifications and experience of the Chief Internal Auditor would be particularly important.

*Internal audit reports:* We propose that all the reports sent by the Chief Internal Auditor to the FRAC and the Chief Executive identifying material weaknesses in the management information systems and systems of internal control identified above should be sent, at the same time, to the external assessors. The assessors should also receive a copy of the responses from the Chief Executive and, where appropriate, evidence that the internal auditors have checked that any such weaknesses have been rectified by management.

*Level of resources available:* We propose that the Chief Internal Auditor be provided with adequate resources to carry out the internal audit work agreed with the FRAC.
We believe that our proposals for an effective and relevant internal audit function should satisfy the criteria identified by the APC (1984, para 10). External assessors should, therefore, be able to satisfy themselves that they can rely on our proposed internal audit function. If they are unable to satisfy themselves on any of the above matters they should report the problems they have identified to the board of directors and to the Audit Review Panel, and consider qualifying the assessors' report. In our view, they should not carry out any of the internal audit work as this would jeopardise their independence.

Even if the external assessors are able to satisfy themselves that they can rely on the internal audit work, they should, nevertheless, make their own judgments on the matters on which they have a responsibility to report. In assessing the work of the internal audit function and bearing in mind the possibility of the directors overriding the internal control systems the external assessors may still wish to carry out limited tests. However, it should be stressed that the external assessors should be able to place similar reliance on the work of the chief internal auditor as external auditors presently place on the work of other experts such as actuaries in insurance companies.

The assessors would have to audit all material items in the financial statements and would have to make their own judgments as to whether the financial statements give a true and fair view. The assessors would have to test the directors' judgment that, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the directors approve the financial statements. An illustration of an external assessors' report is provided below.\textsuperscript{21}

\textsuperscript{21}The Cadbury Committee requires auditors to review each listed company's compliance with certain paragraphs of the Code of Best Practice. The responsibilities of the external assessors identified in this chapter cover paras 4.4 to 4.6. The remaining paragraphs of the Code to be reviewed by the auditors are outwith the focus of our document.
Assessors' Report

It is our responsibility to report whether in our judgment the board of directors has fulfilled its responsibilities as described in the Statement of Directors' Responsibilities on page .

Our judgments on whether the board of directors has fulfilled these responsibilities are based on our assessment of the internal auditing carried out by the Chief Internal Auditor and his or her team under the direction of the Chief Executive and the Financial Reporting and Audit Committee whose members are all non-executive directors and on the additional work we considered necessary to carry out a competent assessment.

In our opinion the board of directors has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to (a) provide the information necessary for the board to prepare financial statements which give a true and fair view and (b) provide the board with reassurances that the opportunities for fraud and other illegal acts are minimised.

In our opinion the financial statements set out on pages ... give a true and fair view of the state of affairs of the company at 31 December 1992 and of the profit (loss) of the company for the year then ended and have been properly prepared in accordance with company law.

These financial statements have been prepared on the basis of the directors’ stated judgment that, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the directors approved the financial statements. We have carried out procedures aimed at testing this judgment and believe it was appropriate for the directors to make such a statement.

Partner
Edinburgh 31 March 1993

on behalf of

External Assessors
To heighten the sense of commitment of the partner in charge of the external assessment to carrying out an independent enquiry we recommend that the assessors’ report is signed in his or her own name on behalf of the firm of external assessors. The above example of an assessors’ report reflects such an approach. We recommend that the Assessors’ Report and the Statement of Directors’ Responsibilities should be on the same page or on facing pages of a company’s annual report.

Independence, accountability and legal liability

From an external auditing perspective we identified, in chapter 3, the following deficiencies in the present system of corporate governance:
1. it is not clear whether external auditors are independent of the directors of the companies they audit;
2. external auditors are left with a very difficult decision as to whether they should report to a third party if they suspect the directors of a company are involved in fraud or other illegal activities;
3. it is not clear whether external auditors are or should be accountable to a wide range of stakeholders or only to primary stakeholders; and
4. it is not clear for what and to whom external auditors are financially liable if they fail in any of their duties.

In this section we describe our proposals for changing the system of corporate governance so that the role of external assessors in regard to the above matters is clear to the public. Our proposals are also aimed at satisfying those expectations of the public that we considered to be reasonable in chapter 3.

The Cadbury Committee (1992) recommends that to increase the independence of the external auditors each company’s audit committee should make recommendations to the board ‘on the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal’ (para 4.35). However, as audit committee members are also members of the unitary board they may not be independent of the executive directors. In any event, it is likely to be difficult to convince the public that non-executive directors are independent of the executives as the responsibility for managing the company is the collective responsibility of all board members.

