Auditing standards applicable to litigation matters

BC

Contents

Overview

In recent years auditor performance has become the subject of numerous litigation matters. It is claimed that the auditor issued the wrong audit opinion on financial statements that were materially misstated and not in accordance with the relevant Australian Accounting Standards (AASBs) as issued by the Australian Accounting Standards Board.

Such matters involve the claim that the auditor failed to comply with the requirements of Australian Auditing Standards (ASAs) as issued by the Australian Auditing and Assurance Standards Board (AUASB).

Understanding which version of the ASA to apply

Australian Auditing Standards establish requirements and provide application and other explanatory material on:

- the responsibilities of an auditor when engaged to undertake an audit of a financial report, or complete set of financial statements, or other historical financial information; and
- the form and content of the auditor’s report.

The ASAs are regularly revised. Litigators should ensure that they have the appropriate versions of the ASAs applicable to the relevant audit being performed. Previous versions of ASAs can be found on the AUASB website.

Key auditing standards

Set out below are the key auditing standards and their relevance to audit litigation matters:

Standard	Key features	Relevance to litigation
ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards	ASA 200 sets out that the auditor must: • comply with relevant ethical requirements; • apply the appropriate level of professional scepticism; • use professional judgement; • obtain sufficient and appropriate audit evidence; and • comply with all relevant Australian Auditing Standards.	ASA 200 sets out that the objective of an auditor is to report on the financial report, and communicate as required by ASAs, the auditor's findings. When an auditor fails to issue a qualified audit opinion on a financial report that has not been prepared in accordance with the relevant AASBs, the auditor has failed to achieve the objective of an audit as set out by ASA 200.
ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information	ASA 220 sets out that the audit partner is required to take responsibility for: • the overall quality of the audit; • ensuring the audit team has the appropriate competence and capabilities to perform the audit engagement in accordance with ASAs; and • the direction, supervision, and performance of the audit engagement in compliance with ASAs, and relevant ethical requirements.	When an auditor fails to recognise the financial report has not been prepared in accordance with the relevant AASBs, it brings into question the competence of the audit team, particularly with respect to the team's knowledge of AASBs and ASAs.

Standard	Key features	Relevance to litigation
ASA 230 Audit Documentation	ASA 230 requires that the audit file enable an experienced auditor, having no previous connection with the audit, to understand the nature, timing, and extent of the audit procedures performed to comply with ASAs. The audit file must provide a sufficient and appropriate record of the basis for the auditor’s report.	The requirements of ASA 230 are often paraphrased as ‘Not documented not done’. There is little defence for an auditor to claim they obtained assurance from information and evidence that was not documented on the audit file.

Standard	Key features	Relevance to litigation
ASA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report	ASA 240 sets out requirement for auditor to apply appropriate level of professional scepticism in respect of fraudulent financial reporting. ASA 240 sets out that fraudulent financial reporting may occur when there is: • incentive or pressure to commit fraud; • a perceived opportunity to do so; and • rationalisation for the act. ASA 240 sets out that incentive or pressure to achieve earnings and financial performance targets set for management in an entity's financial report can lead to: • Incorrect application of AASBs; • Inappropriate estimates and judgement in applying AASBs; • Incorrect timing of revenue recognition; • Overly complex transactions designed to misrepresent the financial position or financial performance of the entity; and • Omitting, obscuring, or misstating disclosures required by the applicable AASBs.	Many alleged audit failures involve: • Overly optimistic estimate and judgements; and • Complex, structured transactions designed to result in misleading accounting outcomes. Where an auditor has accepted over optimistic estimates or has failed to understand the business rationale for overly complex significant transactions, it may be alleged that the auditor failed to apply an appropriate level of professional scepticism. ASA 240 is the relevant standard when auditor has incorrectly ignored or failed to identify fraudulent financial reporting.

