Audit Quality and Audit Liability – a Musical Vignette

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The background

As discussed in a previous paper in this journal[1] for more than thirty years the large accounting and audit firms in the UK have been persistent and pressing in their assertions that they operate within an unfair legal environment in which they are subject to liability for very large amounts in situations where the fault lies elsewhere. In this context they have sought changes in this environment so as to provide them with further protection from claims which they see as unwarranted and a threat to their continued existence. Innovatively overcoming the reluctance of the government to disturb the status quo[2] they were successful in obtaining legislation allowing them to operate as limited liability partnerships (thereby obtaining the benefits of incorporation in terms of protection of the personal assets of members whilst retaining the taxation advantages associated with partnership status).[3] More recently the government has incorporated in its company law reform bill clauses allowing company auditors to agree to limit liability to their clients by means of contract - which would overturn a prohibition on such agreements which has been in UK company law for more than seventy five years. As a perceived quid pro quo the profession, prompted by the large firms, has set up an Audit Quality Forum which is designed to bring together various stakeholders in the audit process for the purpose of 'generating policy proposals which will further enhance confidence in the independent audit by promoting transparency and accountability'.[4]

Although the large firm view of the legal environment within which they work has become, to an extent at least, received wisdom – due in part to the ability of the firms to promulgate their thoughts through the media via their extensive public relations activities and in part through the acquiescence and support of the relevant professional bodies, in particular ICAEW – it has not been unchallenged. There has been criticism of the attitude of the large firms towards issues of quality and independence[5] and recently there has been significant resistance to the proposals to

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1 Gwilliam (2004) 'Auditor liability: Law and Myth' (2004) 20 PN 172.

2 See Sikka P. 'Globalisation and Its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey', paper presented at the EAA Conference, Prague, 2004.

3 See Freedman, J. and Finch, V., 'Limited Liability Partnerships: Have Accountants Sewn Up the "Deep Pockets" Debate' [1997] JBL 387-423 and Finch, V. and Freedman J., 'The Limited Liability Partnership: Pick and Mix or Mix-up?' [2002] JBL 475-512 for extensive discussion of the limited liability partnership organisational form.

4 http://www.icaew.co.uk/index.cfm?AUB=tb2i%5f75804

5 See for example, Cousins J., Mitchell A. and Sikka P., (2004) 'Race to the Bottom: the Case of the Accountancy Firms' Association for Accountancy and Business Affairs; Cousins J., Mitchell A. and Sikka P., 'Auditor Liability the Other Side of the Debate' (1999) 10(3) Critical Perspectives on Accounting 283.

allow the negotiation of limits to liability from bodies representing investors and other stakeholders in the capital markets.[6] There has also been questioning as to whether the low level of provisioning against legal claims by the large and medium sized audit firms can be seen as in any way indicative of a liability crisis requiring legislative intervention.[7] However much of the debate has been conducted at a remove from examination of actual decided cases and the manner in which the courts have approached issues as to the quality of audit work and associated liability. In a number of articles written some years ago[8] I suggested that examination of such cases provided little evidence that, at that time, the courts were treating auditors unfairly either in respect to determining whether they had conducted audits appropriately or, if they had not, whether they should be liable for losses of other parties, whether contractual or otherwise, claiming to have relied on those audits. In fact, if anything, the converse was true. This paper returns to this theme by reference to the legal judgment in the case brought, unsuccessfully, by Elton John against Price Waterhouse (PW)[9] in which *inter alia* he claimed that negligence by PW in respect to the audit of the accounts of his management companies had led to loss to himself. The case was a high profile one but largely because of the details as to Elton John's personal life and in particular the perceived extravagance of his spending.[10] This rather obscured more mundane, but arguably more important, considerations as to the nature of the alleged negligence and the relevant legal arguments - which have perhaps received less attention than they deserve.[11]

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6 For example the Association of British Insurers, the Investment Management Association, the National Association of Pension Funds and, in particular, investment house Morley Fund Management (see *Accountancy Age*, 28 July 2005)

7 Gwilliam 'Auditor liability: Law and Myth' (2004) 20 PN 172.

8 See for example, Gwilliam, D., 'Auditors' Liability: Should the Government Intervene?', The Seventh Tom Robertson Memorial Lecture, University of Edinburgh, 1989; Gwilliam, D., 'The Auditor and the Law: Some Economic and Moral Issues', in M. Bromwich and A. Hopwood (eds) *Accounting and the Law*, Prentice-Hall, 1992; Gwilliam, D., 'Auditors' Liability: the Public Policy Arguments' (1992) 8 PN 147.

9 Elton John is now Sir Elton John and Price Waterhouse, an international firm of accountants, have merged to form PricewaterhouseCoopers. However as these happenings took place after the events discussed in the case (although both had taken place before the case was heard) I shall use the original nomenclature.

10 For example the BBC news coverage at the time highlighted the fact that he had spent £293,000 on flowers between January 1996 and September 1997. http://news.bbc.co.uk/1/hi/uk/1024745.stm

11 Judgment in the case *John and others v Price Waterhouse and another* was given in April 2001. The judgment is unreported. Quotations and other references to the judgment in this article are referenced to the transcript available on Lexis, and paragraph numbers within the judgment. The case went to the Court of Appeal on the preliminary issue of whether the trial judge's decision in respect to whether the costs should have been borne by the management companies was correct, and this decision was upheld (by a majority). The Court of Appeal decision is reported at [2002] EWCA Civ 899. There is also a decision as to costs reported as [2002] 1 WLR 953.