We are of the opinion that to ensure that external assessors are independent of the directors of the companies they assess, and are clearly seen
to be so, it is necessary to make a fundamental change to the system of corporate governance. As the number of primary stakeholders and their transient nature means that there is no effective mechanism for them to supervise the assessment process, we propose that there should be legislation requiring each listed company to have an Audit Review Panel to undertake this responsibility.

*Audit Review Panel* The Panel would have responsibility for supervision of the assessment process on behalf of the primary stakeholders and would ensure that the assessors act in the interests of the primary stakeholders, rather than those of the directors. The Panel would thus provide a mechanism for putting into effect the present formal function of external auditors in the UK which is to act on behalf of the primary stakeholders.

The Panel would also be responsive to the needs of secondary and tertiary stakeholders and would thus provide a vehicle for widening the accountability of companies. When deciding how to respond to the needs of secondary and tertiary stakeholders the Panel would have to consider carefully the reasonableness of each request given that the costs would be borne by the company and ultimately by the primary stakeholders.

The Audit Review Panel would have to be clearly seen as being independent of the board of directors. We propose that some competent authority such as the Stock Exchange should have responsibility for maintaining a list of individuals who are willing and have the appropriate personal characteristics and experience to make them suitable candidates to become members of a Panel, *ie* strength of character, reputation for integrity, experience at a senior level in business or in the auditing profession. In addition to keeping an up-to-date list of suitable candidates, this competent authority would take responsibility for organising courses for candidates to give them appropriate training to enable them to fulfil their responsibilities as members of an Audit Review Panel.

We propose that the number of members of each Panel should be fairly small, say three. In the first instance, the chairman of the company in consultation with the competent authority should invite three individuals from the above list to become members of the Panel, one of whom should be chosen by the Panel as chairman. Thereafter the chairman of the Panel should nominate their successors, also from the above list. Primary stakeholders
would be precluded from becoming members of the Panel because of the rules on insider trading. In any case, many primary stakeholders would not wish to become members of the Panel as they would be subject to restrictions on the buying and selling of shares in that company as quasi insiders. The primary stakeholders would have the opportunity at the annual general meeting to vote for or against the appointment of those nominated. Each member should be appointed for a fixed term, usually three years, but renewable.

The remuneration of the Panel members should be borne by the company and should be on a scale of honorarium set by the competent authority. We envisage this being of a similar amount to that paid to those appointed to the Accounts Commission in Scotland or the Audit Commission in England. In any event, to maintain independence, it will be important that their remuneration is not set by the directors and is not of an amount that would impair the objectivity of Panel members.

We envisage that the Panel would take responsibility for agreeing the process for the appointment of the external assessors with the directors. Candour and trust between the directors and the assessors is an essential ingredient for the effectiveness of the assessment, and therefore the directors should be party to the reviews of the appointments of the external assessors by the Panel. The directors, particularly the Chairman of the FRAC, should attend meetings at which the external assessors make presentations to the Panel. The Panel and the directors would want to satisfy themselves not only that the assessors have the necessary expertise but also that there is likely to be a reasonable, but arm’s length, working relationship between the assessors and the Panel and between the assessors and the company’s directors.

The Audit Review Panel would have responsibility for agreeing the remuneration of the external assessors. We would expect the assessors to provide the Panel with a preliminary estimate of their fees which the Panel would agree with the directors. In the event of any dispute over the assessors’ fees, the Panel would have the authority to make a decision on the matter after considering the arguments of both assessors and directors.

The appointment of the external assessors should be for a period of three years renewable except in extraordinary circumstances. The Panel and the directors would review the appointments at least every six years. Appointments for a longer period than one year avoid many of the pressures
brought to bear on external auditors at the present time and should improve the effectiveness and independence of the assessors as they will have more time to become familiar with the unique aspects of a company's activities. The formal appointment would be made by the shareholders at the annual general meeting on the recommendation of the Panel.

If the Panel is not satisfied with any aspect of the work of the external assessors, it should report those concerns to the recognised supervisory body for the regulation of external assessors. The recognised supervisory body would have responsibility for investigating any complaints that a Panel might have regarding external assessors.

