

The Auditor's Calculus

I.

Applying the most Efficient Audit Approach to the Most Relevant Audit Topics

The need to set a plan of the audit derives from its modern conception. The planning of the audit is a selection process. A Full and meticulous audit of everything would be a counterproductive process, considering that the overall profits would be out of proportion to the input required.

According to the type of the audit, - such as the audit of the reliability of the accounts, audit of legality and regularity, audit of performance, - the Legislator may provide a different regulatory framework, within which the audit institution would issue its reports. For the reliability of the accounts, he can forecast an annual and mandatory audit that would result in an overall or partial view regarding the reliability of the accounts. For the legality and regularity of transactions, he can provide the examination of certain basic categories of expenditure or income once per year. These particular categories may also be examined periodically. Furthermore, regarding performance matters, he can provide a margin of appreciation to the audit institution. In terms of the general principles governing the audit, there is only one requirement: The audit institution should enjoy sufficient freedom in order to develop an *audit program* within which it could fulfil its *auditing options*, from the point of view of its margin of appreciation.

At least three types of audit planning can be distinguished herein: (a). *The multiannual planning* which mainly aims at setting audit strategy objectives and recording of needs of the auditing institution - especially in human and material resources - in order to take timely measures for the fulfilment of the audit strategy. (b). *The annual planning*, which takes place only when the forces and means allocated are already known to the auditing institution and according to this they should rationally be distributed within an audit year in order to carry out the mandatory audits and the optional ones. (c). *The planning of individual audit tasks*.

The multiannual and annual audit plans cannot be adopted by a different internal body to the one that possesses the overall decision-making power in the audit institution. They are also not allowed to be modified by another body than the

aforementioned if the modification may lead to any imbalances in audit resources within the different branches of the audit institution. The annual planning reasonably requires that the human and material resources necessary for the obligatory audits have been calculated in advance. Only after having calculated whatever is needed for carrying out each one of these audits and summing up all these individual needs, can then the human and material resources left to the non-obligatory audits be calculated.

An audit institution should distribute the auditing task throughout the year in a way which avoids, if possible, the alternation between relaxing and intense work periods. The audit work should therefore be rationally allocated throughout the year classifying the auditing tasks depending on the time period within which they have to be carried out. The planning of the annual mandatory audits is also useful for the adoption of the audit efforts when new changes in legislation affect the audit material, or changes in the internal organization of the audited entity or the environment within which it operates or when risks not previously identified have now been identified. Adaptation to the new conditions may require not only a change of the specified objectives and the structure of the audit. It is very often necessary to allocate more resources in manpower and financial resources in order to carry out more and longer-lasting missions. In mandatory, but non-annual audits - mainly related to State Agencies - the auditing body should plan the audits setting the time depth of the recurrence time depending on the margins given by the relevant legislation. The audit institution, if so permitted, would classify the audited entities or the bodies after having done a risk analysis. Thus, the bodies and entities considered in a lower risk would be audited less frequently, namely thrice, twice or annually if necessary. In exceptional cases, the auditing body is forced to organise special non- mandatory audits by using staff from those normally assigned to the execution of the mandatory ones. Subsequently, in that situation several problems regarding the quality of the regular mandatory audit task arise by definition. If there is no other solution, the auditing institution will be required to reduce its programmed audit workload, even if it concerns mandatory audits.

Apart from the mandatory audits, the auditing institutions are entitled to schedule any other audit according to the margin of appreciation on matters they consider necessary themselves for carrying out special audits. Often the right of the Parliament or the Government to ask for an audit on the auditing body for a particular subject and the corresponding obligation is provided, or otherwise, the margin of appreciation of the audit institution to carry out the audit was requested. The audit institution has the obligation to fulfil in due time the mandatory audits the legislature has entrusted. The manpower and the material resources available should primarily be sufficient for this purpose. The optional audits should not substantially disturb the performance of mandatory audit responsibilities of the audit institution. It is not excluded, however, as already mentioned, that a non-mandatory audit should appear as so necessary that the audit institution would decide to carry it out. But this should be a rare event. The principle here is quite simple: optional audits can be scheduled only when there is surplus of manpower and material resources beyond those required for the timely implementation of the mandatory work audit.

Wisdom and foresight are necessary virtues for the audit institution when planning operations. It should face multiple risks, such as risks inherent in the auditing field, organizational and its own operational risks, and furthermore, risks of the wider field within which its reports will be published. The issues of audit options should therefore be derived from a deeper knowledge of the subject. They also have to be realistic and, above all, they should not be impulsive.

The selection of topics for optional audit tasks may be based on fixed standards or on a combination thereof. Such criteria may be a demonstration of interest by the Parliament or the Government about an issue or even public opinion as it makes its appearance in polls or is seen in the press; the risk inherent in an economic activity of not having been conducted in accordance with the rules which govern it and the amount of funds set aside or used to produce an effect, especially for an irregular repetitive activity.

The identification of risk contained in the controlled activities requires a far more specialised task. The auditing body should not expect a random identification of a risk area. While doing so, then most often it would be in a “fait accompli situation” and its activities will be repressive. The auditing body should have a comprehensive understanding of the risks encompassed within its audit field. To estimate the size of each one of the individual risks would be a complex activity. Not all risks have the same features. Even if the amounts involved in an activity are insignificant and the possibility of their irregular use is likely to be less, however, a trivial illegal action could damage the validity of services of the institution, as for instance in a case of illegal expenditure regarding ministers’ private office. The risk can also be inherent in the management or result from the inadequate control mechanisms or the environment within which an activity is conducted. The auditing body should analyze and classify its own audit findings but also observe the findings related to the matter of other audit bodies. Furthermore, it should analyze the applicable laws and be aware of the practices the administration applies for the implementation in order to be able itself to identify risk areas, which are mainly those where a margin of appreciation applies without adequate scrutiny. The auditing body should finally be aware of the programs run by public administrations and be able to assess their economic significance in conjunction with the dangers and the general interest shown for them¹.