The case

As a singer, songwriter and entertainer Elton John operates commercially through a number of management companies. Over the time period relevant to the case each of these companies had an agreement with another company JREL (controlled by John Reid a former partner of Elton John) to act as its manager.[12] These arrangements had been long-standing, although over the years the nature of the agreements, which were critical to the outcome of the case, was subject to periodic renegotiation and revision[13] - but the underlying basis of all of them was that JREL was entitled to twenty per cent of the gross income of the management companies. The essence of the litigation as it related to PW[14] was the claim by the plaintiffs that over the years certain tour costs and salaries which according to the agreements should have been borne by JREL were in fact borne by the management companies. Following a separate investigation by KPMG[15] in 1998, JREL and John Reid had come to an agreement with Elton John's solicitors to repay a total of $5m (subject to offset for outstanding commission) – and this had taken place. The case against PW was for recovery of amounts beyond this. In this context the plaintiffs claimed that in relation to the tour costs PW had internally questioned the practice of who should bear these in the summer of 1989 when they were carrying out the audit of one of the management companies for the year ending 31 March 1987, but had failed to follow this up or to warn anyone independent of JREL of this practice (and this failure had recurred in subsequent years up to the end of July 1997). In relation to the salaries (and associated expenses) the claim was that these should have been recoverable from JREL in accordance with the 1992 management agreement over a five year period running to the end of July 1997 – but were not. Here the judge, Ferris J, was critical of the manner in which the plaintiff's claim was framed:

> 'The pleaded case against PW … is unclear about exactly what conduct on the part of PW is being complained of … In the end the argument against PW was that they ought to have ensured that proper systems were in place for re-charging the relevant salaries and expenses to JREL. This was, in my view barely within the scope of the pleaded case….'[16]

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12 Although the issues in the case relate to the years between 1986 and 1997, the financial status of Elton John's management companies continues to attract occasional comment. See for example http://www.femalefirst.co.uk/entertainment/39692004.htm which reports the sharp rise in the borrowings of the parent company in 2004.

13 Separate agreements were made in 1973, 1977, 1986, 1992 and 1997. The main terms of each of these agreements are set out on pages 7-10 of the judgment.

14 The case also covered similar claims made against Andrew Haydon, financial controller of JREL and from 1986 to 1998 sole director of one of the management companies. These claims, which are not considered separately here, also failed.

15 Another international firm of accountants.

16 At [309]. To the lay person the judge's view that the pleading that these salaries should not have been paid by the management companies was inappropriate - because the agreement was that they should be paid by the management companies and then recharged - may seem a little pedantic. It may also have had a bearing on the manner in which the judge considered the relevant duties of PW – as discussed further below.

Tour costs

In relation to the tour costs the claim failed because, after detailed examination of the construction of the agreements between the various parties, the judge found that JREL was under no obligation to bear the costs.[17] However because of the possibility that a higher court would take a different view[18] the judge was obliged to consider a whole range of further issues including the question of whether PW had in fact been negligent. These other issues included: those relating to the contention by PW that had the agreement been constructed as claimed the parties would have rectified it and therefore PW should not be held liable for the consequences following from its actual construction; an argument in relation to estoppel by convention [because both parties knew and acquiesced in the manner in which the costs were borne neither party should be able claim that they were borne inappropriately]; and whether PW owed a duty of care to Elton John personally rather than just to the companies for which PW were auditors.

Disposing of all of these meant that it was only on page 63 of the 112 page judgment that the question of whether or not PW had carried out their auditing duties appropriately was arrived at. As the judge noted in relation to the tour costs claim at least this was now an academic exercise because of his finding that the tour costs had in fact been appropriately treated. He opined:

> 'It cannot have been a breach of duty for PW to refrain from reporting that correct treatment was incorrect merely because they wrongly thought that it was incorrect at the time. While it may well be the duty of a guardian to sound an alarm, the guardian is not in my view in breach of duty if he fails to sound what would, if given, prove to have been a false alarm.'[19]

The 1989 Audit

Work on the audit for the relevant management company for the year ended 31 March 1987 began in April 1989. This audit was staffed by a qualified senior,[20] a senior manager and an audit partner. It took place under some time pressure because the statutory time limit for filing the accounts was well past when the audit commenced and the final date agreed with the Companies Registrar for filing was 9 June 1989 (in fact the accounts were received at Companies House on 8 August).

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17 This finding was reached notwithstanding the fact that both parties, having taken legal advice, had agreed a settlement on the basis that a significant proportion of the costs at least should have been met by JREL. The trial judge does note (p.13) that the complaint which gave rise to this settlement was much more specific about the failure to recharge salaries than to the tour costs, however the issues of quantum referred to on pages 82 and 83 of the judgment would suggest that by far the greater part of the settlement related to the tour costs.

18 In fact, as noted above, by a majority the Court of Appeal supported the decision of the trial judge in this respect.

19 At [225].

20 According to the judgment he is variously referred to as an assistant manager or senior. It is likely that he was an assistant manager but as the work that he undertook was that more normally associated with that of a senior that is how he is described here.