Standard	Key features	Relevance to litigation
ASA 250 Consideration of Laws and Regulations in an Audit of a Financial Report	ASA 250 sets out the auditors responsibility to consider potential breaches of laws and regulations that do not have a direct effect on the determination of the amounts in the financial report but compliance with which may be fundamental to the operating aspects of the business (e.g., compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations). ASA 250 requires an auditor to be alert to potential breaches of laws and regulations throughout the audit that have a material impact on the entity's financial report. ASA 250 sets out the requirements for communicating identified or suspected breaches to management and those charged with governance.	If an entity is found to have breached laws and regulations (e.g., bribery, corruption, or environmental laws) the impacts on its business and share price can be significant. Failure to be alert to the risk of breached laws and regulations, or failure to appropriately respond to identified or suspected breaches of laws and regulations, will be a failure of the auditor to comply with the requirements of ASA 250.

Standard	Key features	Relevance to litigation
ASA 260 Communication with Those Charged with Governance	ASA 260 requires the auditor to communicate: • Difficulties in performing the audit; • Errors identified by the auditor; and • The intention to issue a modified audit opinion. ASA 260 requires the auditor to communicate and discuss significant findings and concerns of the auditor arising from: • Accounting estimates and judgements applied; • Business plans and strategies that may affect the risks of material misstatement; • Financial report disclosures; • Unusual and non-recurring transactions; and • Transactions that appear to be structured to achieve a particular accounting outcome.	The responsibility for preparation of an entity's financial report is that of the entity's board, **NOT** that of the auditor. However, if the auditor is unable to obtain sufficient appropriate audit evidence to opine on the financial report or has concerns that the financial report is not prepared in accordance with AASBs, the auditor is required to communicate those concerns to the board. Correct application of ASA 260 should be the means by which the board becomes aware of issues with application of AASBs and corrects such errors. Failure to correctly apply ASA 260 is significant in arguing that the auditor caused a materially misstated financial report to be released.
ASA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	ASA 265 requires the auditor to communicate appropriately to those charged with governance and management, deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgement, are of sufficient importance to merit their respective attentions.	Although it is management's responsibility to establish an appropriate internal control environment, ASA 265 requires the auditor to report significant deficiencies they become aware of in the course of their audit to management and the board. Failure to either identify or communicate such deficiencies, which subsequently result in loss to the entity being audited, could be the basis for litigation against the auditor.

Standard	Key features	Relevance to litigation
ASA 300 Planning an Audit of a Financial Report	ASA 300 requires the auditor to develop an audit plan that includes a description of: • The nature, timing, and extent of planned risk assessment procedures, as determined under ASA 315.4; and • The nature, timing, and extent of planned further audit procedures at the assertion level, as determined under ASA 330.	Most audit failures involve an auditor failing to adequately identify the risk of misstatement when performing their risk assessment procedures under ASA 315 and consequently failing to address those risks as required by ASA 330. Consequently, the auditor failed to perform appropriate procedures to provide the auditor with evidence that the financial report was materially misstated.
ASA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	ASA 315 requires the auditor to perform appropriate risk assessment procedures so that the auditor can identify and assess the risks of material misstatement, whether due to fraud or error and design and implement responses to the assessed risks of material misstatement. Obtaining an understanding of the entity and its environment, including the entity's internal controls, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.	Risk identification is fundamental to the audit process and in cases of audit failure, it is usually because the auditor failed to appropriately identify the risk that would lead to material misstatement. As a consequence, the auditor failed to design and perform audit procedures identifying the material misstatement that arose because of the inappropriate risk assessment made by the auditor.

Standard	Key features	Relevance to litigation
ASA 320 Materiality in Planning and Performing an Audit	ASA 320 requires the auditor, when establishing the overall audit strategy to determine materiality for the financial report as a whole. Misstatements, including omissions, are considered material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions to be made by users who have relied upon the financial report (e.g., investors in a listed company).	Litigation against an auditor usually only involves errors in a financial report that are material, either in size and/or nature of the misstatement in the audited financial report.