¹ [2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr. JUSTICE EVANS – LOMBE, BARINGS Plc 503 An important part of the process of planning an audit is to identify the inherent risks affecting the client and to devise procedures which will afford the auditor a reasonable expectation of detecting material misstatements arising from those risks (see SAGs 4 and 12, quoted above, among others). BFS, as a futures broker, was subject to a number of inherent risks. Many, such as the risk of errors in implementing clients’ instructions, are not relevant to this judgment. In this section I deal with two inherent risks which were alleged to have been relevant to D&T’s audits of BFS: the risk of unauthorised trading, and the lack of segregation of duties (though the latter could also be categorised as a control risk which increased other risks). [2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr.

The total annual work of an audit institution is analyzed into specific audits which are identified, on an operational level, by their subject and on an organisational level, by the audit team entrusted with the relevant task.

The audit of the annual accounts of a legal entity of public law, in order to determine its reliability, is a characteristic example of a specific audit. The subject of this audit is clearly specified and is expected to be assigned to an audit team to perform it within a set period of time. It is very likely that the process of such an audit is explicitly provided by the relevant legislation; so this process corresponds to a specific legislative audit mandate given to the audit institution. A broad legislative audit mandate, such as the mandate to issue an opinion regarding the State's annual accounts, could be executed by carrying out individual audits per ministry or department or agency, depending on whether a special audit mandate has been given, by the audit institution, to a specific audit team.

The individual audits, as defined above are usually related to specific public authorities, for instance to a ministry or to legal State entities. Those audits usually concern the management of these departments or entities for one or more years, depending on the content of the audit mandate. Audits may also feature programs operated by one or more associated departments within the same or different ministries or even executed by different legal entities. Those programs are defined by their objective (for instance the construction of a road, or the training of staff), by the resources allocated to them and by the institution or body that undertakes to execute them. Their timeframe may be less than one financial year, however they usually last longer, and in any case, they are not usually concluded within one financial year. The third category of audits includes cross-cutting audits e.g. pursuit of a certain outcome from several departments which are not hierarchically attached.

The planning of specific, individual audits is usually formulated in memoranda, which are prepared by those responsible for the audits and are approved by their superior authorities, who have the overall responsibility for the allocation of the institution's human and material resources. The memorandum includes the subject

JUSTICE EVANS – LOMBE, BARINGS Plc 502 Audit risk is the risk that auditors may not detect a material misstatement in the audit client's accounts and so may incorrectly give those accounts an unqualified audit certificate. According to SAG 27, this comprises three elements: inherent risk (the risk that the accounts may be misstated, which is the product of the client's type of business, its environment and the nature of the accounts), control risk (the risk that misstatements may not be prevented or detected by the system of internal control) and detection risk (the risk that the auditor will not detect the misstatement). [2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr. JUSTICE EVANS – LOMBE, BARINGS Plc 504 An auditor's assessment of audit risk is relevant to the audit evidence he will require in order to obtain reasonable assurance that the financial statements are not misstated: see SAG 9, paragraphs 3 and 4, quoted above.

of the audit, both in terms of objectives and scope, risk analysis of the audit, choosing the appropriate strategy and identifying the time required for the completion of the audit task and the resources needed.

The planning procedure should be set out in writing and be clear and specific so that the individual audit tasks are combined smoothly and the overall audit work of the audit institution can be completed successfully. An audit is primarily determined by its subject. The outcome of an annual financial audit of a public entity is a statement on the reliability of the relevant accounts of this entity and on the legality and regularity of the underlying transactions. This subject, so generally expressed is analyzed into more specific objectives such as the objective to express an opinion about the accuracy, completeness, sincerity and fairness of the accounts or an opinion that staff expenditure or the expenditures for contracts and grants are legal and regular.

The audit mandate is usually addressed by the legislative authority of the audit institution in a broader manner. This does not mean that the same general mandate will be transferred directly from the commanding authority of the audit institution to the auditor who will conduct the audit. The legislative audit mandate, because it is general, requires specialization and such specialization cannot be left to the discretion of each auditor. The distinction between important and minor issues, the concept of high or low risk areas and the emphasis on certain aspects of the public financial management are issues to be decided at the highest possible level of the audit institution, because they affect directly, on the one hand, the implementation of the principle of equality regarding the auditee and, on the other hand, the intensity of the audit effort. For the planning of non-mandatory audits, the audit institution has much more flexibility in specifying the objectives when it chooses the subject of the audit. However, even there, the audit should be coherent and the users of the audit report should feel that all key questions were raised.

When planning the audit procedure, the ideal process is to convert the audit objectives to individual audit actions, until you reach the point of developing questions so that the answer given by the auditor can be yes or a no. The audit of legality and regularity of underlying transactions includes also for example the audit of payments in accordance with the contracts concluded between the auditee and third parties. One such contract category is also the procurement contract. The procurement contracts are signed by the competent public authority when the relevant procurement procedure is completed in accordance with the relevant legal provisions. These provisions stipulate the procedure and conditions for the award of public procurement to a third party. Each provision can be converted to a specific question answered by the auditor so that from the synthesis of the answers the auditor should be able to determine if the relevant expenditure is legal and regular. At the same time the planning of an audit requires the exclusion of some of the questions that could arise either because they are considered as insignificant or because, although interesting, they must be sacrificed for the sake of economy and timeliness of the audit procedure. The audit methodology should help the auditor, by separating the essential from the trivial.

The questionnaire and the audit procedures are also formulated in writing and are usually attached as an annex to the Audit Planning Memorandum. Although there is a standard format, not dependent on the particular audit, it should be adjusted appropriately to the requirements of the specific audit. For example, the audit institution might have prepared standard checklists for the procurement procedures or on how the creditors and debtors should be displayed on the balance sheet. But these questionnaires need modifications in order to adapt to the specific requirements of the individual audit. Their adjustment to those requirements is necessary, either to address the particularities of the auditee or to address specific audit risks and to highlight important aspects of a specific management.

The planning of the audit aims to find the most appropriate approach to ensure that the material to be audited will be submitted in the audit questionnaire after having reconciled two opposing requirements: namely, the requirement of economy and the requirement of the reliability of the audit. The audit body will determine the specific strategy of each one of the audits carried out within the general framework previously set up by the legislature.

