

# LIABILITY OF EXTERNAL AUDITORS: A SYSTEMATIC APPROACH

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## Abstract

The main objective of the paper is to present factors relevant to the descriptive model of liability of external auditors. Detailed analysis of theory and practices of many countries in the field enabled to define currently dominating approaches. Their application to few prepared case studies showed that they could not reliably predict the outcome for a particular case or could not provide an opposite result to what was actually achieved. This failure happened because liability is still analysed only from a few different and isolated views but not as a complex and an even multidisciplinary problem. On the basis of analysis a systematic approach for the description of liability of external auditors is proposed. Novelty of the proposed approach is in statement that liability of external auditor in particular case is determined by interference of numerous factors. Four groups of such factors for the descriptive model were selected and described. Application of argued approach to the same cases achieved better explanatory results.

*Keywords:* auditing, external auditor, liability.

*JEL Classification:* M42, M43, K13.

## Introduction

Liability of external auditors has been a subject for research and practical analysis for many years. The works of V.P. Goldberg (Goldberg, 1988) and J.A. Siliciano (Siliciano, 1988; 1997) should be mentioned among the first. The subject was also a target of applied research. The most well-known and influential to the decision making process in areas of formation of public opinion, development of professional standards and legal regulation were reports prepared by London Economics (London Economics, 1998; 2006). The issues of liability of external auditors quite often were and still are on agenda inside EU. On the basis of numerous and long-lasting discussions inside EU some recommendations were issued (EC, 2008). Because so many studies and researches have been done in this field, at first glance this subject should be clear and no further research should be required. Unfortunately, each new case that considers possible liability of external auditors starts the discussion again. The last few cases in Lithuania once more proved that this subject is more complex than it seems. All this clearly indicates the continuing actuality of problem of liability of external auditors and needs for further research.

The main objective of the paper is to present factors relevant to the descriptive model of liability of external auditors. The research was based on the following methodology. On the first stage detailed analysis of the practices of many countries in the field of liability of external auditors was performed. On the basis of analysis two typical approaches were defined. Further on, these approaches were applied to several prepared case studies with the purpose to verify their abilities to explain the particular situation presented in case study. This enabled to conclude, that not all issues can be explained. The main reason for this is that liability of external auditors usually is analysed only from a few different views but not as a complex and an even multidisciplinary problem. For example, liability of external auditors is quite often analysed as resulting from professional activities regulated by professional standards or as a set of statements by contractual law only. As a result the liability of external auditors is presented as a closed, rigid, finally determined system. On the other hand, many researches indicate, that there are big differences in approaching liability of external auditors among countries inside EU (De Poorter, 2008) and that there are differences in each particular case under investigation. On the basis of findings a new approach was proposed. The novelty of the proposed approach is in statement, that liability of external auditors in each particular case could be determined only as a result of many interfering factors.

## Popular and simplified approach to liability of external auditors

Popular and simplified approaches to liability of external auditors could be presented by the following simple logical chain. Auditors providing assurance services issue an opinion. In the case of this opinion being unqualified, financial statements of the company are free from material misstatements and are prepared in accordance with applicable accounting standards. As some material misstatements can be found in the financial statements after they are audited this is the exact issue of the liability of external auditors. This approach is absolutely wrong, but is still very popular. Many researches were done in different countries and

the results show that it is as popular among companies as among regulators (Stirbu D. *et al.*, 2008). The main problem with this approach is misunderstanding of the basic concepts underlying assurance services.

### **Modern comprehensive approach to liability of external auditors**

There are a few basic concepts in theory and practice of assurance services which are extremely important for understanding liability of external auditors. The first concept, or the so called concept of reasonable assurance (Page M., 2006), is that assurance services provide a high level of assurance, but is not absolute (IFAC, 2010). It means that a risk of material misstatements still persists and that it is connected to the nature of assurance services. In this case, the existence of material misstatements does not directly imply liability of external auditors. In such situations the next concept, or the concept of due care, is applicable. The concept of due care means, that if all assurance services were provided in accordance with a set of code of ethics, accounting standards and regulations, but some material misstatements were found, it is not necessarily an issue of liability of external auditors. Liability of external auditor can be found only in the case of his intentional behaviour, total negligence or in case of his significant departure from auditing standards. The third concept, or the concept of management responsibility for financial statements, creates some general background and is very important in determining the liability of external auditors.

This approach is in line with the nature of assurance, is theoretically sound and therefore is currently dominating. It is possible to look at this approach as a set of clear rules on how to proceed in case of liability of external auditors and what is required is just to follow these given rules. Unfortunately, the analysis of numerous cases of possible liability of external auditors shows, that application of this approach directly in practice is extremely complicated and almost each case is followed by further discussion. All this creates evidence with which further research is required.

### **Proposed systematic approach to liability of external auditors**

Research done indicates that there are factors which are outside of modern approaches to liability of external auditors, but on a practical level often relevant in determination of liability of external auditors or even are sources of complications and discrepancies of this process. For example, attempts to analyse material misstatements of financial statements separately from their source and nature quite often create significant difficulties. Material misstatements of financial statements may be result of fraudulent activities of management (ACFE, 2007), which requires a totally separate analysis in comparison with material misstatements resulting from different application of accounting estimates. On the other hand a lot of different areas are based on professional judgement of auditors. All cases with problems considering existence of concerning assumptions also create separate area for analysis.

