

# **The Standard of Care and Responsibility Required of Auditors in the Detection of Fraudulent or Illegal Activity: The AWA Case**

By

Francis Malane

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the requirements for the degree of  
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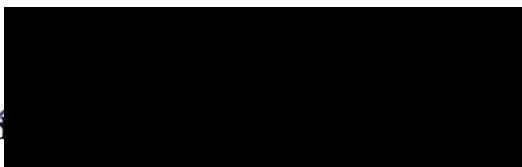


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**DECLARATION**

This thesis contains no material which has been accepted for the award of any other academic degree in any university or other institution, and to the best of my knowledge, contains no material previously published or written by another person, except where due reference is made in the text of this thesis.

Signed



Date 10-5-2006

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*May the road rise to meet you  
May the wind be always at your back*

*May the sun shine warm upon you  
And rains fall soft upon your face*

*You have taught me so much, it's a heavy burden  
But I shall carry it ever so lightly*

*For you have shared your wisdom so kindly  
In my memory it will stay, dear friends*

## ABSTRACT

The auditor's role in the detection of fraudulent or illegal activities has posed a continuing dilemma. In the 1980's, a lengthy period of large profits made by Bond, Skase and others, was followed by corporate collapses and subsequent findings of significant losses. Recently, the large corporate collapses of HIH, Enron and Worldcom have again posed the question 'where were the auditors'?

The auditor's failure to detect major weaknesses, fraud or illegal activities in the failed corporations has led to a widening of the audit expectation gap. This is the gap that exists between what auditors see as their role and what the financial community expects. Damaging publicity arising from subsequent litigation where auditors are found negligent focuses further attention on this problem.

It is often assumed by management and the financial community that the audit certificate indicates a clean bill of health on fraud or illegal activity in the organisation. However, auditors currently have only a limited role in the detection of fraud or illegal activity. Accounting standards do not require auditors to detect fraud or illegal activity in the companies being audited.

It is not surprising that management and the financial community assume that auditors play a far more significant role in fraud or illegal activity detection. With the exception of regulatory authorities such as Australian Prudential Regulation Authority and Australian Securities and Investments Commission, nobody else has the power to examine all financial transactions of the organisation and request management and third party explanations on any aspect of the financial records.

This research examines the AWA case. In AWA, the audit firm of Deloitte was faced with a combination of factors. The foreign exchange manager concealed illegal transactions from the auditors and provided them with false information.

AWA had an accounting system that did not accurately record the foreign exchange transactions and conducted the foreign exchange operations in an environment where the internal controls were poor.

AWA also had a senior management that was inexperienced in foreign exchange management and incapable or unwilling to properly supervise the foreign exchange manager and the information systems of AWA.

Given these circumstances, this case study of the complete AWA court transcript represents a valuable opportunity to evaluate the auditor's actions under the critical examination provided by legal proceedings. Due to financial and other constraints, there are only limited examples in both Australia and internationally of recent audit negligence

cases which have been contested to finality. Most audit negligence disputes are settled out of court.

The thesis provides a background to the issues examined by the courts and addresses the two key findings of negligence in both the original and Appeal cases which was the failure of the auditor to advise the board of directors of internal control weaknesses and the signing of an erroneous profit confirmation letter for the six months ending 31 December 1986.

This study constructed an Audit Fraud Detection Model and developed within a conceptual framework the rationale for a proposed forensic phase in all audits, the requirement for an increased level of audit scepticism, and a need for higher quality audits as recommended in the innovative report by the O'Malley Panel in 2000.

Within five key areas defined as audit planning, audit procedures, high-quality audits, forensic and audit independence, the research makes forty recommendations. These include fourteen recommendations designed to increase the audit focus on illegal activity and twenty-six recommendations designed to improve the audit fraud detection outcome.

In conclusion, this thesis contends that the current failure of auditors to detect fraud or illegal activity is a result of a lack of focus on fraud or illegal activity, which is in turn a consequence of the auditor's current primary emphasis on the certification of the financial statements. The research argues that in order to improve the audit fraud detection outcome, an improved focus on audit fraud or illegal activity detection is required as well as significant changes to the current audit environment.

## **LIST OF ABBREVIATIONS**

AAS	Australian Accounting Standard
AASB	Australian Accounting Standards Board
AFDM	Audit Fraud Detection Model
AAS	Australian Accounting Standard
AIB	Auditor Independence Board
AICPA	American Institute of Certified Public Accountants (USA)
AISB	Auditor Independence Supervisory Board
AMP	AMP Acceptances Limited
Andersen	Arthur Andersen
AOP	Audit Objectives and Procedures Manual
APC	Auditing Practices Committee (UK)
APRA	Australian Prudential Regulation Authority
ASB	Auditing Standards Board (USA)
ASCPA	Australian Society of Certified Practising Accountants
ASIC	Australian Securities and Investments Commission
AUD	Australian Dollar
AWA	Associated Wireless Australia
BBL	Barclays Bank of London
BHP	Broken Hill Proprietary
BNZ	Bank of New Zealand
BRW	Business Review Weekly
C&L	Coopers and Lybrand
CALPERS	California Public Employees Retirement Scheme
CBA	Commonwealth Bank of Australia
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CICA	Canadian Institute of Chartered Accountants
CMA	Cumulative Monetary Amount
COSO	Committee of Sponsoring Organisations



DHS	Deloitte Haskins and Sells
E&Y	Ernst and Young
ECS	Exceptional Client Service
ED	Exposure Draft
FASB	Financial Accounting Standards Board (USA)
FLAG	Forensic and Litigation Accounting Group (North America)
FX	Foreign Exchange
GAAP	Generally Accepted Accounting Practice (USA)
GAAS	Generally Accepted Auditing Standards (USA)
HIH	CE Heath International Holdings (HIH from May 1996)
ICAEW	Institute of Chartered Accountants in England and Wales
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants in Australia
IFAC	International Federation of Accountants
ISA	International Standard of Accounting
JPY	Japanese Yen
NBC	National Broadcasting Commission (USA)
NCFFR	National Commission on Fraudulent Financial Reporting (USA)
NSW	New South Wales
NYSE	New York Stock Exchange
POB	Public Oversight Board (USA)
PWC	PricewaterhouseCooper's
QPR	Quasi Peer Review
SA	South Australia
SEC	Securities and Exchange Commission (USA)
SPE's	Special Purpose Entities
UK	United Kingdom
USA	United States of America
USD	United States Dollar
WA	Western Australia

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## Chapter 1. Introduction

### 1.1. Background

The auditor's role in the detection of fraudulent or illegal activities has posed a continuing dilemma. In the 1980's, a lengthy period of large profits made by Bond, Skase and others, was followed by corporate collapses and subsequent findings of significant losses. Creative accounting techniques had been used to inflate end of year balances as shown by Chambers in the late 70's (Harris 2003), Barry (1990), Carroll (1990), Maher (1990) and Sykes (1989 & 1994). Why were the problems not detected earlier? What were the auditors doing?

The auditor's failure to detect major weaknesses, fraud or illegal activities in the failed corporations led to a widening of the audit expectation gap. This is the gap that exists between what auditors see as their role and what stakeholders expect. Damaging publicity arising from litigation where auditors are found negligent focuses attention on this problem. Accounting standards do not require auditors to detect concealed fraud or illegal activity in the companies being audited. As a result of CLERP 9 in Australia and Sarbannes-Oxley in the USA the financial and general community expects otherwise.

This research will focus on *AWA Ltd v Daniels Deloitte Haskins & Sells* (1992) 10 ACLR 933, which was initially heard in the Supreme Court of NSW before Rogers J. It then went on appeal as *Daniels v AWA* (1995) 13 ACLC 614 to the NSW Court of Appeal before Clarke, Sheller and Powell JJA. Godsell (1993) argues that the major implications from the AWA case for auditors and directors of audited companies are that:

- auditors have a legal duty to assess the adequacy and reliability of the client's internal control systems and must report weaknesses to management;
- auditors must ensure that the audit team have an appropriate level of expertise to deal with technical matters;

- executive directors of companies may be held liable for contributory negligence where auditors have been negligent; and
- non-executive directors have responsibility only in respect of overall policy and corporate governance.

Baxt (1992a, p.16) described the AWA decision as monumental and historic as it dealt with the issue of contributory negligence, the duties of directors, and their evaluation by the court. However, the primary issue concerned auditor's liability. Baxt noted that the auditors were not found liable in general law but with respect to duties under the corporations law. He emphasised that the cap on the auditor's liability needed urgent review. This research seeks to provide assistance in improving the detection of fraudulent or illegal activity by auditors. This should result in a subsequent reduction in audit negligence claims.

This project is especially relevant as during 2001/02 similar difficulties were still occurring. These were identified by Elias (2001, p.5) with HIH, Psaros (2001, pp.44-47) with Harris Scarfe, Riley (2002, p.5) with Enron and the recent collapse of Worldcom and HIH where the role of the auditor is also being questioned.

## **1.2. Research Objectives**

The auditing profession has been criticised for its perceived failure to detect fraud or illegal activity in major corporate collapses and in cases where auditors have been found guilty of negligence. Accounting bodies, however, argue that the ignorance and expectations of stakeholders causes the audit expectation gap, and that auditing standards state that management has the prime responsibility for detecting fraudulent or illegal activities. The responsibility of the auditor rests with the evaluation of internal controls. The accounting profession argues that the 'audit expectation gap' could be narrowed if stakeholders were made aware of the limits of the auditor's responsibility, or alternatively, if the scope of the audit was widened.

The entire AWA court transcript (including the Appeal) will be analysed in order to investigate the actions of the auditors, and the following questions will be pursued;

- did the courts, because of the auditor's personal negligence, find the auditors negligent?
- were there inherent weaknesses in the auditing requirements?
- did the auditors fail to complete the requirements of the audit program?
- did the courts consider that the auditing program itself was incomplete?
- will auditors in the future have to advise the board of directors of significant internal control weaknesses in order to avoid negligence claims?
- will auditors be required in the future to report weaknesses in writing to the directors in order to avoid being sued?
- do these research findings indicate that auditing standards or audit working papers need to be changed to accommodate reporting to directors?
- what procedures relating to audit expertise have to be tightened as a result of the AWA case?

Further, would the AWA case have been decided differently if the auditors had expressed to the directors (at the board meeting) their concerns with the internal control weaknesses in the foreign exchange operations?

### 1.3. Specific Aims

More specifically, this research aims to document the role of the auditor in a particular Australian case where the auditors were found negligent. That case was *AWA Ltd v Daniels Deloitte Haskins & Sells* (1992) 10 ACLR 933 (the AWA case) and the subsequent appeal *Daniels v AWA* (1995) 13 ACLC 614.

The specific objectives include the following:

- to discuss the audit expectation gap;

- to develop recommendations to improve the detection by auditors of fraudulent or illegal activities;
- to discuss the type of constraints that auditors face in achieving their goals;
- to examine the key factors contributing to the non-detection by auditors of fraudulent or illegal activities; and
- to suggest strategies for improvement in Australian auditing procedures by reviewing current methods of dealing with fraudulent and illegal activities within Australia and overseas.

## 1.4. Contribution to Research

There has been limited prior research, both in Australia and internationally, addressing the standard of care and responsibility required of auditors in detecting fraudulent or illegal activity. In 1992, Palmrose *et al.* found, in reviewing the literature they ‘...confronted a paucity of theoretical and empirical research specifically addressing auditors' responsibilities regarding illegal acts by clients’ (Palmrose 1992 *et al.* p.228).

In addition, most prior research in this field has concentrated on the legal aspects of these cases. This research will specifically concentrate on the auditor’s role. The research will make the following contributions to knowledge.

Firstly, it will study the major audit negligence cases in Australia from 1970 to 2000 focusing on the implications for the audit profession and the audit expectation gap. The audit expectation gap was first defined by the (AICPA 1978) Cohen Commission to refer to the difference in the perception of the auditor’s role between auditors and financial report users.

Secondly, the research will analyse the case of *AWA Ltd v Daniels Deloitte Haskins and Sells* (1992) 10 ACLR 933 and the subsequent Appeal *Daniels v AWA* (1995) 13 ACLC

614. The entire court transcript from the 51 days AWA original court proceedings and the subsequent 14 days of Appeal have not been previously researched.

This case was in the Australian courts for several years in the 1990's and is of particular importance, in that the auditors were found negligent based on matters that previously were considered by the auditing profession as not grounds for negligence.

These were:

- the auditors' failure to report internal control weaknesses to the directors at the 22nd September 1986 board meeting even though they had previously reported them to senior management;
- the auditors' failure to report internal control weaknesses to the directors at the 30th March 1987 board meeting although management and the CEO had been advised several times of weaknesses in the foreign exchange internal control procedures; and
- the rejection by the court of the auditors' argument that they were not negligent because they had complied with the minimum requirements of the accounting and auditing standards.

In this research the auditors' role in the AWA case is analysed. The AWA case was the most significant Australian audit negligence case since the landmark *Pacific Acceptance v Forsyth & Others (1970) 90 WN (NSW) 282* case. This study will investigate the actions of the auditors under the intense scrutiny of legal proceedings. In particular, the judges' assessment of the auditors' actions will be considered.

Finally, it is expected that significant recommendations will emerge to assist auditors in the detection of fraud and illegal activity and provide improved directions for regulating auditors.

## **1.5. Research Process**

The research methodology used is an examination of the entire AWA court transcript including the Appeal. This examination will concentrate on the auditor's role in the court case. It provides a unique opportunity to investigate the auditor's actions under the intense scrutiny of legal proceedings and to compare the auditor's actions against the audit expert's view of what the auditors should have done and finally what the court thought of the entire audit proceedings. The AWA case provides one of the very few recent audit legal liability cases that went through the entire court proceedings and therefore is an important addition to the study of audit negligence.

This research first analyses the literature relating to the audit expectation gap and the auditors' role in the detection of fraud or other illegal activity in the major Australian audit negligence cases. Secondly, the audit teams' actions in the AWA audit will be reviewed. These audit actions will then be compared with the audit experts' analysis of the Deloitte Haskins & Sells (DHS) audit. A summation of the courts judgment on the AWA case will then be reviewed.

Finally, the recommendations arising from this research of the AWA case will be presented and an Audit Fraud Detection Model (AFDM) will be developed within a conceptual framework.

## **1.6. Outline of the Research**

This thesis will outline the auditors' role in the AWA case, and the experts' opinions of the audit, and will provide a summation of the research findings and a series of recommendations to assist auditors in improving their detection of fraud or illegal activity.



Chapter 1 provides a brief introduction to the background of the study and the issues related to the role of the auditor in the detection of fraud or illegal activity behaviour. This chapter outlines the aims and also the more specific objectives of the study and provides the context and structure for the research by defining the broad problem associated with the issues, which are elaborated in the following chapters.

Chapter 2 will undertake a literature review including the historical trends in audit fraud or illegal activity detection. Historically, auditing evolved as a means to prevent or detect fraud or illegal activity. However, by the beginning of the twentieth century, a trend had emerged for the emphasis to be placed on financial certification rather than on the detection of fraud or illegal activity. Sikka et al. noted that Sir George. Jessell, in a testimony to the UK Select Committee on the Companies Act 1862, pointed out that ‘...the notion that any form of account will prevent fraud is quite delusive’ (Sikka et al. 1992, p.15).

Following the landmark Cohen Commission (AICPA 1978), the emphasis returned to fraud detection. In 1993, the AICPA (1993, pp.17-19) found that the Public Oversight Board (POB) must, to a greater extent than it does now, ensure that the profession accepts responsibility for fraud detection.

This trend has culminated in the 2000 exposure draft of the O'Malley Panel Report. The O'Malley Panel recommended, ‘...this new forensic-type phase should become an integral part of the audit.’ (O'Malley Panel 2000, p.88). They found that the profession needs to address vigorously the issue of fraudulent financial reporting and that auditors should perform forensic-type procedures on every audit, to enhance the prospects of detecting fraud.

Chapter 3 will link the major Australian audit negligence cases to the AWA case and the subsequent Appeal. In particular, this chapter will examine the landmark 1970 Pacific Acceptance case that is regarded as one of the most comprehensive audit judgments. The

AWA case refers to the *Pacific Acceptance v Forsyth & Others* (1970) 90 WN (NSW) 282 case, to ascertain the current standard of audit care and skill required of the auditor, and how much that standard had increased in the last hundred years.

Both Rogers J in the original AWA judgment and the Appeal judges Clarke, Sheller and Powell JJA referred to *Manning v Cory and Summer* (1974) CLC40 WAR60 and to *Van Reesema v Flavel* (1992) 10 ACLC 291 as precedents for the requirement that the accounting records must be kept on a regular basis and that AWA's foreign exchange accounting records were not so maintained.

Chapter 4 will look at the DHS (Deloitte Haskins and Sells) audit team analysis of the AWA audit. The three main audit members involved in the AWA case were Daniels the audit partner who had been involved in the AWA audit for approximately 37 years, Lloyd, the 1985/86 foreign exchange auditor and Brentnall, the foreign exchange auditor for the six month audit for the period 1-7-86 to 31-12-86.

Chapter 5 will consider and analyse the expert opinion of the AWA audit conducted by DHS. There were three audit experts (Bryant, Lonergan and Westworth) involved in the analysis of the DHS audit of the AWA foreign exchange operation. They (Lonergan Court statement 30-9-87, p.1) were contracted to examine the facts and circumstances giving rise to:

- the inaccuracies in the reported profit position of AWA as at 31st December, 1986;
- the profit or loss resulting from those (foreign exchange) activities up to the date of the departure of Korval (Korval was the AWA foreign exchange manager);
- the profit or loss, realised and unrealised, relating to the year ended 30th June 1987; and
- the role of DHS audit staff members and management in the matter.

Two of the experts were critical of the DHS audit and agreed with AWA that the auditors were negligent. The experts were Lonergan, an audit partner with Coopers & Lybrand (C&L) and Westworth, a partner with Ernst & Young (E&Y) and Bryant, who was an audit partner with Arthur Andersen (Andersen) and who was summoned by the DHS legal team. He was also critical of the DHS audit, but found that the audit was at least satisfactory in terms of compliance with the accounting standards. 'I can't imagine that one auditor out of 100 or 1000 would have decided that AWA had inadequate books and records' (Court proceedings Bryant 6-4-92, p.45). Therefore, he considered that the DHS auditors were not negligent.

Chapter 6 contains a summary of the AWA audit findings. In particular the September 1986 directors' meeting, the 6 month audit certification ending 31-12-86 and the March 1987 directors' meeting, will be analysed.

It will examine why Rogers J was critical of DHS, and in particular, of Daniels. Rogers J found that Daniels had been negligent in failing to answer specific questions from the directors at both the 22 September 1986 and 30 March 1987 directors' meetings. He reminded the audit profession, 'Whether auditors are watchdogs, or bloodhounds, or any form of canine, they cannot allow themselves to be utterly toothless' (1992 AWA judgment, p.24). He also considered Daniels' profit confirmation letter to be reckless.

Rogers J was particularly concerned with Daniels' decision to sign off on the profit confirmation letter prior to receiving all bank confirmations. He criticised Daniels for his decision '...to sign a profit statement before ever all the returns from the circularisation had arrived. This was recklessness indeed' (1995 AWA Appeal judgment Rogers J, p.648).

Chapter 7 will analyse the results of the AWA audit negligence case and the key findings for the audit profession arising from the court case. This will include the need for the

development of an Audit Fraud Detection Model (AFDM) based on key findings from the AWA case and the development of a conceptual framework.

Chapter 8 will outline the major recommendations emanating from the research divided into five key auditing areas. It will also explain the significance of the research, the limitations of the research and any area's for future research. This research will result in recommendations that are designed to assist auditors in detecting fraudulent or illegal activity. In particular, the research recommendations will concentrate on the need for the audit profession to develop a more comprehensive forensic auditing approach.

The AWA case study will include an analysis of the judgments of both courts and the reasoning used by them. The AWA judgment has had an important impact on auditing standards and accepted auditing conduct. The reasons for the rejection of the DHS argument that they had complied with all the requirements of the auditing profession will be examined.

Reviewing the relevant literature highlighted the need for a research project such as this study. The AWA case was the most significant audit negligence case in Australia since the landmark 1970 Pacific Acceptance case. The AWA appeal judges referred to the precedents set in the 1974 Manning case and the 1992 Van Reesema case and quoted from Burt J's judgment in the Manning case. Burt J found that the responsibility to maintain proper records '...is not met simply by keeping the source materials from which a set of books may be written up. The accounting records must be kept on a regular basis' (1995 AWA Appeal judgment, p.651).

The next chapter will examine the historical literature relating to the auditors' role in fraud or illegal activity deterrence and detection as well as the audit expectation gap. The major international and Australian reports will be reviewed. In particular, literature identifying the increasing importance of the auditor's detection role will be analysed. This includes the recommendations of the recent O'Malley Panel Report in the USA.

## Chapter 2. Literature Review

### 2.1 Introduction

This chapter will undertake a literature review including historical trends in audit fraud or illegal activity detection. Historically, auditing evolved as a means to prevent or detect fraud or illegal activity. However, by the beginning of the twentieth century, a trend had emerged for the emphasis to be placed on financial certification rather than on the detection of fraud or illegal activity. Sikka *et al.* noted that Sir George Jessell, in a testimony to the UK Select Committee on the Companies Act 1862, pointed out that ‘...the notion that any form of account would prevent fraud was quite delusive’ (Sikka *et al.* 1992, p.15).

Following the landmark Cohen Commission (AICPA 1978), the emphasis returned to fraud detection. In 1993, the AICPA (1993, pp.17-19) found that the Public Oversight Board (POB) must, to a greater extent than it does now, ensure that the profession accept responsibility for fraud detection.

This trend has culminated in the 2000 exposure draft of the O’Malley Panel. The O’Malley Panel recommended the ‘introduction of a forensic-type fieldwork phase’ (O’Malley Panel 2000, p.88). They found that the profession needs to address vigorously the issue of fraudulent financial reporting and that auditors should perform forensic-type procedures on every audit, to enhance the prospects of detecting fraud.

Sikka *et al.* 1992 found that the historical role of the auditor had always been the detection of fraud. By the beginning of the twentieth century, it was becoming evident that this traditional role was being superseded by the need for the auditor to certify the financial statements of the organisation. However, in the last thirty years, as a result of corporate collapses, often with evidence of fraudulent or illegal activity, there has been an

increasing call by regulatory authorities to restore the fraud detection role as the primary objective of the audit.

The recent HIH collapse has once again highlighted the role of the auditor in the detection of fraudulent or illegal activities. Elias said 'It obviously raises issues about the role of auditors, actuaries, management and the boards of companies' (Elias 2001, p.5).

Humphery et al. (1993, p.vii) argued that, although additional investigation for fraud could impact on audit fees, the public could never be educated to accept anything less than the fact that, if there was a fraud, then it was up to the auditors to find it and to disclose its existence.

George stated '...expectations of the public of the audit function far exceed the role of audit as interpreted by auditors and generally the courts' (George 2001, p.328).

However, this community perception of auditors contrasts markedly with the actual expectations of auditors. Godsell indicated that auditors believed that '...the responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal controls' (Godsell 1993, p.180).

Cohen, who was later a director of HIH, argued that the Australian auditing standards included enough qualifying language to lead some auditors to the conclusion that unless they encountered error or irregularities as part of their planned audit procedures, '...finding them [error or irregularities] is not an audit responsibility' (Cohen 1989, p.10).

Another problem facing auditors is the standard of preparation of accounts, which is often inadequate and misleading to investors and others. The recent literature identifies many examples of creative accounting including '...Tyco, Cedant, Williams Cos, PNC, Elan, Anadarko, and Cisco, who all met the attestation requirements of auditors, yet all were

found to be misleading in some way or other' (George 2002a, pp.52-53). George notes that accounting information system failure was a key reason for the failure of both Enron and HIH.

Tomasic, quoting Gay & Pound (1989), states 'The general public believes that the auditor has a responsibility for detecting all fraud, while the auditing profession believes its responsibilities are limited to planning the audit so that there is a reasonable expectation of detecting material fraud' (Tomasic et al. 2002a, p.165). This difference between the two groups leads to what has been called the 'audit fraud detection gap'.

This wide difference between the public's perceived role of the auditor and the actual role undertaken by the auditor resulted in what has been termed 'the audit expectation gap'. The Cohen Commission in 1978 first coined this term to refer to the difference in the perception of the auditor's role between financial report users and the auditors themselves.

Blair describes the expectation gap '...as a difference between what auditors do and what users of audit reports think they receive' (Blair 1990, p.39).

Sikka et al. found that the '...expectations gap is considered to be one of the major issues confronting the accountancy profession. The users of corporate reports, journalists, politicians and "significant others" expect auditors to detect and report material fraud and irregularities' (Sikka et al. 1992, p.1).

A major reason why auditors have been very reluctant to accept prime responsibility for fraud reporting is because of the potential costs flowing from litigation. The Big Four accounting firms Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers argue that a duty to report fraud would also imply a duty to detect it.

A further problem arises regarding the extra costs involved if the auditors have a legal duty to detect fraud. A survey by the UK Auditing Practices Committee (APC) found that the business community wanted the auditors to have a legal duty to detect fraud but at no additional financial cost to the business community.

This has resulted in the current situation where the issue of whether auditors are responsible for detecting fraud or illegal activity is unclear. Godsell points out that auditors have no legal duty ‘...to necessarily detect fraud, provided that the requisite standards of skill and care are observed’ (Godsell 1993, p.180).

The relevant current Australian standard is AUS210 ‘Irregularities including Fraud, Other Illegal Acts and Errors’. AUS210 emphasises that it is not the auditor's role to prevent irregularities but to exercise skill and care with respect to the planning and conduct of the audit.

However, this current neutral role of the auditor regarding fraud or illegal activity detection does not necessarily meet community or Court expectations. Even though an auditors’ adherence to auditing standards or generally accepted practices may be persuasive in legal cases, it is not necessarily conclusive evidence that an auditor has complied with the requisite standard required by the Courts.

Rogers J, in the AWA case, was critical of the audit for simply relying on the fact that they had complied with the relevant accounting standards, and that was all they needed to do. He said, ‘There is no reason to think one-way or the other that is the prevailing standard. All one knows that is the minimum standard’ (1995 AWA Appeal judgment, p.57). Godsell (1993, p.170) argues that the accounting standards should be amended as a matter of urgency to reflect the pertinent findings in Australian legal cases. Further important evidence was the 2000 O'Malley Panel Report in the USA recommending that auditors take a pro-active role in fraud detection.



Carpenter et al. (2000) note that the exposure draft of the USA Report of the Panel on Audit Effectiveness (The O'Malley Panel) reported, that auditors should be required to audit with a presumption of the possibility of management fraud. The O'Malley Panel found that the profession should address vigorously the issue of fraudulent financial reporting. Auditors should perform forensic-type procedures on every audit, to enhance the prospects of detecting fraud.

A significant forum on auditor independence was undertaken in the Australian Accounting Review in 2002. This included Hayes (2002) who provides an overview of key recommendations in the Ramsay Report. Culvenor et al. (2002) argues that the Ramsay Report has not addressed alternative solutions or assessed the substantial extra costs compared to the expected benefits. Turner et al. (2002) develops a formal model of auditor independence risk that may be used to begin a more rigorous investigation of auditor independence and various factors thought to affect this risk. Krishnemoorthy et al. (2002) findings show that audit committees should play a greater role than they currently do in ensuring financial reporting quality and enhancing auditor independence. Barkess et al. (2002) were unable to identify any instances of fee dependence impairing the independence of auditors, thus lending support to those who argue that auditors should be allowed to provide non-audit services to audit clients. Simnett et al. (2002) point out that researchers should be careful in designing research studies examining auditor independence, as any research on independence will be subject to considerable scrutiny. Schelluch et al.(2002) further explores the audit expectation gap and Gay et al. (2002) examine the different users expectations of the audit detection of fraud.

## **2.2 History of the Auditor's Role in Fraud or Illegal Activity Detection.**

### **2.2.1. Definition of Fraud or Illegal Activity**

The definition of fraud or illegal activity is interesting. In attempting to (do so), Godsell defines fraud from an Australian perspective as '...irregularities involving the use of criminal deception to obtain an unjust or illegal financial advantage' (Godsell 1993,

p.171). Ray (1996, p.8) noted that the vast majority of business transactions are conducted on the basis of trust and properly so ‘...unfortunately, trust is also the fraudster's primary vehicle’.

The Australian accounting standard relevant at the time of the AWA case was AUP16 ‘Fraud and Error’ which defined fraud as referring only to misappropriation of assets or intentional misrepresentations of financial information by one or more individuals among management, employees, or third parties. AUP16 was defensive and neither confirmed nor denied the existence of an auditor's legal responsibilities in relation to fraud and error. AUP16 defined error as an unintentional mistake in financial information.

The current Australian accounting standard AUS210 ‘Irregularities including Fraud, other Illegal Acts and Errors’ states that irregularities consist of:

- (a) fraud which is any act which involves the use of deception to obtain an illegal advantage;
- (b) other illegal acts which involve non-compliance with laws and regulations. This may, or may not, result in misstatements including omissions of amounts or other disclosures from an entity's accounting records or financial reports.

AUS210 defines error as a term referring to unintentional mistakes in financial information.

The USA Accounting Standard SAS82 ‘Consideration of Fraud in a Financial Statement Audit’ found that there are two types of misstatements relevant to a financial statement audit:

1. Misstatements resulting from fraudulent financial reporting. This type of fraud is usually committed by management to deceive financial statement users and may be concealed by falsifying or forging documents, or through collusion among management, employees or third parties.

2. Misstatements resulting from misappropriation of assets. This type of fraud involves the theft of an entity's assets, most often by employees, and can be accomplished in ways such as embezzling cash, stealing or misusing assets, and causing an entity to pay for goods or services not received.

The primary factor that differentiates fraud from error is whether the underlying action that results in the financial statement being inaccurate is intentional or unintentional.

The UK accounting standard, SAS110 'Fraud and Error', states that there is no precise legal definition of fraud. This standard states that it is up to the court to determine, in any particular instance, whether fraud has occurred. However, for the purpose of practicality, the accounting standard defines fraud as comprising both the use of deception to obtain an unjust or illegal financial advantage, and intentional misrepresentations which affect the financial statements and which are made by one or more individuals.

Irregularities, in SAS 110, are defined as:

- any other intentional misstatements in, or the omission of amounts or disclosures from, an entity's accounting records or financial statements', and
- theft, whether or not accompanied by misstatements of accounting records or financial statements.

Error, in SAS110, is defined as '...unintentional mistakes in, or omissions of amounts or disclosures from an entity's accounting records or financial statements'.

The current ISA 240 'Fraud and Error' defines fraud as '...an intentional act by one or more individuals among management, employees, or third parties, when it results in a misrepresentation in financial statements'.

ISA 240 states that fraud can involve:

- manipulation, falsification, or alteration of records or documents;
- misappropriation of assets;
- suppression or omission of the effects of transactions from records or documents;
- recording of transactions without substance; and
- misapplication of accounting policies.

ISA 240 defines error as unintentional mistakes in financial statements, such as:

- mathematical or clerical mistakes in the underlying records and accounting data;
- oversight or misinterpretation of facts; and
- misapplication of accounting policies.

Finally, ISA 240 defines misstatement as a mistake in financial information, when it arises from error or fraud.

Young (2000, p.4) found that a distinction could be drawn between an irregularity and fraud. An irregularity consists of an intentional misstatement in financial statements. However, an irregularity evolves into fraud only when those financial statements are shown to another who then justifiably relies on them to their detriment. However, he found that, in common parlance, the terms were used interchangeably.

### **2.2.2. Historical Trends in Audit Fraud or Illegal Activity Detection.**

An auditor is required to report instances of fraud or irregularities to management. The question is what should the auditor do if management fails to then take appropriate action to remedy the situation? Harding, the President of the International Federation of Accountants, questioned ‘...is it realistic or reasonable to place this burden on members of the accounting profession?’ (Harding 1999, p.6).

International, and particularly UK decisions, have had a major impact on the development of the Australian auditors' role in the detection of fraud or illegal activity. The UK experience is particularly important, because we have relied on the precedent set by their cases in developing our own audit negligence decisions.

Fraud detection was originally the prime objective of the audit. The origins of auditing can be traced back to Greek, Egyptian and earlier civilisations where preventing or detecting fraud or illegal activity was the prime purpose of an audit.

Early European experience with auditors also suggests that audits were primarily associated with the discovery of fraud or illegal activity. Sikka *et al.* note that one of the earliest British mentions of auditors was in a Statute of Edward 1 in 1285. This stated that '...by the testimony of the auditors of the same Account, shall be sent or delivered unto the next Gaol of the King's in those Parts' (Sikka et al. 1992, p.11). This indicates not only that the main aim of these early audits was the detection of fraud, but also that the testimony of the auditor was subsequently being used to imprison the fraudster.

The audit of the City of Pisa in 1394 was also designed to test for fraudulent or illegal activity and '...accuracy was sought in most of these cases, but only insofar as it might indicate the existence of fraud' (Sikka et al. 1992, p.11).

By the sixteenth century, auditors began to be more widely referred to and '...auditors began to be mentioned in Shakespearean plays (e.g. Macbeth, Henry 1V, Henry V111, Hamlet, Coriolanus)' (Sikka et al. 1992, p.11). By the beginning of the Industrial Revolution in 1500, '...audit objectives were still directed to detection of fraud' (Sikka et al. 1992, p.11).

During the first half of the nineteenth century, the audit comprised a comparatively minor element of the work of accountants. Sikka noted that there were few auditors and those few were hired to carry out procedures '...which equated audits with fraud detection' (Sikka et al. 1992, p.12).

The first UK Companies Act in 1844 did not require auditors to be independent, and frequently the auditor was selected from amongst the shareholders. The Building Societies Act of 1874 required the Society's rules to have provisions for an audit but these were not compulsory and professional accountants were not used.

An enormous boost for auditors came from the large increase in limited liability companies in the second half of the 19th century. The UK Companies Act of 1879 made audits compulsory for all banking companies registered as 'limited'. As a result of this Act '...out of 159 banks, 128 appointed auditors' (Sikka et al. 1992, p.13).

Compulsion was also an important feature of the 1879 Act. Cooper in 1886 had noted that the close connection between the non-compulsory need for audits of building societies '...and the frequent disclosure of frauds on Building Societies is significant' (Sikka et al. 1992, p.13).

The emerging auditing profession still relied on the detection of frauds as their primary reason for existence. The courts confirmed this. In *Nicols Case (1859) 3 De G & J 387 and 441*, Lord Justice Turner found that auditors had a common law duty to detect fraud. He noted that '...the false and fraudulent representations were discoverable by them' (Sikka et al. 1992, p.14).

Dicksee (Sikka et al. 1992, p.14) who was described as the most influential nineteenth century accountant, argued that the objectives of the audit were:

- the detection of fraud;
- the detection of technical errors; and
- the detection of errors in principle.

By the middle of the nineteenth century, there was doubt arising as to the validity of the auditor's role in the detection of fraud. Sikka noted that in the UK, Sir George Jessel, in

a testimony to the Select Committee on the Companies Act 1862, pointed out that ‘...the notion that any form of account will prevent fraud is quite delusive’ (Sikka et al. 1992, p.15).

Around the beginning of the twentieth century, there had been an obvious shift in the auditor’s role. In the UK, Robertson in 1897 found that the ‘...prime aim had shifted to whether the balance sheet exhibited a true statement of the assets and liabilities of the company’ (Sikka et al. 1992, p.15). He found that fraud detection was now only a secondary aim.

Auditors also began to argue, with the help of court judgments, that they should not be held responsible when frauds or defalcations escaped detection. In *London and General Bank (No.2) (1895) 2 Ch.673*, Lord Justice Lindley argued that the duty of an auditor was not to detect all fraud and error because ‘...if he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part, say, by the fraudulent concealment of a book from him. His obligation is not as onerous as this’ (Sikka et al. 1992, p.15).

In *Kingston Cotton Mills Ltd (1896) 2 Ch. D. 279*, Lord Justice Lopes found that “...auditors must not be made liable for not tracking out [sic] ingenious and carefully laid schemes of fraud where there is nothing to arouse their suspicion” (Sikka et al. 1992, p.14). Montgomery’s book on auditing was published in the USA in 1912 (Sikka et al. 1992, p.14) and it argued that the detection of fraud or errors had become of secondary importance and that ‘...the relative position of the present-day purposes is: to [firstly] ascertain actual financial condition and earnings of an enterprise and [secondly] to detect fraud or errors’ (Sikka et al. 1992, p.14). However, this finding contrasted with the U.S. public’s attitude, which saw fraud as endemic and detection and prevention as the primary audit function.

Sikka noted that the USA Accounting Series Release No.19 in 1940, released by the United States Securities and Exchange Commission (SEC), argued that the failure to discover fraud was still of prime importance and the ‘...discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that it might not disclose every minor defalcation’ (Sikka et al. 1992, p.16).

This contrasted with the view expressed by professional literature from the 1940s onwards, this was that fraud detection had become the secondary audit objective. However, this did not change the minds of the general public who still believed that the auditor’s primary role was to look for fraud and irregularities. As recently as 1993, (Humphery et al. 1993) found that 86% of financial report users felt that the auditor's role should include a primary responsibility for the detection of fraud or illegal activity.

In the 1970's, a spate of corporate collapses in the UK led to a questioning of the auditors’ failure to detect or report fraud. The 1980's election of the Thatcher government resulted in political, social and economic factors combining to create an environment for the re-emergence of fraud detection/reporting as the major purpose of the audit. Government policy had been tested by revelations of a surge in reported ‘white-collar’ crimes, which included a major reinsurance fraud at Lloyd's Bank in London. The Thatcher government was concerned that these frauds ‘...threatened the position of London...’ (Sikka et al. 1992, p.16) as a major financial centre.

In 1985, (Sikka et al. 1992, p.22) the Institute of Chartered Accountants in England and Wales (ICAEW) presented a report under the chair of Ian Hay Davison, which emphasised management's responsibility for preventing fraud and argued that auditors should have a statutory responsibility to report on the adequacy of internal controls. The Davison Report rejected any statutory duty for the auditor not only to detect, but also to report, fraud. It found that it would be wrong to legislate to require auditors to report such suspicions of fraud to the authorities.



The 1986 Report by Lord Benson favoured no change in the auditor's role and argued that fraud detection was management's responsibility. The accounting profession agreed and argued that '...a duty to report fraud would imply a duty to detect it.' (Sikka et al. 1992, p.24). They saw a duty to report fraud as a threat to the traditional client-auditor relationship.

The accounting professionals opposed imposition of any duty to report fraud by pointing to the absence of any agreed definition of fraud. The major accounting firms were concerned that legislative regulation resulting in a duty to report fraud would lead to an implication that the auditor then had a duty to also detect fraud.

However, this audit concern may not be sufficient to prevent fraud detection again becoming the primary role of the auditor. The United States Treadway Report (AICPA 1987), the MacDonald Report (CICA 1988) and the Public Oversight Board Report (POB 1993) have all decried the growing cost of fraudulent financial reporting. The Public Oversight Board found that '...to a greater extent than it does now, the profession must accept responsibility for fraud detection' (POB 1993, p.42).

The concerns of the auditing profession were further magnified when, in October 1998, at the request of Chairman Arthur Levitt of the United States Securities and Exchange Commission (SEC), a further study on audit fraud detection as the primary function of the audit was commenced. Carpenter (2000) stated that the O'Malley Panel reported that auditors should be required to include in their audit-planning program a forensic-type fieldwork phase '...to improve the likelihood that auditors will detect fraudulent financial reporting' (O'Malley Panel 2000, p.75). The O'Malley Panel found that the audit profession would have to address vigorously the issue of fraudulent financial reporting in the future.

### **2.2.3. The Audit Expectation Gap**

#### *2.2.3.1. The Importance of the Gap*

It is not surprising that the audit expectation gap is of so much importance. Fraud has become a major factor in current business operations.

An Irish study by Divilly (1995) found that 40% of companies admitted to having been victims of fraud and over 60% believed that the incidence of fraud in Ireland would increase over the coming year.

A later English study by Peterson (2001, p.1) reported that a 1999 survey by KPMG found that 83% of companies suffered fraud, 75% of this fraud was by employees and 48% resulted from a collusion by employees and a third party. Peterson also noted that in 2001, PricewaterhouseCoopers (PWC) fraud investigation department found that the real cost of fraud, globally, was in excess of GBP 20 billion.

Shareholders question why the auditors don't detect these frauds as part of their audit program. Divilly reported that '...poor internal controls, the nature of the industry and collusion between employees and third parties are often the main reasons why fraud occurs' (Divilly 1995, p.19).

#### *2.2.3.2 Measures to Reduce the Audit Expectation Gap*

Divilly found that the most pro-active means of fraud prevention is the '...review and improvement of internal controls' (Divilly 1995, p.21). One of the major difficulties for the elimination or reduction of the audit expectation gap is that in relation to fraud prevention, detection and reporting there is a wide divergence between the expectation of audit users and auditors.

A UK study by Humphery et al. (1993) found that only 43% of accountants felt that the auditor's role involved the detection of fraud or illegal activity. Of the auditors surveyed, 60% agreed, compared with 62% of financial directors. However, 86% of financial report users saw it as the auditor's role.

A South African study by Gloeck et al. (1993) found that auditors accepted little responsibility for the detection of fraud. The research found that more than half (57.8%) of the auditors surveyed felt that the financial report users held a different view. Beasley *et al.* (2000a, p.449) reported that the 1987 Report of the National Commission on Fraudulent Financial Reporting (NCFRR) stated that 13% of the cases against public companies involved misappropriation of assets.

The public expects company auditors to take primary responsibility for detecting fraud. However, the auditing profession argues that primary responsibility for fraud detection lies with management.

A report (Audit Office NSW 1994), on fraud and control, highlighted the auditor's role in testing internal control systems and recommending improvements. This report saw the auditor's role as helping prevent fraud or illegal activities by maintaining surveillance over the effectiveness of internal control systems, rather than by detection.

Sikka et al. (1992, p.1), found that the audit expectation gap is one of the major issues confronting the accounting profession. The users of corporate reports, journalists, politicians and many others, expect auditors to detect and report material fraud and irregularities. This contrasts with the audit profession who would argue that fraud detection and reporting is not the major objective of the audit.

Sikka believes that because of the socially contested nature of auditing, the audit expectation gap cannot be eliminated. He argued that only if all the stakeholders agreed on a single meaning of auditing, could this occur because even ‘...though well directed

efforts to reduce the expectations gap may meet with some success, competing meanings of audits will always exist' (Sikka et al. 1992, p.26).

In the USA, the profession is now slowly embracing the responsibility to detect fraud. The USA Accounting Standard SAS 82 requires auditors to specifically address the risk of fraud on a financial statement audit and to respond appropriately. Braun found that 'SAS 82 requires that auditors specifically assess the risk of material misstatement of the financial statements due to fraud' (Braun et al. 2001, p.45).

Bernardi (1994 p.84) found three main issues confronting auditors in detecting fraud. They were:

- auditors don't normally change their audit program, even when they have knowledge of a client's lack of integrity or competence;
- audit managers normally outperform seniors in fraud detection, this suggests that the more experienced an auditor, the greater the likelihood of fraud detection; and
- detection increased directly with an auditor's prior experience in fraudulent audit cases. Again, this suggests that an auditor who has, at the least, practical (on the job) forensic training, will have a greater chance of detecting an actual fraud.

This confirmed the work of Reckers et al. (1993) who found that individual auditors were not more cautious when the potential for fraud is higher. This finding conflicts with auditing literature, auditing standards and public expectations. These assume that the auditor's perception of client integrity should affect the auditor's actions.

Davidson, of Ernst & Young's Forensic and Litigation Accounting Group (FLAG), confirmed Bernardi's findings and raised the importance of the supervisory issue. Audit firms need to be aware of '...a need to rectify the typical audit situation in which the

people who do the work don't have the experience and the people who have the experience don't do the work' (Davidson 1994, p.89).

Davidson also suggests that auditors should spend some time in a forensic practice to increase their sensitivity to client integrity and competence. The O'Malley Panel recommended that training programs should include case examples of how defalcations might be effected, and also that using auditors '...with forensic audit backgrounds to assist in this training would be beneficial' (O'Malley Panel 2000, p.93).

In 1990, Wright (p.273) found that auditors viewed the evaluation of client integrity and competence as one of the most difficult steps in the audit process.

Sullivan (1993, p.91), the Chairman of the US Auditing Standards Board (ASB) found that there were two basic approaches to improving fraud detection by auditors. They were

- a frontal assault involving larger audit samples and more detailed tests. This would require a significant increase in the cost and time needed to complete the audit; and
- an approach 'from the side' involving auditors being smarter about fraud detection. This would require more investment in auditor training and in improved decision aids. Auditors would need to have a better understanding of a client's business and the industry. This would lead to an improvement in an auditor's position to detect fraudulent details buried in financial records.

Pincus suggests a third approach. The industry should focus on recruiting auditors better suited to fraud detection tasks. She suggests that auditors should be selected from those with an increased sensitivity to potential 'red flags'. She called this '...an individual differences approach' (Pincus 1994, p.91).

The O'Malley Panel (2000, p.86) noted that their own research suggests auditors do not always pursue sufficiently conditions discovered during an audit or corroborate management representations made to them. The term 'red flags' is sometimes used to describe these conditions but is often used in a pejorative way to imply an auditors' failure to pursue the obvious. The O'Malley Panel recognized that what might appear obvious in hindsight is not always obvious at the time and accordingly avoided use of the term. However, it is a term commonly used by the audit profession.

The 1999 Committee of Sponsoring Organisations of the Treadway Commission Report (COSO) disclosed that there was a significant number of financial statement frauds in which senior management were involved. This was because management were in a key position to manipulate financial statement results, if they were so inclined. Treadway (AICPA 1987) noted that in 72% of the fraud cases reviewed, the CEO was implicated and in 43% of the cases, the chief financial officer was associated with the financial statement fraud.

The then Irish President of the Institute of Certified Public Accountants, Dennis J. Ryan, agreed that some change was necessary to restore public confidence in the audit profession '...and in the independence and relevance of the audit function' (Ryan 2000, p.1).

## **2.3. Significant Reports on Audit Fraud Detection**

### **2.3.1. The Cohen Commission**

The Cohen Commission (AICPA 1978) in the USA, first coined the term 'audit expectation gap' to refer to the difference between auditors and financial report users in the perception of the auditor's role. Cohen's Report commented on the standard of fraud detection and sought to improve the effectiveness of independent auditors. Their recommendations included:

- in planning and conducting the audit, taking account of unusual circumstances or relationships that may predispose management to commit fraud, and being prepared to extend the audit procedures or take other necessary steps;
- increasing the standard of professional skill and care required in the study and evaluation of controls that bear significantly on the prevention and detection of fraud;
- reporting material weaknesses to the proper level of management, even to the audit committee or the full board, and following up reports to determine whether the weaknesses have been eliminated; and
- developing and disseminating up-to-date information on detecting, perpetrating and concealing fraud.

### **2.3.2. UK Fraud Detection Reports**

In the UK, there have been several important reports into the problem of fraud detection. In 1984 the Roskill Committee (Sikka et al. 1992, p.23) considered the conduct of criminal proceedings arising from corporate fraud and the improvements that could be made. The Davison Committee commissioned by the UK accounting bodies in 1985 consisted of a working party on fraud.

Sikka noted that, in 1986, the ICAEW established the Benson Committee under the chairmanship of Lord Benson to examine the auditor's role in reporting fraud. The findings '...argued that fraud detection was the management's responsibility' (Sikka et al. 1992, p.23). The Committee also analysed the issues for auditors reporting suspected fraud, these included the purpose, scope, and nature of their auditors' report, and considered the case for amending the accounting bodies' guidelines and for changes in the auditor's duties.

The UK Cadbury Committee recommended legislation to protect auditors who reported ‘...reasonable suspicions of fraud to the appropriate investigatory authorities’ (Sikka et al. 1992, p.56).

### **2.3.3. The Treadway Commission**

The Treadway Commission in the USA (AICPA 1987) recommended that auditors be required to assess the risk of fraudulent financial reporting when planning and conducting audits. It developed a set of procedures called the Good Practices Guidelines for Assessing the Risk of Fraudulent Financial Reporting. The guidelines, in providing insight into the causes of fraudulent financial reporting, concentrated on the environment and pointed to the wide range of factors that can influence it.

Treadway recommended that in each audit, the auditor take affirmative steps to assess the potential for fraud and to then design relevant tests to provide reasonable assurance of fraud or illegal activity detection.

### **2.3.4. The MacDonald Commission**

The MacDonald Commission in Canada (CICA 1988) investigated the detection of fraudulent or illegal activities by auditors. They drew attention to:

- the way in which the possibility of fraud should affect the planning and performance of audits;
- the significance of fraud for financial statements, and the auditors’ responsibility to report all frauds discovered to the audit committee or board of directors; and
- the way in which financial reporting and the auditors’ responsibilities are affected by the illegal activities engaged in by the client.



### **2.3.5. The 1993 POB Report**

The 1993 Public Oversight Board (POB) report in the USA recommended that guidelines should be developed to assist auditors in assessing the likelihood that management are involved in fraud. These guidelines should also specify additional auditing procedures where an auditor finds evidence indicating the possibility of management fraud.

### **2.3.6. The Big Six Paper, 1993**

The USA report (Big Six Paper 1993), by the Big Six auditing firms recommended that management, attorneys, other advisers and regulators be required to inform the auditor of suspected financial fraud or manipulation.

### **2.3.7. Australian Study on Financial Reporting and Auditing**

In 1993, an Australian accounting research study into bridging the expectation gap (ASCPA & ICAA 1994) was commenced. Its purpose was to investigate financial reporting and the audit expectation gap in Australia. It also looked at their relationship with the current accounting standards.

The preliminary recommendations of the task force were completed in 1994 and included the finding that the professional requirements regarding the auditor's responsibility for the detection and reporting of fraud, were adequate. However it suggested that the accounting bodies should be more pro-active in advising the community of that responsibility. The task force also found that the accounting bodies should seek the support of other parties such as management, solicitors, other advisers and regulators to inform auditors of suspected fraud or manipulation.

The final report from this study was presented in a June (ASCPA & ICAA 1996) paper titled 'Beyond the Gap'. The major recommendations of this study were classified into

three categories. The recommendations particularly relevant to this current research study were in corporate governance, financial reporting and auditing.

The recommendations were:

**(a) Corporate Governance**

- to promote the development of a Management Responsibility Statement outlining both the need for a sound internal control system, and, also the value of an internal audit department;
- to enhance the disciplinary process of the accounting bodies by undertaking immediate reviews of any entity failures;
- to place responsibility for the appointment, removal and remuneration of auditors with the audit committee;
- to disclose the reasons for the resignation to ASIC and, to the auditor when directors resign; and
- to require directors to ensure that audit tenders provide sufficient resources to undertake a comprehensive audit. Directors should not accept lower tenders where the price will not be adequate to allow full audit testing to be undertaken. They should also ensure that there is appropriate liaison between the internal and external audits;

**(b) Financial Reporting**

- the recommendation was to increase the understanding of shareholders who are the primary users of the financial reports; and

**(c) Auditing**

- to allow auditors to provide additional services because the Task Force found that the provision of non-audit services contributed to the auditor's knowledge of the business;
- to give the audit complete independence and ensure that the auditor receive all board agenda papers and minutes and has the right to attend all board and

audit committee meetings where there is any issue that the audit believes should be put before the board;

- to ensure that regulators promptly advise the audit of any current investigations relating to the business being audited;
- to include an audit committee in all organisations and to ensure that audit committees are mandatory for all listed companies and 'best practice', for other reporting entities; and
- to ensure that Corporations Law require all directors and staff to inform the auditor of suspected fraud or manipulation.

#### **2.3.8. 1999 Committee of Sponsoring Organisations of the Treadway Committee Study (COSO)**

A Study released in March (COSO, 1999) in the USA analysed approximately 200 SEC financial statement fraud actions brought against public companies from 1987 to 1997. Beasley et al. note that, by understanding this fraud profile and addressing the issues with management, '...auditors can reduce possible exposure to fraudulent financial reporting' (Beasley et al. 2000b, p.16).

The study found these common indicators in the fraud profile.

- a substantial number of frauds included illegal transactions perpetrated as end of period adjustments or by the use of non-standard entries;
- twenty five percent of the companies involved did not have an audit committee;
- many of those with audit committees did not have any directors with relevant financial experience;
- sixty percent of board members lacked independence because they had close ties to the company;
- directors were often inexperienced with forty percent of companies having boards with no previous directorial experience;

- forty percent of fraudulent companies came from just four industries; computer hardware, computer software, health care and financial services; and
- directors/senior officers owned up to a third of the companies shares. Some were experiencing net losses and many were only breaking even. There was evidence that share market pressures may have provided the incentive for fraud.

### **2.3.9. The O'Malley Panel Report 2000**

The US Securities Exchange Commission (SEC) had become particularly concerned about the increasing trend for companies who, failing to meet projected earnings were coming under unprecedented pressure to 'make the numbers'. The SEC used the term 'earnings management' to describe this manipulation of financial results and it was concerned that earnings management could sometimes lead to, or constitute, fraud.

In October 1998, at the request of Chairman Arthur Levitt of the SEC, the POB established the Panel on Audit Effectiveness under the chair of Shaun O'Malley, a former chairman of PWC. The O'Malley Panel conducted a comprehensive review and evaluation of the way independent audits of financial statements of publicly traded companies were performed. It also assessed the effects of recent trends in auditing on the quality of audits and on the public interest.

The O'Malley Panel endeavoured to reach its own independent judgment about the current state of auditing and the adequacy of the existing self-regulatory process. Kirk noted that the O'Malley Panel's brief was wide-ranging, but slightly less ambitious and more focused on audit methodology than the significant findings of the Cohen Commission had been '...21 years ago the work of the Cohen Commission resulted in a landmark study' (Kirk 2000, p.105).

On 31<sup>st</sup> of August 2000, the O'Malley Panel issued its Report and Recommendations. The O'Malley Panel had analysed comments received from organisations and individuals

who had testified during the two days of public hearings or who had submitted letters or comments. The timetable for review and assessment of the O'Malley Panel Report was originally September 15, 2001. However, this time-line was extended by a year to September 15, 2002.

The O'Malley Panel believed that the audit profession needed to address vigorously the issue of fraudulent financial reporting. This included fraud, in the form of illegitimate earnings management. It was concerned that auditors were not requiring as much evidence to achieve reasonable assurance as they had in the past, especially in areas where they believed risk to be low.

The O'Malley Panel noted that many frauds could have been detected by the use of retrospective auditing procedures, and that fraudulent or illegal activity was often concealed through non-standard entries or processed in interim financial periods.

It was concerned that auditors should serve an important role in detecting material financial statement fraud. Auditors cannot be a substitute for the enforcement of high standards of conduct by management, boards of directors and audit committees, but they can be an important factor in promoting high standards. In particular, the O'Malley Panel was interested in the auditor working with the audit committee to assess the strength of management's commitment to a culture of intolerance for improper conduct.

Of over 250 O'Malley Panel recommendations, three in relation to earnings management and fraud were drawn on by this current research study. As adapted by this research they were:

- the need for a forensic type fieldwork phase;
- increased auditor scepticism; and
- higher quality audits.

### *2.3.9.1 Forensic-Type Fieldwork Phase*

The first recommendation was that a forensic-type fieldwork phase should be introduced into the auditing process. The O'Malley Panel was concerned that current auditing standards fell short in effectively deterring fraud or significantly decreasing the likelihood that the auditor would detect material fraud '...largely because it fails to direct auditing procedures specifically towards fraud detection' (O'Malley Panel 2000, p.86).

#### *2.3.9.1.1 Rationale for Forensic-Type Fieldwork Phase*

In the recent corporate collapses at Enron, Worldcom and HIH, there was significant evidence of the failure of the auditors to detect significant illegal activities in these organisations. The public and the financial community are asking what measures the audit profession is taking to rectify audit failures in the future.

A sound starting point would be the implementation of the O'Malley Panel recommendations which include a forensic-type fieldwork phase to improve the likelihood that auditors will detect fraudulent financial reporting and to '...provide guidance to auditors on the detection of fraud' (O'Malley Panel 2000, p.75). This would represent a positive response to the current 'audit expectation gap' problem. It would provide the audit profession with the tools necessary to turn around the current low image of the auditor and to act as an effective future deterrent to fraudulent or illegal activity by management or corporations.

The O'Malley Panel acknowledged an increase in the time and cost involved in undertaking the forensic phase of the audit. When they acknowledged the question of the extra cost and time required, a number of respondents to the exposure draft suggested that it '...would result in numerous, extensive and unnecessary or ineffective procedures,...' (O'Malley Panel 2000, p.95). Members of the accounting profession were critical of the Panel's failure to quantify the extra costs and time required. Mike Conway from KPMG told the Panel hearing that they could have done a better job on the cost side and that 'the

marketplace is out there and it's a cost benefit relationship' (Panel Hearing July 2000, p.94).

The O'Malley Panel rejected the idea of a full fraud audit. It found that '...converting GAAS audits to fraud audits would involve costs far in excess of the foreseeable benefits to the public' (O'Malley Panel 2000, p.76). It therefore decided to set the standard at a reasonable level because 'to raise the level of assurance from that of reasonable to a higher standard, such as high or virtually certain' (O'Malley Panel 2000, p.85) would result in excessive costs and unreasonable expectations. The introduction of a forensic-type phase in all audits would provide this reasonable level without any significant increase in cost.

The O'Malley Panel recognised that implementing this recommendation would '...increase audit costs for most entities' (O'Malley Panel 2000, pp.7-8). However, the O'Malley Panel expected that those entities would attempt to analyse the benefits, which outweigh the costs of the forensic-type phase. For example, the SEC reported that in 1999 audit fees were USD 9.5 billion whilst NBC reported that in 1999 investors lost USD 32 billion as a result of the restatement of financial restatements, which is a revised financial statement figure (usually at a substantially lower profit figure) that accompanies a recalculation after the previous audited financial statement profit figure had been released.

As a direct consequence of the collapses of Enron/Worldcom, the USA has now instituted regulations making the CEO responsible for the accuracy of the financial statements. The penalties for failure to comply include a jail sentence. As a result of this increased responsibility on the CEO, IASB chairman Sir David Tweedie predicted: 'I wouldn't be surprised if the extent of the audit was hugely extended in the United States as a result of recent US developments' (Ravlic 2002, p.81). Therefore, the additional costs involved in implementing '...the O'Malley Panel's forensic audit phase...' (O'Malley Panel 2000,

p.88) in all audits, should be examined in the context of the current need for a more comprehensive, and therefore more expensive, audit program.

The O'Malley Panel (2000, p.88) felt that the introduction of a '...forensic-type fieldwork phase...' should become an integral part of every audit. A forensic-type fieldwork phase '...seeks to convey an attitudinal shift in the auditor's degree of skepticism' (2000, p.88). They were concerned that auditors were not currently questioning management sufficiently.

It believed that auditors should accept greater responsibility for fraud detection. Even though the introduction of a forensic phase would not mean that the auditor would be performing a fraud audit, this may not be readily apparent to the investor community. The addition of a forensic-type fieldwork phase might result in the community assuming that auditors would then detect all fraud or illegal activity. A failure to reach this high level may actually increase the audit expectation gap if the investing community is not educated on the limitations of a forensic audit phase.

However, the O'Malley Panel concluded that the auditor is best placed to assess management's preventative and detection controls over fraud and that this is an important consideration in deciding on the nature and extent of testing in the forensic-type phase. Auditors are best able to consider whether the controls deal with fraudulent financial reporting as opposed to, for example, misappropriation of assets or illegal acts only indirectly related to financial statements.

#### *2.3.9.2 Auditor Scepticism*

The second recommendation related to audit scepticism. The O'Malley Panel was concerned that even though professional scepticism was already a part of the auditing standards, '...but auditing standards need to provide better guidance on how to implement that concept' (O'Malley Panel 2000, p.85).



The O'Malley Panel agreed that the premise of professional scepticism should continue to be based on an assumption that management was neither honest nor dishonest. However, the O'Malley Panel argued that '...the auditor should modify the otherwise "neutral" concept of professional skepticism...' (O'Malley Panel 2000, p.91) and replace it with a presumption of the possibility of management fraud during the initial forensic audit phase. All companies are vulnerable to financial statement fraud. Therefore, the auditor should initially assess the magnitude of an organisation's vulnerability to perpetrate fraud.

#### *2.3.9.2.1 Rationale for Auditors' Scepticism*

The O'Malley Panel noted that the objectives in an audit should include detecting material financial statement fraud, to drive both auditing standards and the way they are applied, and 'By meeting that objective, audits will serve to deter fraud as well as detect it' (O'Malley Panel 2000, p.82).

It is important to note that the O'Malley Panel (2000, p.85) found that auditors interviewed in focus groups '...expressed uncertainty about their responsibility to detect fraud' and that auditors were uncertain about their ability to detect fraud, especially collusive activities or falsified documentation. However, while auditors expressed knowledge of forensic auditing techniques, '...no evidence pointed to any significant use of such techniques in GAAS audits' (O'Malley Panel 2000, p.85).

Auditing standards often do not provide sufficient guidance-nor does GAAS provide the information to implement the concept of professional scepticism adequately. This is because management is judged as usually possessing integrity, despite the fact that management has the most opportunity to perpetrate fraudulent financial reporting if lacking integrity. GAAS dismisses collusion as impossible (or too difficult) to detect and pointedly explains the lack of expertise of auditors with respect to determining the authenticity of documents.

The O'Malley Panel acknowledged that these factors were, and have continued to be, inherent limitations of an audit. It found that all or most financial reporting frauds involved collusion and many involved falsified documentation. It was concerned that auditors '...do not appear to place any special emphasis on the areas where the risk of misappropriation of assets is considered significant' (O'Malley Panel 2000, p. 87). However, the O'Malley Panel recognised that the primary responsibility for the prevention and detection of fraud rests with management, boards of directors and audit committees. So management should create a culture that deters fraud and should set, and communicate, clear corporate policies against improper conduct. The O'Malley Panel (2000, p.83) found that 'auditors serve an important role in detecting material financial statement fraud'.

#### *2.3.9.3 High-Quality Audits*

The O'Malley Panel (2000, p.82) recommended that audit firms should put more emphasis on the performance of high-quality audits in communications from top management, performance evaluations, training and compensation and promotion decisions. They wanted audit firms to '...aspire to "zero defects" as their goal and endeavour to eliminate audit failures completely'.

They also pointed out that high-quality audits should include more emphasis on (a) retrospective audit procedures, (b) investigation of non-standard entries, (c) audit control of interim periods and (d) liaison with audit committees.

##### *2.3.9.3.1 Rationale for High-Quality Audits*

The O'Malley Panel points out that aspiring to zero defects does not suggest there would not be an undetected material financial statement fraud. This is because the standard of responsibility for auditors is that of reasonable assurance, not absolute assurance.

#### 2.3.9.3.2 Retrospective Audit Procedures

The O'Malley Panel recommended that the ASB, as part of its requirement of a forensic phase for fieldwork, should require the use of retrospective audit procedures. In these, auditors would assess how various issues involving accounting estimates and judgments were resolved in previously issued financial statements.

The O'Malley Panel recommended the introduction of retrospective audit procedures requiring an analysis of selected opening balance sheet accounts of the previously audited financial statement. This retrospective review and testing of previously audited accounts '...is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud...' (O'Malley Panel 2000, p.91). This retrospective audit approach could be incorporated into the pre-audit program normally incorporated into every audit.

#### 2.3.9.3.3 Non-Standard Entries

The O'Malley Panel (2000, p.83) noted that the term 'non-standard entries' was not defined precisely but that the term is used commonly by accountants to describe financial statement changes initiated by management when these are not routine and not associated with the routine processing of transactions.

The auditor undertaking the retrospective audit phase should investigate non-standard entries. A Quasi Peer Review (QPR) considers non-standard entries. This is a matter related to the issue of fraudulent financial reporting and to the current adequacy of audit tests to address the possibility of its (non-standard entries) occurrence.

The O'Malley Panel found that in about fifteen percent of engagements, auditors had an inadequate understanding of a client's system for preparing, processing and approving non-standard entries. Furthermore, in about 31% of the engagements reviewed, the auditors did not perform procedures to identify and review non-standard entries.

#### 2.3.9.3.4 Interim Period Reports

Auditing procedures should also concentrate on interim period reports, in which many frauds are initiated. The main reason for this is that management can influence the timing of the execution of some transactions, and their recording in the accounts. This would highlight the importance of tests for transaction cut-off dates, especially at the end of quarterly or annual periods.

The Panel provided recommendations to the ASB for specific guidance for the application of procedures in interim periods using a forensic-type approach. It provided guidance on how forensic audit procedures could be addressed in interim periods and how they ‘...may be useful as “continuous auditing” techniques to improve full-year audits’ (O’Malley Panel 2000, p.92).

O’Malley recommended the provision of criteria in reviews of interim financial information where there was a high degree of subjectivity, complex accounting standards and related party transactions, and in areas where controls were particularly susceptible to override.

It also provided guidance to the ASB regarding procedures employed in interim periods to address the potential for fraud in financial reporting. These procedures would act as continuous auditing techniques to improve full-year audits. It encouraged the ASB to research and address concepts of continuous auditing in furtherance of a more effective audit model.

#### 2.3.9.3.5 Audit Committees

O’Malley noted that audit committees rarely addressed the potential for management to commit financial statement fraud or to request auditors to perform specific tests to detect that possibility. They recommended that audit firms should be required to discuss with

audit committees an entity's vulnerability to financial reporting fraud and exposure to asset misappropriation.

They suggested that auditors also needed to consider the likelihood that internal controls actually serve to inhibit management fraud, because management at any level is in a position to override them. An important consideration was whether management had reported to the audit committee on the entity's control environment and '...how that environment and the entity's policies and procedures (including management's monitoring activities) serve to prevent and detect financial statement fraud' (O'Malley Panel 2000, p.94).

The Panel also suggested that the nature and extent of testing should be influenced by the auditors' understanding of an audit committee assessment of the strength of management intolerance for improper behaviour, which should influence the nature, and extent of testing. Auditors should be cautious however, not to place excessive emphasis on management's high level monitoring of financial and non-financial data as a reason for reducing the extent of testing in the forensic-type phase.

#### *2.3.9.4 Conclusion*

The Panel arrived at some fundamental conclusions. There was a high degree of expectation that the auditor would not only deter but also detect frauds. The auditor should aim to '...obtain reasonable, but not absolute assurance that the financial statements are not materially misstated sets the responsibility at an appropriate level' (O'Malley Panel 2000, p.85).