Whether an ex-ante or ex-post audit will be carried out, is an issue that is usually not left to the audit's institution margin of appreciation, but is regulated by the legislator himself. What is left to the audit institution's discretion is the selection of the most appropriate approach in order to collect sufficient evidence to support the audit results. A proper preparation of the audit should record in a text, specific instructions regarding the audit methods to be used by the auditor. It is important to know whether any potential sampling would be carried out and to what extent; the procedure of how the sample will be selected; what kind of tests is required; whether audit methods supported by electronic means will be used; and finally whether any investigation concerning the reliability of the internal audit system will take place. The specific audit procedure may depend on the auditor's discretion. However, since the methods appropriate can be chosen at the audit preparation stage, it is preferable for the auditors to have at least a guideline for the audit. It is difficult to calculate in advance the exact time needed for an audit. The audit institution, as a good administrator of public resources, should keep records for the consumption of "human-weeks" for the production of a specific audit work. Thus, it should have an appropriate database which would be able to provide accurate information on the time needed to carry out the auditing tasks.

II.

Achieving the Highest Audit Quality with the Less Possible Audit Means

Smart's Audit distinctive feature is that audit data are examined with sparing use of resources, on the basis of which conclusions concerning the whole are drawn, without it being necessary to carry out an exhaustive examination of the subject matter concerned.

With a view to accomplishing its mission successfully, modern audit uses a technique which may be defined as the one used by auditors in the private sector adapted to the requirements of the State management context. This technique was adopted because, *firstly*, it ensures compliance with the stringent requirements of modern professional standards and, *secondly*, makes it possible to audit the public financial management in its entirety in the most economic manner possible, so that the auditor can express a general opinion on the management as a whole without having audited exhaustively the audit area. Contemporary public financial audit is judged according to the extent to which it transcends the contradictions that are inherent in its principles. These contradictions may be expressed in the following question: how can a general judgement be made concerning the matter subject to audit when not all of the matter is examined or, in other terms, how can limited audit work support findings concerning all the matter subject to audit? To overcome these contradictions, contemporary public financial audit is carried out on the basis of step-by-step programming of audit work following audit-risk analysis, where the most economical and efficient audit approach is selected, which is governed by strict quality assessment criteria.

The documentation of an audit involves two different areas. Firstly, documenting each finding individually; this is to prove that the individual breach of a rule that the auditee should have observed in the course of his management is an objective fact derived from the information the auditor has collected. Secondly, documenting one or more general conclusions in which the overall audit resulted;

this is to support an overall view of the management, based on individual findings, when, by implication, the audit institution concludes that the annual accounts are, all in all, unreliable or when, despite the existence of such findings, it still accepts that the accounts are reliable.

The purpose of audit technique is to keep within reasonable limits the risks that waylay the auditor and constitute a menace to the quality of his work. Audit risks reflect the possibility that there are errors in the subject matter under examination which the auditors will not be able to detect, although they have a professional duty to detect them². Hence, auditors have to limit their audit risks by compiling appropriate evidence to document sufficiently their judgements.

² See A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union (2001) http://ec.europa.eu/internal_market/auditing/liability/index_ : “As a general rule, statutory auditors are not required to check all the corporate transactions, but to audit the financial statements using a risk approach in order to form their opinion regarding the substantial – or material – inaccuracies that could hinder the “true and fair view” qualification of the financial statements. The question of the required competence of a statutory auditor is also of high importance considering that the auditor is a professional of accounting, and not a professional of every audited company’s activity. As a result, there is a substantial part of judgement in the choice of the audit tests as well as in his opinion. Providing guidelines for the statutory auditor’s conduct therefore allows determining the scope of his duties and consequently the scope of his breach of duty. Subject to the slight differences noted below, in all the Member States, the standard applied to determine fault or negligence is primarily an objective “reasonable person” standard. The test is whether the statutory auditor has exercised the care and skill reasonably to be expected of a normally diligent and prudent statutory auditor. A general description of this objective standard may be as follows: he is an ordinary member of the profession, an average, prudent and diligent auditor, who follows good auditing practices as any reasonable person would, and who has the professional skills and knowledge that allow him to be referred to as a reasonably competent member of his profession. In some Member States, this model may be adapted to circumstances of fact: - in Belgium and in France, the standard depends on the situation in which the auditor was placed, meaning that one must consider an ordinarily diligent man placed in the same circumstances; -in Italy, a Court decided that the duty of care of the auditor varies in relation to the particular situation that he has to take into account, and the auditor must be more diligent where there is clear “evidence of risks”. In addition to this objective standard, some Member States may refer to subjective elements: -in Belgium: the level of diligence changes, based on the qualifications of the auditor; -in the Netherlands: the reasonable standard includes subjective elements regarding the party which gave the assignments at stake, and the elements of the specific assignments; -in Spain: subjective tests, such as the degree of sophistication or the fees of the auditor, may be used; -in Sweden, such subjective elements would not help to determine the fault, but may have some importance on the amount of damages to be awarded. The behaviour of this “normally diligent and prudent auditor” may in some respect be defined by standards issued by professional regulatory bodies. While these standards are never binding on the Courts, they often refer to them. In addition, in Belgium, professional rules bind Courts as some rules of the Institut de Réviseurs d’Entreprises have been implemented by statute. Likewise, in Spain, the Technical Rules on Audit are legal rules that the judge is obliged to follow and reference to other professional standards is made only where legal rules and contractual requirements are not sufficient. In common law countries, Courts have significantly contributed to the definition of the standard, together with the professional bodies for statutory auditors: -in Ireland, Justice O’Flaherty of the Irish Supreme Court stated that the auditors’ duty entails «

The fact that complete assurance is not sought in modern financial auditing means that auditors are required to express just an opinion on the subject matter audited, not to deliver a certificate of accuracy. They must do so once they have carried out the audit and processed their findings. The opinion comprises the conclusion reached following the audit activities, which is the direct objective of the audit. What will be audited, the amount of work that will be done, how the audit procedure will be organised and what evidence will be obtained depend on the contents the opinion aims to provide and the level of assurance sought to cover the opinion. The opinion forms part of a procedure involving assessment or decision-making by a third person, but it is not an actual decision in the legal sense of the term. Modern financial auditing is aimed at the auditor forming an opinion relating to the subject audited on the basis of what is commonly known as *reasonable assurance*.