The audit fieldwork was done by the audit senior with some assistance from the PW Los Angeles office. This resulted in fourteen pages of 'Final Notes' which went to the senior manager for review. On the basis of these notes the senior manager then produced three further pages recording points arising and by about the middle of June the notes were marked as 'All cleared'. The file then went forward for partner review which resulted in a listing of fourteen points on which the partner required further information. These included a query as to why payments were being made to a particular agency: 'Howard Rose Agency – why do they need yet another agent? - …(and what did the producer [another company called Constant Communication] do*)*.'[21] The audit senior made enquiries of JREL and reported that, in relation to Howard Rose, under the terms of the management agreement the costs did not come out of JREL's 20%. He also confirmed that the payment to Constant Communication was a bona fide expense of the company being audited. At this point (13 July) the audit senior went to the United States on holiday for ten days. Meanwhile the senior manager took the file to the partner, but the partner was not happy with the explanations received noting in writing: 'Not so per clause 7.2.2 unless agreed in writing. To be followed up' in respect of the Howard Rose payments and, in relation to the assertion that the payment to Constant Communication was a bona fide one: 'No – see GAB [i.e. his own] review.' He then endorsed the front of the audit file: 'Approved subject to resolution of: JRE commission deduction of direct venue costs [a separate issue not relevant to the action]; treatment of sub agents costs on JRE commission.'[22]

On 18 July the senior manager, who was going on holiday the next day, wrote a note for the audit senior explaining the situation. He also referred to a conversation with Andrew Grocott (who was in charge of accounting and bookkeeping at JREL) in relation to the outstanding points and noted that Grocott's views were very much: 'we aren't going to change the numbers so let us know what documentary evidence you need to support the numbers as they stand.'[23]

After this as the judge noted: 'There, unfortunately, PW's written records of what was done come to an end. Not surprisingly after eleven years, [none of the PW audit personnel] could remember precisely what happened thereafter.'[24] Chronologically the partner and senior manager both returned from holiday in early August and an audit clearance meeting was arranged for 7 August. The first item on the agenda for this meeting was 'All 1987 audits completed and accounts filed'. Indeed the financial statements showed that the audit report was signed by PW on 7 July 1989 although the judge was confident that this did not happen until the 3rd, 4th or perhaps the 7th of August.

In conclusion, the judge considered that it was clear that PW did not report their concerns to either Elton John or his solicitors ('the only independent party to whom it would have been sensible to make such a report on behalf of Sir Elton'[25]). This left the 'stark alternatives' that: 'PW either (i) signed off the accounts without

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21 At [235].

22 At [239].

23 At [240].

24 At [241].

25 At [246].

satisfying the irregularity which they thought they had uncovered or (ii) obtained satisfaction from a source and in a manner of which no one concerned has any recollection and in respect of which no note was made.'[26] Some evidence to support the first possibility lay in the fact that the points noted on the front of the audit file had not been crossed off, although that would have been normal practice. However, and largely based upon his assessment of the professional capabilities and character of the PW personnel, the judge was convinced that the audit partner had indeed sought and obtained a convincing explanation from the client's financial controller Andrew Haydon (an ex PW employee). More than two pages of the judgment[27] are taken up with the evidence given by the audit partner, which effectively consists of surmising as to what explanations might have been received – but the reality is that no specific evidence was adduced that any explanation had been received. The judge's finding that PW had not been negligent was essentially based on his belief that if the audit partner had so signed off without having obtained convincing evidence to satisfy himself that his concerns were baseless it would have been: 'an aberration on his part, entirely out of character.'[28]

From 1988 until 1997 tour costs continued not to be paid by JREL (although the management company through which the overseas tours were arranged changed to a wholly owned subsidiary of the company whose 1987 year end was audited in 1989). PW audited this company but there is no reference in the judgment to PW ever having again considered or raised the issue of the propriety of the management company accepting the costs. However the judge rejected the argument that had PW been in breach of their duty with respect to the 1987 year end audit they would have continued to be in breach of their duty subsequently, quoting[29] from *Midland Bank v Hett, Stubbs & Kemp*[30]: 'It is not seriously arguable that a solicitor who or whose firm has acted negligently comes under a continuing duty to take care to remind himself of the negligence of which, ex hypothesis, he is aware.' As the facts relating to subsequent audits had not been examined, the issue of negligence in relation to these audits could not be considered.

Salary Recharges

The question of whether PW should be liable in any way in respect of the failure of the management companies to recover fully salary costs which were agreed to be recharged to JREL received significantly less attention in the judgment than that in relation to tour costs (and was not raised in the Court of Appeal). In part this may have been because the amounts involved appear to have been rather smaller than those in relation to the tour costs. It was also clear that Ferris J was unhappy with the manner in which the case had been pleaded by the plaintiffs.[31] As noted above the judge considered that the allegation related to PW's failure to ensure that proper internal control systems were installed to ensure the recharges took place. With

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26 Ibid.

27 pp.68-70

28 At [251].

29 At [267].

30 [1979] Ch 384 at 403.

31 He noted, at [303]: 'The pleading of the case in this way reveals a remarkable failure to understand the plain effect of Clause 3 of the 1992 Agreement'.

respect to the judge, this is a strange interpretation at least as it relates to PW's duties as an auditor. The auditor's duty is not to ensure that proper internal control systems are installed. However if weaknesses in internal control systems exist which may result in a company suffering loss then if the auditor is, or should be, aware of such weaknesses then the auditor should draw these to the attention of management and, if no action is taken, consider whether further reporting action is necessary.[32] In the outcome the judge was convinced, apparently on the basis of expert witness evidence, that the losses to the management companies sustained by the failure to recharge salaries and associated expenses were not material in the auditing sense and therefore it could not be concluded that there had been a breach of duty by PW. For the reasons discussed further below, this finding is, at the least, open to question.

Other issues

After disposing of the question of whether PW had or had not been negligent the judge then proceeded to examine evidence as to causation. In this respect he formed the opinion that it was unlikely that Elton John or the management companies would have pressed a claim against JREL had they known that the opportunity was available – consequently if PW had been negligent their actions would not have caused measurable loss (and even if a claim was made the amount available for recovery would have been less than that claimed).

