



# **Auditing failures that result in litigation**

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## Objective of the auditor

An auditor is required to obtain sufficient, appropriate audit evidence to allow the auditor to form an opinion as to whether or not the financial report they are auditing has been prepared in accordance with Australian Accounting Standards (AASBs).

## Auditing standards

The Australian Auditing Standards (ASAs) require an auditor to undertake various procedures that if not performed appropriately can result in the auditor being exposed to litigation.

## Performing an audit

There are three phases to an audit: planning, execution and concluding. The auditor's assessment of audit risk is a continuous and dynamic process, responding to information obtained in all phases of the audit.

### Plan

In the planning phase the auditor identifies the areas of audit risk and determines what audit evidence is required and how that audit evidence will be obtained in order to form an audit opinion.

### Execute

In the execution phase the auditor performs audit procedures to obtain sufficient, appropriate audit evidence to allow the auditor to form an opinion. The auditor updates their risk assessment based upon all audit evidence (corroborative and contradictory) obtained.

### Conclude

In the concluding phase the auditor reviews the audit evidence obtained to determine if:

- they have obtained sufficient and appropriate audit evidence to allow the auditor to form an opinion; and
- whether the evidence they have obtained identifies a material error.

## Auditor obligations

The auditor is required by the ASAs to:

- Be independent;
- Apply an appropriate level of professional scepticism and be aware of potential management bias;
- Have an understanding of the relevant AASBs and ASAs;
- Have an understanding of the client and the environment in which it operates; and
- Appropriately communicate significant matters to management and those charged with governance.

## Common auditing failures

Most auditing failures centre on circumstances where the auditor has expressed an unqualified audit opinion on a financial report that was materially misstated and did not comply with the relevant AASBs.

In these circumstances the auditor either failed to obtain sufficient, appropriate audit evidence to identify a material error or obtained evidence to identify the error but ignored or misinterpreted that evidence.

The common auditing failures can be summarised as:

- Auditor was not independent or was intimidated by the client;
- Audit team lacked the appropriate skill and knowledge to perform the audit;
- Auditor failed to adequately identify the risk of material misstatement;
- Auditor failed to design an audit plan that would identify the material misstatement;
- Auditor did not apply appropriate level of professional scepticism and be aware of potential management bias in obtaining and considering the audit evidence obtained;
- Auditor placed over reliance on audit evidence prepared by a management expert;
- Auditor placed overreliance on oral and written representations received from management;
- Auditor ignored contradictory audit evidence;
- Auditor failed to identify material errors in the prior year financial report audited by a predecessor auditor;
- Auditor failed to direct or review the work of a component auditor;
- Auditor failed to obtain sufficient or appropriate audit evidence to determine whether or not there was a material error;
- Auditor failed to request a material misstatement be corrected;
- Auditor failed to consider whether a material uncertainty existed as to the entity's ability to continue as a going concern;
- Auditor failed to adequately consider the impact of subsequent events;
- Auditor failed to issue a modified audit opinion; and
- Auditor failed to communicate the audit issues arising in the audit with management and those charged with governance.

We have set out the relevant ASAs that outline auditors' obligations addressing common auditing failures.

Auditing failure	Relevant ASA	Relevance to litigators
Breach of auditor independence	ASA 200, ASA 220, and APES 110	<p>ASA 200 requires an auditor to comply with relevant ethical requirements, including those pertaining to auditor independence.</p> <p>APES 110 sets out the following threats to independence an auditor is required to consider whether the auditor has any:</p> <ul style="list-style-type: none"> <li>• Self-interest threats;</li> <li>• Self-review threats;</li> <li>• Familiarity threats; and</li> <li>• Intimidation threats.</li> </ul>
Lack of skill and quality of the audit team	ASA 220	<p>Most audit failures centre on the auditor failing to adequately understand the applicable AASBs resulting in the auditor failing to identify a material misstatement in the audited financial report.</p> <p>ASA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:</p> <ul style="list-style-type: none"> <li>• Perform the audit engagement in accordance with ASAs, relevant ethical requirements, and applicable legal and regulatory requirements; and</li> <li>• Enable an auditor to issue a report that is appropriate in the circumstances.</li> </ul>