O'Malley made it very clear that audit firms should aspire to zero defects as their goal and endeavour to eliminate audit failures completely. To meet this requirement, audit training programs oriented towards fraud detection should be undertaken. Training programs should include case examples showing how defalcations might be effected, the types of

controls over the safeguarding of assets that are effective in preventing and detecting defalcations, and how defalcations are concealed.

It emphasised the importance of the audit committee and recommended that audit committees should assess the strength of management's commitment to a culture of intolerance for improper conduct. It recommended that auditors should work with audit committees in assessing the risk of financial statement fraud and in implementing the controls designed to mitigate such risks.

Their recommendations reflect current trends. Sir David Tweedie, the chairman of the IASB, suggests much greater scrutiny by audit committees in the future. He made the suggestion to '...put toughies in there so the auditor reports to them and the internal auditor reports to them' (Ravlic 2002, p.82). Tweedie also would like the audit committee to take outside advice, be able to hire and fire the auditors and generally '...scare the auditor to death' (Ravlic 2002, p.82).

### **2.3.10 The Ramsay Report**

In October 2001, Professor Ramsay of Melbourne University completed a report on the independence of Australian company auditors. This report recommended the establishment of an Auditor Independence Supervisory Board (AISB) which would play a vital role in ensuring public confidence in the independence of auditors by monitoring implementation and compliance with Australian and international requirements.

Ramsay also emphasised the importance of the Audit Committee, as did the 2000 United States O'Malley Panel. Ramsay believed that the audit committee played an important role in ensuring the independence of the auditor from the organisation. The Ramsay Report recommended that the audit committee should seek the views of auditors on their assessment of the risks of financial statement fraud and should review, in consultation

with the auditor, any significant disagreements between the auditor and management, irrespective of whether they were resolved.

Ramsay also commented on non-audit services. He suggested that the regulations should be revised and updated to ensure mandatory disclosure of non-audit services and the fees paid. He also recommended strengthening the role of the audit committee in overseeing non-audit services and the use of the AISB in monitoring disclosure of non-audit services.

George (1993) noted that 31% of industry fees came from consulting, but, by 1999, that figure had grown to 51%. He questioned the provision of both non-audit services and auditing to the same client, and he observed that ‘...it seems unlikely that the same enterprise can both advise a corporation and then audit the implementation of that advice in an independent way’ (George 2002a, p.54).

### **2.3.11 Links between the Ramsay Report and International Reports**

This research has drawn extensively on Australian, United States and United Kingdom reports into the auditor’s role in fraud or illegal activity. In particular, it has referred to various Australian and international reports that have developed strategies to improve the auditors’ role both in deterring and also in detecting fraud and illegal activity.

It is relevant to note that the 2001 Ramsay Report in Australia also drew heavily on overseas auditing models. It drew on the O’Malley Panel Report, which had been set up by the chairman of the United States SEC (Securities and Exchange Commission) Arthur Levitt in 1998 to examine the current audit model thoroughly. Ramsay noted that, in relation to the independence of auditors, ‘...the SEC rules represent the only example of which we are aware of a regulator developing very detailed rules in this area’ (Ramsay Report 2001, p.60).

Ramsay also noted the O'Malley Panel findings that '...audits improve the reliability of financial statements, make them more credible and increase shareholder's confidence in them' (Ramsay Report 2001, p.20), and that the credibility of the audit report, as described by the O'Malley Panel, is based on the audit assessment '...of whether the financial statements are presented fairly in conformity with generally accepted accounting principles' (Ramsay Report 2001, p.21).

Ramsay also noted that insight to elements of the AISB structure developed by his Report '...had been drawn from the supervisory bodies established in the United Kingdom to independently govern the accountancy profession' (Ramsay Report 2001, p.67).

### **2.3.12. Relevant Accounting Standards Internationally**

Some comfort for auditors is that Godsell (1993, p.76) found that no court has ever ruled that an auditor has a mandatory duty to detect fraud, if fraud exists. The question of negligence is decided by the court's assessment throughout the conduct of the audit work of the standards of professional skill and care exercised by the auditor. The courts will look at the auditor's planning, testing of records, enquiries and any other procedures the auditor had performed as well as the final audit reports.

In New Zealand, the accounting regulation dealing with fraud states that the responsibility for the prevention and detection of fraud and error rests with management. The auditor is required to seek reasonable assurance that financial information is correct or will be corrected.

In Canada, the auditor, in examining the financial statements, seeks reasonable assurance that fraud and error, which may be material to the financial statements, has not occurred. Where it has occurred, it should be corrected or properly accounted for in the financial statements. Management, and not the auditor, is responsible for the prevention and detection of fraud or error.



In the USA, the current standard SAS 82 'Consideration of Fraud in a Financial Statement Audit' covers the auditor's responsibility for the detection of fraudulent or illegal activities. It states that the auditor must assess the risk of errors/irregularities causing a material misstatement.

It specifies that auditors have a responsibility to obtain reasonable (not absolute) assurance to ascertain whether the financial statements are free of material misstatement, and if they are not, whether the material misstatements are caused by error or fraud. SAS 82 found that, because of the concept of reasonable assurance, even a properly planned and executed audit might not detect material misstatements resulting from fraud.

The exposure draft of the O'Malley Panel, at June 2000 found that, if the O'Malley Panel recommendations were fully implemented, the auditor's responsibility for detecting fraud would significantly change the requirements of SAS 82.

Significantly, the O'Malley Panel found that the risk assessment and response process, called for by SAS 82 '...falls short in effectively deterring fraud or significantly increasing the likelihood that the auditor will detect material fraud...' (O'Malley Panel 2000, p.86) largely because it fails to direct auditing procedures specifically towards fraud detection.

The O'Malley Panel (2000, p.87) recommended that the ASB should '...develop stronger and more definitive auditing standards to effect a substantial change in auditors' performance...' and thereby improve the likelihood that auditors will detect fraudulent financial reporting.

The accounting standard in the UK is SAS 110 'Fraud and Error' which states that it is not the auditor's function to prevent fraud and error. The fact that an audit is carried out may, however, act as a deterrent. The detection of fraud committed by management poses particular difficulties for the auditor because management can be in a strong

position to commit fraud and conceal it from others within the entity and from the auditors.

Based on their risk assessment, the auditors should design audit procedures so as to have a reasonable expectation of detecting misstatements which have arisen from fraud or error, and which are material to the financial statements.

Two Australian accounting standards are applicable in this area. They are AUS 210 'Irregularities including Fraud, other Illegal Acts and Errors' and AUS 402 'Risk Assessment and Internal Controls'. In a preliminary planning phase, the auditor should refer to AUS 402 to determine possible risks and to plan a risk assessment strategy.

In compliance with AUS 402, the auditor must also assess the internal controls and should begin to assess which of them are most important for an effective audit plan. The internal control structure is defined as the plan of the organisation and all the methods and procedures adopted by management to assist in achieving management objectives.

AUS 402, 'Risk Assessment and Internal Controls', evolved from AUP 12, 'Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit' in January 1983. AUS 210 'Irregularities including Fraud, other Illegal Acts and Errors' evolved from AUP 16 'Fraud and Error' in February 1994.

AUS 210 has two functions. It is a vital tool in planning the detection of financial misstatements caused by fraudulent or illegal activities. During an audit, it provides the procedures necessary when fraudulent or illegal activities are expected. It also provides the reporting process that must be followed when these activities are suspected.

This accounting standard emphasises that it is not the role of the auditor to prevent irregularities but to exercise skill and care with respect to the planning and conduct of the audit. AUS 210 states that the auditor should assess the risk of breaches to the law that could lead to material misstatements. Acts that cause breaches of the law will vary

according to the nature of the organisation being audited. Therefore, the auditor must plan the audit program to take account of the particular risks that the organisation is likely to face.

AUS 210 provides a list of certain classes of illegal acts that may result in material misstatements. It also provides a list of statutes and regulations to assist auditors. In addition, it provides guidance to auditors in considering the impact of the internal control structure on audit risk. AUS 210 should be read in conjunction with AUS 402.

The relevant 1994 Standards are ISA 400 'Risk Assessment and Internal Controls' and ISA 240 'Fraud and Error' which states that management is responsible for the prevention and detection of fraud and error through the implementation and continued operation of adequate accounting and internal control systems.

### **2.3.13 Conclusion**

It is interesting to consider the impact that the forthcoming adoption by Australia of international accounting standards will have on the detection of fraud or illegal activity regulations.

There is currently no requirement in the international or the Australian accounting or auditing standards for an auditor to search for fraud or illegal activity that could not be reasonably detected if the auditor has followed appropriate auditing procedures. The relevant Australian and international accounting standards are uniform in their assessment that the auditor should not be held responsible for failing to detect concealed fraud or illegal activity.

However, the accounting and auditing standards state that the auditor must carefully plan and carry out the audit in order to detect fraud or illegal activity, which should be identified by reasonable audit procedures.

The O'Malley Panel was critical of the current auditing standards. The standards specify that the '...[SAS No. 82] auditor's judgment may be that audit procedures otherwise planned are sufficient to respond to the risk factors' (O'Malley Panel 2000, p.76). This is particularly important when we consider in the AWA case, the auditors judged that, although there were substantial risks in foreign exchange, the auditing team had been able to decide the audit circularisation procedures were sufficient to deal with the foreign exchange risks. Subsequently, the foreign exchange risks resulted in a loss of \$49.8 million to the audit client AWA.

The O'Malley Panel recommends that expanded auditing standards should be introduced and '...be over and above those that are now contemplated by a GAAS audit' (O'Malley Panel 2000, p.87). They were particularly concerned that auditors should be required to undertake a full range of audit procedures to adequately test any risks encountered during the audit.

## **2.4. Significant Examples of Auditor's Failure to Detect Fraudulent or Illegal Activities**

On 16th March 2001, the Executive Chairman of Harris Scarfe announced a 45% reduction in net profit for the 6 months ended 31-1-2001. Only 18 days later on 3-4-2001, Harris Scarfe appointed a voluntary administrator.

The Harris Scarfe directors were shocked to discover that critical financial management information and evidence of accounting irregularities had not been provided to them. The board of directors were surprised that they had been supplied with a deliberately false and misleading view of the company's true financial position over the past six years. This was despite the fact that '...the accounts had been cleared by the auditors at least three times in the last fifteen months' (Psaros 2001, p.47).

There has been a significant number of corporate collapses where the auditor's role has been questioned. Current Australian cases under investigation include HIH, Harris Scarfe, One.Tel and more recently Ansett.

The more significant audit cases include the Report of the Special Committee on Equity Funding (AICPA 1975, pp. 38-39) where it was stated that frauds involving large sums of money are more likely to be detected, but that detection cannot be guaranteed.

The Equity Funding fraud reached over a hundred million AUD in the USA. The accounts were audited regularly and yet the fraud was discovered only when an involved, disgruntled employee reported it. The Special Committee found that the longer and larger an undetected fraud became, the greater the chance of its detection by audit because of the number of audit trails leading to it. However, the Special Committee found that where the fraud was worked within the internal control system it was very difficult to detect.

An Australian example is the Royal Commission into Tricontinental (Royal Commission, 1992). Evidence was given that a junior auditor detailed significant prudential failures in the loans portfolio. However, the audit team failed to follow up on this finding. When Rothwells collapsed in 1990, the auditor's unsuccessful defence was that he had consistently reported internal control weaknesses in his audit reports on Rothwells.

More recent audit negligence cases are listed below.

- Arthur Andersen (Andersen) recently settled with the SEC for USD 7 million over the Waste Management Inc audit (Peterson 2001, p.1);
- Deloitte have recently settled with The Australian Securities and Industries Commission (ASIC) over the Adsteam audit for \$10 million (Ravlic 2001, p10);
- Ernst & Young (E&Y) are facing increased litigation over one of the largest frauds in corporate history. E&Y had previously agreed to pay Cedant (Rogerson 2000, p.4) shareholders USD 335 million, but they now face new allegations of consciously avoiding evidence of the fraud which lasted for 12 years and cost Cedant approximately USD 500 million;

- Andersen's failure occurred in the Enron collapse. It is alleged the '...Enron auditor's had overstated the Enron profits by USD 569 million over a four-year period' (Fenton-Jones 2002, p.4);
- Andersen's failure occurred in the Worldcom, alleged USD 3.8 billion fraud. It is alleged, that Andersen reviewed and approved Worldcom's use of charging to operating expenses, USD 3.8 billion; and
- Andersen's failure occurred in the HIH collapse. There was evidence to the HIH Royal Commission that HIH's published accounts were deficient by \$1 billion in 1999 and that takeover target FAI's books covered up a \$350 million deficiency in 1998.

In the UK, an audit partner of Bird Lucklin (Coyle 2000, p.1) has been investigated by the UK Joint Disciplinary Tribunal for failing to ensure that the accounts of QMH gave a true and fair view. QMH had reported losses of approximately GBP 1 billion.

It is no wonder that the POB (POB 1993 p.42) found that no problem confronting the profession is as demanding, or as difficult to resolve as the problem of management fraud and its detection by auditors.

#### **2.4.1 Summary**

Beasley et al. (2000b, pp. 15-21) found that, if auditors could understand the fraud profile and address the issues with management, they could reduce possible exposure to fraudulent financial reporting. Their study found that:

- most companies committing financial statement fraud were relatively small (less than USD 75 million in assets and revenues).
- in 83% of cases, the CEO or the CFO or both were involved in the fraudulent financial statement.

There seems no doubt that in the next decade, much greater pressure will be placed on the audit profession to undertake a leading role in the detection of fraud and/or illegal activity.

Significantly, the O'Malley Panel found that the relevant SAS 82 accounting standard in the US was deficient in collectively deterring fraud or in significantly increasing the likelihood that auditors will detect material fraud. This is largely because the standard fails to direct auditing procedures specifically towards fraud detection.

As a result of Enron and Worldcom the AICPA issued SAS 99 which the AICPA President Barry Melancon described as reminding auditors that they must approach every audit with professional scepticism. He insisted that they should not assume that management is honest but be mindful of the threat of fraud.

## **2.5 Conclusion**

In this chapter the literature relevant to the research project has been outlined. In particular, the literature review has attempted to identify the increasing importance of the auditor's role in detecting and deterring fraud and illegal activity.

One of the O'Malley Panel's major recommendations was that '...auditors should perform some forensic-type procedures on every audit to enhance the prospects of detecting material financial statement fraud' (O'Malley Panel 2000, p.1). This is particularly important when the literature traces the current emphasis back to the role of the auditor in detecting fraudulent or illegal activity.

Landsittel (2000, p.61) found that three ingredients ignite frauds: pressure to meet profit expectations or increase share values: opportunity due to lack of internal controls over financial reporting: and rationalisation compromised ethical reasoning justifying the

fraud. Auditors must be alert to evidence of all three ingredients particularly opportunity if they are to improve their role in deterring and detecting fraud or illegal activity.

In the next chapter the major Australian audit negligence cases analysed include the original AWA case in 1992 and the 1995 Appeal. Cases from the landmark Pacific Acceptance case in 1970 to the State of South Australia case in 1997 will be examined. The 1974 Manning case and the subsequent 1992 Van Reesema cases, which were seen as precedents by the judges in assessing the adequacy of the accounting records kept by AWA, are reviewed to establish the impact that the court placed on their importance to the outcome of the AWA judgments.



## Chapter 3. Audit Negligence Cases

### 3.1 Introduction

Chapter 3 links the major Australian audit negligence cases to the AWA case and the subsequent appeal. In particular, this chapter will examine the landmark 1970 Pacific Acceptance case regarded as one of the most comprehensive audit judgments. The AWA case refers to *Pacific Acceptance v Forsyth & Others* (1970) 90 WN (NSW) 282, to ascertain the current standard of audit care and skill required of the auditor, and how much that standard has increased in the last hundred years.

Both Rogers J, in the original AWA judgment, and the appeal judges, Clarke, Sheller and Powell JJA, referred to *Manning v Cory and Summer* (1974) CLC 40 WAR 60 and the subsequent case, *Van Reesema v Flavel* (1992) 10 ACLC 291, as precedents for the requirement that accounting records must be kept on a regular basis. They noted AWA's foreign exchange accounting records were not so maintained.

This chapter traces the important audit legal precedents from the landmark United Kingdom case of *Kingston Cotton Mill Ltd*, (1896) 2 Ch. D. 279 through to the internationally significant Australian Pacific Acceptance case. Major Australian audit negligence cases are examined with particular emphasis on the implications for *AWA Ltd v Daniels Deloitte Haskins & Sells* (1992) 10 ACLR 933 and the subsequent appeal by the auditors DHS (Deloitte Haskins & Sells) in 1995 in *Daniels v AWA* (1995) 13 ACLC 614.

The history of the liability of professionals in the tort of negligence can be traced to the English case, *Donoghe v Stevenson* (1932) AC 562. That case decided that a manufacturer owed a duty of care to a consumer who was injured where there was no possibility of prior inspection by the consumer of the goods.

This principle was extended to cover negligent misstatements in the House of Lords' decision in *Hedley Byrne & Co. Ltd. v Heller and Partners Ltd.* (1963) 2 All ER. 575; (1964) AC 465. Since 1964, the law relating to negligent misstatement has been refined and the current Australian position appears to be that laid down by the High Court in *Mutual Life and Citizens Assurance Co.Ltd. v Evatt* (1968) 42 ALJR 316 affirmed in *L. Shaddock & Associates Pty. Ltd. v Parramatta City Council* (1981)36 ALR 385 and in *San Sebastian Pty. Ltd. & Ors. v Minister Administering Environmental Planning and Assessment Act 1979 and Anor* (1986) 61 ALJR 41. The position is that people who hold themselves out as competent to give information and advice will be liable.

- if due to negligence, the information or advice is incorrect;
- if they realise or ought to realise that they are being trusted to give correct information and advice; and
- if it is reasonable in the circumstances for the other party to act on that information or advice.

### 3.2. The History of U.K. Audit Negligence Cases

The history of the liability of auditors in the tort of negligence can be traced to the 1895 UK case of *re London and General Bank (No. 2)* (1895) 2 Ch 673 in which Lindley L.J. stated that an auditor must take reasonable care. He raised the question of what reasonable care is and defined it as being dependent on the circumstances of the particular case. However, he noted that, where suspicion is aroused, more care is necessary although an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion.

Lindley L.J. found that the duty of the auditor was that '...he must be honest...that is, he must not certify what he does not believe to be true, and he must take care and skill before he believes that what he certifies is true' (Godsell 1993, p.92).

The Kingston Cotton Mill case is an historic audit negligence case. Lopes LJ ruled that auditors must exercise reasonable skill, care and caution in performing their work but that ‘...an auditor is not bound to be a detective, or as was said, to approach his or her work with suspicion or with a foregone conclusion that there is something wrong’ (Godsell 1993, p.93).

Lopes LJ stated that auditors should not be expected to track down ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicions. The judge likened an auditor to a canine when he said ‘He is a watch-dog, but not a blood-hound’ (Godsell 1993, p.93). Lopes LJ believed that an auditor should be reasonably careful, as distinguished from suspicious, and that to substitute the one expression for the other would lead to serious error.

The judge found that ‘...it is the duty of an auditor to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use’ (Godsell 1993, p.93). He found that the question of what is reasonable skill, care and caution must depend on the particular circumstances of each case.

He ruled that the auditor is justified in believing tried servants of the company and in assuming they are honest and that he can rely upon their representations, provided he takes reasonable care.

The canine theme instigated in the Kingston Cotton Mills case was continued in *Irish Woollen Co. v Tyson and Others* (1900) 26 *Irish Appeal Courts The Accountant Law Reports* 13 where Holmes LJ stated, ‘...that they are to adopt the role of a watch-dog, not a bloodhound, and that the watch-dog should bark occasionally, and if when sniffing around he should hit on the trail of something wrong he should follow it up and keep his eyes open and his nose too’ (Godsell 1993, p.93).

*The City Equitable Fire Assurance Company Ltd (1925) Ch 406* case in conjunction with *The London Oil Storage Co Ltd v Seear Hasluck & Co.(1904) The Accountant Law Reports 1* and *Henry Squire (Cash Chemist) Ltd. v Ball, Baker & Co.,(1911) 27 TLR 269*, firmly established the auditor's duty to audit 'outside the books'. Pollock MR, in the City Equitable case agreed with the ruling in Kingston Cotton Mills that auditors could not be expected to track down '...ingenious and carefully laid schemes of fraud where there is nothing to arouse their suspicion' (Godsell 1993, p.96). However, he cautioned auditors that the '...greater the number of undiscovered frauds or misappropriations the more difficult it will be for the auditors to resist a finding of negligence' (Godsell 1993, p.96).

In *Formento (Sterling Area) Ltd v Selsdon Fountain Pen Co.Ltd (1958) 1 All ER 11*, Lord Denning stated that the auditor's approach was to come to it with an enquiring mind, not expecting dishonesty '...but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none' (Godsell 1993, pp.97-98).

Pennycuik J, in *Thomas Gerrard & Son Ltd. (1968) Ch. 455*, reminded the auditor that, having ascertained the precise facts of the illegal activity '...so far as it was possible for him to do so, he should have informed the board' (Godsell 1993, p.100). This ruling to communicate to the board of directors (and where available the audit committee) rather than to confine communication only to management was now becoming a more common requirement of the courts.

The judge also arrived at the measure of compensation. He found that this must consist of a loss to the company caused by the auditor's breach of duty, especially where that breach was the direct cause of the loss.

He did not believe that the quality of the auditor's duty had changed in any relevant respect since 1896. The duty to audit a company's books with reasonable care and skill still remained. However, he found that the difference between the Kingston Cotton Mills

case is that ‘...the standards of reasonable care and skill are, upon expert evidence, more exacting today than those which prevailed in 1896’ (Godsell 1993, p.100).

An interesting view on this was that of the Chief Justice of WA, Hon. David Malcolm, who in 1972, believed that if Lopes LJ was to comment today then he would be more likely to say that while not exactly a blood-hound, the auditor ‘...is more than a watch-dog and must be on the lookout for a scent, and if he picks it up he should search for it and act as a retriever’ (Godsell 1993, p.101).

*Caparo Industries PLC v Dickman & Ors* (1989) 2 WLR 316 : (1989) 5 BCC 105 related to a claim that the auditors had been negligent in their failure to detect and report material misstatements in the financial statements. Taylor LJ denied the existence of a duty of care to potential investors. He found no close or direct relationship between the potential investors and the auditors.

He found that the duty of care was to existing members and shareholders because the auditor had a statutory duty to report to them and the shareholders had a corresponding statutory entitlement to receive audit reports. He found that ‘...all [the auditors] can foresee is that some unidentified investor or investors may inspect their report and act upon it’ (Godsell 1993, p.60).

He conceded the foreseeability of reliance but found that the element of proximity was lacking. He ruled that even though it was foreseeable that the audit report might come into unidentified investors’ hands and be relied upon by them, this was not sufficient to create an audit/investor relationship.

### **3.3. Australian Audit Negligence Background**

#### **3.3.1. Audit Negligence Out of Court Settlements**

It is important to point out that many of the Australian audit negligence disputes either never reach the courtroom or are settled privately prior to court judgment. Two recent cases, where the out-of-court settlements were made public, are presented below.

In 1991, KPMG made a record settlement of USD 96.3 million to the Victorian State Government over the collapse of Tricontinental, a merchant bank subsidiary of the government owned State Bank of Victoria. Tricontinental had loans exceeding the total assets of its parent, the State Bank of Victoria.

Burroughs (1993) noted that in the State government's lawsuit for damages of AUD \$1.094 billion the auditors had been blamed for some of the losses, which the bank had incurred on bad loans when Tricontinental collapsed with losses of AUD \$1.7 billion. Tricontinental was the merchant bank arm of the State Bank of Victoria. It was subsequently taken over by the Commonwealth Bank (CBA) in 1992.

Ferrers (1992, p.64) pointed out that KPMG had been sued partly because it was better insured than Tricontinental's directors. This 'deep pockets' syndrome resulted in a \$1.094 billion lawsuit and outstanding writs, totalling \$2,700 million, against KPMG.

A negligence claim for \$256 million by NSCA against Howarth & Howarth was settled out of court for only \$2 million (Boreham 1994). The two interesting aspects of this audit were that, first, the settlement had been for such a small amount and, second, that NSCA had claimed that they had emergency vehicles and planes at various locations throughout Australia. In fact, they only had equipment at their head office. The auditors never attempted to check the equipment at the other bases throughout Australia.

### **3.3.2. Australian Audit Criminal Convictions**

Two significant cases of Australian auditors who have been found guilty of criminal offences were the 1965 H.G.Palmer case, where a 500,000 pound civil action settlement resulted. The director Herbert Palmer was given a four year jail sentence and the auditor McBlane was given a three year jail sentence for his part in the fraudulent omission of material particulars in the profit statement in a prospectus, the valuation of debtors and treatment of unearned income. He was found to have been an accomplice in the certification of a grossly exaggerated prospectus.

The auditor of Rothwells Bank (Carter 2000, p.58) received a prison sentence of four years and three months from the WA Supreme Court in 1996. Carter was convicted of signing financial statements knowing them to be materially false and the profit materially overstated.

Carter argued that an auditor's prime function is to form an opinion on the financial statements prepared by the company. He contended that it was not the auditor's role to question the business dealings of the organisation. 'Auditors play no part in the construction of business deals' (Carter 2000, p.58).

McCusker, the Inspector appointed by the WA Attorney General to report on the Rothwells bank collapse, was critical of Carter's assertion of ignorance of Rothwells business deals. He believed that Carter was criminally negligent in not investigating large and frequent balance day adjustments, especially when they were reversed on the following day. He believed that no auditor should simply accept, without question, such artificially contrived transactions '...and they should carefully investigate their validity and the real reason for them' (Carter 2000, p.50).

### **3.4. Australian Audit Negligence Cases**

#### **3.4.1. DOMINION FREEHOLDERS LTD, V AIRD, SPARGO [1966] 67 SR [NSW] 150**

In this case, the auditor sued the client's accountant for negligence, alleging breach of duty in that he had failed to provide the information, which the auditor required of him. Jacobs JA, in the Court of Appeal, held that ‘...the auditor owes a duty of care to the company in his audit’ (Godsell 1993, p.132). He found that, where the auditor was made liable in contract, he couldn’t succeed in an action against an accountant, alleging want of care in the making of a representation, when reliance on such a representation would be in breach of an auditor's duty.

The other members of the Court of Appeal unanimously accepted the view of Jacobs J.A. Wallace. P made the telling statement that the auditor could not argue successfully for a failure to perform what was part of his audit role because it ‘...would defeat the primary purpose of having company auditors’ (Godsell 1993, p.132).

The court ruled that, if an auditor was told that he must perform a statutory duty according to his own opinion, it was unacceptable that he could have a cause of action against another person, merely because that other person gave an opinion, which the auditor had accepted and had adopted as his own.

#### **3.4.2. PACIFIC ACCEPTANCE V FORSYTH & OTHERS [1970] 90 WN [N.S.W.] 282**

The position of auditors, with regard to negligent misstatements, was made clear in the Pacific Acceptance case. Godsell noted that Australian auditors were ‘privileged’ in that the ‘...world’s most comprehensive judgment concerning the nature and extent of auditors duties...’ (Godsell 1993, p.101) was given in Australia, in the Pacific Acceptance case (1970).



In this case it was established that any plaintiff, bringing an action in negligent misstatement against an auditor had to establish four elements. They were:

- there must be a duty of care owed to the plaintiff by the auditor;
- the behaviour complained about must fail to achieve the required standard of care;
- the auditor's negligence must have caused the plaintiff's loss; and
- the plaintiff's loss must have been a reasonably foreseeable consequence of the auditor's breach of a duty of care.

In the Pacific Acceptance case the bulk of the judgment consisted of an exhaustive evaluation of an auditor's duties and responsibilities, and the standards of skill and care, which should be exercised in achieving audit objectives. Moffitt J found that '...reasonable skill and care calls for changed standards to meet changed conditions or changed understanding of dangers, and, in this sense, standards are more exacting today than in 1896' (Godsell 1993, p.107).

#### *3.4.2.1. Responsibility to Supervise Audit Staff*

In Pacific Acceptance, Moffitt J found that '...to a substantial extent the principal shortcomings of the audit had their origin in the work of two audit clerks' (Godsell 1993, p.110). The court referred to the precedent set in *Nelson Guarantee Corporation Ltd. v Hodgson (1958) NZLR 609* in which Romer J held the auditor negligent because he had not advised his assistant to exercise particular care in checking the work of a new bookkeeper. In Pacific Acceptance, it was ruled that audit partners who failed to properly supervise the work of their staff, were in breach of the duty of care and were liable for the negligence of subordinates, however inexperienced or careless the subordinates may have been.

### 3.4.2.2 *Audit Planning*

Moffitt J warned the auditor that proper planning had to be undertaken. ‘It is clear that in planning and carrying out his work an auditor must pay due regard to the possibility of error and fraud’ (Godsell 1993, p.103). He found that it was the auditor's duty to go behind the books and determine the true financial position of the company. The audit had to consider the relevant circumstances of any irregular or unusual matters observed.

These relevant circumstances were defined by Moffitt J as ‘...such circumstances as the auditor ought reasonably to have considered in relation to the matter discovered’ (Godsell 1993, p.104). The initial audit plan must include provision for procedures to be applied if the audit does discover unusual activities. Failure to plan properly or to follow these procedures will leave the audit open to criticism from the courts.

### 3.4.2.3 *Audit Testing*

Moffitt J commented in relation to audit testing procedures that ‘Prima facie the auditor's job is to check material matters for himself from available documents...’ (Godsell 1993, p.106) and that he has not done his job or audit, if he merely seeks the assurance of management as to the checks that they have made, or to their views on the effects of documents. He also referred to the precedent set in *City Equitable* concerning the dangers of placing sole reliance on statements made by persons of high authority or reputation.

In *Pacific Acceptance*, it was ruled that sighting the documents relating to material matters must satisfy the auditor. This procedure must be followed even though, in practice, it may sometimes require significant additional audit time and effort to locate and analyse the documentation. The use of an expert third party should be used to interpret complex material rather than relying solely on the interpretation of the audit client.

#### *3.4.2.4 Responsibility to Report Internal Control Weaknesses*

Moffitt J stated that auditors have a duty to warn management promptly of any reasonable suspicions that fraud or error may exist. 'The auditors perform their duty to the company and safeguard the interests of shareholders by making communication, properly called for, to the appropriate level of management or the directors, during the course of the audit' (Godsell 1993, p.103).

The need for the auditor to report to the directors was highlighted by Moffitt J who found that 'they do not perform such duty if, having uncovered fraud or having suspicion of fraud in the course of the audit, they fail promptly to report it to the directors' (Godsell 1993, p.103). The appropriate level to communicate internal control weaknesses to, was not clarified by the Pacific Acceptance case. However, a prudent auditor, communicating to management on internal control weaknesses, should include a specific response time. Failure of management to reply within that time should lead to the auditor reporting the weaknesses to the directors.

The outcome of the Pacific Acceptance case suggests that, whilst a professional audit by its nature cannot always provide the same prompt detection as internal control, it can, and should, examine the internal controls and direct management's attention to the weaknesses which provide opportunities for fraud.

#### *3.4.2.5 Qualification of the Financial Statements*

Moffitt J considered that a qualification should be unambiguous. It should express the opinion of the auditor rather than his doubts or indications of the need for further enquiry. He recognised the considerable difficulties faced by auditors in deciding whether, and to what extent, an audit report should be qualified. It should allude, in particular, to the duress which can be exercised over auditors by a company's management. The clear implication is that such use of undue influence may compromise the robustness of audit independence.

#### 3.4.2.6 *Detection of Fraud or Illegal Activity*

Moffitt J was clear that an auditor should not have to adopt the role of a detective or special investigator. He held that it ‘...would be unreasonable to expect him to connect matters in the fashion that one would expect as on a special investigation or by one whose suspicions have already been aroused’ (Godsell 1993, p.104). However, he did expect the auditor to reasonably connect a series of material irregularities occurring during a short period ‘...and he might be expected to go back over past working papers, even those of a prior audit clerk, to bring to mind similar irregularities’ (Godsell 1993, p.104).

The implication of *Pacific Acceptance*, therefore, was that there was a duty to pay due regard to the possibility of, and to actively investigate, potential fraud in circumstances in which suspicions were, or should have been aroused. He found that an auditor should plan and perform the audit so that ‘...if a substantial or material error or fraud has crept into the affairs of the company he has a reasonable expectation that it will be revealed’ (Godsell 1993, p.106).

#### 3.4.2.7 *Contributory Negligence*

Moffitt J stated ‘I do not find merit in a submission which in effect is that although the auditors were negligent they should be excused because the directors also were negligent’ (Godsell 1993, p.106). He rejected the auditor’s argument of contributory negligence. The court found that it would negate a fundamental reason for the appointment of the auditor, if an auditor were to be excused because the directors or management were also at fault, and particularly if they failed to perform their duty with independence and to check on management and the board.

#### 3.4.2.8 *Summary*

Moffitt J recognised the impracticality of the courts setting specific rules concerning the conduct of auditors and agreed that it was not possible, in most situations, to make an

absolute pronouncement as to what an auditor should do in an auditing situation stated generally. He added that there is ‘...always some exception, or in some cases an extreme that provides a reason for a special approach in some cases’ (Godsell 1993, p.108).

However, he found that, in a practical sense, there is a great deal of uniformity in the situations met. As a result, it is often possible to say that the operations, audited reasonably, demanded some particular approach, whether the matter be looked at prior to the event, at the time, or afterwards.

### **3.5 MANNING V CORY AND SUMMER [1974] CLC40 WAR 60**

In *Manning* and later in *Van Reesema v Flavel* (1992) 10 ACLC 291 there were important precedents for Rogers J in AWA in relation to the adequacy of the accounting records. Both Rogers J and the appeal judges were concerned that the AWA accounting records were not kept in a manner where the affairs of the company could be identified readily.

Rogers J referred to *Manning* in which Burt J had ruled in accordance with the *Companies Act 1961*. This Act required that a company keep such books as were necessary to exhibit and explain the transactions and financial position of the trade or business of the company, and that ‘...the evident policy of such a requirement was that the account should disclose or exhibit the financial position of the company at all times and at any time’ (1995 AWA Appeal judgment, p.651).

Burt J ruled that the books of account had to show where, in a financial sense, the company was, and that it was not enough for a competent accountant to produce a set of accounts long after the date to which the cheque butts, receipts etc related and then to say the company is insolvent and unable to carry on.

Burt J was critical of the fact that an accountant could find the company insolvent. He ruled that the whole purpose of the *Companies Act 1961* was to prevent that from

happening. The AWA Appeal judgment noted that the purpose of the audit was ‘...to prevent its officer from flying the company blind and upon its crash, and without having any information capable of sustaining the opinion, from then saying that he thought that he had more altitude’ (1995 AWA Appeal judgment, p.651).

### **3.6 SIMONIUS VISCHER & CO. V HOLT & THOMPSON [1979] CLC 40-575; [1979] 2 NSWLR 322**

Moffitt J's views in this case were confirmed in the Court of Appeal by Samuels JA who said, ‘If the auditor could simply fall back on the work of the internal accountants this would defeat the very idea of the audit’ (Godsell 1993, p.131).

The AWA Appeal court found an argument, that the effect of DHS's (Deloitte Haskins and Sells) negligence was completed by 18th May 1987, could not be sustained. They referred to the Simonius Vischer case and found there was evidence directors were ignorant about many aspects of the operations therefore ‘...DHS's breach of duty could be seen to be causally connected to the loss as a matter of commonsense’ (1995 AWA Appeal judgment, p.616).

The AWA Appeal case also referred to the contributory negligence precedent in the Simonius Vischer case. There, Moffitt J said it was difficult to find a situation where ‘...the conduct of any servant or director could constitute the relevant negligence, so as to defeat the claim against the auditor, whose duty is to check the conduct of such persons...’ (1995 AWA Appeal judgment, p.711).

Finally, the 1995 AWA Appeal court referred to the Simonius Vischer case to decide that the negligence of AWA senior management, which had been present from the beginning of the foreign exchange operation ‘...was not an intervening act which broke the chain of causation between DHS's negligence and the ultimate loss’ (1995 AWA Appeal judgment, p.695).

### **3.7 CAMBRIDGE CREDIT CORPORATION LTD. AND ANOR V HUTCHESON AND ORS [1985] 3 ACLC 263**

Although it was not sustained on appeal, Rogers J found that the judgment demonstrated that ‘...the financial consequences of the auditor’s negligence may not emerge for some years...’ (1995 AWA Appeal judgment, p.695) and that when they do the consequences might far exceed any amount contemplated at the time of the negligent act. ‘This makes the task of insuring against loss one of immense difficulty for the auditor, and for the underwriter’ (1995 AWA Appeal judgment, p.695). He posed the question as to how the accountant could adequately insure, when the amount of possible liability was so speculative.

The Cambridge Credit case was significant primarily for the large amount awarded against the auditors. The AUD \$145 million award in 1985 was based on several counts of negligence and, although overturned on appeal, it created a major concern for the financial viability of the auditing profession and the audit insurance industry.

Rogers J found that:

- the defendant auditors Hutcheson were negligent in failing to require in the accounts for the financial year ending 30<sup>th</sup> June 1971, that provision be made against the debt owed by Hunter; and
- but for the defendants’ negligence, the trustee for the debenture holders of Cambridge would have caused a receiver to be appointed on or about 30th September 1971, rather than on 30th September 1974, and
- the deficiency in the funds of Cambridge in so far as it was greater in 1974 than in 1971, was due to the negligence of the defendants.

This judgment was overturned on Appeal because the plaintiffs had failed to establish a sufficient causal relationship between the auditors’ negligence and the losses that the

corporation had suffered. Litigation continued until 1988 when there was an out of court settlement of \$19.5 million.

The AWA Appeal judges noted that courts have had to consider whether, in cases of tort, the breach of duty of a defendant was a cause of a loss, which had been identified in the evidence. In *Cambridge Credit* the court found that the ultimate test of causation was whether, using common sense, the relevant act or omission was a cause of the loss. 'It was also said that the 'but for' test was sufficient in most cases to provide the relevant answer' (1995 AWA Appeal judgment, p.682).

Rogers J in *Cambridge Credit* found that, whilst there were a number of difficulties in assessing the question of the plaintiff's loss, it was, simply stated, the difference between the amount which would have been realised had the receiver been appointed in September 1971 rather than in September 1974. 'On any view, the plaintiff established a minimum figure of \$145,000,000' (1995 AWA Appeal judgment, p.682).

### **3.8 B.G.J. HOLDINGS PTY. LTD.V TOUCHE ROSS & CO [1987] 12 ACLR 481**

The BGJ case is seen as particularly significant to AWA because both cases related to losses caused by foreign exchange transactions. The major claim in BGJ was that the auditors had not alerted the directors to the foreign currency losses of \$4 million. The findings in favour of the auditors in that case can be contrasted with the findings in the AWA case where the auditor was found negligent.

Baxt (1988, pp.66-68) reported that Marks J in the Victorian Supreme Court reaffirmed the traditional view that an auditor is a watch-dog and not a bloodhound. He denied a claim for damages brought by a company against the auditors when large losses had been sustained on foreign exchange transactions.



Rogers J expanded on this traditional view in AWA when he stated that ‘...whether auditors are watchdogs, or bloodhounds, or any other form of canine, they cannot allow themselves to be utterly toothless’ (1992 AWA apportionment judgment p.24).

The BGJ case and the AWA case have several similar characteristics. In BGJ, the plaintiff’s principal claim was that the auditors had not alerted the directors to the unauthorised foreign currency transactions which resulted in the loss of \$4 million. This case was dismissed on the evidence that the auditors had raised the matter with other directors and senior executives by means of a letter of recommendation.

Marks J ruled that the auditor has a contractual duty to use reasonable care and skill (that is not to be negligent) but that he is not obliged to investigate and report on the prudence of speculative foreign currency transactions which expose the company to the risk of exchange rate changes affecting the costs of overseas purchases. However, circumstances arising out of the conduct of the audit ‘...may give rise to a duty of the auditor in tort (if not in contract) to take action about the existence of some such exposure if he comes to know about it’ (Godsell 1993, p.115).

The only remaining issue was whether it was sufficient for the auditors to merely inform senior management of their suspicions, without verifying the nature of the company’s policy and the value of transactions entered into, in breach of that policy. Marks J concluded that the auditors had done all that was required in raising the matter with management in the way that they had.

### **3.9 W.A. CHIP AND PULP CO. PTY. LTD. V ARTHUR YOUNG & CO. [1987] 5 ACLR, WAR 1002**

In WA Chip, the court found that the auditors had a duty to pay due regard to the possibility of fraud and to warn management of any evidence that this had occurred.

Pidgeon J relied on Moffitt J's judgment in Pacific Acceptance and ruled that auditors have a duty to:

- audit the financial affairs of the company throughout the relevant accounting period, and not merely to report an opinion as to the truth and fairness of the financial statements, and
- pay due regard to the possibility of fraud, and warn management of any evidence that this has occurred.

Pidgeon J held that the auditors' decision in August 1979 to defer further action concerning the irregularities until the 1980 audit was incorrect and was made negligently. He found that, in making its judgment, the material before the defendant was an escalating unsecured debt by a principal officer. He considered such an account ought to have aroused some suspicion and it called for inquiry to see if it was authorised. '...common sense would indicate this' (Godsell 1993, p.116).

An important issue raised in WA Chip, concerned the materiality of irregularities. Pidgeon J held that '...the amount was immaterial in as much as it was not sufficient to cause a deflection from the accounts giving a true and fair view of the state of affairs of the company' (Godsell 1993, p.117). The fact that the court held the fraud to be immaterial had no bearing on its decision that the auditors had been in breach of their duty. This finding has very important implications, given that auditors have traditionally assumed their responsibilities relate, primarily, to matters, which materially affect the truth and fairness of financial statements.

On appeal, the majority of the Full Court of Western Australia held that the defence of contributory negligence was not open to a defendant where the plaintiff had brought its action in contract rather than in tort. Pidgeon J stated that the plaintiff's lack of care would have needed to be '...the sole cause of the loss...' (Godsell 1993, p.133) however it was merely a concurrent cause.

The auditors' argument had been that contributory negligence should be found because the relevant employee had failed to report the facts, as he knew them, to the general manager. The judge stated that to agree to this would deny the purpose of the audit, which was to safeguard the interests of the shareholders.

### **3.10 SEGENHOE LTD V AKINS & ORS [1990] 8 ACLC 263**

In this case, the accounts audited and certified by DHS contained both an under-provision of approximately \$517,441 in the provision for taxation and a consequent overstatement of retained profits. On receipt of the accounts, Segenhoe resolved to pay an additional dividend. As a result of the error in the accounts, \$494,111 of that dividend was required to be paid out of capital. Segenhoe claimed this amount from DHS in damages for negligence.

The court found the auditors negligent and, therefore, liable to the client for the amount of the dividend, which had been paid out of capital. Baxt (1990) stated that the NSW Supreme Court decision in the Segenhoe case gave a new focus to the risks faced by auditors when certifying company accounts.

### **3.11 AGC [ADVANCES] LTD V R LOWE LIPPMAN FIGDOR & FRANCK 2 VR 671 [1990] 10 ACLC 1, 168**

In this case, the Supreme Court of Victoria held that the auditors owed a duty of care to AGC in that they had been negligent, and, consequently, that damages be awarded to

AGC for the loss which it had suffered. This finding is consistent with precedent as it follows the 'specific known user' test proposed by Lord Denning and subsequently approved in *Hedley Byrne and Caparo*.

The AGC case extended the liability of the auditors to a third party who had directly contacted the auditors requesting a copy of the audited financial statements. Thompson (1993, p.57) found this to be a leading Australian authority on the duty of care owed by auditors. AGC sued the auditors of a company to which it had lent money. The court held that the knowledge or belief that AGC would probably rely on the report was not the same as an intention to induce AGC's reliance upon the report.

George noted in AGC, Vincent J found it was reasonable for AGC to have relied on the audit certification of the Lyvetta accounts by the auditors and '...to encompass the reasonable possibility that the party requesting the information may rely upon it in the course of its business relationship with that client' (George 1992, p.9).

The Appeal Division of the Supreme Court of Victoria relied on the reasoning in the San Sebastian case to find that the auditors of financial accounts which had been improperly audited, and which had, allegedly, been relied upon by a major creditor of the audited company in advancing further money, did not owe a duty of care to the creditor.

The judges, on Appeal, were convinced that there was no intention on the part of the auditors to induce the lenders to make a loan based upon the issue of an unqualified audit statement. George (1992, p.9) noted that the court was (somehow) convinced that the '...auditors did not intend the lenders [AGC] to act on their report when supplied to its clients'. This reversal is consistent with the decision of the House of Lords in the *Caparo* case.

In the High Court, in *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* 188 CLR 241 (1997), McHugh J referred to the AGC case as a precedent. He held that the

mere act of supplying a signed report stating the company's financial position when the auditor knew that the company would, in turn, pass the statement on to its major creditor, was not enough to establish a duty of care in the circumstances.

### **3.12 VAN REESEMA V FLAVEL [1992] 10 ACLC 291**

The AWA judges referred to Van Reesema and the previous Manning case to assess the adequacy of the accounting records kept by AWA.

The AWA Appeal Court judges found that there was no doubt the application of the philosophy espoused in Manning and Van Reesema precedents that ‘...the accounts should disclose or exhibit the financial position of the company at all times and at any time...’ (1995 AWA Appeal judgment, p.651) meant that a company engaging, on a daily basis ‘...in foreign exchange transactions worth millions of dollars, must keep contemporaneous and timely records of the transactions’ (1995 AWA Appeal judgment, p.651).

In Van Reesema, the South Australian Full Court referred to Burt J's judgment in Manning where he had stated it was hardly necessary to say that the obligations, under similar legislation, would not be met simply by keeping source materials from which a set of books could be written up. The AWA Appeal Court used Van Reesema as a precedent and found that ‘...the accounting records must be kept on a regular basis. AWA's foreign exchange accounting records were not’ (1995 AWA Appeal judgment, p.651).

### **3.13 AWA LTD V DANIELS DELOITTE HASKINS & SELLS [1992] 10 ACLR 933**

In late 1985, AWA decided to hedge against foreign currency fluctuations by making forward purchases of foreign currency against contracts for imported goods. In 1986, and

in the first half of 1987, they appeared to have made substantial profits from foreign exchange dealing.

In fact, AWA had lost over \$49 million. Weaknesses in the company's internal controls and record-keeping concealed its true position. The company's management had failed to set up an adequate system of internal control and records of foreign exchange dealing.

The company's auditors, DHS, though aware of the weaknesses and inadequacies of the system, failed to report them to the board of directors. At the end of June 1987, when the board knew the true situation, remedial steps were taken to close uncovered foreign exchange positions.

Rogers J emphasised that, on both occasions, in which Daniels had attended board meetings (22-9-86 and 30-3-87) he was aware of the condition of the books but failed to tell the board. His Honour saw this failure to report on the condition of the books as going to the very core of the auditor's reason for existing. In noting that '...at the heart of the auditing function must lie an examination of the books of account' (1992 AWA judgment Rogers J, p.24).

Baxt (1992b) stated that Rogers J confirmed the view that a director is justified in trusting officers of the corporation to perform all the delegated duties. However, Rogers J distinguished between the position of the chief executive Hooke and the non-executive directors, and held that there was liability on the part of Hooke, the CEO of AWA.

The Appeal judges agreed with Rogers J '...that the chief executive was negligent' (1995 AWA Appeal judgment, p.616). Rogers J created an historical precedent in Australian audit negligence cases when he held that AWA was guilty of contributory negligence as a result of the negligence of members of AWA's management team which was imputed to AWA (with apportionment set as 20% to AWA, and 80% to the auditors).

### **3.14 COLUMBIA COFFEE & TEA PTY. LTD. V CHURCHILL 29 NSWLR [1992] 10 ACLC**

In *Columbia Coffee and Tea Pty. Ltd. v Churchill* 29 NSWLR [1992] 10 ACLC the court ruled that the audit responsibility extended to a third party due to the audit firm's statement in its audit manual. The NSW Supreme Court interpreted statements in an auditor's manual as an acceptance of responsibility to anyone who might reasonably and relevantly rely upon the audited accounts for the purpose of ordering their business affairs. Thompson (1993, p.57) noted that the Court ruled that a company, which had relied on the accounts when deciding to buy shares in Columbia Coffee, could sue the auditors if those accounts proved to be incorrect.

Livanes (1993) suggested that the controversy over auditor's liability has been revived following the decision of the Supreme Court of NSW in *Columbia Coffee*.

Gibson *et al.* (1994) noted that as a result of *Columbia Coffee*, this case extends the duty of care owed to parties outside contract. And how this duty has potentially been extended to a wider class of financial statement user as a result of this case, and has important implications for the auditing profession. Ferrers (1993) reported that the auditors subsequently escaped liability because *Columbia Coffee* could not show how the breach of duty led to the actual loss.

The presiding Judge, Rolfe J, concluded that what may have been the restriction on the duty owed by the auditors, the auditors accepted that it was owed to a class of persons wider than the company for which the audit was being conducted, and its shareholders.

Rolfe J considered it possible that the defendant auditors could have established a claim for contributory negligence if the particulars of their defence had extended further, to include an allegation of failure by one of the directors to disclose, to the auditors, matters relevant to the audit.

### **3.15 DANIELS V AWA [1995] 13 ACLC 614**

The issues on appeal in Daniels v AWA (1995) 13 ACLC 614 were:

- by September 1986 the value of open foreign exchange contracts had exceeded \$700 million;
- as at 31-12-86 AWA had no record of loans of \$38.8 million, which Korval (foreign exchange manager) had taken out to fund foreign exchange losses;
- on 9-3-87, DHS confirmed that the results of the AWA group for the 6 months ending on 31-12-86, showed an operating profit of \$16.068 million when AWA had actually sustained a substantial operating loss;
- an adequate system for conducting foreign exchange dealing had only been implemented during July 1987; and
- AWA's board had not learnt that AWA had lost \$49.8 million from foreign exchange operations until July 1987.

DHS appealed on the basis that there had not been a breach of duty by the auditors in relation to their actions in:

- not warning the directors of weaknesses in internal controls;
- the failure to follow up on the “wrong way around” position;
- the failure to qualify in relation to accounting records; and
- the auditors’ actions in relation to the December 1986 examination.

The Appeal Court found that the trial judge had correctly found that DHS had been negligent and had failed to comply with sec.285 of the Companies Code in respect of the foreign exchange operations.



### **3.15.1 Reporting Internal Control Weaknesses**

The Appeal judges found that, if the auditor in the course of evaluating internal control and other auditing procedures became aware of material weaknesses or internal control weaknesses, then ‘...the auditor must ensure, usually by a communication in writing, that management becomes aware of these weaknesses on a timely basis’ (1995 AWA Appeal judgment, p.645).

The AWA Appeal Court noted that even DHS's own audit manual stated that it was then generally accepted practice to report to management on matters which came to the auditor's attention. The report should ‘...not normally be addressed to someone below board level unless the matters dealt with in the report are of relatively minor importance’ (1995 AWA Appeal judgment, p.629).

The Appeal judges then went on to state that ‘If management does not react appropriately, the auditor must report the weaknesses to the board’ (1995 AWA Appeal judgment, p.645-6).

### **3.15.2 The 31-12-86 Profit Confirmation Letter**

The Appeal judges and Rogers J were equally critical of the decision by Daniels to sign the profit statement before all the returns had been received from the banks. Rogers J declared that ‘Further, Daniels disregarded material in hand which showed discrepancies and worse yet the existence of the FX [foreign exchange] loans which were not supposed to exist’ (1995 AWA Appeal judgment, p.648).

The Appeal judges referred to the precedents set in Manning and Van Reesema and quoted from Burt J's judgment in Manning where he said ‘...it is not met simply by keeping the source materials from which a set of books may be written up. The accounting records must be kept on a regular basis’ (1995 AWA Appeal judgment,

p.651). The Appeal judges confirmed Roger J's belief that AWA's foreign exchange accounting records were not kept on a regular basis.

The Appeal Court found that the standards of reasonable care and skill are more exacting today than those which prevailed in 1896 when the Kingston Cotton Mills case was decided.

### 3.15.3 Contributory Negligence

The Appeal judges agreed with Rogers J and upheld the auditor's contributory negligence claim and found that there was no principle of law or fact which denied to the auditor an appropriate deduction in respect of any contributory negligence of the company.

## 3.16 ESANDA FINANCE CORPORATION LTD V PEAT MARWICK HUNGERFORDS 188 CLR 241 [1997]

In *Esanda Finance Corporation Ltd v Peat Marwick Hungerfords* 188 CLR 241 [1997] the auditor was alleged to have failed to comply with the accounting standards. Esanda Finance relied on the audited accounts and audit report in entering into transactions. The Full Court had declined to follow a decision of the Supreme Court of NSW in *Columbia Coffee* where Rolfe J held that the audit manual extended the auditor's duty to a group far wider than the company and the shareholders being audited.

Baxt (1994) noted, in the July *Charter*, that the Esanda case reduced the legal duties of auditors to third parties. The appeal judges in the High Court, Brennan CJ, Dawson, Toohey, Gaudron, McHugh and Gummow JJ stated that the courts were concerned that sophisticated financial investors were expecting the auditor to compensate them for a loss that arose from their self induced reliance on the auditor's work but were not prepared to pay for it.

In the High Court, Brennan CJ (1997) referred to *Caparo* where Lord Roskill rejected the premise that there was an unlimited duty of care extending to anyone who used these accounts. 'A duty extending to anyone who may use these accounts for any purpose such as investing in the company or lending the company money, seems to me untenable' (1997 Esanda Appeal judgment, p.78).

Dawson J, in the High Court of Australia, found that the Full Court was correct in regarding the existence of the accounting standards referred to in Esanda as not amounting to an assumption of responsibility on the part of Peat Marwick Hungerford and in rejecting the reasoning in *Columbia Coffee*.

The decision of Esanda endorsed the decision in *Caparo* in the UK. This meant that auditors did not owe a duty of care to third parties who claimed that they had relied on statutory audit reports regardless of whether the auditor had foreseen or had actually known of that reliance.

As a result of the ruling in Esanda, the duty of care needs to be established by the third party and they need to show that the auditors intended to induce them to act on the audit report. Justice McHugh was concerned at the way sophisticated financiers were being given a 'free ride' on the auditor's work suggesting that they require the auditor to compensate them for the loss that arose from their self-induced reliance on the auditors' work, but were not prepared to pay for it.

In Esanda, Tomasic et al. stated that '...the High Court was finally able to lay down decisive guidelines for Australian law about the liability of auditors to third parties' (Tomasic et al. 2002a, p.163). This decision severely restricts the auditors being pursued under common law but we may now see increased action under the Trade Practices Act claiming misleading and deceptive conduct.

The decision in Esanda eases the auditors' litigation risks and results in a decrease in the size and source of claims and more certainty in professional costs.

### **3.17 STATE OF SOUTH AUSTRALIA V PEAT MARWICK MITCHELL & CO [1997] 24 ACSR 231**

This case *State of South Australia v Peat Marwick Mitchell & Co* [1997] 24 ACSR 231 arose from the discovery of large losses incurred by the State Bank of South Australia. The Bank then required a bail out by the State Government to prevent its collapse. Peat Marwick Mitchell was sued for the losses, which the SA government considered should have been identified at a much earlier date.

However, Olsson J noted that in *Pacific Acceptance*, Moffitt J had earlier accepted that the basic duty of an auditor has always been to audit accounts with reasonable care and skill, and that the standard of care and skill required has increased since *Kingston Cotton Mills Ltd*, [1896] 2 Ch D. 279 in 1896.

However, Olsson J found that it was not a question of the Court requiring higher standards simply because the profession has adopted higher standards. It was more a question of the Court applying the law, which has necessarily been extended to meet the modern conditions and complexities of business.

Olsson J noted that ‘...the Court [was] applying the law, which by its content expects such reasonable standards as will meet the circumstances of today, including modern conditions of business and knowledge’ (*State of South Australia* 1997, p.255).

He found that professional accounting standards and practices provided a sound guide to the court in determining what is reasonable. He agreed with Rogers J in the AWA case that such a view was simply plain commonsense and complied with commercial reality.

However, he referred to Pacific Acceptance and agreed with Moffitt J that auditors should not simply rely on a defence that they had met the technical requirements of the professional standards and he questioned, using the words of Lindley MR in *London and General Bank*, whether ‘...substantial justice should be sacrificed to a wretched technicality’ (State of South Australia 1997, p.255).

Olsson J noted that the legal duty to audit the accounts with reasonable skill and care had not changed but ‘...reasonableness and skill in auditing must [had to] bring to account and be directed towards the changed circumstances’ (State of South Australia 1997, p.252).

### **3.18 Summary and Conclusion**

In this chapter the major Australian audit negligence cases were examined and particularly their impact on the findings in the AWA case. The chapter also highlights the standard now expected of the auditor. In *Pacific Acceptance* (1970), AWA and in *State of South Australia* (1997), the courts have consistently rejected the auditors’ argument that they had met the professional accounting standards and that was all they needed to comply with.

Rogers J summed up the court’s conclusion when DHS argued that they had complied with AUP12 ‘Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit’ and that was all they needed to do. Rogers J found that ‘...there is no reason to think one-way or the other that is the prevailing standard. All one knows that is the minimum standard’ (1992 AWA judgment, p.57).

The Courts invoked the canine theme, which has often been used by the courts to describe the auditor’s role. Holmes LJ in *Irish Woollen*, as long ago as 1900, reminded auditors that the watch-dog should bark occasionally ‘...and if when sniffing around he should hit

on the trail of something wrong he should follow it up and keep his eyes open and his nose too' (Godsell 1993, p.93).

In the next chapter the audit conducted by the DHS audit team is analysed. The relevant statements to the Courts by the DHS members, their answers to questions during the Court proceedings and the comments of Rogers J on the actions and answers of the DHS auditors will be examined.

This analysis represents a valuable opportunity to evaluate the auditors' actions under the critical examination provided by legal proceedings. Due to financial and other constraints there are limited opportunities to follow recent audit negligence cases to their finality. This research examined the entire AWA Court case including the subsequent Appeal.

## **Chapter 4. The Deloitte Haskins and Sells Audit Team's Conduct (or Non Conduct) of the AWA Audit**

### **Major Participants Appearing in Chapter 4**

**Alagna:** AWA chief accountant who first discovered Korval's illegal loans.

**Belfanti:** AWA internal audit manager and long time friend of Daniels.

**Brentnall:** DHS audit senior responsible for the 6 month audit ending 31-12-86.

**Daniels:** DHS audit partner responsible for the AWA audit for over ten years.

**Gibson:** AWA general manager and also long time friend of Daniels.

**Hooke:** AWA chief executive officer (CEO) and chairman of the board.

**Korval:** AWA foreign exchange manager responsible for the loss of \$49.8 million.

**Laidlaw:** DHS audit manager from 15-7-86.

**Lloyd:** DHS audit senior responsible for the 1985/86 foreign exchange audit.

**Mileham:** AWA accountant responsible for Korval before February 1987.

**Murray:** DHS audit manager until 11-7-86.

**Wickham:** AWA finance manager responsible for Korval after February 1987.

## **4.1 Introduction**

In Chapter 4 the DHS audit team analysis of the AWA audit will be considered. There were three main audit members involved in the AWA case. Daniels, the audit partner, who had been involved in the AWA audit for approximately 37 years; Lloyd the 1985/86 foreign exchange auditor, and Brentnall, the foreign exchange auditor for the six months audit, 1-7-86 to 31-12-86.

There were also three main players involved in the loss by AWA of \$49.8 million in foreign exchange. They were Korval, the AWA foreign exchange manager; Hooke, the AWA CEO; and Daniels the DHS audit partner.

There was clear evidence throughout the audit that Korval had given false information to the audit team. The Internal Audit Manager, Belfanti, had asked Korval to check whether the contract list was complete and all losses included, ‘...as I am calculating your commission. Are all the losses included?’ (Court statement Belfanti 4-2-91, p.22). Korval had taken the list away and a few days later had returned it to Belfanti and had told him that ‘I have checked the list and it is all OK [okay]’ (Court statement Belfanti 4-2-91, p.23).

Korval had then received a bonus of 560% of his salary based on his stated profits. He was paid an \$84,618 bonus for the six months ended 31-12-86 based on his stated net profits of \$13.4 million. His yearly salary was \$30,187 and this represented a bonus of approximately 560%. (Court statement Lonergan 30-9-87, p.8).

Hooke, the CEO, did not properly monitor the foreign exchange operation and did not heed warning signals from various sources. He was given several warnings by the DHS audit team but failed to follow them up. Daniels advised Hooke, on 13-3-86, of significant weaknesses and this was one reason he did not tell the board of directors



‘...because, he said, he expected that Hooke would have done so’ (1995 AWA Appeal judgment, p.641).

It is not surprising that the Appeal judges agreed that Rogers J ‘...was correct in finding that the chief executive was negligent’ (1995 AWA Appeal judgment, p.616). The managing director of Barclays Bank (BBL) had told Hooke, on 5-11-86, that the AWA foreign exchange operation was in a dangerous situation. ‘Your company has very substantial unrealised losses arising out of our mutual dealings’ (1995 AWA Appeal judgment, p.637). Despite these warnings, Hooke failed to take any appropriate action.

Daniels had been the senior audit partner on the AWA audit and he had been responsible for the AWA audit for over thirty years. He had failed to respond to significant irregular activities noted by the DHS audit team. Murray, the DHS audit manager, had believed that a 100% bank circularisation test meant that it was not necessary to gain an understanding of the accounting system and its related controls. ‘If you were going to test 100% of the population there is no point in testing the internal controls’ (Court proceedings Murray 20-3-92, p.13).

The DHS audit team had unquestioningly accepted Korval's assertion that he could speculate in large amounts of foreign exchange. However, the DHS auditors should have checked his naive statements. Korval told them ‘...it was only a matter of time before these contracts would come into profit again...’ (Court proceedings Lloyd 23-3-92, p.12). It was strange that the auditors would accept, without question, Korval's assertion that the unrealised losses on the USD contracts would never eventuate into real losses.

Daniels had decided to treat the contracts as specific after taking into account Korval's view that they were specific. He allowed Korval to dictate the interpretation of the accounting standard. Daniels then agreed to treat the contracts as specific: ‘We had already determined that they were specific’ (Court proceedings Daniels 31-3-92, p.40) which meant that AWA did not need to comply with AAS20 and include unrealised losses in their accounts. This contrasted with the view of Gibson (the AWA general

manager) who said to Daniels ‘The foreign exchange contracts are general hedges. The unrealised loss should be booked.’ (Court statement Daniels 24-5-91, p.14). If the contracts had been classed as general, then in compliance with AAS 20 section 28, any unrealised losses arising on hedge transactions ‘...ought to be recognised in the profit and loss account or its equivalent in the period in which they arise’ (1995 AWA Appeal judgment, p.410).

Daniel’s view contrasts with that of the other DHS audit members. Lloyd, the DHS foreign exchange auditor, concluded that the foreign exchange contracts could not be classified as specific hedges under the definition of the standard. ‘The final conclusion that I came to was that you couldn’t identify any of those contracts as being specific hedges under the definition of specific hedges in AAS 20’ (Court proceedings Lloyd 24-3-92, p.10). The rest of the DHS audit management team agreed with Lloyd that, in accordance with AAS20, the contracts were not specific but general.

## **4.2 Background**

The three key issues in both the original Court case and the Appeal case were:

- the failure of Daniels to report to the Board of Directors on 22-9-86, the absence of proper internal controls over AWA's foreign exchange operations;
- the signing, on 9-3-87, of a \$16.068 million profit confirmation letter for the six months ended 31-12-86; and
- the failure of Daniels to report to the Board of Directors on 30-3-87, the absence of proper internal controls over AWA's foreign exchange operations. This was despite Daniels then having even greater knowledge of poor controls and records than he had been aware of at 22-9-86.

In late 1985, AWA decided to hedge against foreign currency fluctuations by making forward purchases of foreign currency against contracts for imported goods. In 1986, and

in the first half of 1987, AWA appeared to have made substantial profits from foreign exchange dealing. In fact, it had lost \$49.8 million. Weaknesses in the company's internal control and record keeping had concealed the true position.

The company's management had failed to set up an adequate system of internal control and record of foreign exchange dealings. The company's auditors, DHS, although aware to a varying degree of the weaknesses and inadequacies of the system, failed to report them to the board of directors. In July 1987, when the board knew the true situation, remedial steps were taken to close out uncovered foreign exchange positions.

AWA had a history of detailed accounting systems and stringent authorisation requirements. The AWA internal audit used a Cumulative Monetary Amount (CMA) sampling system. The monetary precision amounts used by AWA internal auditors in their CMA sampling, meant that most foreign exchange transactions, if entered in the accounting records, would be selected for vouching or sub-sampled for checking by the internal audit section. Unfortunately, many of Korval's foreign exchange transactions had not been entered in the accounting records.

This history of a detailed accounting system at AWA had an effect on the DHS auditing procedures. Murray did not undertake a detailed review of the adequacy of the foreign exchange accounting system because 'I expected that AWA's internal auditor would have examined the system at the time of commencement of the foreign exchange department's operations' (Court statement Murray 2-5-91, p.3).

#### **4.2.1 The Foreign Exchange Manager**

It is surprising that when AWA decided, in early 1986, to transfer the foreign exchange operation from Ashfield to its Sydney head office, it did not incorporate the foreign exchange operation into its accounting system. Instead, it set it up as a separate profit centre under the control of 23-year-old Andrew Korval who told Lloyd that the only limits placed on him were those imposed by the banks. 'However, I [Korval] do not

know what those limits are anyway. Furthermore, I can deal with whomever I like' (Court statement Lloyd 14-5-91, p.10).

Mileham advised Korval that the foreign exchange operations were to be treated as a profit centre and that he would be paid a substantial bonus for any profits made. He told Korval that the various AWA branches had import requirements of \$150 million a year and that he could trade in those contracts to the value of two years import requirements. Murray did not check to see whether Korval had any limit on his dealing either with any particular bank or generally. Korval was then no longer restricted to hedging and began speculating in foreign exchange contracts in excess of \$300 million.