Finally the judge considered the contribution claim made by PW against Elton John's legal advisers, Frere Cholmeley, which contended that had they carried out their duties appropriately the loss would not have arisen. Despite characterising the evidence of one of the employees of Frere Cholmeley as 'remarkable' and his conduct 'quite extraordinary'[33] (he had noted an ambiguity in the management agreement but decided not to do anything about it) the judge would not have upheld the contribution claim because he did not consider that the legal advisers were retained to advise whether the agreements entered into were being operated appropriately.

The Audit Approach

The question of whether an auditor has exercised reasonable skill and care in the conduct of an audit is ultimately one for the courts but in coming to their decisions the courts will take cognizance of (and normally attach great weight to) generally accepted practice within the auditing profession and also adherence to codified

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32 The Auditing Guideline Internal Controls (issued in 1980 and not replaced by SAS 300 Accounting and internal control systems and risk assessments, until 1995) stated at para. 4: 'It is a responsibility of management to decide the extent of the internal control system which is appropriate to the enterprise'; and paras 21 and 22: 'It is important that the auditor should report, as soon as practicable, significant weaknesses in internal controls which come to his attention during the course of an audit to an appropriately senior level of management of the enterprise…The fact that the auditor reports weaknesses in internal controls to management does not absolve: (a) management from its responsibility for the maintenance of an adequate internal control system; or (b) the auditor from the need to consider the effect of such weaknesses on the extent of his audit work and on his audit opinion'.

33 At [438] and [440].

standards.[34] It is surprising, then, that there is no reference at all to codified auditing standards in the judgment. In the UK codified standards were first issued in 1980, by the then Auditing Practices Committee, as three (subsequently reduced to two) high level standards supported by a number of auditing guidelines which were designed to amplify and expand on the standards themselves. In 1991 the Auditing Practices Committee was replaced by the Auditing Practices Board and this body commenced a programme of revising and reissuing standards effectively incorporating (and where necessary amending) guidelines into a much more detailed and encompassing set of standards, with compliance with sections in bold type being effectively mandatory. The first such standard SAS 600 *Auditors' Reports on Financial Statements* was issued in May 1993 and the greater part of the changeover had been achieved by March 1995. Given that the PW audits in question spanned this period the applicable standards and guidance varied according to when the audit was undertaken, with the 1989 audit falling completely within the ambit of the Auditing Practices Committee's standards and guidelines whereas audits after 1995 fell within that of the revised standards issued by the Auditing Practices Board.[35]

There is little doubt that in certain respects the 1989 audit did not measure up fully to the then standards and guidelines. With regard to audit documentation the then applicable guideline[36] stated: 'Audit working papers should include a summary of all significant matters identified which may require the exercise of judgement, together with the auditor's conclusions thereon….It is important to be able to tell what facts were known at the time the auditor reached his conclusion and to be able to demonstrate that, based on those facts the conclusion was reasonable.'[37] In that the PW working papers provided no assistance at all in demonstrating how the conclusion (that the tour costs were an appropriate charge to the management company) was reached they manifestly failed to comply with this guideline.

In other, perhaps less important, aspects the 1989 audit may also have not fully conformed to the then guidelines. The dating of the audit report nearly four weeks ahead of the actual conclusion of the audit and the actual signing off of the report was not in accordance with then applicable auditing standard.[38] There is no reference in the judgment to a management representation letter confirming the management's view that the costs were being appropriately treated being obtained[39]

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34 *Jackson & Powell on Professional Negligence* 5th ed. (2002) states, at p. 1115, with reference to UK auditing standards (SASs): 'Although SASs do not directly have the force of law, compliance with them is powerful evidence that the auditor has acted reasonably, while failure to comply without adequate explanation is powerful evidence to the contrary.'

35 Strictly speaking the Auditing Practices Committee did not issue standards and guidelines in its own name, they were issued by the professional bodies comprising the Consultative Committee of Accountancy Bodies (CCAB).

36 Auditing Guideline *Planning, controlling and recording*.

37 Para. 20. This was reinforced in SAS 230 *Working papers* issued in March 1995 which includes a bold type requirement that: 'Auditors should record in their working papers their reasoning on all significant matters which require the exercise of judgement and their conclusions thereon' (SAS 230.3).

38 Auditing Standard (Revised) *The Audit Report*, issued in March 1989 stated that: 'The auditor should not sign and date his report until…he has completed his audit…' (para. 34).

– although this is not to say that there was not one. Nor is there any reference in the judgment to the sending by PW of a management letter to the client identifying significant issues arising in the course of the audit – although again this is not to say that a management letter was not sent.[40] Furthermore the engagement letter or acknowledgment thereof was not signed by any directors of the management companies.[41]

Although the 1989 audit may not have been fully aligned with the auditing standards and guidelines then applicable (and almost certainly not with PW's own audit manuals and procedures) this does not in itself mean that it was negligently carried out and the judge was prepared, on the balance of probabilities, to accept that suitable and appropriate audit evidence had been obtained to justify both the audit report given and the failure to report possible concerns as to who(m?) should bear the costs under dispute. Others perhaps might consider the possibility that the need to comply with the filing deadlines and the lack of continuity occasioned by the concatenation of the holidays of all three key audit persona could have resulted in the outstanding issues having effectively been passed by default or on the basis of the acceptance of a client explanation with little in the way of further enquiry. Whatever the truth, it is surprising that, at least as far as can be established from the judgment, the issues do not appear to have been considered in subsequent years. The reality of the audit environment is that under time pressure toward the end of an audit there may be acceptance of management assertions and representations on weaker evidence than one would consider to be ideal – but in circumstances where the issues are ongoing these are carried forward for closer attention in the audit of the following year. The fact that this does not seem to have occurred might be taken as supportive of the fact that PW did in fact receive evidence that it considered to be compelling at the time of the 1989 audit. Again however others might interpret it as evidence of an insufficiently sceptical and enquiring audit approach over the period of PW's audit association with the management companies.