In addition to supervising the appointment of the external assessors and ensuring that they are not only independent of the directors but are clearly seen to be so the Panel would have the responsibility of:

1. receiving a report from the assessors on their work, together with any management letter detailing observations arising from the assessment together with the board's response;
2. receiving any reports from the assessors on sensitive issues;
3. considering the reasonableness of requests from stakeholders for the assessors to carry out additional investigations. As already noted the Panel's primary responsibility is to oversee the assessment process on behalf of the primary stakeholders but it should also be prepared to consider the reasonableness of requests for additional investigations from any stakeholder or group of stakeholders whether they be primary, secondary or tertiary;
4. requesting additional investigations by the external assessors and insisting that their costs be borne by the company. These additional investigations may arise as a result of problems identified in the original assessment, eg the assessors suspect that the directors are involved in fraudulent activities. Alternatively they may result from a request, considered

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22A recognised supervisory body is an accountancy body recognised by the Secretary of State for Trade and Industry for the purpose of overseeing and maintaining the conduct and technical standards of company auditors. The bodies so recognised are The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland, The Institute of Chartered Accountants in Ireland, The Chartered Association of Certified Accountants and The Association of Authorised Public Accountants.
reasonable by the Panel, from a concerned stakeholder or group of stakeholders, *eg* a request that the assessors provide an independent opinion as to whether the company has set up systems to ensure that its employees with responsibility for disposing of toxic waste are aware of all legal restrictions on such disposals;

5. counselling the assessors on whether they should report to a third party such as the Police or appropriate prosecution authorities, the Department of Trade and Industry, the London Stock Exchange or the Securities and Investment Board when they suspect the directors of a company are involved in fraud or other illegal activities (the assessors may also wish to take legal advice before reporting to a third party);

6. agreeing the remuneration of the assessors; and

7. reporting publicly in the company’s annual report and accounts on the work of the Panel during the year.

There has been much written on the subject of whether auditors should be allowed to provide other services to the companies they audit. It is useful to quote the relevant paragraphs from the Cadbury Committee (1992 paras 5.10 to 5.11):

> Among the propositions made to the Committee to strengthen the objective relationship between auditors and management, one was that audit firms should not provide other types of service to their audit clients. The argument runs that such a prohibition would remove any pressure on the auditors to give way to management on audit matters in order not to jeopardise their other business services; and that it would remove any incentive for auditors to take on audits at rates which could risk corner-cutting in the hope of obtaining more remunerative non-audit work.

Such a prohibition would limit the freedom of companies to choose their sources of advice and could increase their costs. The Committee was not persuaded that any potential gains in objectivity would outweigh these disadvantages. It does, however, strongly support full disclosure of fees paid to audit firms for non-audit work. The essential principle is that disclosure must enable the relative significance of the company’s audit and non-audit fees to the audit firm to be assessed, both in a UK context and, where appropriate, a worldwide context.
We agree with these views and believe there will be occasions where the experience of the external assessors’ firm will be invaluable to a particular company. In a free market a company should not be deprived of that benefit.

We propose that the directors should be required to obtain the permission of their company’s Audit Review Panel before employing their company’s firm of external assessors to carry out consultancy services. Before providing that permission the Panel should satisfy itself that the independence of the assessors would not be impaired.

The annual report and accounts should include a report by the Audit Review Panel on how it fulfilled its responsibilities during the year. The Panel’s report should be located near to the Statement of Directors’ Responsibilities and the Assessors’ Report. The Panel should include in its report:

(a) a description of the process used for the appointment of the external assessors (when this occurred during the year);
(b) details of the terms of appointment of the external assessors; and
(c) any matters that the Panel feel should be brought to the attention of the primary stakeholders.

As noted above the Panel would have responsibility for the supervision of the assessment process on behalf of the primary stakeholders and would be responsive to the needs of secondary and tertiary stakeholders.

**Legal Liability** We believe that external assessors should be financially liable only to the primary stakeholders if they fail in any of their duties. We are particularly sympathetic to one of the arguments against extension of the auditors’ duty of care identified by the Cadbury Committee (1992, p 83):

To hold the auditors liable to all and sundry for any purpose for which they might choose to rely on the auditors’ statement would result, in the classic words of Cardozo C J, in ‘liability in an indeterminate amount for an indeterminate time to an indeterminate class’.

We believe that the legal liability of auditors should be limited to amounts that reflect their degree of negligence. The idea of proportionate liability has been proposed by the big six firms in the US (Arthur Andersen
& Co et al 1992) and by the Public Oversight Board (1993, p 12) of the American Institute of Certified Public Accountants. If proportionate liability is introduced together with the other proposals made in the chapter it would be important that the respective responsibilities of boards of directors and external assessors be clearly distinguished. We believe that our proposals do clarify their respective responsibilities. We have recommended that boards’ responsibilities be clearly spelt out in the Statement of Directors’ Responsibilities and that external assessors’ responsibilities are to assess and to express an opinion on whether the directors have fulfilled these responsibilities. Thus the external assessors should be financially liable only if they have negligently expressed an opinion without carrying out a competent assessment of whether the directors have fulfilled their responsibilities. By distinguishing clearly between the respective responsibilities of boards of directors and external assessors we believe that our proposals should make it easier to apportion the blame for failure to fulfil these responsibilities.