When the auditor's opinion is negative, pursuant to public law standards, the opinion must be adequately justified. In other words, the findings, as set out in the audit report, must satisfactorily support the audit result. Where the findings result from an examination of just part of the matter being audited, conclusions relating to the whole of the matter subject to audit must necessarily be supported by inductive reasoning, according to the rules of logic. A negative judgement of the auditor that is not founded on conclusive and sufficient evidence will result in the auditee reacting by presenting evidence to undermine or rebut the audit findings or to prove the opposite. Hence, auditors who express a negative judgement know that their judgement will be opposed and that they will be asked to duly justify it, by means of further investigation, or eventually to withdraw it. In this sense, there is far less risk of a negative judgement being inaccurate than a positive judgement. A positive judgement, based on the fact that there were insufficient findings, will not be opposed by the auditee. However, positive judgements also have to be based on sufficient evidence. Otherwise, a positive conclusion may be inaccurate and, if such was proved by means of a different procedure (usually seeking out criminal acts), this would deal a serious blow to the audit institution's credibility. This is why the documentation of a positive judgement is equally, if not more, demanding than that of a negative audit judgement.

The procedures for documenting the audit findings and the audit opinion generally include gathering evidence able to support the auditor's confidence in the validity of the conclusion, or that of anyone other than the auditor who might examine the data collected. In the broad sense, documentation procedures include examining the reliability and efficiency of the internal control systems used by the auditee. This examination influences the auditor in his or her determination of the need for extra specific procedures aiming to verify the details of the veracity of events or the legality

bringing reasonable skill and competence to their task. But they are not required to act as super-humans; nor are they to be faulted simply because an expert witness is produced who says that, if he had been in charge of things, affairs might have been ordered better » -in the United Kingdom, if the auditor can show that he acted in accordance with a practice or opinion shared by a substantial body within the profession, a Court will usually find that the required standard has been satisfied, although it is still possible for the Court to conclude that the practice or opinion is unreasonable”.

and regularity of transactions underlying the accounts. Examination of the reliability and efficiency of an internal control system includes, *firstly*, establishing whether the auditee department's internal organisation has an internal control system, as provided for in the legislation; *secondly*, establishing the internal control system's adequacy in dealing with serious risks that constitute a threat to the department being audited; and, *thirdly*, proving that the system actually works in practice and deals with risks by either preventing detrimental operations or identifying such operations and remedying their consequences.

The documentation procedures also include procedures aimed at identifying data which, when compared with other data for the financial year concerned or previous financial years, give rise to unease or even suspicion. Data analysis is a way of first approaching the subject under examination. When auditors open an expenditure file or examine an account, they have to have formed an idea beforehand of the figures and states of affairs that they would consider to be within pre-determined limits, and that will enable them to examine whether what they will see, constitutes evidence of discrepancies that cannot be explained. Where such discrepancies are identified, the auditor must investigate them further by means of either oral explanation given by the auditee or full verification procedures.

Documentation procedures are not entirely the same as *verification* procedures. Verification procedures comprise part of documentation procedures. Verification procedures include, firstly, *external verifications*, i.e. verification of data presented by the auditee on the basis of data kept by third parties, for example, when the balance shown for a bank account is verified by data held by the actual bank or, similarly, by the auditee's lender or debtor; secondly, *physical examinations*, i.e. verification that a physical object exists, as recorded in the inventory, by the auditor examining it with his or her own eyes or counting certain elements in order to verify their number as recorded in the accounts; thirdly, *comparisons of numbers and reviews of calculations*, in other words, checking the correctness and transfer of amounts from one entry to another or into an account or the accuracy of calculations underlying the balances produced; fourthly, *legal classifications*, or verification of the soundness of the auditee's legal judgements with regard to the applicable legislation, its interpretation, its application with regard to the case concerned in the light of the accompanying facts and their classification within the meanings provided for by the law; lastly *examination of supporting documents*, that is to say checking the balances in an account on the basis of real data kept by the auditee, e.g. proof of payment, from which it is clear that the recorded balance is true and correct³.

³ « Verification is the vehicle that carries one to a position of confidence about any given proposition. Such confidence may be positive or negative; that is, there may be assurance supplied by the verification procedure that the proposition is right or wrong, but the confidence cannot be blind. There must be evidence to support it, sufficient reason, sufficient 'competent evidential matter'. Otherwise the fancied assurance is nothing more than folly. », in *The philosophy of auditing*, R.K Mautz et al, American Accounting Association, 1961, p.43.

The findings of modern financial auditing are presented in reports in which the individual observations set out by the audit institution are commented on by the auditee dealt with in the report. The auditee's comments are published in the report and, eventually, in a column facing that in which the audit observation has been made. The above conditions require the audit institution to document individual observations based on the individual audit findings in a manner that precludes question. In order for individual findings to be unquestionable, they should not result from complex reasoning or subjective assessments, but should be based directly on facts that *speak for themselves* or, where interpretation of rules or evaluations are involved, on valid opinions (case law, expert opinion), or it must be obvious that the auditor's conclusion is based on common sense.

Sampling is what takes place each time a certain number of a set of transactions or balances are audited and conclusions are drawn by implication with regard to the whole set. Sampling is either statistical or non-statistical. Non-statistical sampling is based on the professional judgment of the auditor, who must always keep up to date with the lessons of common experience and common sense. Statistical sampling is based on applications of the mathematical theory of probability.