With respect to the question of whether PW should have alerted management and possibly others to the fact that salaries and expenses were not being recharged in accordance with the 1992 agreement the judge was again prepared to adopt a view as to the appropriate nature of an auditor's duties and responsibilities which would not command universal acceptance. It was not in debate that PW were aware of the provisions of the 1992 agreement which contained a clear requirement for certain salaries (and expenses) to be recharged with invoices sent to JREL on a monthly basis. In fact recharges were made but for less than the appropriate amount

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39 Auditing Guideline *Representations by management* in force at the time suggests that the auditor should obtain written confirmation of representations in situations where the auditor cannot obtain independent corroborative evidence.

40 Auditing Guideline *Reports to management* then in force would have been supportive of the issue being raised in a management letter.

41 The Auditing Guideline *Engagement letters* then in force required (para. 3) discussion of the contents of the engagement letter with 'the directors of the company and persons acting with similar authority' and (para. 19) that the auditor should request confirmation by the board of their agreement to the terms of the engagement. In fact the engagement letter was signed by Elton John personally, who was not a director of any of the management companies. Whether he came within the category referred to as a person acting with similar authority as a director is an interesting legal point. Unfortunately very few details are provided in the judgments (it is referred to briefly in the main judgment discussed here and again briefly in the judgment on costs) as to the content of the engagement letter.

and on an annual basis. There was agreement between the parties that the recharges were less than they should have been but disagreement as to by how much. The amounts were not enormous but they were not negligible either.[42] A number of interesting insights into the audit approach taken both overall and in respect to these recharges can be gained from the evidence provided under examination by counsel for the plaintiffs by the audit partner. This evidence suggests that the audit was primarily a substantive one:

> 'If you have a big company, with good systems and controls, you test the systems and controls and then rely on the controls to produce the financial statements, a so-called compliance audit. When you have a situation such as we had with these clients, where you do not have good systems and controls, you test balances and transactions, but having - in addition to testing the material balances and transactions in the financial statements one also does a little bit of test-checking of other items just to be alert to the fact that, or just to make sure, or try and make sure that there is nothing untoward going on in other areas which one has not specifically focused on in the compliance testing. So if there is a change in a Management Agreement, I think we would have briefly tested the application, or sought to test the application of that, just to see if there was anything obvious that was not being done, but it would not have been a primary focus...'[43]

As the judge noted the plaintiffs sought to attach significance to the following exchange between counsel for the claimants and a PW partner (who had been senior manager on the audit from 1991 onwards before becoming the audit partner in 1995):

> 'Q. Did you ever discover whether…satisfactory internal controls existed in JREL in relation to the salaries and expenses?
> A I am not certain whether we looked at it specifically in that context, no. I cannot recall.'[44]

The judge interpreted this as:

> 'While Mr Bowman was clearly accepting that there needed to be some system for operating Clause 3 [the clause in the 1992 agreement relating to the recharges], he cannot be taken as accepting that no system was in place or that PW had formed the view that what was in place was not satisfactory. He simply said that he could not recall how PW had looked at the matter.'[45]

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42 The judgment refers (at [317]), on the basis of schedules prepared by an expert witness, to the ratio of relevant salaries and expenses in relation to Elton John's gross remuneration (from each company separately) in the years under consideration as falling between 0.9% and 4.3% for one management company and 1.1% and 2.7% for another management company.

43 At [313]. Although as reported at least there seems to be some confusion with regard to the use of the term 'compliance testing' which is normally used in relation to the testing of controls in contrast to the term 'substantive testing', i.e. the more traditional direct testing of balances and transactions.

44 At [310].

45 At [311].

In that PW were not placing audit reliance on the systems of internal control at the management companies or JREL then much of this questioning and the interpretation of the judge seems to me only to be relevant to the issue of whether they should have reported to management, and possibly others, internal control weaknesses. The question of whether PW were negligent in failing to appreciate that salaries and expenses were not being fully recharged in accordance with the 1992 agreement is essentially one of whether their substantive audit testing should have uncovered this. In this context the judge noted that counsel for the plaintiffs:

> 'tried to gain support from the fact that PW's witnesses were not very specific about what checks PW made in respect of salaries and expenses in auditing the accounts from 1983 [per the transcript – presumably 1993] onwards. But their answers must, in my view, be considered in the light of pleaded allegations setting out the details of the acts or omissions relied upon.'[46]

In evidence one audit partner (Mr Bowman) did state that: 'in the audit files there are a number of schedules that demonstrate that there were recharges or adjustments made to the accounts that clearly show that salaries and indeed, related expenses were recharged', and in response to the question as to whether it would have been part of the audit team's job to check that the relevant salaries and expenses were being borne by JREL the previous engagement partner (Mr Barker) replied: 'No, not precisely that, no I think it would have been - our overriding job is to look at the truth and fairness of the financial statements and therefore look at things that are material. I think, with a change of Management Contract, we would have wanted to test that recharges were taking place just to satisfy ourselves that nothing looked untoward, but we would not have felt it as part of our job to check the detailed application of that, because we would not have regarded it as particularly significant to the financial statements'. In answer to a request for more information as to what was meant by wanting to test the recharges he replied: 'if there is a change in a Management agreement, I think we would have briefly tested the application, or sought to test the application of that, just to see if there was anything obvious that was not being done, but it would not have been a primary focus.'