Auditing failure	Relevant ASA	Relevance to litigators
<p>Risk assessment and response to the risk of material misstatement</p>	<p>ASA 315, ASA 240, ASA 330</p>	<p>The foundation of an audit is the auditor having an appropriate understanding of the entity being audited and the environment in which the entity operates. Such understanding is required for the auditor to identify the risk that entity's financial report has not being prepared in accordance with AASBs.</p> <p>Many auditor litigation matters centre on the auditor not having an appropriate understanding of the entity being audited and the environment in which the entity operated. Consequently, the auditor failed to design or perform audit procedure that should have provided the auditor with sufficient, appropriate audit evidence to identify material misstatements.</p>

Auditing failure	Relevant ASA	Relevance to litigators
Audit planning	ASA 220, ASA 240, ASA 300, ASA 315, ASA 330	<p>Many audit failures occur because the auditor failed to adequately plan the audit to detect a material misstatement.</p> <p>The planning phase comprises the following elements:</p> <ul style="list-style-type: none"> <li>• Client reacceptance and continuance (ASA 220);</li> <li>• Assigning the appropriate audit team (ASA 220);</li> <li>• Understanding the entity and the environment it operates in (ASA 315);</li> <li>• Assessing and identifying the risk of material misstatement (ASA 240 &amp; ASA 315);</li> <li>• Design audit procedures that will provide sufficient and appropriate audit evidence that the risks identified have not led to a material misstatement (ASA 330).</li> </ul> <p>The auditor is required to document the above in an audit plan (ASA 300).</p>
Professional scepticism	ASA 200, ASA 240	<p>In many instances of audit failure, it is the auditor lacked professional scepticism. The auditor failed to obtain sufficient, appropriate audit evidence, accepting the evidence provided by management and management representations.</p> <p>It is common that the auditor ignored contradictory audit evidence that was or could have been available to the auditor at the time of executing the audit and/or concluding upon the audit report.</p>

Auditing failure	Relevant ASA	Relevance to litigators
Response to bias	ASA 240, ASA 540	The application of AASBs in many cases requires the use of estimates and management judgement. In many audit failures in is alleged management's estimates were biased and overly optimistic. Such estimates usually centre on impairment of assets, including goodwill, inventory, and financial assets.
Use of a management expert	ASA 500	<p>Many audit failures arise from overstatement of an entity's assets and the failure to recognise impairment losses on assets which are stated above their recoverable amounts.</p> <p>In many audit failures it is alleged management's expert was biased and overly optimistic when performing the valuation of the asset. Estimates are made when testing for the impairment of assets, such as goodwill, inventory, and financial assets.</p>
Management representation	ASA 450, ASA 580	In many auditor litigation cases, the primary evidence the auditor obtained was management representation that the transaction was in accordance with AASBs. The ASAs are clear that ' <i>management representation alone does not represent sufficient or appropriate audit evidence</i> '.
Contradictory audit evidence	ASA 200, ASA 330, ASA 500	A major area to be considered in auditor litigation is whether an auditor issued an inappropriate audit opinion, despite contradictory audit evidence existing that should have alerted the auditor to the fact that the entity's financial report was materially misstated.



Auditing failure	Relevant ASA	Relevance to litigators
Material errors in the prior year financial report	ASA 510	<p>Many instances of audit litigation arise in a first-year audit, that is, when an auditor has a new client, taking on an audit from another auditor.</p> <p>The incoming auditor fails to recognise that that the former auditor failed to identify material errors or inappropriate accounting policies and does not correct these errors in their audit.</p>
Group audits	ASA 600	<p>Audit litigation matters can occur when components of the audit (e.g., overseas subsidiaries) have been audited by an audit firm other than the head office audit firm.</p> <p>ASA 600 is clear that it is the head office auditor (being the auditor that expresses an opinion on the consolidated financial report) that is responsible for directing and reviewing the work of the component auditor. The head office auditor must satisfy themselves as to whether the component auditor has provided the head office audit team sufficient, appropriate audit evidence to allow them to opine that the consolidated financial report has been prepared in accordance with the AASBs.</p>
Unable to obtain sufficient and appropriate audit evidence	ASA 330, ASA 700, ASA 705	<p>If the auditor fails to obtain sufficient, appropriate audit evidence, they must first inform those charged with governance and request that the problem be solved. If appropriate evidence is not provided to the auditor to allow them to opine whether or not the financial report complies with AASBs, the audit is required to issues a modified audit opinion.</p>