Hight, the managing director of Toronto Dominions, told Mileham at a meeting in November 1986 that '...Korval was rolling over loss-making contracts and that his trading was highly speculative' (1995 AWA Appeal judgment, p.638). Mileham never reported this to Hooke or to the directors.

Mileham, who had no prior experience in foreign exchange, allowed Korval to operate without instituting any adequate supervision and there was never any reconciliation of Korval's foreign exchange contracts or implementation of any other appropriate internal controls.

#### **4.2.2 The AWA CEO**

Hooke was the AWA CEO and had no experience of foreign exchange. He was entitled to assume that senior management were properly supervising Korval. However, Daniels had advised him on several occasions of foreign exchange internal control weaknesses. More importantly, he had been advised on two occasions by BBL of substantial unrealised foreign exchange losses but he had failed to follow up these warnings.

On 5 November 1986, Heerding, the Managing Director of BBL, wrote to Hooke advising him of AWA undertaking historic rate-rollovers with his bank resulting in ‘...very substantial unrealised losses arising out of our mutual dealings’ (1995 AWA Appeal judgment, p.637).

Hooke later met with Locke from BBL who identified AWA's exposure as \$169 million. Locke also told Hooke that ‘...your company has very substantial unrealised losses arising out of our FX [foreign exchange] dealings’ (1995 AWA Appeal judgment, p.637).

Hooke's explanation was that ‘...he did not understand that BBL was telling him that AWA had losses which were being rolled over’ (1995 AWA Appeal judgment, p.637).

#### **4.2.3 Daniels, the DHS Audit Partner**

There were many early indications that Korval's actions were very unusual. The DHS audit team under Lloyd noted the following points early in the 1985/86 audit and Daniels, as the audit partner, was responsible for ensuring they were properly investigated.

- Lloyd was aware that the last time he saw entries in the dealing register ‘...there were only contracts up to the end of June...’ (Court proceedings Lloyd 23-3-92, p.72) and this was in August. Korval's records were poorly kept. Large amounts of paper on his desk were evidence of records being entered in batches well after the date of the transactions and contracts being entered on unnumbered slips of paper. The dealing register had not been maintained after 30-6-86.
- Lloyd quickly assessed that Korval was responsible for all aspects of AWA's foreign exchange operations including strategy. Lloyd observed that Korval was solely responsible for foreign exchange dealings and had responsibilities ‘...for both settlement and accounting functions...’ (Court proceedings Lloyd 24-3-92, p.19). This resulted in no effective controls over Korval.
- Korval told Lloyd that the only limits on him were those imposed by the banks. At the time of the 1985/86 audits he was covering two years foreign exchange

purchases. This was in excess of \$300 million. Lloyd realised that a \$6.2 million loss had been incurred on AUD/USD contracts by 30-6-86. ‘Yes, but on the basis that it was material, then I didn’t think the company needed to adjust their records to account for it [the loss]’ (Court proceedings Lloyd 24-3-92, p.10).

- on the bank confirmation replies for 30-6-86 Lloyd noted that three listed contracts, including a \$2 million contract from BBL dated 26-6-86, had not been listed by Korval. Lloyd did not check with BBL as he didn’t think there was any point in any further test. ‘...but it was up to Andrew Korval to decide how far forward he wanted to hedge’ (Court proceedings Lloyd 23-3-92, p.27). Korval had millions of dollars of unrealised losses at 30-6-86 but had falsely told Lloyd that it related to rolled over contracts and that there were no unrealised profits or losses.
- Korval told Lloyd that he used ‘wrong way around’ foreign exchange contracts and this exposed AWA to an uncovered position of \$84 million. Lloyd was initially concerned that the AUD/USD contracts were ostensibly the wrong way around. However, the reason he changed his view was because of his conversation with ‘...Mr Korval and Mr Mileham’ (Court proceedings Lloyd 23-3-92, p.25).
- Korval told Lloyd that accounting standard AAS20 was very simplistic and ‘...that anything to do with foreign exchange is speculating’ (Court proceedings Lloyd 23-3-92, p.24). He believed that the accounting standard had been written by people who did not understand foreign exchange in practice.
- Korval also said his contracts were specific hedges because they were hedges upon hedges. However, the difference between the two groups of contracts at 30th June was approximately \$23 million or twenty percent value difference. It was Lloyd's view that the ‘...unrealised position on both sets of contracts would have to be brought to account’. (Court proceedings Lloyd 24-3-92, p.10)
- Korval told Lloyd, ‘...don't worry about the second leg. The discrepancy will eventually right itself’ (Court proceedings Lloyd 24-3-92, p.24). Korval said that the AWA general manager, Gibson, was worried about contracts showing a large

unrealised loss and wanted them closed out but Korval advised Lloyd that Gibson did not understand foreign exchange. 'Korval thought that he had more knowledge than anyone, let alone people in AWA; as to foreign exchange and I took it in that context' (Court proceedings Lloyd 23-3-92, p.77).

- Belfanti, the AWA audit manager, noted that, because Mileham had changed the former policy of covering individual import requirements to one of covering bulk requirements, it meant that the internal audit could no longer trace a foreign exchange contract back to individual import contracts as they previously had been able to. The realised position had been absorbed into the general ledger but the unrealised position had not because the '...green book would only record what was recorded' (Court proceedings Belfanti 10-3-92, p.92).

Daniels' position in respect to the implementation of AAS20 lacks credibility. Mileham and Korval were anxious that the AWA hedges should be classed as specific hedges because this meant that the substantial unrealised losses did not have to be brought to account in the financial statements.

All the DHS auditors, excluding Daniels, agreed that the hedges were general. The decision by Daniels to agree with Korval's interpretation of the contracts as specific meant that \$297.5 million in speculative foreign exchange contracts was not disclosed in notes to the accounts. The net unrealised loss at 30-6-86 which should have been shown as \$2.4 million, was instead shown as \$300,000.

Importantly, the directors would have been alerted to the real situation if, in compliance with AAS20, AWA had disclosed the gross exposure position of \$147.5 million in unrealised contracts as a note to the financial statements as AAS20 (28) required. Korval had a total speculative foreign exchange of \$297.5 million gross. However, as these contracts could be netted off against each other, the actual exposure position was \$147.5 million, approximately half of the gross amount.

### **4.3 Experience in foreign exchange auditing**

The DHS audit team did not include anybody with relevant foreign exchange auditing experience. This was certainly a great disadvantage. Daniels was aware that Korval was operating a large-scale foreign exchange operation without any effective internal controls and that the AWA directors and management had no experience in foreign exchange. In these circumstances, an experienced foreign exchange audit manager or a specialist foreign exchange consultant was needed.

However, the audit team did have extensive general auditing experience. This should have been sufficient to identify the weaknesses of the internal controls, and to detect evidence of the unauthorised loans. It should also have been sufficient to identify the fact that Korval was involved in high-risk speculation. Lloyd agreed that AWA was, in effect, basing its hedging strategy on an assumption that the AUD would move favourably against the USD. Korval told Lloyd that ‘...the long Aussie dollar contracts were to protect against competitors coming into the car radios market’ (Court proceedings Lloyd 23-3-1992, p.18).

Daniels had only had experience with the low risk foreign exchange hedging at Ashfield. However, he did have knowledge of the foreign exchange standard: ‘...my understanding of the concept of hedging was derived, as of June 1986, from my reading of AAS 20’ (Court proceedings Daniels 30-3-1992, p.65). Murray, the audit manager, left DHS on 11-7-1986 and had no other foreign exchange experience. Laidlaw, who only had experience of a foreign exchange operation similar to that at Ashfield, replaced Murray, but like Freeman, the audit partner assisting Daniels, Laidlaw was familiar with AAS20.

Laidlaw, who started on the AWA audit on 15-7-1986, was concerned about the level of foreign exchange experience of the DHS audit team. He decided to ask DHS for an experienced foreign exchange auditor.



Lloyd was seconded from the DHS branch in the UK and was supposed to have had appropriate foreign exchange auditing experience. He actually had very limited experience in small foreign exchange operations and was unfamiliar with a large speculative foreign exchange operation like the one at AWA.

Rogers J was critical of Lloyd's interpretation. 'According to you, BHP should hedge against the fall in the Taiwanese whatever it is, in case somebody from Taiwan may produce steel more cheaply' (Court proceedings Lloyd 20-3-1992, p.56). Lloyd had a fundamentally incorrect interpretation of hedging and confused it with speculation. He believed that any company, which had no direct liability for foreign currency but was indirectly affected by a competitor, is entitled to hedge.

For the December 1986 audit, Daniels and Freeman decided that they did not require Lloyd or another UK auditor with foreign exchange experience.

Brentnall, who was working in the Sydney DHS branch, was appointed the foreign exchange audit supervisor for the six-month audit ending 31-12-1986. He had no previous experience in foreign exchange auditing or in auditing an operation as large as AWA.

However, Brentnall did utilise his general auditing experience to consider the foreign exchange system. '...I concluded that the [AWA] staff had inadequate experience and knowledge of FX [foreign exchange] operations' (Court proceedings Brentnall 24-3-1992, p.59). He prepared a document titled 'Meeting on Audit Approach Re AWA Foreign Exchange,' and this did point out some of the concerns in this area. He found that no proper dealing slips were written or kept and telexes and rollover confirmations '...were generally not retained until 1-3-1987. He reported these matters to Daniels' (Court proceedings Brentnall 24-3-1992, p.62). It was not until Brentnall arrived that any of the auditors used their general auditing experience to understand at least some of Korval's activities.

Brentnall's report advised that the total exposure position of approximately \$400 million was in the order of four times the annual requirements of \$100 million a year in electronic parts imports from Japan. Brentnall used the previous year's average requirement of \$100 million a year in electronic parts imports whereas Mileham based his \$150 million a year on the anticipated requirements for the upcoming year.

Brentnall found that the bulk of this exposure was for contracts that did not appear in AWA's records. He also concluded that '...there was not an adequate system of segregation of duties' (Court proceedings Brentnall 24-3-1992, p.58).

Brentnall also reported to Daniels that no ledger of foreign exchange transactions was being kept and warned of '...the practice of successive rollovers and the risks of concealment of large losses' (1995 AWA Appeal judgment, p.640). But Daniels failed to follow through on these recommendations and elected not to take Brentnall to the 30-3-1987 directors' meeting. Brentnall had recommended a presentation to the directors on the overall foreign exchange scenario and associated risks.

It is clear that the lack of any specialised foreign exchange auditing experience was a factor in the non-detection of the large unauthorised loans undertaken by Korval. However, there is also ample evidence of the lack of compliance with general auditing procedures by the DHS team, excluding Brentnall. This was also very significant. 'At the heart of the auditing function must lay an examination of the books of account' (1992 AWA apportionment judgment, p.24).

#### **4.4 Reasons for No Engagement Letter**

Daniels did not regard an audit engagement letter as important. 'I never saw any need for such a letter' (Court statement Daniels 24-5-1991, p.2). Daniels had a long-term policy of not sending AWA an audit engagement letter. No audit engagement letter had been forwarded to AWA since, the latest, 1969. Even when Yarwood Vane, who had

previously conducted the audits, merged with DHS in 1979, the audit engagement letter was not updated.

When AWA requested a special audit for the six months ended 31-12-1986, it would have been an important time to have updated the engagement letter and to have negotiated and documented the exact terms of the special audit.

Daniels also did not see any need to document audit meetings with AWA because he was familiar with their management and preferred to discuss problems in person. He did not even regard it as necessary to provide AWA with a management letter at the completion of the audit ‘...as I [Daniels] viewed the exit meeting as fulfilling the same role’ (Court statement Daniels 24-5-1991, p.2). He was legally entitled to adopt this approach as AUP9 stated that on recurring audits the auditor might decide not to send a new engagement letter each year.

However, paragraph 5 of AUP9 provides for changes in the business environment. It states that the introduction of a significant change, such as a large-scale foreign exchange operation, may cause the auditor to send a new letter. The importance of updating the audit engagement letter is that it provides both management and the auditor with an opportunity to clarify issues to be undertaken in the audit. It also acts as a useful plan for the audit to follow, and it indicates to the auditor any issues undertaken during the audit that were not included in the original engagement letter and therefore should now be brought to management’s attention.

## **4.5 Audit Planning**

The audit planning undertaken by DHS was inadequate. Prior to the audit, Daniels did not give consideration to what was necessary to conduct a proper audit of the foreign exchange operation. One of the planning objectives of the foreign exchange audit should

have been to ensure that all foreign exchange deals had been authorised, complete and accurate, as set out in DHS's own audit manual.

The 1985-86 audit-planning meeting was on 26 June 1986. At this meeting it was decided that for year-end verification purposes, DHS would place no reliance on the foreign exchange internal controls and would instead rely entirely on external verification of open foreign exchange transactions at the year-end.

Two issues arose from this plan. First, DHS planned to place no reliance at all on the internal controls. This indicates the very seriousness of the weaknesses in the internal controls. The auditors owed AWA an obligation to not only evaluate the sufficiency and reliability of the internal control structure in its planning but also to warn an appropriate level of AWA management concerning the serious weaknesses in the internal controls.

As a result of the internal control weaknesses identified by DHS, Daniels, and Murray agreed that 100% circularisation of open positions ‘...was the appropriate means of testing the open positions’ (Court statement Daniels 24-5-1991, p.10).

Second, DHS both planned to, and did, rely on AWA's records in undertaking its external verification. This was a dangerous audit procedure. DHS had first decided that the internal controls were inadequate because the records prepared by Korval could not be relied on. DHS then proceeded to rely on AWA to prepare the bank confirmations from the same records for the external verification. Consequently, the bank confirmations did not provide a 100% verification of all ‘open’ positions.

Daniels was confident that AWA had a complete list of banks ‘...so that circularisation of all banks was not necessary’ (Court statement Daniels 24-5-1991, p.10). He decided not to undertake a full circularisation of the relatively small number of banks dealing in large foreign exchange transactions in Australia, even though this would have given him certainty, at least in Australia. Surprisingly, he thought that the alternative to relying

upon AWA was far more complex and that was to ‘...circularise every foreign exchange dealer in Australia’ (Court statement Daniels 24-5-1991, p.10).

DHS also did not undertake adequate planning meetings throughout the audit. This was particularly noticeable with regard to the dual responsibility that Korval, as manager, had of both the foreign exchange and money market operations. Lloyd assumed that cash discrepancies in the foreign exchange area were being picked up in the money market area.

Lloyd was not responsible for audit work in respect of the reconciliation of cash balances ‘I believed that this work was done in the course of the audit and that no discrepancies were revealed’ (Court statement Lloyd 14-5-1991, p.24). The audit of the foreign exchange area had discovered some unusual cash transactions that they presumed were relevant to the money market operations and not part of the foreign exchange operation.

Korval also gave false information to the DHS team’s questions. This information appeared to confirm the auditor’s belief. Lloyd questioned Korval as to why contracts had been omitted from typed contract lists. Korval falsely told him ‘...it was a typing error because they are actually included on the circularisation letters sent to the counterparties’ (Court statement Lloyd 14-5-1991, p.21). A regular audit meeting should have resulted in adequate cross-referencing that would have uncovered the true situation.

#### **4.6 Foreign Exchange Auditing Procedures undertaken by DHS**

The foreign exchange auditing procedures undertaken by the DHS audit team were inadequate. Some examples of flawed procedures are given below.

- Murray told Laidlaw that the system of control over accounting for foreign exchange transactions are not adequate. The DHS audit team had correctly

identified significant weaknesses in the internal control system but then failed to follow up with a comprehensive investigation.

- DHS could have covered 100% of all Australian financial institutions in bank confirmations, as there was only a small number of such institutions. Daniels believed that ‘...we had a complete list of banks so that circularisation of all banks was not necessary’ (Court statement Daniels 24-5-1991, p.10).
- DHS then failed to properly check all the completed bank confirmations, especially the reply from Bank of New Zealand (BNZ), which clearly showed evidence of unauthorised loans. Brentnall noted a BNZ loan, dated 15-12-1986 for USD 4.697 million, which Korval had not included on his list. Korval falsely told Brentnall that the loans ‘...the loan was in fact closed out on (sic)’ (Court proceedings Brentnall 25-3-1992, p.27).
- the DHS audit team failed to undertake any adequate post audit date review. Lloyd did no post-balance date review in respect of the books and records ‘...but I didn’t perform any audit work on them’ (Court proceedings Lloyd 23-3-1992, p.9). A post audit date review would have provided an audit trail back from the current contracts through the records to the end of year audit date.
- finally, DHS decided not to undertake a systems review of the 1985/86 audit because AWA were soon to change their accounting system. Lloyd said Laidlaw told him not to study or evaluate the current system for audit purposes because he was aware the system was about to change and ‘...it would not be appropriate to do a detailed review of the old systems...’ (Court proceedings Lloyd 23-3-1992, p.7). This was a prime reason to have undertaken a comprehensive review as AWA had only recently expanded its foreign exchange into a large-scale operation.

AWA changed from a policy of covering individual import contracts to one of covering bulk requirements. This meant that the internal audit procedures could no longer trace a foreign exchange contract back to an individual import contract.

Internal audit checked the 'green book' (foreign exchange register) up to June 1986, after which time it was no longer kept. After June 1986, they checked a telex or letter from the selling bank, which was attached to the cheque requisition. However, since this procedure only checked deals that had been recorded in the green book, it could not check any deals not recorded. Rogers J commented that 'What you did not allow for was a situation in which the contracts may not be entered into the green book...' (Court proceedings Murray 20-3-1992, p.35).

#### **4.6.1 The 1985-86 Audit**

The first auditing procedure undertaken by Lloyd for the 1985/86 audit was to examine the foreign exchange accounting records. He looked at the green book but did not examine the records. Therefore, he could not confirm that all deals had been entered into the green book. He checked a sample of transactions from the green book as well as a sample of five contracts from the file to the green book. Deals were not entered in the green book after 30-6-1986 and they were not being entered in chronological order.

Lloyd did not tell his supervisor, Laidlaw, that the dealing register had not been written up after June 1986. He saw his audit responsibility as confined solely to the audit period and therefore did not consider cessation of the green book after 30 June 1986 [wouldn't have been] '...important to me at that stage because I was just auditing as to 30 June' (Court proceedings Lloyd 23-3-1992, p.49).

Lloyd had a responsibility to investigate why the green book was no longer being kept and whether the Lotus software system was an appropriate replacement. He was conducting the audit three months after the cessation of the green book and he could not dismiss this finding merely because it was not part of his audit program.

This was particularly important as Lloyd also found that the other accounting records were also deficient. When he did random sampling from the dealing register to the

contract notes he found that the contract note files were not in sequence and therefore he could not ascertain whether any were missing. This finding of contract files combined with the cessation of the green book should have resulted in Lloyd undertaking a far more comprehensive audit investigation. It should have resulted in the unleashing of the 'blood-hound' as first mentioned by Lopes LJ in the Kingston Cotton Mills case in 1896.

Daniels was the senior partner responsible for the AWA audit but he allowed the decision to evaluate internal controls to be made by Murray who was about to resign from DHS and would not be further involved in the audit program. Murray told Daniels and Laidlaw they should not be placing any reliance on internal controls and that they should rely entirely upon external verification of open transaction. '...I had no experience with [foreign exchange] replies and how accurate they would be. I just assumed the banks would have their records in order' (Court proceedings Murray 20-3-1992, p.38).

Murray decided not to rely on AWA's internal controls because he was aware of the risk that authorised transactions might not be properly recorded in the accounting records '...and therefore might not be disclosed by any internal checks' (Court proceedings Murray 20-3-1992, p.38).

Daniels '...agreed that 100% circularisation of open positions was the appropriate means of testing the open positions' (Court statement Daniels 24-5-1991, p.10). He adopted a very dangerous procedure in relying on the accounting records prepared by Korval in preparing the bank circularisation letters. He had been made aware by Murray that authorised transactions might not be properly recorded in the AWA accounting records. However, he still decided to rely solely on those same records.

Daniels could have adopted the far safer procedure of undertaking a full circularisation within Australia. There is only a limited number of Australian banks and financial institutions and it would have been reasonable to expect a 100% circularisation. This would have given, at least, full certainty for the results within Australia.



Also, the fact that he could not be certain that he had covered all open positions, which were not on AWA's listing, gave more reason for DHS to undertake an extensive post-balance date audit.

#### **4.6.2 The 31 December 1986 Audit**

For the December audit, Daniels and Brentnall decided to increase the substantive testing. They decided not to rely on a larger sample option because not all deals were complete and some might have not been recorded. So they decided to obtain from at least one dealer, Macquarie Bank, externally generated details from that dealer of all deals done with AWA and to do a proof in total. It would have been a simple exercise to have at the same time also requested authorisation limits from Macquarie Bank along with the request for a print-out of deals.

Brentnall did not circularise Westpac even though he knew that Korval had dealt with them in the past. This was because Korval falsely told him that he had not dealt with them in the last six months.

Daniels should have directed Brentnall to trace all current contracts on hand back from the current date to 31 December 1986 as they had discovered that not all deals were complete and might not have been recorded. This would have provided Brentnall with an audit trail to confirm that at least those current contracts were complete and had been recorded. This audit procedure should have uncovered evidence of at least some of the \$38.8 million in unauthorised loans at 31 December 1986.

After he discovered there had not been complete circularisation, Brentnall prepared follow-up letters to be sent out. He wrote to each foreign exchange department of the banks with which Korval had been dealing, and to some he attached a schedule of contracts he wanted confirmed and for the rest, he asked dealers to provide details of open contracts at balance date.

The circularisation procedure was dependent on the adequacy of AWA's records. The replies indicated 33 discrepancies totalling approximately \$4.6 million. Daniels had been involved in both the 1985/86 and the 31-12-1986 audit and should have realised that this pattern of significant discrepancies had continued throughout both audits.

A few relatively quick audit procedures could still have been undertaken even at this late stage. Daniels could have traced foreign exchange contracts, closed in January 1987, to the listing of open contracts at 31-12-1986. He could have also checked with AWA management and the banks what the authorisation limits were.

Finally, Daniels should have been alarmed that the reason Korval had ceased using the green book was because the volume of transactions had increased substantially. AWA was faced with a situation where there was now no reliable record of million dollar foreign exchange contracts. Daniels should have immediately taken this finding to senior management. This was not a case of scruffy records, this was a case of no reliable records being kept of the most important part of the foreign exchange transactions.

#### **4.6.3 Audit Testing for Fraud or Illegal Activity**

There was ample evidence that the DHS audit team did not plan their audit to uncover a possibility of fraudulent activity. Their appeal defence argued that DHS was confronted by an extraordinary conjunction of events including ‘...a junior and trusted employee being in fact engaged in a fraudulent suppression of losses’ (Section A, Discovery of Loans, M/930104/Appsub/DHS/Liabilit.15.29449.1.4).

Daniels did not consider that the rolling over of contracts could have led to fraudulent activity. ‘If we could get a four month contract it would be in a similar sort of scene as a one month rolled over three times’ (Court proceedings Daniels 31-3-1992, p.64). He was not concerned that, unless proper records of the contracts and the roll-overs were kept, a situation could evolve where large unrealised gains or losses were incurred without

management knowing of the existence of gains and losses. His reason for this attitude was that unrealised gains of \$4.9 million at 31-12-1986 would cover any losses.

Murray did not suspect fraud or deliberate concealment when considering the completeness of the circularisation list. He was primarily looking for accidental omission.

Brentnall certainly realised that Korval's salary was based on a percentage of foreign exchange profits. He was also aware of the possibility that large losses might have been buried in the rollovers. Brentnall was also aware that there was a possibility that Korval's decision as to where funds go raised the risk of siphoning off to a private account. He noted in his audit working papers '...as yet no suspicions of collusion, dealers should not be communicated with as they are the one category of person with whom AK [Korval] could collude' (Court proceedings Brentnall 25-3-1992, p.14).

In 1986, Laidlaw was not aware of banks transferring funds to other banks at Korval's direction. 'The possibility of such a transaction as a means of concealing losses did not occur to me' (Court statement Laidlaw 17-5-1991, p.4). Laidlaw also did not believe that the board could think that Korval could earn large profits on trading without the risk of also making similar losses. This was because of the inherent risk in foreign exchange policy, and particularly, because Korval's expectation that the USD would fall against the AUD and the JPY over time, meant that '...there was the risk of an unfavourable movement' (Court statement Laidlaw 17-5-1991, p.20).

Lloyd agreed that there was a possibility that the constant rolling over of contracts could have the effect of disguising losses, which were accumulating on a fairly regular basis but '...because I thought that it was remote' (Court proceedings Lloyd 24-3-1992, p.13) he did not undertake any further tests.

## **4.7 Responsibility to Report Internal Control Weaknesses**

### **4.7.1 The 22 September 1986 AWA Directors' Meeting**

Daniels was invited to attend the board meeting on 22-9-1986 as the board wanted to discuss foreign exchange results in the draft accounts. They were puzzled about the foreign exchange operation because it was a new area of responsibility and they wanted to be assured by Daniels that it satisfactorily met the auditor's examination. Daniels had reviewed the audit working papers prepared by Lloyd and Laidlaw relating to foreign exchange, and should have noted significant weaknesses in the system.

These weaknesses included:

- Korval jotting down his deals on unnumbered deal slips. Lloyd said, 'I am not aware that they were numbered in any way' (Court proceedings Lloyd 23-3-1992, p.3). Daniels should have been aware of a lack of adequate accounting books. He had been told by Lloyd that the foreign exchange records were poorly kept and that there was evidence of records being entered in batches long after the transaction date;
- Korval making naive statements to Lloyd that he could make quick, large profits without any risk of loss. Lloyd agreed that Korval's theory was that the Australian dollar was volatile and this would cause these contracts to come into profit at some stage. 'Yes' (Court proceedings Lloyd 23-3-1992, p.19). Korval believed that all current loss making contracts would eventually come into a profit situation, '...it is my understanding of what Korval was telling me' (Court proceedings Lloyd 23-3-1992, p.19);
- Korval covering foreign exchange contracts exceeding \$700 million annually while being inadequately controlled. There was no attempt to check what his authorisation limits were. Daniels' did not examine the records personally. 'That was not my practice' (Court proceedings Daniels 31-3-1992, p.21);

- Daniels partly agreeing that a director at the 22-9-1986 meeting may have asked a question relating to anything arising out of the audit which the Board should be made aware of. 'He may have said that'. (Court proceedings Daniels 1-4-1992, p.5). Daniels told the directors that all profits from the foreign exchange contracts had been banked to the New York USD account. He also told them that the exchange differences in the hedge transactions were included in the profit and loss account and were adequate;
- Daniels replying to Rogers J's questioning as to why he had failed to answer a direct question from a director, 'A matter of custom, your Honour, back to 1970' (Court proceedings Daniels 31-3-1992, p.26) was less than satisfactory. Daniels decided not to advise the directors of the relevant internal control weaknesses because he did not appreciate the urgency involved and he wanted to wait until the audit exit meeting to formally discuss the poor records, the lack of adequate accounting books and absence of controls in the foreign exchange operations with management. This response was a concern to Rogers J who found it difficult to understand why the auditor would fail to answer a relevant question from a director;
- Daniels acknowledging that he might have erred in his decision not to report to the board by claiming that 'At the time I thought not. At this time I think perhaps I should have' (Court proceedings Daniels 31-3-1992, p.30). Conforming with custom may have been a legitimate aim when he first entered the meeting, however the questions from the directors must have alerted him to the fact that Hooke had not advised them of any internal control weaknesses and that they were seeking reassurance. Under these circumstances, Daniels had been duty bound to advise them of the true situation;
- Daniels was confused when Bathurst QC asked if non-compliance with an accounting standard would have been of great concern to the Board of AWA. Daniels reply was 'The amount of material used?' (Court proceedings Daniels 2-4-1992, p.20). When Daniels went to the board meeting on 22-9-1986, the directors were also proceeding on the assumption that AWA was complying with

all accounting standards. Daniels had an obligation to advise the board that his audit team regarded the contracts as general. This would have meant that AWA should have disclosed as a note to the financial statements, a gross exposure position of \$147.5 million. The directors would have been clearly concerned by this gross exposure position; and

- Daniels incorrectly leading the directors to believe that the foreign exchange operation was being properly managed. To show how foreign exchange profits were treated in the 1986 profit and loss account, Daniels referred the board to an article in the *Business Review Weekly*, which, he suggested, best explained managed hedging. ‘To explain managing hedges, yes’ (Court proceedings Daniels 2-4-1992, p.10). Part of the article identified forward cover as a primary method of hedging foreign exchange exposure. From Daniels’ reference to this BRW article the directors believed that he was advising them that the AWA foreign exchange operation was following the BRW model with a properly managed hedging operation. Daniels’ unqualified certification of the AWA accounts then compounded this impression of a well-managed foreign exchange operation.

There can be no doubt that Daniels was aware of his audit team’s feeling on the foreign exchange contracts. Freeman (DHS audit partner assisting Daniels) expressed the view that the contracts could not be regarded as specific hedges but were general. Lloyd also expressed the view that the contracts ‘...could not be classified as specific hedges under the definition of the standard’ (Court proceedings Lloyd 24-3-1992, p.10). Laidlaw sent a note to Daniels advising him that ‘...the accounting standard AAS20 was not being complied with for the 1986 accounts’ (Court proceedings Daniels 2-4-1992, p.17).

This pattern of poor records and internal control weaknesses continued after the 22 September 1986 directors’ meeting. At the audit exit meeting of 28 October 1986 with Daniels and Mileham, Belfanti reported that Korval’s records were not being filed in a timely manner, the register of foreign exchange transactions was not up to date, and there was a lack of audit trail for transactions.

In late 1986, Brentnall also reported to Daniels that large losses had been sustained on foreign exchange operations because the short-term movements of the AUD were proving unpredictable.

Daniels could have still advised the directors of the weaknesses, even at this late stage. If he had sent a management letter after 28 October 1986, then it would have provided the directors with evidence of the internal control weaknesses. Daniels did not send any management letter and the only record of the meeting were the minutes taken.

#### **4.7.2 The 30 March 1987 AWA Directors Meeting**

If there was any question in Daniels mind at the 22 September 1986 meeting as to whether the weaknesses had been significant enough to have caused full disclosure to the board, then by 30 March 1987 the further evidence of significant weaknesses should have dispelled any doubt.

Daniels was again invited to attend a board meeting with the directors on 30 March 1987. Korval was reporting profits, which now represented 25% of AWA's total profits. The directors were concerned how a new, small operation conducted by a 23 year old could be reporting profits of \$13 million in less than two months.

Daniels should have been aware by 30 March 1987 of significant problems with the foreign exchange operations because his audit team had already noted the following weaknesses in their audit work papers or had discussed them with Daniels.

- Brentnall had previously noted in his audit work papers that, whilst the Macquarie software system was operational, it was still not operating correctly and Crane, the foreign exchange assistant, was struggling to cope with her duties. Brentnall believed that large losses could be suffered even though there were stop losses in place. 'Only insofar as Mr Korval was able to extract money out of the company

bank accounts' (Court proceedings Brentnall 25-3-1992, p.71). This was because Korval was responsible for imposing and removing those stop losses.

- Brentnall had summarised the total exposure position of \$362 million as being more than three times the yearly requirements and the bulk of that exposure as being in respect of contracts that did not appear in AWA's records. Brentnall told Daniels that the exposure reports gave erroneous information concerning open positions, as the records for the input to the system were incomplete. Daniels noted this 'When I was reviewing Stewart Brentnall's working papers for the six-months examination to 31 December 1986' (Court proceedings Daniels 31-3-1992, p.14).
- on 26 March 1987, Brentnall prepared a situation summary, which was available to Daniels '...for presentation to the board meeting on 30-3-1987' (1995 AWA Appeal judgment, p.640). Brentnall had recommended a presentation to the board on the overall foreign exchange scenario and associated risks. However, Daniels elected not to take Brentnall, who was responsible for the foreign exchange audit, to the 30 March 1987 directors meeting.
- by 30 March 1987, Daniels had become aware that bank circularisations had disclosed unrecorded contracts with an unrealised loss position of approximately \$4.6 million. Daniels did not consider that large losses and a lack of awareness as to where those losses were being funded, or out of which accounts, necessarily called for audit investigation. 'Not necessarily' (Court proceedings Daniels 2-4-1992, p.27).
- Brentnall found that no ledger of foreign exchange transactions was being kept and that Korval was solely responsible for foreign exchange dealings. He reported his findings to Daniels. 'Yes, I did' (Court proceedings Brentnall 24-3-1992, p.59). Daniels met Hooke on 13 March 1987 and advised him that contract notes for roll-overs had not been retained and the day book of contracts written had not been maintained for some months.
- at the 13 March 1987 meeting with management, Daniels had recommended that a new person with knowledge of foreign exchange should be responsible for



settlements, data input and other administrative matters and that these were essential and urgent matters. Daniels partly accepted Brentnall's statement that pre-November 1986 they were extremely incomplete and that post-November 1986 they were chaotic and irregular 'We were addressing the period ending 31-12-1986...' (Court proceedings Daniels 1-4-1992, p.44). He conceded in cross examination that 'There were omissions from the records, yes' (Court proceedings Daniels 1-4-1992, p.44).

- Brentnall found that Korval was simply playing the market and that there was '...no limit on his trading activities' (Court proceedings Brentnall 24-3-1992, p.80). Brentnall told the 13 March 1987 meeting that AWA's overall foreign exchange exposure should be assessed with a view to establishing a maximum downside risk. He also recommended that day-to-day monitoring of the system and trading results should be performed.

There was no valid reason for Daniels' belief, at the 30 March 1987 meeting, that the foreign exchange operations were not so serious that they did not need to be reported immediately to the directors. Daniels met Hooke shortly before the 30 March 1987 directors' meeting. This had been an ideal time for Daniels to tell Hooke that he must advise the directors about the internal control weaknesses discussed at the 13 March 1987 management meeting.

Daniels had been asked to attend the 30 March 1987-board meeting to discuss foreign exchange issues. He agreed that, at the meeting, one of the directors had said to him that they were concerned about the large profits emerging from the foreign exchange area. 'Yes' (Court proceedings Daniels 2-4-1992, p.44). Daniels indicated to that director that he would observe subsequent profit allocations and weight their examination more heavily in the impending 30 June 1987 audit.

Rogers J questioned Daniels as to whether he had any obligation to inform the board. Daniels did not agree that, because he had already told Hooke, he should have told the board about the unrealised losses. '...we had informed Mr Hooke and I believed it was

Mr Hooke's duty to inform the board...' (Court proceedings Daniels 1-4-1992, p.56). Daniels expected Hooke, as the chairman of the board and chief executive, to advise the directors.

The directors were still not satisfied with the foreign exchange operation. Finley, a Director, had told Daniels at the 30 March 1987 board meeting, that the directors wanted assurance that DHS had investigated the whole area '...and that we are not kidding ourselves in accepting these figures presented to us in the monthly accounts' (1995 AWA Appeal judgment, p.641).

Finley later invited Daniels to a private meeting at his office on 30 May 1987. Finley opened this private meeting with the words 'You can see how worried the board is about the foreign exchange situation...' (Court statement Finley 24-8-1990, p.13). Daniels did not pass on any information to Finley regarding the records, the internal controls or the unrealised profits for the same reasons that he had not told the board on 30 March 1987. In fact, he told Finley 'The profits are all being banked' (Court statement Daniels 30-3-1987, p.38). Daniels was obliged to have honestly answered the questions of the directors (who included Finley) about the foreign exchange operations and he should have advised them of the serious internal control weaknesses. 'The reported profits have been realised' (Court statement Daniels 30-3-1987, p.33) was not a sufficient response to the directors. Exposure Draft 38 'Fraud and Error' paragraph 12 states that the auditor also has a responsibility to report irregularities to the governing body when suspicions are aroused as a result of normal, careful evidence gathering, whether or not these are material to the financial report.

The DHS audit manual also stated that the auditor should provide a written report to the board. However, it was Daniels' practice never to write reports, although a management letter would have informed the board of the considerable weaknesses in the foreign exchange operation.

## **4.8 Reasons Why the 1985-86 Accounts Should Have Been Qualified**

There were four main concerns over the non-qualification of the 1985-86 accounts. They were that:

- non-compliance with AAS20 meant that a \$147.5 million gross exposure position was not brought to account;
- DHS were aware that \$6.2 million in foreign exchange losses had been incurred;
- the foreign exchange contracts were the wrong way around exposing AWA to an uncovered position of over \$84 million; and
- there was a \$23 million difference between the two sets of contracts.

### **4.8.1 Non-Compliance with AAS20**

Lloyd, Laidlaw and Freeman all gave evidence that they regarded the foreign exchange contracts as general and not specific. Daniels decided to instead agree with Mileham and Korval and treat them as specific. This decision to not comply with AAS20 meant that a \$147.5 million gross exposure position was not shown as a note to the 1985-86 accounts even though the accounting standard became mandatory only one month later.

Korval believed that the accounting standard ‘...is ridiculous because the definition of specific hedges is very simplistic...’ (Court statement Lloyd 14-5-1991, p.34) and that the whole standard had been written by somebody ‘...who obviously doesn't appreciate how the management of FX [foreign exchange] and FX [foreign exchange] dealing generally works in practice’ (Court statement Lloyd 14-5-1991, p.34). It is surprising that Daniels would take the opinion of Korval instead of his own experienced audit team. He realised that Korval was a qualified accountant but he had been described by Rogers J as a ‘...young inexperienced person...’ (1992 AWA judgment, p.39) who had a poor opinion of the AAS20 accounting standard.

Daniels had decided that they would write an accounting note stating what AWA had done, without really mentioning general or specific hedges. This was on the basis that AAS20 did not come into force until four weeks later in October 1986. It was eventually concluded that as AAS 20 was not yet in effect, ‘...we would not attempt to comply with the standard in this audit’ (Court statement Laidlaw 17-5-1991, p.14). This action caused the accounts to lack a note exposing the large unrealised losses. This note would have acted as a warning to the directors of the dangers in the foreign exchange operation.

#### **4.8.2 Outstanding Losses**

Lloyd was aware that a \$6.2 million loss had been incurred on the AUD/USD contracts by 30 June 1986 and that because the contracts were the wrong way around they exposed AWA to an uncovered position of \$84 million. He was also aware that there was currently a \$23 million difference between the two sets of contracts.

#### **4.8.3 Contrast with the 1986-87 Audit**

The thoroughness of the 1986-87 DHS audit contrasts with the lack of attention in the 1985-86 audit. Daniels told the court that, because they had been aware of the foreign exchange losses when commencing the 1986-87 audit, they had undertaken a far more detailed investigation of the accounts than they had with the 1985-86 accounts. Daniels conceded that they had paid little attention to the foreign exchange accounting system and internal controls in the 1985-86 audit because they were not intending to rely on them.

#### **4.8.4 Summary**

The combination of concerns relating to the 1985-86 accounts should have resulted in DHS undertaking a far more detailed examination of the 1985-86 accounts. DHS did not do this and, therefore, they were obliged to have qualified the 1985-86 financial accounts in compliance with section 267(1) of the Companies Act. The qualification was to be based on the examination that they did undertake.

Rogers J found that the books and records of AWA, for the financial year ended 30 June 1986, failed to meet the requirements of section 267(1) of the Code. Section 267 (1) requires the company to keep its accounting records in such a manner as will enable:

- (i) the preparation from time to time of true and fair accounts of the company; and
- (ii) accounts of the company to be conveniently and properly audited in accordance with this Code.

This resulted in a breach of section 285. ‘DHS had failed to comply with s 285 of the Companies (NSW) Code (the Code)’ (1995 AWA Appeal judgment, p.619).

#### **4.9 Six Monthly Audit ended 31 December 1986**

On 11 December 1986, Gibson had asked DHS to undertake a six-month audit from July to December 1986, as AWA had been considering making a takeover offer involving the issue of shares. AWA had wanted it completed by the board meeting of 9 March 1987. Daniels had signed off on the profit figure of \$16.068 million on the morning of 9 March 1987. The signing of this profit figure of more than \$16 million was incorrect because by 9 March 1987 DHS were aware of the following facts.

- Daniels agreed that he did not consider it necessary to tell the board of directors on 30 March 1987 about the \$6.2 million unrealised loss. DHS were aware of an unrealized

loss of AUD 6.2 million although the actual losses were significantly higher. Daniels 'Correct' (Court proceedings Daniels 1-4-1992, p.36). Daniels was aware of this loss. He considered disclosing this in the financial statements, but his opinion was that the amount was in the grey area of materiality and it was not necessary to disclose it.

- he was aware of an open exposure of approximately \$260 million. The actual amount of open exposure was \$297.5 million and, if netting off was inappropriate, the total exposure at December 1986 was approximately \$400 million. However, he still signed a profit for the 6 months of \$16.068 million on 9 March 1987 although he agreed under cross-examination that his circularisation had thrown up discrepancies in a fairly substantial amount. 'Yes' (Court proceedings Daniels 1-4-1992, p.35).
- Daniels did not wait until he had received replies from all the bank confirmations before he signed the profit confirmation on 9 March 1987. Rogers J was extremely critical of the fact that Daniels '...was prepared to sign a profit statement before ever all the returns from the circularisation had arrived. This was recklessness indeed...' (1995 AWA Appeal judgment Rogers J, p.648).

Daniels did not consider it necessary to disclose unrealised losses at 31 December 1986 because DHS did not issue any accounts and the letter he gave to AWA was only a comfort letter on the profits. Although the large profits did not include undisclosed losses, Daniels also considered approximately \$13 million reported in the first two months of 1987, although he did not check these figures. This was a surprising assumption. He was taking into account profits outside the audit period but not including losses within that same period.

Daniels included all potential profits in this 31 December 1986 figure but was reluctant to also include potential losses. Daniels met with Freeman and Brentnall on 6 March 1987 and concluded that two adjustments to the accounts were necessary:

- Daniels believed that a \$200,000 unrealised profit on a contract, closed prior to 31 December 1986, where the cash had not been received by that date should be recognised in the half-year accounts;
- there was a \$4.9 million profit in respect of four long Yen contracts, which had been rolled over since early 1986. It was Daniels' opinion that they were specific hedges, therefore the profit should be recognised in the 31 December 1986 accounts.

Daniels should have made at least two changes to the 31 December 1986 accounts. His reason for not including these amounts was that '...the letter I gave to AWA was only a comfort letter on the profits' (Court proceedings Daniels 1-4-1992, p.33). First, he should have included unrealised losses of at least \$6.2 million and second, he should have also disclosed, in the profit confirmation letter, that AWA had incurred an exposure of \$260 million in earning the stated profit. Daniels was aware of an exposure of \$260 million or over two years requirement for foreign exchange purchases. This information would have been in conformity with AAS20, which became mandatory a month later in October and which would have been of significance to the directors.

Daniels considered, incorrectly, that he did not need to include the unrealised losses in the 31 December 1986 profit statement. His reason was that large profits were reported in January 1987, the trading contracts did not come under the AAS 20 definition and, because it was AWA's accounting policy at the time to only book realised profits and losses.

#### **4.10 Non-Detection of Illegal Activity by the AWA Foreign Exchange Manager**

The DHS audit team should have identified a pattern of error and inconsistencies that would have resulted in their properly investigating the statements and actions of Korval. The additional auditing procedures should have resulted in the discovery of serious

irregularities including evidence of unauthorised loans of \$38.8 million at 31 December 1986.

The difficulty of uncovering the irregularities concealed by Korval is shown by the following actions.

- on the bank confirmation replies, Lloyd noted that three listed contracts, including a \$2 million contract from BBL dated 26 June 1986, had not been listed by Korval. Korval actually had millions of dollars of unrealised losses at 30 June 1986. He falsely told Lloyd that it related to rolled over contracts and that there were no unrealised profits or losses at 30 June 1986. Lloyd accepted Korvals' false version of rolled over contracts without further checking. He didn't think there was any point in any further tests because he didn't intend to rely on internal controls because there were weaknesses. 'It doesn't mean records outside of the books couldn't be used to write up transactions' (Court proceedings Lloyd 23-3-1992, p.70).
- Belfanti checked the green book for the 6 months ended 31 December 1986 to assess Korvals bonus. Belfanti specifically asked Korval to check for any loss making contracts that had not been included in the final assessment for the bonus. Korval falsely told him 'I have checked the list and it is all OK [okay]' (Court statement Belfanti 4-2-1991, p.23).
- Korval had approximately \$38.8 million of loss making contracts at 31 December 1986. He received a bonus equivalent to 560% of his annual salary based on his reply to Belfanti that he had no loss making contracts.
- Brentnall asked Korval if he had dealt with Westpac in the six months, which ended 31 December 1986, as he wanted to circularise all the banks Korval had dealt with in that period. Korval falsely told Brentnall that he had not dealt with Westpac in the past six months. He actually had substantial current contracts with Westpac at 31 December 1986.
- Brentnall observed the BNZ response to the bank circularisation letter for 31 December 1986. This showed a loan of USD 4.697 million (\$7 million AUD). On 5



March 1987, Brentnall asked Korval about these loans and Korval told him that it was not a foreign exchange transaction, and that ‘...Mr Korval’s remark about the item being a money market item...’(Court proceedings Brentnall 25-3-1992, p.45) and that it was a money market transaction.

- with Brentnall present in the room, Korval then allegedly rang BNZ to confirm with them that the loans had been closed out prior to 31 December 1986. He then falsely told Brentnall that BNZ had confirmed that the loans had been closed out before 31 December 1986. The BNZ loans with Korval were still open at 5 March 1987;
- Brentnall asked Korval why these particular contracts were not recorded in the records of AWA. Korval told him that ‘...the contracts were of a short term roll-over nature’ (Court proceedings Brentnall 25-3-1992, p.23). Korval’s explanation on the BNZ loan was credible to Brentnall because of his knowledge of AWA using certain foreign currencies and having the possibility of surplus or deficits in those currencies.

Despite Korval’s concealment of information and false answers to questions, there was substantial evidence that a reasonable audit approach would still have resulted in much earlier detection. The following occurrences should have led to further investigation by DHS.

- Daniels was aware prior to the 22 September 1986 board meeting that Korval was using foreign exchange contracts which were the wrong way around. ‘I found that out when I reviewed these papers [prior to the board meeting]...’ (Court proceedings Daniels 31-3-1992, p.56). Lloyd and Daniels both noted that Korval was using a ‘...wrong way around...’ (Court proceedings Lloyd 23-3-1992, p.24) approach for foreign exchange contracts. When Lloyd first saw the foreign exchange contracts ‘...that was my initial view, yes...’ (Court proceedings Lloyd 23-3-1992, p.24) was that the AUD-USD contracts were ostensibly the wrong way around.
- in his working papers, Lloyd noted evidence of loans being taken out to cover losses and then being rolled over into further loans. He first noticed the BNZ loan of USD \$4.697 million which, he noted, was to repay BBL and National Mutual Royal Bank

for losses. Lloyd also noted on his audit papers that this loan was repaid by another loan from Lloyds Bank.

- Daniels claimed he did not discover this early evidence of the BNZ loan until after the loan transactions were discovered by AWA in July 1987. However, Daniels should have been well aware that loans were being rolled over. Brentnall noted that very large profits or losses could be hidden from a person who only had access to the books and records by ‘...the practice of successive rollovers and the risks of concealment of large losses’ (1995 AWA Appeal judgment, p.640). On 26 March 1987, Brentnall prepared a situation summary for Daniels. It included Brentnall's assessment that permitting Korval to deal in the way that he was dealing exposed the company to the risk of large losses.
- at the board meeting held on 14 July 1986, Gibson's report on foreign exchange pointed out that ‘These positions cannot result in realised losses (although unrealised losses can be substantial where calculated on downtrends)’ (1995 AWA Appeal judgment, p.635). Brentnall noted that on contracts where divisions had requested cover, but hedges generated losses, Korval was reluctant to accept a loss as it adversely affected his bonus.
- on 5 March 1987, Brentnall received a letter from BNZ which showed 12 unrecorded contracts with a \$2.5 million unrealised loss. Daniels checked the audit work papers on 7th and 8th March but did not notice the BNZ loans. Daniels did not check that the contracts register had not been used since 30 June 1986. At the time he signed the auditor's report he had not seen the primary records relating to AWA's foreign exchange operations. He stated that ‘I had relied on my staff’ (Court proceedings Daniels 31-3-1992, p.9).
- Brentnall did not advise Bloom (DHS money market auditor) to check the BNZ loan because Korval had told him ‘...that those loans had been closed out’ (Court proceedings Brentnall 25-3-1992, p.48). The BNZ loans also included a loan made before the end of 1986 for USD 4.697 million (\$7 million AUD). Brentnall did not go to the bank accounts of AWA to see if there was an entry for this amount even

though he had not accepted Korval's explanation that it was a short-term money market item.

- Belfanti faxed DHS on 25 February 1987 relating to a loan of USD 822,000 from Macquarie Bank and on 30 April 1987 he also distributed to DHS, information outlining a foreign exchange loss of AUD \$1.648 million. Both these loans had been authorised by only Korval. Daniels did not see this information until November 1987.
- the DHS money market team noted that what they had thought to be deposits were instead shown as exchange gains and losses receivable from BBL in New York. However, due to a lack of liaison between the money market and foreign exchange audit teams, these irregular findings were never followed up.
- the discovery of the existence of Korval's substantial loans occurred when he was on sick leave due to a car accident. Alagna, the AWA chief accountant, discovered them when requests for payment of interest on the loans were directed to him in Korval's absence. Korval expressed surprise that AWA was concerned about unrecorded loans because he didn't think they were booking them. Alagna angrily replied, 'Well what do you think we have been doing with them?' (Court statement Alagna 18-2-1991, p.14).
- Daniels was advised on 1 July 1987 of the unrecorded loans. Daniels was told of the discovery of loans totalling \$17 million, which had been recorded in the company's books and which had been used to cover foreign exchange losses. On 15 September 1987, Daniels met with Hooke. Hooke questioned Daniels (Court statement Daniels 24-5-1991, p.41) about the unrecorded loans. 'Can you explain how such a loan could have taken place without authorisation and without detection by either AWA's own controls or by [DHS commonly referred to as] Deloitte's?' (Court statement Daniels 24-5-1991, p.41). Daniels replied that DHS were not sure why the loans were not discovered but they were looking into it.

#### **4.10.1 Conclusion on Non-Detection of Illegal Activity**

Despite Korval providing the auditors with false information and concealing records, an auditor following reasonable auditing procedures should have detected the irregularities if he/she had examined in detail the numerous instances of unusual loans and other transactions they discovered.

One instance was the early discovery by Lloyd and Daniels of the evidence of ‘wrong way around’ foreign exchange transactions. They should have questioned why Korval was using a procedure that was the wrong way around. Why wasn't he using the correct way around?

Daniels should have discussed this ‘wrong way around’ approach with an independent foreign exchange consultant. This would have then revealed that Korval was adopting a highly speculative position that left the second leg of the hedge open and was exposing AWA to downward movements of the AUD against the USD.

Given this discovery, Daniels should have comprehensively checked the contracts register to ensure that all contracts were being recorded properly. This would have revealed that the contracts register had not been entered after 30 June 1986. ‘The system was, however, updated irregularly [before 30-6-1986] on the basis of information from Korval’ (1995 AWA Appeal judgment, p.625). The reason given for this should have alarmed Daniels. It was that the register was not being maintained because the volume of contracts had increased markedly.

Daniels should have quickly discovered that between 30 June 1986 and 18 August 1986 no record of contracts was kept and that after 18 August 1986 a Lotus spread sheet was used but ‘...the system never worked efficiently’ (1995 AWA Appeal judgment, p.625). These auditing procedures did not require any special foreign exchange experience and should have been undertaken by any conscientious auditor.

#### **4.11 Summation of the weaknesses of DHS in the AWA audits**

In this chapter it is shown that DHS failed in their audit on four major points.

- DHS failed to conduct adequate auditing procedures on the AWA foreign exchange accounts. Daniels was told by Brentnall that internal controls were poor from the point of view of monitoring Andrew Korval's activity. DHS failed to undertake an adequate assessment of the internal controls. The weaknesses were material and DHS should have insisted that prompt attention be given by AWA management to the implementation of adequate internal control.
- DHS should have advised the directors of the internal control weaknesses at both board meetings. At the 22 September 1986 board meeting, Daniels was asked by a director to give an assurance that the profits had been fairly stated. Daniels had a responsibility to ensure that either Hooke had advised the board or if he had not, then the auditor should have reported to the directors. However, he told the court that '...we had informed Mr Hooke and I believed it was Mr Hooke's duty to inform the board as he saw fit' (Court proceedings Daniels 1-4-1992, p.57).
- DHS should have qualified both the 1985-86 audit and the 6-month audit ended 31 December 1986. DHS did not take into account the unrealised losses that they knew existed. On 3 March 1987, Brentnall gave Daniels a document, which showed a total gross exposure figure of \$260 million and a net liability of \$147.5 million and a further exposure of \$200 million. Daniels agreed that, if netting off was inappropriate, then the total exposure was approximately \$400 million. Daniels failed to take these exposure positions into account before signing the financial certificate on 9 March 1987.
- DHS should have uncovered evidence of the \$38.8 million unauthorised loans taken out by Korval at 31 December 1986 which, then increased to \$49.8 million

by September 1987. Daniels knew that some contracts were being rolled over. 'Well if you rolled it over it would have the same effect as taking out a four-month contract' (Court proceedings Daniels 31-3-1992, p.61). This meant that any profit or loss would not be recorded in AWA's bank account or ledger. However, he did not see it as important, he saw it '...in a similar sort of scene as a one month rolled over three times' (Court proceedings Daniels 31-3-1992, p.62).

By 26 March 1987, Daniels was aware that Korval was operating a very speculative operation. Brentnall reported that Korval was speculating or playing the market beyond the requirement of hedges and that this '...exposed the company [AWA] to the risk of suffering enormous losses' (1995 AWA Appeal judgment, p.641).

## **4.12 Conclusion**

This chapter contained an analysis of the DHS audit team's procedures and attitude during both the 1985-86 and 31 December 1986 audits. It has traced the weaknesses discovered by the audit team and has noted DHS's failure to report these weaknesses to the directors even though, on two separate occasions, the directors had invited Daniels to board meetings and had asked him questions relating to the foreign exchange audit.

A significant point in the court case was Daniels' answer to judge Rogers J questioning why he had not informed the board. His Honour asked: 'You did not think you had any obligation to inform the board, it was sufficient to tell Hooke?' Daniels replied: 'Tell the chairman yes, your Honour' (Court proceedings Daniels 1-4-1992, p.56). This was because Daniels, as DHS audit partner, relied on his long standing custom that he was unable to advise the board until he had clarified all the points with management at the audit exit meeting. If he had answered their questions honestly, the director's would have been alerted to significant problems with the foreign exchange operation.

A director, Finley, asked Daniels the question. Do you know that ‘...the directors want to be assured by you that you have really dug into the whole area [foreign exchange] and that we are not kidding ourselves in accepting these figures presented to us in the monthly accounts?’ (1995 AWA Appeal judgment, p.641). He was obliged to have answered honestly the questions from the directors on the foreign exchange audits. He did not, and therefore was found negligent by the courts and held responsible for AWA losing \$49.8 million in unauthorised loans.

The next chapter contains an analysis of the three audit experts’ interpretation of the DHS audit of AWA. The AWA prosecution called two of the experts. They were Lonergan, an audit partner with C&L, and Westworth, an audit partner with E&Y. They both believed that DHS should have qualified both the 1985/86 and the six month audit ended 31-12-1986. The DHS defence called Bryant who was an audit partner with Andersen. Bryant was critical of certain aspects of the DHS audit but suggested that ‘...I can’t imagine that one auditor out of 100 or 1000 would have decided that AWA had inadequate books and records’ (Court proceedings Bryant 6-4-1992, p.45). He believed that, if you get a scruffy set of records but you still finish with the correct results, then the records are adequate.

Chapter 5 contains an analysis of the reason’s Lonergan and Westworth failed to agree with Bryant’s findings and why the two audit experts called by AWA found that DHS should have qualified both the 1985-86 and six month audit ending 31 December 1986. It examines the reasons that Lonergan and Westworth gave for their view that DHS had failed to undertake adequate audit tests, had not ensured compliance with AAS20, and had signed a profit confirmation letter when the accounting records were either non-existent or inadequate.

## **Chapter 5. The Audit Experts Analysis of the AWA Audit by DHS**

### **Major Participants in Chapter 5**

**Bryant;** An Arthur Andersen audit partner called by the DHS legal team as an expert witness.

**Lonergan;** A Coopers and Lybrand audit partner called by the AWA legal team as an expert witness.

**Westworth;** An audit partner with Ernst and Young called by the AWA legal team as an expert witness.

### **5.1 Introduction**

In this chapter the expert opinion of the AWA audit by DHS will be considered and analysed. On 28 October 1988, AWA brought proceedings against DHS to recover damages for breach of contract and negligence. A key argument of Clayton Utz, the AWA prosecution lawyers, was that the board of directors did not learn ‘...that AWA had lost \$49.8 million from FX [foreign exchange] operations until July 1987’ (1995 AWA Appeal judgment, p.620). In their defence, Madgwick Partners, the DHS lawyers, alleged that AWA’s loss was caused or materially contributed to by its own fault.

There were three audit experts (Bryant, Lonergan and Westworth) involved in the analysis of the DHS audit of the AWA foreign exchange operation. They (Court statement Lonergan 30-9-1987, p.1) had been contracted to examine the facts and circumstances giving rise to:



- the inaccuracies in the reported profit position of AWA as at 31 December 1986;
- the profit or loss resulting from those (foreign exchange) activities up to the date of the departure of Korval (Korval had been the AWA foreign exchange manager);
- the profit or loss, realised and unrealised, relating to the year ended 30 June 1987; and
- the role of DHS audit staff members and management in the matter.

Two of the experts were critical of the DHS audit and agreed with AWA that the auditors were negligent, Lonergan was an audit partner with C&L and Westworth was a partner with E&Y. The DHS legal team called Bryant, an audit partner with Andersen. He also was critical of the DHS audit, but found that the audit was at least satisfactory in terms of compliance with the accounting standards. Therefore, he considered that the DHS auditors were not negligent.

The three audit experts were called in the AWA case. The AWA prosecution called Lonergan, an audit partner with C&L, and Westworth, an audit partner with E&Y. The DHS defence called Bryant an audit partner with Andersen.

Rogers J found that the three key points in AWA were:

- the failure of Daniels to advise the board on 22 September 1986 of internal control weaknesses in AWA's foreign exchange operations;
- the signing by Daniels on 9 March 1987 of a grossly erroneous profit confirmation letter for the six month audit ended 31 December 1986; and
- the failure by Daniels on 30 March 1987 to reveal to the board the state of AWA's internal controls and records which was then known to DHS.

## **5.2 Three Audit Partners Called as Expert Witnesses**

Wayne Lonergan, a partner in C&L, provided two statements to the court on 30 September 1987 and 18 March 1991. He appeared in court on 19 March 1992. Lonergan concluded that ‘...there should have been a qualified report for the year ended 30-6-1986 in terms of AUS 1’ (Court proceedings Lonergan 19-3-1992, p.31). He was critical of DHS's failure to understand that Korval was speculating and not just hedging because ‘At 30 -6-1986 at least some of their activities were definitely speculative’ (Court proceedings Lonergan 19-3-1992, p.46). He agreed with Westworth of E&Y that the auditing procedures undertaken by DHS were inadequate.

Christopher Westworth, a chartered accountant and partner in E&Y provided three statements to the court. They were dated 21 May 1990, 20 March 1991 and 17 April 1991. He appeared in court on the 18th and 19th of March 1992.

Westworth was critical of DHS's auditing procedures. He agreed that the 1986 audit would have put a reasonably competent auditor on notice of a high risk of unreported transactions. He found that the green book was an inadequate record of foreign exchange contracts. The state of the dealings register should have caused an auditor to enquire whether books and records have been properly kept. It ‘...would indicate to shareholders that the company was engaged very actively in a different business to the one that the accounts reflected’ (Court proceedings Westworth 18-3-1992, p.36). He believed that both the 1985/86 annual audit and the 6 month half year audit ending 31 December 1986 should have been qualified because of ‘...the general obligation for the accounts to present a true and fair view’ (Court proceedings Westworth 18-3-1992, p.37).

Bryant, an audit partner with Andersen, submitted three statements to the Court. They were on 8 February 1991, 31 July 1991 and 10 September 1991. He appeared in Court on the 6th and 7th of April 1992.

Bryant found that the accounting records for 1985/86 were sufficient to give some assurance, even though ‘...they weren't perhaps adequate to give as much assurance as an auditor might have wanted to have at the time’ (Court proceedings Bryant 6-4-1992, p.33). He also believed that, even though the auditing tests of DHS were not what Andersen would have done, they were at least satisfactory in terms of the accounting standards. He concluded that there is a big gap between what the professional standards and guidance releases say and what we do. Bryant believed that, because DHS had complied with at least the minimum requirements of the professional standards, then the auditors could not be considered negligent.

### **5.3 DHS Experience in Foreign Exchange Auditing**

All three-audit experts agreed that DHS had failed to understand that Korval had not simply been hedging but had been speculating. DHS should have included audit staff with more foreign exchange knowledge or they should have had access to a foreign exchange expert who understood the risks associated with speculative foreign exchange dealing.

The directors had never been told of the speculation and senior management had been both ignorant and irresponsible in relation to foreign exchange. Westworth considered that Korval's supervisors either had not understood or had not cared what Korval had been doing. His Honour questioned: ‘Did you conclude that Mileham and Gibson were fools or knaves?’. Westworth replied: ‘The answer [to both] is Yes’ (Court proceedings Westworth 18-3-1992, p.34).

The directors had delegated to senior management the responsibility for conducting the foreign exposure protection exercise, subject to the requirement that ‘...no substantial risk be taken’ (1995 AWA Appeal judgment, p.622).

Rogers J found that the seeds of disaster were concealed in Hooke's belief that he '...could safely leave it to the next rung of management to ensure that the policies of the board were implemented...' (1995 AWA Appeal judgment, p.620).

The directors had left management with the task of '...putting in place appropriate accounting and other record systems and internal controls' (1995 AWA Appeal judgment, p.622). It had been DHS's responsibility to ensure that those internal controls and accounting records were in place and operating correctly.

Westworth found that the statement that AWA had hedges upon hedges '...would be incomprehensible as a simple statement on its own' (Court proceedings Westworth 18-3-1992, p.14). Even without expert knowledge, reasonable auditing procedures should still have detected that Korval was speculating on a large scale. DHS should have asked AWA regarding the contracts on which the hedges were based.

#### **5.4 Requirement for an Audit Engagement Letter**

All three-audit experts agreed that DHS should have updated its audit engagement letter with AWA. Bryant found that no audit engagement letter has been found relating to DHS's June 1986 audit of AWA. 'We agree that DHS's engagement plan was not responsive to the identified weaknesses...' (Court statement Bryant 8-2-1991, p.9). The AWA internal audit manager, Belfanti, stated that 'I never saw an audit engagement letter from Deloitte...' (Court statement Belfanti 4-2-1991, p.5). He had been employed by AWA since 1969.

Lonergan felt that DHS should have updated its engagement letter at least when it merged with Yarwood Vane in 1969. In particular, DHS should have prepared a new engagement letter for the 31 December 1986 audit to clarify, with AWA, the objective and scope of the work to be performed.

The Court found that there were no documents setting out the terms upon which DHS undertook audit work for AWA. The Appeal Court found that ‘There was no written contract, retainer or audit engagement letter...’ (1995 AWA Appeal judgment, p.624). DHS, in consultation with AWA should have constructed a completely new engagement letter to include the foreign exchange audit.

## **5.5 Audit Planning**

Westworth found that DHS's work papers contained no evidence that DHS ‘...understood the nature of the foreign exchange transactions being undertaken by AWA’ (Court proceedings Westworth 18-3-1992, p.18). This was an important reason for DHS to have placed far greater emphasis on the audit-planning phase because Westworth also found that ‘...the work papers of Deloitte, which was a muddled set of statements...’ (Court proceedings Westworth 18-3-1992, p.20).

DHS had indicated in broad terms on the audit plan, the significance of the high level risk of foreign exchange, but this was not supported by any detailed discussion on how DHS planned to approach the foreign exchange audit. Westworth told the Court ‘...I only had Deloitte's work papers, which didn't in any form describe to me what was happening’ (Court proceedings Westworth 18-3-1992, p.70).

Lonergan found that DHS's audit files did not provide any summary of the extent of the foreign exchange operations, no consideration of risk areas and no evidence of audit programs.

The audit plan had not discussed, with AWA, the expectations regarding the foreign exchange audit and therefore the DHS audit team was not in a proper position to report to AWA when the foreign exchange audit findings deviated from what the directors had planned for foreign exchange. This was that ‘Transactions be related to AWA's underlying exposure...’ (1995 AWA Appeal judgment, p.622).

## **5.6 Assessment of DHS's Foreign Exchange Auditing Procedures**

Whilst all three experts agreed that DHS's foreign exchange experience, audit engagement letter and audit planning were unsatisfactory, the three experts disagreed on the assessment of DHS's foreign exchange auditing procedures. The main arguments related to the following sequence of events.

- DHS found that the internal controls were inadequate. This led them to decide not to rely on the internal controls but, instead to rely on a bank confirmation procedure. Bryant stated ‘...I would have said, Internal controls...’ (Court proceedings Bryant 6-4-1992, p.16).
- DHS were then not relying on the internal controls, and decided that they did not need to conduct any further examination of the foreign exchange accounting records. Westworth concluded ‘That the dealing register per se was an inadequate record of foreign exchange contracts’ (Court proceedings Westworth 18-3-1992, p.39). The accounting records prepared by Korval were incomplete, and should not have been totally relied on by DHS in preparing their bank circularisations.
- DHS relied on Korval and his foreign exchange accounting records to prepare the bank confirmation certificates. Westworth argued that, because the letters were compiled by Korval, DHS should ‘...still have checked those against the records at the client’s premises to ensure that they were complete statements’ (Court proceedings Westworth 18-3-1992, p.49).
- as the accounting system was to be computerised, DHS then decided that there was no point in undertaking any significant post balance day audit. Lonergan would have reconstructed the trading for the year and undertaken a very detailed examination of post-balance date settlements. The fact that the accounting system was about to be changed was an important reason to undertake a review of the current system prior to computerisation. ‘If that was the sole record [green book], then one would have had to say well perhaps proper books and records are not being kept’ (Court proceedings

Westworth 18-3-1992, p.39). In that way all the recommendations of the review could be incorporated into the new system.

### **5.6.1 Examination of Internal Controls**

An essential difference between the three audit experts was the decision by DHS, after only a short preliminary review of the foreign exchange internal controls, to decide they were inadequate and instead to rely on a bank circularisation procedure.