The judge found this to be a proper approach and the question then arose as to whether it was properly carried through: 'In particular was there anything which went unremarked upon by PW which was "material".' To answer this question the judge adopted a view of materiality provided by two expert witnesses (both present or former partners in large international firms of accountants) which agreed that an item amounting to less than 5% of Elton John's gross remuneration from the particular company would not be considered material. Because in all the years under consideration the amounts involved fell beneath the 5% cut off the judge was able to conclude that: 'PW adopted a proper approach in carrying out their audits … and they did not overlook any item which was material in the auditing sense. Accordingly they were … not in breach of their duty so far as the staff salary and expenses claim is concerned.'[47]

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46 At [310].

47 At [318]. An interesting aspect of the materiality issue not explored in the judgment as it is not of immediate relevance to the case brought is that although the amounts may not have been material (in the sense of impacting the true and fair view) to the management companies they may have been material to JREL which was also audited by PW (as of course would have been the tour costs if indeed they should have been borne by JREL). Unfortunately no specific details are provided as to the

With respect to the judge, this perspective is, by some distance, at a remove from the conventional approach to the role and purpose of audit and of the nature and meaning of materiality in the audit context. I would also suggest that it fails to take sufficient account of a long line of legal authority which makes clear that there are duties within the term and contract of audit beyond that of merely ensuring that a set of financial statements is true and fair in the usual usage of the term. In the context of the particular circumstances of the companies which PW audited the management contracts were of key importance and it may well be considered that a duty within the contract of audit would be to satisfy themselves that significant aspects of these contracts were being adhered to – and if not, to report accordingly. The impression given in the judgment is that, aware that the management agreement called for recharge of certain salaries and expenses, PW satisfied themselves that this term was being met on the grounds that schedules showing that recharges took place were in existence. Whether they tested in any way in any one of the relevant five years of audit for which these recharges took place that they were appropriately calculated is much less clear. If they had not, then, in the view of the judge, this was acceptable because in none of these years could, for any single company, the recharges amount to more than 5% of Elton John's gross income. This reveals a signal failure of understanding of the nature of materiality in the audit process. In general terms if one accepts that there is a 'correct' profit figure for an entity which should be reported[48] nevertheless for the great majority of such entities the amount of check and audit required to ensure that this 'correct' figure is actually the one reported would be uneconomic and a diversion and waste of resources. Therefore a materiality level in respect to the range at which auditors might consider the final reported figure to be appropriate is a key audit concept. However one cannot infer from this that because an item in a set of draft financial accounts amounts to less than 5% of a set materiality level then the auditor can be automatically absolved from conducting any audit testing in respect to this item - and I do not believe that any auditor acting as an expert witness would endorse such an approach (and here in fairness to the expert witnesses in the case on whose evidence the judge appears to be relying it is not clear how the issues were put to them or how the judge interpreted their evidence).

That such an approach is untenable can be clearly seen from the extreme case in which all separate expenditure items form less than 5% the set materiality figure in which case there is apparently no requirement for any audit testing whatsoever. If in this particular case the auditors had tested the recharges and established that the numbers reported were inappropriate than it may well be that they would have been entitled not to qualify the accounts in any one year on the grounds that the amounts were not material (although this would not absolve them from their duties with regard to making senior management aware of the loss suffered by the company and – if senior management took no action to remedy the situation - to consider wider reporting responsibilities). However, and at the risk of

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JREL audit in the judgment. (More generally it would be fascinating to know whether JREL contemplated (or took) action against PW having settled with the management companies following the KPMG investigation or whether they sought any recovery against their legal advisors after the outcome of this case for having made an unnecessary settlement.)

[48] And this necessitates abstracting from the whole range of conceptual and measurement problems associated with financial reporting which mean that for most economic entities reported profit is just one representation, arrived at in a particular way, of the outcome of a range of diverse activities.

labouring the point, *ex post* materiality levels (which are more usually applicable in respect to disagreement with the client in circumstances where there is a greater or lesser degree of subjectivity - for example impairment issues, provisions for bad debts or obsolescence, or where different points of view may be held - for example as to an appropriate accounting treatment) cannot be used at the planning stage of an audit to justify a complete absence of testing on a particular item. At the planning level the decision as to what to test will encompass a range of factors including *inter alia*: likely materiality, potential for mistake or error in the item or the underlying transactions, the ease or difficulty of testing, the availability or otherwise of other sources of evidence which could obviate the need for direct testing, the outcome of previous audits (including whether the item had been tested previously), specific duties actual or inferential placed upon the auditor. It is suggested that, on the basis of the evidence available in the judgment, consideration of these factors should have led PW to conclude that in at least one year of the relevant years of audit (including almost certainly the first year of the implementation of the agreement) specific direct testing of the recharging should have taken place – a task which, even allowing for certain complications referred to in the judgment,[49] would quickly have identified that there were issues relating to the implementation of this part of the agreement (if only that the recharging that was taking place was on an annual basis and not a monthly one as specified in the agreement).

Here perhaps the most telling (indirect) commentary on the PW audit of the salary recharges comes from Andrew Haydon, who stated that the recharging was: 'terribly straightforward to implement, to have been implemented by competent, qualified, people.' While this comment may seem a little odd in that as financial controller of JREL he was effectively in charge of the recharging, nevertheless it might be thought that if the recharging should have been so easy to implement it should perhaps have been equally easy to audit.