Auditing failure	Relevant ASA	Relevance to litigators
Discovery of an error	ASA 450, ASA 705	<p>If an auditor discovers an error, the auditor is required to inform management of the issue, and request that the error be quantified and corrected.</p> <p>If a material error is not corrected, the auditor is required to issue a modified audit opinion.</p>
Going concern	ASA 570	<p>Many auditor litigation cases result from an entity going into administration shortly after the auditor has issued an unqualified audit opinion and the financial report made no reference to the material uncertainty that existed as to the entity's ability to continue as a going concern.</p> <p>The auditor is required to consider whether there is a material uncertainty as to an entity's ability as a going concern for a period of 12 months after the date of the audit report, and if such an uncertainty exists that uncertainty is disclosed in the entity's financial report.</p> <p>If the material uncertainty in respect of an entity's ability to continue as a going concern is not appropriately disclosed, the auditor is required to issue a qualified audit opinion and disclose the uncertainty in the audit report.</p>

Auditing failure	Relevant ASA	Relevance to litigators
Subsequent events	ASA 560	<p>The auditor is required to consider events that occurred after the year end up to the point of signing the audit opinion for their impact on the financial report.</p> <p>Certain events occurring after the year end but before the signing of the audit opinion may indicate errors in management estimates made in applying the AASBs (particularly in respect of asset impairment assessments). The auditor is required to request the estimates be reconsidered in light of these subsequent events where they provide evidence of conditions that existed as at year end (these are adjusting subsequent events).</p> <p>In other cases, AASB 110 requires the entity to disclose significant events that have occurred subsequent to the year end (these are non-adjusting subsequent events).</p>

Auditing failure	Relevant ASA	Relevance to litigators
<p>Issuing a modified audit opinion</p>	<p>ASA 330, ASA 570, ASA 705</p>	<p>ASA 705 requires the auditor to express an appropriately modified opinion on the financial report when:</p> <ul style="list-style-type: none"> <li>• The auditor concludes, based on the audit evidence obtained, that the financial report as a whole is not free from material misstatement; or</li> <li>• The auditor is unable to obtain sufficient, appropriate audit evidence to conclude that the financial report as a whole is free from material misstatement.</li> </ul> <p>ASA 570 mandates modification to the audit report if:</p> <ul style="list-style-type: none"> <li>• the financial report has been prepared using the going concern basis of accounting but, use of the going concern basis of accounting in the preparation of the financial report is not appropriate; or</li> <li>• adequate disclosure about the going concern material uncertainty is not made in the financial report.</li> </ul> <p>ASA 330 sets out that if the auditor determines that they have not obtained sufficient, appropriate audit evidence the auditor is required to request they be provided with such evidence and if that does not occur to issue a modified audit opinion.</p>

Auditing failure	Relevant ASA	Relevance to litigators
Communication	ASA 260, ASA 265, ASA 450, ASA 600, ASA 705, ASA 720	<p>The responsibility for the preparation of a financial report in accordance with AASBs rests with the directors <b>NOT</b> the auditor. However, if the auditor identifies errors in the application of AASBs, this must be communicated to management and those charged with governance.</p> <p>Had the directors been informed of the error then it is most likely that they would have corrected it and the financial statements would not be materially misstated.</p>

## Principles of auditing

Principle	Relevant standard	Relevance to litigators
Materiality	ASA 320	<p>The concept of materiality as outlined in ASA 320 is based on an error in or omission from a financial report that would impact an investor's understanding of an entity, its financial performance and financial position.</p> <p>An auditor cannot issue an unmodified audit opinion, if the financial report contains material errors or the auditor has failed to obtain sufficient appropriate audit evidence to opine whether or not there is a material error.</p>
Audit documentation	ASA 230	<p>The level of documentation on the audit file is required to be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:</p> <ul style="list-style-type: none"> <li>• The nature, timing, and extent of the audit procedures performed to comply with the ASAs;</li> <li>• The results of the audit procedures performed, and the audit evidence obtained; and</li> <li>• Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.</li> </ul> <p>The documentation requirement of an auditor when preparing an audit file to support the auditor's report is often quoted as '<i>(if it is) not documented, (then it is) not done</i>'.</p>

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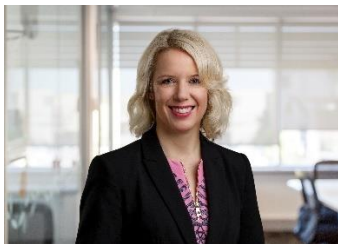
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