Basford Consulting

Standard	Key features	Relevance to litigation
ASA 330 The Auditor's Responses to Assessed Risks	ASA 330 is critical to the audit at both the planning and concluding phases. At the planning phase of the audit ASA 330 requires the auditor to design and implement overall responses to address the assessed risks of material misstatement at the financial report level. At the concluding phase of the audit ASA 330 requires the auditor to evaluate the sufficiency and appropriateness of the audit evidence obtained. Where the auditor determines that they have not obtained sufficient, appropriate audit evidence, ASA 330 requires the auditor to request they be provided with such evidence and if that does not occur to issue a modified audit opinion. A significant requirement of ASA 330 is that when the auditor concludes as to whether they have obtained sufficient and appropriate audit evidence, the auditor is required to consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial report.	Compliance with ASA 330 is usually central to the determination as to whether the auditor complied with ASAs and issued the appropriate audit opinion. If the auditor did not obtain sufficient, appropriate audit evidence to allow them to opine whether a particular transaction was recorded in accordance with the relevant AASB, or management had ignored contradictory evidence, the auditor should have: • Notified those charged with governance, with the presumed consequence that production of appropriate audit evidence would have informed both the auditor and those charged with governance of the material error and allowed the error to be corrected; or • Issued a modified audit opinion, which would have informed users of the Financial Report that the auditor could not form an opinion that a particular transaction was accounted for in accordance with the relevant AASB. In many cases the auditor will have ignored contradictory evidence in reaching their conclusions.

Standard	Key features	Relevance to litigation
ASA 450 Evaluation of Misstatements Identified during the Audit	ASA 450 deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit on the financial report. ASA 450 requires an auditor to communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management. ASA 450 requires an auditor to request management correct identified misstatements. If uncorrected misstatements are material to the understanding of the financial report, the auditor is required to issue a modified audit report.	In cases involving audit failure it is often argued that if a reasonably competent auditor had complied with the relevant ASAs they would have identified a material misstatement and in accordance with ASA 450 they would have: • Informed those charged with governance of the error; • Requested that the error be corrected; and • Qualified their audit opinion if the error was not corrected.

Basford Consulting

Standard	Key features	Relevance to litigation
ASA 500 Audit Evidence	ASA 500 sets out that the auditor is required to design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. ASA 500 sets out that when the auditor is using information prepared by a management expert the auditor is required to evaluate the competence, capability, and objectivity of that expert. If audit evidence obtained from one source is inconsistent with that obtained from another, the auditor is required to determine what modifications or additions to audit procedures are necessary to resolve the matter. ASA 500 sets out that interests and relationships that may create threats to a management experts' objectivity may include: • Financial interests; • Business and personal relationships; and • Provision of other services.	The relevance of ASA 500 to auditor litigation usually centres on: • The auditor failing to obtain sufficient, appropriate audit evidence; • The auditor failing to challenge the key judgements and assumptions made by the management expert; and • The auditor failing to consider contradictory audit evidence. In many cases the auditor will have ignored contradictory evidence in reaching their conclusions.

Basford Consulting

Standard	Key features	Relevance to litigation
ASA 510 Initial Audit Engagements — Opening Balances	ASA 510 sets out that in conducting an initial audit engagement, the auditor is required to obtain sufficient appropriate audit evidence about whether: • Opening balances contain misstatements that materially affect the current period's financial report; and • Accounting policies reflected in the opening balances have been consistently applied in the current period's financial report, or changes have been appropriately accounted for. If the auditor is unable to obtain sufficient, appropriate audit evidence regarding the opening balances, the auditor is required to express a qualified opinion or disclaim an opinion on the financial report, in accordance with ASA 705. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial report, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor is required to express a qualified opinion or an adverse opinion, in accordance with ASA 705.	Instances of audit litigation often arise when an auditor is performing an audit for the first time. Issues arise when the auditor fails: • To identify that there were material errors in the prior year audit; and/or • Inappropriate accounting policies have been accepted by the prior year auditor which continue to be applied by the entity.