Liability of external auditors in each case could be described as a result of numerous factors. All the factors could be structured in the following way:

**First group** includes factors that deal with professional activities of auditors and of audit companies. This group of factors is related to perception of professional duties and ethical requirements by each auditor and the culture of the audit company he is working in, including governance and quality assurance measures. Such traditional factors as size of the audit company, previously accumulated experience, client portfolio, applied technology are also of great importance and are included in this group. As resulting from processes of clarification of auditing standards and assistance to small and medium auditing practices it was recommended to simplify some auditing and documentation procedures. On the other hand, investigation considering reasonable assurance and due care are directly connected to quality control and documentation processes inside the audit company. As reasonable assurance is often presented as a concept of evidence collection, simplification in process of documentation could be the result of lack of documentation of the evidence.

**Second group** of factors is related to oversight, governance and monitoring of auditing activities nationally or internationally. This group of factors includes requirements of professional standards and different auditing oversight systems that are in force. For example, dominance of international auditing standards is clear around the world, but in fact there are still big differences on set of standards in force in the EU or even in separate EU countries, for example UK (APC, 2009). There is a framework of oversight of the auditing activities that was set by the EU directives, but there are still big differences in oversight structures inside EU countries related to separation of responsibilities between state or quasi state structures and self-governing bodies like chambers of auditors. Most effort and appropriate new regulations during the last years

(EC, 2008) were directed to the area of auditing of public interest companies, but quite often basis for statutory audit is much wider. In such situations some zones with partly unclear regulations of governance and monitoring are developed. Another important point is that new governance and monitoring structures were created within few years and they are certainly still developing and all results and consequences of their activities are not clear yet. Beside specially designed governance bodies there is parliamentary control, which is usually directly involved only in case of big scandals related to bankruptcy or fraud. This could create a negative public opinion on auditors and create high pressure or even tension between all parties involved.

**Third group** of factors is related to the legal and court system of each country. Depending on law traditions and accumulated experience, liability of external auditors may be a part of civil, contract, or even criminal law. For example there are still big differences among EU countries considering tort law applications for auditor's liability to third parties. Even countries with long history of audit services experience complications if the case with possible liability of external auditors is approaching court. The main reason for this is that it is rather difficult for courts to deal with practical applications of concepts of reasonable assurance and due care in case of auditors, because for courts they are more different than other cases. Another important issue is the changing of audit standards and regulations on auditing governance and oversight.

**Fourth group** of factors unites factors related to governance of companies to be audited and public perception of auditor's activities and profession. For example, there are entirely different approaches to governance of companies of public interest and other companies, although companies of different types could still have statutory audit. One of the most important and complex factors from this group is the existing "expectations gap". Post-SOX development inside companies of structures responsible for oversight of management and of internal and external auditors was also quite important.

More detailed analysis of factors belonging to each group shows that some factors could be reviewed as "hard", it means more or less defined and described, and "soft", it means that the importance and possible influence of the factor at the moment is highly uncertain. There are possibilities of shifts of factors between "soft" and "hard". For example, absence of court practice considering cases with liability of auditors involved should be considered as a "soft" factor. After some time, as practice on case basis will be accumulated, this factor will shift to "hard", as the court decision for the particular case will be estimated with a higher level of predictability.

### Cases for analysis

Case 1. A middle sized company. There is one shareholder who is actively participating in management and everyday activities of the company. Company was audited on statutory basis. Auditor is experienced. Opinion was unqualified. Material misstatements resulted from a rather complicated fraud scheme with participation of management. A lot of errors were done in investigation because of lack of experience. Civil and criminal cases started against auditor and his company. Outcome is totally unclear.

Case 2. A big company with statutory audit which is audited by small audit company. Multiple errors in planning and performing audit engagement were done. Material misstatements resulted from fraud performed by top management. Case against auditors was initiated by a third party. Positive decision in favour of auditors by court was made.

Case 3. Company of public interest with statutory audit was audited by highly skilled audit company. Issue with going concern, as company was bankrupted as serious error in strategy was done. Case against auditor was not started.

Case 4. Financial institution of public interest was audited by auditors with great experience in financial sector. Opinion was unqualified. Bankruptcy of financial institution was initiated by the body responsible for oversight of financial institutions. Fraud by top management and main shareholders is under investigation. Because of the size of financial institution, situation is under control of parliament commission. Extreme pressure on institution responsible for oversight of auditors has been accumulated. A negative public opinion on auditors was formed. Courts have no experience for cases of such size and complicatedness. Outcome is not clear.

All presented cases are rather simple, but clearly show that a dominating approach to determine liability of external auditors failed or its application is extremely complicated. On the other hand, in case of application of proposed systematic approach and particular addition to analysis of soft factors could significantly improve situation. For example, failure in application of the dominating approach could be

explained by existence of a soft factor level in institutional development of legal and court system. In case such system is underdeveloped the outcome of all cases with investigation of liability of external auditors can become totally uncertain.

### Conclusions

Current approaches for liability of external auditors certainly are too rigid in case of their direct application on practice. The main reason is that many relevant factors are currently outside of approaches and consequently are out of analysis. There is need to broaden existing approaches and to develop new ones.

The four groups of factors proposed as basis for development of descriptive models of liability of external auditors:

- a) factors that deal with professional activities of auditors and of audit companies;
- b) factors that are related to oversight, governance and monitoring of auditing activities nationally or internationally;
- c) factors that are related to the legal and court system of each country;
- d) factors that are related to governance of companies to be audited and public perception of the auditor's activities and profession.

More detailed analysis of factors inside groups show that some factors based on their uncertainty could be reviewed as "hard" or "soft", it means that the importance and possible influence of the factor at the moment is highly uncertain. Existence of "soft" factors significantly complicates cases with investigation of auditor liabilities and can bring unforeseen results and this creates wrong practices for the later cases.

Deployment of proposed structures by the author for analysis of particular cases in which the external auditor liabilities were analysed resulted in relatively good results. Few cases considering liability of external auditors are presented.

Further detailed research considering each group of presented factors and more formal presentation of descriptive model of liability of external auditor is required.

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