In any event, we believe our proposals will enable both boards of directors and external assessors to carry out their responsibilities more effectively and should therefore lead to a reduction in the number of claims for damages. If each company has a strong team of internal auditors working on a continuous basis they should be able to identify quickly any problems with the company’s management information systems and systems of internal control. If all problems identified by the internal auditors are reported promptly to executive management and any problems which management fails to resolve are reported promptly to the board through the FRAC, the board should be able to carry out effectively its monitoring responsibilities. Furthermore, our proposals should ensure that the work carried out on a continuous basis by the internal auditors provides a sound basis for part of the external assessment.

We believe that our proposals in regard to corporate governance issues would ensure that:

1. external assessors would be independent of the directors of the companies they assess and would be clearly seen as being so;
2. external assessors would receive the benefit of the counsel of the Audit Review Panel when they suspect that the directors of a company are
involved in fraud or other illegal activities which the assessors are considering reporting to a third party;
3. all stakeholders (primary, secondary and tertiary) would have the right to request that the Audit Review Panel consider asking the external assessors to carry out additional investigations on their behalf at the company’s expense; and
4. external assessors would be financially liable only to primary stakeholders and only for damages that reflect the assessors’ degree of fault.

Conclusions

We explored in chapter 2 what we believe to be the public’s expectations in regard to the reassurances sought from present-day external audits of listed companies and in chapter 3 what we believe to be the public’s expectations in regard to the role of the external auditor within the present corporate governance framework. In this chapter we have described our proposals for providing the public with more confidence in the truth and fairness of each company’s financial statements than is provided at the present time and our proposals for changing the corporate governance framework.

Any decision on whether to implement our proposals would require consideration of costs and benefits. Implementation of our proposals would result in additional costs which would be incurred initially by companies and borne ultimately by primary stakeholders. These additional costs would be incurred by companies as they established or strengthened their internal audit departments, as they established and maintained a FRAC (where an Audit Committee is not already in place) and an Audit Review Panel. These additional costs should be offset to some extent by reductions in the fees paid to external assessors vis-à-vis the fees paid to external auditors at the present time.

The benefits of our proposals would accrue to a number of constituencies. Boards of directors would be provided with reliable and relevant information which should enable them to assess whether they have fulfilled their responsibilities. Boards should also be able to improve the governance of their companies by ensuring that the opportunities for fraud and other illegal acts are minimised. Internal auditors should benefit from having a significant
degree of independence and authority within each organisation as a result of reporting to the Chief Executive and to the FRAC.

External assessors should benefit from the clear distinction in our proposals between their responsibilities and those of the directors. The assessors should benefit from being independent and being seen to be independent of the executives as a result of being appointed by, and reporting to, the Audit Review Panel. They should also benefit from the Panel’s counsel when considering reporting some matter, such as their suspicions that a company’s directors are involved in fraud or other illegal acts, to a third party.

All stakeholders should benefit from having greater confidence in the reassurances provided by both boards of directors and external assessors and from having the Audit Review Panel look after their interests.

We believe that the benefits of our proposals are sufficiently important to justify the additional costs. We recognise that, the changes we propose are of a fundamental nature and that they will not be implemented without a change in legislation. Given the present public concern about the effectiveness of auditing we believe that appropriate legislation is required as a matter of urgency.
EXECUTIVE SUMMARY

1. Listed companies have a major role in the economy and, therefore, there is a need to consider the financial audit of these organisations from a public interest perspective.

2. Our analysis suggests that in regard to certain aspects of the monitoring of a company's activities it is reasonable for the public to expect greater reassurances than are provided at the present time. To achieve this we believe that both boards of directors and external auditors (or external assessors as we rename them) should provide more reassurances to the public.