Bryant agreed with DHS that only if the auditor decided to rely on internal controls was it necessary to undertake a detailed study and evaluation of controls. He believed that many audits were conducted on a wholly substantive basis, with no study or evaluation of internal controls. He argued that, - 'The existence of S.285 (4) is no support in itself for the proposition that an auditor has to "assess" internal controls' (Court statement Bryant 31-7-1991, p.25). Section 285 (4) of the Companies (NSW) Act required DHS to ensure that AWA had complied with the need to maintain certifiable accounting records that could be audited conveniently and properly.

Lonergan found that DHS audit files contained only a three-page report titled 'Foreign Exchange Exposure and Payment Policy'. He believed that 'There was a failure to correct FX [foreign exchange] internal control weaknesses...' (Court statement Lonergan 18-3-1991,p.25). DHS were then not in a position to make a proper preliminary evaluation of the internal controls.

Westworth was critical of the tests conducted by DHS in reaching their conclusions on foreign exchange positions. He felt that, after DHS had correctly found that the internal controls were inadequate, they should have then prepared the bank circularisation independently of Korval.

Westworth argued that a perusal of the dealing register should have caused an auditor to inquire whether proper books and records had been properly kept. ‘...its state was such that they should have asked, is this the only record of foreign exchange transactions...?’ (Court proceedings Westworth 18-3-1992, p.39). He believed that, if the DHS auditor found from a preliminary examination that the internal controls were inadequate, it was then a reasonable assumption to expect the auditor to investigate the matter further and find out if the records were an accurate reflection of the foreign exchange accounting system.

### **5.6.2 Further Audit Testing**

The DHS audit team had decided that because the internal controls were inadequate, they would not do any further testing of internal control systems or other relevant testing. This could not be considered a reasonable decision. DHS had found that the dealing register *per se* was an inadequate record of foreign exchange contracts. ‘...is there some other record of foreign exchange transactions kept by way of pre numbered FX [foreign exchange] contracts in a properly ordered file...?’ (Court proceedings Westworth 18-3-1992, p.39).

In Westworth's opinion, if the green book was the sole record ‘...then one would have to say well perhaps proper books and records are not being kept’ (Court proceedings Westworth 18-3-1992, p.39). DHS should have asked if the green book was the only record of foreign exchange transactions kept in a properly ordered file or similar, by way of pre-numbered foreign exchange contracts.

### **5.6.3 Bank Circularisation Procedures**

The DHS audit team had decided that the weaknesses in the internal controls meant that the foreign exchange accounting records were inadequate and that, instead, DHS would rely solely on 100% bank circularisations. Korval had been responsible for preparing



these accounting records. DHS had then relied on Korval to prepare the bank circularisations from these same records.

This chain of events does not appear to have been a logical approach. DHS had correctly identified that the foreign exchange records were inadequate. They should not have then relied on Korval to prepare the circularisation forms.

Lonergan agreed that DHS should have attempted to ensure certainty. 'So you do 100% circularisation of all people that you could do business with and you would reconstruct the trading...' (Court proceedings Lonergan 19-3-1992, p.58). He found that if anyone had no internal controls and a list of open positions provided by AWA, then that person would place far less confidence in the bank circularisation reaching all positions.

Westworth believed '...because the letters were compiled by Andrew Korval that DHS should have checked those to the available records at AWA to ensure that they were complete statements' (Court proceedings Westworth 18-3-1992, p.47). He was concerned because his experience had been that bank circularisations were notoriously inaccurate and incomplete, and he would have wanted to carefully check to ensure that the letters were complete. 'I would. And at the risk of being argumentative to Deloitte, the manual says that is what you should do' (Court proceedings Westworth 18-3-1992, p.47).

Bryant did not agree that, because of the inadequacy of the AWA foreign exchange records, an audit based entirely on external circularisation could not be regarded as being conveniently audited. He believed that provided external tests can give adequate assurance that the audit is correct, it does not matter if, because of the inadequacy of the internal records it is impossible to establish and maintain an audit trail through the company's records themselves.

#### **5.6.4 Post-Balance Day Review**

All three audit experts agreed that DHS should have undertaken post balance day audit procedures. This procedure would have provided them with an audit trail.

Bryant found it impossible to establish an audit trail through AWA's records because as he said the '...internal controls are poor; need attention' (Court proceedings Bryant 6-4-1992, p.21). He believed that this should have resulted in DHS undertaking a roll back to trace contracts through the records and this would have provided DHS with an adequate audit trail.

'I would have done a roll-back', (Court proceedings Westworth 18-3-1992, p.66) Westworth stated. He added that he would have sought to compile all contracts and all realisations up to the audit date and worked back to 30-6-1986, exactly as he would have done if the auditor had not undertaken a stock take at 30th June. If the audit had chosen a date of 22nd August to do that test, they should have established controls over Korval at that stage, tested onwards and then rolled back.

Lonergan would have reconstructed the trading for the year and conducted a very detailed examination of post-balance date settlements. He agreed that this would at least provide the auditor with an understanding of the accounting system and related internal controls because it '...called for investigation as to what the company's policy was in relation to historic rate roll-overs' (Court proceedings Lonergan 19-3-1992, p.55).

#### **5.6.5 Summation of Experts Analysis of Foreign Exchange Auditing Procedures**

Bryant considered that DHS had complied with the accounting standards. They had been able to balance the books and 'No. They were conveniently audited within a reasonable time frame in June 1986, and the conclusion that was come to as a result of the work was materially correct' (Court proceedings Bryant 6-4-1992, p.42).

Bryant did not agree that, because of the inadequacy of the AWA foreign exchange records, an audit based entirely on external circularisation could not be regarded as being conveniently audited. Rogers J questioned this logic and emphasised that it was the disregard of internal controls that bothered him.

Westworth also felt that it should have been considered a very important weakness that the inadequacy of the internal controls prevented an audit trail through the AWA company records. Given this weakness Westworth added that you can also look at the events after date to see if those reveal counter parties. 'If Korval is part of that record keeping process and there is inadequate control, I can't have reasonable assurance as to the completeness of that record' (Court proceedings Westworth 18-3-1992, p.66). If DHS had rolled back the contracts from about two months after the audit date, then they should have picked up evidence of the BNZ loans. '...I would have sought to have established controls over Korval at that stage, tested onwards and rolled back' (Court proceedings Westworth 18-3-1992, p.66). They should then have immediately inquired whether there might have been other unrecorded liabilities.

The BNZ loan represented a window of opportunity to detect the illegal activity. A letter attached to the reply from BNZ included evidence of unauthorized loans that Korval had not disclosed to the audit. Brentnall could have followed up on this 'red flag' and then discovered the magnitude of the unauthorized loans.

Lonergan criticised the method used in the bank circularisation procedures because '...if you have no controls and you get a list, all you have confirmed is [that] what is on the list has been confirmed by the people that were listed for you. It confirms nothing more than that' (Court proceedings Lonergan 19-3-1992, p.63). He believed that because there were no adequate internal controls and a list of open positions provided by AWA, you would therefore place far less confidence in the DHS bank circularisation reaching all open positions. He was critical of DHS's lax attitude to identified foreign exchange losses

‘There is no question of someone else absorbing losses. It is AWA’s loss’ (Court proceedings Lonergan 19-3-1992, p.55).

## **5.7 Responsibility of DHS to Report Internal Control Weaknesses**

The responsibility of the auditor to report in a timely manner to the directors on the internal control weaknesses at both the 22 September 1986 and the 30 March 1987 directors meetings were key features of the AWA argument of auditor negligence. Rogers J found that ‘The auditor must then, in the absence of appropriate and timely action by management, report the deficiencies to the board’ (1995 AWA Appeal judgment, p.615).

### **5.7.1 Directors Meeting of 22 September 1986**

If the directors had not been informed at the board meeting, Bryant would have written to the directors shortly after the meeting. He told the court: ‘I can certainly say that if I had not done that I would feel that very shortly afterwards I would want to be writing...’ (Court proceedings Bryant 6-4-1992, p.16). Prior to the meeting he would have gone back to Gibson and told him how serious the position was.

Bryant who would have taken Gibson to Hooke, said ‘So even if it was immediately before the meeting I would have gone and seen him’ (Court proceedings Bryant 6-4-1992, p.16). He would have then said at the 22 September 1986 meeting that the internal controls in the foreign exchange operation were poor and needed attention and that Hooke would be undertaking measures to overcome this.

Lonergan would have gone to the directors as soon as the auditors had become aware of a problem as material as the foreign exchange internal control weaknesses. ‘No. It isn’t just the complexity. No. It is the very seriousness of the weaknesses’ (Court proceedings Lonergan 19-3-1992, p.66). He believed that because AWA had not kept proper books

and records in a major area of the company's activities in a high risk area, 'Yes. You raise it with management but you go to the Board' (Court proceedings Lonergan 19-3-1992, p.63).

Westworth believed that DHS should have been aware from the meeting of 26-6-1986 that management was either not aware of the nature of the foreign exchange dealings or were participating in disseminating misleading information. He agreed that Mileham and Gibson were fools or knaves. '...I have seen no rational description of why AWA entered into buying AUD contracts' (Court proceedings Westworth 18-3-1992, p.35). His final conclusion was that they certainly ought '...to have been put on inquiry as to whether they were fools or knaves' (Court proceedings Westworth 18-3-1992, p.34). Either result would have meant that the risk of loss and error was substantial and increased the need for effective controls.

#### **5.7.2 Directors Meeting of 30 March 1987**

DHS were again invited to attend a board meeting with the directors on 30 March 1987. The directors were concerned about the large foreign exchange profits, which Korval was reporting. They at that time represented 25% of AWA's total profit. Korval reported a \$13 million profit for the first two months of 1986. This represented over 25% of AWA's total profit. It was reasonable for AWA directors to be concerned how a small foreign exchange operation was able to generate such profits when they had specifically told management that they wanted a low risk foreign exchange operation. Bryant considered that the board was really only interested in profits or losses. He said, '...I think what the Board expects, and is mainly interested in, is the bottom line-right or wrong materially' (Court proceedings Bryant 6-4-1992, p.84).

At the 30 March 1987 board meeting, Finley, a director, opened the discussion with Daniels by stating that the directors '...found it hard to believe that AWA could be making profits of the order which were emerging in the monthly results' (1995 AWA Appeal judgment, p.641) and wanted to be assured by Daniels that he had investigated the

whole area ‘... and that we are not kidding ourselves in accepting these figures presented to us in the monthly accounts’ (1995 AWA Appeal judgment, p.641).

In relation to the 30 March 1987 board meeting, DHS portrayed to all the directors that they were reassuring them that the level of foreign exchange profits was accurate and should give the directors no cause to believe that the foreign exchange internal controls were unsatisfactory. ‘He did not even tell the board of the concerns he had expressed to Hooke...’ (1995 AWA Appeal judgment, p.641). Bryant believed that it is extremely unusual for an auditor to communicate with a board without first meeting with management to ensure that the auditor’s understanding of the facts is correct.

‘Okay. Well at some point after June I would have gone back to Gibson. If that had got no action I would have gone to Hooke’ (Court proceedings Bryant 6-4-1992, p.18) He believed that even if five minutes before the meeting, if he had not previously communicated with management, he would accelerate the process and at that point ‘...I am going to grab Mr Gibson and see Mr Hooke and say. There is a problem here’ (Court proceedings Bryant 6-4-92, p.15). He would then have expected Hooke to advise the board at the meeting.

Loneragan would have gone to the directors as soon as he became aware of a problem as material as foreign exchange internal control weaknesses. He was critical of Daniels’ failure to tell the board that the Macquarie system was only an incomplete record of transactions and that he Daniels, did not raise ‘...any of these matters with the board’ (1995 AWA Appeal judgment, p.641). Lonergan stated that Daniels should have advised the board that AWA had a high- risk operation with no controls.

In Westworth’s view, DHS should have verbally reported the weaknesses in the system of accounting and internal controls to Gibson and, then, if that appeared ineffective, to Hooke when first aware of the size of the exposure. He believed that DHS should have

communicated the internal control weaknesses prior to the 20-2-1987 planning meeting, preferably in writing, to the directors.

## **5.8 The Non-Qualification of the AWA Accounts for the Year ended 30 June 1986**

The AWA legal argument was that DHS, by certifying the 1985-86 accounts, were in breach of their audit duty. They claimed that DHS had failed to discover and report in writing to Hooke and the board that:

- in compliance with AAS20, \$6.2 million in unrealised losses had not been brought to account and speculative foreign exchange contracts of approximately \$297.5 million had not been disclosed in the 1985-86 accounts;
- the books and records of AWA were inadequate to enable AWA's foreign exchange exposure and the profit and loss on foreign exchange to be ascertained.

### **5.8.1 Non-Compliance with AAS20**

Daniels had received ample feedback that the hedges were general, not specific. The DHS audit team agreed that the hedges were definitely general. Daniels agreed that both Freeman and Lloyd were of the view that the buy Australian dollar contracts were general and not specific. However, 'I believe them not to be general hedges' (Court proceedings Daniels 2-4-1992, p.7). Laidlaw had also sent a note to Daniels advising him that the accounting standard AAS20 was not being complied with for the 1986 accounts.

Daniels had ignored the advice of his audit team and had instead agreed with Korval that the hedges were specific. 'I did not alter my view that they were specific' (Court proceedings Daniels 2-4-1992, p.2). Korval who had a poor opinion of the accounting standard, told Lloyd that AAS20 was very simplistic and that anything to do with foreign exchange was speculative. Daniels had also ignored the opinion of the general manager, Gibson, who thought that the hedges were general. Daniels agreed that non-compliance

with an accounting standard would have been of great concern to the Board of AWA. However he was also aware that AAS 20 was not yet mandatory. 'Unrealised exchange losses on specific contracts could be deferred in accordance with AAS 20' (Court proceedings Daniels 2-4-1992, p.17).

Bryant found that AWA should have brought unrealised losses to account in compliance with AAS20. He would not see it as necessary to advise the board that there were unrealised gains and losses not brought to account because he would have assumed that management would comply with AAS20 in the future.

Lonergan would have qualified the financial statements because the accounts were not drawn up in accordance with AAS20. In terms of the Companies Code and in particular in terms of AUS 1 Lonergan felt that there should have been a qualified report for the year ended 30-6-1986. '...the fundamental problem that the weaknesses were so great that the accounts potentially would not show a true and fair view' (Court proceedings Lonergan 19-3-1992, p.28). He claimed that the disclosure of information of \$297.5 million in speculative foreign exchange contracts to the directors would have alerted them to the large speculative position being taken by Korval.

The failure of Daniels to follow the advice of his audit team in relation to the AAS20 auditing standard is consistent with his failure to follow up on the audit team findings throughout the entire audit period. Daniels could have detected the illegal activity if he had been willing to listen to the information and advice he had received from his audit team.

### **5.8.2 Foreign Exchange Accounting Records and Internal Controls**

Bryant was adamant in his belief that he couldn't imagine that one auditor out of 100 or 1000 would have decided that AWA had inadequate books and records. '...if they get to the right answer you don't, there is then no question that, scruffy or not, they are



adequate' (Court proceedings Bryant 6-4-1992, p.45). He believed that if you still finish with the correct results, then the records were adequate.

The main problem with this argument is that the material weaknesses not reported in the 1985/86 financial statements were so fundamental, that, unless DHS fully investigated them then, they could not certify the accounts.

The essential difference between Bryant and both Lonergan and Westworth was that the latter two experts found that the weaknesses were so material that the accounts potentially would not show a true and fair view.

Lonergan admitted that it was rare to qualify accounts for defective books and records. However, he believed that, in terms of the Companies Code 1961 section 285 (4), and in compliance with AUS1, there should have been a qualified audit report for the year ended 30-6-1986. This was because of a lack of internal controls and accounts recording AWA's foreign exchange operations. He found that '...there is always the overlapping obligation to give a true and fair view of the accounts' (Court proceedings Lonergan 19-3-1992, p.49).

Westworth also admitted that he agreed '...that it is extremely rare to qualify for defective books and records' (Court proceedings Westworth 18-3-1992, p.85). He had come to the conclusion that the weaknesses in the internal control systems were so significant that they should have been promptly reported. '...I cannot agree they could be audited' (Court proceedings Westworth 18-3-1992, p.85). The material identifiable errors in unrecorded foreign exchange positions and loans would have also led Westworth to qualify the audit report unless significant corrections were made to those financial statements.

## **5.9 Results of the Half-Year Audit ended 31 December 1986**

All three-audit experts agreed that DHS should have qualified the 6-month audit ending 31 December 1986. Daniels signed this profit confirmation letter believing, but without bothering to check, that the unrealised loss contracts at 31 December 1986 had been realised in profit in January 1987. Instead of an operating profit of \$16.068 million ‘...the true result was a large loss. Furthermore it was inaccurate to suggest that the examination had been completed’ (1995 AWA Appeal judgment, p.634).

‘...what a reasonable auditor would have known at that time with no knowledge of the other things that subsequently happened, I don’t believe that any audit would have qualified [for 30-6-1986]’ (Court proceedings Bryant 6-4-1992, p.58). Bryant believed that at December 1986, the accounting records were materially wrong. ‘At December, the omissions were material; at June they were not’ (Court proceedings Bryant 6-4-1992, p.55). He found that the errors disclosed by the bank circularisations were material, that there was deterioration in the primary record keeping and that the bank confirmations, which showed significant omissions in what AWA, had been able to put together.

Loneragan would ‘...reconstruct the trading for the year’ (Court proceedings Lonergan 19-3-1992, p.58). He felt that the timing, presentation and content of DHS’s advice about management of the foreign exchange internal control weaknesses were inadequate. He agreed that ‘...the use of historic rate roll-overs was a means by which losses on transactions could be concealed’ (Court proceedings Lonergan 19-3-1992, p.22). Because DHS did not raise the seriousness of these issues before they gave clearance to the 31 December 1986 financial results, which they confirmed by their letter dated 9 March 1987, the financial accounts should have been qualified.

Westworth stated that he would try to do a 100% circularisation. ‘But I would include – one could call post-balance bank checks’ (Court proceedings Westworth 18-3-1992, p.52). He believed that DHS should have fixed a point at the date they were doing the

audit of all positions and should have tracked back from there to 31 December 1986, all the available records of foreign exchange contracts to determine the true position. He would have gone back to the filing cabinets where the bank foreign exchange contracts were filed and he would have wanted to check those against the circularisation list.

### **5.10 Non-Detection of Illegal Activity by the Foreign Exchange Manager**

The DHS legal team argued that DHS had no reason to suspect fraud on the grand scale that Korval had practised by suppression of losses. They further argued, whilst it is easy to see with 100% hindsight that Korval was dishonest (1.4. December 1986 examination M/930104/APPSUB/DHS/LIABILIT 15.29449 submission by Madgwicks on Appeal) at the time of the audit it was reasonable for DHS to assume that Korval was an honest employee who was operating within a relatively uncontrolled accounting environment.

Lonergan agreed that Korval's use of historic rate rollovers was a means by which losses on transactions could be concealed. 'Audits are not guaranteed to detect all frauds' (Court proceedings Lonergan 19-3-1992, p.60). No one, including the audit experts, considered that it was possible that Korval could obtain loans to pay for losses without a superior officer knowing of the transactions.

The DHS legal defence argument of ignorance of Korval's fraudulent activities conflicts with the knowledge available to Daniels at the time of the 30 March 1987 directors' meeting. Brentnall had passed on to Daniels on 26 March 1987 a report (1995 AWA Appeal judgment, pp.640-641) which included the following information about:

- Korval's ability to siphon off funds;
- the practice of successive roll-overs and the risks of concealment of large losses;
- the view which Brentnall had formed that Korval was speculating or playing the market beyond the requirements of hedges ; and

- Brentnall's assessment that permitting Korval to deal in the way that he was dealing exposed the company to the risk of suffering enormous losses.

This indicates that at least two of the DHS audit team were aware that Korval was operating a high-risk operation. Given such information, and combined with extensive evidence of poor and missing records, it seems difficult to comprehend how the DHS audit team had not eventually discovered evidence of Korval's illegal activity.

It appears that there were two main issues that, if followed up, should have helped DHS discover the illegal activity. They were that:

- DHS did not undertake reasonable investigative procedures when they found suspicious or unusual procedures; and
- DHS did not follow appropriate audit methods in relation to the BNZ loan, a red flag which should have enlightened the auditors and encouraged further and closer investigation.

#### **5.10.1 DHS Investigative Procedures**

Bryant told the court that he was unsure of Korval's motives in opening and operating unauthorised bank accounts. He presumed either fraud or just error in opening a bank account and not telling anybody about it. Bryant did not see it as mandatory to search for evidence of fraudulent or illegal activities. He believed that the auditor should plan his audit so as to identify the effects of a material fraud or any other type of material misstatement.

He did not agree with Lonergan that there was an obligation on DHS to search for fraud or material misstatement. Bryant was relying on accounting standard AUP 16 'Fraud and Error' which requires the auditor to plan the audit in order to detect material misstatements that may include fraud. However, AUP 16 did not require the auditor to

search for fraud that may be concealed and would not be discovered by normal audit procedures.

Bryant conceded that one way of protecting the company from ‘...the possibility of defalcation or fraud is to impose proper internal controls’ (Court proceedings Bryant 6-4-1992, p.19).

Loneragan agreed that a competent auditor who was experienced in auditing foreign exchange operations, after confirming that it wasn't a clerical error, would have concluded from the discrepancy rates that ‘...AWA was engaging in historic rate roll-overs’ (Court proceedings Lonergan 19-3-1992, p.22). This should have alerted DHS to the possible existence of fraud or material error.

Loneragan found that there were numerous matters which should have alerted DHS to the possible existence of fraud. He believed that DHS should have pointed out to management that the use of historic rate rollovers was a means by which losses on transactions could be concealed. He found that the lack of a comprehensive program of extended substantive testing was a fundamental reason why the accounts at 30 June 1986 were materially misstated.

Westworth would have considered that Korval might be ‘...suppressing or hiding or fiddling with contracts...’ (Court proceedings Westworth 18-3-1992, p.73) simply to not disclose the losses because it would affect Korvals’ bonus. He believed that DHS rightly confirmed that AWA's foreign exchange internal controls were inadequate. This should have led to DHS designing more detailed testing of the foreign exchange system. Westworth felt that if they had followed their own audit procedures in the December 1986 audit, then they would have found evidence of the unauthorised loans. He found that ‘...without controls over Korval I don’t know that he was not suppressing contracts’ (Court proceedings Westworth 18-3-1992, p.66).

### **5.10.2 The BNZ (Bank of New Zealand) Loans**

On 4 March 1987, BNZ sent a reply, which included the requested 31 December 1986 balances, but also a list of all loans opened during the period 1 July 1986 to 31 December 1986. This list included loans and transactions which did not appear in AWA's records. It represented a window of opportunity because it included a BNZ loan for USD 4.697 million (AUD \$7 million) dated 15 December 1986 and maturing on 22 January 1987. This evidence of a large unauthorized loan represented a 'red flag' which should have been followed up by the audit team.

The three audit experts had differing opinions on the procedures that DHS should have undertaken in relation to the BNZ loans. The details of the major BNZ loan were that as part of the 31 December 1986 bank confirmations, DHS had received a reply from BNZ which indicated that a USD 4.697 million (\$7 million AUD) loan had been taken out on 15 December 1986. It matured on 22 January 1987 but did not appear in AWA's records.

On 5 March 1987, Brentnall asked Korval about the BNZ loans. Korval falsely told Brentnall that '...they hadn't been disclosed because they represented a pair of rolled over contracts or were of a shorter term speculative nature...' (Court statement Brentnall 17-5-1991, p.20) as opposed to hedging contracts. He also told Brentnall that they had been closed prior to 31 December 1986.

Brentnall was not satisfied with this reply, so in his presence Korval allegedly rang BNZ. Brentnall told the court '...I believe I may have been standing next to him, would have heard at least half the conversation, and may have heard the response' (Court proceedings Brentnall 26-3-1992, p.24). After finishing the telephone conversation, Korval then falsely told Brentnall that he had confirmed with BNZ that the loans had been closed out prior to 31 December 1986.

If Bryant had seen the BNZ loan of 15 December 1986, he would have checked whether it appeared in AWA's records and whether it had been repaid prior to the end of the year. Unless and until he had got to the source of these loans and got to the reasons they had been taken out. 'I think I would have wanted to know whether the actual positions were being reported to senior management' (Court proceedings Bryant 6-4-1992, p.76), he would not have signed the profit confirmation. He would have also checked the loans that appeared to have been taken out post balance day.

Westworth noted that a letter attached to a reply from BNZ of the completed bank confirmation request did mention loans. He said that this should have alerted the auditor to the existence of foreign currency loans. DHS should have investigated it and made enquiry as to the origin of the loan so that they could determine whether there were any other such loans. He was critical of DHS auditing procedures and told the court that he found Brentnall's assumption that the loans were related to money market transactions '...without any further inquiry [to be] totally unacceptable audit practice' (Court proceedings Westworth 18-3-1992, p.88). The BNZ loan should have alerted the audit to Korvals long term rolling over of unauthorized loans. Lloyd had first noted the USD 4.697 million BNZ loan in his 1985-86 audit working papers.

### **5.11 Summation of Key Differences between Audit Experts**

The audit experts all agreed that DHS lacked any valid experience in foreign exchange auditing, that their audit planning was inadequate and that the audit engagement letter should have been updated regularly. The Appeal Court agreed and found that '...there was no written contract, retainer or audit engagement letter...' (1995 AWA Appeal judgment, p.624).

Interestingly, Bryant argued that the DHS audit was adequate because it complied with the minimum requirements of the accounting standards, even though it did not meet the

Andersen standard. Bryant found that there was a big gap between what the professional standards and guidance releases said and what Andersen did.

Rogers J rejected Bryant's argument, asking why does one go to DHS or Andersen or E&Y instead of a local accountant in Bankstown? His Honour distinguished between the minimum quality he would expect of a small accounting firm and the quality he expected of a Big Five (now Big Four as Andersen ceased operating) audit firm.

There are four key areas of difference between the methods the three audit experts were following.

- first, in relation to the assessment of AWA's lack of accounting procedures, it was apparent that DHS had conducted inadequate auditing tests.

Bryant felt that although DHS's auditing procedures were not entirely adequate, the basic aim of working from the green book to the closing position at the end of the year was accurate. He was satisfied that the auditor could carry out an audit that was not in any way dependent upon the internal controls. He concluded that '...scruffy or not, they are adequate' (Court proceedings Bryant 6-4-1992, p.61). In particular, he traced DHS's audit work from the green book to the closing position and within 90 minutes arrived at the same figure as Westworth had finished with. '...but the totality of what there was to find was going to confirm that the records were materially right' (Court proceedings Bryant 6-4-1992, p.61).

The 1995 AWA Appeal Court disagreed with this process and found that DHS and Bryant were simply not correct in saying that '...the unrealised gains and losses on open positions could be ascertained from the records in AWA's FX [foreign exchange] department, namely the green book and the contracts file...' (1995 AWA Appeal judgment, p.628).



Lonergan was critical of DHS's accounting procedures and believed that it would have been desirable practice to have undertaken a post-balance date review. His argument was that DHS had agreed that Korval had had poor internal control procedures and inadequate records and yet they had then relied on Korval to provide the records for the external confirmations. Lonergan said that he would have reconstructed the trading for the year and argued '...so you do a 100% circularisation of all people that you could do business with' (Court proceedings Lonergan 19-3-1992, p.65). DHS had then relied totally on the results of the external confirmations and had not undertaken any post balance date check.

Westworth argued that the accounting procedures had been inadequate and that the auditors should have done a rollback by compiling all contracts and all realisations and then worked back to the audit date. 'If I chose a date 22<sup>nd</sup> August to do that test, I would have sought to establish controls over Korval at that stage, tested onwards and rolled back' (Court proceedings Westworth 18-3-1992, p.66). He believed that a reasonable auditor '...would go back between one and two months because that [was] is the average length of his [Korval's] deals' (Court proceedings Westworth 18-3-1992, p.68).

- second, all three auditors believed that Daniels should have reported the internal control weaknesses to the directors, at least at the 30 March 1987-board meeting.

'...I am going to grab Mr Gibson and see Mr Hooke...' (Court proceedings Bryant 6-4-1992, p.15). Even on the day of the meeting Bryant would have advised Hooke that he should tell the board about the internal control weaknesses so even if it had been immediately before the meeting he would have gone and seen Hooke. Bryant would have said to Hooke, '...there is a problem here' (Court proceedings Bryant 6-4-1992, p.16). At the subsequent board meeting, Bryant could then have said that the internal controls were poor but that Hooke was then undertaking measures to overcome the problem.

Lonergan would have gone to the directors as soon as he had become aware of a problem as material as the foreign exchange internal control weaknesses. He found that, despite

having been requested by the AWA board to discuss AWA's foreign exchange dealings at both the directors meetings on 22 September 1986 and 30 March 1987, DHS had not adequately explained ‘...to the AWA board the seriousness of the weaknesses’ (Court statement Lonergan 30-9-1987, p.26). He disagreed with Bryant’s argument that it would have been adequate to have waited until the 30 March 1987 board meeting particularly as the notes of the 13 March 1987 meeting with management ‘...did not, in our opinion, adequately deal with all the internal control weaknesses and breakdowns’ (Court statement Lonergan 30-9-1987, p.26).

Westworth would have reported the weaknesses to management at the time of the planning meeting and then to the directors in writing. He agreed with Lonergan that DHS should not have waited for the board meeting and that they should have been pro-active in advising the directors. Westworth stated: ‘In our view the auditors should have alerted the directors to this particularly in the light of the requirements of AUP19’ (Court statement Westworth 21-5-1990, p.24).

- the third issue was the non-qualification of the AWA accounts for the 1985-86 and 31 December 1986 accounts.

Bryant agreed that the 31 December 1986 accounts should have been qualified but believed that there had been no reason to qualify the 1985-86 accounts. The essential difference between Bryant and both Lonergan and Westworth was that the two other experts found that the weaknesses were so material that the accounts potentially would not show a true and fair view.

Bryant believed that if you get a scruffy set of records and you do all the work, which is necessary, and you get the right answer, then they are adequate. He found that the accounting records for that period were disorganised but ‘...there is then no question that, scruffy or not, they are adequate’ (Court proceedings Bryant 6-4-1992, p.45). His tests

concluded that the green book could be balanced, within an hour and a half, to approximately the balance achieved by Westworth.

Lonergan found that the fundamental problem was that the weaknesses were so great that the accounts potentially would not show a true and fair view. He agreed that ‘...in terms of the Companies Code and in terms of AUS1 there should have been a qualified report for the year ended 30-6-1986’ (Court proceedings Lonergan 19-3-1992, p.30).

Westworth found that material identifiable errors in unrecorded foreign exchange positions and loans were so significant that they should have led to a qualified audit report or corrections being made to the financial statements even though he agreed ‘...that it is extremely rare to qualify for defective books and records’ (Court proceedings Westworth 18-3-1992, p.92).

- finally, the three audit experts disagreed as to whether DHS should have discovered evidence of the \$49.8 million in unauthorised loans.

All three-audit experts conceded that it was not reasonable to expect DHS to assume that Korval could divert funds to a bank account other than an AWA authorised bank account.

However, Lonergan found that there had been extensive evidence throughout the audit to confirm his findings that there were numerous matters that should have alerted DHS not only to additional foreign exchange control weaknesses but also to the possible existence of fraud or material error. Korval was rolling over loss-making contracts and Lonergan agreed that this ‘...called for investigation as to what the company's policy was in relation to historic rate roll-overs’ (Court proceedings Lonergan 19-3-1992, p.22).

He believed that an auditor, experienced in auditing foreign exchange operations, would have concluded from the discrepancy rates that AWA had been engaging in historic rate

rollovers. That should have then alerted DHS to the possible existence of fraud or material error.

Westworth found that DHS should have detected evidence of unauthorised loans from a post balance day review if they had followed their own audit procedures in the December audit. He would have been very concerned if he had detected evidence that Korval could be deliberately ‘...suppressing or hiding or fiddling with contracts’ (Court proceedings Westworth 18-3-1992, p.73).

He believed that this discovery of potential fraud should have resulted in DHS undertaking far more extensive audit testing than they actually had. Westworth believed that Korval's motive could have been that he was ‘...doing it for his own profit’ (Court proceedings Westworth 18-3-1992, p.66). If DHS had undertaken more extensive audit testing, they then would have found evidence of the unauthorised loans.

Bryant argued that it was not a mandatory requirement to search for evidence of fraudulent or illegal activities and agreed with DHS ‘...that there is considerable doubt as to whether a reasonable auditor would have detected the loans’ (Court statement Bryant 8-2-1991, p.67). He believed that the auditor should plan his audit so as to identify the effects of material fraud just as he would any other type of material misstatement.

In relation to the BNZ loan, Bryant would have checked whether it had been recorded in AWA's records and whether it had been repaid prior to the end of the year. However, he did not believe that it could be established, on the balance of probabilities ‘...that DHS should have found \$38.8 million in unauthorised loans’ (Court statement Bryant 8-2-1991, p.9).

## **5.12 Conclusion**

In this chapter the three audit experts' analysis of the AWA audit have been examined. It was concluded that the two audit experts Lonergan and Westworth were correct in their overall finding that the DHS audit was unsatisfactory. DHS should have qualified the 1985-86 accounts, they had failed to advise the directors at both the 22 September 1986 and 30 March 1987 board meetings about the internal control weaknesses that they had been aware of and they failed to qualify the 6-month audit for the period ending 31 December 1986.

There was clear evidence that the negligence of DHS could be directly linked to the loss of \$49.8 million in foreign exchange by AWA. Lonergan found that an auditor, experienced in foreign exchange, should have concluded from the discrepancy rate that AWA was engaging in historic rate roll-overs. 'Subject to confirming it wasn't a clerical error in the typing of the schedule that would be the conclusion one would draw' (Court proceedings Lonergan 19-3-1992, p.22). This should have been a warning to DHS of the possible existence of fraud or material errors '...not only to additional foreign exchange internal control weaknesses, but also to the possible existence of fraud or material error' (Court proceedings Lonergan 19-3-1992, p.21). They were obliged to investigate this matter further and should have discovered evidence of large unauthorised loans.

Bryant found that the audit tests by DHS were sufficient to give some assurance even though '...they weren't perhaps adequate to give as much assurance as an auditor might have wanted at the time' (Court proceedings Bryant 6-4-1992, p.33). However, one very important feature of the accounting records not reported on by the DHS audit tests was that there was an exposure of \$297.5 million in speculative foreign exchange contracts not included in the 1985-86 accounts. The directors were adamant that, if they had been made aware of such a large speculation, then they would have examined the total foreign exchange operation.

Even Bryant agreed that at December 1986 the accounting records were materially wrong. 'At December, the omissions were material' (Court proceedings Bryant 6-4-1992, p.55). Finally, the audit failed to follow up significant weaknesses resulting in Bryant finding it impossible to establish an audit trail through AWA's records because the '...internal controls are poor; need attention' (Court proceedings Bryant 6-4-1992, p.16). Based on Bryant's findings, the audit tests were definitely not sufficient to give any assurance.

The next chapter consists of a summary of the AWA case and in particular the 1992 judgment of Rogers J and the findings of the three judges involved in the subsequent 1995 AWA Appeal. Chapter 6 consists of an examination of the Court judgments, which found that DHS had failed to properly audit the AWA books and accounts and even those internal control weaknesses that they did discover had not been passed on to the directors.

## **Chapter 6. Summary of the AWA Audit Findings**

### **Major Participants involved in Chapter 6**

**Clarke:** one of the three NSW Supreme Court judges who heard the Appeal.

**Powell:** one of the three NSW Supreme Court judges who heard the Appeal.

**Rogers:** the NSW Supreme Court judge who heard the original AWA case.

**Sheller:** one of the three NSW Supreme Court judges who heard the Appeal.

### **6.1 Background**

Chapter 6 contains a summary of the court findings of the AWA audit. In particular, it analyses the September 1986 directors' meeting, the 6 month audit certification ending 31 December 1986 and the March 1987 directors' meeting.

The reason why Rogers J was critical of DHS and, in particular, Daniels is examined. Rogers J found that Daniels was negligent in failing to answer specific questions from the directors at both the 22 September 1986 and 30 March 1987 directors' meetings. He reminded the audit profession that 'Whether auditors are watchdogs, or bloodhounds, or any form of canine, they cannot allow themselves to be utterly toothless' (1992 AWA judgment, p.24). He also considered Daniels' profit confirmation letter to be grossly erroneous.

Rogers J was particularly concerned with Daniels' decision to sign the profit confirmation letter prior to receiving back all bank confirmations. He criticised Daniels for his decision '...to sign a profit statement before [ever] all the returns from the circularisation had arrived. This was recklessness indeed...' (1995 AWA Appeal judgment, p.648).

Rogers J compared the quality expected of a large multi-national audit to that of a small firm audit. He said, 'If you go to buy a Mercedes you expect it to stand up in a smash. If you buy a Suzuki, you expect it to crumble' (Court proceedings Rogers J 16-9-1991, p.48). He used this analogy to highlight this contrast.

He was critical of DHS's and Bryants claim that DHS had not been negligent because they had complied with the minimum required by the accounting standards. '...AUP12, or whatever it is, and that is as much as you need to discharge. There is no reason to think one way or the other that is the prevailing standard. All one knows that is the minimum standard' (Court proceedings Rogers J 16-9-1991, p.54). He wondered why a firm like AWA would pay a substantial premium for a DHS audit unless they expected a higher quality audit. He posed the question, 'Why does one go to DHS or Arthur Andersen or E&Y instead of a chap in Bankstown?' (Court proceedings Rogers J 16-9-1991, p.55).

The liability judgment in the AWA case was handed down on 3 July 1992. It is considered the most important Australian judgment on audit negligence since the international landmark Pacific Acceptance case. The 280-page judgment of Rogers J in the AWA case extended key aspects of audit duties beyond previous audit negligence cases.

Rogers J found DHS negligent on three main points. They were that:

- DHS were guilty of negligence on 22 September 1986 in not advising the board of the absence of proper internal controls over AWA's foreign exchange operations.
- they were negligent in signing on 9 March 1987, a grossly erroneous profit confirmation letter for the six months ended 31 December 1986; and
- DHS were negligent in their failure, on 30 March 1987, to reveal to the board the appalling state of AWA's internal controls and records.



The judge found that:

- DHS had failed to comply with Section 285 of the Companies (NSW) Code;
- AWA was guilty of contributory negligence with liability to be apportioned 20% to AWA and 80% to DHS;
- the management of AWA, including Hooke as chief executive, were guilty of negligence but the non executive directors were not; and
- DHS were entitled to a contribution from Hooke of 10% of the 80%.

### **6.1.1 Highlights of the AWA Judgment**

#### *6.1.1.1 The 22nd September 1986 Directors' Meeting*

Rogers J considered Daniels' performance at the 22 September 1986 board meeting to be '...a singularly blinkered view' (1992 AWA judgment, p.974). Daniels, who was aware of internal control weaknesses by the time of the board meeting, failed to disclose them to the directors.

Rogers J was particularly critical of Daniels' failure to answer a direct question from one of the directors, Finley, who '...had specifically asked Daniels whether there was anything that the board should be aware of' (1992 AWA judgment, p.992). He found that Daniels' silence was an act of negligence.

#### *6.1.1.2 The Six Month Audit ending 31 December 1986*

Rogers J also found DHS negligent in relation to the 31 December 1986 profit statement. Daniels decided to rely on full circularisation because the internal controls were inadequate. He did not rely on AWA's financial records, but did not wait until he had received back all the circularisations before signing the profit statement.

Daniels signed the profit letter to the Board on 9 March 1987. He decided to sign the letter as ‘...the divisional and subsidiary audits had been completed save that my review of non-risk areas was still in train’ (Court statement Daniels 17-1-1992, p.5).

Rogers J was critical of Daniels’ actions in that he ‘...was prepared to sign a profit statement on 9-3-1987 before all the returns from the circularisation had arrived. This was recklessness indeed’ (1992 AWA judgment, p.978).

#### *6.1.1.3 The 30 March 1987 Directors Meeting*

The third area where Rogers J found DHS negligent was in relation to the 30 March 1987 directors’ meeting. The directors had asked DHS to come to this meeting on 26 March 1987. Prior to the board meeting, Daniels had received a comprehensive situation summary report from Brentnall. This outlined significant weaknesses including the fact that stop losses were not an effective control on Korval and were not effective in stopping or preventing large losses taking place.

However, Daniels opted not to take Brentnall to the meeting or to disclose to the directors the very serious weaknesses reported to him by Brentnall.

Rogers J suggested that the attitude and questions from the board should have prompted Daniels to realise that Hooke had not advised the board of his meeting with the auditors. He also suggested that Daniels’ knowledge of ‘...more disturbing matters had emerged after 9 March 1987 and cast further doubt on the validity of the certificate which Daniels should have brought to the attention of the board’ (1992 AWA judgment, p.978). He should have also advised the board of the deficiencies that Brentnall had discovered.

The court found it difficult to understand why Daniels had adhered to custom and had not replied to Finley’s direct request. Finley had stated to Daniels that: ‘The directors want to be assured by you that you really have dug into the whole area [foreign exchange] and

that we are not kidding ourselves in accepting these figures presented to us in the monthly accounts' (1995 AWA Appeal judgment, p.641).

#### *6.1.1.4 General Findings*

The AWA judgment raised the standard of care required by an auditor and expanded on the duty of care required of auditors in the *BGJ* case. DHS were found negligent even though on several occasions they had reported the absence of proper records and the weaknesses in internal controls to management. In the AWA case, the standard was raised. The courts ruled that in the absence of appropriate and timely action by management, the auditor must report the deficiencies to the board.

The case arose '...after AWA lost \$49.8 million...' (AWA 1992 judgment, p.623), during 1986 and 1987 due to foreign exchange speculation by its foreign exchange manager Andrew Korval. The main factors for the loss were inadequate supervision, a general lack of internal control, inadequate audit procedures and reports, and a lack of prompt preventative action by both auditors and management.

DHS presented a relatively poor argument in this aspect in that they relied on the fact they had complied with AUP12 'Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit'. Rogers J rejected the statement that there was only a minimal duty imposed on the auditor to warn management of matters of internal control, which have the effect of creating a foreseeable risk of harm.

Rogers J was critical of DHS simply relying on the fact that they had complied with AUP12, and that was all they needed to do. Rogers J found that 'There is no reason to think one-way or the other that is the prevailing standard. All one knows that is the minimum standard' (Court proceedings Rogers J 16-9-1991, p.54). His Honour was not impressed by DHS's argument and stated that he was more interested in the prevailing standards of the multi-national audit firms rather than in minimum compliance with the

accounting standards. He noted that even DHS's audit manual recommended that significant matters should be reported to the directors.

The Appeal Court judges Clarke, Powell and Sheller JJA confirmed Rogers J's decision but reduced damages to \$6 million because, in their opinion, there was no certainty that the directors would have changed their policy if DHS had brought the internal control defects to the board's attention.

## **6.2 Need for Expert Assistance in the AWA Audit**

Korval told Lloyd that '...I have taken short positions in the USD against the AUD to the tune of \$84 million' (Court proceedings Lloyd 23-3-1992, p.24). All three-audit experts agreed that DHS had no relevant foreign exchange auditing experience. A key point, made by the experts, was DHS should have realised that Korval was speculating and this was clearly contrary to the directors' wishes. There was clear evidence that some of Korval's actions were purely speculative. Korval had told Lloyd that '...anything to do with foreign exchange is speculating' (Court proceedings Lloyd 23-3-1992, p.24).

The AWA Court decision indicates that auditors must ensure that, where complex technical matters such as foreign exchange are concerned, then an appropriate level of expertise must exist in the audit team and must be utilised. If a sufficient level of audit expertise is not available, then the audit must obtain assistance from a recognised expert such as a consultant.

The use of a foreign exchange consultant would have been of assistance to Lloyd in particular. Lloyd believed that any company with no direct liability for foreign currency but affected by a competitor is entitled to hedge. '...it could include hedging against any possible exposure to an exchange rate movement not necessarily relating to an import of goods' (Court proceedings Lloyd 20-3-1992, p.55). Rogers J was critical of this

interpretation and found that Lloyd had ‘...a fundamentally incorrect interpretation of hedging and confused it with speculation’ (Court proceedings Lloyd 20-3-1992, p.63).

The Court decided that even an auditor without any foreign exchange experience should have at least been concerned enough about Korval’s actions to have undertaken further investigation. Korval had told the DHS auditors that he was buying the AUD because the AUD would rise against the USD and that it was a profit making exercise.

This was pure speculation and Lloyd knew that the contracts were ‘the wrong way around’. Yet he accepted Korval’s explanation and did not consider investigating this matter with the help of an independent person experienced in foreign exchange.

Rogers J found that, if ever there was ample reason for calling in a specialist foreign exchange expert to assist the DHS team, this was it. By the 30 March 1987 board meeting, it had been made abundantly clear to Daniels by the directors that they were most concerned and troubled by the risks involved in foreign exchange transactions and sceptical of the profit figures reported.

Whilst Rogers J considered DHS primarily negligent, he was also critical of the naiveté of the highly experienced directors. He commented that ‘...blind Freddie would have realised that the sort of profits that were said to be being made could not have been made otherwise than by speculative activity’ (Court proceedings Rogers J 16-9-1991, p.20). The directors and Hooke, the CEO, had believed that it was possible to make such profits without any compensating risks.

### **6.3 Benefits of Updating the AWA Audit Engagement Letter**

Bryant agreed that his firm, Andersen, had a high standard. This applied to the quality of the audit engagement letter. Bryant stated that ‘There is a big gap between what the professional standards and guidance releases say and what we do’ (Court proceedings Bryant 7-4-1992, p.28). He was not sure whether other auditors had such a high standard.

Rogers J found that there was no audit engagement letter setting out the terms upon which DHS undertook audit work for AWA. In fact, the audit engagement letter had not been updated for at least 16 years. Daniels did not regard an audit engagement letter as important. He stated in his first report to the Court, ‘I never saw any need for such a letter’ (Court statement Daniels 24-5-1991, p.2). Daniels did not discuss its terms with AWA for either audit. This discussion would have clarified the expectations of the audit for both AWA and DHS.

All three audit experts agreed that DHS should have updated its engagement letter with AWA. Lonergan felt that this was particularly important when AWA requested a six-month audit ending 31 December 1986. On 11 December 1986, Gibson requested Daniels undertake a six month audit for the period ending 31 December 1986 to provide AWA with a profit confirmation letter. The audit had to be completed for the 9 March 1987 board meeting.

The Court found that ‘There was no written contract, retainer or audit engagement letter...’ (1995 AWA Appeal judgment, p.624). Daniels should have clarified in writing with AWA the objective and scope of the work to be performed.

George suggests that ‘...the absence of a current audit employment letter contributed to the failure of the audit in the AWA case’ (George 2001, p.331). The findings in the AWA case reinforce the need for an up to date audit engagement letter, which would have set out the terms upon which DHS should have undertaken the audit work for AWA.

## **6.4 Need for Adequate Audit Planning by DHS**

There was no effective pre-audit planning. Appropriate audit planning would have resulted in a focus on the lack of adequate segregation of duties and responsibilities, either prescribed or observed, as a weakness in the system. Korval's dual responsibility as foreign exchange and money market manager should have been clarified at this planning stage.

Westworth found that DHS's work papers contained no evidence that DHS understood the nature of the foreign exchange transactions being undertaken by AWA. He said, 'We had no source, except a series of papers in the Deloitte work papers that were uncertain and unclear in what they were proposing to do' (Court proceedings Westworth 18-3-1992, p.18). Appropriate planning would have clarified Korval's dual role of foreign exchange manager and money market manager. This was important in that DHS did detect significant foreign exchange discrepancies but assumed that it was part of the money market operation.

Because Lloyd was confused by Korval's dual responsibility, he did not pass money market transactions on to the money market audit team. He stated 'If it had been relating to a liability or an asset over the year end then yes, I would' (Court proceedings Lloyd 25-3-1992, p.41), but not otherwise.

Rogers J found that there was sufficient evidence that if DHS had adequately planned the foreign exchange audit, it would have discovered the illegal activity including '...very substantial weaknesses in the set up and operation of the FX [foreign exchange] area...' (1995 AWA Appeal judgment, p.624) and would have reduced the damages suffered by AWA.

## **6.5 DHS Foreign Exchange Auditing Procedures**

This was the first issue on which the three audit experts disagreed. Whilst Bryant found that DHS's auditing procedures were adequate, Lonergan and Westworth were more critical of them.

### **6.5.1 Weaknesses in Foreign Exchange Operations**

Daniels told the court ‘Well, there were no internal controls, or they needed vast improvements so that we discounted the internal controls and extended our tests’ (Court proceedings Daniels 3-4-1992, p.44).

Rogers J found that ‘...between 30 June and 18 August 1986 no records of any kind were maintained’ (1995 AWA Appeal judgment, p.625) and emphasised in his judgment the importance of DHS’s own report of 16 November 1987 titled ‘Inadequate Records Maintained and Retained’ and the DHS report of November 1987 titled ‘Inadequate System of Internal Controls’. In their Court evidence, both Daniels and Lloyd had accepted that, in general, the weaknesses in the system these reports described existed before 30 June 1986. These DHS reports showed that an adequate foreign exchange system had not been implemented until July 1987.

Before July 1987, the DHS reports showed that the AWA accounting system had many weaknesses. These were that:

- the records were poorly maintained and not always retained;
- internal controls were inadequate;
- management control of foreign exchange activities was ineffective;
- no contracts register was kept between October 1986 and April 1987;
- no proper dealing slips were written or kept until 1 July 1987;



- telexes and roll-over confirmations were generally not retained until 1 March 1987 and this prevented a proper audit trail from being established and maintained;
- many computer confirmations and telexes were not sorted or filed, and accumulated in various locations in Korval's office and in the general accounting area. Together with the lack of daily summaries, this significantly hampered the assembly of foreign exchange records, the recording of results and the detection of losses and loans;
- no ledger of foreign exchange transactions was kept until the Macquarie system was brought up to date during June 1987;
- exposure reports gave erroneous information concerning open positions because the records for the input to the system were incomplete;
- from the beginning of the foreign exchange operation in late 1985, there was no written record of responsibility or reporting structure and no administrative and accounting procedures manual;
- adequate segregation of duties and responsibilities was neither prescribed nor observed. Korval was solely responsible for foreign exchange dealing and also for settlement and accounting functions;
- access to records was not controlled. Korval was able to open mail. He was also able to authorise accounting journal entries;
- there was no written record of accounting procedures, organisational responsibilities or delegation of responsibility to particular officers;
- there was only a small staff in the foreign exchange area, and they had an inadequate level of foreign exchange knowledge either about the substance of a transaction or about its documentation;
- at no stage were effective dealing limits imposed. Korval was told in April 1987 of the expected exposure guidelines and limits; and
- no action was taken to create agreed limits and advise foreign exchange dealers with whom AWA did or might transact business.

This long list of weaknesses, prepared by DHS in November 1987, highlighted the significant inadequacies in the AWA foreign exchange operations during the audit period.

### **6.5.2 Audit Testing of Accounting Records**

Rogers J found very substantial weaknesses in the set up and operation of the foreign exchange area ‘...and deficiencies in the keeping of cash books, loan and deposit ledgers and a general ledger’ (1995 AWA Appeal judgment Rogers, p.624). Even the DHS auditors agreed that there were substantial weaknesses in the foreign exchange system at AWA. Brentnall told the court, ‘...I am suggesting that there was no, as far as I could see it, there was no limit on his [Korval] trading activities’ (Court proceedings Brentnall 24-3-1992, p.80).

Bryant believed that the accounting procedures and books and records were essentially correct. He examined the green book maintained by AWA and found it to be badly organised, but that it recorded the foreign exchange transactions of AWA, with immaterial exceptions for the year ended 30 June 1986. Bryant believed that, by going outside the books and obtaining information from other sources, such as the banks, he could still decide on the adequacy of the records.

Rogers J found that DHS were negligent and had failed to comply with Section 285 of the Companies Code in relation to the duty of the auditor to report on the accounts in respect of the foreign exchange operations. It was most important that the foreign exchange records were accurate as Lonergan found that ‘Funds directed by Mr Korval were often transferred through a series of loan and deposit accounts with various banks in an effort, we believe, to further conceal foreign exchange losses’ (Court statement Lonergan 30-9-1987, p.9).

Rogers J found that ‘Not only were there no effective internal controls in place but the system of books and records was also deficient’ (1995 AWA Appeal judgment, p.647). The Appeal judges found that, given the high audit risks associated with foreign exchange operations and the materiality of the foreign exchange operations to AWA's accounts, a

detailed study and evaluation of AWA's foreign exchange internal controls was warranted.

Rogers J concluded that it was important to remind auditors that elementary financial measures such as books and records and internal controls were standard and well tested requirements for a good reason. He emphasised that ‘...at the heart of the auditing function must lie an examination of the books of account’ (1992 AWA judgment, p.24). Rogers J warned the profession that it was not for the auditor to be prepared to countenance their absence.

The Appeal Court found that Rogers J was correct in finding DHS negligent because, in DHS's own report of 16 November 1987 on the 1 July 1986 to 30 June 1987 accounts, they had stated that the records of AWA were poorly maintained and not always retained ‘...the internal controls were inadequate...’ (1995 AWA Appeal judgment, p.650) and the management control of foreign exchange activities was ineffective.

Clarke, Sheller and Powell JJA, the three Appeal judges, supported Rogers J and found that the various contradictory and incomplete records could not be described as accounting records, which had correctly recorded or explained the transactions and the financial position of AWA in accordance with their own (DHS) audit manual. The Appeal Court found that ‘...DHS were under a duty to report the acknowledged absence of proper records and the weakness in internal controls...’ (1995 AWA Appeal judgment, p.650). They found that this report should have been passed on to the directors.

### **6.5.3 Bank Circularisation Procedures**

Rogers J noted that because DHS had found that there were no opening balances at 1 July 1985, and because of the recognised absence of, or deficiency in, internal controls, the appropriate audit method should have been to confirm 100% of the open contracts.

DHS however, limited their circularisation to the counter parties indicated by AWA's records, even though it was realised that they might have been incomplete. Daniels stated, 'It seemed to me impractical to try to devise a test to cover the possibility of dealing with any of those counterparties' (Court proceedings Daniels 23-3-1992, p.40). Daniels told the Court that his understanding of what happened was that he was to request from AWA, letters of open positions with all the companies and with all the banks they dealt with. 'This would be compiled by AWA, we would have them sign the letters...' (Court proceedings Daniels 2-4-1992, p.60).

Westworth argued that, because the letters were compiled by Andrew Korval, DHS should '...have checked those to the available records at AWA to ensure they were complete circularisations' (Court proceedings Westworth 18-3-1992, p.47). DHS allowed AWA to sign the confirmation letters, and then DHS mailed the letters to the banks listed by AWA. Korval was therefore in a position to exclude those banks for which he had substantial unauthorised loans.

Because there were only a limited number of Australian financial institutions capable of accommodating large foreign exchange transactions, the correct procedure would have been for DHS to circularise them. This would have been a simple process and it would have given DHS 100% confidence that they had covered all Australian balances.

#### **6.5.4 Post-Balance Day Review**

Lonergan argued that DHS should have reconstructed the trading for the year and undertaken 'a very detailed examination of post-balance date settlements' (Court proceedings Lonergan 19-3-1992, p.65). When the responses revealed two discrepancies, no further checks were done to see if the records were adequate. 'In a position with strong controls, what you say is yes. In a position with no controls, no, you would not be particularly confident' (Court proceedings Lonergan 19-3-1992, p.58). A decision was then made by DHS not to perform a detailed systems review. One reason for this was that

those responsible for the audit understood that a new system, notably the Lotus software system, was in the process of being developed.

AWA argued that a post-balance date review should have been undertaken. This would inevitably have revealed that the green book had not been maintained since 30 June 1986 and that the Lotus system had not immediately come into existence. Even when it was introduced, it had never operated correctly.

Bryant agreed that DHS could not establish an audit trail through AWA's records but because of external confirmations, said 'No, it doesn't matter' (Court proceedings Bryant 6-4-1992, p.42). By undertaking a post balance day audit, DHS could have developed an audit trail back through the system.

Westworth argued that 'I would have done a roll back' (Court proceedings Westworth 18-3-1992, p.66). This would have established control over Korval and he would have tested onwards and then rolled back. This roll back would have included compiling all contracts and all realisations up to the date of the audit and then working back to 30 June 1986.

#### **6.5.5 Summation of DHS Foreign Exchange Auditing Procedures**

Lloyd did not consider it important to advise his supervisor Laidlaw, and ultimately Daniels, that AWA had ceased recording the green book. Lloyd told the court '...I don't recall telling him that, [green book not up to date] because it didn't, wouldn't have been important to me at that stage because I was just auditing as to 30 June' (Court proceedings Lloyd 23-3-1992, p.49). Lloyd's decision to ignore this cessation because it was outside his audit period, was unacceptable.

Rogers J (1995 AWA Appeal judgment, p.647) found that Daniels knew the following facts:

- there were no records kept at all between 1 July 1986 and 15 August 1986;
- even when the Lotus system was brought on stream nothing was done about internal controls;
- the foreign exchange trading was not tied into the computerised accounts;
- foreign exchange was both a high audit risk area and a high commercial risk;
- foreign exchange was an area where internal controls were absolutely critical; and
- the exposure was in a large sum of money.

Given the fact that Daniels knew of these serious weaknesses, and the further findings of DHS's own report of 16 November 1987, it was imperative for DHS to conduct much greater testing before performing a 100% circularisation of all Australian financial institutions. They should have also conducted a very extensive post-balance date audit review.

In their evidence both Daniels and Lloyd accepted that, in general, the weaknesses in the system that DHS had described in the report of 16 November 1987, had existed before 30 June 1986. This report by Deloitte identified that an adequate foreign exchange system was not implemented until July 1987. (1995 AWA Appeal judgment, p. 624).

Lloyd had been responsible for the 1985-86 foreign exchange audit but his auditing methods had been inadequate. He agreed that his auditing had not included any great detail. He admitted, 'I would say very little attention to [foreign exchange accounting systems and internal controls] because I wasn't intending to rely on them when I did my audit. I didn't need any great detail' (Court proceedings Lloyd 23-3-1992, p.60).

## **6.6 Responsibility to Report Internal Control Weaknesses**

The DHS legal team relied on the belief that the only proper evidence of the extent of the duty of an auditor was the practice of the profession as a whole. DHS believed that they had met this responsibility by complying with the requirements of AUP12 'Study and

Evaluation of the Accounting System and related Internal Controls in Connection with an Audit’.

In the AWA case, Rogers J found DHS negligent in that they should have reported the weaknesses to management and particularly the ‘...appalling state of AWA’s internal controls and records...’(1995 AWA Appeal judgment, p.619) and, failing action, to the directors at board level. He was further critical of the audit certification in that ‘Daniels did not simply fail to show his teeth, he kept his mouth firmly shut when he signed, without qualification the auditor’s certificate’ (1992 AWA judgment Rogers J, p.24). He found that auditors had a legal duty to assess the adequacy and reliability of the client’s internal control systems, and were required to promptly report all significant deficiencies in the design or operation of the internal control structure to an appropriate level of management.

Rogers J found that if management did not respond adequately to the seriousness and urgency of the matter, then the auditors should have promptly raised the matter with the board of directors. Rogers J stated that ‘...on both occasions Daniels attended board meetings he was aware of the state of the books but forbore from telling the board...’ (1992 AWA judgment Rogers J, p.24).

#### **6.6.1 Directors’ Meeting of 22 September 1986**

Rogers J found that ‘Daniels was taking a chance on the fact that whilst he dallied to comply with custom, nothing could go wrong. That was negligence of the first order. Things went very wrong’ (1992 AWA judgment, p.990).

Finley, a director, had ‘...specifically asked Daniels whether there was anything the board should be aware of’ (1995 AWA Appeal judgment, p.648). Daniels falsely answered that everything was satisfactory because he was relying on his previously followed custom, that he would wait until the audit exit meeting with management.

Daniels then compounded the impression of a satisfactory foreign exchange operation by presenting an article on efficient foreign exchange hedging to the directors. 'This article in Business Review Weekly [BRW] probably best explains what has been happening' (Court statement Daniels 24-5-1991, p.16). The directors incorrectly assumed that Daniels was advising them that AWA's foreign exchange operations followed the BRW example.

Rogers J questioned Daniels as to why he had not replied to Finley's question. Daniels answered, 'A matter of custom, your Honour, back to 1970' (Court proceedings Daniels 31-3-1992, p.26). However, Daniels did acknowledge that he might have erred in his decision not to report to the board by saying, 'At the time I thought not. At this time I think perhaps I should have' (Court proceedings Daniels 31-3-1992, p.30).

#### **6.6.2 Directors Meeting of 30 March 1987**

The Courts found that Daniels failed to honestly answer a question put to him by Finley, one of the directors, at the 30 March 1987 meeting. Finley told Daniels, 'The directors want to be assured by you that you really have dug into the whole area and that we are not kidding ourselves in accepting these figures presented to us in the monthly accounts' (1995 AWA Appeal judgment, p.648).

Daniels did not agree with that wording and stated that Finley had said 'I am concerned that the divisional figures are being camouflaged by the foreign exchange results'. Daniels did agree that 'I did indicate that our audit examination did not reveal anything untoward about the foreign exchange profits' (Court statement Daniels 24-5-1991, p.33).

Rogers J also found that DHS had been negligent on 30 March 1987 for the failure to reveal to the board the state of AWA's internal controls and records. He found that at the 30 March 1987 meeting, that 'Daniels was guilty of negligence...' (1995 AWA Appeal judgment, p.619) because the attitude and questions from the board indicated that Hooke



had not told the directors of the internal control weaknesses. He left no doubt of his opinion, 'Daniels was negligent in the course he adopted at the meeting with the board on 30 March 1987' (1995 AWA Appeal judgment, p.648).

### **6.6.3 Summation of both Directors' Meetings**

On both 22 September 1986 and 30 March 1987, Daniels failed to advise the AWA directors that he had uncovered significant weaknesses despite being questioned specifically by the directors. Particularly as the questions indicated that '...they had not been advised by Hooke of his meeting with the auditors' (1995 AWA Appeal judgment, p.648). This failure to reply correctly to the directors' questions indicated to them that the auditors considered that the foreign exchange system was operating satisfactorily.

Clarke, Sheller and Powell JJA confirmed Rogers J's decision that DHS were negligent, but found that the trial judge erred in treating his finding as certain. The directors claimed that they would have immediately undertaken procedures to prevent any further foreign exchange losses. Rogers J believed that it '...would, not might, have taken place' (1995 AWA Appeal judgment, p.617). The Appeal judges found that 'On a reassessment of damages the appropriate measure of the damages resulting from the negligence of DHS was \$6 million' (1995 AWA Appeal judgment, p.617).

The decision in the AWA case and confirmed on Appeal required the auditor to report internal control weaknesses to the directors. This was a significant additional audit duty which mirrored recent developments in the United States of America. The 2000 O'Malley Panel reported that auditors should inform the audit committee '...when they [the auditors] believe that an entity's accounting principles are approaching unacceptability, even if the policies have not yet crossed into that territory' (O'Malley Panel 2000, p.79). This need for the auditor to provide an early warning signal to management, directors and audit committees is a practical measure that corresponds with the Courts' attitude in AWA.

Finley typified the reaction of the directors and management to the finding of Korval's loss of \$49.8 million, when he said that had he been informed, 'I would have called for an explanation as to how these [foreign exchange losses] could have occurred and I would have called for the immediate removal of those responsible' (Court statement Finley 24-8-1990, p.17). Finley would have insisted on urgently calling in foreign exchange experts. The CEO, directors and management all expressed bewilderment when told that Korval had been speculating and not conducting a low-risk operation. DHS should have informed management and the directors in writing of their findings. They had incorrectly assumed that the directors already knew there was at least some risk in operating a foreign exchange program.

Reporting all evidence of irregularities promptly to the directors extends beyond the duty, established in Pacific Acceptance and confirmed in the WA Chip case. It also extends beyond the guidance provided in ED 44 'Communications to Management on Matters' arising from the audit.

## **6.7 Requirements of DHS to Qualify the 1985-86 Financial Statements**

Bryant argued 'No. A qualification on books and records is not there to warn about potential. The books and records either were adequate or were not, and at 30th June they were' (Court proceedings Bryant 6-4-1992, p.41). The DHS legal counsel argued that the qualification of the accounts is an issue separate from the argument as to whether or not AWA were correct in their contention that internal control and record keeping was a matter for the auditor to bring to the attention of management. They argued that, from the green book and full circularisation, DHS were able to identify the position of AWA's foreign exchange transactions at 30 June 1986.

The DHS results were confirmed by Bryant who stated that he '...attempted to work from the green book to the closing position at the end of the year. It takes about an hour and a

half and you get exactly the answer that Mr Westworth says' (Court proceedings Bryant 6-4-1992, p.41).

The Appeal judges disagreed with this finding and stated 'It is simply not correct to say, as DHS submitted, that the unrealised gains and losses on open positions could be ascertained from the records in AWA's FX [foreign exchange] department, namely the green book and the contracts file...' (1995 AWA Appeal judgment, p.628).

He believed that the existence of a register not written on a timely basis, coupled with an absence of any controls to ensure that all dealings were recorded in the company's records without any further adequate audit testing should have resulted in the qualification of the 1985-86 accounts.

Lonergan believed that the accounts should have been qualified. His support [for that qualification] came from '...the fundamental problem that the weaknesses were so great that the accounts potentially would not show a true and fair view' (Court proceedings Lonergan 19-3-1992, p.28).

Two important aspects of the 1985-86 accounts were the failure of DHS to comply with AAS20 'Foreign Currency Translation' and their failure to undertake any investigation of the dramatic change in foreign exchange profits immediately after the audit period.

### **6.7.1 AAS 20 Foreign Currency Translation**

Lloyd had a discussion with Mileham and Korval. Lloyd told them, 'These contracts appear to be general or speculative' (Court statement Lloyd 14-5-1991, p.30). Mileham told Lloyd that Korval had mentioned this to him and he agreed with Korval that, 'They [the 'unnatural hedges'] are hedges of specific hedges so I believe we should classify all of them as specific hedges' (Court statement Lloyd 14-5-1991, p.31).