Standard	Key features	Relevance to litigation
ASA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	ASA 540 expands on how ASA 315 and ASA 330 and other relevant ASAs are to be applied in relation to the audit of accounting estimates. The auditor is required to determine whether any accounting estimates have been identified as having high estimation uncertainty which could give rise to a significant risk of material misstatement in the financial report. In identifying and assessing the risks of material misstatement, as required by ASA 315, the auditor is required to evaluate the degree of estimation uncertainty associated with an accounting estimate. The auditor is required to determine whether: • Management has appropriately applied the requirements of the applicable AASB relevant to the accounting estimate; • The methods for making the accounting estimates are appropriate and have been applied consistently; and • Changes, if any, in accounting estimates, or in the method for making them from the prior period, are appropriate in the circumstances.	Many audit litigation matters centre around management's failure to make appropriate estimates when applying AASBs and the auditor's failure to identify material errors arising from inappropriate estimates.

Standard	Key features	Relevance to litigation
ASA 560 Subsequent Events	ASA 560 requires the auditor to obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial report and the date of the auditor's report that require: • adjustment of; and/or • disclosure in the financial report is in accordance with the applicable AASBs.	Application of ASA 560 is often relevant for audit litigation, where it is alleged evidence was available to the auditor up to the date of the audit report, that should have informed a reasonably competent auditor that an entity's financial report was materially misstated. Disputes typically arise where information became available post year end that cast doubt on the reliability of management's estimates. Such information typically centres on sales levels, cashflows and profitability that was not in line with estimates made in impairment models.

Standard	Key features	Relevance to litigation
ASA 570 Going Concern	ASA 570 requires the auditor to obtain sufficient, appropriate audit evidence regarding: • The appropriateness of management's use of the going concern basis of accounting; and • Based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. If the financial report has been prepared using the going concern basis of accounting but, in the auditor's judgement, management's use of the going concern basis of accounting in the financial report is inappropriate, the auditor is required to express an adverse opinion. If disclosure about a material uncertainty that the entity may not be able to continue as a going concern is not made in the financial report, the auditor should: • Express a qualified opinion or adverse opinion, as appropriate, in accordance with ASA 705; and • State that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial report does not adequately disclose this matter.	A significant number of audit litigation matters centre on the collapse of the entity being audited, shortly after the issue of a financial report was issued, where the financial report made no mention that a material uncertainty existed as to the entity's ability to continue as a going concern.

Standard	Key features	Relevance to litigation
ASA 580 Written Representations	Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial report. Accordingly, similar to responses to enquiries, written representations are audit evidence. Written representations are required to support other audit evidence relevant to the financial report or specific assertions in the financial report by means of written representations if determined necessary by the auditor or required by other Australian Auditing Standards.	ASA 580 paragraph A12 sets out: *Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.* In many audit litigation matters the only evidence an auditor has obtained to support an accounting treatment that has subsequently been shown not to be in accordance with the relevant AASB is management representation.
ASA 600 Special Considerations- Audits of a Group Financial Report (Including the Work of Component Auditors)	ASA 600 sets out that the group engagement partner is responsible for the direction, supervision, and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances	In a number of audit litigation matters the area of dispute or non-compliance with AASBs relates to a component audited by a component auditor rather than the head office auditor (e.g., foreign subsidiary of an Australian group). ASA 600 makes it clear that in such cases it is the responsibility of the head office audit team to determine the adequacy of the audit evidence provided by the component auditor.