In modern financial audit auditors are required to deliver a judgement as to the reliability of the accounts and the legality and regularity of the underlying transactions or the soundness of the financial management. The judgement they pass, usually referred to as an *opinion*, relates to the whole of the subject matter under examination, but, as a general rule, it is hardly ever based on an all-embracing audit of the subject matter concerned. Sampling is not carried out where, on the basis of their personal professional experience, auditors have detected transactions and account balances that seem suspect or risky to them and have established serious failures therein, in terms of both quantity and quality, which enable them to support a negative audit opinion solely on the basis of these specific findings. Sampling presupposes projection, based on common sense or the theory of probability, of conclusions reached following examination of just a part of the subject matter under examination to all of the subject matter concerned⁴. When an auditor, with the task of auditing 500 procedures for the award of public works, supplies and services involving total expenditure of 500 million euro, establishes, on the basis of his or her personal professional experience, that 20 of the procedures, involving total expenditure of 50 million euro, are illegal, he or she may draw a negative judgement on the whole of the management examined. There can be no talk of sampling, because no extrapolation has been made to the whole. Quite simply, what the auditor has established as illegal is in itself sufficient to support a negative judgement, given that it accounts for 10 % of the total

⁴ GUY M. Dan, CARMICHAEL R. Douglas, WHITTINGTON Ray, Audit Sampling, an introduction, 5th edition, John Wiley and Sons, Inc, USA, 2002.

expenditure, thus above a generally accepted materiality threshold. However, when the auditor selects randomly limited audited procedures, detects breaches involving a value less than the materiality threshold and projects this amount to the total amount of audited expenditure, then he or she is sampling. In other words he or she extrapolates the part to the whole.

There are always three stages in sampling, each of which presents its own problems. The first stage comprises identifying the total number of transactions or account balances which fall under the audit field. The second involves determining, by a selection process, the individual transactions and balances that will be audited. At the third stage, based on the conclusions drawn following audit of the transactions and balances, further conclusions are drawn with regard to the whole of the subject matter under examination. In order to carry out sampling, whether statistical or not, an auditor must have a clear understanding of the subject matter under examination, which is termed the *population*, and of the representativeness of the subject matter. On the basis of this understanding, the auditor will determine and select the transactions or balances he or she will audit. For example, the population in a legality audit comprises all commitments and all payments. The auditor selects the *sample*, i.e. the units of the population that he or she will audit, using a list of commitment operations and another list of payment orders effected by the management under examination, whereupon each payment order will be coded with a serial number, which will also identify on an individual basis each unit of the population he or she may select for audit.

Depending on the subject of the auditors' investigations and the object they have assigned to their audit, the samples are divided into samples concerned with properties and samples based on variables, which make up the units of the population. The purpose of the properties-related samples is to find out the number of units in a population (e.g. payments orders) that have a common feature (e.g. incorrect calculation of the payment amount or absence of a signature required of an official jointly responsible). By way of example, it might be concluded that three of 20 payments audited had the requisite feature, with samples based on variables making up the population relating to monetary amounts whose management had been found to be inefficient. What is ultimately of interest in these samples is not the number of payment orders in which problems were detected, but the amount of money those orders involve. Samples based on population features are used mainly to judge the reliability of internal control systems, for example, in the matter of how many orders were not approved *ex ante* by the body responsible or, mainly during the audit, to detect failures that are significant in themselves, irrespective of the sum involved, as would be the case with criminal acts. Variable-based samples are used mainly in the audit to pinpoint sums that have been irregularly managed, so that conclusions may be drawn with reference to all the sums managed.

An essential prerequisite for sampling is to ensure that the population from which the sample will be selected is uniform. If it is not, it is inadmissible to draw conclusions from what has been audited that have been projected to the entire population. Of course, every sample-unit has its own particular features and, ultimately, none can be entirely the same as another. Uniformity does not mean

complete resemblance. It means that there is no difference with regard to the features that are important in the light of what is sought. In order for the population to be uniform it must be stratified on the basis of the common features of each more specific group within the population, and a sample must be selected from each stratum of the population so that, following appropriate processing, it will allow reference to the whole population.

Statistical sampling is carried out in audit departments under the guidance of a statistician, who is a permanent member of the department's staff. Any auditor with no training in statistics may have learnt to deal with models and tables recommended in statistics for determining the number in a sample and selecting sample-units on an individual basis or for references to the whole. This does not mean that he or she themselves have become specialised in statistics. A statistician knows the underlying mathematical theories and can prove the correctness of the models or contents of tables mathematically.

37. In order for a statistician to meet an auditor's request for help in fixing the number in a sample, the auditor must have already made certain choices or established some certainties in her mind before approaching the statistician. Auditors must have clear ideas on the following: *Firstly, the degree of certainty they aim to obtain from the sample testing.* If they are aiming at 100 %, they should check 100 % of the auditable subject matter and thus forget statistical sampling. They will turn to statistical sampling where a margin of error or failure has already been accepted, even if only around 1 %. Audit institutions usually aim at certainty of between 90 % and 95 %, which means that they accept a failure risk of between 5 % and 10 %. *Secondly, the presumed error rate in the subject matter under examination.* This is a working assumption auditors make on the basis of either a prior rough investigation or their personal appraisal, which they ask the statistician to confirm, reject or even improve upon. Depending on the type of sampling (properties or variables), the error rate will refer to either the number of transactions or balances or to a sum of money. *Thirdly, the percentage divergence from their initial assumption, which they consider tolerable.* If this percentage is exceeded, the original working assumption should be improved or set aside. *Lastly, with specific regard to the samples relating to variables⁵, the auditor must set the level of insignificance.* The level of insignificance is the volume of the sums managed irregularly that will not adversely affect his or her judgement. This amount is expressed as a percentage of the entire amount under examination and, as a rule, fluctuates between 0,5 % and 2 %.

Once the number in the sample has been determined, the transactions and balances to be audited must then be identified individually. These have to be selected entirely at random. The selection of a sample using a symmetrical method (the selection of

⁵ GUY M. Dan, CARMICHAEL R. Douglas, WHITTINGTON Ray, Audit Sampling, an introduction, 5th edition, p. 96, 97.

payment orders at intervals of 10, e.g. 3rd, 13th, 23rd and so on; or using some other similar method, 3rd + 1, 13th + 2, 23rd + 3) is to be excluded. The risk in this case is the possibility of illegal transactions following a corresponding pattern. If, for example, a department's fictitious staff have been coded with a serial number at intervals of 10, starting at number four, then sampling at intervals of 10, starting at number three, will make it impossible to identify any illegal payments. In the case of sampling based on variables, the sample may be selected on the basis of the unit for the variable, rather than on that of the transaction or the item in the account in which each unit is located. If we have an account showing 100 transactions involving the management of 100 000 euro, instead of selecting transactions, we may select euros, from the first to the hundred thousandth, and select the transactions to which those euros relate. This presupposes our sorting the transactions according to the corresponding amounts of money in an order whereby, if we were to select the fifty thousand and tenth euro, we would know in which transaction in the series it was located. By using this method to define the sample, the size of the sample is reduced, because a transaction involving the management of a large sum of money is likely to be selected more than once.