3. We believe that each board of directors should report:
   (a) whether it has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to provide the board with (i) the information necessary for the preparation of financial statements which give a true and fair view, and with (ii) reassurances that, inter alia, the opportunities for fraud and other illegal acts are minimised;
   (b) whether the financial statements give a true and fair view of the state of affairs of the company at the period end and of the profit or loss for the period then ended and have been properly prepared in accordance with company law; and
   (c) whether in the board's judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the board approved the financial statements.
4. To provide a board of directors with reassurances that its management information systems and internal control systems are sufficiently reliable and relevant we believe each company should establish and maintain a strong internal audit function under the direction of a Chief Internal Auditor. We envisage an internal audit team that is significantly stronger than is typically found in UK listed companies at the present time. As the internal auditors will be carrying out their work on a continuous basis and as they should have a sound understanding of the range of activities in which a company is involved, the Chief Internal Auditor should be in a strong position to provide a board of directors with reassurances regarding the reliability and relevance of the systems being operated within that company.

5. To ensure that the internal auditors have a significant degree of independence from the executives we propose that, in addition to reporting to the Chief Executive, the Chief Internal Auditor should report to a Financial Reporting and Audit Committee (FRAC) made up entirely of non-executive directors. The FRAC should approve the appointment, and the termination of the employment, of the Chief Internal Auditor. The Chief Internal Auditor should be free to communicate with the external assessors at any time.

6. We believe that the public will continue to expect an independent opinion on the reassurances provided by a board of directors. However, if each listed company has a strong team of internal auditors much of the detailed work in today’s external audit will have been done by them. There seems little point in repeating all of this detailed audit work. For this reason we propose a change of name from external auditors to external assessors. We envisage that a large proportion of the work of the external assessors will be judgmental in nature.

7. The external assessors would have responsibility for reporting their opinion of:
   (a) whether a board of directors has established and maintained management information systems and internal control systems that are sufficiently reliable and relevant to provide the board with (i) the
information necessary for the preparation of financial statements which give a true and fair view and with (ii) reassurances that the opportunities for fraud and other illegal acts are minimised;

(b) whether the financial statements give a true and fair view of the state of affairs of the company at the period end and of the profit or loss for the period then ended and have been properly prepared in accordance with company law; and

(c) whether it was appropriate for the directors to state that in their judgment, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to continue in business for at least twelve months from the date the directors approved the financial statements.

8. To heighten the sense of commitment of the partner in charge of the external assessment, we recommend that the assessors’ report is signed in his or her own name on behalf of the firm of external assessors.

9. To ensure that the external assessors are independent of, and are clearly seen as being independent of, the directors of the companies they assess, we propose that an Audit Review Panel should take responsibility for the appointment, and the termination of the appointment, of the external assessors. The Panel should also take responsibility for agreeing the remuneration of the assessors.

10. The Audit Review Panel would be completely independent of the directors and would have responsibility for the supervision of the assessment process on behalf of the shareholders and be responsive to the needs of other stakeholders.

11. The Panel would have responsibility for counselling the external assessors on whether they should report to a third party when they suspect that the directors of a company are involved in fraud or other illegal activities.
12. Finally, we propose that external assessors should be financially liable only to shareholders and only for damages that reflect the assessors' degree of fault.

We see the above proposals as providing a vision of how the audit of listed companies might be made more effective in providing reassurances to the public. Our proposals should make a contribution towards reducing the audit expectations gap. We recognise that the changes we propose are of a fundamental nature and that they will not be implemented without a change in legislation. Given the present public concern about the effectiveness of auditing we believe that appropriate legislation is required as a matter of urgency.
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AUDITING INTO THE TWENTY-FIRST CENTURY

In this discussion document the Research Committee of The Institute of Chartered Accountants of Scotland explores the public’s expectations regarding the reassurances sought from the external audit of listed companies as well as the public’s expectations regarding the independence, accountability and legal liability of external auditors within the present corporate governance framework. The Committee sets out its proposals for providing the public with more reassurances about these matters than is provided at the present time.

The discussion document is likely to be of interest to all those who are involved in or are affected by auditing: eg directors, managers, external auditors, internal auditors, investors and other users of financial statements. The Research Committee’s proposed changes are likely to be of particular interest to the Auditing Practices Board, which has responsibility for setting standards of auditing, and to the Government, when considering new legislation aimed at improving the framework of corporate governance in the UK. Finally, the discussion document should be useful to students who wish to enhance their understanding of the important issues in auditing.

The Research Committee of The Institute of Chartered Accountants of Scotland consists of chartered accountants working in industry, commerce, public practice and academia. The Committee is chaired by Professor Ian Percy, a practising auditor, a member of the Auditing Practices Board and Chairman of the Accounts Commission in Scotland.

Dr Bill McInnes coordinated the project, reviewed previous relevant publications as well as acting as editor. He is Director of Research at The Institute of Chartered Accountants of Scotland, a post to which he is seconded from the University of Strathclyde where he is Senior Lecturer in Accounting. He has published in various research journals on accounting topics.

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