Standard	Key features	Relevance to litigation
ASA 700 Forming an Opinion and Reporting on a Financial Report	ASA 700 sets out that in order to form their audit opinion, the auditor is required to conclude as to whether the auditor has obtained reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error. That conclusion shall take into account: • The auditor's conclusion, in accordance with ASA 330, whether sufficient appropriate audit evidence has been obtained; and • The auditor's conclusion, in accordance with ASA 450, whether uncorrected misstatements are material, individually or in aggregate.	Most audit litigation involves the allegation that the auditor incorrectly issued an unqualified audit opinion on a financial report that was materially misstated.

Basford Consulting

Standard	Key features	Relevance to litigation
ASA 701 Communicating Key Audit Matters in the Independent Auditor’s Report	ASA 701 requires the auditor to determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. The auditor is required to determine which of the above were of most significance in the audit of the financial report of the current period which are the key audit matters (KAMs). ASA 701 requires the auditor to communicate each key audit matter in a separate Key Audit Matters section in the audit report providing: • A description of the individual key audit matter; • The auditor’s approach to the assessed risk of material misstatement; • A brief overview of audit procedures performed; • An indication of the outcome of the auditor’s procedures; and • Key observations with respect to the matter.	ASA 701 is a recent standard applying to the audit of financial reporting periods ending on or after 15 December 2016. (i.e., year ends 31 December 2017 or 30 June 2018) and accordingly has yet to be tested in litigation. It is likely that the disclosed key audit matters (KAMs) will result in allegations that the auditor: • Failed to identify the correct KAMs; • Failed to adequately address the identified KAMs; • Did not adequately perform the procedures they described in their audit report as having been performed; and/or • Failed to correctly conclude on audit evidence obtained and failing to consider the impact of contradictory audit evidence.

Standard	Key features	Relevance to litigation
ASA 705 Modifications to the Opinion in the Independent Auditor's Report	ASA 705 requires the auditor to express clearly an appropriately modified opinion on the financial report that is necessary when: • The auditor concludes, based on the audit evidence obtained, that the financial report as a whole is not free from material misstatement; or • The auditor is unable to obtain sufficient, appropriate audit evidence to conclude that the financial report as a whole is free from material misstatement.	Most audit litigation involves the allegation that the auditor incorrectly issued an unqualified audit opinion on a financial report that was materially misstated.

Standard	Key features	Relevance to litigation
ASA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing an Audited Financial Report	ASA 720 requires the auditor to read and consider whether financial or non-financial other information included in an entity's annual report to: • Determine whether there is a material inconsistency between the other information and the audited financial report; • Determine whether there is a material inconsistency between the other information and the auditor's knowledge obtained whilst performing the audit; and • Respond appropriately when the auditor identifies that such material inconsistencies appear to exist, or when the auditor otherwise becomes aware that other information appears to be materially misstated.	ASA 720 is a recent standard applying to the audit of financial reporting periods ending on or after 15 December 2016 (i.e., year ends 31 December 2017 or 30 June 2018) and accordingly has yet to be tested in litigation. If an entity's directors' report or other information is materially inconsistent with the audited financial report, then either: • readers of this information are being misled; or • the financial report is materially misstated. Therefore, users of the financial report may claim the auditor failed to comply with the requirements of ASA 720.

Basford Consulting Litigation Support Services

The team at Basford Consulting have prepared numerous expert reports for use in court proceedings dealing with the application of accounting and auditing standards. We provide independent expert evidence drawing from our considerable experience in providing technical accounting, auditing and governance solutions for clients.

Our Litigation Support Team - Wayne Basford

Wayne has given expert evidence in Federal Court of Australia, Supreme Court of New South Wales, Supreme Court of Victoria, International Court of Arbitration and the CALDLB. Wayne has provided evidence in a 'hot tub' setting.

wayne@basfordconsulting.com

Susan Oldmeadow-Hall

Susan has given expert evidence in the Supreme Court of Western Australia. Susan works closely with Wayne in critiquing opposing experts' reports, conducting expert conclaves and the coordination and preparation of joint expert reports.

susan@basfordconsulting.com