The findings of any type of audit cannot be considered definitive, unless the auditee has been given the opportunity to rebut them. This is a matter of basic precaution: an auditor cannot know everything, nor is an auditee always at fault. Hence, an auditee should be heard before an audit is brought to a close. Once an auditee has been heard, the definitive audit findings may then be formulated.

The audit conclusions are finalised following hearing the auditee's views on the findings on which the conclusions are based⁶. The auditee's opinion is expressed using formal, or even informal, procedures. Modern financial auditing gives an auditee the opportunity to state his or her position on the audit findings in such a way that it can be easily understood by anyone reading the audit report. As a rule, this position is included in the printed matter in which the audit report is published and sometimes it is even in a column alongside, on the same page.

The purpose of *hearing an auditee* is primarily to build on the actual audit finding. Each type of finding, whether it concerns the reliability of accounts or legality and regularity or sound financial management, is seen from a different angle when, brought to the attention of the auditee, she explains how the situation that the auditor believes is in breach of a rule, came to pass. Sometimes the auditee's explanations are

⁶ Reference to third parties in the Auditor's reports should be avoided: BERNICOT Jean François, CHAMPOMIER Jean-Michel. L'auditeur et le juge : Cour de justice des Communautés européenne, 10 juillet 2001 : Ismeri Europa Srl c/ Cour des comptes des Communautés européennes (Affaires C-315/99 P)', Revue française de finances publiques, 2002, n. 77, pp. 185-195. INGHELRAM Jan. 'L'arrêt Ismeri: quelles conséquences pour la Cour des comptes européenne?', in : Cahiers de droit européen, année 37 (2001), pp. 707-728.

accompanied by documents that were not in the file the auditor was shown at the outset. On other occasions it is not possible to back up documents that are missing, but explanations are given whereby the auditor is convinced that the situation concerned is a one-off or specific one in which the absence of supporting documents is justified. On yet other occasions auditors will discover that what they believed to be a finding, i.e. a breach of a rule, is actually entirely mistaken on their part, either due to their failure to take correct account of the applicable legislation or because they had not read the file documents carefully or, lastly, because their calculations were incorrect.

The *contradictory procedure* allows the auditor to make up any deficiencies in the sampling method he or she used. Let's imagine that in the audit of a supplies award the auditor finds that the two award procedures she selected evidence the same material problem. He or she may conclude provisionally that all the other procedures will evidence the same problem, but the auditee, to whose attention the finding is brought, is able to prove, by producing the details of other procedures, that the error is isolated or, at least, not general in all the procedures.

The procedure for discussing the findings with an auditee is divided into several stages. At the end of a mission, the auditor has to organise a meeting with the appropriate people in the department being audited to discuss the findings with them and hear their objections on the spot. Many points will remain outstanding; hence it is likely that auditors will be awaiting additional information after they have returned to their workplace and that they will hear the auditee by contacting them before making their observations. At the next stage, once the auditor's departmental head has studied the audit-mission report, she will reject anything she does not believe constitutes breach of a rule and will send, now formally, a letter to the auditee asking her to set out her views in writing. The audit body's audit report will be drawn up after the auditee has taken a stance beforehand with regard to the contents of the formal letter or, at least, following expiry of a reasonable time limit laid down for reply.

Many findings concerning the drawing up of the annual accounts may become inapplicable, if the auditee accepts and is able to rectify the error detected. However, other findings, such as those concerning breaches of legislation on competition prior to conclusion of a contract or unlawful payments to beneficiary State creditors, cannot be rectified.

With regard to the first type, i.e. relating to the annual accounts, once the auditee demonstrates that they have drawn up the accounts as required, there is no reason to maintain the audit observation, unless the original cause continues to exist, e.g. non-compliance of the accounting methods used or lack of basic knowledge on the part of the department accountant who made the mistake. In the case of the second type, that is findings that cannot be rectified, they are of a historical nature and cannot be reversed by future actions, unless, for example, the competition is cancelled and the funds paid to the beneficiaries on the basis of its outcome are recovered. The auditee body is not usually faced with this, mainly because any payments made to third persons will have

been made legally in their regard, provided that the competition procedure was not cancelled. Only if it is proved that a payment was made in the *absence* of the return provided for or *earlier* than provided for, or to a person not entitled, may recovery of the amount be demanded. In other cases, what the auditee may do in her defence is either, as already mentioned, prove that the finding is isolated in nature or, where such cannot be proved, prove that she has taken appropriate measures to ensure the same mistake is not repeated in the future.

Modern financial audit does not result in the adoption of legally enforceable acts, i.e. acts that give rise to rights and obligations. In traditional financial auditing, in its *ex post* form, an accountant is either granted discharge or imputed in respect of her management, whereas the *ex ante* form results in approval of a commitment or expenditure or, conversely, the prohibition of such. Modern financial auditing is always carried out *ex post*, generally after the end of the financial year for which the management is being audited, and results in the issue and, usually, publication of a report recording the findings, which form the basis of the conclusions and recommendations put forward.

The final stage of the procedure of hearing an auditee includes final presentation of the audit finding by the audit institution as an observation in the report to be published, accompanied by the auditee's corresponding counter-observations, which will also be published, possibly in a column facing that containing the text of the audit report.