The aftermath

Following the judgment PwC (as the firm had become) was not backward in giving its version of the outcome. As reported by *Accountancy Magazine* the day following the decision:

> 'PwC spokesman Jon Bunn said that the firm was "delighted" by what amounted to a total vindication of its position. "This was a case wholly without merit and resulted in misguided proceedings being brought" he said.
>
> "Serious allegations were made by Sir Elton about the competence of our partners and staff. Mr Justice Ferrers [sic] found that these were completely unfounded. We view today's judgment as a complete vindication of both individuals and the firm, whom the judge found to be frank, honest and reliable in very difficult circumstances."
>
> He said that PWC was not a "bank of last resort available as a deep pocket." He added that the firm was looking forward to recovering its substantial legal costs from Sir Elton.'[50]

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[49] There were issues as to which salaries should be included, whether certain pay rises for relevant staff authorised by Elton John were to be included, which categories of expenses were rechargeable (p.83).

Two months later when leave to appeal was refused by the trial judge (a decision subsequently overturned by the Court of Appeal) PwC commented: 'We're delighted by Mr Justice Ferris' decision. The original judgment rejecting Elton John's claim against us was absolutely right. It's not surprising that he has been refused leave to appeal as well.'[51, 52]

Reflections

The case can be reviewed and interpreted in many ways. A legal sociologist or perhaps a psychologist might direct their attention to speculation as to whether the manner in which this case was brought and the surrounding publicity as to personal relationships, extravagant lifestyles, the aversion to 'men in suits' whether accountants or lawyers attributed to Elton John[53] might have sub-consciously influenced the public school and Oxford educated judge[54] himself an expert in patent law. It is clear from the judgment that the judge was more impressed with the witnesses from a professional background, whether that of accounting or the law, and much less so with those from the more glamorous world of music and entertainment.[55] It is also possible that what would appear to be his irritation at what he considered to be sloppy pleading might have influenced the manner in which he viewed the salary and expenses recharge claim as discussed above. It is also of interest that one of the few aspects of the PW legal argument which was not supported by the judge was the claim by the accounting firm against the law firm

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50 http://194.143.187.55/accountancy/main.asp?StoryID=2129

51 http://194.143.187.55/accountancy/main.asp?StoryID=2495

52 Jon Bunn was head of media relations at PWC until July 2005 when he moved to Prudential as Director of Public Relations. A former news editor at *Accountancy Age* magazine, it is not known whether his comments are underpinned by a particular training in either accounting or the law. Although the trial judge in a separate hearing refused leave to appeal as he thought that the case would have little chance of success (as noted above a decision overturned by the Court of Appeal) I am not aware that the judge at any stage described the case as wholly without merit. The judge did find Mr Barker to be a 'straightforward, frank, careful and thoroughly honest' witness who brought to his work 'a proper degree of objectivity or even scepticism' (at [251]). He made few comments in the judgment, about the other PW personnel involved although in relation to the team undertaking the 1989 audit he did say that: 'They all appeared to me to be competent professionals' (at [249]).

53 Counsel for Elton John referred to his 'aversion to men in suits whether they were lawyers, accountants or others badgering him to take on board lots of boring details' http://news.bbc.co.uk/1/hi/entertainment/998238.stm . More than once Elton John declined to meet with partners in Price Waterhouse and on one occasion he returned to Mr Haydon a report from PW critical of his spending habits torn into small pieces.

54 Bryanston and Oriel College Oxford

55 'My impression of Mr Haydon [an accountant] was that he was an honest and straightforward witness… I had a less favourable impression of John Reid's evidence. Lisa Ferguson [an accountant] was clearly a witness of truth' (at [86]); 'Nevertheless it appeared to me that both Mr Lee and Mr Eadie [both lawyers] were essentially truthful witnesses who were doing their best to recollect accurately what had occurred' (at [153]); 'Moreover Sir Elton was not, in my judgment, a very reliable witness' (at [185]); 'Mr Robbins' [a tour manager] last answer is perhaps an unsurprising one. But his previous answer casts considerable doubt on the accuracy of his evidence in chief on this point' (at [198]).

which advised Elton John. Again one might also wonder whether the experience of the litigation was influencing the comments made in February 2005 by Glyn Barker (the partner in charge of the 1989 audit and subsequent audits until 1995 and who, in July 2002,[56] became the partner heading the assurance line of service for PwC in the UK) about the newly formed Audit Inspection Unit.[57] Mr Barker said of their work:

> 'They could typically spend a five-man week reviewing an audit, and they expect to see a lot of documentation in that period," says Glyn Barker, UK head of assurance at PricewaterhouseCoopers. "Their assumption is that if it's not documented, it wasn't done, or if a conversation with a client wasn't minuted, it didn't happen. That's the world we're living in.'[58]

A lawyer might reflect more specifically on the manner in which the construction of the 1986 agreement was viewed both in the lower court and the Court of Appeal or perhaps on the interesting legal issues raised by the claims in respect to rectification, estoppel by convention, and as to whether as auditors PW owed a duty of care to Elton John.[59] A media specialist might note the fact that the greater part of the media coverage of the case dwelt on issues which were almost entirely peripheral. There is no mention of expenditure on flowers at any point in either the lower court judgment or that of the Court of Appeal. The unwillingness of commentators whether in the general media, or, perhaps more culpably, in the financial press, to engage with the detail of the case outside mere sensationalism is perhaps symptomatic of an environment which allows the media and public relations experts in the large firms to construct and portray their own perceptions of reality in terms of the nature of their own activities and of the legal environment within which they operate. A case in which the judge is confronted with the 'stark alternatives that PW either (i) signed off the accounts without satisfying themselves in respect of the irregularity which they thought they had uncovered or (ii) obtained satisfaction from a source and in a manner of which no one concerned now has any recollection and in respect of which no note was made' and in which context the judge noted: 'The claimant's case is undoubtedly a formidable one'[60] becomes in the hands of PwC's head of media relations 'a case wholly without merit'. The finding that: 'Weighing all these factors I have come to the conclusion that it is rather more likely that Mr Barker received an explanation which justified him in taking no further action than that he signed off the accounts without resolving the query that he had raised'[61] is

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56 The month after the Court of Appeal upheld the decision of the trial judge in respect to the preliminary issue as to whether the management companies or JREL should have borne the tour costs.