‘We were agreeing with the company’s decision to treat them as specific hedges, yes’ (Court proceedings Daniels 2-4-1992, p.3). Daniels had been told by all his audit team that the foreign exchange hedges were general hedges in compliance with AAS20. However, he ‘...believed them to be specific’ (Court proceedings Daniels 2-4-1992, p.3). The AWA general manager Pat Gibson thought they were general hedges. Daniels told Gibson, ‘Pat, we discussed this in June and we have already determined that the contracts were specific and therefore the unrealised loss should not be booked’ (Court statement Daniels 24-5-1991, p.14). Daniels chose, instead, to agree with Korval and classify them as specific hedges.

This resulted in Korval not having to disclose his unrealised losses. The disclosure to the directors of information of \$297.5 million in speculative foreign exchange contracts would have alerted them to the large speculative position taken by Korval. Lloyd agreed that Korval’s actions had exposed AWA to the ‘extent of \$84 million in short positions of the USD against the AUD’ (Court proceedings Lloyd 23-3-1992, p.24). Korval had told Lloyd that AAS20 was very simplistic and that anything to do with foreign exchange is speculating. Lloyd stated that ‘...I could not understand (given that the AUS\$/US\$ contracts were ostensibly the wrong way around) how it would be possible to classify the transactions as specific hedges within the AAS 20 definition’ (Court statement Lloyd 14-5-1991, p.29).

### **6.7.2 Significant Changes in Foreign Exchange Profits**

The other aspect of the 1985-86 accounts was the failure of DHS to investigate a \$6.2 million loss at 30 June 1986 which, had by August 1986, turned into a \$9 million profit. A competent auditor would have been suspicious of significant changes in profits or losses immediately after the audit balance date and would have investigated this \$15.2 million turnaround. Lloyd had not undertaken any investigation.

Lloyd explained 'It seemed to me likely that those foreign exchange contracts opened at 30 June 1986, which then showed a loss, were likely to have become profitable so as to have reduced the loss' (Court proceedings Lloyd 23-3-1992, p.78). Lloyd was seduced by the fact that the foreign exchange department was seen as '...the largest dollar generating department in the company' (Tomasic et al., 2002a, p.156).

### **6.7.3 Summation of the Non-Qualification of the Financial Accounts**

The Appeal judges Clarke, Sheller and Powell JJA confirmed that Rogers J was correct in finding that DHS should have qualified the financial accounts for the year 1985-86. They noted that 'Rogers J found that by 30 June 1986 Daniels knew that AWA's records were not adequate' (1995 AWA Appeal judgment, p.625).

The AWA Appeal judges relied on the precedent set by Manning and by Van Reesema in finding that, for a company engaging, on a daily basis, in foreign exchange transactions worth millions of dollars 'It was a requirement that a company keep such books as were necessary to exhibit and explain the transactions and financial position of the trade or business of the company' (1995 AWA Appeal judgment, p.615). They found that the accounting records had to be kept on a regular basis and that AWA's foreign exchange accounting records had not been.

## **6.8 The Responsibility on DHS in the Non-Statutory 31 December 1986 Audit**

Bryant agreed that the 31 December 1986 accounts should have been qualified. However, he argued that there was a major difference between the weaknesses in the June and December accounts. He admitted '...in February and March 1987 that, if the recorded weaknesses persisted DHS might conclude, in the June 1987 statutory audit, that proper books and records had not been kept' (Court statement Bryant 8-2-1991, p.63). DHS argued that the audit was not a statutory audit and therefore they had only undertaken an

examination to provide AWA with a profit confirmation and were not certifying the financial accounts.

Daniels argued ‘...the letter I gave to AWA was only a comfort letter on the profits’ (Court proceedings Daniels 1-4-1992, p.33), he believed that he was not obliged to undertake as comprehensive an audit as would have been required for a statutory financial audit. However, Bryant stated that ‘...to give reasonable assurance as to detection of material misstatements, and the work required to achieve the objective would not differ greatly whether the work was labelled ‘audit’ or some other term’. (Court statement Bryant 8-2-1991, p.58).

AWA claimed that the audited profit figure at 31 December 1986 was incorrect. Rogers J agreed and found that DHS were negligent in the ‘...signing on 9 March 1987 of a grossly erroneous profit confirmation letter for the six months ended 31 December 1986...’ (1995 AWA Appeal judgment, p.619). After 30 June 1986, the green book was not used and between 1 July 1986 and 18 August 1986 no records of any kind were kept. He found that, for the six-month period ending 31 December 1986, AWA's records were inaccurate and inadequate.

Daniels had decided to have a full circularisation because of the absence or insufficiency of records and internal controls. He had also disregarded material in hand which showed discrepancies and the existence of foreign exchange loans which were not supposed to exist. Rogers J was most critical of Daniels’ decision to sign the profit confirmation letter whilst all these matters were still outstanding. He asked Daniels, ‘...why on earth didn't you say to Gibson at least, look, I am going to give you this letter but I have not had any response from two of the banks?’ (Court proceedings Daniels 3-4-1992, p.17).

The Appeal Court also agreed that the inappropriateness of the signing of the profit statement on 9 March 1987 could not be denied. The signing occurred in the knowledge that the defective system of records and internal controls had not been improved and that

the circularisation of the banks had revealed discrepancies in the accounts that had never satisfactorily been explained.

It is important to point out that Daniels signed the profit confirmation on Monday 9 March 1987 before he had undertaken a thorough examination of the audit work papers which had not been completed by Brentnall until Friday 6 March 1987. Rogers J posed the question to Daniels that he couldn't presently recall actually looking at the work papers on Saturday 7th or Sunday 8th March 1987. Daniels answered, 'No, but I believe I did' (Court proceedings Daniels 3-4-1992, p.2).

## **6.9 Should DHS have Detected the Illegal Activity in the AWA Audit**

Lonergan agreed that audits were not guaranteed to detect all frauds and that it was particularly difficult to find fraud or illegal activity. However he found that '...had the audit been conducted by a competent auditor in accordance with generally accepted audit practice and principles, the irregularities would have been reported...' (Court statement Lonergan 18-3-1991, p.8). DHS believed that the extraordinary circumstances operating in AWA resulted in reasonable audit methods being unable to detect the illegal activity and the \$38.8 million in unauthorised loans at 31 December 1986.

The circumstances were:

- Korval's concealment of information and records;
- Hookes' and senior managements' negligence in not adequately supervising the foreign exchange operations; and
- banks advancing loans at Korvals' request and paying the funds into non-AWA accounts.

### **6.9.1 Korvals' Concealment of Information**

A prime incentive for Andrew Korval to show all profits, but conceal many losses, was that he received a very large bonus. Korval was paid a bonus of \$84,618 for the six months ended 31 December 1986 based on his stated net profits of \$13.4 million. His yearly salary was \$30,187 (\$15,093 for six months) and this payment represents a 560% bonus ( $\$15,094 \times 5.6 = \$84,526$ ) (Court statement Lonergan 30-9-1987, p.8).

There is clear evidence that Korval deliberately concealed losses in order to inflate the bonus payment. Belfanti spoke to Korval after 31 December 1986 and told him 'Here is a copy of the list of FX [foreign exchange] transactions for the 6 months to 31 December 1986 which I have obtained from the general ledger...' (Court statement Belfanti 4-2-1991, p.22). He asked Korval to check that the list was complete as he was calculating Korval's bonus. He specifically asked Korval to check, 'Are all the losses included?' (Court statement Belfanti 4-2-1991, p.22). A few days later Korval said to Belfanti, 'I have checked the list and it is all OK' (Court statement Belfanti 4-2-1991, p.22). The true situation was that at 31 December 1986, Korval had taken out unauthorised loans of \$38.8 million in order to roll over his loss making contracts.

Korval also consistently attempted to avoid the difficult questions asked by the DHS auditors as well as by Belfanti. During the February 1987 internal audit review, a loan of USD 822,858 from Macquarie Bank to AWA was discovered. Belfanti asked Korval about the loan and Korval told him that '...it was a Deutschmark FX [foreign exchange] contract profit offset' (1995 AWA Appeal judgment, p.651). Belfanti further questioned Korval about this foreign exchange loan and Korval said he would look into it and get back to him. Belfanti never received a reply.

Another example was the discovery by internal audit of a foreign exchange loss of approximately \$1.6 million in the Head Office journal. Belfanti said to Korval 'We can't find any reference to this loss in the CBA New York account. Can you explain this?'



Belfanti could not recall what Korval said in reply but ‘...my recollection is that I formed the belief that his answer was not adequate’ (Court statement Belfanti 4-2-1991, p.24).

### **6.9.2 Hooke’s Negligence**

Loneragan found that AWA management ‘...did not properly investigate the large number of significant internal control weaknesses reported to management by Deloitte in March 1987...’ (Court statement Lonergan 30-9-1987, p.21). Rogers J found that Hooke as CEO and the management of AWA ‘...were guilty of negligence’ (1995 AWA Appeal judgment, p.619). This finding was also confirmed by the Appeal Court. They found that ‘Rogers J was correct in finding that the chief executive officer was negligent’ (1995 AWA Appeal judgment, p.616). Hooke’s appeal was allowed as the ‘...negligence of the chief executive was taken into account in determining the apportionment for contributory negligence...’ (1995 AWA Appeal judgment, p.617).

Loneragan was also critical of management in that ‘...when a number of AWA’s bankers had expressed concern at the nature and extent of Mr Korval’s dealings they did not properly investigate these concerns’ (Court statement Lonergan 30-9-87, p.21).

Hooke subsequently met with a BBL executive who advised him ‘...your company has very substantial unrealised losses arising out of our mutual dealings’ (1995 AWA Appeal judgment, p.637). This information from BBL should have precipitated a major review of the foreign exchange operation and should have resulted in the discovery of unauthorised loans, but Hooke failed to act on this advice.

### **6.9.3 Unauthorised Loans**

All the parties involved in the AWA case agreed that they did not consider that Korval could have obtained loans from banks to pay for losses without its authorisation by AWA management and payment into an AWA bank account.

Bryant argued that it was not a mandatory requirement to search for evidence of fraudulent or illegal activities. He told the Court that in relation to DHS ‘...we agree that there is considerable doubt as to whether a reasonable auditor would have detected the loans’ (Court statement Bryant 8-2-1991, p.66). Bryant argued that if these loans had been authorised by AWA management or had been paid into an authorised AWA bank account, then this would have resulted in the loans being detected through the bank reconciliations. These loans had not been authorised or entered into an AWA bank account.

Westworth agreed that he could not explain why the responding banks failed to identify contracts but concluded that Korval may have been suppressing or hiding or fiddling with contracts simply to not disclose the losses. He found that the failure by the banks to identify the contracts was the single most significant reason why the contracts were missed by DHS. However, if he had been conducting the audit he would have been much more careful than DHS. ‘If I am seeking to conduct a check as to the accuracy of his [Korval] work, I would seek some controls over his work...’ (Court proceedings Westworth 18-3-1992, p.66).

### **6.9.4 Legal Requirement to Detect Fraud or Illegal Activity**

DHS argued that, in Australia, there were no statutory provisions requiring auditors necessarily to detect fraud or other irregularities. There are statutory provisions in sections 331 and 332 of the Corporations Law 1989, requiring auditors to investigate or to report any irregularities which may come to their notice in the course of their audit

work and which are of sufficient size or importance to affect the truth and fairness of the financial statements.

The Courts were particularly influenced by the fact that Alagna, the AWA accountant, took only 2 days to discover the extent of the unauthorised loans. On 27 June 1987, Alagna, was advised by Korval's assistant, Crane, of unusual loans. He presumed it was simply an accounting error, but upon investigation he discovered two unrecorded Westpac loans totalling over \$16 million. On 29 June 1987, he reported his findings to senior management.

Clayton Utz, the prosecution lawyers, successfully argued that DHS had had access to much greater evidence of unusual loans, as early as September 1986. The legal team pointed out that with this information, the auditors should have discovered evidence of unauthorised loans much earlier than had Alagna. And, with this information, DHS should have reported to AWA management and directors and consequently could have stopped the loss of much of the \$49.8 million in unauthorised foreign exchange loans.

Rogers J found that the negligence was not that the auditors had failed to detect some error or misstatement in the accounts but the failure to advise the board of the absence of proper internal controls. 'In my opinion there can be no argument that Daniels and his assistants in the course of their audit became aware of a major deficiency in internal controls' (1995 AWA Appeal judgment, p.630).

Moffitt J noted, in the 1970 Pacific Acceptance judgment, that once fraud has been detected, it is easy in hindsight to blame the auditor. However, it may be unreasonable to expect her/him to connect matters in the fashion that would be expected in a special investigation or where suspicions have already been aroused.

He also stated that an auditor must plan and carry out his work with due regard to the possibility of error or fraud. Error, fraud or unsound accounting is the auditor's concern.

An auditor must pay heed to the reality that there is always a material possibility that human frailty may lead to error or fraud in the financial dealings of any organisation.

## **6.10 Summary of the AWA Audit**

### **6.10.1 Foreign Exchange Experience**

Korval was responsible for the operation of both the AWA foreign exchange and the money market. Rogers J was critical of this dual responsibility, which ‘...required a separation of the dealing room function from the settlement function if it was to be efficiently and safely conducted’ (1992 AWA judgment, pp.966-967). The DHS audit team did not understand the fundamentals of a foreign exchange operation. The three audit experts and the Courts were in agreement that DHS should have obtained more foreign exchange assistance from auditors, or if they were not available, from consultants.

Westworth believed that the DHS audit team lacked even a basic understanding of foreign exchange. He found that the statement that AWA had hedges upon hedges ‘...would be incomprehensible as a simple statement on its own’ (Court proceedings Westworth 18-3-1992, p.14).

### **6.10.2 Audit Engagement Letter**

All three audit experts also agreed that DHS should have updated the AWA audit engagement letter. However, the DHS audit partner, Daniels, did not regard an audit engagement letter as important because he said ‘During the period I was involved with AWA audits it was not our practice to issue an audit engagement letter...’ (Court statement Daniels 24-5-1991, p.2). Daniels had had a long-term policy of not sending AWA an audit engagement letter ‘...as I viewed the exit meeting as fulfilling the same role’ (Court statement Daniels 24-5-1991, p.2). No audit engagement letter had been forwarded to AWA since at least 1969.

When AWA requested a special audit for the six months ended 31 December 1986, it would have been an important time to have updated the engagement letter and to have negotiated and documented the exact terms of the special audit.

### **6.10.3 Audit Planning**

All three-audit experts also highlighted the lack of adequate audit planning. The directors had approved a foreign exchange operation where ‘...transactions be related to AWA's underlying exposure...’ (1995 AWA Appeal judgment, p.622). DHS should have gained an understanding of the accounting system and related internal controls. They should have also studied and evaluated the operation of those internal controls upon which the auditor wished to rely, in determining the nature, timing and extent of other audit procedures.

Whilst all three-audit experts agreed that the DHS audit was deficient in relation to the three weaknesses of a lack of foreign exchange expertise, no updated audit engagement letter and inadequate audit planning, there was considerable debate amongst the three audit experts in relation to the adequacy of the accounting procedures. However, there was no doubt in Roger J's judgment that DHS had been negligent in their auditing procedures.

### **6.10.4 Accounting Procedures**

Rogers J found it difficult to follow the DHS audit procedure by which they first decided that they could not rely on the poor internal controls, but then could not undertake a 100% circularisation of the financial institutions. This was because as Rogers J asked, ‘The corollary to that, and correct me if I am wrong, because I have never been an auditor, would have been to check on the internal controls wouldn't it?’ (Court proceedings Rogers J 23-3-1992, p.40).

His Honour found that DHS could have circularised the small number of financial institutions in Australia capable of large foreign currency transactions, to provide at least a completeness check within Australia. This was especially important when the court found that not only were there no appropriate internal controls in place but the system of books and records was not satisfactory.

The Appeal Court noted that Rogers J had found that DHS had not checked the internal controls or alternatively undertaken a 100% bank circularisation despite the fact that ‘...because of the absence, or insufficiency, of records and internal controls he [Daniels] decided to have a full circularisation...’ (1995 AWA Appeal judgment, p.648).

His Honour was adamant that DHS should have undertaken a much more detailed audit and the Appeal judges agreed because ‘...we are not prepared to accept that such contradictory and incomplete records of FX [foreign exchange] transactions could be described as accounting records...’ (1995 AWA Appeal judgment, p.628).

DHS and Bryant’s argument therefore rested on proving that the green book was able to provide the same balances and correct totals that the AWA legal team had accumulated.

Bryant had argued that despite the disorganisation of the accounting records ‘...there is then no question that, scruffy or not, they are adequate’ (Court proceedings Bryant 6-4-1992, p.45). He felt that if you do all the work that is necessary and you get the right answer then they are satisfactory. His tests concluded that the green book could be balanced to approximately the same balance achieved by Westworth within an hour and a half.

Rogers J disagreed with Bryant. He found that it was not correct to say that the unrealised gains and losses on open positions could be ascertained from the records in AWA's Foreign Exchange department.

The Appeal Court agreed with Rogers J in his finding that DHS were negligent because in DHS's own report of 16 November 1987 on the 1986-87 accounts they had disagreed with Bryant's contention that it was possible to balance the books from the available records. The Appeal Court found that 'Exposure reports gave erroneous information concerning open positions as the records for the input to the system were incomplete' (1995 AWA Appeal judgment, p.624).

#### **6.10.5 Reporting Internal Control Weaknesses**

The three audit experts all agreed about the significance of DHS's report of the internal control weaknesses to the directors. However, there was a dispute about when this should have occurred. If Bryant had not advised the directors at the 22 September 1986 meeting, then he claimed, he would have promptly written to the directors. He said '...I would feel that very shortly afterwards I would want to be writing...' (Court proceedings Bryant 6-4-1992, p.16). This attitude contrasted with that of Lonergan who would not have waited until the 22 September 1986 meeting. He told the Court that the internal control weaknesses were so serious that there was no time to wait for management to act. He said, 'No It is the very seriousness of the weaknesses' (Court proceedings Lonergan 19-3-1992, p.66).

Rogers J regarded Daniels' decision not to report the internal control weaknesses to the board as '...a singularly blinkered view' (1995 AWA Appeal judgment, p.647). Especially, as one of the directors, Finley, had asked Daniels at the 22 September 1986-board meeting "...whether anything arose from the audit that the board should be aware of..." (1995 AWA Appeal judgment, p.647). Daniels' reason for not telling Finley and the board of the foreign exchange internal control weaknesses was that "...he wanted to make a "more formal statement' to management first" (1995 AWA Appeal judgment, p.647).

In relation to the board meeting of 30 March 1987, Bryant felt that the directors were more concerned with profitability than with internal controls. He told the court, 'I think what the board expects, and is mainly interested in, is the bottom line-right or wrong materially' (Court proceedings Bryant 6-4-1992, p.84).

Bryant believed that it was extremely unusual for an auditor to communicate with a board without first meeting with management to ensure that the auditor's understanding of the facts is correct.

This contrasted with Lonergan's finding that he would have gone to the directors as soon as he became aware of a problem as material as the foreign exchange internal control weaknesses.

Rogers J was critical of Daniels' performance at the 30-3-1987 directors' meeting in that "...the attitude and questions from the board suggested that they had not been advised by Hooke of his meeting with the auditors" (1995 AWA Appeal judgment, p.648). Rogers J's conclusion was that the negligence of DHS on 22-9-1986 was followed by "...and its consequences refreshed, by further acts of negligence each step of the way up to 30 March 1987" (1995 AWA Appeal judgment, p.649).

Rogers J summed up by stating that, "I greatly regret to put it as bluntly as this but I am afraid that Daniel's failure to disclose the matters I have earlier specified was negligence" (1995 AWA Appeal judgment, p.648). The Appeal Court was equally critical of Daniels' performance at the 30-3-1987-board meeting. They found that "DHS were then aware, but failed to tell the board, of the net unrealised losses of approximately \$4.6 million disclosed by bank responses" (1995 AWA Appeal judgment, p.641).



#### **6.10.6 The 1985/86 Accounts**

Another contentious area among the three audit experts was the non-qualification of the 1985/86 accounts. Bryant was adamant that the accounts should not have been qualified because he said, "...I just can't conceive that somebody would reach that conclusion [qualify the accounts]" (Court proceedings Bryant 6-4-1992, p.45).

Westworth disagreed with Bryant and believed that the key reason for qualification was the state of the internal controls surrounding the compilation of those records, he '...would not issue an unqualified opinion before undertaking steps to ensure completeness of FX [foreign exchange] particularly as the apparent deficiencies in FX [foreign exchange] were then borne out by the errors...' (Court statement Westworth 17-4-1991, p.6). He found that the material identifiable errors in unrecorded foreign exchange positions and loans were so important that, without any further adequate records, the accounts should have been qualified.

The Appeal Court agreed with Rogers J and found that DHS should have qualified the financial accounts for the year 1 July 1985 to 30 June 1986. Referring to the Companies Act, the Appeal Court found that '...conformably with the requirements of s285 (4), DHS should have formed the opinion that proper accounting records had not been kept as at 30 June 1986' (1995 AWA Appeal judgment, p.651).

#### **6.10.7 The 31 December 1986 Audit**

Bryant agreed that the half-year audit, ended 31 December 1986, should have been qualified because the accounting records were materially wrong. At June, the controls had the potential for '...the books to be wrong but in fact the books were right and that is the key difference between June and December' (Court proceedings Bryant 6-4-1992, p.57). The Courts were very critical of DHS's signing a profit confirmation letter for the 6-month audit ending 31 December 1986. Rogers J found DHS negligent for '...the

signing on 9 March 1987 of a grossly erroneous profit confirmation letter for the six months...' (1995 AWA Appeal judgment, p.619).

The Appeal Court agreed with Rogers J and found that 'The inappropriateness of the signing of the profit statement of 9 March 1987 could not be denied' (1995 AWA Appeal judgment, p.650) as the circularisation of the banks had revealed discrepancies in the accounts never satisfactorily explained.

#### **6.10.8 Detection of Fraudulent or Illegal Activity**

The AWA case underlines the higher standard of care required of auditors in detecting fraudulent or illegal activity in often complex situations. DHS argued that they were confronted by an extraordinary conjunction of events in that '...a junior and trusted employee is in fact engaged in a fraudulent suppression of losses' (1.3. Failure to qualify in relation to accounting records. DHS appeal submission, p.15.29449).

On 15-9-1987, Hooke questioned Daniels as to why DHS had not discovered the unauthorised loans. Hooke said to Daniels 'Well that leads me to wonder what other matters have now been discovered in relation to our foreign exchange activities...' (Court statement Hooke 15-9-1990, p.34). He then told Daniels that '...I found this [Westpac] revelation extremely disturbing' (Court statement Hooke 15-9-1990, p.36). He had only just been advised of unauthorised, unrecorded loans from Westpac taken out by Korval. Daniels replied that at this stage he was not sure exactly why the loans weren't discovered. 'We are looking into that' (Court statement Hooke 15-9-1990, p.36).

Bryant argued that it was not mandatory to search for evidence of fraudulent or illegal activities, however he agreed that a way of protecting a company '...from the possibility of defalcation or fraud is to impose proper internal controls' (Court proceedings Bryant 6-4-1992, p.20).

Westworth thought that DHS should have considered that Korval may be ‘...suppressing or hiding or fiddling with contracts simply to not disclose the losses...’ (Court proceedings Westworth 18-3-1992, p.73) because it would affect his performance and consequently his bonus.

The Appeal judges rejected the argument that a reasonable auditor would not have detected at least some of the illegal activity and agreed with Rogers J. They concluded that ‘...either Daniels was guilty of almost incredible negligence in failing to read the work papers or as his Honour thought more likely, he simply failed to react appropriately to the situation they revealed’ (1995 AWA Appeal judgment, p.648).

#### **6.10.9 Legal Implications**

Rogers J referred to the South Australian Full Court *Van Reesema* case in which no books at all were kept. In *Van Reesema*, the South Australian Full Court quoted from Burt J’s judgment in Manning that the accounts should disclose or exhibit the financial position of the company at all times and at any time. These two cases were both important precedents for Rogers J and the Appeal judges who were concerned that AWA’s accounting records were not kept in a manner where the affairs of the company could be readily identified.

Rogers J found ‘...adapting the words of Burt J, [that] it is not enough that the green book, together with full circularisation, was sufficient to show the position of the company in foreign exchange transactions’ (1.3 “Failure to qualify in relation to accounting records”, DHS Appeal submission, p.15.29437).

DHS argued that in compliance with AUP12 there was no obligation on DHS to report internal control weaknesses to the AWA board because ‘...in other words the reporting of weaknesses is offered gratuitously and not as a matter of obligation’ (1.3 ‘Failure to qualify in relation to accounting records’, DHS Appeal submission, p.15.29437).

The important consequences of the AWA case meant that the duty of skill and care of auditors has been further questioned. It also extends the duty beyond AUP35 'Communications to Management on Matters arising from an Audit'.

The AWA case further confirms the findings in both Pacific Acceptance and WA Chip that an auditor's compliance with the auditing standards or with generally accepted practice may be persuasive but is not necessarily conclusive evidence that an auditor has complied with the requisite standards of professional skill and care. The courts will be the final arbitrators of whether the auditor has met the requisite standard of skill and care required.

## 6.11 Conclusion

This chapter has considered the findings of Rogers J in the original 1992 judgment, the statements of the 1995 Appeal Court judges Clarke, Powell and Sheller JJA and the comments of the three audit experts together with the conclusions drawn from them. The overall finding was that the DHS auditors had not complied with accepted auditing procedures in undertaking the AWA audits.

Rogers J found that, when doubts were raised about Korval's actions, '...the auditors were [then] under a duty to make inquiries from senior management' (Tomasic *et al.* 2002a, p.157). It is difficult to comprehend how Daniels could accept Korval's use of a wrong way around foreign exchange operation without consulting any third party to clarify the matter. The logical question that should have been asked was why wasn't he using the correct way around?

Another important red flag to the auditors should have been the size of the exposure that Korval was generating without any adequate supervision. 'At one stage, the largely unsupervised foreign exchange dealings and borrowings left the corporation exposed to a potential liability totalling US 600 million' (Tomasic *et al.* 2002a, p.156).

The aim of this research was to examine the role of the auditor in detecting fraudulent or illegal activity. Korval concealed information and records, and obtained unauthorised loans, which he knew AWA would not have agreed to. These illegal activities resulted in Korval receiving bonus payments of at least \$84,618, which represented a 560% bonus on his annual salary.

In analysing Korval's actions, I find that he illegally suppressed or omitted unauthorised transactions. He wilfully misrepresented foreign exchange results in the financial statements. These deceptions resulted in him obtaining an illegal financial advantage of \$84,618 and meant that Korval could be considered fraudulent under the definitions of fraudulent activity in both the Australian accounting standard AUS 210 and the UK accounting standard SAS 110.

Unfortunately, Korval was not called in the AWA Court case so it is not known whether Korval would have been found guilty of fraud or illegality. But, based on the research findings, Korval can be shown to have concealed unauthorised transactions in order to gain a significant financial advantage. The question that then remains was whether the auditors should have detected evidence of Korval's illegal activities.

There seems little doubt that if DHS had undertaken more thorough auditing tests, which included a comprehensive testing of internal controls, a 100% circularisation of Australian financial institutions and an adequate post-balance day review, then they should have detected evidence of unauthorised loans.

Then, too, if Daniels, who had become aware of the internal control weaknesses, had reported them to the board at the 22 September 1986 and 30 March 1987 directors meetings, then it is probable that the directors would have reviewed the foreign exchange operation and uncovered evidence of unauthorised loans.

And finally, if DHS had undertaken a proper analysis of the financial statements, they should have qualified both the 1985-86 and the 6-month audit ending 31 December 1986. DHS failed to ensure that AWA had complied with AAS20 and this resulted in non-disclosure in the financial statements of \$297.5 million in foreign exchange contracts. They also failed to investigate the \$6.2 million loss at 30 June 1986 that had suspiciously translated into a \$9 million profit by August 1986.

The inclusion of these matters in the financial statements should have resulted in the qualification of the financial accounts. This would have highlighted to AWA the fact that the foreign exchange records required a review and investigation. Therefore, on balance, the auditors should have detected evidence of Korval's fraudulent or illegal activity particularly when, in July 1987, Alagna within a very short time was able to detect evidence of unauthorised loans during Korval's absence because of a minor car accident.

Korval had been involved in a minor car accident and was temporarily in hospital. Whilst he was on leave, Alagna the AWA chief accountant looked after the foreign exchange operation. He found two Westpac loans totaling \$16 million, which he promptly reported to senior management. Hooke was advised on 3 July 1987.

In the final two chapters the audit problems uncovered during the research of the AWA case and the recommendations for resolving them will be identified. The research had found that the audit profession needs to review the current methods available to auditors for detecting fraudulent or illegal activities. The AWA case highlights the fact that the current system is not satisfactory in this area.

The content of both chapters draw heavily on the O'Malley Panel Report in 2000 and they are designed to enable auditors not only to deter fraud and illegal activity but also to act as a detector of fraud and illegal activity.

## **Chapter 7 ANALYSIS OF THE DATA AND KEY FINDINGS**

In this Chapter the results of the AWA audit negligence case are analysed. This analysis results in five key recommendations that are designed to assist auditors in detecting fraudulent or illegal activity. In particular, these recommendations will concentrate on the need for the audit profession to develop a more comprehensive forensic auditing approach. This will include the need for the development of an Audit Fraud Detection Model (AFDM) and the placing of recommendations within a conceptual framework.

This section presents, within a conceptual framework, a study of an improved method of the audit detection of fraudulent or illegal activity behaviour. It is based on the literature review of the theory of the audit expectation gap and includes very recent literature, such as the O'Malley Panel Report in 2000 and the findings from the research into the AWA case. It highlights the need for the auditor to take a far more significant role in detecting and deterring fraud and illegal activity.

This framework involves the integration of the ideas for improving the audit fraud detection outcome and consequently for reducing the audit expectation gap. The basic presumption of this study is that the financial investing community,<sup>1</sup> as a result of Enron/Worldcom et al. will no longer continue to allow auditors to adopt a position of only minimal responsibility for detecting fraud or illegal activity.

On 9 July 2002, the US President George W. Bush criticised auditors' failure to detect illegal activity in the recent US corporate collapses at Enron/Worldcom and called for a '...new era of integrity in corporate America' (Wolk 2002, p.1). As a result, he ordered the creation of a special Corporate Fraud Task Force. The massive accounting scandal at WorldCom Inc., which is the biggest bankruptcy-court filing in U.S. history, rocked financial markets around the world and drew the ire of federal investigators, regulators

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<sup>1</sup> The financial investing community is defined as all the stakeholders involved in the financial area excluding the auditors.

‘...and President Bush, who called the alleged USD 3.8 billion fraud ‘outrageous’ (Sandberg et al. 2002, p.1). The actions of the US President make it clear, that, as a result of Enron/Worldcom, auditors should treat any information that has an impact on financial statements, with a renewed professional scepticism as ‘The entities with the most sophisticated frauds often were concerned about concealing them from the auditors...’ (O’Malley Panel 2000, p.85), and also that the auditing profession now has to accept a greater responsibility for fraud or illegal activity detection.

## **7.1 Conceptual Framework Discussion**

An AFDM within the context of a conceptual framework, should lead to forensic additions to the current audit program. It includes a change to a more sceptical attitude and relationship with the audit client and should result in improved audit detection. Once established, the AFDM could be used to study corporate collapses in which audit failure has been a feature. It would be possible to compare these cases to see whether they exhibit different audit behaviour patterns to those cases where auditors have successfully detected fraud or illegal activity. This study focuses on the auditing profession in Australia, the explanations of auditing behaviour in general, and particularly, the profession’s behaviour in relation to the discovery of fraud or illegal activity.

The audit expectation gap theory was defined by Sexton as ‘...the gap between the public’s expectation of auditor performance and the public’s perception of the auditor’s actual performance’ (Sexton 2001, p.59).

The auditing profession have consistently denied any major responsibility for detecting fraud or illegal activity. This is confirmed by the auditing standards, which have not required an auditor to detect any fraud, or illegal activity that, in a well-planned audit would not be evident. Sikka noted that whilst current auditing standards require management to be responsible for the detection of fraud and error, the financial and the



general community ‘...expect auditors to detect and report material fraud and irregularities’ (Sikka 1992, p.1).

The financial investing community believes that an auditor must accept a greater responsibility for fraud or illegal activity detection. Bartholomeusz noted that the auditing profession is now facing significant difficulties, and that ‘...the controversy in the United States over Arthur Andersen's role in the Enron scandal should lead to radical changes in the nature and structure of global accounting firms’ (Bartholomeusz 2002, p.1).

A major reason for the financial investing community believing that an auditor should accept a greater responsibility for fraud or illegal activity detection is that the auditor is in the unique position to legally examine all company accounting records and to question management about any financial activities in which the company is involved.

Except for statutory authorities such as Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC), other members of the financial investing community do not have the same legal right to examine the financial records in the same detail and they consequently must rely on the findings of the auditors’ examination.

It is reasonable to accept the financial investing community’s argument that since auditors are in the best position to examine and follow-up danger signs, they should, therefore, adopt a far more sceptical attitude to discover evidence of irregular or unusual financial transactions.

The reluctance of auditors to be held responsible for fraud or illegal activity detection, is an expression of the audit profession’s adapted culture. It has arisen, primarily for the purpose of reducing audit legal and personal liability. This contrasts with the attitude of

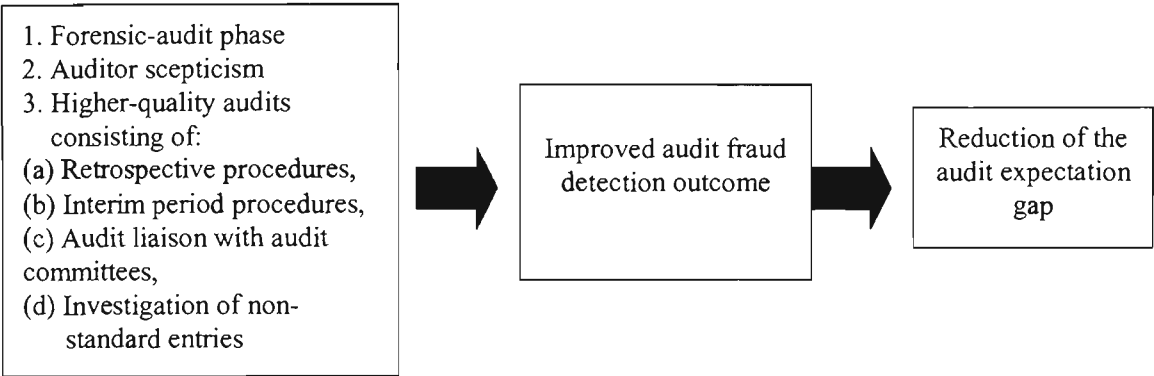
the financial investing community who believe that the auditor must take greater responsibility for detecting and deterring fraud or illegal activity.

This framework, sets the context for this study of the relationship between an improved audit fraud detection outcome and the audit expectation gap. The audit expectation gap is a product of the perceptions of both auditing and financial investing communities. The conceptual framework explains the linkages between an improved audit fraud detection outcome and a reduction in the audit expectation gap. It emphasises the similarities and differences between the audit profession's and the financial investing community's endeavour to create a distinct auditing fraud or illegal activity detection culture.

This leads to the development of the premise that the audit does not place as much importance on the detection of fraud or illegal activity as does the financial investing community who regards the detection of fraud or illegal activity as an essential feature of the audit.

Figure 7.2 Conceptual Framework

*The relationship between the improved audit fraud detection outcome and the audit expectation gap*



### **7.3 Development of the Audit Fraud Detection Model**

As discussed above, the integration of the theoretical audit expectation gap approach, combined with the recent literature on the need for auditors to improve their audit fraud detection outcome, provides the theoretical framework for a development of this model entitled the Audit Fraud Detection Model (AFDM).

In the AWA case, it was evident that DHS failed to investigate for any evidence of fraudulent activity and even when they were presented with clear examples of 'red flags' they still failed to pursue them. The AFDM explains the relationship between an improved audit fraud detection outcome and, in particular a reduction in the audit expectation gap. The former is viewed as emanating from an increased audit focus on fraud or illegal activity and is drawn from three recommendations of the 2000 O'Malley Panel<sup>2</sup>. They are introduction of a forensic audit phase in all audits, the adoption of audit scepticism during this forensic phase, and the need for higher quality audits.

A clear example of a lack of any forensic testing in the AWA audit was the BNZ loans. On 3 March 1987, DHS found a BNZ loan for USD 4.697 million (AUD \$7 million) which, did not appear in AWA's records. The audit was told that they had been closed prior to 31 December 1986 but in fact they were still current. It would have been a simple process for DHS to check with BNZ independently as to whether it had been repaid prior to the end of the year.

O'Malley indicated that this new forensic-type phase should become an integral part of the audit. And that '...a forensic-type phase seeks to convey an attitudinal shift in the auditor's degree of skepticism' (O'Malley Panel 2000, p.88). The O'Malley Panel recommended that this phase should be incorporated into all audits. It would require the performance of substantive tests directed at the possibility of fraud and should include tests to detect an override of internal control by management.

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<sup>2</sup> Approximately 250 O'Malley Panel recommendations.

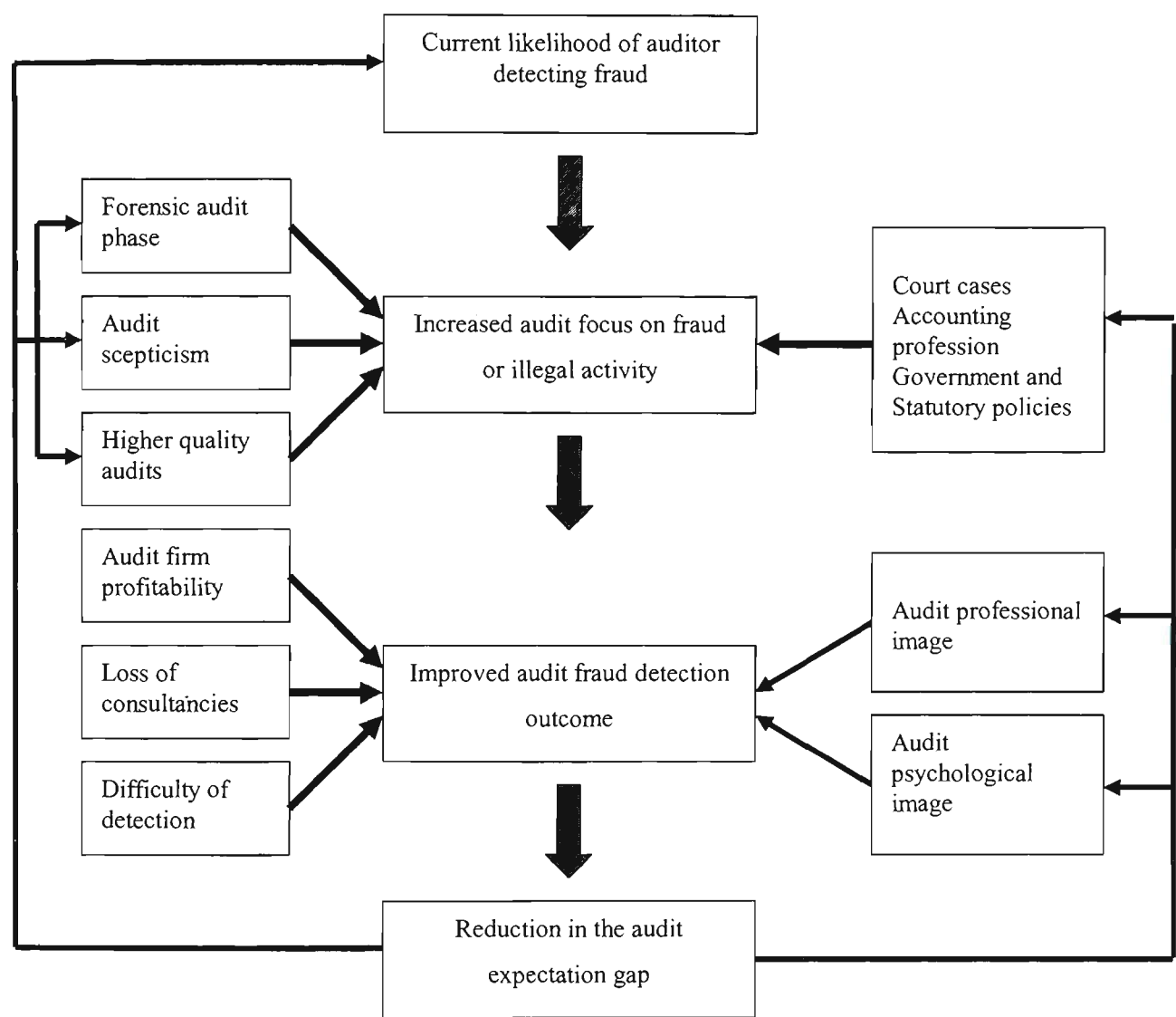
DHS exhibited no professional audit scepticism in the AWA audit. Although on several occasions they discovered evidence of unusual loans in both audits they ignored them. Contrast this with Alagna the AWA accountant. He was told of unusual loans and within 2 days had discovered two unrecorded Westpac loans totalling over \$16 million. The O'Malley Panel noted that professional scepticism should be more than just words in the auditing standards '...it should be a way of life for auditors' (O'Malley Panel 2000, p.82). They added that the objective in an audit had to include the detection of any material financial statement fraud if it was present. The O'Malley Panel believed if that was her/his goal, that should drive both auditing standards and the way they are applied. The O'Malley Panel found that, by meeting that objective, the audit would serve to deter fraud as well as detect it.

AWA did no retrospective auditing tests. If they had it would have revealed that the green book had not been maintained since 30 June 1986 and that between 30 June and 18 August no records of any kind were maintained. DHS also failed to conduct interim period tests on a \$6.2 million loss at 30 June 1986 that by August 1986 had turned into a \$9 million profit. DHS should have investigated this \$15.2 million turnaround in less than two months. Daniels had no proper liaison with the board of directors (AWA did not have an audit committee) and on two occasions when he was requested to attend board meetings he informed the board incorrectly that the AWA foreign exchange operation was functioning effectively.

There was a clear need for DHS to have conducted a high quality audit especially when they discovered a lack of internal controls in foreign exchange, always a high risk area.

There was no testing of non-standard entries. DHS became aware of Korval using historic rate rollovers and the audit should have known that this is a means by which losses on transactions could be concealed. Lonergan found that the lack of a comprehensive program of extended substantive testing was a fundamental reason why the accounts at 30 June 1986 were materially misstated.

Figure 7.4 Audit Fraud Detection Model



In relation to higher quality audits, the O'Malley Panel identified four key factors that would need to be included in all audits in order to improve the quality of audits in relation to the detection and deterrence of fraud or illegal activity. The four factors are:

- (1) retrospective audit procedures. 'This retrospective look at and testing of accounts that previously had been audited is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud,...' (O'Malley Panel 2000, p.91);
- (2) interim period tests. This factor was triggered by '...the observations in the 1999 COSO Report [Committee of Sponsoring Organisations of the Treadway Commission] Report that many frauds are initiated in interim periods' (O'Malley Panel 2000, p.92);
- (3) increased liaison with audit committees. '...audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks' (O'Malley Panel 2000, p.94); and
- (4) tests of non-standard entries. 'These entries can provide an avenue for management to override controls that could lead to fraudulent financial reporting' (O'Malley Panel 2000, p.97).

Referring to audit detection generally, the Canadian Institute of Chartered Accountants' (CICA) 1988 Macdonald Commission noted that one of the derived motives of an audit should be to draw attention to the way in which the possibility of fraud should affect the planning and performance of the audit. Following McDonald therefore, it could be expected that an improved audit detection of fraud or illegal activity awareness would have a greater impact on an auditor's behaviour. This may provide a focus for the conceptual dimension of audit fraud detection motives in the context of the prevailing audit patterns.

## **7.5 Identification of Variables and their Relationships**

It is proposed that a failure to adapt auditing to the need to detect fraudulent or illegal activity is partly an element of overall societal constraints and partly an attempt to preserve the current identity and meaning of auditing as perceived by the auditing profession.

One of the societal constraints is the financially competitive nature of auditing. In relation to the identity of current audits, the provision of consultancies other than the audit is clearly linked to the maintenance of the audit firms present profitability levels. As an example, in the case of Enron (Cheffers 2002 pt.2, p.5) Andersen received USD 25 million yearly in audit fees but it was also providing consultancies to Enron of USD 27 million annually.

This leads both to a questioning of the financial viability of the audit profession, as it currently exists, and also to the belief that the proposed changes would have a significant impact on the financial viability of audit firms. Governmental suggestions to restrict or ban non-audit services by audit firms could result in the loss of profitable consultancies. This would seriously diminish the audit firms' profitability, whilst, at the same time, the addition of a forensic audit phase would increase the cost involved in undertaking individual audits. The question of who would pay the extra cost involved in the audit, (governments, audit client or audit firm) has not yet been clarified.

The legal implications of an auditor pursuing too vigorously audit scepticism and therefore incorrectly assuming the dishonesty of management is another constraint. Auditors do not have the training or experience of police or lawyers and could easily make mistakes. The O'Malley Panel noted that studies of auditors indicated a lack of confidence in them detecting fraud or illegal activity. 'They also expressed doubt about their ability to detect fraud, especially fraud involving collusive activities or falsified documentation' (O'Malley Panel 2000, p.85).



Therefore, auditors would need significant forensic audit training. They would have to be educated in the legal processes to follow in detailing and reporting alleged dishonesty of management. Currently, auditors are reluctant to report allegations of dishonesty because of the potential legal and personal implications if they incorrectly allege an honest manager to be dishonest.

The difficult role the auditor undertakes in detecting fraud or illegal activity can be seen when we compare auditors with police and lawyers. Police and lawyers are normally aware of information of potential illegal activity prior to beginning their investigation, defence or prosecution. However, the auditor is normally unaware of any illegal activity prior to beginning most audits and therefore has the difficult role of actually identifying if illegal activity has occurred.

A further constraint is to be found in the image auditors and the general public have of the accounting profession. Andersen had a policy of 'exceptional client service' and attracted high quality graduates to a profession in which consultation and problem solving for clients were emphasised. The task of recruiting high quality employees to auditing is a combination of both attractive conditions and the image that potential employees have of the profession.

Young graduates attracted to the positive image of solving audit client problems may not be as attracted to the negative image of professional scepticism where they would be expected to presume the possibility of dishonesty at various levels of management. This includes the likelihood that management might be involved in '...collusion, override of internal control and falsification of documents' (O'Malley Panel 2000, pp.88-89). In the future this could result in even greater difficulty in attracting high quality employees to the auditing profession.

Yet another societal constraint is to be found in the psychological pressure on auditors to perform two very conflicting tasks. An auditor will initially be expected to adopt a

sceptical approach to the audit during the forensic audit phase. In the vast majority of audits there is no fraud or illegal activity present. The auditor will then be expected to continue the audit and provide client service to the same management. This dual responsibility of an adversarial, customer service oriented approach may confuse auditors. Other professions, such as the police, adopt an adversarial approach only, whilst the legal profession split the client service or solicitor's role from the adversarial or barrister's role.

The final psychological pressure comes from the competing audit tasks. These are the certification of financial accounts and the simultaneous detection of fraud or illegal activity. Auditors, like other people, find it difficult to concentrate on two reasonably difficult and different tasks at the same time. One task tends to take precedence. As certification is a requirement of all audits, and fraud or illegal activity occurs only in a few audits, auditors tend to focus on certification and consign fraud or illegal activity detection to a lesser role. As a result, instances of auditors ignoring or overlooking evidence of fraud or illegal activity is commonplace in any study of audit negligence cases such as in the AWA case.

This constraint gives rise to the assertion that auditors are currently employed and trained to provide financial attestation and client service. Significant behavioural change will be needed if auditors are to effectively undertake a forensic audit phase in all audits.

## **7.6 Distinguishing Features of Current and Proposed Audit Fraud Detection Improvements**

As in all professions, audit relevance involves the retention, the modification or the rejection of certain attitudes, values and behaviours from the existing auditing process, and, at the same time, the adoption of some new values and behaviours to meet the continuing need to remain relevant as a profession. In this research improved audit fraud or illegal activity detection is identified as an additional value that the audit profession should adopt.

Opposition to an increased audit focus on fraud or illegal activity might be anticipated. Residual influences are evident in many aspects of auditing behaviour, and include audit testing procedures, audit firm practice and audit statutory regulations. The auditing profession, in particular, is expected to contest the notion, inherent in an increased audit fraud focus, that audit firms should provide either no, or limited, non-audit services because of the impact on their profitability.

Potential changes include adding audit forensic tests to the current audit program, increasing the independence of the auditor from the client and changing government and professional regulations that require auditors to accept greater responsibility for fraud or illegal activity detection.

These changes cannot be viewed as equal in terms of importance or significance. They cannot, in other words, be understood independently of their cultural context, or of their meaning for the auditing profession and the financial investing community. The attachment of the financial investing communities to their world of meanings and values attributes a significance to the various aspects of the auditing process which is different from that of the auditing profession. This is particularly noticeable in relation to fraud or illegal activity detection.

The implementation of improved audit fraud detection is therefore not a consequence of a static, fixed audit process. It is one, which must be undertaken within a dynamic, constantly evolving audit world. It is a product of the interaction between what has been learnt from the past such as lessons from previous audit. The implementation of improved audit fraud detection is therefore not a consequence of a static, fixed audit process. It is one which must be undertaken within a dynamic, constantly evolving audit world. It is a product of the interaction between what has been learnt from the past such as lessons from previous audit failures, Court decisions in audit negligence cases such as AWA, recommendations from regulatory authorities and the current views of audit stakeholders.

If the audit world is to retain its relevance as a profession, it needs to be constantly evolving to meet all these requirements. In this context, improved audit fraud detection is one of the current issues, which the financial investing community clearly see as requiring reform. The auditing profession must provide the product that the stakeholders require. The failure of the auditing profession to adapt to this requirement could lead to other professionals like lawyers and forensic investigators filling this fraud detection gap. This would lead to a subsequent reduction in the relevance and status of the auditing profession.

The audit expectation gap theory has contributed to this examination of the current audit process, for it looks at the way in which the auditing profession in evolving inevitably has discarded or modified some of their previous processes and continued to adopt some new aspects to the audit package in order to retain the relevance of the profession. This would create an evolving audit identity that determines the auditing profession's position within the financial investing community and its retention as a valued profession.

The AFDM model encompasses the following parameters:

- the preservation of auditing as a valued profession;
- fraud or illegal activity detection as an essential aspect of the audit process;
- the role of government and regulators in increasing the audit focus on fraud or illegal activity;
- a revised audit program including a forensic audit phase, auditor scepticism and higher quality audits as identified in the O'Malley Panel; and
- the need to develop audit scepticism, forensic audit training and the employment of auditors with a propensity for undertaking forensic or investigative auditing procedures.

Audit behavioural components are treated as independent variables, whereas the major dependent variable is the audit expectation gap. Improving the likelihood of the auditor detecting fraud or illegal activity is regarded as the push factor in the model. Appropriate

analytical methods would be applied to test the relationship between variables as further research studies are undertaken.

Causality between components in the model is indicated by arrows, which show the direction of postulated influence. The model also addresses behavioural variables that will in turn have an impact on auditor values. The solid lines together with the arrows, show hierarchically, how determinants cause or influence other determinants. The model shows that the relationship between the current likelihood of the auditor detecting fraud and an increased audit focus on fraud or illegal activity would result in an improved audit fraud detection outcome. This in turn would reduce the audit expectation gap. There is a feedback flow in the model reflecting a number of potential relationships. This is supported by the literature and the findings of this research into the audit cases.

The role of the audit firm is highlighted because it constitutes a central concept in the traditional auditing structure, where the importance and influence of the Big Four<sup>3</sup> is viewed as particularly important. This is because in practice, the Big Four are responsible for auditing most major Australian and international companies.

## 7.7 Conceptual Framework Themes

Four main themes are developed from this model. They are:

- the relationship between the desire of audit firms to maintain profitability and independence, contrasting with the financial investing community's perception of the audit resulting in a desire to constrain audit from non-audit and other profitable services;

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<sup>3</sup> The Big Four audit firms are Deloitte Touche Tohmatsu (formerly DHS), Ernst & Young, KPMG and PricewaterhouseCoopers. They are responsible for auditing many of the major national and international companies.

- the comparison of the behavioural characteristics of the current moderate audit focus on fraud detection with the behavioural characteristics required for an improved audit fraud detection outcome;
- the audit expectation gap and a comparison between its importance to the audit profession and the financial investing community; and
- the relationship between the highly complex role actually facing auditors in first identifying and then detecting fraud and illegal activity, and the financial investing community's perception of audit fraud detection as a relatively uncomplicated task.

## **7.8 Conceptual Framework: Conclusion**

This segment contains an examination of the links between an increase in the audit focus on fraud or illegal activity, a reduction in the audit expectation gap and the ongoing interaction between the two. The theoretical foundation for the study is based on the integration of the audit expectation gap theory with the current literature and reports which identify a need for the auditor to take a greater responsibility in detecting fraud or illegal activity.

The study of audit fraud detection in Australia has three parts. They are:

- an investigation into changes that the audit profession is going through in order to adapt to the current needs of stakeholders;
- the way in which this affects their behaviour in general; and
- their fraud detection behaviour in particular.

An attempt has been made to identify both behavioural and adapted audit fraud detection practice. It is expected that the proposed audit fraud detection practice outcome is a consequence of behavioural patterns emphasising both the commonalities within, and the differences between, the current and the improved audit focus on fraud or illegal activity.

The development of the theoretical framework has been based on an understanding of how audit fraud detection determinants are derived and how they influence behavioural dispositions in general. Accordingly, the AFDM incorporates variables that were identified and formulated following a close examination of the literature and the AWA case.

It is proposed that, in the future, an empirical study be undertaken to verify the corresponding patterns of fraud detection behaviour in an auditing context. The multiple techniques of data analyses could be used to test the themes outlined in part 7.6 Conceptual Framework Themes.

The conceptual framework complies with the main objective of this research. This was to consider the standard of care, and the responsibility required of auditors as exemplified by the AWA case in detecting fraudulent or illegal activity. The O'Malley Panel considered that the objectives in an audit should include '...detecting material financial statement fraud-that goal should drive both auditing standards and the way they are applied' (O'Malley Panel 2000, p.82).

One of the important motives for this research was that there had been little previous case study research on audit negligence cases in Australia. The result of this research, highlights the fact that the auditor's role '...has not kept pace with a rapidly changing environment' (O'Malley Panel 2000, p.82).

The final result of the research into AWA audit negligence is a series of recommendations designed to assist auditors in not only deterring, but also detecting, fraud or illegal activity.

## **7.9 Key Findings**

### **7.9.1 The Audit Failure of DHS in the AWA case**

The purpose of this research was to examine the standard of care and responsibility required of auditors in the detection of fraudulent or illegal activity in the AWA case. DHS clearly failed in their audit procedures in the AWA case and consequently were not then in a position to identify potential fraud or illegal activity. DHS quickly recognised that the internal control system was deficient, but they still failed to undertake more substantive auditing procedures. A good example of this lack of attention to a reasonable standard of care and responsibility was the unrealistic and unalterable deadline set for the six months audit ending 31 December 1986.

Daniels only had the weekend to complete his examination of the audit working papers. He should have given himself a reasonable amount of time (at least 10 working days) to thoroughly read the final audit working papers. Audit budgets and timelines should be only a guide and not more important than the completion of a full and comprehensive audit program. This research argues however that, whilst the auditors were negligent in AWA, their actions must be analysed within the context of the overall environment in which they operated. Whilst specific aspects of the foreign exchange weaknesses can be attributed to the failure of DHS, AWA developed and encouraged a culture of excessive risk-taking by directly linking the foreign exchange manager's remuneration and huge bonus to increased profits.

### **7.9.2. Significance of the Audit Expectation Gap**

There is a gap of large proportions between the role that auditors actually undertake and the perception that the financial community understand to be their role. There was overwhelming evidence throughout the AWA case to show that significant red flags were evident to the auditors. The list included the lack of even basic internal controls, the use of 'wrong-way around' foreign exchange transactions, the failure of Korval to maintain



the green book, and finally, the evidence that Korval was speculating in large amounts, (Tomasic *et al.* 2002a, p.156) at one stage over \$850 million.

A reasonable auditor should have recognised at least some of these red flag examples and realised that something was seriously wrong. This in turn, should have led to a much more comprehensive analysis of the foreign exchange operation than had been undertaken. Such an analysis should have then discovered evidence of illegal transactions. The failure of the AWA auditors in relation to these red flags can only add pressure to the audit expectation gap debate.

However, AWA was also significantly to blame. There was an unrealistic expectation, by AWA management, of the responsibility of the auditors. AWA followed a high-risk foreign exchange strategy focused on profit-making, using inexperienced staff, and then relying totally on the auditors to detect and report any weaknesses. There was clearly evidence in AWA, that company management blamed the auditors for all the corporate failings of AWA. The auditors had informed senior management, including the CEO and executive director Hooke, of some internal control weaknesses, but AWA failed to follow up on this information.

It is important also that AWA had been advised of significant problems in their foreign exchange operations by banking consultant Binstead who had stated 'Its just too large an amount to have [been] made from hedging...' (Court statement Hooke undated, p 52) but AWA again failed to follow up on these revelations. Instead they placed too much reliance on the auditors. Hookes reply to Binstead was 'The accounts are being audited. The auditors are happy with the position' (Court statement Hooke undated, p.52). Prudent management should have discovered that Korval was speculating in large amounts of up to \$850 million. This was far above his authorised limit of \$300 million.

Management should have adopted sound administrative procedures and made sure that Korval did not exceed his limit. In summary, whilst the auditors were negligent, the

AWA management, and particularly the CEO Hooke, also showed an alarming lack of care and responsibility.

In the final analysis however, the judges ruled that the auditors were to be left to carry 80% of the negligence claim. Therefore, the results of the AWA case indicate that a significant audit expectation gap still existed between the actual role and responsibility of the auditor and the auditor's role as perceived by the financial community and especially by the Courts in relation to the detection of fraud or illegal activity.

### **7.9.3 Development of Recommendations within a Conceptual Framework**

This research has argued that the role of the auditor is a complex task that must be examined in terms of the environment in which it operates. There was also evidence of audit environmental factors being important in the AWA case. The theoretical and conceptual framework in which the AFDM was developed offers some new perspectives on the complex role auditors currently face in detecting fraud or illegal activity.

This model identifies the issues surrounding the detection of fraud or illegal activity by auditors. It postulates that the failure of auditors to detect fraud or illegal activity is a consequence of the current lack of focus on fraud or illegal activity. This in turn reflects the consequences of the auditor's current primary emphasis on the certification of the financial statements. It theorises that an increased audit focus on fraud or illegal activity can be undertaken by concentrating on three recommendations of the O'Malley Panel.

They are;

- a forensic audit phase in all audits;
- an increased audit scepticism in undertaking an audit; and
- the provision of higher quality audits.

It suggests that higher quality audits could be achieved by retrospective audit procedures, concentration on non-standard entries, interim period reports and closer links with audit committees.

Further, it postulates that an improved audit fraud detection outcome can be achieved, but only if the constraints on it are effectively negated. These constraints include the impact on audit firm profitability of the loss of non-audit services, loss of consultancies and the actual difficulty of detecting fraud or illegal activity.

In 2000, the major accounting firms strongly resisted the O'Malley Panel's recommendations partly because of the extra costs involved, but principally because the O'Malley Panel report signalled a threat to their very profitable non-audit consultancies. Jim Turley, Deputy Chairman of E & Y, defended non-audit consultancies and argued that audit firms had been able to perform non-audit services '...whilst maintaining their independence, objectivity and integrity' (O'Malley Panel 2000, p.164).

The resistance of the audit firms is hardly surprising because the non-audit consultancies have grown to the point where they now represent about half of the Big Four's total income. George noted that, in 1993, 31% of industry fees came from consulting, but, by 1999, it had grown to 51%. He questioned the provision of both non-audit, and auditing services to the same client with the observation that '...it seems unlikely that the same enterprise can both advise a corporation and then audit the implementation of that advice in an independent way' (George 2002a, p.54).

A further constraint is imposed by the actual difficulty of detection. Auditors are first trained to certify financial statements. The detection of fraud or illegal activity is currently only the second concern. In the AWA case, the auditors were focused on certification of the financial statements and overlooked significant danger signals. In relation to this last point, the auditors' professional and psychological mindset would have to be understood and taken into account if a serious attempt was to be made to

improve audit fraud detection. Auditors would need to be trained in the techniques of audit fraud or illegal activity detection and people with the correct professional and psychological mindset should be encouraged to join the audit forensic teams.

#### **7.9.4 Issues that the Accounting Profession should Investigate**

This research has argued that the role of the auditor is not only complex, but that the environment in which the audit is conducted can also seriously constrain an auditor successfully detecting fraud or illegal activity. Whilst there was certainly evidence of auditor negligence in the AWA case, the problem of the non-detection of illegal activity was also a result of serious limitations in environmental factors.

The lack of clarity in accounting standards was one of the main environmental factors. Indeed, the O'Malley Panel which saw this as the starting point stated that '...definitive auditing standards form the starting point for promoting quality audits' (O'Malley Panel 2000, p.5). There was a difference of interpretation of AAS 20 between Daniels and the rest of the audit team. Daniels decided to treat the hedge contracts as specific and allowed Korval to treat foreign exchange losses as deferrals. The rest of the audit team interpreted the contracts as general contracts in accordance with AAS 20 and required the losses to be brought to account.

The DHS lawyers also argued unsuccessfully that DHS had complied with the minimum requirements of the accounting standards but Rogers J, found that even though DHS might have met the minimum requirements, they were, in fact, required to meet a much higher standard than minimum compliance with the requirements of the accounting standards. Rogers J stated 'There is no reason to think one-way or the other that is the prevailing standard. All one knows that is the minimum standard' (Court proceedings Rogers. J 16-9-91, p.57). A difficult situation is created for an auditor when compliance with the accounting standards is not acceptable. The prime difficulty for the auditor is then to ascertain what the prevailing standard is.

In the recent HIH Royal Commission, lawyers for Andersen argued that the wording in AASB 1023 'Financial Reporting of General Insurance Activities' and AASB 1002 'Events Occurring After Reporting Date' were ambiguous enough to justify a variety of interpretations. It was suggested that the interpretations included an insurance company taking a different approach to account for transactions that had occurred subsequent to balance date. George (2002b, p.3) notes that both Enron and HIH accounts were prepared in accordance with accepted accounting principles and practices. Dean and others note that WorldCom's capitalised expenses '...could be defended under conventional accounting rules' and that Waste Management's alleged manipulation of its depreciation charges was defensible because of the profession's declaration that depreciation is the '...allocation of cost' (Dean et al. 2003 p.7). Clearly, the accounting standards should be reviewed with the aim of developing a more precise interpretation that removes confusion.

There were other ambiguities in relation to the statutory requirements. Who does the auditor have to report evidence of internal control weaknesses to, and who is ultimately responsible for detecting fraud or illegal activity? These matters should be clarified by the statutory authorities, so that auditors have more certainty as to their responsibilities under the relevant statutory regulations.

Finally, the accounting profession operates in an environment where the auditor is responsible for ensuring a high standard of care and for the detection of fraud or illegal activity. However, the auditor also has unreasonable constraints placed on that role. Auditors are forced to operate in an environment where audits are let out to tender, and where it is often the lowest tender that has been awarded the audit contract. They are thus expected to audit a company which has the power to hire or fire the auditor. They have to work in a culture where companies are driven by the need to take greater risks to achieve higher returns to satisfy their investors and where management is under increasing pressure from the share market to 'make the numbers' or face significant loss of share price.

This complex auditing environment was clearly evident in the AWA case. There was substantial evidence that the auditors were far too compliant in their dealings with the client in relation to the certification of the financial statements. However, there was also evidence that AWA management put pressure on the auditors to allow Korval to use extreme interpretations of AAS 20 in order to hide losses and to inflate profit results. In the AWA case it was revealed that senior AWA management were under considerable pressure to come up with profits to fight off an anticipated take-over bid from Christopher Skase.

It is not surprising, in that environment, that AWA was only too pleased to accept the large profits being reported by Korval and that some senior management were not very concerned about questioning the accuracy of those results. It was also mentioned in the court case that Korval's manager was under the impression that Korval had to be treated with kid gloves because he was delivering large profits and AWA were worried about losing him to a rival company.

It is the accounting profession's responsibility to investigate these environmental issues, to suggest changes to legislation that would increase the authority of the auditor and to assist auditors to more capably operate within their environment. The accounting profession could also investigate the recommendation of legislation to outlaw audit tendering that is based purely on price alone. It should push for legislation that would give more certainty to an auditor's authority, particularly in relation to the current right of a firm to dismiss its auditor, and that would, in general, create an environment in which auditors would be more certain of their independence and would be in a far better position to resist the pressures from companies, to agree to artificial financial manipulation.

A key aspect, that the accounting profession need to review, is the peer review process. The O'Malley Panel saw this as a critical aspect in 'closing the loop' to '...provide assurance to the public that audit performance measures up to high standards and continues to improve' (O'Malley Panel 2000, p.5).

### 7.9.5 Issues that the Accounting Firms Should Investigate

Whilst it is here argued that the role of the auditor is a complex task that must be examined in terms of the environment in which the audit is undertaken, there are many practical issues, which the accounting firms can investigate and which would result in improvements to the auditing function.

Firstly, there is an inherent conflict in the independence of a firm providing extensive financial consulting services to a company to which it is also the auditor. This conflict of independence has been highlighted recently in Enron and HIH. The financial community is now clearly signalling a need for auditing to be the major function of the 'Big Four' and that non-audit services should be transferred to separate independent companies.

One of the important underlying consequences of a loss of non-audit services would be its impact on accounting firm profitability. The major accounting firms who expressed resistance to the O'Malley Panel recommendations based that resistance partly on the impact these restrictions would have on their profitable non-audit services. A key focus of the accounting firms must therefore be to make the auditing function profitable.

The 'Big Four' accounting firms audit the majority of the large international companies. This results in a potentially profitable and continuous financial advantage that the 'Big Four' might use to ensure that they are fairly compensated for the true cost of the audit. In the past, there had been a tendency for accounting firms to see the audit as a loss leader in order to gain lucrative non-audit services. The accounting firms should re-cost their audits to ensure a reasonable return which is based purely on the auditing role. If this were done it would allow the accounting firms to concentrate on their core business of auditing.

