

The limits of audit: public perceptions and legal realities

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Patisserie Valerie

Patisserie Valerie entered into administration at the start of this year following the discovery of fraud within the company. It is thought that inflated profit margins and sale figures and thousands of false entries in the company's ledgers caused the company's accounts to be overstated by approximately £94m. These factors were not identified by Grant Thornton when it conducted its audit. This was despite the fact that suspicions were raised by HMRC over two years ago.

Luke Johnson, a successful entrepreneur and the majority shareholder in Patisserie Valerie, wrote in his article in the Sunday Times[1] that *"In business, as in life, there are certain documents and facts you rely on. They might be audited accounts, bank balances, a passport or a qualification. If these are fake, you wonder what is real and what is not."*

Expectations v Reality

On a broad-brush approach Luke Johnson's reliance on audited accounts seems reasonable. Not least because the statutory requirement to audit makes it clear that, even in the absence of a contract with the individual shareholders, the auditor's report is provided to the shareholders as a whole. So the auditors must reasonably know, especially if the company is listed, that shareholders will rely on the information contained within that report. Furthermore, since the auditors are both qualified and paid for their work, there is an expectation that the report will be prepared with reasonable skills and care.

However the situation is more nuanced and complicated in practice.

Auditors report

As is commonly known an audit involves a detailed examination of the financial reports for a company. The balance sheet, income statement, statement of cash flows and note disclosures are evaluated against some form accounting criteria, either GAAP or IFRS.

It is true that Auditors report is addressed to the shareholders. However, the audit review is limited to those entries which are 'material' (i.e. above a certain benchmark in terms of monetary value or frequency). This is because it would be impossible for auditors of a large company to check every single entry. Also, the audit reports are subject to a number of qualifications which limit the scope and reliance which can be placed on them. By way of an example, 'The Audit Report and Auditor's Duty of Care to Third Parties' Report prepared by ICAEW recommend that the following wording is included:

- *"To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our work, for this report, or for the opinions we have formed." (paragraph 10)*
- *"In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting..." (Appendix 1)*

The Courts in England & Wales have reiterated that the purpose of accounts is to "enable [members] to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part to the statutory purpose for the preparation and distribution of the accounts"[2] (underline added).

Duty of reasonable skills and care

The auditors' *"duties are duties of reasonable care in carrying out the audit of the company's accounts. They are owed to the Company in the interests of its shareholder. No duty is owed directly to the individual shareholders (underline added). This is because the shareholders' interests are protected by the duty owed to the company"*[3]

However this begs the questions, why, if the shareholders' interests are protected by the duties owed to the company, do these matters keep coming before the Courts? Also, why do the Courts In England and Wales refuse to extend the duties of auditors to individual shareholders and/or confirm an additional duty of care in tort?

Some of the reasons that have been proffered in the judgments are that:

1. the company will have its own cause of action for the same losses as the shareholders could claim. That cause of action would constitute a bar to any shareholder suing because of the principle against reflective loss[4]

2. trading losses from an unprofitable business are not caused in law by the auditor's negligence, even if these losses would not have been incurred but for the auditor's breach of duty to exercise reasonable skill and care to the company[5];
3. responsibility for preparing the financial statements and assessing whether they give a true and fair value rest with the directors of the company. This is because they are responsible for the internal controls etc. to ensure that they are free from material misstatement; and
4. auditors are "*watchdogs and not bloodhounds*"[6].

Nevertheless there is still, evidently, a gap between shareholders' expectations and auditors' expectations. It remains to be seen whether and how this gap can be bridged. Some possible routes to resolution include intervention by GAAP and IFRS via their policies, appraising shareholders of their rights from the outset and the auditors being more frank in their auditors reports.

[1]<https://www.thetimes.co.uk/article/luke-johnson-on-his-very-public-disaster-with-patisserie-valerie-9p5xbwph8>

[2] Caparo Industries plc v Dickman [1990] 2 AC 605 p 660

[3] Stone & Rolls [2009] 1 AC 1291, p.19

[4] [1989] QB 653

[5] Galloo v Bright Grahame Murray [1994] 1 WLR 1360

[6] Re Kingston Cotton Mill Co (No 2) [1896] 1 Ch. 331

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