57 Part of the Professional Oversight Board for Accountancy (itself part of the Financial Reporting Council) which has responsibility for monitoring the audits of all listed and public interest entities.

58 Published in the February 2005 edition of CFO Europe available at http://www.cfoeurope.com/displayStory.cfm/3599468

59 The judge considered that JREL would have had 'quite a strong claim' for rectification but left it to a higher court to decide, if necessary, whether this could assist PW, he did not support the claim in relation to estoppel by convention and held that as auditors to the management companies PW did not owe a duty of care to Elton John as an individual.

60 At [246] and [248] respectively.

transformed in the hands of the PwC media team as amounting to a 'total vindication of [PW's] position'.

Abstracting from the psychological, legal, media-related questions interesting though these may be, from an accounting and audit viewpoint the case does provide an insight into the manner in which one of the world's largest and most reputable firms of accountants conducted its work on one of its audits. The audit was a high profile one with certain distinctive features which may have added to the problems it posed. Perhaps in response to this PW assembled an impressive team both on the audit team and as advisors.[62] Why then did the audit result in protracted litigation – the outcome of which was not anything like as clear cut as the 'official' portrayal in terms of subsequent PW comment? Here one might speculate as to how the downplaying of the importance of audit as compared to the provision of other services to clients in the 1980s and 1990s, together with the perceived change in the nature of audit methodology and audit approach in the 1990s, might have affected the manner in which this particular audit was conducted. In this respect the 1990s saw a well documented shift toward what was termed a business risk audit approach with the audit emphasis being placed on an assessment of the integrity of management, assessment of the quality of high level controls and the adequacy of the control environment and a reliance on the client's own systems of internal control and check to ensure the accuracy of routine transaction processing. Such an approach greatly reduced the emphasis given to traditional audit testing of routine controls and to actual testing of transactions. It also fitted in well with the idea that the auditor was there to add value to the client and indeed audit firms were anxious to portray themselves as nesting comfortably in a quasi-consulting capacity within the client's overall risk management framework rather than promoting the more traditional perspective that the auditor was there to provide a check on management for the benefit of the shareholders and other parties.[63]

On the evidence of the judgment such an approach would be clearly unsuited to the nature of the audits which PW were undertaking in respect to the commercial activities of Elton John. They were well aware that the whole purpose of the companies was to act as a channel for Elton John's remuneration and also knew that the allocation of costs between Elton John's companies and JREL was a significant factor in determining the profits of the management companies and the level of remuneration of Elton John and from the JREL viewpoint no doubt that of John Reid.[64] Apart from this, almost everything that would justify a greatly reduced level of

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61 At [257].

62 As noted above Mr Barker is now head of UK assurance services and Mr Bowman the senior manager from 1991 onwards became a partner in 1995. In addition the partner who gave evidence in respect to PW's role as financial advisors to Elton John, Mr Tilson, is now head of advisory services in the UK.

63 For a description of these developments see Bell T., Marrs F., Solomon I., and H. Thomas (1997), 'Auditing through a Strategic-Systems Lens: The KPMG Business Measurement Process', Montvale, New Jersey: KPMG LLP; Jeppesen K., 'Reinventing auditing, redefining consulting and independence' *European Accounting Review*, (1998) September, pp. 517-539; Lemon W., Tatum K. and S. Turley (2000), 'Developments in the Audit Methodologies of Large Accounting Firms', ABG.

64 One might wonder from an independence perspective, given the clear potential for conflicts of interest between the management companies and JREL, whether it was appropriate for PW to act as auditor to both the management companies and JREL. In practical terms there would have been benefit in terms of audit efficiency in that as

substantive testing was missing[65] - in particular there is nothing in the judgment which would suggest that either the control culture or the actual control systems at either the management companies or JREL would enable PW to legitimately reduce the level and extent of substantive testing. In fairness to PW they recognised this and characterised their audit approach as a substantive one – but one may still surmise that against an overall background and environment in the large firms within which tests of detail were seen as near obsolete they in fact failed to carry through this approach appropriately.

Conclusion

The reflections above necessarily contain subjective elements, some perhaps more than others, and the reader may judge and interpret them accordingly. However to return to the main theme of whether the legal environment within which auditors work is a hostile one, I would conclude that the above analysis provides no evidence to support this contention. More generally the manner in which the courts interpret what is reasonable skill and care in the conduct of an auditor's duties, taken together with the formidable obstacles placed in the way of claimants in respect to issues relating to duty of care and causation[66] continue to make it difficult for aggrieved parties to recover losses which they may consider to be attributable to negligent auditing from audit firms. The claims by the large accounting firms for further specific protection need to be considered in this context.

JREL effectively ran the accounting functions for the management companies two sets of auditors might well have led to duplication of work and of course as auditors to both PW would have a wider information set than would necessarily have been available to them if they had only audited the management companies.

65 Other than perhaps the assessment of senior management integrity. In evidence (at [252]) Glyn Barker referred to having formed (and that he still held) the view 'that Andrew Haydon was a very open and honest and straightforward person'.

66 In this case even if the finding as to negligence had gone against PW the claim would have separately failed (subject to appeal) in respect to the question of both whether the tour costs should have been recharged and also the question of causation – apart from the issue as to rectification on which the judge did not come to a definite conclusion.