The two texts, i.e. the audit body's report and the auditee's reply, are not finalised separately. They interact with each other. This procedure, carried out prior to the finalisation of the texts is improperly referred to as a *negotiation*: the auditee seeks less severe observations from the audit institution, which may agree provided that the auditee accepts the observations of the institution's auditor without objection⁷. This procedure may appear unjustified to someone who cannot see the political significance of an audit report. The report is published and becomes the property of all, journalists use it as news material or to support their comments and Parliament makes use of the report when it is brought before it during the procedure for granting discharge to the Government or when aspects of policy relating to the contents of the report are discussed⁸. From the point of view of a citizen, journalist or politician reading the

⁷ « Auditing (...) requires the exercise of judgement. And the more widely the auditor shares the preparation of his or her judgements with colleagues and auditees the more likely they are to commend acceptance as soundly based, well thought and relevant. », in *Public sector auditing*, Sir John Bourn, John Wiley & Sons Ltd, 2007, p.359.

⁸ « (...) Auditing has its principal roots, not in accounting which it reviews, but in logic on which it relies heavily for ideas and methods. An apt analogy is difficult to find, but to some extent at least the relationship of accounting and auditing may be likened to that of an author and an editor. », in *The philosophy of auditing*, R.K Mautz *et al*, American Accounting Association, 1961, p.14.

report, reading an observation and then a reply disproving or ostensibly refuting it makes a very negative impression. Whether the problem comes down to interpretation of the law or its application or whether it is a regulatory or factual matter, none of the three readers has direct access to the file to enable her to establish what actually happened, nor are they likely to have the legal knowledge to enable them to resolve a legal doubt, let alone the interest. In any case, the impression created is negative and this often gives a negative impression of the actual audit institution, which would seem not to have the necessary authority to impose itself on the auditee when its observation is correct. On the other hand, it is obvious that the audit institution cannot systematically give way to a negatively disposed auditee, as if held hostage. Should a stalemate result, the audit institution must either counter the auditee's reply, thereby putting an end to the dispute, or be prepared to provide explanations or data, if so requested, particularly during the parliamentary procedure, in order to prove that its observations are correct.

III.

Adapting Audit Mandate to Modern Needs

Traditional public financial audit is aimed at stopping an illegal item of expenditure or holding the accounting officer to account in respect of the amount of any deficit detected. Contemporary public financial audit constitutes an element of the Parliament's process of political control over the management of public finances. It exists in order to provide the Parliament with the means to understand how public financial management is really conducted and what needs to be done to remedy shortcomings and improve the system in general. Contemporary public financial audit satisfies the need of a modern parliamentary system for increased and better

information to Parliament and Government concerning the quality of the public financial management. Public financial audit is a democratic requirement.

The area that is being audited may undergo three types of audit, depending on the criterion of the completeness of its examination. The first is a global exhaustive audit, in which each item of an account or each underlying transaction is investigated by the auditor. This is the model used in Greek financial auditing⁹, in line with which, firstly, draft contracts and payment orders are submitted for *ex ante* control¹⁰ and, secondly, the accounts of public accounting officers and legal persons under public law are subject to *ex post* control, as provided for by Greek law in both cases. In principle, the audit institution is not given any scope for selection. The second type of audit is based on a selection made by the audit institution on the basis of freely exercised discretionary powers of judgement. This is the Community model that applied prior to 1994¹¹; it is also the French model that applied prior to the 2001-2006 reform and the introduction of the new system of financial management¹². With this type of audit, the audit institution issues a report dealing with various matters without drawing conclusions concerning the whole of the management. To put it simply, problems and shortcomings in the areas audited are identified and reported. At European Union level, this model is still used for the audit of sound financial management¹³. The third is an audit that is not actually exhaustive in covering all the subject matter under examination, but one that, given the technique used to carry it out, allows more general conclusions to be drawn with reference to all of the subject matter being audited. This has been the European Union model since 1994, with the introduction of the European Court of Auditors' Statement of Assurance as to the reliability of the accounts and the legality and regularity of the underlying transactions¹⁴, and the French model since 2006. The third model of those just described is the one that is used for the financial auditing of limited companies. Private companies issue financial statements every year. The external auditors who examine them, neither audit them exhaustively, nor do they audit what appears most interesting to them and express an opinion in that regard alone. They audit the accounts and express an opinion as to their reliability, again, on

⁹ National Audit Office *State Audit in the European Union*, 2005, pp 110-121.

¹⁰ FLIZOT *Les relations entre les institutions supérieures de contrôle financier et les pouvoirs publics dans les pays de l'Union européenne* LGDJ 2003p. 217.

¹¹ European Commission *European Union Public Finance* 4th Editions 2008, pp.

¹² BARILARI, BOUVIER *La nouvelle gouvernance financière de l'Etat*, L.G.D.J., 2004, pp.

¹³ See however European Court of Auditors Annual Reports 2010, Chapter 8 on getting results from the EU budget.

¹⁴ « As required by the Treaty, the DAS [the Court's Statement of Assurance] is global in nature: it is not intended to produce a specific assessment or arrive at a quantified conclusion on any particular operational or geographical area of Community activity. », in *Special report in support of the Statement of Assurance concerning activities financed from the general budget for the financial year 1994*, Official Journal C352, 1995, §1.9.

the whole, as is needed by the shareholders and investors¹⁵. It would, of course, be interesting for the shareholders and investors to know more about some particular aspects of the management of the company being audited, but the subject that is of central interest to them is the overall management as reflected in the annual accounts¹⁶. The rules governing the auditing of private companies require their external auditors to express an opinion as to the reliability of the accounts they audit¹⁷. They do not require

¹⁵ « The independent auditor must never lose sight of the fact that auditing procedures are directed toward enabling the formulation and reporting of an opinion concerning a set of financial statements. », in *Auditing Principles*, fourth edition, Howard F. Stettler, Prentice-Hall, Inc., 1957, p.7.