The O'Malley Panel argued that accounting firms need comprehensive and vigorous audit methodologies based on the accounting standards that '...drive the behaviour of their

auditors to a higher plane' (O'Malley Panel 2000, p.5). The auditing function should be the most important function that they undertake. A renewed focus on auditing would be reflected in an increased emphasis on higher quality auditing as was recommended by the O'Malley Panel.

Accounting firms also need to concentrate on a more flexible approach and to place less emphasis on strict budget timelines that will allow the auditor adequate time to follow up on unusual activities. In the AWA case, there was evidence that the auditors were under extreme time-pressure and that this was a factor in the auditors' failure to follow-up on the evidence of unusual transactions.

The long history of auditors' failure to detect fraud or illegal activity suggests that a substantial proportion of fraud or illegal activity is reasonably difficult to detect. The recent corporate collapses, such as Enron and HIH where large fraudulent and illegal activity was not detected, highlight the need for further training by accounting firms in fraud auditing and ethical behaviour. Auditors are reasonably well trained in certifying financial statements but have far less training and experience in forensic auditing. It is argued here that part of the solution to the on-going problem of an audit expectation gap requires a renewed emphasis on the auditor's training and responsibilities in fraud and illegal activity detection. This is clearly a role that the major accounting firms can and should undertake.



## **Chapter 8 Research Recommendations**

### **8.1 Introduction**

In this Chapter the results of the AWA audit negligence case are analysed. This analysis results in recommendations that are designed to assist auditors in detecting fraudulent or illegal activity. In particular, these recommendations will concentrate on the need for the audit profession to develop a more comprehensive forensic auditing approach. This will include the need for the development of an Audit Fraud Detection Model.

### **8.2 Background to the Recommendations**

The AWA case (1995 AWA Appeal judgment, p.619) concerned major audit negligence. It resulted in a Big Four audit firm Deloitte Haskins & Sells (DHS) being found negligent on three key issues. They were:

- (a) DHS's failure to advise the AWA directors at the 22-9-1986 Board meeting of the absence of proper internal controls within AWA's foreign exchange operations;
- (b) the signing by DHS on 9-3-1987 of a grossly erroneous profit confirmation letter for the six months ended 31-12-1986 and;
- (c) the failure on 30-3-1987 to reveal to the Board the appalling state of AWA's internal controls and records when DHS had already known about it.

### **8.3 Plan of the Research Recommendations**

The research of the AWA case results in the following in recommendations which have emanated from the findings of the AWA case and the earlier literature which focused on the need for auditors to take a greater responsibility in detecting fraud or illegal activity.

## 8.4 Recommendations

The research recommendations are divided into five key areas, which were all found to be deficient in the AWA case. In analysing the AWA case it was evident that

- audit planning was lacking (**audit planning**);
- audit procedures were poor or non-existent (**audit procedures**);
- there was a very real need for a high quality audit and the court found the DHS audit was very low quality (**high-quality audits**);
- there was a need for a more sceptical approach by the auditors leading to a forensic phase (**forensic**) and;
- clearly there was little evidence of any audit independence from the client in the DHS audit of the AWA organisation (audit independence).

## 8.5 Recommendations Designed to Increase the Audit Focus on Fraud or Illegal Activity from the AWA case

### 8.5.1 Recommendations Derived from the AWA case

#### Recommendations Relating to Audit Planning

##### AUDIT RISKS (**Audit Planning**)

- (a) In the AWA case a comprehensive up-date of the audit appointment letter in the AWA case would have resulted in an increased audit awareness of the potential for loss and or illegal activity in the foreign exchange operation. In AWA, the judges pointed out the need for the auditors to regularly view the appointment letter to see whether it had been updated. In AWA, the audit appointment letter had not been

updated for well over twenty years.<sup>4</sup> During this period, major changes in the foreign exchange operation had occurred<sup>5</sup>.

*Background to Recommendation 1.*

Because audit firms must take into consideration their clients' expectations, these should be spelt out in the engagement letter. They might include the expectation that the auditor would inform the Board of matters that might benefit business. The engagement letter should spell out whether management expects information or services beyond the financial statement audit, and whether they should be given separately or as an integral part of the audit processes and methodologies. The audit engagement letter should particularly identify any new or continuing audit risks and the measures that the audit would undertake to test these risks. Sufficient remuneration should be added to the audit fee for any new or significantly upgraded risk factors.

**Recommendation 1. That the appointment letter identify the major matters subject to audit and include any new or significantly changed risks. It should be updated annually and signed by both the auditor and the audit committee.**

*Background to Recommendation 2.*

The appointment letter should include guidance aimed at the nature of procedures and at reducing the incidence of inadequate sample sizes and variations in similar circumstances.

**APPOINTMENT LETTER (Audit Planning)**

**Recommendation 2. The appointment letter incorporate a suitable method linking substantive tests to risk assessments and include guidance aimed at the nature of**

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<sup>4</sup> Belfanti had not seen an audit engagement letter since he started at AWA in November 1987. Daniels had been involved in the AWA audit since 1950 and did not issue audit engagement letters.

<sup>5</sup> In 1983 the Australian dollar was deregulated, the foreign exchange operation had become a profit centre with a bonus for above normal profits and it was no longer part of the regular AWA accounting system with appropriate controls.

**procedures and at the reduction of the incidence of inadequate sample sizes and variations in similar circumstances.**

- (b) Accounting standard AUS 204 'Terms of Audit Engagements' states that a significant change in the nature or size of the client's business may make a new letter essential. That letter should propose an analysis of the audit program, update of client changes within the previous year and a scrutiny of the program in non-statutory audits.
- (c) Because the letter should identify those potential danger areas, a comprehensive analysis of the appointment letter would improve the audit focus on fraud or illegal activity. The auditor should increase audit testing in those areas. In the AWA case, the appointment letter should have highlighted the significant increase in risk to foreign exchange operations. This should have led to the earlier identification of Korval's illegal activity.

## **Planning**

- (a) The DHS audit team responsible for the AWA foreign exchange audit failed to liaise with the money market audit team. There were unauthorised loans that the foreign exchange auditors incorrectly thought belonged to the money market. There were also weaknesses in the documentation in relation to the change over of audit staff.
- (b) AUS 302 'Planning' and AUS 210 'Irregularities, including Fraud, other Illegal Acts and Errors' stress the need for the audit to ensure that its work is planned in an effective manner so that there is a reasonable expectation of detecting misstatements that have a material impact on the financial report. The Cohen Commission (AICPA 1978, p.145) the Treadway Report (AICPA 1987, pp.50-51), Sexton (2001) and Moffit J in Pacific Acceptance, all stress the importance of

properly planning the audit so that audit procedures result in a reasonable expectation that material fraud or error will be detected. As a result, there must be an orderly flow of information between all members of the audit team.

#### *Background to Recommendation 3*

Because things could go wrong at the individual level, the audit should make inherent risk assessments for significant account balances and classes of transactions. The plan should include discussion by supervisory engagement personnel about the vulnerability of the entity to fraud. It should also include discussion between the audit partner and other engagement team members. Auditors should be cautious however, not to place excessive emphasis on not only management's high-level monitoring activities, but also on high-level monitoring of financial and non-financial data. The monitoring should not be a reason for reducing the extent of planned testing in the forensic-type phase.

### **ANALYTICAL PROCEDURES (Audit Planning)**

**Recommendation 3. At the planning stage, audit firms incorporate analytical procedures or adopt sophisticated, computerised systems for identifying engagement risk. The systems should involve both quantitative and qualitative factors and include a search for potentially unfavourable information about the firm or its management. It should then integrate those findings into the audit.**

#### *Background to Recommendation 4*

The audit plan should provide additional guidance about the factors that affect inherent risk. Guidance should be given about the entity's business processes and risks and the depth of the auditor's understanding of those factors. The plan should require that a partner be actively involved in making inherent risk assessments at both the overall financial statement level and the assertion level for significant account balances and classes of transactions. This planning should encompass what is

expected of team members in dealing with a potential for fraud in the specific areas of the audit assigned to them.

#### **AUDIT LIASON (Audit Planning)**

**Recommendation 4.** At the planning stage, the audit firm should require liason between the partner, the review partner and the audit manager on the importance of establishing realistic time budgets and work loads. The audit firm should also require the review partner to have an increased involvement in the planning stage of the audit.

(c) In the AWA case, an improved audit focus on fraud or illegal activity in the audit planning phase would have resulted in appropriate tests, at an earlier stage, identifying evidence of Korval undertaking unauthorised activities.

#### **1. New or Recently Upgraded Operations**

(a) The AWA foreign exchange management had been significantly changed from a small operation which hedged specific foreign exchange contracts, to a large operation speculating on 2 years foreign exchange requirements. The internal controls may have operated effectively on the small-hedged operation, but were totally inadequate for the large speculative operation.

(b) In an important environmental audit change, such as the introduction of a new foreign exchange operation, AUS 302 'Planning' requires the auditor to extend the planning process to identify potential problems and to revise them during the audit. According to Godsell (1993, p.123) there is a need to comprehensively audit new or recently upgraded operations.

#### *Background to Recommendation 5*

The auditor needs to have an understanding of new or upgraded operations, their inherent risk and an appropriate basis for assessing it below the maximum. If auditors conclude

that the effort required to assess inherent risk below the maximum for an assertion would exceed the potential reduction in audit procedures derived from such an assessment, they should assess inherent risk at the maximum when designing tests.

### **NEW OR CHANGED OPERATIONS (Audit Planning)**

**Recommendation 5. New or recently upgraded operations be identified in the letter of appointment. Additional audit fees to test these operations should be specified and should indicate the increased level of risk the firm would be undertaking.**

- (c) This recommendation should result in a significant improvement in the focus on fraud or illegal activity because there will be a greater likelihood that internal controls and other accounting requirements might be neglected in the early stages of new or upgraded operations. An increased audit focus on fraud or illegal activity in the AWA case would have also highlighted the need for a significant increase in audit fees to compensate for the significantly upgraded audit tests required for auditors to audit the new and highly speculative operations.

## **Recommendations Relating to Audit Procedures**

### **AUDIT TESTS (Audit Procedures)**

- (a) DHS failed to undertake appropriate or adequate audit tests. Lloyd had stated, ‘I would have looked at the green books. I wouldn’t say I conducted an examination of them...[I] flicked through the pages’ (Court proceedings Lloyd 23-3-1992, p.42). In particular, because the records and internal controls were poor, they did not undertake a comprehensive audit test of the accounting system. This should have led to a better audit-testing program which included an undertaking of a 100% circularisation of all Australian financial institutions capable of dealing in large foreign exchange transactions.
- (b) AUS 202 ‘Objective and General Principles Governing an Audit of a Financial Report’ and AUS 402 ‘Risk Assessments and Internal Controls’ require an auditor

to use professional judgment to assess audit risk and to design appropriate audit procedures. O'Malley (2000, p.76) and Sexton (2001, p.59) remind the auditor that she/he has the responsibility of performing audit tests in order to obtain reasonable assurance that the financial statements are free of material misstatement.

#### *Background to Recommendation 6*

The audit should develop more definitive authoritative guidance on linking to risk assessments the nature, the timing and the extent of substantive tests. Guidance should be given about the nature of procedures and the reduction of the incidence, in similar circumstances, of inadequate sample sizes and variations in sample sizes. The audit firm should emphasise to audit personnel the importance of obtaining evidence from third parties whenever possible. Firms of all size should critically examine the standard of their audit work on internal control. In many situations, firms should increase the engagement time allotted to internal control, particularly in the audit-planning phase. Audit firms should also raise the level of involvement by more experienced audit personnel. Additionally, they should provide guidance on how procedures which are employed in interim periods and which address the potential for fraud in financial reporting can also be useful as continuous auditing techniques for improving full year audits. Substantive tests should be performed and directed at the possibility of fraud. They should include tests which detect the override of internal control by management. These tests should be centred around the balance sheet date for balance sheet accounts, and should be carried out throughout the year for income statement accounts in high-risk areas, areas requiring disclosure of significant accounting policies and material balance sheet accounts that turn over several times throughout the year. Tests of accounts traditionally or frequently deemed low risk should also be included. There should be tests of detail or precise substantive analytical procedures, but because management can override controls and because these tests may not be effective in detecting fraud, no tests of controls, but a check of internal control functions should be undertaken at many levels. These internal



controls can range from high-level oversight by management, to detailed review and reconciliation activities of employees, to numerous procedural steps and protocols carried out by individuals and to sophisticated controls embedded in computer systems. An understanding of the way that internal control functions at varying levels is important to the way the auditor addresses the forensic-type phase. The audit should remember that management can influence the timing of both the execution and the recording of some transactions. This highlights the importance of tests of transaction cut-offs especially at the end of quarterly or annual periods.

#### **AUDIT TESTS (Audit Procedures)**

**Recommendation 6. That the audit develop an improved method for linking substantive tests to risk assessments and should include procedures aimed at reducing inadequate sample size and variations. Firms must also examine critically their audit work on internal control and should consider increasing the engagement time allotted to internal control evaluations, particularly in the audit-planning phase. Those areas which are considered higher risk are allocated more detailed audit testing.**

- (c) The O'Malley Panel findings clearly indicate that audit tests focusing on fraud or illegal activity detection will have a significant impact on the earlier detection of fraud or illegal activities.

#### **Checking Verbal Statements**

- (a) There was considerable confusion within AWA (1995 AWA Appeal judgment, p.620) as to what the foreign exchange ceiling actually was. DHS accepted Korval's assertion that there was no upper limit on his trading activities. The auditor should have requested written evidence of Korval's actual dealing limit, (Tomasic et al. 2002a, p156). At one stage, Korval's trading exceeded \$800 million. The authorisation of the dealing limit should have been minuted in the

directors meeting and verified by the audit. This was particularly the case, as the directors were under the impression that Korval had a limit of only \$300 million, which was equivalent to two years import requirements (\$150 million a year).

- (b) Moffitt J, in *Pacific Acceptance* (Godsell 1993, p.102), ruled that it is not sufficient for the auditor only to seek the assurance of another; the auditor must check material matters for himself.

### *Background of Recommendation 7*

An auditor should confirm management's verbal representations by sighting written authorisation and documentation. To overcome the presumption that it is necessary to send confirmations, the audit firm should articulate precisely the considerations that should be present. The auditing profession should undertake research to develop more effective methods of confirmation or other means of obtaining evidence from third parties, such as through the use of technology. There should also be requests for written confirmations from customers or vendors that otherwise would not be undertaken and they should be tailored to address the nature and specific terms of the underlying transactions.

### **WRITTEN DOCUMENTATION (Audit Procedures)**

**Recommendation 7. That the auditor be required to confirm management's verbal representations by sighting written authorisation and documentation.**

- (c) Because management which is involved in fraud or illegal activity are most likely to provide false verbal representations to the auditor, the implementation of this recommendation would result in more audit confidence in management assertions. It would also act as a warning to management that they could not side-step the auditor with false or unsubstantiated assertions.

## Bank Circularisations

DHS (court proceedings Daniels, 1-4-1992, p.33)

- (a) The auditors forwarded bank confirmation forms to the various financial institutions relying only upon the bank account details supplied by Korval. They assumed that the banks would include and complete any details not provided by Korval. However, most banks only completed documentation as supplied by the auditors.
- (b) AGS 1002 'Bank Confirmation Requests' requires the auditor to be satisfied that bank confirmation forms are complete before the auditor forwards them to the bank. Hammond, (court proceedings 14-10-1991, p.46) from PWC, agreed that the auditor has to complete the bank confirmation request properly.

### *Background of Recommendation 8.*

The audit should ensure that the bank confirmation forms are complete prior to forwarding them to the bank. The O'Malley Panel became aware, from the feed-back from the focus groups and other inputs, that some auditors believe that confirmation was not a particularly effective audit procedure in many situations. On a few engagements the Quasi Peer Review (QPR) reviewers noted that the engagement team had permitted the entities' personnel to mail or receive the confirmation requests and that the auditors had accepted fax responses without taking appropriate precautions such as verifying, by a phone call to the purported sender, the source and contents of the response. 'In approximately eight percent of the key areas where the engagement team noted confirmation exceptions, the QPR reviewers found that the exceptions were resolved inappropriately' (O'Malley Panel 2000, p.36), and that the decisions regarding the need not to have additional substantive tests were inappropriate.

## **BANK CIRCULARISATIONS (Audit Procedures)**

**Recommendation 8.** That the auditor be required to ensure that the bank confirmation forms are complete prior to forwarding them to the bank. The auditor should prepare the bank confirmations independently particularly where weaknesses in the accounting system have been identified.

Audit firms should develop case studies or other communication to audit personnel that illustrate the dangers of losing control over the confirmation process. They should undertake research to develop more effective methods of confirmation or other means of obtaining evidence from third parties, such as through the use of technology.

- (c) An improved focus on fraud or illegal activity would result in a greater scrutiny of management listing of their bank accounts by the auditor. Korval was able to omit his unauthorised bank accounts from the list supplied to the auditors. This resulted in the auditor receiving information on only those accounts that had no illegal transactions. Under this recommendation a common-sense approach would be adopted to the reality that banks typically check only the accounts filled in by audit or management.

## **Cross-Checking**

- (a) Korval was both the money market and the foreign exchange manager. He was solely responsible for foreign exchange dealings and had responsibilities in settlement and accounting functions. Korval had access to his own mail and could authorise accounting entries. The letters sent to foreign exchange dealers seeking confirmation of open contracts at 31 December 1986 had been addressed to the persons with whom he actually dealt, rather than to the settlements department at each dealer. The lack of cross-checking by other AWA staff helped Korval conceal losses and unauthorised loans.

(b) AUS 402 ‘Risk Assessments and Internal Controls’ requires the auditor to obtain an understanding of the internal control structure, sufficient to ensure audit risk is reduced to an acceptably low level. Adequate internal control procedures would result in cross-checking providing detection of all but fraud or illegal activity involving collusion between two or more people. GAAS dismiss collusion as impossible or too difficult to detect and make a point of explaining the lack of expertise of auditors with respect to determining the authenticity of documents. In *Pacific Acceptance*, the judge reminded the auditors that reliance on sources or clients is an aid to, and not a substitute for, appropriate audit procedures.

#### *Background of Recommendation 9*

Because it means that even fraud or illegal activity involving one person would not be identified, the audit should pay particular attention to operations where adequate cross-checking is not apparent from any initial review of internal control procedures and processes. O’Malley Panel QPR reviewers found indications that ‘auditors [in key risk and control areas] did not place any special emphasis on the areas where the risk of material misappropriation of assets was considered significant’ (O’Malley Panel 2000, p.84). Auditors tend not to place much importance on the risk of asset misappropriation. The reality is that all or most financial reporting frauds involve collusion and may involve falsified documentation.

#### **CROSS-CHECKING (Audit Procedures)**

**Recommendation 9. That audit firms be required to pay particular attention to operations where, from an initial review of internal control procedures and processes, adequate cross-checking is not apparent.**

(c) The importance of this recommendation for fraud or illegal activity can be seen when we review how Korval’s activities were finally detected. Korval rarely took leave and on those rare occasions, when he did, carefully instructed his staff to hold all significant financial transactions until he returned. His illegal activities

were not discovered until he was involved in a car accident in June 1987 and confined to hospital. Crane, a foreign exchange assistant, received a telephone call from Westpac. This would have normally been handled by Korval. Westpac asked Crane if AWA wanted to rollover certain unauthorised loans, which were about to expire. She was confused and reported this to Alagna. As a result, on Saturday 27 June 1987 Alagna found 2 unrecorded loans from Westpac totalling AUD \$16 million which he treated as an accounting problem and reported this to Wickham. Hooke was told about these two loans on 3 July 1987. Adequate cross-checking by AWA staff or by the audit would have resulted in much earlier detection of Korval's illegal activities.

## **2. Documentation of Audit Procedures**

- (a) The DHS audit team (Court proceedings Lloyd 23-3-1992, p.63) failed to document audit procedures undertaken during the audit. Daniels had a practice of not documenting audit procedures and this practice apparently flowed on to his audit team. C&L audit partner Lonergan (Court proceedings 18-3-1991, p.24) found that DHS's audit files provided no summary of the extent of the foreign exchange operations, no consideration of risk areas, and no evidence of audit programs. Westworth found that he only had DHS work papers, which didn't describe to him what was happening. 'DHS workpapers contain no evidence that DHS understood the nature of the FX [foreign exchange] transactions being undertaken by AWA and in particular that they were speculative...' (Court statement Westworth 21-5-1990, p.2).
- (b) AUS 208 'Documentation' requires the auditor to plan, perform, record and analyse the results of the audit in the audit working papers. In Pacific Acceptance, the judge reminded the auditors of the need to adhere to audit documentation procedures. The courts are correctly suspicious of audit assertions that they had

performed audit procedures when the results of the tests were not recorded in the audit work papers.

*(c) Background of Recommendation 10*

All aspects of the audit procedures should be fully documented in the audit work papers. It should be a requirement in all audits that it is an experienced audit manager at least, who reviews the resolution of all exceptions noted in the audit work-papers. That manager must ensure that the exceptions had been resolved appropriately and that appropriate decisions regarding the need for additional substantive tests had been made. The audit profession should provide sufficient guidance in quality control standards for working paper documentation to enable firms and peer reviewers to judge the quality of engagement performance, including the supervision of the work of assistants.

**DOCUMENTATION (Audit Procedures)**

**Recommendation 10. That all aspects of audit procedures be fully documented in the audit work papers. Properly documented audit work papers would improve the focus on fraud and illegal activity.**

- (d) The audit partner would then have access to detailed information to better analyse the audit work papers and detect any unusual activities that might lead to the discovery of fraud/illegal activity, or indicate the need for further audit attention.

**Partner Role**

- (a) The AWA case highlighted the need for proper planning to anticipate tight deadlines and avoid situations where the audit prematurely stops pursuing identified problems. Rogers J was most critical of the excuse from DHS that they did not complete all aspects due to time pressure. Daniels was given the complete audit working papers on the Friday afternoon and had only the weekend to analyse

the audit work papers, which he said in court, he had no clear recollection of having looked at. Rogers J asked Daniels. ‘You cannot presently recall actually looking at the work papers on Saturday 7<sup>th</sup> or Sunday 8<sup>th</sup> March 1987?’ Daniels replied ‘No, but I believe I did’. His Honour concluded that ‘Either Daniels was guilty of almost incredible negligence in failing to read the work papers or as his Honour thought more likely, he simply failed to react appropriately to the situation they revealed’ (1995 AWA Appeal judgment, p.648).

- (b) In *Pacific Acceptance*, Moffitt J warned that the audit partner must ensure that there is careful planning of the audit and that the audit partner will be held liable for the consequences of any negligent conduct during the audit by any member of the audit team. Treadway (AICPA 1987, p.56) warned that tight reporting deadlines are particularly troublesome because fraudulent financial reporting activities often occur near the end of a reporting period.

#### *Background of Recommendation 11*

The audit partner is responsible for ensuring that a systematic and timely analysis of all aspects of the audit is undertaken. This analysis should include the provision of sufficient time for the completion of working papers for the audit partner to form an opinion. The audit firms should develop specific performance measures which are to be included in the review of the audit working papers and which relate to the quality of the firm’s practice and to the effectiveness of the audit. The partner review should include additional qualitative evaluations of the information obtained during the review. As soon as reasonably possible after the commencement of litigation against the firm such as in the AWA case, a firm should conduct an internal review of the subject engagement to evaluate the performance of the senior engagement personnel.

#### **PARTNER ROLE (AUDIT PROCEDURES)**

**Recommendation 11. That audit firms develop specific performance measures that relate to the quality of the firm’s practice and to the effectiveness of the**



**audit and include them in the review of the audit working papers. It should be the responsibility of the audit partner to ensure that the performance measures are completed satisfactorily.**

It is essential that the audit partner ensure that all members of the audit team perform the audit to a high standard. Adequate supervision from planning through to the final audit report is the responsibility of the audit partner who is in the best position to assess early evidence of unusual activities that could lead to evidence of fraud or illegal activity.

### **3. Adequate Accounting Records**

- (a) In AWA, the record of foreign exchange contracts had been poorly kept and had not been maintained for a long period. DHS had failed to qualify the accounts because of this and had attempted to audit around the records. They had been unsuccessful and this resulted in the auditors subsequently being found negligent. Rogers J (1995 AWA Appeal judgment, p.615) found that DHS had failed to comply with section 285 of the Companies (NSW) Code 1961, 'Duties of Auditors to Report on Accounts'. Under the circumstances DHS was not entitled to relief from liability under section 1318 of the Corporations Law 1989.
- (b) AUS 502 'Audit Evidence' and AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' require the auditor to ensure that adequate accounting records have been maintained. In Manning and in Van Reesema and in Section 285(4) of the Companies (NSW) Code 1961, auditors are reminded that it is their responsibility to point out any failure to maintain appropriate accounting records.

#### *Background of Recommendation 12*

Auditors should insist that the client maintain adequate accounting records. A key element of quality audit assurance should be a review of the firm's accounting practices. Minimum standards for quality control of the firms accounting system

should serve as the benchmark for this review. The ASB supports both the auditing standards and the quality control standards that auditors and their firms are required to follow in their accounting and auditing practices. Those standards measure the quality of performance that auditors should adhere to in conducting their audits and that firms should follow in conducting their practices. The audit firms hire, train, develop and provide career opportunities for their own personnel, obtain the clients and develop audit methodologies and quality control systems to help ensure that audits are performed in accordance with professional standards. The USA SEC Peer Review Committee determines whether the firms follow the auditing standards and the quality control standards in their accounting and auditing practices in the conduct of their audits. This serves to close the loop between the standards and the way audits are actually performed. Definitive professional standards and well-conceived firm policies, procedures, guidance materials should be accompanied by a strong commitment by the audit firms to make continuous improvements in their processes and to strive to meet the goal of zero defects. The audit firm leaders should convey a tone of high professionalism as the principal message to their auditors. Minimum requirements for quality control of the firms accounting system as documented in the accounting standards should serve as a benchmark for this review.

### **ACCOUNTING RECORDS (Audit Procedures)**

**Recommendation 12. That auditors must insist that the audit client maintains adequate accounting records.**

- (c) Historically, poor or inadequate accounting records have been used to disguise fraud or illegal activity. Therefore, in order to improve audit performance, it is important that this recommendation make it mandatory for management to maintain appropriate accounting records and internal controls. If the client fails to maintain these records, then the auditor should qualify the accounts accordingly. This would benefit the audit profession in any subsequent audit negligence cases.

## **8.6 Recommendations designed to Increase the Audit Focus on Fraud or Illegal Activity from the O'Malley Panel Report and the AWA case.**

### **8.6.1 Recommendations Derived from the O'Malley Panel Report and the AWA case.**

#### **Recommendations Relating to Higher Quality Audits**

- (a) The four audit procedures recommended by the O'Malley Panel to achieve higher quality audits were retrospective reviews, interim period tests, improved liaison with audit committees, and the testing of non-standard entries.
  
- (b) AUS 206 'Quality Control for Audit Work' required the auditor to ensure that the quality of an audit met a satisfactory standard. The Cohen Commission (AICPA, 1978, p.141) and the AWA case emphasised the need for higher quality audits. The O'Malley Panel believed that audit firms should aspire to zero defects as their goal and endeavour to eliminate audit failures completely. In the AWA case, both DHS and AWA failed to realise that future computerisation of a poor accounting system would not solve the basic weaknesses in the system. DHS should have reported on the weaknesses that they found in the accounting system. The auditors discovered weak internal controls, a lack of accounting records and non-compliance with accounting standards, but they were too tolerant of poor accounting practice. Treadway (AICPA, 1987, p.56) warned that audit firms had to design their quality control to take account of organisational and individual pressures and control them through second partner reviews.

#### *Background of Recommendation 13*

Auditors must concentrate on higher quality audits. This aspiration should be codified in the auditing standards. The O'Malley Panel found that the basic

responsibility of auditors is to obtain reasonable, but not absolute assurance that financial statements are not materially misstated. This is what sets the responsibility at an appropriate level. To raise the level of assurance from that of reasonable to a higher standard, would put an unreasonable burden on the auditing profession and place an unjustified cost burden on entities subject to audit.

### **ACCOUNTING STANDARDS (High Quality Audits)**

**Recommendation 13. That auditors must concentrate on higher quality audits. Audit firms throughout the world should implement uniform audit methodologies that use international auditing standards as the basic minimum, and should encourage their employees to even higher quality aspirations in their audit work.**

- (c) Auditors should not accept proposed changes to a flawed system as a reason not to fully report on the current audit situation. This recommendation would result in an auditor demanding a higher accounting standard and complete records from the client. Management assurances that they will improve the system in the future, whilst necessary for future high-quality audits, should not impact on the current auditor's report.

### **12. Liaison with Audit Committees**

Ravlic (2001), Ramsay (2001, pp.14-16) and Macdonald (CICA, 1988) indicate that if a company such as AWA had had an audit committee, then Daniels should have discussed with the audit committee both the vulnerability of the entity to fraudulent financial reporting and the entity's exposure to the misappropriation of assets. It would have been Daniels' responsibility to report in a timely manner to the audit committee as well as to the directors.

### *Background of Recommendation 14*

The auditor should become more involved with the audit committee in order to assess the entity's likelihood for fraudulent or illegal activity. The auditor should prepare a situation summary report and forward it to the audit committee prior to each monthly meeting. This recommendation would result in the audit committee working with the auditor to minimise the potential for fraudulent or illegal activity. The O'Malley Panel recommends that audit committees increase the time and attention they devote to discussions of internal control with the management and the auditors. The audit committee should review the external auditor's performance on an annual basis and, as the external auditors' primary client, exercise responsibility to assess the auditor's responsiveness to the committee's expectations. The auditor should make sure that the audit committee's expectations are fully understood and the auditor's communication with the audit committee is directly responsive to those expectations.

### **AUDIT COMMITTEE (High-Quality Audits)**

**Recommendation 14. That the auditor become more involved with the audit committee in assessing the entity's likelihood for fraudulent or illegal activity. The audit committee should also assess the strength of management's commitment to a culture of intolerance for improper conduct.**

Tomasic (2002b, p.13) notes that this is especially important because of the recent failure of the Enron audit committee to detect illegal activity despite the audit committee's compliance with relevant regulatory rules. The auditor should prepare and forward a situation summary report to the audit committee prior to each monthly meeting. This recommendation would result in the audit committee working with the auditor to minimise the potential for fraudulent or illegal activity.

## 8.7 Recommendations for an Improved Audit Fraud Detection Outcome from the AWA case

### Technical Expertise (High-Quality Audits)

Korval's foreign exchange theory was flawed but the auditors lacked the necessary knowledge and experience to detect it. AWA management were reluctant to actively monitor the foreign exchange area because they, too, also did not understand foreign exchange transactions.

AUS 606 'Using the Work of an Expert' and AGS 1030 'Auditing Derivatives Financial Instruments' points out the complex nature of foreign exchange and the need for technical expertise sufficient to undertake an effective audit. AWA, Godsell (1993, p.119) and Campbell (2001) identify how risky foreign exchange trading can be. The recent Allied Irish Banks (AIB) foreign exchange fraud, estimated to be USD 691 million, clearly showed this. Korval's foreign exchange theory was flawed, but audit lacked the necessary knowledge and experience to detect it.

### *Background of Recommendation 15*

Auditors should have expertise in the technical areas or have access to expert consultants particularly at the planning stage. The auditing profession should emphasise the importance of having personnel with significant audit and industry experience available to participate in internal control work. Increasingly, auditors will find it necessary to understand fully the risks associated with both new and advanced business information systems and with the controls that are needed to respond to those risks. Auditors must expand their technological knowledge and skills, devise more effective audit approaches by taking advantage of technology and they should design different types of audit tests to respond to new business processes. Highly skilled technology specialists will become even more essential members of audit engagement teams and they will require a better

understanding of auditing. Auditors, in turn, will not be able to cede all technological matters to technology specialists.

### **TECHNICAL EXPERTISE (High-Quality Audits)**

**Recommendation 15. The audit team should have substantial expertise in the technical area or have access to expert consultants.**

This recommendation would result in the audit team developing a strategy to audit technical areas such as foreign exchange, and also in an improved scrutiny of management assumptions within the highly complex areas of the audit. The result would give an improved audit detection outcome.

### **Audit Risk**

Management are under increasing pressure to deliver on the high earning expectations of shareholders and are tempted to seek out such higher risk activities as speculation on foreign exchange. If DHS had undertaken a risk analysis it would have identified a large increase in the business risk of AWA and also the risk to DHS.

AUS 402 'Risk Assessments and Internal Controls' notes that an auditor needs to consider whether substantive procedures such as bank confirmations can reduce detection risk to an acceptable level. Mancino (1997), O'Malley Panel (2000, pp.175-179), Campbell (2001), Treadway (AICPA, 1987) and the Pacific Acceptance case all emphasise the risk involved in the audit process.

### *Background of Recommendation 16*

Auditors must be more investigative of risk related activities undertaken by their audit client. The auditor should be required to make inherent risk assessments for significant account balances and for classes of transactions by considering what could go wrong at the individual assertion level. It should be a requirement that the inherent risk assessment

for high-risk clients should be reviewed by the concurring partner or by an industry expert before the related tests of controls and substantive tests are designed and performed. There should be a final review by supervising audit personnel at the conclusion of the audit of high-risk areas to reassess whether conditions identified during field-work or test results (exceptions and related explanations by entity personnel) might call for additional tests.

### **AUDIT RISK (High Quality Audits)**

**Recommendation 16. That auditors must be more investigative of risk-related activities undertaken by their audit client. An effective way to indicate the additional audit risk to the client is by correctly pricing the extra substantive audit tests that must be undertaken for auditors to perform an audit of the higher risk activities.**

This recommendation will result in the identification by the audit of the risk related activities undertaken by the audit client and should provide an early warning to the client of the degree of audit risk. The audit would also significantly increase the audit fee to allow for extended testing procedures, Tomasic (2002b) noted that this increased audit fee can often alert management to the reality that they are undertaking a higher-risk venture. In critical risk cases, such as HIH, the auditor should withdraw from the audit when the risk is assessed by the auditor to be too high.

### **Written Communication to the Directors**

DHS failed to document meetings with management and failed to follow up audit exit meetings with written management letters. 'These audit exit meetings were in my view an effective means of ensuring that matters arising out of the course of the audit were brought to the attention of management' (Court statement Daniels 24-5-91, p.2). Daniels had not seen any need for such a letter to document audit meetings with AWA because he



was familiar with their management and 'Our firm and its predecessors had been the auditors of AWA for in excess of fifty years' (Court statement Daniels 24-5-91, p.2).

AUS 710 'Communication to Management on Matters Arising from an Audit' requires the auditor to report any significant matters in writing to management and, if deemed necessary, to the directors and to request a prompt written reply. The Cambridge Credit case, BGJ case, Ravlic (2001), Cohen (AICPA, 1978), Treadway (AICPA 1987, p.58), Macdonald (CICA, 1988), Sikka (1992, p.22) AWA and Cheney (2002) all remind auditors of the requirements to report material weaknesses to the appropriate level of management. If a prompt reply is not received from management then the auditor should report to the board of directors.

#### *Background of Recommendation 17*

The audit must recognise that the directors are acting on behalf of the shareholders, as the parties to whom they are accountable and the audit should tailor their relationships and communications accordingly. Based on information from focus groups and comments from QPR reviewers the O'Malley Panel (2000, p.32) argued, that management and auditor communications with audit committees frequently do not devote sufficient time and attention to internal control. It was felt that audit committees and boards of directors were likely to presume that auditors do more work in this area than they actually do, and they take more comfort than is warranted, or intended, by the auditors. Audit committees and boards of directors seldom ask management and the auditors in-depth questions about internal control. It was widely recognised that the efficiency of effective internal control is critical to the reliability of the financial reporting process. The O'Malley Panel concluded that, while it would not recommend that the SEC require management and auditors to report on internal control, the need for greater audit committee involvement with internal control matters was emphasised. The O'Malley Panel also recognised that, as the demand for new and timelier information rises, management and auditor reporting on internal control may become inevitable.

## **WRITTEN REPORTS (High-Quality Audits)**

**Recommendation 17. That the auditor ensure that verbal communications are followed up by prompt written reports with the audit client, as an effective means of ensuring that audit recommendations are implemented. It is also a very important source of evidence in any audit negligence defence.**

Written communication should result in all necessary parts of a client's organisation being made aware of relevant audit matters. A copy of the report of the audit exit meeting should be forwarded directly to the board of directors. This recommendation would result in greater certainty because the client will be required to respond in writing. And, particularly in relation to potential audit litigation, the report would provide evidence that the auditor had documented and reported upon accounting weaknesses.

### **Tradition**

Daniels allowed past protocol to result in him not answering questions from the directors. He did not appreciate the urgency of the position and wanted to wait until the audit exit meeting to formally discuss the lack of adequate accounting records and the lack of controls in the foreign exchange operation with management. Rogers J questioned Daniels' decision. Daniels replied that it was a custom he had followed since 1970.

In the Pacific Acceptance case (Godsell 1993, p.102) Moffit J ruled that auditors have a continuous duty to warn management promptly of any reasonable suspicions that fraud or error might exist.

### *Background of Recommendation 18*

The auditor must adopt a professional approach to the audit and must not allow past protocol or tradition to prevent that responsibility. The auditor must make sure that the client's expectations of the audit are fully understood and that the auditor's communications with the client are directly responsive to those expectations.

Transparency, which simply means openness, should be an integral part of the audit tradition and this transparency should be evident to the client's management and also to the audit committee and the board of directors. This is a concept that calls for a full and fair disclosure of information to the constituencies who need that information. An effective and efficient global capital market depends on financial information that is reliable and comparable, regardless of its country of origin. Transparency is hindered in some areas of the world by a lack of requisite accounting and auditing standards, corporate governance practices and regulation, and other issues.

### **PROFESSIONAL AUDIT (High-Quality Audits)**

**Recommendation 18. That the auditor adopt a more professional approach to the audit and not allow past protocol or tradition to weaken it.**

The auditor must realise that the board of directors and the audit committee are acting on behalf of the shareholders and the auditor should be open in any discussion with them.

In the AWA case, protocol and tradition appears to have been designed for the comfort of AWA management and DHS (Daniels) and not to provide directors with all the relevant facts. The audit must increase its focus on fraud detection. Comfort should not be allowed to deflect it from this aim. The audit partner should be experienced enough to know when to dispense with tradition in order to ensure a professional audit and should move to the role and responsibility of an Audit Partner rather than, as in the AWA case, boating with the client on Sydney Harbour.

### **Fraud Training**

The O'Malley Panel Report recommends that audit firms should develop or expand training programs for auditors at all levels '...oriented toward responsibilities and procedures for fraud detection' (O'Malley Panel 2000, p.93). These programs should be oriented toward responsibilities and procedures for fraud detection. These programs should emphasise interviewing skills and the exercise of professional scepticism, as well

as fraudulent testing techniques. Training programs should include case examples of how defalcations might be detected, the type of controls that safeguard assets and that are effective in preventing and detecting defalcations, and the ways in which defalcations are concealed.

A 1996 Australian study (ASCPA and ICAA) found that auditors were not fully aware of auditing standard requirements nor had adequate training to satisfy these standards. There was also no evidence in the Awa audit that the DHS audit team had undertaken any fraud identification program or that fraud detection was even a consideration of either DHS or the audit team.

#### *Background of Recommendation 19.*

Fraud detection training programs for auditors should be developed and expanded and there should be a greater emphasis placed both on training programs where the components of internal control are discussed and on assessing and testing those controls. The objective should be to increase significantly the overall effectiveness of auditors in identifying and responding to risks. Key controls and deficiencies in the internal control environment and information systems are some of the area's where the auditor needs to identify potential risks.

#### **FRAUD TRAINING (High-Quality Audits)**

**Recommendation 19.** That fraud detection training programs for auditors be developed and expanded. The training programs should place greater emphasis on each of the components of internal control as well as on the assessment and testing of internal controls.

#### *Background of Recommendation 20*

The O'Malley Panel recommends expanded training programs for auditors at all levels, designed to improve responsibilities and procedures for fraud detection. Training programs should include case examples of how defalcations might be effected, '...the

types of controls over the safeguarding of assets that are effective in preventing and detecting defalcations, and how defalcations are concealed' (O'Malley Panel 2000, p.93).

### **IMPROVED SKILLS (High-Quality Audits)**

**Recommendation 20. That audit training make increased knowledge and skills a higher priority for all experience levels within the audit firm. The objective should be to increase significantly the overall effectiveness of auditors in identifying and responding to risks, key controls and control deficiencies in the internal control environment, and in information systems.**

Appropriate fraud detection training programs are an essential part of improving the audit fraud detection outcome.

### **Ethics**

In the AWA case, the judges questioned the ethics of the audit partner. They were critical of Daniels' compliance with Korval's wishes which were not in compliance with AAS 20 'Foreign Currency Translation'. Daniels also failed to properly review the audit working papers and he certified the 31-12-86 financial statement before he had received back all the bank confirmation replies.

Wood (2002, pp.3-7) noted that companies had since the beginning of the 20<sup>th</sup> century focused on corporate continuance. This could impact on their compliance with ethical requirements, because long term survival may sometimes be endangered by ethical requirements. It was, therefore, important that auditors ensure that they adopt an ethical approach to their responsibilities. AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' requires the auditor to comply with the ethical requirements of the profession. Plummer (2002) and Lampe et al. (1992) indicated that ethics should be given a higher profile in the training of auditors. It is noted that one of the three ingredients of every fraud is rationalisation when ethical reasoning is compromised to justify the fraud.

### *Background to Recommendation 21*

Ethical requirements should be emphasised to all auditors. Audit firms should address the importance of the role and responsibility of audit professionals as well as the concepts of integrity and objectivity, professional scepticism and accountability to the public. Ramsay (2001, p.14) also recommended that the AISB should promote the teaching of professional and business ethics by the professional accounting bodies and universities. Like independence, the ethical climate of the audit profession is the most important factor. A climate of high ethical behaviour within the major audit firms will be passed down to the most junior auditors.

### **ETHICS (High-Quality Audits)**

**Recommendation 21. That the audit firm ensure that auditors maintain a high ethical standard throughout their career because a culture of high ethical standards within an audit firm will assist auditors to resist the aggressive accounting policies of some clients.**

An ethical culture within the audit firm could assist in preventing a re-occurrence of failures such as that of Enron/Worldcom where unethical complicity with management about tax avoidance among other things led to the failure of Andersen, which at the time was the fifth largest audit firm in the world.

### *Background to Recommendation 22*

The auditing profession will need to restore the historic attractiveness of auditing as a profession and convince the best people that it offers excellent long-term career opportunities. To do so it will have to lift the public's perception of the profession to a higher plane and convincingly demonstrate the worth of the profession. Some measures designed to do this include effective, independent and high quality accounting and auditing standards, audit firms with effective quality controls worldwide, profession wide quality assurance, active regulatory oversight and audit firms that have implemented uniform audit methodologies throughout the world.

## **AUDIT CAREERS (High-Quality Audits)**

**Recommendation 22. That the auditing profession should promote its long term career opportunities.**

The importance of an audit has been confirmed by recent reports. The Ramsay Report confirmed the importance of the audit process. It stated that “...audited financial statements are an important part of the financial information that is available to the capital markets and an important part of effective corporate governance” (Ramsay 2001, p.20). And the O'Malley Panel found that ‘...auditors constitute the principal external check on the integrity of financial statements’ (O'Malley Panel 2000, p.vii). It is important that auditing be returned to its former status as the main role of the public accounting firm. The proposed AISB should examine and, where necessary, restrict audit tendering where it is found to be harmful to the full performance of all audit requirements necessary to perform a comprehensive audit program. Treadway (AICPA 1987, p.56) warned that fee and budget pressure led to red flags not being thoroughly investigated.

## **19. Peer Reviews**

### *Background of Recommendation 23*

The O'Malley Panel recommends that the SECPS Peer Review Committee should develop more detailed inquiries for peer reviewers of audit firms' methodologies and engagement performances relating to audit work on internal control. The SECPS should focus particularly on internal control considerations in planning the audit. Peer review inquiries should also focus on the depth of the engagement team's understanding of the entity's information system and related risks that are relevant to financial reporting. In addition, they should address both the engagement team's effectiveness in identifying, testing and assessing key controls, and the sufficiency of the involvement of experienced professionals.

Peer review captains should be instructed to include professionals with the necessary specialised technology expertise on their peer review teams. It is also suggested that peer reviewers include their findings in their reports to the SECPS Peer Review Committee.

### **PEER REVIEW (High-Quality Audits)**

**Recommendation 23.** That the peer review process should be seen as a critical element. It should provide assurance to the public that audit performance measures should be up to high standards. They should address the audit team's effectiveness in identifying, testing and assessing key controls, and the sufficiency of the involvement of experienced professionals.

The first audit involving clients new to a firm should be automatically selected for peer review. Proper peer reviews should assist the accounting profession, which is currently self-regulated, to set accounting standards and also to measure their implementation.

### **FORENSIC**

#### **Retrospective Reviews**

The O'Malley Panel (2000, p.x) and the AWA case remind auditors of the importance of retrospective reviews. DHS did not undertake any post balance date review even though this was required by the accounting standard. Bryant, Lonergan and Westworth, the three audit experts, all agreed that DHS should have undertaken post balance day audit procedures. Lonergan, in particular, would have reconstructed trading for the year and conducted a very detailed examination of post balance date settlements.

#### *Background of Recommendation 24*

The audit should include retrospective audit procedures, and there should be an analysis of selected opening balance sheet accounts of previously audited financial statements. The accounts should be selected using risk-based criteria. The objective of the audit tests should be, with the benefit of hindsight, to assess how issues involving accounting



estimates and judgments were resolved. In the retrospective review, the auditors should modify their otherwise 'neutral' concept of professional scepticism. A retrospective review and testing of accounts that previously have been audited, is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud. This recommendation would result in a comprehensive post balance date audit review and appropriate retrospective auditing procedures being mandatory.

### **Recommendations Relating to Forensic Aspects of the Audit**

A forensic audit approach should include retrospective auditing and special attention to audits of interim periods and non-standard entries. There should be no reliance on internal auditors in the forensic audit phase. Bonus payments should be especially examined because of their high profile in recent frauds. Auditors should look for material misstatements, non-statutory audits, auditor unpredictability, red flags and regulations to help fraud detection.

#### **RETROSPECTIVE REVIEW (Forensic)**

**Recommendation 24.** That audit incorporate retrospective audit procedures of previously audited accounts using a selection of risk-based tests. These tests should be designed to assess how certain issues involving accounting estimates and judgments were resolved with the benefit of hindsight.

#### **Interim Period Tests**

The O'Malley Panel (2000, p.92) provided recommendations to the Auditing Standards Board (ASB) on procedural guidance for interim periods.

#### *Background of Recommendation 25*

O'Malley recommended specific guidance for the application of procedures in interim periods using a forensic-type approach. The 1999 COSO (Committee of Sponsoring Organisations) Report found '...that many frauds are initiated in interim periods'

(O'Malley Panel Report 2000, p.42). The criteria that should be checked in interim periods are those involving a high degree of subjectivity, areas involving complex accounting standards, related party transactions and areas where controls are particularly susceptible to being overridden. The audit profession should provide criteria for the areas that should be addressed in reviews of interim financial information. They should include areas which involve a high degree of subjectivity such as reserves, complex accounting standards and related party transactions. The auditing profession should provide guidance on how procedures, which are employed in interim periods and which address the potential for fraud in financial reporting may also be useful as 'continuous auditing' techniques to improve full year audits. The O'Malley Panel provided guidance on how forensic audit procedures could be addressed in interim periods and how they might be useful as 'continuous auditing' techniques to improve full year audits.

### **INTERIM TESTS (Forensic)**

**Recommendation 25. That specific procedures be undertaken in interim periods using a forensic-type approach, because the 1999 COSO report found that many frauds are initiated in interim periods.**

The O'Malley Panel provided guidance to the ASB regarding procedures employed in interim periods which as continuous auditing techniques to improve full year audits, address the potential for fraud in financial reporting. It encouraged the ASB to research and address concepts of continuous auditing in furtherance of a more effective audit model.

### **Non-Standard Entries**

Treadway (AICPA, 1987) noted that fraudulent financial improprieties were frequently accomplished through unusual transactions near the end of a reporting period in industries which are experiencing rapid change. The 1999 COSO Study noted that many frauds included transactions outside normal accounting procedures. In the AWA case, non-standard entries were not checked thoroughly by the audit. Korval told Lloyd that he used

“wrong-way” around foreign exchange contracts, which exposed AWA to an uncovered position of \$84 million. Rogers J questioned why the auditors had not asked AWA why they were not using the right-way around foreign exchange method rather than the wrong-way around method. He was also curious to see whether DHS had then checked these non-standard entries properly. Korval also told Lloyd that ‘...the second leg of the contracts was not covered’ (Court proceedings Lloyd 23-3-92, p.24). This resulted in foreign exchange contracts not being hedged. DHS should have investigated why AWA was not using standard foreign exchange accounting procedures.

#### *Background of Recommendation 26.*

The O’Malley Panel Report found that documentation showed that entities with sophisticated frauds were concerned about concealing them from the auditors and making the numbers and relationships look right when the auditors performed their analytical procedures. A favourite technique for accomplishing this was to play around with the numbers, often by using non-standard entries, until the numbers ‘seemed correct’. They also used information technology to facilitate this. All, or virtually all entities, record non-standard entries. Generally, these non-standard entries are genuine but in some cases these entries can provide an avenue for management to override controls. This can lead to fraudulent financial reporting, and consequently, auditors need to design tests in the forensic-type phase to detect non-standard entries and examine their propriety. This aspect of the forensic-type phase would affect not only the extent of the testing, but also the timing, because such entries can be recorded at various times during the year. This recommendation should result in improvements in the forensic-type phrase by identifying non-standard entries.

#### **NON-STANDARD ENTRIES (Forensic)**

**Recommendation 26.** That to detect non-standard entries auditors should design tests in the forensic-type phase, because the O’Malley Panel Report research has shown that entities with sophisticated frauds often used non-standard entries to conceal fraud or illegal activity from the auditors.

Treadway (AICPA 1987, p.51) noted that non-standard entries inherently carry a greater likelihood of fraudulent or illegal activity. The auditor should be more sceptical of transactions that do not follow standard procedures because these entries can be used to override controls that could lead to fraudulent financial reporting.

### **Reliance on Internal Auditors**

AUS 604 'Considering the Work of Internal Auditing' reminds external auditors that they are solely responsible for the audit opinion which they express and that the responsibility is not reduced by the use of internal auditing. This view was confirmed by the O'Malley Panel.

In the AWA case, DHS reduced their testing because the internal auditors had previously audited the foreign exchange contracts. However, the internal auditors had no longer been able to adequately check the foreign exchange contracts. These contracts were no longer linked to specific projects but were, instead, listed as general foreign exchange transactions and consequently, neither audit team detected unauthorised foreign exchange contracts. The defence of DHS of not undertaking substantive tests because of reliance on internal audit work was not acceptable to the court.

### *Background of Recommendation 27.*

During their internal inspection program and especially on large engagements, the external auditor should consider whether the audit engagement team are using the work of internal audit excessively. The external auditor should not rely on the work of internal auditors in carrying out tests directed at the possibility of fraud. It is possible that the internal auditors might provide limited direct assistance to the external auditor and might perform similar procedures to supplement the work of the external auditor. When the work of the internal auditors is expected to affect the audit, the external auditor should consider the extent of the effect, co-ordinate the audit work with the internal auditors, and evaluate and test the effectiveness of the internal auditors' work. These tests may be accomplished either by examining some of the controls, transactions or balances that the

internal auditors have examined or by examining some of the controls, transactions or balances that the internal auditors have not actually examined.

### **INTERNAL AUDIT ROLE (Forensic)**

**Recommendation 27. It is recommended that the external auditors should not rely on the work of internal auditors in undertaking forensic tests.**

This recommendation would result in the external auditors undertaking a fully comprehensive forensic audit phase. This is important because in performing tests and evaluating their results, the forensic phase requires an attitudinal shift in the professional scepticism of the auditor. There will still be many opportunities for external auditors to take into consideration the results of internal audit tests when deciding on their own tests.

### **Bonus Payments**

The importance of checking bonus payments to management was pointed out in AWA. In that case Korval was paid a 560% bonus based on six monthly profit. At that stage, Korval had unauthorised loans of \$38.8 million, and was rolling over his loss making contracts. Korval falsely told Belfanti that all losses had been included in the calculations.

#### *Background to Recommendation 28.*

If the auditor had closely investigated all bonus payments, calculations and documentation their susceptibility to abuse would have become apparent. Companies such as AWA, HIH, Enron and Worldcom are increasingly linking executive remuneration to continuous increases in profits and share prices.

## **BONUS PAYMENTS (Forensic)**

**Recommendation 28. That the auditor particularly investigate all bonus payments because of their susceptibility to abuse.**

Worldcom CFO Sullivan (Meeks 2002, p.4) was paid a USD 10 million bonus upon reporting that he had achieved certain financial targets. This report was false. Bonus payments were also a major incentive at Enron. Riley (2002) noted that Enron had constructed a labyrinth of about 800 offshore companies to shift USD 600 million of debt off Enron's books. Franklin found that this drive to maintain profitable earnings and, continue to receive bonuses, was evidenced by the scene at Enron when the company handed out annual bonuses in Houston. On that day the car park became an impromptu auto show as '...dealers displayed the latest exotic imports' (Franklin 2002, p.14).

This recommendation should result in improved audit detection. Bonus systems are particularly susceptible to manipulation and, in some cases, to fraud or illegal activity. It is normal for honest employees to want to present their results in a format, which maximises their yearly bonus. However, it is then only a small but illegal step for them, to present results, which falsely boost their yearly bonus. Once this illegal step is taken it may unfortunately become increasingly difficult for the perpetrator not to continue this illegal action.

## **Financial Statements**

DHS did not qualify either the 1985/86 audit or the 31-12-86 audit despite identification of significant weaknesses. Rogers J believed that the existence of a register not written up on a timely basis, coupled with an absence of any controls ensuring that all dealings had been recorded in the company's records should have resulted in the qualification of the 1985/86 accounts.

The O'Malley Panel warned that the misstatement of financial statements has reached epidemic proportions and are capable of distorting the Stock Exchange results. AUS 702

'The Audit Report on a General Purpose Financial Report' requires the auditor to certify that the accounts are presented fairly, in accordance with applicable accounting standards and other mandatory professional reporting requirements. Treadway (AICPA, 1987), the Cambridge Credit case, Section 52 of the Trade Practices Act 1974 and Sections 298, 299 (1) and Section 331 of the Corporations Law 1989 all require the qualifying of accounts which were misleading or deceptive under the regulations.

*Background to Recommendation 29.*

The audit must qualify financial statements when the accounts fail to show a true and fair view. Earnings management generally implies that the activities undertaken are designed either to smooth earnings (O'Malley Panel 2000, p.77-78) over two or more interim or annual accounting periods or to achieve a designated earnings level, perhaps to meet securities analysts forecasts. Earnings management may legitimately involve the intentional recognition or measurement of transactions and other events. However, it may also involve the intentional recognition or measurement of transactions and other events and circumstances in the wrong accounting period or the recording of fictitious transactions. Both of these constitute fraud. Choosing the appropriate period in which to recognise a transaction requires both the management and the auditor understanding all the relevant facts and circumstances. If, for example, a right of return privilege on a large sale has been concealed from the auditor as part of a scheme to increase reported earnings, the financial statement misstatement involves fraudulent financial reporting. This suggests that the wide variety of earnings management activities, which cannot always be classified easily, constitutes a continuum that ranges from complete legitimacy at one extreme to fraud at the other. The complexity of this decision is evident from HIH, Enron and AWA where the accounts were able to be certified, even though they were clearly misleading and misstated.

## **AUDIT PARTNER ROLE (Forensic)**

**Recommendation 29. That the audit partner must be more sceptical when assessing the financial statements in deciding whether the accounts have been materially misstated. Further, that the audit partner be involved actively in making inherent risk assessments at both the financial statement level and the assertion level for significant account balances and classes of transactions.**

The audit profession must become far more critical in assessing whether the weaknesses are significant enough to result in non-certification of the financial statements. This recommendation would result in greater scrutiny of the accounts by the audit and an improved reliance by the financial community on the accuracy of financial statements.

## **Non-Statutory Audits**

Daniels' attitude to the non-statutory audit was different from the one he had to the yearly statutory audit. When questioned in Court about his failure to disclose a potential loss of \$4.2 million in the non-statutory audit, Daniels replied, 'We did not issue any accounts on this examination Mr Bathurst, and the letter I gave to AWA was only a comfort letter on the profits' (Court proceedings Daniels 1-4-92, p.33).

AUS 802 'The Audit Report on Financial Information other than a General Purpose Financial Report' and AGS 1016 'Audit and Review Reports on Half-Year Financial Reports of Disclosing Entities Under the Corporations Act 2001' require the auditor in all cases to undertake a complete and effective audit. Section 309 of the Corporations Law requires all audits to be conducted appropriately.

## *Background of Recommendation 30.*

It is recommended that auditors place as much importance on non -statutory audits as on statutory audits. According to the (O'Malley Panel 2000, p.81) frauds often start in one of the first three quarters of an entity's fiscal year (from COSO 1999 Report, p.34). "What ends up as a massive financial fraud, in effect, a waterfall, rarely starts with a grand plan or conspiracy" (O'Malley Panel 2000, p.81). Auditors' responsibilities for



interim financial information are generally limited to quarterly financial reports. Auditors are often engaged to review that information but it is not subjected to the same scrutiny as are the full year's audited financial statements. Therefore, while it is easier for management to manipulate earnings in interim periods, but this is often rationalised by management as being only temporary borrowings since there is plenty of time left in the year to correct the problem. When this borrowing accelerates the trickle becomes a waterfall and the perpetrators end up either taking positions that are indefensible or developing a scheme for concealment to avoid discovery. Sometimes, by the end of the fiscal year, when the manipulations have grown, they either may escape detection by the auditors or, if found, may be judged to be immaterial errors. When these manipulations eventually come to light because they have grown to such a significant size that they are material as well as non-standard entries, they often lead to a restatement of the financial statements and usually to allegations of audit failure. Restatements of previously audited financial statements will inevitably raise questions about '...whether the system that provides assurances about both the quality of audits and the reliability of financial reports is operating effectively' (O'Malley Panel 2000, p.82).

#### **NON-STATUTORY AUDITS (Forensic)**

**Recommendation 30. That auditors must place as much importance on non-statutory audits as they place on statutory audits. The auditors should also be required to comprehensively review, before certifying, selected interim financial information prior to its public release.**

An improved audit fraud detection outcome requires an equal emphasis on all audit programs. The danger is that if a fraud occurs in a non-statutory period, and is overlooked because of an incomplete audit, then in subsequent audits the auditor may assume that the fraudulent area has already been comprehensively audited and by reducing the audit the fraud continues.

## **8.8 Recommendations for an Improved Audit Fraud Detection Outcome from both the O'Malley Panel Report and the AWA case.**

### **Audit Unpredictability**

The O'Malley Panel (2000,p.90) noted the benefit of taking unusual circumstances into account, being prepared to extend the audit procedures, and including an element of audit unpredictability that may surprise the fraudulent client who has become familiar with the normal audit program.

The AWA audit did not include any surprise tests, or periodic coverage of non-corporate or non-local operations. A surprise audit test of the money market operation could have resulted in substantial evidence of unauthorised transactions. AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' indicates the need for the auditor to adopt an attitude of professional scepticism throughout the audit.

#### *Background to Recommendation 31.*

The forensic and other audit plans of the audit should include a degree of auditor unpredictability. Non-corporate and non head office locations should be covered by significant tests directed at the possibility of fraud. Rotation of locations, tested over a reasonable number of audit periods, would be acceptable. Auditors should consider incorporating a surprise or unpredictability element in their tests. Recounts of inventory items or unannounced visits to locations would be examples of an unpredictable pattern by the auditor. Interviews of company personnel, in both the financial and non-financial sectors, in different areas or locations, would also be relevant as would tests of accounts which were not ordinarily tested annually. Another area to be considered would be some tests of accounts which were traditionally, or frequently, deemed low risk. A way to do this would be for auditors

to select for testing in the forensic-type phrase, some accounts or classes of transactions that fall below normal levels of planning materiality, or some locations not normally included in the scope of their work.

### **AUDIT UNPREDICTABILITY (Forensic)**

**Recommendation 31. That forensic and other audit phases include a degree of auditor unpredictability in the tests. Auditors should include a surprise or unpredictable element in their tests. This could include some recounts of inventory items, unannounced visits to a few locations and some tests of accounts traditionally or frequently deemed low-risk.**

To implement this recommendation, surprise tests of accounts which are not ordinarily performed annually or which are of low-risk, should be performed. There should also be surprise tests and periodic coverage of subsidiary accounts at various locations. This recommendation would be of assistance in detecting fraud or illegal activity because while fraudulent management might become aware of a predictable audit system, unpredictable or surprise tests and visits could discover concealed fraudulent or illegal activity.

### **Red Flags**

In the AWA case, there were also four important red flags that were missed by the auditors, all of which should have been obvious to them. Korval was insistent that the unrealised losses should not be included in the accounts although they were required by AAS 20. He advised the auditors that ‘...the unrealised losses on the USD contracts will never eventuate into real losses’ (Court proceedings Lloyd 23-3-92, p.12). He had received a 560% bonus based on realised profits and was therefore reluctant to include losses. Finally, Brentnall observed a BNZ response showing an unauthorised loan for USD 4.697 million (AUD 7 million) which was not recorded in AWA’s books. All these red flags should have alerted DHS to the real possibility of fraud or illegal activity.

AUS 402 'Risk Assessments and Internal Controls' and AUS 210 'Irregularities, including Fraud, other Illegal Acts and Errors' require the auditor to investigate and report any irregularities where audit suspicion has been or ought to have been aroused. Cheffers (2002, pt.5, p.1) reminds auditors, that courts will often take into account auditor failure to follow up on red flags in assessing negligence damages. There could hardly have been bigger red flags than in Enron. **Red Flag One.** After discovering unauthorised related party transactions with an Enron partnership on 5 February 2001, Andersen met to discuss whether to retain Enron as a client. **Red Flag Two.** On 20 August 2001, Sherron Watkins the Enron internal audit manager discussed accounting concerns with an Andersen partner, only five days after she had sent an anonymous letter to the Enron CEO highlighting her concerns with the company's accounting practices.

*Background to Recommendation 32.*

In the AWA case, the auditor should have paid particular attention to red flags. After noticing them the auditor should have actively pursued them and should have made it a priority to include amendments to the audit program to allow for sufficient time to have investigated any of the red flags the auditor considered necessary. During the forensic-audit phase, auditors should modify their otherwise neutral concept of professional scepticism and presume at the various levels of management, the possibility of dishonesty in the form of collusion, overriding of internal control and falsification of documents.

The key question that auditors should ask is, where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it? Time pressures on auditors have been a pervasive and long-standing issue within the profession. It is important that, if red flags are to be properly investigated, the tight budgets and time-lines are relaxed, particularly during the forensic audit phase. If audit personnel perceive that their individual performance is measured primarily by their meeting time deadlines and budget estimates, then they will invariably respond by focusing on time constraints. This is sometimes at the expense of a more investigative approach. These threats to audit quality frequently appear at or near the completion of the engagement in the form of client

pressures on the engagement team to finalise the audit and hurry the issue resolution process. A study of SEC Accounting and Auditing Enforcement Releases indicated that, in a limited number of instances, ‘...succumbing to time pressures may have contributed to the auditors’ failure to detect material misstatements. Conversely, in other situations the auditors’ resistance to time pressures may have facilitated the detection of material misstatements’ (O’Malley Panel 2000, p.106).

### **RED FLAGS (Forensic)**

**Recommendation 32. That the auditor pay particular attention to any red flags and actively pursue them. Amendments to the audit program to allow adequate time for the auditor to investigate them should be a priority.**

This recommendation is particularly important because the extent to which a Court will grant an auditor leeway in malpractice deliberations ‘...is directly related to the number, extent, and obviousness of the danger signs [red flags] the auditor missed on the engagement’ (1995 AWA Appeal judgment, p.634). The appropriate following up of danger signs is an important factor in earlier fraud or illegal activity detection.

### **Forensic Audit Phase**

DHS had focused primarily on certifying the financial statements and had failed to respond to evidence of potential fraud or illegal activity. The auditors did not undertake any forensic tests in the AWA audit. Bryant did not see it as mandatory to search for evidence of fraudulent or illegal activities. He believed that the auditor should plan his audit so as to identify the effects of material fraud as he would do for any other type of material misstatement.

This recommendation is integral to the research outcomes and leads to an increased audit focus on fraud or illegal activity as well as to an improved audit fraud detection outcome. The WA Chip case found that fraud even though immaterial still had to be reported. MacDonald (CICA, 1988) and AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' requires the auditor to plan the audit to detect misstatements arising as a result of irregularities.

*Background of Recommendation 33.* The audit should incorporate a forensic phase into all audits. The O'Malley Panel recommended that the accounting regulatory bodies should develop stronger and more definitive auditing standards in order to effect a substantial change in the auditors' performance and thereby improve the likelihood that auditors would detect fraudulent financial reporting. As recommended by the O'Malley Panel (2000, p.75) the auditor should include a forensic phase in the audit program. Because it would result in the auditor having to specifically search for fraud or illegal activity, it would assist in addressing the issue of fraudulent financial reporting and other illegal activity.

### **FORENSIC AUDIT PHASE (Forensic)**

**Recommendation 33. It is recommended that a forensic phase be incorporated in all audits. This would thereby improve the likelihood that auditors would detect fraudulent financial reporting.**

### **Accounting Standards**

In the AWA case, the auditors argued that they had complied with the minimum requirements of the accounting standards and were not required to search for evidence of fraud or illegal activity. DHS also had ignored the spirit of AAS 20 and had not included unrealised losses even though it became mandatory only one month later. DHS should have insisted the losses be included because they knew that it would be mandatory in a month's time.

AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' states that the responsibility for the protection and detection of irregularities rests with management. Enron, Worldcom and HIH show that this approach is not satisfactory. It should be the auditor's responsibility to undertake a forensic phase to improve the likelihood of preventing or detecting irregularities. MacDonald (CICA, 1988) found that simple analytical procedures could have detected well-known frauds. O'Sullivan (1993) recommended a strengthening of the auditor's responsibility for detecting fraudulent financial reporting. Dawson (2000) questioned the accounting standard measures protecting whistle-blowers. In the Enron collapse, (Cheffers, 2002) Andersen turned a blind eye to Enron's failure to consolidate, their failure to make \$51 million in proposed adjustments in 1997, and their failure to adequately disclose the nature of transactions with subsidiaries. Andersen should have insisted upon adjustments to Enron's financial statements in conformity with the accounting standards and, if not so changed, should have issued a qualified or adverse report. Treadway (AICPA 1987, p.56) warned that pressure to agree to aggressive accounting practices had an aggregating and undesirable impact on the overall financial statements. Clarke et al. (1997,p.122) noted that conventional accounting and auditing practices, by their very nature, provided a vehicle for public deception in the Cambridge Credit case.

#### *Background of Recommendation 34*

The accounting standards should be reviewed and amended with the purpose of directing auditing procedures specifically towards fraud detection. Accounting standards must serve to provide reasonable and measurable benchmarks for performance by auditors. To serve as effective measures of the quality of performance, however, auditing standards need to provide clear, concise and definitive imperatives for auditors to follow. The O'Malley Panel believed that auditing standards had to serve to provide both reasonable and measurable benchmarks for performance by auditors. Accounting standards need to be reasonable in that they should not force auditors to adhere to rules that do not take into account the myriad of circumstances that exist on audits. To serve as effective measures

of the quality of performance, however, auditing standards need to provide clear, concise and definitive imperatives for auditors to follow. Stronger and more definitive audit standards are required to effect a substantial change in an auditor's performance and to thereby, improve the likelihood that auditors would detect fraudulent financial reporting. Critical to the reliability and comparability of financial information and, therefore, to its transparency is the establishment of a set of accounting principles and practices that can be accepted internationally.

### **ACCOUNTING STANDARDS (Forensic)**

**Recommendation 34. That the accounting standards be reviewed and amended with the purpose of directing auditing procedures specifically towards fraud detection.**

It is important that the regulatory authorities direct accounting standards towards an improved audit fraud detection outcome. In the USA, the O'Malley Panel (2000, p86) found that the risk assessment and response process, called for by SAS 82, fell short of effectively deterring fraud or significantly increasing the likelihood that the auditor would detect material fraud. This was largely because it failed to direct auditing procedures specifically toward fraud detection.

#### *Background of Recommendation 35.*

Ramsay (2001, p.14) recommended that the Australian Stock Exchange Listing Rules be amended to require all listed companies to have an audit committee. George (2002b, p.6) reported that, despite recommendations by the SEC in the USA that audit committees be comprised of independent directors only, the listing rules of the NYSE still provide generous rules regarding membership of audit committees. He also noted, there is no documented evidence to show that audit committees have resulted in any obvious reduction in accounting and audit failure. Given these findings, it may require legislation to ensure that all companies have audit committees and rules which include details regarding the membership of such committees and the independence of members.

### **Recommendations Relating to Independence**



An audit committee should be mandatory, there should be audit rotation every seven years, also restrictions on the hiring of auditors by audited firms, non-audit services need to be researched to see how they effect the independence of auditors, the auditors should pursue independence in all aspects both in actuality and in perception, there is a good argument for audit firms to concentrate primarily on auditing.

### **AUDIT COMMITTEE (Independence)**

**Recommendation 35. Audit committees should be mandatory for all listed companies and should be focused on maintaining a high degree of independence in their decision-making. The audit committee should also review the auditor's performance annually and be responsible for the appointment of the auditor.**

### **Audit Rotation**

In the AWA case, Daniels (Court statement 24-5-1991, p.2) admitted that he had been auditing AWA for over thirty years. 'I was involved in the auditing of AWA's accounts from 1950 to 1987' (Court statement Daniels 24-5-91, p.1). He had become far too familiar with senior management and was no longer acting as a watchdog. 'The AWA General Manager's Friday lunch was a tradition. I was usually invited to these lunches...' (Court statement Daniels 24-5-91, p.37). The independence of Daniels in the AWA case had become blurred. 'Along with Mr Gibson and others I spent some time on the Dameeli, AWA's motor cruiser, on Friday 24 April 1987. We had lunch [on Sydney Harbour]' (Court statement Daniels 24-5-91, p.37).

Paul Volcker, who heads the International Accounting Standards Foundation (IASB), was told (Gullapalli 2002, p.16) that rotation of auditors was a terrible idea thought up by accountants. On the other hand, the European Commission President Romano Prodi said that it had worked well in Italy.

*Background to Recommendation 36.*

Audit partners should be rotated every seven years to avoid capture by the client organisation. However, if we look at how close AWA senior management and DHS had become then audit partner rotation would not seem to be the appropriate answer. Audit firm rotation would have been necessary to implement a more independent approach to the audit of AWA.

### **AUDIT ROTATION (Independence)**

**Recommendation 36. The audit firm should be rotated every seven years to ensure the independence of auditors and the probity of the audit.**

The Ramsay Report (2001, p.16) recommended a 7 years rotation with a period of at least 2 years before the partner could again be involved in the audit of the client. The Ramsay Report recommendation will reduce situations such as occurred with Daniels where the independence of the auditor had become blurred. But this recommendation goes further and agrees with George (2002b, p.16) who argued for audit rotation of firms as a preferred path not only for the independence of auditors but also the probity of an audit.

*Background to Recommendation 37.* In the HIH case, former Andersen partners Cohen, Fodera and Gardner joined the Board of HIH in 1992, 1995 and 1998 respectively. Cohen was chairman of the HIH audit committee from August 1999 and had been a partner at Andersens from 1965 to 1990. Cohen continued as a consultant with Andersen and ‘enjoyed office facilities, professional indemnity insurance and other benefits from Andersen’ (HIH Report 2003, pp.86-7) while Chairman of the Board of HIH of which Andersen continued to be auditors.

## **HIRING AUDIT FIRM PERSONNEL (Independence)**

**Recommendation 37.** That the audit committee require the auditor and management to advise them of any plans to hire audit firm personnel into high-level positions and the actions, if any, the auditor and management intend to take to ensure that the auditor maintains independence in these circumstances.

## **Non-Audit Services**

### *Background of Recommendation 38*

Non-audit services, performed by audit firms, should be reviewed by the audit committee to ensure that audit independence is maintained. The audit committee should ask such questions as whether the service is being performed principally for the audit committee and whether the auditors, in effect, would be auditing their own numbers. The audit committee should also ask whether the role of those performing the service would be inconsistent with the normal auditing role. Finally, the effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process should be questioned.

(a) The O'Malley Panel (2000, pp.xi & xii) recommended that audit committees should pre-approve non-audit services that exceed a threshold amount. A guiding principle for determining the appropriateness of non-audit services is whether the services facilitate the performance of the audit, improve the client's financial reporting processes or are otherwise in the public interest. The Ramsay Report (2001, p.10) was also critical of the threat to the auditors' independence resulting from non-audit services conducted by audit firms that are also responsible for undertaking the audit. The Ramsay Report recommends four steps to improve the provision of non-audit services.

The following suggestions would assist in improving audit fraud detection outcome.

- they are revised and updated professional ethical rules;
- the mandatory disclosure of non-audit services and of the fees paid for these services;
- the strengthening of the role of audit committees; and
- the establishment of an Auditor Independence Supervisory Board (AISB) which would have among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

### **NON-AUDIT SERVICES (Independence)**

**Recommendation 38.** That non-audit services performed by audit firms be reviewed annually by the audit committee to ensure that audit independence is maintained. The type of questions the committee should be asking include Is the service performed principally for the audit committee? Will the auditor be auditing their own numbers? Will the service be inconsistent with the normal auditing role. And finally, the effects of the service on the quality of the entity's financial reporting process.

### **Independence**

Ramsay drew on the O'Malley Panel finding of auditor independence. The O'Malley Panel had noted that the audit reports would not be credible, and investors and creditors would have little confidence in them '...if auditors were not independent in both fact and appearance' (Ramsay 2001, pp.20-21).

AUP 32 'Audit Independence' requires an auditor to maintain an independent approach to an audit. Cheney (2002, p.8) and Ramsay (2001, p.10) have proposed the creation of an independent oversight body to monitor the auditing profession. In the AWA case, Daniels had become too close to the AWA general manager, Gibson, and to Belfanti, the AWA internal audit manager. This resulted in the independence of the auditor being

weakened. The Ramsay Report (2001, p.7) recommended that the auditor should make an annual declaration to the board of directors, that the auditor had maintained its independence in accordance with the Corporations Act and the rules of the professional accounting bodies.

*Background of Recommendation 39.*

For these reasons the auditor should maintain an independent approach to all aspects of the audit. The auditing profession should evaluate the adequacy of IFAC's ethics standards. This includes independence standards for firms and individual auditors who serve the interests of public investors, creditors and other users of financial statements. The auditing profession should establish independence policies covering relationships between its member firms, its benefit plans and its professionals. One suggestion is to assign an audit partner to be in charge of each audit engagement for no more than a maximum of 7 years. There are threats to auditor independence when clients hire former audit firm personnel. Have the auditors exercised appropriate audit scepticism prior to departure from the audit firm? Would the departing auditor's knowledge of the audit allow her/him to circumvent it if he were to become an employee of the client? Would the former auditor have undue influence over the audit team? Audit committees should be advised, by the auditor and management, of plans to hire any of the audit firm's personnel into high level positions and the actions, if any, the auditor and management intend to take to ensure that the auditor maintains independence. A seven year turn over of audit firms should assist in this matter. The proposed AISB will assist in addressing the challenge of implementing new auditor independence requirements in Australia (Ramsay 2001, p.12).

**INDEPENDENT AUDIT APPROACH (Independence)**

**Recommendation 39. That the auditor maintain independence in all aspects of the audit.**

The auditing profession should evaluate the adequacy of IFAC's ethic standards, including independence standards for firms and individual auditors in serving the interests of users of financial statements.

The independence of the auditor is an essential aspect of the aim to improve audit efficiency, effectiveness and fraud detection. In the AWA case, the auditor had lost his independence and was far too compliant to the wishes of management even when it conflicted with the proposed accounting standard AAS 20.

### **Audit Status**

The O'Malley Panel (2000, p.vii) found that auditors constitute the principal external check on the integrity of financial statements. It is important that auditing be returned to its former status as the main role of the public accounting firm. The O'Malley Panel was particularly concerned about the relative importance of the audit practice to public accounting firms. The proposed AISB should examine and, where necessary, restrict audit tendering when it is found to be harmful to the full performance of all the audit requirements necessary to perform a comprehensive audit program.

AUS 202 'Objective and General Principles Governing an Audit of a Financial Report' and Moffitt J in Pacific Acceptance (Godsell 1993, p.102) reminded auditors that their primary role is to audit the accounts. Rogers J, in the AWA case and Godsell (1993, p.118) reminded auditors that they have a fundamental duty to audit the books and accounts of the entity. However, Volcker and Awty, UK heads of assurance for KPMG, complained of intense audit fee pressure affecting the status of the audit. There has been a trend over recent years to regard the audit watchdog process as less important and to place more importance on other aspects of the audit. In the Enron case, it was perceived that there was an inherent conflict between Andersen providing 'exceptional client services' and '...acting as a public watchdog' (Cheffers 2002 pt.1, p.2). There has also been a tendency for firms to put their audit out for tender in order to gain the lowest cost

audit. This may have resulted in audit firms being forced to reduce essential audit tests in order to win the tenders.

#### *Background to Recommendation 40*

Auditing should be the primary objective of the audit firm. Accounting firms should cost their audits to ensure a reasonable return based purely on the auditing role. They should review performance measures for all experience levels and ensure that performing high-quality audits is recognised appropriately as the highest priority in performance evaluations and in compensation, promotion and retention decisions for all personnel.

The measures should focus on the substance and depth of understanding of the client's business and risks, on responsiveness to unexpected or unplanned conditions encountered in audits, on the development of innovative audit approaches, professional scepticism and persistence and finally on knowledge of accounting principles and practices. A solid auditing infrastructure requires effective, independent and high quality accounting and auditing standards, effective worldwide quality controls, profession-wide quality assurance, active regulatory oversight and audit firms that have implemented uniform audit methodologies throughout the world and that use international auditing standards as the basic minimum. The firm should also subject all audit practice units to periodic inspection procedures that cover all audits and assign personnel throughout the world to function as technical consultants in the application of international accounting and auditing standards.

#### **AUDIT PRIMARY OBJECTIVE (Independence)**

**Recommendation 40. Auditing must be the primary objective of the audit firm. Accounting firms should price their audits to ensure a reasonable return. They should recognise and control organisational and individual pressures that potentially reduce audit quality. They should review performance measures for all experience levels and ensure that performing high-quality audits is appropriately**

**recognised as the highest priority in performance evaluations and in compensation, promotion and retention decisions for all personnel.**

## **8.9 Suggestions for Further Research**

The purpose of this research was to examine the standard of care and responsibility required of auditors in the detection of fraudulent or illegal activity. It has been shown that the role of the auditor is complex and must be examined in terms of the environment in which the auditor operates. It is also argued that the solution to the on-going problem of an audit expectation gap requires not only a renewed emphasis on an auditor's training and responsibilities in fraud and illegal activity detection but also a comprehensive appraisal of the environmental conditions in which auditors operate.

The identification of similarities and differences between the audit parties in the AWA case has enhanced the understanding of how auditors operate within such a complex environment. The AFDM model can provide a theoretical foundation for determining a better method for the detection of audit fraud and illegal activity. It suggests that audit fraud detection is not just a consequence of auditing effectiveness. It is also an expression of the environment in which the auditor operates.

Further research could be undertaken into the AFDM:

Is it true that the AFDM provides an enhanced understanding of audit fraud or illegal activity detection? This can only be finally answered on the basis of its ongoing application. This study has been exploratory in nature and identifies the specific stages of adaptation that would require further research and should include a comprehensive testing of the AFDM. The areas to be examined follow. What are the effects of an increased audit focus on fraud or illegal activity in improving audit fraud detection outcomes? What are the measurable effects of this increased focus on the audit expectation gap?



The increased audit focus on fraud or illegal activity should be studied and should include a survey of auditors and the financial investing community. The confidence in detection of fraud or illegal activity by a sample of auditors who have utilised all or some of the O'Malley Panel recommendations in their audit program should be compared with a similar sized sample of auditors who are not using these measures. The findings of the study could result in adjustments to the AFDM to take account of the survey findings. The identification of similarities and differences in the two sample groups would help to provide an enhanced understanding of how auditors deal with their role in audit fraud or illegal activity detection. Validation of the AFDM would also provide an empirical foundation for the model.

Another important area of further research would be the investigation of whether some audit firms have adopted some of the O'Malley Panel's key suggestions of a forensic audit phase, audit scepticism and higher quality audits and what the effectiveness of these measures is. It is important to examine any changes and their impact on the sample audit firm's profitability, effectiveness and on the confidence levels of the auditors.

In relation to audit firms that have implemented the O'Malley Panel suggestions, it would be interesting to measure the effects of an auditor's confidence levels on the audit personnel's perception of the difficulty of detection. Traditionally, auditors have not been confident about their ability to detect fraud or illegal activity. What impact would the introduction of the O'Malley Panel reforms have on the auditor's professional image if an effective audit were to be conducted? Would the increased audit detection tests improve the auditors' confidence and lead to a belief that they had conducted a higher quality audit?

The psychological pressure of the dual audit tasks of certification of the financial accounts and the mindset required for a simultaneous endeavour of detecting fraud or illegal activity on the auditor should be examined. The O'Malley Panel expected an auditor to adopt a far more sceptical approach in the initial stages of the audit and then to

revert to a more neutral approach if no evidence of fraud or illegal activity was detected. A study of this dual role could be examined. Generally, people find it difficult to change from an adversarial role to a more customer-based role whilst still dealing with the same client. It would be interesting to examine how the auditing profession would deal with this problem.

Another aspect of the psychological framing that could be studied would be the competing audit tasks of the certification of the financial statements and the detection of fraud and illegal activity. Auditors are concerned primarily with their statutory responsibility of certification of the financial statements. Most audits do not have any fraud or illegal activity and auditors, therefore, become oblivious to evidence of fraud and illegal activity, and could easily miss or not even be aware of what are later seen to be unusual or suspicious transactions. A study into this aspect of the competing audit tasks could be undertaken at a further stage.

A further interesting area of future research could be the study of a recent corporate collapse in which the actions of the auditors have come under scrutiny. A current example would be the Royal Commission Report into the HIH collapse (HIH Royal Commission, 2003). A suggested approach, which is similar to that adopted in this research into the AWA case and one which is followed by (George et al. 2003) in the analysis of both the AWA and HIH failures, would be to analyse the transcripts of the HIH Royal Commission Report. The study could focus on the questioning of the auditors and on the findings and their interpretation of the auditors' actions.

Future research could investigate another aspect of the audit expectation gap. This is the confusion that currently exists between an auditor's actual responsibility to detect fraud and illegal activity and the financial community's perceived understanding of the auditor's responsibility. Various sectors of the financial community hold differing views about the auditor's responsibility and this causes further confusion in interpretation. Such research could be directed to identifying the various sectors of the financial community

and investigating their interpretations of the auditor's role. Analysis of the results could then be used to develop an overall approach to the financial community's perception of an auditor's detection responsibility.

### **8.10 Significance of the Research**

The auditor's role in the detection of fraudulent or illegal activities has posed a continuing dilemma. The auditor's failure to detect major weaknesses, fraud or illegal activities in the AWA case has led to a widening of the audit expectation gap. This is the gap that exists between what auditors see as their role and what stakeholders expect. Damaging publicity arose from the AWA case, which ran from 1992 to 1995. The auditors were found negligent both in the original case and on Appeal. Following the AWA case, the audit expectation gap widened still further.

There has been limited prior research, both in Australia and internationally, addressing the standard of care and responsibility required of auditors in detecting fraudulent or illegal activity. In 1992, Palmrose found that, in reviewing the literature, they '...confronted a paucity of theoretical and empirical research specifically addressing auditors' responsibilities regarding illegal acts by clients' (Palmrose et al. 1992, p.228). In addition, most prior research in this field has concentrated on the legal aspects of these cases.

The primary aim of this study was to gain an insight into the role of the auditor in a major audit negligence case and to provide a foundation for further research into similar cases. This research has concentrated specifically on the audit aspects of the AWA case. The major audit negligence cases in Australia from 1970 to 2000 were studied and focused on their implications for the audit profession and the audit expectation gap. The AWA case was very important because it was one of the very few audit negligence cases that went to the Appeal Court. Most similar cases are now settled out of Court or very early in the actual Court case.

The AWA case was in Court for 61 days. The decision was appealed. Two auditing actions that had previously not been seen as negligent by the accounting profession were ruled by the Court to now represent audit negligence. This case therefore represented a rare opportunity to examine the actions of the auditors when subjected to the pressure of cross-examination. It is also important to analyse the full case and compare what a community member thought should have happened with what the judges in both Courts had decided was the appropriate outcome.

In an example from the case, Rogers J ruled that the accounting firms had to reach a higher standard in their auditing than the minimum that was required by accounting standards. He asked, 'Why does one go to DHS or Arthur Andersen or Ernst & Young instead of a chap in Bankstown?' (Court proceedings Rogers J 16-9-1991, p.55). Traditionally, the standard of care and responsibility had been the same for all accountants, and it was surprising to see that Rogers J had clearly differentiated between the standard required of a big accounting firm and a local, small accounting firm. This ruling had potential consequences for all professionals, not just auditors.

The rationale for this case study has been three fold. Firstly, the auditor's actions were considered in a real courtroom situation under the pressure of cross-examination which forced them to justify their actions. Secondly, the judgment of Rogers J provided a detailed insight into the reasons for finding the auditors to be negligent. And thirdly, under the considered analysis of an Appeal, the three Appeal judges, whilst agreeing with the general findings of Rogers J, had a different interpretation on many aspects of the original judgment.

Much of the current dissatisfaction with the role of auditing can be attributed to the perceived failure of the auditing profession to deal with corporate excesses. The role of the auditor is complex and has to be examined in terms of the corporate environment in which the auditor operates. Whilst there is certainly evidence of auditor negligence, the audit problem is also a result of such limitations in audit environmental factors as the

accounting standards, the weaknesses in statutory auditing requirements, the culture of corporate risk-taking and the unrealistic expectations of the community which demands both a high quality of audit but allows the audit tender process to be a commercial decision in which the lowest bidder is often successful.

The author argues that the solution to the on-going problem of the audit expectation gap requires not only a renewed emphasis on the auditor's training and responsibilities in fraud and illegal activity detection, but also a comprehensive appraisal of the environmental conditions in which auditors operate.

In this research the author set out to investigate the AWA case within the context of the audit expectation gap theory. Its main premise was to examine why the auditors had failed to detect a \$49.8 million illegal loss by the foreign exchange manager. The question (O'Malley 2000 p. viii) '...where were the auditors?...' is not only applicable to the AWA case but is of importance in all corporate collapses where fraud or illegal activity is suspected.

This study explored both the theoretical and practical aspects of audit fraud detection and concluded that the current auditing system is not designed to enable auditors to use reasonable auditing procedures to detect the many instances of financial fraud or illegal activity. This is important because the failure of the auditor raises doubts about the value of audits in ensuring the reliability of financial statements. It also questions a key element in the efficient functioning of the capital markets. The improvement of the auditor's ability to more readily detect fraud or illegal activity is, therefore, an important means of reducing the audit fraud detection gap, it is a prime element in the underpinning of the professional future of the auditor, and it contributes to the efficient operation of capital markets.

The AWA case and the appeal has been analysed, in relation to the audit expectation gap and the auditor's role in detecting fraud or illegal activity. The analysis concentrated on

the audit team's actions in the AWA audit and the audit experts' analysis. Significant weaknesses in the auditor's actions were identified. These included the failure to undertake reasonable auditing procedures, the failure to follow up unusual or irregular activities by the foreign exchange manager and the failure to recognise that Korval had been speculating heavily and that this was clearly outside the guidelines laid down by the directors.

The actions of the audit partner Daniels came in for special criticism. Daniels failed to properly review the audit working papers and to follow up information of the serious weaknesses identified by Brentnall. The Court considered Daniels negligent in that he did not advise the directors of internal control weaknesses, even when asked about them, at both the 22-9-86 and 30-3-87 directors' meetings. However, Rogers J reserved his most severe criticism for the fact that Daniels '...was prepared to sign a profit statement before all the returns from the circularisation had arrived' (1995 AWA Appeal judgment, p.648). Daniels was perhaps fortunate to escape the wrath of Rogers J with just a stern word although His Honour considered this final action by Daniels '...recklessness indeed' (1995 AWA Appeal judgment, p.648).

This work has expanded theoretical knowledge and has developed a speculative model called the AFDM within a conceptual framework designed to improve audit fraud detection outcomes. The model developed in this study is capable of a significant contribution to the current body of theory and adds to the models now available to researchers.

A need for further comparative studies is suggested. This study makes a contribution by proposing a number of opportunities for building upon the present study. It thereby breaks new ground concerning our understanding of the auditor's role in fraud or illegal activity detection.

An empirical examination of audit fraud detection could be undertaken using the model developed by this study as a starting point. The findings should have relevance for similar research on audit fraud detection. The conceptual framework developed by this study can also provide guidance for other studies. It is therefore suggested that similar research of audit fraud detection should be undertaken and should use the AFDM to test for applicability and validity. Further studies into this field could include an analysis of the HIH case. (HIH Royal Commission Report, 2003).

This research resulted in a series of recommendations for improving the auditor's role in fraud or illegal activity detection. It also has implications for future government policy in relation to recommendations for improved regulations to provide earlier warning of the likelihood of fraud or illegal activity and should therefore reduce the subsequent amount of losses.

The results of this study also provided insights into the traditional values and meanings associated with auditing. These help to understand the continuing evolution of the audit role in fraud or illegal activity detection. In examining audit behaviour within a conceptual framework, this research makes a contribution to the knowledge of the detection role. It might form a basis for comparative studies within different areas of the financial community, so that an overall approach to the financial community's attitude to and interpretation of the auditor's detection role.

Further research into the two competing aims of continuity versus change could be undertaken. This is because certain sectors of the financial community, such as the large audit firms, are resistant to significant change in the auditor's role in fraud or illegal activity detection. They would prefer the current system to continue because change could have an adverse effect on profitability, status or other unknown consequences. A different view is held by other sectors of the financial community, such as investors and regulators who are pursuing reforms in order to give them greater certainty in investment. They therefore are, the present drivers of change. They want the auditor to detect all

fraud or illegal activity but at no or only a small additional cost. Research into the identification of the similarities and the differences between the two competing sample groups could help to provide an enhanced understanding of the behaviour of the financial community. It would also be of value to research the costs involved in undertaking these reforms and to identify who will pay those costs.

In this research the key factors contributing to the non-detection by auditors of fraudulent or illegal activities have been examined. The theoretical and conceptual framework in which the AFDM was developed offers some new perspectives on the complex task auditors currently face in detecting fraud or illegal activity. It suggests that Australian auditing procedures would be improved by reviewing current methods of dealing with fraudulent and illegal activities within Australia and overseas. It draws on the findings and recommendations of the 2000 O'Malley Panel Report, in particular.

### **8.11 Limitations of the Research**

This research concentrates solely on a case study of the AWA case. An empirical study could be undertaken in the future. The research cannot, therefore, draw any general conclusions about auditor behaviour. However, there were audit failings that were typical of audit negligence cases, which include the recent HIH Royal Commission Report.

A failure to adapt auditing to the need to detect fraudulent or illegal activity is partly an element of overall societal constraints and partly an attempt to preserve the current identity and meaning of auditing as perceived by the auditing profession who regard the certification of financial accounts and the provision of non-audit consultancies as essential.

The societal constraints include the financially competitive nature of audit tendering. In relation to the current identity of auditors, the maintenance of an audit firm's present profitability levels is clearly linked to the provision of consultancies other than audits.



There are legal implications for an auditor pursuing audit scepticism too vigorously and consequently incorrectly assuming the dishonesty of management. Auditors do not have the training or experience which police and lawyers have and could easily make mistakes. The O'Malley Panel noted that studies of auditors have indicated they lack confidence in their ability to detect fraud or illegal activity.

Auditors will need further forensic audit training and a concentration on forensic auditing will change the image that auditors and the general public have, of the accounting profession. The task of recruiting high quality employees to auditing is a combination of both attractive conditions and image. Young graduates attracted to the positive image of solving audit client problems are not as attracted to the negative image of professional scepticism which presumes the possibility of dishonesty at various levels of management.

The psychological pressure on auditors to perform two very conflicting tasks is a difficult one. Auditors will initially be expected to adopt a sceptical approach to the audit during the forensic audit phase. In the vast majority of audits there will be no fraud or illegal activity present. The auditor is expected both to continue the audit and to provide client service to the same management. This dual responsibility of an adversarial/customer service oriented approach will confuse auditors.

The psychological pressure of the competing audit tasks of certification of the financial accounts and the simultaneous endeavour of detecting fraud or illegal activity is a constraint on auditors. Certification is a requirement of all audits. Fraud or illegal activity occurs in only a few audits. Auditors focus on certification and regard fraud or illegal activity detection as less important. Instances of auditors ignoring or overlooking evidence of fraud or illegal activity is common.

Auditors are currently employed and trained to provide financial attestation and client service. Significant behavioural change is necessary if auditors undertake forensic audit phases in all audits.

A number of issues have not been addressed in this study although their investigation should prove useful. A survey of the auditors' attitudes, an empirical study of the audit findings and a quantitative analysis of the research findings would prove enlightening.

## **8.12 Conclusion**

This study proposes that audit fraud or illegal activity detection plays a crucial role in maintaining the integrity of the financial system, and that the environmental aspects of the financial system impinge on the auditing role. It examines the influence of these environmental factors on the auditors' behaviour with particular reference to the detection of fraud or illegal activity. It investigates the effect which such environmental factors as the impact on the audit firm on its profitability of the loss of non-audit services, the loss of consultancies and the actual difficulty of detecting fraud or illegal activity, have on the audit function. It proposes a conceptual framework which provides a basis for examining the relationship between the audit expectation gap and audit fraud or illegal activity detection.

This research provided knowledge, insights and recommendations for a better understanding of auditing behavioural characteristics in the context of an environmental culture of corporate excesses. It is hoped that the research will have wide applicability to auditing situations generally.

The behavioural characteristics of the members of the financial community were investigated, as were the importance and meaning they attached to auditing. It is hoped that this study will contribute to wider community understanding of the auditing role in general and of the auditing community in particular.

The AFDM was designed to analyse the relationship between the financial community culture and current audit fraud behaviour. The model will provide a means of measuring the strength and significance of traditional auditing culture.

Some behavioural issues examined in this study may apply only to the AWA case, others may have broader applicability to auditing fraud detection generally. The results should provide a convincing argument to researchers that similar patterns of audit and corporate weaknesses exist.

The analysis of AWA resulted in recommendations that were designed to assist auditors in detecting fraudulent or illegal activity. In particular, the recommendations were concentrated on the need for the audit profession to develop a more comprehensive forensic auditing approach and included the need for the development of an AFDM and the placement of recommendations within a conceptual framework.

An analysis of the judgments and the reasoning of both courts was undertaken. The AWA judgment had an important impact on auditing standards and accepted auditing conduct. The reasons for the rejection of the DHS argument that they had complied with all the requirements of the auditing profession was examined.

The AWA case was the most significant audit negligence case in Australia since the landmark 1970 Pacific Acceptance case. The AWA Appeal judges referred to the precedents set in the 1974 Manning case and the 1992 Van Reesema case and quoted from Burt J's judgment in the Manning case. Burt J found that the responsibility to maintain proper records '...is not met simply by keeping the source materials from which a set of books may be written up. The accounting records must be kept on a regular basis' (1995 AWA Appeal judgment, p.651).

It is sometimes argued that fraud or illegal activity detection is exclusively an audit issue but it is argued in this research study, that it includes not only the auditor but also the environment in which the auditor operates. It also includes such activities as the limitations of the accounting standards, weaknesses in statutory auditing requirements, the culture of corporate risk taking and the unrealistic expectations of the public.

The following conclusions can be made from this study. Firstly, the auditors were negligent in the AWA case. Secondly, the audit expectation gap was re-emphasised in the AWA court findings and thirdly the development of an AFDM could provide a significant improvement in the methodology needed to improve the audit fraud detection role.

This study suggests that the behaviour of auditors in the detection of fraud or illegal activity is significantly affected by the audit environment in which they operate. The data and evidence presented allows the proposition to be made that the relationship between improved audit fraud detection outcomes is dependent on an increased audit focus on fraud or illegal activity. This study has developed an innovative model designed to assist in focusing the attention on three key features developed from the innovative O'Malley Panel Report in 2000. The study also developed a range of theoretical constructs which can be tested in future research.

Importantly, and as has been noted in this study, the relationship between an improved audit fraud detection outcome and an increased audit focus on fraud or illegal activity is not one of simple cause and effect. Auditing is a dynamic and complex field, and the interaction between an increased audit focus on fraud or illegal activity and its effect on non-audit services, audit profitability, detection difficulty and the audit professional and psychological image must be assessed.

This study has specifically examined the AWA case in which the auditing firm of Deloitte was found to have been negligent in both the original Court case and later on Appeal. This research has examined the auditor's role, the audit experts' opinion of Deloitte's audit and finally the Courts summation of their findings. The research concluded that the auditors had been seriously deficient in their auditing duties and had failed to follow reasonable auditing procedures. The study also identified the numerous instances where an experienced audit partner such as Daniels would have been expected to have become suspicious of the activities of Andrew Korval and by undertaking a much

more through audit to have detected evidence of Korval's \$49.8 million in illegal foreign exchange loans.

As with all studies of such a complex issue, many questions have been raised and many areas opened up for further study. It is the researcher's hope that these questions and areas will be explored and that the methodology which has been developed, will contribute to the ongoing advancement and knowledge of this area.

This study has looked at the links between an increased audit focus on fraud or illegal activity and a reduction in the audit expectation gap and the ongoing interaction between the two. The theoretical foundation for this study has been formed by the integration of the audit expectation gap theory combined with the current literature and reports identifying the need for auditors to take greater responsibility in detecting fraud or illegal activity.

This research into audit fraud detection in Australia includes an investigation into the changes that the audit profession is going through in order to adapt to the current needs of stakeholders into the effects of their behaviour in general, and into their fraud detection behaviour in particular. An attempt has been made to identify both adapted audit fraud detection practice and behaviour. It is expected that the proposed audit fraud detection outcome is a consequence of behavioural patterns emphasising both the commonalities and differences between the current and the improved audit focus on fraud or illegal activity.

The development of the theoretical framework has been based on an understanding of how audit fraud detection determinants are derived and how they influence behavioural dispositions in general. Accordingly, the AFDM incorporates variables that were identified and formulated following a close examination of the literature in the AWA case.

It is proposed that in future an empirical study be undertaken to verify the corresponding patterns of fraud detection behaviour in an auditing context and that multiple techniques of data analysis could be used to test the themes.

The main objective of this research, which has been to consider the standard of care and responsibility required of auditors, in detecting fraudulent or illegal activity, as it was exemplified by the AWA case. The O'Malley Panel considers that the objectives in an audit should include '...detecting material financial statement fraud, [and] that goal should drive both auditing standards and the way they are applied' (O'Malley Panel 2000, p.82).

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## **Appendix A**

### **Explanation of Korval's Foreign Exchange Policy**

1. Background.
2. Previous foreign exchange procedures.
3. Decision to change to a profit based foreign exchange operation.
4. Korval's foreign exchange operations.
5. Inadequate supervision of Korval by AWA management.
6. DHS's failure to warn AWA of Korval's activities.
7. Hedges upon hedges-the wrong way around position.
8. Stop losses.
9. Summary

#### **1. Background**

In 1983, the AUD was floated against international currencies. The devaluation of the AUD in this period increased the uncertainty of the cost of imported components and hence of manufacturing. It also led to significant fluctuations in forecasting budgets where foreign exchange was involved. To protect against this, importers and exporters usually, if not invariably, hedged against fluctuations in the value of the AUD. Klopfenstein noted that hedging is defined by the New World Dictionary '...as an attempt to try to avoid or lessen losses' (Klopfenstein 1997, p.274).

AWA was required to import electronic parts from Japan to be used in their electronic equipment. The length of time between AWA entering into contracts to purchase Japanese parts and delivery, which could be six months or more, resulted in the need for greater certainty for their costing and production processes and also the need to be able to forecast future prices. AWA did not want to deal with large and unpredictable variations in foreign exchange costs.



An Australian importer could not easily exchange AUD for foreign currencies other than the USD on the Australian foreign exchange market due to the thinness of the market.

As the USD was the base settlement currency against which the rates for all other currencies worldwide were determined, a two-step procedure was used:

A.                   Buy: JPY  
                      Sell: USD

B.                   Buy: USD  
                      Sell: AUD

The result was a liability in AUD (sell) and an asset represented by JPY (buy), described as 'short AUD long JPY'. If the second step was omitted, the result was 'short USD, long JPY'.

In October 1985, Mileham the finance manager arranged for AMP Acceptances Limited (AMP) to prepare a report for AWA covering all aspects of its currency exposure position to provide recommendations as to actions required to achieve effective management of the foreign exchange operation. This report was received on 13-2-1985, but not passed on to Hooke.

The report from AMP dealt with various strategies open to AWA. The three choices were hedge nothing, hedge everything or hedge selectively. The report warned that the vulnerability of a company to exchange rate fluctuations is measured by its currency exposure, defined as the net effect of exchange rate changes on the profit and loss account and on the balance sheet position.

In general, currency exposure can be sub-classified into three categories of which transaction exposure and economic exposure are relevant to this case. Transaction exposure refers to the risk of a cash loss caused by exchange rate fluctuations in the period

between the time when prices are agreed and the time when payment is made or received for current transactions denominated in other currencies.

Economic exposure arises from a company's commitment to specific currencies and currency environments, which may involve an interest in essential raw materials, actual or potential markets or the activities of subsidiaries. Such commitments are especially important where the company's trading margins or market share may be influenced by the relative position of major competitors where costs are incurred in other currencies.

The most conservative policy is to lock-in the current exchange rate by a hedge. This results in a certainty that when the goods are delivered, they will be costed at the current exchange rate. The only expense is then the cost of the hedge. Another policy is to manage the currency exposure, restricting losses and potentially making reasonable profits on the exposure. The difficulty for this policy is that it requires a very competent foreign exchange manager and considerable time and effort to appropriately manage it.

The third and most high-risk policy and the one adopted by Korval was to speculate on forecasting the currency rate movements and to gamble on this forecast. This can lead to high returns but conversely to large losses.

## **2. Previous Foreign Exchange Procedures**

One of AWA's major activities was the manufacture, import and export of electronic and electrical products. AWA imported large quantities of components from Japan and other countries. To hedge against foreign currency fluctuations in late 1985, AWA began to make forward purchases of foreign currency against contracts in place or anticipated for imported goods.

From mid 1985, the foreign exchange operation had been based at Ashfield under the divisional manager Hughes. He organised forward cover against the JPY for each

individual import contract from Japan. Hughes was shortly to retire and therefore AWA decided to move the operation to its Sydney head office.

### **3. Decision to Change to a Profit Based Foreign Exchange Operation**

In late 1985, AWA directors agreed to change the foreign exchange operation to a profit-based centre and to rely on a global limit of \$200 million (approximately two years foreign equipment purchases of \$100 million a year) rather than the previous conservative policy of individually hedging every foreign purchase. AWA management interpreted this decision as two years at \$150 million a year, equal to \$300 million in total. However, Korval was actually speculating with amounts well over this limit in excess of \$850 million.

An important aspect of the new foreign exchange policy was that it was to be a stand-alone profit centre. This meant that it was separated from AWA's traditionally conservative accounting procedures which DHS had in previous audits recognised represented a sound internal control system. The new foreign exchange operation was set up without any appropriate accounting system and with pressure on the operator to focus on profits, with a substantial bonus for reported profits.

Rogers J found that by March 1986, the board had delegated to senior management the responsibility for conducting a foreign currency exposure protection exercise, subject to the requirements that

- no substantial risk be taken,
- stop losses be in place, and
- transactions be related to AWA's underlying exposure.

The board delegated to senior management the authority to devise and implement managed trading in foreign currency contracts including:-

- putting in place appropriate accounting and other record systems and internal controls;

- hiring necessary staff; and
- ensuring compliance with the board conditions and advising DHS of the board's wishes and intentions.

#### **4. Korval's Foreign Exchange Operations.**

In December 1985, Andrew Korval was appointed foreign exchange manager of AWA. He was already the AWA money market manager. Korval appeared to be brilliantly successful. AWA seemed to be making huge profits on foreign exchange dealings. However, AWA claimed that by July 1987, '...Korval had undetected lost \$ 49.8 million...' (1995 AWA Appeal, p.619) as a result of DHS's repeated failure, as auditors, to report gross deficiencies in the company's records and internal controls.

Korval started dealing in foreign currency to hedge against its future commitments to pay for imported goods. On 2-12-1985, the first entry was apparently made in the foreign exchange register, which was referred to as the 'green book'. The last entry in the green book was on 30-6-1986. He appeared to be brilliantly successful. AWA appeared to be making huge profits on foreign exchange dealings.

Korval acted outside the contemplated area of his operations in two particular ways. Firstly, he allowed the open contracts to excessively exceed one years' anticipated purchases or two years' anticipated net exposures. Secondly, without any authority, he illegally borrowed at first on a small scale in May 1986, but later in very large amounts, from various banks to cover losses suffered on some of the closed out contracts.

The banks made the loans on Korval's oral request. He was not an authorised signatory on any AWA cheque account and had no express authority to make any borrowings. At maturity dates, he frequently netted profitable loans with unrecorded profits or extended the loans if there were further losses. Interest payments were generally rolled into the principal.

The foreign exchange market was a highly competitive one in which rates for foreign currency could move very rapidly. A bank corporate dealer assigned to a particular account might not have personal contact, except by telephone, with the corporate customer's dealing representative. The bank dealer saw it as necessary to be in a position to respond quickly to the offers of business. The firm's control was that banks confirmed in writing any transactions that were entered into by the participant.

Korval's illegal activities went undetected for a long time because neither AWA management or DHS correctly understood foreign exchange procedures. The AUD had only been recently floated and it is not surprising that AWA management was not familiar with foreign exchange.

## **5. Inadequate Supervision of Korval by AWA Management**

Korval was solely responsible for foreign exchange dealing and had responsibilities for both settlement and accounting functions. He was also the money market manager. This dual responsibility resulted in an inadequate separation of duties and responsibilities. Also, no effective dealing limits were imposed. No action was taken to create agreed limits and to advise foreign exchange dealers with whom AWA did or might transact business.

The 1987 budget adopted in August 1986 did impose a limit on open contracts of two years' exposed purchases, which, at the time, translated into \$200-250 million. However, Korval who regularly had over \$700 million, at one stage it '...reached over \$850 million in open contracts...' (Tomasic et al. 2002a, p.156) continued to operate without adequate supervision. He had commonly been buying foreign currency and selling USD without taking the second step in the procedure of buying USD and selling AUD. Not only was the USD/AUD leg being left uncovered, but the AUD was also being purchased which indicates pure speculation.

At 30 June 1986, AWA was short USD 147.5 million. The open AUD/USD contracts were unnatural in that they were the reverse of what would have been expected if AWA was hedging payment for imports. They were the ‘...wrong way around’ (1995 AWA Appeal, p.632). Korval asserted that these transactions were implemented on the advice of Macquarie Bank. Korval described them as hedges on specific hedges. A prudent AWA manager with no knowledge of foreign exchange should still have questioned why was Korval using a wrong system, why wasn’t he using the correct system (the right-way around system).

The worst aspect of AWA's foreign exchange policy was the non-segregation of the function of settlement in the closing out of open forward contracts. If the contract showed a gain and Korval required payment, then the receipt could be traced through a bank account of AWA. Similarly, if the settlement showed a loss and Korval paid the counter party, the payment could be traced through a bank account by AWA and the auditor. The weakness in the system was that Korval was circumventing proper scrutiny by not including some of his transactions in AWA's records.

Korval's adopted method resulted in the gains or losses on contracts not being promptly received or paid out through AWA's books. He sometimes rolled over losses at the historic rate into a further contract or discharged it by a loan. He sometimes held onto gains and then later used the credit for further trading or to pay out a third party. Most importantly, he was able to override any procedures designed to restrict his foreign exchange activities.

## 6. DHS's Failure to Warn AWA of Korval's Activities

It was DHS's responsibility to ensure that they had auditors expert in foreign exchange or had access to a foreign exchange consultant. However, even though they lacked foreign exchange experience, DHS did find evidence of unauthorised loans, wrong way around contracts and significant speculating by Korval. DHS did tell AWA management of some weaknesses in the system, but never informed the directors.

In fact, Daniels gave the impression to the directors that the foreign exchange operation was being properly managed. To show how foreign exchange profits were treated in the 1986 profit and loss account, Daniels referred the board to an article in *BRW*, which he suggested best explained managed hedging. Part of the article read: 'Forward cover remains a primary method of hedging foreign exchange exposure'. The directors believed that by this action that Daniels was telling them that the AWA foreign exchange operation was following the 'BRW model'.

This impression of a well-managed foreign exchange operation was compounded by the certification of the accounts by DHS. The notes to the accounts under Foreign Currencies referred only to hedge transactions. Daniels accepted that the term 'hedge' when used in statements of accounting policies and balance sheets had the ordinary meaning defined in AAS 20 'Foreign Currency Translation'. So by the statement of accounting policy, Daniels represented to the directors that all the forward foreign exchange transactions were hedge transactions within this meaning. After examining them, the board approved the accounts on 30 September 1986.

It is therefore not surprising that when the directors found that AWA had lost \$49.8 million in unauthorised foreign exchange operations that they were surprised and angry. They blamed DHS for not advising them of the true situation and for having led them to believe that the foreign exchange operation was appropriately hedged and operating on the BRW model. They were puzzled by the failure of Daniels to answer truthfully their

questions about the foreign exchange operation at the directors meetings. Daniels did acknowledge that he might have erred in his decision not to report to the board because ‘...at the time I thought not, at this time I think perhaps I should have’ (Court proceedings Daniels 31-3-92, p.31).

On 28 October 1988, AWA brought proceedings against DHS to recover damages for breach of contract and negligence. Roger J’s original judgment in 1992 found that DHS were guilty of negligence. DHS was ordered to pay \$13,600,000 and Hooke was ordered to pay DHS \$1,360,000.

On 15 May 1995, the NSW Court of Appeal judges Clarke, Sheller and Powell JJA reduced the damages to \$6 million because in the opinion of the Appeal judges ‘...there was no certainty that the director’s would have changed their policy if DHS had brought the internal control defects to the board’s attention’ (1995 AWA Appeal judgment, p.617). They disagreed with Rogers J who had argued that it was a certainty that the directors would have changed their policy.

An interesting aspect of the case was that none of the auditors involved in the Court case believed that Korval could move funds between banks, without those funds moving through an account of AWA and therefore becoming subject to the controls in place. DHS and the directors never contemplated that Korval could obtain loans from banks to settle losses or direct transfer of the funds from the lender bank to the borrower bank.

## **7. Hedges Upon Hedges - the Wrong Way Around Position**

AWA had commonly been buying foreign currency and selling USD ‘...without taking the second step in the procedure of buying USD and selling AUD’ (1995 AWA Appeal judgment, p.632). Not only was the AUD/USD leg being left uncovered but AUD was being purchased. As at 30 June 1986, AWA was short USD 147.5 million.



Daniels had noted the summary of open positions, and that the open AUD/USD contracts were ‘unnatural’ in that they were the reverse of what would have been expected if AWA was hedging payment for imports. They were the wrong way around to what would have been expected if Korval had been following accepted foreign exchange policy.

Daniels mentioned this to Lloyd who told him that Korvals transactions were done on the advice of Macquarie Bank. He described them as hedges on specific hedges. Daniels claimed that the reference to Macquarie Bank resolved any question that he might have had about the position. The reason Lloyd changed his view ‘...was because of the conversation with Korval and Mileham’ (Court proceedings Lloyd 23-3-1992, p.24).

Daniel’s actions in this regard were totally unacceptable, even given his lack of knowledge of foreign exchange. He was told that the contracts were the reverse of the correct way. As a very experienced auditor, he should have been used to following up activities, which he knew to be unnatural or unusual. The basic premise of audit scepticism is to question and investigate non-standard procedures. The O’Malley Panel (2000) noted that the QPR considered non-standard entries as a matter closely related to the issue of fraudulent financial reporting and were concerned that audit tests are not currently addressing the possibility of its occurrence.

## **8. Stop Losses**

Since exchange rate movements impact directly on the sums exposed, it may be appropriate to establish ‘stop-loss’ points which, when reached, automatically trigger a hedging decision. These can be calculated by reference to the maximum impact the company is prepared to tolerate. The significance of stop-losses in the AWA case was that the directors and the CEO assumed that the use of stop-losses by Korval would prevent any significant loss whilst allowing for the potential of significant profits.

The reality is that stop-losses require continual monitoring and adjustment. They are not a total solution to preventing losses but are one of a range of foreign exchange products that can be used to manage foreign exchange. AWA directors incorrectly assumed that the use of stop-losses meant that the company could not lose significant amounts. However, stop-losses have to be regularly adjusted if they are to track the movements in currencies.

Korval was most reluctant to activate stop-losses as he believed that the losses would eventually turn into profits. Therefore, he ignored stop-loss points and instead rolled over the losses into unauthorised loans whilst he waited for them to turn into profits. A retrospective review and testing of the stop loss system as recommended by the O'Malley Panel (2000, p.91) would have resulted in the audit identifying that Korval was not following the correct procedures.

## **9. Summary**

In late June 1987, Korval was slightly injured in a car accident and was confined to hospital. Crane, the foreign exchange assistant, received a telephone call from Westpac which would have normally been handled by Korval asking if AWA wanted to roll-over certain unauthorised loans which were about to expire.

Crane could not find any recording of these loans and was confused. She then reported this to Alagna, the AWA chief accountant. At first, Alagna assumed that it was a minor accounting problem. However, as Alagna began to investigate the loans he became more concerned and increased his investigation. On Saturday 27 June 1987 he found two unrecorded loans from Westpac totalling AUD \$16 million which were only authorised by Korval.

Korval had no authority to take out such loans. Alagna reported his findings to the AWA chief finance manager Wickham, that these loans were not authorised by AWA. On 3 July 1987 Hooke was advised of the unauthorised loans. Further intensive investigation

by AWA and BBL discovered that at 30 June 1987 Korval had taken out \$49.8 million in unauthorised loans.

This prompt detection by Alagna was important in the Court case because the AWA lawyers Clayton Utz successfully argued that DHS should have also detected the loans much earlier than Alagna. They pointed out that DHS had uncovered knowledge of unauthorised loans at least a year before Alagna, but had failed to properly follow them up. On 15-9-1987, Hooke asked Daniels why he had not discovered the unauthorised loans. Daniels replied that he was not sure exactly why the loans weren't discovered. 'We are looking into that' (Court statement Hooke 15-9-1990, p.36). The Court accepted the argument, that if DHS had investigated the evidence that they did find, then they could have promptly alerted AWA management and prevented the loss of some of the \$49.8 million.

## **Appendix B**

### **Glossary of People Involved in the AWA case**

**Alagna**-AWA chief accountant who first discovered evidence of Korval's illegal loans. He was then able to quickly identify further substantial loans. This was important because the AWA prosecution argued that with the information DHS had discovered then they should have found these loans much earlier than Alagna.

**Anderson**-was an AWA director.

**Bathurst**- QC for AWA.

**Belfanti**- AWA internal audit manager and a long-time friend of Daniels since they both worked together at Yarwood Vane as junior auditors. Belfanti did uncover evidence of Korval's illegal transactions but he was diverted from his investigations by Korval's falsehoods.

**Binstead**- investment banker with Lloyds Bank.

**Blume**- DHS audit partner assisted Daniels in the 31 December 1986 AWA audit.

**Brentnall**- DHS audit senior responsible for the 6 month AWA foreign exchange audit ending 31 December 1986. Had no prior experience in foreign exchange but used his general audit experience to quickly discover substantial weaknesses in the foreign exchange operation. Brentnall warned of '...the practice of successive rollovers and the risks of concealment of large losses' (1995 AWA Appeal judgment, p.640). Brentnall did report weaknesses to Daniels and even prepared a detailed list, which he was prepared to present to the directors. Daniels decided not to take Brentnall to the board meeting. However, Brentnall missed a 'red flag' when he failed to follow up evidence of a USD 4.697 million BNZ loan.

**Bryant-** an Andersen audit partner called by the DHS legal team as an expert witness. He found that even though the auditing tests of DHS were not what Andersen would have done, they were enough, '...they weren't perhaps adequate to give as much assurance as an auditor might have wanted to have at the time' (Court proceedings Bryant 6-4-1992, p.35). Bryant considered that DHS had complied with the accounting standards. He was adamant that the accounting records though scruffy, were adequate for the 1985/86 accounts.

**Campbell-** AWA director.

**Clarke, Powell and Sheller JJA-** the three NSW Supreme Court judges hearing the Appeal. They reduced damages to \$6 million because they believed that there was no certainty that the director's would have changed their policy if DHS had brought the internal control defects to the board's attention. They confirmed Rogers J 's finding that DHS was negligent. The Appeal judges were equally critical of Daniels performance in not advising the directors, at two board meetings, of significant internal control weaknesses. The Appeal Court noted that Daniels signed the profit confirmation letter on 9-3-1987 before he had properly read the audit working papers. They found that Daniels would have been guilty of incredible negligence in failing to read the work papers but accepted Rogers J's finding that '...he simply failed to react appropriately to the situation they revealed' (1995 AWA Appeal judgment, p.648).

**Crane-** AWA foreign exchange assistant to Korval. In June 1987, she went to Alagna with evidence of unauthorised loans.

**Daniels-** DHS audit partner responsible for the AWA audit. Had been involved in the AWA audit since the 1950's. During 1985/86, Daniels became aware of significant weaknesses in the AWA foreign exchange operation but had too close an association with AWA management and failed to document or even report verbally those weaknesses to directors. Rogers J found that '...Daniels was taking a chance on the fact that whilst he

dallied to comply with custom, nothing could go wrong. That was negligence of the first order. Things went very wrong' (1992 AWA judgment, p.990). The Courts found Daniels negligent.

**Finley-** AWA deputy chairman and AWA director. Was instrumental in questioning Daniels at both the 22 September 1986 and 30 March 1987 directors meetings as to the situation in relation to foreign exchange. Even invited Daniels to a private meeting at his office on 30 May 1987, when he was still dissatisfied with the foreign exchange operation. Daniels did not pass on what he already knew about internal control weaknesses, poor records or unrealised profits.

**Freeman-** DHS audit partner assisted Daniels in the 1985-86 AWA audit.

**Gibson-**AWA general manager and long-time friend of Daniels. Frequently socialised with Daniels including regular Friday lunches and a trip on Sydney Harbour in AWA's yacht. Gibson welcomed Korvals foreign exchange profits, as the rest of AWA was not performing well. He did not seriously question Korval's methods in obtaining those profits.

**Hammond-** Price Waterhouse audit partner appeared for Lloyd's Bank.

**Heerding-**managing director of BBL (Barclays Bank).

**Hight-** Kenneth Hight was the managing director of Toronto Dominion.

**Hooke-** AWA chief executive officer and chairman of the board. Had no experience in foreign exchange and left control to Gibson. Hooke believed that he could rely unquestioningly on information supplied to him by senior executives. However, the transmission of information from AWA management to Hooke and to the board and in reverse was extremely haphazard. Hooke also ignored warnings from various financial

institutions that Korval was speculating on a large scale. Locke from BBL told Hooke on 5 November 1986 that there were ‘...very substantial unrealised losses arising out of our mutual dealings...’ (1995 AWA Appeal judgment, p.637), but Hooke failed to follow this up. The Courts also found Hooke negligent.

**Hughes-** divisional manager at AWA Ashfield.

**Korval-** AWA foreign exchange manager responsible for the loss of \$49.8 million. Korval speculated on a large scale with over \$700 million in exposed foreign exchange contracts. Korval believed that he could make quick, large profits without any risk of losses. There was substantial evidence that Korval gave false information to conceal his activities, that he took out unauthorised loans to cover foreign exchange losses and that he was partly motivated in his actions by a 560% bonus. Korval falsely told Belfanti that there were no loss-making contracts. ‘I have checked the list and it is all okay’ (Court statement Belfanti 4-2-1991, p.23). Korval never appeared in court.

**Laidlaw-** DHS audit manager from 11 July 1986.

**Lewis-** AWA director.

**Lloyd-** DHS audit senior responsible for the 1985-86 AWA foreign exchange audit. He had limited knowledge of foreign exchange. He accepted Korval's statement that ‘...the unrealised losses on the USD contracts will never eventuate into real losses’ (Court proceedings Lloyd 23-3-1992, p.12). Rogers J found Lloyd's audit actions confusing. He decided not to place any reliance on Korval's accounting records because the internal controls were weak but then used Korval's records to identify full circularisation of financial institutions. As a result, he did not uncover unauthorised loans that Korval had not included on his records. The AWA lawyers Clayton Utz argued successfully that Lloyd had failed to perform his audit responsibilities properly.

**Locke-** BBL bank manager. Advised Hooke on 5 November 1986 that the AWA foreign exchange operations were in a dangerous situation.

**Lonergan-** A C&L audit partner called by the AWA legal team as an expert witness. He was critical of DHS's failure to understand that Korval was speculating and not just hedging. Lonergan would have qualified the financial statements because the accounts were not drawn up in accordance with AAS 20 and in terms of the Companies Code and in '...particular in terms of AUS 1, there should have been a qualified report for the year ended 30-6-1986' (Court proceedings Lonergan 19-3-1992, p.31).

**Luders-** AWA foreign exchange assistant.

**Lynch-** AWA foreign exchange administration officer and Korvals assistant.

**Mackrill-** The AWA company secretary.

**McAlary-** QC appeared for DHS.

**Mileham-** AWA chief accountant responsible for Korval until 2 February 1987. He reported directly to the AWA General Manager Gibson. He did not understand foreign exchange but supported Korval's actions because he regarded him as a foreign exchange expert. Instrumental in convincing Lloyd that Korval's 'wrong way around' foreign exchange method was correct.

**Moffitt J-** the judge who delivered the Pacific Acceptance verdict in 1970. It is considered a landmark judgment on auditor responsibilities in both Australia and internationally.



**Murray-** DHS audit manager on the AWA audit, left DHS on 11 July 1986.

**Parkes-** director of Lloyds bank.

**Respinger-** head of Lloyds bank treasury department.

**Rogers J-** The NSW Supreme court judge who heard the original AWA case. He was critical of Hooke, the directors and Bryant but reserved his major criticism for the DHS audit team. It is surprising that Daniels escaped with just a severe lecture, because His Honour was extremely critical of Daniels decision to sign the profit statement. In his judgment, he found Daniels actions in that he was prepared to sign a profit statement on 9-3-1987 before all the returns from the circularisation had arrived ‘...was reckless indeed’ (1992 AWA judgment, p.978). He told Daniels that ‘why on earth didn't you say to Gibson at least, look, I am going to give you this letter but I have not had any response from two of the banks’ (Court proceedings Rogers J 3-4-1992, p.17). In summary, the judge referred to Burt J's judgment in the Manning case and the subsequent South Australian Full Court Van Reesema case in which no books were kept as a precedent.

**Sanford-** Duesbury's audit partner appeared for Westpac bank.

**Westworth-** An audit partner with E&Y called by the AWA legal team as an expert witness. He was critical of DHS's auditing procedures in that the 1986 audit should have put a reasonably competent auditor on notice of a high risk of unreported transactions. Westworth agreed with Lonergan about a lack of post-balance day reviews. He came to the conclusion that the weaknesses in the internal control system were so significant that they should have been promptly reported. He did ‘...agree that it is extremely rare to qualify for defective books and records’ (Court proceedings Westworth 18-3-1992, p.92).

**Wickham-**AWA chief finance manager responsible for Korval after February 1987. He did not understand foreign exchange but felt that he needed to support Korval because he

was aware that Korval was reporting substantial profits. He was conscious that Korval's profits represented a significant proportion of AWA's revenue and realised that as a new AWA manager he needed to maintain Korval's profitable revenue stream.

## Appendix C

### Chronology of Events in the AWA case

**1942.** Yarwood Vane begins auditing AWA accounts.

**1950.** Daniels commences employment at Yarwood Vane as a junior auditor on the AWA accounts. He stated that no audit engagement letter issued to AWA since at least 1950.

**1952-60.** Belfanti commences employment at Yarwood Vane as a junior in the accounting and then audit area. Becomes a friend of his work colleague Daniels.

**1967.** In November Belfanti commences work at AWA as internal auditor.

**1969.** No audit engagement letter had been forwarded to AWA since this date.

**1970.** Daniels appointed Yarwood Vane audit partner. Audit engagement letter not updated for next 16 years. The landmark Pacific Acceptance case was decided. Daniels believed that a custom of waiting until the audit exit meeting to formally discuss the audit findings was established about this time.

**1975-** Daniels was appointed the Yarwood Vane audit partner responsible for the AWA audit. He already had 25 years auditing experience at AWA.

**1979.** Yarwood Vane who had conducted the AWA audits since 1942 merged with DHS. Daniels retained his position as audit partner for the AWA audit.

**1981-** Marjorie Crane employed by AWA from 1981 to 1988 first as overseas accounts clerk and then from some time in 1987 in assisting Korval as a foreign exchange administrator.

**1983-** Australian dollar floated, commencing deregulation of Australian financial markets. Financial community including AWA unsure how to account for this new phenomena. Belfanti appointed AWA Internal Audit Manager. He never saw an audit engagement letter from DHS.

**October 1984-** AMP asked by Mileham to undertake a foreign exchange review. This was to cover all aspects of AWA's currency exposure position and to make recommendations as to actions required to achieve maximum management of the foreign exchange operation.

**February 1985-** Gibson appointed AWA general manager. Long time friend of Daniels.

**13-2-1985-** AMP's foreign exchange review recommendations received by Mileham, but not passed onto Hooke. The report dealt with various strategies open to AWA. Hedging nothing, hedging everything or hedging selectively.

**1-7-1985 to 31-12-1986.** No opening balances in foreign exchange for the 1985-86 financial statement. DHS decided not to undertake a systems review of the 1985-86 audit because AWA soon to computerise their accounting system.

**November 1985-** Foreign exchange department formed as profit centre with a global foreign exchange, rather than hedges linked to individual foreign exchange contracts. No written records or administrative and accounting procedures manual.

**December 1985-** Korval took over from Ashfield the responsibility for short-term money market and payment of overseas creditors. AWA started dealing in foreign currency to hedge to pay for imported goods. It now became a profit centre and Korval was paid a bonus for any profits.

**2-12-1985-** First entry made in a foreign exchange register, referred to as the green book. Entries not entered sequentially, and often entered in a batch long after the actual date of the deal and the green book was not maintained at all after 30 June 1986.

**1986-87.** AWA appeared to be making substantial profits from foreign exchange dealings. They had actually lost \$49.8 million due to foreign exchange speculation. Between 30 June 1986 and 18 August 1986, no records of any kind were kept.

**31-1-1986-** forward cover resulted in Korval reporting \$1.032 million foreign exchange profit and unrealised gains of \$1.887 million. This result was well above budget.

**10-3-1986-** Gibson told AWA board of directors that since late 1985 the Ashfield division had taken out forward cover against the JPY, and that Hughes, the Ashfield manager would be coming to the board meeting to speak on his report.

**30-3-1986-** foreign exchange cover discussed at the AWA board meeting. At March 1986 meeting, foreign exchange cover was discussed without any clear-cut written policy. Campbell a director, thought dealing limits were to be a maximum of one-year foreign exchange contracts (\$150 million).

**April 1986-** directors advised by Mileham that foreign exchange stop losses in place. Management prepared a revised memorandum on foreign exchange cover of 1 years-anticipated purchases.

**May 1986-** Korval began verbally borrowing on a small scale from banks. This later increased to larger loans from more financial institutions. Entries in the green book were now becoming more irregular. Evidence of batch recording in the green book, for example 87 deals dated May 1986 and 10 deals dated April 1986.

**26-6-1986.** Preliminary 1985-86 audit planning meeting. DHS decided not to rely on internal controls but instead relied entirely on bank confirmations because of Korvals inadequate records. Lloyd noted a \$2 million BBL contract dated 26 June 1986 not listed by Korval who told Lloyd it was a recording error.

**30-6-1986-** last entry in the green book. Between 30 June 1986 and 18 August 1986, no records of any kind were kept. Internal audit checked the green book after which time it was no longer kept. Lloyd noted that contracts were not recorded in the dealing register after this date and that at 30 June 1986, AWA had incurred a \$6.2 million loss. The net unrealised loss at 30 June 1986 was shown as \$300,000. There was a difference of approximately \$23 million between the contracts. Daniels and Lloyd agreed that the weaknesses in the system described in DHS's November reports existed prior to 30 June 1986. Lonergan found by 30 June 1986 that Korval was speculating on a large scale.

**7-7-1986-** Belfanti recorded that the green book was not up to date.

**11-7-1986.** Murray the DHS audit manager resigned.

**14-7-1986-** prior to a board meeting, Hooke requested Gibson to report on foreign exchange. Gibson reported to the board that AWA foreign exchange positions could not result in realised losses.

**15-7-1986-** Laidlaw replaced Murray as the DHS audit manager on the AWA audit.

**27-7-1986-** DHS sent a bank circularisation to BNZ requesting any outstanding foreign exchange contracts at 31 December 1986.

**July 1986-** the budget report for 30 June 1987 was tabled at the board meeting.

**15-8-1986.** Lloyd noted that no records were kept at all between 1 July 1986 and 15 August 1986.

**18-8-1986-** the general manager reported a foreign exchange trading profit of \$22.8 million. AWA commenced Lotus spreadsheet recording, however the system did not operate correctly. No proper records were kept until the Macquarie system and dealing slips were recorded from 1 July 1987 onwards.

**Aug 1986-**Lloyd noted that the green book had not been recorded since the end of June 1986. Stop losses ceased to be used by Korval meaning that the cap on foreign exchange losses was now removed.

**19-8-1986-** Laidlaw instructed Lloyd on the 1985-86 foreign exchange audit.

**22-8-1986-** Westworth would have tested or rolled back to 30-6-1986 from about this date.

**22-9-1986-** Daniels was invited to attend the AWA board meeting. Daniels referred the board of directors to an article in BRW, which he suggested explained managed hedging. Daniels failed to report to the director's the absence of proper internal controls over AWA's foreign exchange operations, even though Daniels was asked about foreign exchange by the directors.

**30-9-1986-** the board approved the 1985-86 accounts. The value of the open foreign exchange contracts now exceeded \$700 million.

**9-10-1986-** all 3 audit experts agreed that the post-date audit review should have been conducted between 1 July 1986 and the end of the audit period of 9 October 1986. Daniels signed off on the 1985-86 accounts. No contracts register was kept between October 1986 and April 1987.

**28-10-1986-** Daniels verbally reported at an audit exit meeting with Mileham, Belfanti and Alagna present that there were some weaknesses in the green book. Daniels did not convey the dangers or urgency of the situation. If Daniels had sent a management letter after this date, it would have provided directors with evidence of internal control weaknesses.

**Oct 86/ Apr 87-** Brentnall noted that no contracts register was maintained after Oct 1986. AAS 20 'Foreign Currency Translation' now mandatory.

**5-11-1986-** Heerding managing director of BBL warned Hooke that AWA had \$169 million in unrealised contracts in a potential loss situation.

**7-11-1986-** Hooke replied to Heerding advising him that contracts had now been reduced to \$113 million in a potential loss making situation.

**11-11-1986-** At the board meeting, Mackrill advised AWA directors of \$250 million held in foreign exchange contracts and that the foreign exchange profit for the 3 months ending September 1986 was \$8.8 million. Korval also made a presentation on the foreign exchange operations.

**November 1986-** Toronto Dominion told Mileham that Korval was rolling over loss making contracts and speculating heavily.

**4-12-1986-** Daniels wrote a letter to the board recommending improvements in the internal audit department but did not mention foreign exchange internal control weaknesses that had been known for 6 months and had been drawn to the attention of senior management without producing any improvement.

**11-12-1986-** Gibson requested Daniels undertake a six month audit for the period ending 31 December 1986 to provide AWA with a profit confirmation letter. Gibson wanted it



completed by the 9 March 1987 board meeting. AWA was under pressure from a potential take over offer from Christopher Skase. Daniels decided not to rehire Lloyd for the 6 month audit.

**15-12-1986-** Korval took out a BNZ loan of USD 4.697 million (approximately \$7 million AUD) which matured on 22 January 1987. Later, Brentnall noted the BNZ loan for \$4.697 million which Korval had not included on the bank confirmation list. It was still outstanding when Brentnall found it on 4 March 1987.

**December 1986-** DHS were found negligent by the courts in relation to the 31 December 1986 profit statement. AWA had no record of loans of \$38.8 million, which Korval had taken out to fund foreign exchange losses. Brentnall reported to Daniels losses sustained on foreign exchange operations. Total exposure was now approximately \$400 million.

**22-1-1987-** The date of maturity of the BNZ loan.

**31-1-1987.** Daniels failed to trace foreign exchange contracts closed in January 1987 to the listing of open contracts at 31 December 1986. He believed that the unrealised loss contracts at 31 December 1986 had been covered by the foreign exchange profit of \$12 million.

**2-2-1987-** Wickham was appointed AWA chief financial officer.

**6-2-1987-** Freeman circulated an AWA planning memo for the December audit.

**9-2-1987-** Gibson reported to the board of directors at the end of November that realised foreign exchange gains were \$8.308 million and by 9-2-1987 had grown to \$19.617 million. Represented in excess of \$11 million profit from foreign exchange in only 11 weeks. Experienced directors should have insisted on the details of the risks they were taking in making a million dollars a week in foreign exchange profits.

**20-2-1987-** Daniels instructed Brentnall on the 31 December 1986 audit prior to the beginning of the half year audit. DHS were aware of significant defects in the AWA foreign exchange operation for 8 months. Brentnall undertook the half-year audit work between 20 February 1987 and 6 March 1987. DHS failed to communicate internal control weaknesses to the directors prior to the 20 February 1987 planning meeting. This should have been done preferably in writing.

**25-2-1987-** Belfanti faxed DHS relating to an unauthorised loan of USD 822,000 from Macquarie bank. Daniels did not see this fax.

**27-2-1987-** Alagna signed and sent letters to BNZ, Midland, Lloyds, Chase, AMP, BT and Sanwa seeking information on outstanding foreign exchange contracts at 31 December 1986.

**February 1987-** Crane was now appointed the foreign exchange administrator assisting Korval. The Macquarie system was introduced, but did not work properly until July 1987. Korval reported approximately \$13 million foreign exchange profit for the first two months of 1987.

**1-3-1987-** telexes and rollover confirmations which had not been retained, sorted or filed, were now kept from this date by Crane.

**3-3-1987.** Brentnall told Daniels that there was an exposure of over \$200 million and that no proper dealing slips had been retained until 1 March 1987.

**4-3-1987-** BNZ returned a bank circularisation listing foreign exchange contracts outstanding at 31 December 1986. The document was titled 'Foreign Exchange Contracts Outstanding at 31-12-1986' and listed loans totalling AUD \$21 million. It not only included the loans listed by Korval but also some loans which Korval had not revealed to the auditors including a USD 4.697 (\$7 million AUD) loan. This loan had been opened

on 15 December 1986 maturing on 22 January 1987. This loan did not appear in Korval's records and thus represented a 'red-flag' that Brentnall should have followed up.

**5-3-1987.** Brentnall asked Korval about the BNZ loan USD 4.697(\$7 million AUD). Korval falsely told him that it was closed out prior to 31 December 1986. Korval claimed to have rung BNZ to confirm closure. Brentnall was negligent in not following up this BNZ loan and should have had the closure confirmed in writing by BNZ.

**6-3-1987-** Daniels and Freeman met Gibson and discussed contracts rolled over for last 12 months. Daniels told Gibson that four open foreign exchange contracts to buy JPY, sell USD were rolled over for about 12 months at historic rates. Brentnall had a deadline of 6 March 1987 to complete his audit and gave Daniels his completed audit work late in the afternoon.

**7/8-3-1987-** Daniels only had the weekend to review the audit work-papers although in court he could not remember actually looking at them.

**9-3-1987-** The dead-line date for DHS to complete the six months audit ended 31 December 1986. Daniels signed the profit confirmation letter (which Rogers J found grossly erroneous) for directors confirming \$16.068 million profit. Signed profit confirmation letter without checking if the unrealised loss contracts at 31 December 1986 were realised in profit in January 1987 and with some bank confirmations still not returned from the banks.

**10-3-1987-** AWA met Barclays Bank manager who pointed out the danger of AWA's foreign exchange historic rate rollovers. Mileham disagreed with Barclays and told them that Korvals aggressive dealing gave AWA greater accounting flexibility.

**13-3-1987-**Daniels met Hooke and advised him that (a) a day book of contracts had not been kept since October (b) only the banks were setting dealing limits (c) there was

inadequate segregation of duties (d) the Macquarie software was not being used or understood (e) open positions were substantially misstated (f) realised contract profits and losses could be rolled into future contracts instead of receiving cash, and (g) the overall down-side risk needed to be assessed.

**26-3-1987-** Brentnall prepared an extensive summary of foreign exchange weaknesses for the board on 30 March 1987, which he gave to Daniels. Daniels decided not to take Brentnall to the board meeting or advise directors of Brentnalls summary of weaknesses.

**30-3-1987-** The directors asked DHS to attend the board meeting on 30 March 1987 to discuss foreign exchange in detail. Daniels failed to reveal to the board the appalling state of AWA's foreign exchange internal controls and records. He also elected not to take Brentnall to the board meeting or to advise the directors of Brentnalls summary of weaknesses.

**31-3-1987-** Wickham advised Hooke that there was now a daily report on the foreign exchange position.

**March 1987-** Hooke was told by Lloyds Bank that Korval must be speculating. Hooke argued that DHS were satisfied with the foreign exchange operation.

**10-4-1987-** Hooke noted that AWA was now providing a daily report. He also noted that this was showing foreign exchange exposure increasing substantially.

**13-4-1987-** A board meeting was told by Gibson of a foreign exchange loss for March 1987. He also advised them that Lynch had been appointed foreign exchange administration officer.

**April 1987-** Korval was now informed that he had exposure guidelines and limits. The Macquarie system had now commenced. However, at no stage were effective dealing limits imposed.

**30-4-1987-** Belfanti distributed to DHS information outlining a foreign exchange loss of AUD \$1.648 million. This loan had only been authorised by Korval. Daniels claimed he did not see this information until November 1987. At no stage were effective dealing limits imposed.

**11-5-1987-** Gibson advised the board of the April foreign exchange loss of \$3.8 million. The directors expressed concern at the high level of foreign exchange trading.

**18-5-1987-**The DHS legal team in the court case argued unsuccessfully that the effects of DHS's negligence were spent by 18 May 1987. This was rejected by Rogers J.

**30-5-1987.** Director Sir Peter Finley invited Daniels to his home because he wanted assurance that DHS had investigated the whole area. Daniels did not pass on any information of weaknesses to Finley. Instead, he reiterated what he had told Finley at the 30 March 1987 audit meeting that DHS would look more closely at the foreign exchange operation in the 1986/87 audit.

**23-6-1987-** Belfanti noted the repayment of a Macquarie bank loan not recorded in Korval's records. He became aware of a cheque requisition for repayment of a loan to Macquarie bank. No ledger of foreign exchange transactions was kept until the Macquarie system was brought up to date during June 1987.

**25-6-1987-** Lloyds Bank told Hooke that AWA had an open position of USD 800 million and an exposure of USD 600 million.

**27-6-1987-** Korval was on leave due to a car accident. Crane took a phone call from Westpac asking if AWA wanted to rollover the loan due. Crane found no record of loans in AWA's books. She reported it to Alagna. He thought it was an accounting error but on further checking found 2 unrecorded Westpac loans amounting to \$16 million. Within a short time he was able to identify further unauthorised loans. He subsequently reported his findings to Wickham. Korval was later dismissed by AWA.

**29-6-1987-** Hooke was told by Lloyds Bank that AWA was not covering the second leg of the foreign exchange contracts. He was told by Wickham that foreign exchange unrealised losses were over \$18.7 million.

**30-6-1987-** Daniels had told directors at the 30 March 1987 board meeting that he would examine more heavily profit allocations in the subsequent 30 June 1987 audit. He believed that the 1986-87 audit was not qualified.

**June 1987-** No ledger of foreign exchange transactions was kept until the Macquarie system was brought up to date. AWA had now lost \$49.8 million in unauthorised foreign exchange transactions.

**1-7-1987-** Appropriate dealing slips were now being written up and kept. Lloyds Bank agreed to help Hooke unwind surplus cover and implement AUD to USD cover for AWA. No proper dealing slips had been written up or kept until 1 July 1987.

**2-7-1987-** Lloyds bank reported to AWA that they had found unrealised losses of \$21 million.

**3-7-1987-** Hooke was advised of Alagna's finding of unrecorded foreign exchange loans of \$16 million. Hooke immediately contacted Respinger the treasurer of Lloyds Bank and asked for his assistance. He wanted to be sure that an adequate foreign exchange system

was implemented. Hooke also promptly advised the directors who then closed out of all open positions.

**6-7-1987-** Lloyds Bank was now advised that AUD to USD cover was now in place.

**7-7-1987-** Lloyds Bank advised Hooke that imports were now protected for the next 12 months.

**27-7-1987-**DHS sent a bank circularisation to BNZ.

**July 1987-** An adequate system for conducting foreign exchange dealing was not implemented until July 1987. The AWA board first learnt that it had lost \$49.8 million in foreign exchange.

**15-9-1987-** Daniels met Hooke who asked him why DHS had not discovered the unauthorised loans.

**30-9-1987-**Wayne Lonergan an audit partner with C&L first report to Clayton Utz submitted on their investigations into the foreign currency and money market activities of AWA.

**16-11-1987-** Chairman of DHS sent Hooke an audit report for the year ended 30 June 1987 titled 'Inadequate Records Maintained and Retained'.

**November 1987-** DHS reported inadequate segregation of duties and inadequate system of internal controls titled 'Inadequate System of Internal Controls'. Daniels first saw two unauthorised loans, they were USD 822,000 from Macquarie bank and a foreign exchange loss of AUD \$1.648 million which had been referred by Belfanti on 25 February 1987 and 30 April 1987.

**end 1987-** Daniels ceases to be employed on the AWA audit.

**28-10-1988-** AWA brought proceedings against DHS to recover damages for breach of contract and negligence. DHS alleged that AWA's loss was caused or materially contributed to by its own fault and in addition cross-claimed to recover indemnity or contribution collectively against four of the directors, Hooke, Finley, Anderson and Campbell.

**21-5-1990-** Christopher Westworth an audit partner in E&Y prepared the first of his three reports for Clayton Utz in relation to the accounts of AWA at 30 June 1986 and 31 December 1986 and his analysis of the audits and examinations conducted by DHS for those periods.

**4-2-1991-** First statement of Belfanti the AWA internal audit manager for Clayton Utz.

**8-2-1991-** Bryant an audit partner with Andersen prepared the first report replying to Westworths report of 21 May 1990 for Madgwicks.

**18-3-1991-** Lonergan completed his report for Clayton Utz of the audits performed by DHS for the year ended 30 June 86 and the half-year ended 31 December 1986.

**20-3-1991-** Westworth completed the second of his reports for Clayton Utz on the quantum of damages for negligence against DHS with respect to the 30 June 1986 audit.

**17-4-1991-** Westworth completed an amended report for Clayton Utz on the quantum of damages for negligence against DHS with respect to the 30 June 1986 audit.

**17-5-1991-** Brentnall completed his first statement and Freeman completed his statement. Also Laidlaw completed his first statement for Madgwicks.



**24-5-1991-** Daniels prepared his first statement for Madgwicks.

**31-7-1991-** Bryant prepared the second of his three reports for Madgwicks replying to Lonergan for C&L's report of 18 March 1991.

**10-9-1991-** Bryant prepared the final of his three reports for Madgwicks replying to Westworths report for E&Y reports of 20 March 1991 and 17 April 1991 in which they quantified the amounts of damages they believed to flow from the DHS audits of 30 June 1986 and 31 December 1986 audits.

**16-6-1991-**AWA Court case commenced in NSW Supreme Court with Rogers J presiding.

**4-10-1991-**Report by Hickey for Madgwicks on the liability of the banks (Westpac, Lloyds and National Mutual Royal) for the loans provided to Korval in 1986.

**29-10-1991-** Blume prepared his statement and Daniels prepared his second statement for Madgwicks.

**6-11-1991-** Brentnall prepared his second statement for Madgwicks.

**23-12-1991-** Second statement for Madgwicks by Belfanti the AWA internal audit manager.

**24-12-1991-** Report by PWC for Freehill Hollingdale & Page on the liability of Lloyds Bank for the loans provided to Korval in 1986.

**6-1-1992-** Report by PWC for Freehill Hollingdale & Page in relation to audit confirmation correspondence provided by Lloyds Bank in 1987 and in relation to audit work conducted by AWA's internal audit department in 1986 and 1987.

**17-1-1992-** Daniels prepared his third statement and Laidlaw completed his second statement for Madgwicks. Also report by Duesburys for Minter Ellison in relation to audit confirmation correspondence provided by Westpac in 1987.

**10/11-3-1992-** Belfanti appeared in Court.

**18/19-3-1992-** Westworth appeared in Court.

**19-3-1992-** Lonergan appeared in Court.

**20/21-3-1992-** Lloyd appeared in Court.

**23-3-1992-** Lloyd was asked by Rogers J why he had not undertaken a comprehensive test of the internal control system.

**24/25-3-1992-** Brentnall appeared in Court.

**30/3-3/4-1992-** Daniels appeared in Court for 5 days.

**6/7-4-1992-** Bryant appeared in Court.

**4-5-1992-**the AWA Court proceedings ended after 51 sitting days

**3-7-1992-** Rogers J tabled his liability judgment in the AWA case.

**18-11-1992-** Rogers J apportionment judgment. AWA Ltd v Daniels t/a Deloitte Haskins & Sells & Ors (No 2) 10 ACLC 1643.

**7-4-1993-** Rogers J quantification judgment.

**3-5-1993-**Rogers J's orders to take effect on 3 May 1993. DHS ordered to pay AWA \$13,600,000 plus \$1,303,998.33 interest and Hooke ordered to pay DHS \$1,360,000 plus \$1,303,998.33 interest. Directions given for adjustments to the amount of damages and interest of changing company tax rates applicable to AWA. DHS and Hooke appealed. AWA cross-appealed.

**6-4-1994-**The Appeal by DHS against the original AWA judgment court proceedings commences in the Supreme Court of NSW (Court of Appeal).

**28-4-1994-** The Court proceedings in the Appeal case ended after 14 sitting days.

**15-5-1995-** Appeal judgment of Clarke, Powell & Sheller JJA tabled. DHS's appeal allowed in part, chief executive officer's appeal allowed and AWA's cross-appeal allowed in part. A reassessment of appropriate damages resulting from negligence of DHS reduced to \$6 million. In an historic judgment in the context of contributory negligence, the Appeal Court found that the trial judge was correct to regard the acts of management as the acts of AWA.

## Appendix D

### Glossary of terminology involved in the AWA case

**AAS20**-accounting standard 'Foreign Currency Translation' defined hedging as action taken, whether by entering into a foreign currency contract or otherwise, with the object of avoiding or minimising possible untoward financial effects of movements in exchange rates. The standard (in paragraph 27) recognised the distinction between hedging transactions relating to specific commitments and those designed to cover overall net actual or anticipated foreign currency exposures.

**AFDM**-integration of the theoretical audit expectation gap approach combined with the recent literature on the need for auditors to improve their audit fraud detection outcome, provides the theoretical framework for the development of the model that is developed in this study, entitled the Audit Fraud Detection Model.

**AISB**-Auditor Independence Supervisory Board as recommended by the Ramsay Report.

**Andersen**-Arthur Andersen was one of the major accounting firms at the time of the AWA audit. Bryant an Andersen audit partner was called as an expert witness in the AWA case. After 89 years Andersen ceased to exist from September 2002 as a result of its part in the Enron/Worldcom collapses.

**APC** UK Auditing Practices Committee

**APRA**- Australian Prudential Regulation Authority

**ASB**- USA Auditing Standards Board.

**ASIC**-Australian Securities and Investments Commission

**AUD-** the Australian dollar. In 1983, the AUD was floated against all other currencies. This resulted in uncertainty in foreign exchange transactions and the need for organisations such as AWA to set up foreign exchange departments and hedge or speculate on changes in foreign exchange transactions.

**AUS 210-** Australia's new audit standard 'The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report' has been active since June 2002. It is three or four times the length of the old AUS 210 'Irregularities, Including Fraud, Other Illegal Acts and Errors' and is specific about the need for auditors to look for fraud. However, it still states that primary responsibility for fraud is the responsibility of management. As a result of the upgrading of AUS 210, there is now an increased responsibility on the auditor to detect and deter fraud or illegal activity.

**AWA-** large Australian manufacturer, importer and exporter of electronic and electrical products. AWA purchased large amounts of electronic parts from Japan.

**BBL-**Barclays Bank. The managing director of Barclays Bank told Hooke on 5 November 1986 that the AWA foreign exchange operation was in a dangerous situation.

**BNZ-** Bank of New Zealand provided DHS with evidence of unauthorised accounts opened by Korval that were not recorded in AWA's green book. However, Brentnall failed to properly investigate the BNZ loans and accepted Korvals excuse that they had been closed. Investigation would have shown that these accounts were still open.

**Board of directors-**The AWA board of directors requested Daniels to address the board on 22 September 1986 and 30 March 1987. On both occasions Daniels was asked questions about the foreign exchange operation. Daniels failed to tell the board that there were serious internal control weaknesses at both board meetings. The board consisted of very experienced directors but lacked knowledge of foreign exchange operations. Sir Peter Finley was the board spokesman.

**CALPERS**-California Public Employees Retirement Scheme. Enron entered into a contrived scheme with CALPERS whereby if the share price fell, no losses were charged to Enron from reductions in Enron's share value.

**CHEWCO**-Enron management created Chewco to buy out Calpers interest in Jedi.

**Clayton Utz**-the AWA prosecution lawyers.

**C&L**-Coopers and Lybrand a major auditing firm involved in AWA case. Lonergan a C&L audit partner was called as an expert witness in the AWA case.

**CMA**- Cumulative Monetary Amount. The AWA internal audit used this sampling system. The monetary precision amounts used in the CMA sampling meant that most foreign exchange transactions, if entered in the accounting records, would be selected for vouching or sub-sampled for checking by the internal audit section. Unfortunately, many of Korval's foreign exchange transactions were not being entered in the accounting records.

**Cohen Report**-AICPA 1978 first coined the term audit expectation gap. Cohen's report added to the standard of audit fraud detection and recommended significant improvements in the effectiveness of auditors.

**Corporate Fraud Task Force**-set up by President Bush on 9 July 2002 to focus on corporate crime as a result of Enron/Worldcom.

**COSO**- Committee of Sponsoring Organisations of the Treadway Commission reported in 1999 in the USA.

**DHS-** Deloitte, Haskins and Sells are now one of the Big Four international audit firms. Recently changed name from Deloittes Touche Tohmatsu to simply Deloitte in UK. Prior to 1986, they had been the audit firm responsible for the AWA audit for over 35 years.

**ECS-**Exceptional Client Service was the motto of Andersen. However, (Cheffers 2002) found that it resulted in two conflicting tasks. Firstly, it meant pushing auditors to figure out new and more creative ways to make financial statements like Enrons appear better (less leveraged and greater margins on profits etc) but then to ask the same audit firm to look at the same transaction as a public watchdog.

**Enron** Enron collapsed on 2 December 2001, but the series of cover-ups and the failure of the auditors goes back a lot further. For example, in the annual report of 31 December 2000, Enron recorded an item of revenue 'other operating activities' USD 1.113 billion without any explanations. Enron also recorded a profit of USD 979 million but USD 763 million of this represented Enron marking up the value of its contracts which later proved to have no substance. The question can certainly be asked, where were the auditors? Enron was declared bankrupt on 2 December 2001 with pre-bankruptcy assets of USD 63.4 billion.

**Ernst & Young-** a major auditing firm at the time of the AWA case. Westworth an E&Y audit partner was called as an expert witness in the AWA case.

**FASB-**USA Financial Accounting Standards Board.

**GAAP-**USA Generally Accepted Accounting Practice.

**GAAS-**USA Generally Accepted Auditing Standards.

**HHH**-Evidence to the HHH Royal Commission was that the published accounts were incorrect by more than \$1 billion in 1999 and that takeover target FAI's books had covered up a \$350 million deficiency in 1998. Counsel assisting the Royal Commission Wayne Martin QC said that in deliberations over whether to certify the accounts as true and fair, that in virtually every instance of controversy Andersen ultimately yielded to management's view of the accounting treatment to be adopted. This invariably had the effect of overstating profitability and understating liabilities.

**IASB**- International Accounting Standards Board

**IFAC**-International Federation of Accounting Confederation

**JEDI**-joint venture between Enron and Calpers. Actually contrived to take Enron losses off the balance sheet.

**JPY**- Japanese Yen. AWA needed to buy approximately \$150 million a year in electronic parts from Japan. They were concerned about the variation in foreign exchange between the date of purchase and the date of settlement. The market in AUD/JPY was too thin therefore AWA had to undertake two steps. Firstly, buy JPY/sell USD and the second leg, buy USD/sell AUD.

**KPMG**-current Big Four auditing firm. Were the auditors of Enron partnerships which have the potential for liability exposures of a very significant amount.

**LJM's**-Enron used these vehicles to promote a better looking financial statement. The end result was to hide more than USD 1 billion in losses arising from numerous transactions and projects.



**Lotus-** spread sheet system designed to record foreign exchange transactions after 30 June 1986. The appeal court (1995 AWA Appeal judgment, p.625) noted that the Lotus system never worked efficiently.

**Macquarie-**In February 1987, a software system designed to record foreign exchange transactions was provided by Macquarie bank. The Appeal Court noted that the Macquarie system did not work accurately until July 1987 (1995 AWA Appeal judgment, p.625). It also had the same problem as the previous green book and Lotus system in that it could only enter those transactions recorded by Korval.

**Macdonald Report-**The Macdonald Commission in Canada (CICA 1988) investigated the detection of fraudulent or illegal activities by auditors. They drew attention to the way in which the possibility of fraud should affect the planning and performance of audits.

**Madgwicks-**the DHS defense lawyers.

**Manning case-**In the Manning case Burt J ruled that in accordance with the Companies Act 1961, that a company must keep those books necessary to exhibit and explain the transactions and financial position of the trade or business of the company at all times and at any time. Rogers J and the Appeal judges treated the Manning case as an important precedent.

**NYSE-** New York Stock Exchange

**O'Malley Panel-**This research drew extensively on the findings of the 2000 O'Malley Panel Report. It was a ground-breaking report that focused on the weaknesses in the detection of fraud or illegal activity by auditors

**Pacific Acceptance-** 1970 audit negligence case. This judgment is considered to be an international landmark decision outlining the requirements that any auditor must

undertake in order to reasonably perform the audit when fraud or illegal activity is involved.

**POB**-USA Public Oversight Board. Oversaw the O'Malley Panel Report.

**PWC**-PricewaterhouseCoopers are currently one of the Big Four auditing firms. Sherron Watkins a senior Enron internal audit manager specifically named PWC as possibly implicated in the Enron case.

**QPR**-Quasi Peer Review in the 2000 O'Malley Panel review of auditing practice.

**RAPTOR**-Raptor was one of the dummy vehicles set up by Enron to sell equity which was falsely disguised as cash sales.

**Ramsay Report**-In October 2001, Professor Ramsay completed a report on the independence of Australian Company Auditors. This report recommended the establishment of an Auditor Independence Supervisory Board (AISB), emphasised the importance of the audit committee and recommended mandatory disclosure of non-audit services and the use of the AISB in monitoring the disclosure of non-audit services.

**SAS 82**-USA Standard 'Consideration of Fraud in a Financial Statement Audit' required an auditor to exercise professional scepticism and neither assume that management is dishonest nor assume unquestioned honesty. This standard was rewritten and called SAS 99 on 15 October 2002. The accounting standard was rewritten to create more focus on fraud detection. Key provisions are increased emphasis on professional scepticism, discussions with management on areas of concern, unpredictable audit tests of areas not expected by the client and responding to management override of controls.

**SEC**-USA Securities Exchange Commission.

**SPE's-Enron Special Purpose Entities.** Enron used SPE's extensively to distort the true results according to GAAP and attempted to present an inflated earnings result.

**Treadway Report-USA** AICPA 1987 recommended that auditors be required to assess the risk of fraudulent financial reporting when planning and conducting an audit. It developed a set of procedures called the Good Practices Guidelines for Assessing the Risk of Fraudulent Financial Reporting. The guidelines concentrated on the environmental factors in providing insight into the causes of fraudulent financial reporting and pointed to the wide range of factors that can influence it.

**Unnumbered deal slips-**Lloyd noted in August 1986 that Korval only had contract entries in the dealing register up to June. There were large amounts of paper on his desk, evidence of records being entered in batches well after the date of the transactions, contracts being entered on unnumbered slips of paper as well as the dealing register not being maintained after 30 June 1986.

**USD-** the United States dollar. All foreign exchange contracts had to be done through the USD as the market in AUD/JPY was too thin.

**Van Reesema case-**In this case the South Australian Full Court referred to the Manning case and stated that it was hardly necessary to say that the obligations would not be met simply by keeping source materials from which a set of books could be written up. The AWA Appeal Court referred to this case as a precedent and found that '...the accounting records must be kept on a regular basis. AWA's foreign exchange accounting records were not' (1995 AWA Appeal judgment, p.651).

**White-collar crime-**generally referred to crime such as fraud or illegal activity undertaken by professionals or management, hence white collar. Has normally resulted in a much lower jail penalty than similar amounts stolen by armed robbers or other blue-collar crimes.

**WA Chip-** a 1987 audit negligence case involving illegal unauthorised borrowing. Considered important because it raised the level of management which the auditor must report to if fraudulent or illegal activity occurred.

**Worldcom-**Worldcom collapsed shortly after Enron and that meant that Andersen was now doomed to extinction. The amount of the collapse even exceeded the size of Enron's collapse and set a new record. Similar poor auditing practices evident in Worldcom which was declared bankrupt on 21 July 2002 with pre-bankruptcy assets of USD 103.9 billion.

**Yarwood Vane-**Yarwood Vane was the original audit firm responsible for the AWA audit. It merged with DHS in 1979 and Daniels who had been the Yarwood Vane audit partner responsible for the AWA audit retained his previous position with DHS.

## **Appendix E**

### **The Relevance of AAS20 to the AWA case**

1. Other accounting standards relevant to the AWA case.
2. The AAS 20 standard.
3. The DHS Audit Teams Assessment.
4. Result of classification as specific hedges.

#### **1. Other Accounting Standards Relevant to the AWA case**

##### **1.1 Fraud and Irregularities**

In June 1983, AUP 16 Statement of Auditing Practice 'Fraud and Error' was introduced. In June 1992, ED 48 'The Auditors Responsibility for Detecting and Reporting Irregularities including Fraud, other Illegal Acts and Error' was presented. In March 1993, AUP 16 was revised as 'The Auditors Responsibility for Detecting and Reporting Irregularities Including Fraud, other Illegal Acts and Error'. In February 1994, the Auditing Standards Board issued ED 54 'Codification and Revision of Auditing Pronouncements' and suggested a new auditing standard AUS 210 'Irregularities including Fraud, other Illegal Acts and Error'. On 1 July 1996, AUS 210 replaced AUP 16.

The USA legislation includes SAS 53 'The Auditor's Responsibility to Detect and Report Errors and Irregularities' which was replaced in February 1997 by the AICPA by SAS 82 'Consideration of Fraud in a Financial Statement Audit' which became effective for audits beginning on or after 15 December 1997.

The UK audit legislation includes Statement of Auditing Standard 110 'Fraud and Error', was issued in January 1995. The current International Standard is ISA 240 'Fraud and Error'.

## **1.2 Foreign Currency Translations**

Accounting Standard AAS 20 'Foreign Currency Translations' was issued in October 1985. ASRB 1003 'Foreign Currency Translations' was approved on 30 September 1987 and effective from 1 January 1988. A revised version ASRB 1012 'Foreign Currency Translations' was effective from 30 September 1988.

## **1.3 Audit Engagement Letters**

In June 1983, Statement of Auditing Practice AUP 9 'Audit Engagement Letter to Clients' was issued. In December 1993, the Auditing Standards Board issued ED 53 'Codification and Revision of Auditing Pronouncements: AUS 204 'Terms of Audit Engagements''. On 1 July 1996, AUS 204 'Terms of Audit Engagements' replaced AUP 9 'Audit Engagement Letter to Clients' from 1 July 1996. In September 1999, AUS 204 was reviewed and revised in ED 74 'Terms of Audit Engagements'.

## **1.4 Internal Control**

In February 1977, Statement CP 2 'Internal Audit as it effects the External Auditor' was issued. In January 1983, AUP 12 'Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit' became effective. In January 1992, ED 45 'Consideration of the Internal Control Structure and its Impact on Risk Assessment in a Financial Report Audit' amalgamated AUP 12 with AUP 30 'Inherent and Control Risk Assessment and their Impact on Substantive Procedures'.

In March 1993, a revised AUP 12 was issued. It superseded AUP 12 and AUP 30. In February 1994, ED 54 'Codification and Revision of Auditing Pronouncements: AUS 402 'Risk Assessments and Internal Controls''. Then in October 1995, AUS 402 was issued and became operative from 1 July 1996.

## **2. The AAS20 Standard**

Section 27 states that hedges of specific commitments include those related to the establishment of:

(a) the price of goods or services to be purchased or sold.

Section 28 states that with the exception of hedge transactions of the type contemplated in paragraph 27 (a), any exchange differences arising on hedge transactions (whether they relate to specific commitments or otherwise) ought to be recognised in the profit and loss account or its equivalent in the period in which they arise (that is, when the relevant exchange rates change).

Section 29 states that where a hedge transaction of the type referred to in paragraph 27 (a) occurs (which is a specific commitment) the gain or loss on that hedging transaction up to the date of purchase or sale may be deferred. Any costs or gains arising at the time of entering into that transaction need to be deferred and included in the measurement of the purchase or sale transaction.

Therefore, AAS20 is quite explicit in that only those specific commitments that relate to the price of goods or services to be purchased or sold do not have to appear in the current profit and loss account.

## **3. The DHS Audit Teams Assessment**

Daniels was advised by the DHS audit team that the foreign exchange contracts were general and not specific. Daniels decided to ignore his audit teams advice and instead agree with Korval that they were specific. Korval "...was critical of the construction of AAS20..." (Court proceedings Lloyd 23-3-1992, p.24) and wanted his foreign exchange contracts classed as specific so that his gross exposure position of \$147.5 million did not need to be shown as a note to the 1985-86 accounts.

The most senior of the audit team was Freeman (appeared in Court on 26 March 1992) who was himself a DHS audit partner assisting Daniels in the AWA audit. In his statement of 17 May 1991, he stated that he had advised Daniels that AWA's hedges were general hedges and not specific in relation to AAS20.

Laidlaw the DHS audit manager in his Court statement of 17 May 1991, noted that the treatment of the realised profit from foreign exchange trading in relation to '...accounting standard AAS20 was the subject of considerable discussion during the audit' (Daniels Court proceedings 2-4-1992, p.18).

Lloyd noted that Korval adjusted his open position so that when the foreign exchange contracts came to be completed, there was little or no possibility of identifying the remnants of the traded position amongst the aggregate open positions of AWA. Lloyd was the auditor responsible for the foreign exchange audit and he felt that there were few specific contracts written by AWA.

Lloyd produced a report discussing the appropriate treatment of the foreign exchange contracts and the profits and losses. Lloyd discussed this with Daniels, Laidlaw and Freeman. Daniels decided that because AAS20 was not yet in effect, that they would not comply with the standard in that years accounts.

In Lloyds Court proceedings of 20 March 1992 and 21 March 1992, he stated that even though the accounting standard AAS20 was not yet mandatory (but compulsory only one month later), in his opinion it was still considered appropriate for the auditor to comply with the standard. Lloyd believed that the foreign exchange contracts '...could not be classified as specific hedges under the definition of the standard' (Court proceedings Lloyd 24-3-1992, p.10). Compliance with AAS20 would have had a significant effect on the accounts and could have been discussed with the board of directors of AWA. Non-compliance with AAS20 meant that \$5.4 million in unrealised losses was not brought to account in the 1985-86 accounts.



Importantly, it meant that an exposure of \$297.5 million was not disclosed as a note to the accounts. The directors were adamant that if knowledge of such a large exposure had been made known to them, then they would have taken the same action they took when Alagna later discovered \$17 million in unauthorised foreign exchange loans.

Lloyd came to the conclusion that you could not identify any of the contracts as being specific hedges under the definition of AAS 20, therefore they should be classed as general hedges. Freeman agreed with both Lloyd and Laidlaw that ‘...the AWA hedging was general’ (Court proceedings Freeman 26-3-1992).

Daniels ignored the opinions of his audit team that the contracts were general and that they should be included in the current profit and loss account. Instead, he took the advice of Korval who was critical of the authors of AAS20 and was primarily interested in not having to account for his unrealised losses. He told the audit team that he would hold the foreign exchange contracts until the AUD was restored to parity with the USD at which time he would close out the contracts and bank the profits. He told the auditors that ‘...the unrealised losses on the USD contracts will never eventuate into real losses’ (Court proceedings Lloyd 23-3-1992, p.12).

#### **4. Results of Classification as Specific Hedges**

The result of classifying the contracts as specific hedges instead of general hedges was that an important signal to the directors that the foreign exchange operation was not operating correctly was missed. If general hedges then they would have had to been brought to account in the current financial year results.

Korval had \$362 million (before netting off) in exposed foreign exchange contracts which represented over three years of AWA's requirements in import contracts in electronic parts. There was no doubt that his hedges were general and not specific and if he had been forced to account for them in the profit and loss account, then the directors would

have been warned that the foreign exchange operation was both highly exposed and speculative.

The result of Daniels decision not to comply with AAS 20 also meant that \$5.4 million in unrealised losses was not brought to account in the 1985-86 accounts. Daniels decision meant that the directors were not advised that Korval's foreign exchange contracts were not specifically aligned to the need for purchasing electronic parts from Japan as the board had directed.

Another point was that Daniels decision resulted in the directors being denied vital information on Korvals speculative activity. Daniels decided to treat the contracts as specific ‘...after taking into account, AWA’s view that they were specific’ (Court proceedings Daniels 31-3-1992, p.41). If AWA had been required to include in the notes to their accounts the fact that they had speculative foreign exchange contracts of \$297.5 million then this would have acted as a warning to the directors.

All the directors reported in their statements that if they had been advised that Korval was speculating on such a large scale, then they would have taken prompt action to ensure that the speculation ceased. Once they became aware of the situation they did take action. They closed all open contracts when they were advised in June 1986 by Alagna, the AWA accountant, of evidence of \$17 million of Korvals unauthorised foreign exchange contracts.

Daniels met the directors on 22 September 1986 and the AAS20 standard came into effect shortly after on the first of October. Daniels should have at least advised the board that they would have to comply with the AAS 20 standard in the next financial years accounts and that the directors would have to take measures to implement this new standard. Again, if Daniels had provided this information to the directors it would have given them the opportunity to realise the large-scale speculation of Korval. Korval was very open

about his speculation and told Lloyd ‘...that anything to do with foreign exchange is speculating’ (Court proceedings Lloyd 23-3-1992, p.24).

## **Appendix F**

### **The O'Malley Panel**

1. Introduction.
2. O'Malley Panel General Findings.
3. O'Malley Panel Recommendations to the Auditing Standards Board.
4. Forensic-Type Fieldwork Phase.
5. Rationale for the Forensic -Type Fieldwork Phase.
6. Auditor Scepticism.
7. Rationale for Audit Scepticism.
8. Higher Quality Audits.
9. Rationale for Higher Quality Audits.
  - 9.1. Retrospective Audit Procedures.
  - 9.2. Non-Standard Entries.
  - 9.3. Interim Period Reports.
  - 9.4. Audit Liaison with Audit Committees.
10. Summary.
11. Current Situation

## **1. Introduction**

In October 1998, in the USA at the request of Arthur Levitt who was at that time chairman of the SEC the POB appointed a Panel of Audit Effectiveness of eight members, charging it to thoroughly examine the current audit model.

The United States Panel on Audit Effectiveness, commonly referred to as the O'Malley Panel after Shaun O'Malley a former chairman of Price Waterhouse who was appointed chair of the Panel, reported on 31 August 2000 (Report and Recommendations). The O'Malley Panel was charged with assessing whether independent audits of the financial statements of public companies adequately serve and protect the interests of investors.

The O'Malley Panel (2000, pp .75-98) included an extensive analysis of the auditor's role in earnings management and fraud. It examined the professional standards that define fraud and that provide guidance to the auditor on the detection of fraud. It also explored the concept of earnings management and the quality of earnings and how earnings management may lead to or constitute fraud.

The O'Malley Panel (2000, p.75) importantly recommended a forensic-type fieldwork phrase, which should be included in every audit to increase the likelihood that auditors will detect fraudulent financial reporting. The auditor was to specifically concern themselves with fraudulent acts that could cause a material misstatement in the financial statements.

The O'Malley Panel noted that a financial statement audit performed in accordance with GAAS is not a fraud audit or a detailed forensic-style examination of evidence. They agreed that converting GAAS audits to fraud audits would involve costs far in excess of the benefits and would still only provide reasonable, not absolute assurance that those material misstatements would be detected.

The O'Malley Panel also noted that USA accounting standard SAS 82 'Consideration of Fraud in a Financial Statement Audit' requires an auditor to exercise professional skepticism, which includes a questioning mind and a critical assessment of audit evidence. SAS 82 also requires the auditor to neither assume that management is dishonest nor assume unquestioned honesty. This differs from a forensic auditor who would generally assume dishonesty unless there is evidence to the contrary.

The O'Malley Panel clarified what they meant by the following terms, which they found to be important to audit fraud detection.

**(a) Misstatements**

Two types of intentional misstatements are relevant to the auditor's consideration of fraud. Firstly, misstatements arising from fraudulent financial reporting and secondly, misstatements arising from misappropriation of assets. Fraudulent financial reporting, which involves intentional misstatements or omissions of amounts or disclosures in financial statements, perhaps as part of a scheme to manage earnings. Misappropriation of assets (defalcation) involves the theft of an entity's assets, accompanied by financial statement misrepresentation.

**(b) Earnings Management.**

The term earnings management covers a wide variety of actions by management. It can range from legitimate managerial activities at one end of the spectrum to fraudulent financial reporting at the other. Earnings management involving intentionally recognising or measuring transactions and other events and circumstances in the wrong accounting period or recording fictitious transactions both constitute fraud.

Earnings management that constitutes fraud is distinctly different from earnings management that is perceived as reducing the quality of earnings. However, determining

whether or when the behavior in the earnings management crosses the line from legitimacy to fraud in a specific situation is not always easy. At some point in the continuum, the motivation behind earnings management may become strong enough to result in fraud.

### **(c). Management Override.**

Management possesses the power to manipulate the accounting records and prepare fraudulent financial reports if it is so inclined. It can also override controls by directing or enlisting staff members to assist. Therefore, it is important that the board of directors and management promote high ethical standards and install appropriate controls to prevent and detect fraud.

This will significantly reduce, but not eradicate, the opportunities for management to commit fraud. Concealment of fraud from the auditors can be very difficult to detect and for that reason adequate planning is necessary to successfully assess the risk of fraud or illegal activity.

### **(d) 'Trickle to a Waterfall' Fraud**

Academics have conducted a substantial amount of research on fraud, which suggests that fraud often starts out small, like a trickle, where the participants do not believe that they are stepping over the line. They honestly believe that they are legitimately managing earnings and exploiting ambiguities in the accounting rules.

However, this trickle soon becomes a waterfall when this borrowing accelerates and the perpetrators end up either taking positions that are indefensible or developing a scheme for concealment that will avoid discovery. Interim periods are particularly troublesome because management may rationalise borrowings as a temporary loan to be replaced before the end of the financial year. Management may rationalise their manipulations as

an attempt to avoid earnings volatility and surprises and therefore undertaken in the shareholders best interests.

The manipulations may grow but still escape detection by the auditors or, if found may be judged to be immaterial errors. When these manipulations come to light and they are material, they often lead to a restatement of the financial statements and usually to allegations of audit failure. Restatements of previously audited financial statements raise questions about whether the system that provides assurances about both the quality of audits and the reliability of financial reports are operating effectively.

## **2. O'Malley Panel General Findings**

The QPR findings in the areas of fraudulent financial reporting and misappropriation of assets were provided. The O'Malley Panel believes that the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management. It believes that audit firms should aspire to 'zero defects' as their goal and endeavor to eliminate audit failures completely.

The O'Malley Panel also believed that professional scepticism should mean more than only words in the auditing standards, it should be a way of life for auditors. The objectives in an audit should include detecting material financial statement fraud. By meeting that objective, audit will serve to deter fraud as well as detect it.

The O'Malley Panel also accepts the premise that a GAAS audit is not, and should not become, a fraud audit. It accepts the premise that reasonable, not absolute, assurance is a sufficiently high standard of responsibility. However, the O'Malley Panel is concerned that auditors may not be requiring as much evidence to achieve reasonable assurance as they have in the past, especially in areas where they believe that risk is low.



The O'Malley Panel was concerned that in the past 15 years, audit firms may have reduced the scope of their audits and their level of testing. They should redesign their audit methodologies to ensure that adequate audit testing is undertaken. The O'Malley Panel recognises that the primary responsibility for the prevention and detection of fraud rests with management, the board of directors and the audit committee. Management should create a culture that deters fraud and should set and communicate clear corporate policies against improper conduct.

However, the O'Malley Panel placed a high expectation on auditors to serve an important role in detecting material financial statement fraud. They found that the auditor must not only deter but also take a leading role in detecting fraud. They believed that their recommendations '...would improve the likelihood that auditors would detect fraudulent financial reporting' (O'Malley Panel 2000, p.85).

To meet the aim of zero defects, audit training programs oriented towards fraud detection should be undertaken. These training programs should include case examples showing how defalcations might be effected, the types of controls over the safeguarding of assets that are effective in preventing and detecting defalcations and in examining how defalcations are concealed.

### **3. O'Malley Panel Recommendations**

The O'Malley Panel recommends stronger auditing standards to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will detect fraudulent financial reporting. These new requirements would be over and above those that are now contemplated by a GAAS audit.

At the planning and supervision stage, the O'Malley Panel recommends discussion by supervisory engagement personnel (including the auditor with final authority, usually the

engagement partner) with other engagement team members about the vulnerability of the entity to fraud.

This discussion should encompass what is expected of team members in dealing with the potential for fraud in the specific areas of the audit assigned to them. An important objective of these discussions would be to identify the appropriate engagement team members to address the potential for fraud. The objective of a strengthened auditing standard should be to ensure substantive dialogue about how fraud might be perpetrated. This dialogue should guide how engagement team members address the possibility of fraud.

The O'Malley Panel made a considerable number of recommendations (over 250) and three of them were particularly relevant to my current research project.

#### **4. Forensic-type Fieldwork Phase**

The first recommendation was that a forensic-type fieldwork phase should be introduced into the auditing process. The O'Malley Panel was concerned that the current SAS 82 auditing standard fell short in effectively deterring fraud or significantly increasing the likelihood that the auditor would detect material fraud '...largely because it fails to direct auditing procedures specifically towards fraud detection' (O'Malley Panel 2000, p.86).

The O'Malley Panel believed that this new forensic-type phase should become an integral part of the audit. A forensic-type fieldwork phase was not meant to convert a GAAS audit to a fraud audit, rather a forensic-type phrase sought to convey an attitudinal shift in the auditor's degree of scepticism.

The O'Malley Panel was concerned about the high level of trust currently placed by the audit on the internal control system. Internal control systems, which are judged by the audit as operating effectively, tend to influence the extent of and the nature of the tests. However, management can influence the timing and execution of the transactions and

when they are recorded in the accounting system. They can override the best of internal controls.

In order to undertake this forensic phase, the O'Malley Panel believed that auditing standards should require the performance of substantive tests directed at the possibility of fraud, including tests to detect the override of internal control by management. High-risk areas should be identified by the audit team, these should include those areas where the opportunity to perpetrate fraud is higher than normal.

These tests should be either tests of detail or substantive analytical procedures, but not tests of controls. This is because tests of controls may not be effective in detecting fraud as management can override controls. The external auditor should not rely on the work of internal auditors in carrying out tests directed at the possibility of fraud.

The audit should target in the auditing of financial statements where the highest (O'Malley Panel 2000, p.96) possibility for human intervention, especially management override, exists in the financial statement preparation process. This would be an important step in designing the auditing work for the forensic-type phase.

A forensic phase in all audits is essential when we consider that '...some of the recent audit and accounting failures appear to centre upon fraudulent behaviour which was not identified by the auditors' (George 2002b, p.5). Auditors have correctly come under intense scrutiny because of these recent failures.

This is not a new phenomenon, because as long ago as 1885 the UK Accountants Journal as a result of similar failures reminded auditors of the care they should exercise to verify any statement of accounts and that '...it was by carelessness and inaccuracy in such matters that the public and companies were defrauded' (Chandler 1996 et al, p.6). Over one hundred years later, it is certainly time for the auditing profession to undertake measures such as a forensic phrase to reduce the likelihood of future audit failures.

## **5. Rationale for the Forensic-Type Fieldwork Phase**

In the recent corporate collapses at Enron /Worldcom there was significant evidence of a failure of the auditors to detect significant illegal activities in these organisations. The public as well as the financial community is asking why the illegal activities were not detected and most importantly, what measures the audit profession is taking to ensure that the auditor will detect fraud or illegal activity in the future.

A significant starting point would be to implement the O'Malley Panel recommendations including a '...forensic-type fieldwork phase to improve the likelihood that auditors will detect fraudulent financial reporting' (O'Malley Panel 2000, p.75). This would represent a positive response to the current audit expectation gap problem. It will provide the audit profession with the tools necessary to turn around the current low image of the auditor and to act as an effective future deterrent to fraudulent or illegal activity by management or corporations.

The O'Malley Panel did acknowledge an increase in the time and cost involved in undertaking the forensic phase of the audit. They acknowledged the question of the extra cost and time required when a number of respondents to the exposure draft suggested that it '...would result in numerous, extensive and unnecessary or ineffective procedures' (O'Malley Panel 2000, p.95).

The O'Malley Panel rejected the costs involved in a full fraud audit. The O'Malley Panel found that '...converting GAAS audits to fraud audits would involve costs far in excess of the foreseeable benefits to the public' (O'Malley Panel 2000, p.76). The introduction of a forensic-type phase in all audits would provide this reasonable level without any significant additional increase in costs.

The O'Malley Panel recognised that implementing this recommendation 'will increase audit costs for most entities' (O'Malley Panel 2000, pp.7-8). However, the O'Malley

Panel expected that the benefits would far outweigh the costs of the forensic-type phase. For example, the SEC reported that in 1999 audit fees were USD 9.5 billion whilst NBC reported that in 1999 investors lost over three times that amount in USD 32 billion as a result of a restatement of financial statements.

The O'Malley Panel felt that the introduction of a '...forensic-type fieldwork phase' (O'Malley Panel 2000, p.88) should become an integral part of every audit. A forensic-type fieldwork phase '...seeks to convey an attitudinal shift in the auditor's degree of scepticism' (O'Malley Panel 2000, p.88). The O'Malley Panel was concerned that auditors were not currently questioning management sufficiently.

The O'Malley Panel believed that auditors should accept greater responsibility for fraud detection. However, even though the introduction of a forensic phase does not mean that the auditor is now performing a fraud audit, this may not be readily apparent to the general public. The addition of a forensic-type fieldwork phase may result in the community assuming that auditors will now detect all fraud or illegal activity. Unless the public is educated to the limitations of a forensic audit phase, then a failure to reach this high level may actually increase the audit expectation gap.

The O'Malley Panel concluded that the auditor is best placed to assess management's preventative and detection controls over fraud and that this is an important consideration in deciding on the nature and extent of testing in the forensic-type phase. Auditors need to consider whether the controls deal with fraudulent financial reporting as opposed to, for example, misappropriation of assets or illegal acts only indirectly related to the financial statements.

## **6. Auditor Scepticism**

The second recommendation was that of audit scepticism. The O'Malley Panel was concerned that even though professional scepticism was already a part of the auditing standards, '...but auditing standards need to provide better guidance on how to implement that concept' (O'Malley Panel 2000, p.85). The O'Malley Panel suggested that '...the auditor should modify their otherwise neutral concept of professional scepticism' (O'Malley Panel 2000, p.91) and replace it with a presumption of the possibility of management fraud. Auditors should ask themselves, where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?

## **7. Rationale for Audit Scepticism**

The O'Malley Panel noted that the objectives in an audit should include the detecting of material financial statement fraud and that goal should drive both auditing standards and the way they are applied and '...by meeting that objective, audits will serve to deter fraud as well as detect it' (O'Malley Panel 2000, p.82).

There is clearly a need for improved training of auditors in forensic auditing techniques. The O'Malley Panel found that auditors interviewed in focus groups '...expressed uncertainty about their responsibility to detect fraud' (O'Malley Panel 2000, p.85). The focus groups also found that auditors were uncertain about their ability to detect fraud, especially collusive activities or falsified documentation. While auditors expressed knowledge of forensic auditing techniques 'No evidence pointed to any significant use of such techniques in GAAS audits' (O'Malley Panel 2000, p.85).

Auditing standards often do not provide sufficient guidance or information to adequately implement the concept of professional scepticism because management usually is judged as possessing integrity, despite the fact that management (if lacking integrity) has the greatest opportunity to perpetrate fraudulent financial reporting.

GAAS also dismiss collusion as impossible or too difficult to detect and pointedly explain the lack of expertise of auditors with respect to determining the authenticity of documents. The O'Malley Panel acknowledges that these factors are and will continue to be inherent limitations of an audit. The O'Malley Panel found that all or most financial reporting frauds involve collusion and many involve falsified documentation. They were concerned that auditors '...do not appear to place any special emphasis on the areas where the risk of misappropriation of assets is considered significant' (O'Malley Panel 2000, pp.86-87).

The O'Malley Panel recognised that the primary responsibility for the prevention and detection of fraud rests with management, boards of directors and audit committees. Management should create a culture that deters fraud and should set and communicate clear corporate policies against improper conduct. However, the auditing profession must accept their responsibility for fraud or illegal activity detection. The O'Malley Panel found that 'Auditors serve an important role in detecting material financial statement fraud' (O'Malley Panel 2000, p.83).

There is significant evidence of a lack of audit scepticism in previous audit collapses such as AWA. Auditors have generally been too ready to take the word of management and have adopted a tolerant attitude towards management, not a sceptical approach. The O'Malley Panel was concerned that auditing must now begin to take on a far more sceptical approach and seriously question management about unusual transactions.

They believed that audit scepticism should be incorporated into the audit training programs. The O'Malley Panel recommended that audit firms should develop or expand training programs for auditors at all levels oriented towards responsibilities and procedures for fraud detection. These programs should emphasise the exercise of professional scepticism and the possibility that misappropriation of assets is a significant risk.

The training should use auditors with forensic audit backgrounds. The training should also include case examples of how defalcations might be effected, the types of controls over the safeguarding of assets that are effective in preventing and detecting defalcations and how defalcations are concealed.

Audit firms should be committed to refreshing and improving these training programs as circumstances in clients and industries evolve and more is learned about fraud.

Even the audit committee (O'Malley Panel 2000, p.94) can help the auditor to maintain a more sceptical approach. They should require of management as to how the entities policies and procedures serve to prevent and detect financial statement fraud. Fraud prevention and detection are primarily the responsibility of management, however audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.

## **8. Higher-Quality Audits**

The O'Malley Panel recommended that audit firms should put more emphasis on the performance of high-quality audits in communications from top management, performance evaluations, training, compensation and promotion decisions. They wanted audit firms to '...aspire to zero defects as their goal and endeavour to eliminate audit failures completely' (O'Malley Panel 2000, p.82).

The O'Malley Panel recommended that to achieve higher-quality audits that would have a greater likelihood of detecting fraud or illegal activity, then emphasis should be placed on the following four key points.

These were

- retrospective audit procedures,
- investigation of non-standard entries,



- audit control of interim periods; and
- appropriate liaison with audit committees.

## **9. Rationale for Higher-Quality Audits**

The O'Malley Panel noted that there was a need for higher quality audits to identify fraudulent activity. They noted that currently, auditors are not paying sufficient attention to these four aspects of the audit.

### **9.1 Retrospective Audit Procedures**

The O'Malley Panel recommended that the Auditing Standards Board (ASB) as part of its requirement for a forensic phase of fieldwork should require the use of retrospective audit procedures in which auditors would assess how various issues involving accounting estimates and judgments in previously issued financial statements were resolved.

This retrospective look at and testing of accounts that previously had been audited is intended to act as a fraud deterrent by posing a threat to the successful concealment of fraud, but not to second-guess reasonable judgments based on information available at the time the financial statements were originally issued.

There should be a debriefing of the audit team assigned to retrospective audit procedures and those undertaken during the forensic-type phrase. This should include an analysis of specific documentation relating to the retrospective procedures including those carried out during the forensic-type phase of the audit. There should be a summation of the results of the assessments made.

The O'Malley Panel also recommended that the retrospective audit procedures should include an analysis of selected opening balance sheet accounts of the previously audited financial statements. This retrospective review and testing of accounts that had been previously audited '...is intended to act as a fraud deterrent by posing a threat to the

successful concealment of fraud' (O'Malley Panel 2000, p.91). The retrospective audit procedures could be incorporated into the pre-audit program normally included in every audit.

## **9.2 Non-Standard Entries**

Non-standard entries should be investigated by the auditor whilst undertaking the retrospective audit phase. The O'Malley Panel noted that a QPR considered non-standard entries as a matter closely related to the issue of fraudulent financial reporting and was concerned that audit tests are not currently addressing the possibility of its occurrence.

The O'Malley Panel noted that research had found that in about 15% of audit engagements, the auditors did not have an adequate understanding of the clients system for preparing, processing and approving non-standard entries. Furthermore, in about 31% of the audit engagements reviewed, the auditors did not perform procedures necessary to identify and review non-standard entries. The O'Malley Panel noted that '...financial statement misstatements often are perpetrated by using non-standard entries to record fictitious transactions' (O'Malley Panel 2000, p.83).

The O'Malley Panel recommended that a guiding principle for determining the appropriateness of non-audit services is whether the services facilitate the performance of the audit, improve the client's financial reporting processes or are otherwise in the public interest. A good case study would have been the lucrative tax avoidance consultancy undertaken by Andersen in the Enron audit, which would certainly not have met this test.

## **9.3 Interim Period Reports**

Another area auditing procedures should concentrate upon is interim period reports because it is more likely that a fraud will be initiated during this time. This is because management can influence the timing of the execution of some transactions and their

recording in the accounts. Fraudulent management will be encouraged to process illegal transactions in interim periods because they believe that the audit will place less scrutiny on them. This highlights the importance of tests of transaction cut-off dates, especially at the end of quarterly or annual periods.

The O'Malley Panel (O'Malley Panel 2000, p.92) recommends that the audit profession should include in its standards specific guidance for the application of procedures in interim periods using a forensic-type approach. The ASB should consider the observations in the 1999 COSO Report that many frauds are initiated in interim periods.

The O'Malley Panel would also like to see the ASB provide guidance to auditors on how audit procedures employed in interim periods that address the potential for fraud in financial reporting may also be useful as continuous auditing techniques to improve full-year audits.

The O'Malley Panel recommended the provision of criteria in reviews of interim financial information where there is a high degree of subjectivity. These would include the interpretation of complex accounting standards and related party transactions and areas where controls are particularly susceptible to being overridden.

#### **9.4 Audit Liaison with Audit Committees**

The O'Malley Panel emphasised the importance of the audit committee. It recommended that audit committees should assess the strength of management's commitment to a culture of intolerance for improper conduct. The O'Malley Panel recommended that auditors should work with the audit committee in assessing the risk of financial statement fraud and in implementing the controls designed to mitigate such risks.

It recommended that audit firms should be required to discuss with the audit committee the organisations vulnerability to financial reporting fraud and exposure to asset misappropriation. The O'Malley Panel noted that audit committees rarely address the

potential for management to commit financial statement fraud or request auditors to perform specific tests to detect that possibility.

Auditors need to consider that internal controls serve to inhibit management fraud, but only if management at any level were not inclined to override them. An important consideration is whether management has reported to the audit committee on the entities control environment and ‘...how that environment and the entity's policies and procedures [including management's monitoring activities] serve to prevent and detect financial statement fraud’ (O’Malley Panel 2000, p.94).

Auditors understanding of an audit committee's assessment of the strength of management intolerance for improper behaviour should influence the nature and extent of testing. Auditors should be cautious however, not to place excessive emphasis on management’s high level monitoring of financial and non-financial data as a reason for reducing the extent of testing in the forensic-type phase.

The audit committee should require of management as to how the entity's policies and procedures serve to prevent and detect financial statement fraud. Fraud prevention and detection are primarily the responsibility of management, however audit committees should seek the views of auditors on their assessment of the risks of financial statement fraud and their understanding of the controls designed to mitigate such risks.

The O’Malley Panel also recommended that audit committees should pre-approve non-audit services that exceed a threshold amount even though audit firms who are concerned about losing lucrative consultancy fees will strongly resist these proposed measures.

## **10. Summary**

It is interesting to review in July 2002 after the collapse of Enron /Worldcom the progressive nature of some of the 31-8-2000 O'Malley Panel recommendations. These include the recommendations that

- auditors should perform forensic-type procedures on every audit,
- a strengthened and independent oversight accounting body
- audit committees should pre approve non-audit services; and
- audit firms should put more emphasis on the performance of high quality audits.

It is important to consider that had these recommendations been implemented in 2000 what impact they could have had on the subsequent audits of Enron /Worldcom. They may have helped save Andersen from collapse?

The former SEC chairman Arthur Levitt criticised those who argued that the cost of implementing many of the O'Malley Panel proposals would be too great. 'I disagree' Levitt said at the Public Hearings on the Exposure Draft. He believed that they should consider the losses investors have incurred in recently reported frauds and that '...the cost in the loss of investor confidence cannot be understated' (O'Malley Panel 2000, p.13).

In summary, the O'Malley Panels recommendations met with strong resistance from the audit firms. This was because of Levitts impetus for the adoption of the O'Malley Panel and similar hard-line issues. The profession received the controversial nature of the O'Malley Panels recommendations to create greater objectivity and independence amongst auditors, especially the curtailment of non-audit services negatively.

Leviitt who had adopted a tough, combative stance to the business and accounting communities was ousted and replaced by Harvey Pitt as SEC (Securities and Exchange Commission). Chairman Pitt was committed to free market principles and has been a reluctant reformer. Pitt, to the then great relief of the business and accounting community

promised upon his election '...a kinder, gentler SEC' (Schoen 2002b, p.2). Those words have now come back to haunt him.

US senators amongst others are now arguing that the SEC needs a more proactive leader who will assert the independence and authority of the SEC to protect the integrity of financial markets. The election of a new hard-line SEC chairman similar to Levitt would mean that the more controversial aspects of the O'Malley Panel recommendations could be adopted.

As a result of the demise of Levitt, the accounting firms were able to use their power to resist the O'Malley Panels main recommendations. However, as a consequence of Enron/Worldcom, the debate has been revived. US President Bush on 9 July 2002 ordered the creation of a special Corporate Fraud Task Force within the Justice Department to focus on corporate crime and to require a majority of a company's directors and all members of the company's audit committee to have no material relationship with the company, so that they are truly independent. It would create a '...financial crimes SWAT team' (Wolk 2002, p.1).

On 14 July 2002, the US Senate passed a bill that would result in a new independent accounting oversight board controlled by people with no ties to the industry and with final responsibility for corporate bookkeeping rules. This board will replace the current POB through which accountants currently make the rules.

Congress is flagging the possibility of forcing auditing firms to sever ties with the lucrative consulting work in firms that they audit and limiting the number of years an auditor can be the auditor of the same firm. Congress is also keen to change the current system where the Financial Accounting Standards Board, which is financed by the accounting industry and its clients, has the last word on rule making.

In summary, the recommendations of the O'Malley Panel may be seen as a quick way of dealing with the crisis now confronting the auditing profession. With the demise of Andersen, the Big Four may view the O'Malley Panels recommendations in a more favorable light and realise that by implementing the O'Malley Panels recommendations that this will help to release the pressure the auditing profession is currently under from the financial investing community and even the US President.

It is interesting to note that the US Congress passed a bill on 24 July 2002 that includes legislation similar to some of the O'Malley Panel recommendations. The Congress legislation includes barring audit firms from doing consulting work for companies where they are also the external auditor and the creation of an independent accounting oversight board.

## **11. Current Situation (as at July 2003)**

### **11.1 USA Situation**

Currently, the three most important aspects of fraud detection are that;

- The American accounting profession has rewritten its audit standard to create more focus on fraud detection.
- The Australian AUS 210 audit standard was rewritten in June 2002 and requires auditors to be more vigilant about fraud.
- Auditors still insist they are 'watchdogs' not 'bloodhounds' and believe that to chase every fraud would be prohibitively expensive.

On 15 October 2002, the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) announced its new standard statement on auditing standard SAS 99 'Consideration of Fraud in a Financial Statement Audit'. This amendment of SAS 82 gives US auditors significantly expanded guidance for detecting material fraud

and reminds auditors that it must approach every audit with professional scepticism and not assume that management is honest.

AICPA vice president in charge of professional standards and services Arlene Thomas describes SAS 99 as such, 'A strongly worded affirmation of the auditor's mission that the grey area between what an auditor has to chase and what they might catch by being diligent has now shrunk' (Abernathy 2003, p.57).

SAS 99 requires the auditor to adopt a degree of professional scepticism and to ask for hard corroborating evidence. It also identifies the need for increased education of auditors in detecting fraud.

SAS 99 sits within an AICPA agenda called the Anti-Fraud & Corporate Responsibility Program. The AICPA will establish a new body called the Institute for Fraud Studies and is embarking on a program to have more fraud-related materials included in auditors education and wants the audit firms to make at least 10% of their educational programs fraud related.

The key provisions of SAS 99 are;

- increased emphasis on professional scepticism, avoiding an assumption that management is honest.
- discussions with management requiring management to explain areas of concern.
- unpredictable audit tests including testing areas of the company not expected by the client.
- responding to management override of controls, the new standard prescribes a test for whether management is overriding controls.

Thomas complains that at the moment the AICPA is taking on fraud detection alone but that it really requires a complete environmental approach. 'It overlaps into corporate



governance, internal audit, internal fraud programs and risk management-it's a whole system' (Abernathy 2003, p.58).

She notes that fraud detection and deterrence hinges on internal oversight and that independent board members and independent audit committees are very important in this regard. 'You have to have that strong internal oversight' (Abernathy 2003, p.58).

In early 2003, the SEC set its guidelines for financial literacy on audit committees. They require at least one person on an audit committee to be financially literate. The AICPA would like to see a majority of the audit committee financially literate.

SAS 99 does not change the responsibility of the auditor to report that the financial statements are free from material misstatement, whether due to error or fraud. However, SAS 99 departs from SAS 82 in the performance of the audit.

SAS 99 requires a brainstorming session within the audit engagement team. At this meeting, the auditors should be asking where the fraud could occur, what management's motivation might be, where disputes could arise and how the auditors would handle that. A fraud specialist should be used in this brainstorming session.

Management override where executives pressure staff to change the books must now be targeted by the audit team. Non-standard entries must now be more thoroughly checked by the audit team. The auditor must also reach a view on how aggressive the company is by looking at historic estimates against performance.

Under SAS 99, auditors must also review unusual transactions to establish their rationale, and direct enquiries must be made to management as to the completeness and integrity of the documentation. The auditor must require that management give a written undertaking that all the documents have been supplied and that none of them have been fabricated.

## **11.2 Australian Situation**

In June 2002, Australia's new audit standard AUS 210 'The Auditor's Responsibility to Consider Fraud and Error in an Audit of a Financial Report' was presented. The old standard dealt with irregularities in general. The revised AUS 210 is three to four times the length of the old one and is specific about the need for auditors to look for fraud. It requires audit firms to make an assessment of the company's fraud risk factors and if the fraud risk is high, then the audit has to be upgraded to allow for the risk. AUS 210 and SAS 99 still only require the auditor to look for material misstatement, rather than to detect fraud.

Carter a partner at PWC says that to require the auditor to detect fraud '...then audit would become prohibitively expensive' (Abernathy 2003, p.59). AUS 210 requires the auditor to take a greater responsibility to detect material frauds, but not to detect all frauds.

Auditors will still not be responsible for detecting \$1 or 2 million frauds in large corporations because they would not be considered material. However, if for example the audit team identifies a high fraud risk in the purchasing section of a client but does not increase the audit testing to reflect that, if there is then a \$1 million fraud the auditor will probably be held liable.

AUS 210 still holds management primarily responsible for fraud but '...obviously there is some responsibility for the auditor' (Abernathy 2003, p.59). Carter says that the debate really comes down to whether auditors are watchdogs or bloodhounds. He defines the difference as external auditors play the watchdog role while management is responsible for the bloodhound role including internal controls, internal auditing and special investigations projects.

Auditors will be expected to look for material misstatements and should use their professional judgment in designing suitable audits for individual clients. AUS 210 increases the professional responsibility by requiring a fraud risk analysis for each client.

Carter argues strongly that fraud detection should not be totally lumped on the auditor. He points out that it would be prohibitively expensive to require the auditor to take primary responsibility for fraud detection as well as impractical. Auditors, unlike management, do not have control over the crucial areas of internal control, internal audit, corporate governance, or a corporate culture of risk taking and other environmental aspects.

Carter says that audit standards will be dynamic over the ensuing years and that there is still a gap between what regulators and investors want auditors to take responsibility for and what auditors want to be responsible for. The most important factor is that standards such as SAS 99 and AUS 210 are now aggressively using language that specifies fraud detection in the auditor's duties. 'For now, the big change is the greater acknowledgement of fraud detection as a duty in audit' (Abernathy 2003, p.59).