¹⁶ 465 U.S. 805 (104 S.Ct. 1495, 79 L.Ed.2d 826) UNITED STATES, Petitioner, v. ARTHUR YOUNG & COMPANY et al. No. 82-687. Decided: March 21, 1984. Chief Justice BURGER delivered the opinion of the Court. II Corporate financial statements are one of the primary sources of information available to guide the decisions of the investing public. In an effort to control the accuracy of the financial data available to investors in the securities markets, various provisions of the federal securities laws require publicly held corporations to file their financial statements with the Securities and Exchange Commission. [5](#) Commission regulations stipulate that these financial reports must be audited by an independent certified public accountant in accordance with generally accepted auditing standards. By examining the corporation's books and records, the independent auditor determines whether the financial reports of the corporation have been prepared in accordance with generally accepted accounting principles. The auditor then issues an opinion as to whether the financial statements, taken as a whole, fairly present the financial position and operations of the corporation for the relevant period. IV By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

¹⁷ See *London and General Bank (No 2)*, Court of Appeal, 6 August 1895 [1895] 2 Ch. 673: "Taking the balance-sheet, the certificate, and report together, Mr. Theobald (the Auditor) stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would, by its consequent publicity, be very injurious to their interests, and in such a case I am not prepared to say that an auditor would fail to discharge his duty if, instead of publishing his report in such a way as to insure publicity, he made a confidential report to the shareholders and invited their attention to it and told them where they could see it. The auditor is to make a report to the shareholders, but the mode of doing so and the form of the report are not prescribed. If, therefore, Mr. Theobald had laid before the shareholders the balance-sheet and profit and loss account, accompanied by a certificate in the form in which he first prepared *685 it, he would perhaps have done

enough under the peculiar circumstances of this case. I feel, however, the great danger of acting on such a principle; and in order not to be misunderstood I will add that an auditor who gives shareholders means of information instead of information respecting a company's financial position does so at his peril and runs the very serious risk of being held judicially to have failed to discharge his duty. In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders in certifying and laying before them the balance-sheet of February, 1892, without any reference to the report which he laid before the directors and with no other warning than is conveyed by the words, "The value of the assets as shewn on the balance-sheet is dependent upon realization." The most important asset on that balancesheet is put down as "Loans to customers and other securities," 346,975l., and on these a full and detailed report was made to the directors shewing the very unsatisfactory state of these loans and securities, and it is impossible to read the oral evidence, the report of Balfour and Brock, dated December 22, 1891, and the report of the auditor to the directors of February 3, 1892, without coming to the conclusion that the entry of that large sum as a good asset without explanation was unjustifiable. It is a mere truism to say that the value of loans and securities depends on their realization. We were told that a statement to that effect is so unusual in an auditor's certificate that the mere presence of those words was enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse inquiry, and, although an auditor might infer from an unusual statement that something, was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it. But Mr. Theobald relies on the fact that he was induced to omit from his certificate all reference to the report which he made to the directors because Mr. Balfour, the chairman, promised to mention that report in his speech to the shareholders, and he did so. But, although Mr. Balfour twice alluded to the *686 report, he did so in such a way as to avoid attracting attention to it. The second time he mentioned it was after a dividend had been declared and when a motion to reappoint the auditors was before the meeting. The truth is that not a word was said to convey to the shareholders the substance of the information contained in the report or to induce them to ask any question about it. The balance-sheet and profit and loss account were true and correct in this sense - that they were in accordance with the books. But they were, nevertheless, entirely misleading, and misrepresented the real position of the company. Under these circumstances I am compelled to hold that Mr. Theobald failed to discharge his duty to the shareholders with respect to the balance-sheet and certificate of February, 1892. Possibly he did not realize the extent of his duty to the shareholders as distinguished from the directors, and he unfortunately consented to leave the chairman to explain the true state of the company to the shareholders instead of doing so himself. The fact, however, remains, and cannot be got over, that the balance-sheet and certificate of February, 1892, did not shew the true position of the company at the end of 1891, and that this was owing to the omission by the auditor to lay before the shareholders the material information which he had obtained in the course of his employment as auditor of the company, and to which he called the attention of the directors. But then it is contended that, even if this be so, there was after all no payment of dividend out of capital, and further that, even if there was, still that such payment was not the natural or immediate result of Mr. Theobald's certificate and of the accounts which he prepared. Whether the payment was made out of capital or not is a question of fact. The payment was professedly made out of profits made by the bank, by charging its customers with interest and commission on loans and discount. The books shewed such profits; but the question is, Where did the money come from with which the dividends were paid? The money came from cash at the bankers or in hand; but this cash could not be properly treated as profit, and the directors and auditors knew this perfectly well. This part of the case has been most carefully investigated by the learned judge whose decision we *687 are reviewing and, after attending closely to the observations of counsel on the reasonings and conclusions contained in the judgment appealed from, I see no reason whatever for dissenting from them. On the contrary, I entirely agree with the learned judge in saying that the profits for the year 1891 never really existed except on

the auditors to approve the accounts or guarantee their accuracy¹⁸. It may be that, in practice, there is no significant difference between opinion, certification and approval.

paper, and that, to use his words, "whatever may be the right line to draw as to when profit not received may be carried to profit for the purpose of the annual revenue account, it is plain that there was no justification for so doing in the present case." The real truth is that the assets of the bank were put down in the balance-sheet at far too high a figure, and this entry, though not misleading if explained (as it was to the directors), was seriously misleading in the absence of explanation. Mr. Theobald says that he regarded the assets of the bank as only locked up; but his report and the schedule to it go far beyond this. The value of the principal asset depended on the probability of the Balfour group of companies and some of the other large borrowers repaying their loans. They were financing each other; their indebtedness to the bank had increased largely during the year; the securities held by the bank for these loans were, to say the least, to a great extent of very doubtful value; and yet the total amount due to the bank in respect of these loans is inserted in the balance-sheet as a good asset, without any deduction and without a word of explanation to the shareholders. We know now that those assets have realized a comparatively small sum, and we were very properly warned against the danger of doing injustice by being wise after the event. But, disregarding the result of realization, and attending only to what was known to the auditors in February, 1892, the entry in the balance-sheet of the sum of 346,975l. as a good asset was wholly unjustifiable, unless explained. We are now in a position to understand the true meaning of the passage contained in the auditors' report to the directors of February 3, 1892, and which runs thus: "We cannot conclude without expressing our opinion unhesitatingly that no dividend should be paid this year." I find it impossible to treat this as a statement by the auditors that there are profits divisible amongst the shareholders, but that the auditors cannot recommend a dividend. I can only regard the passage as meaning that there are no funds out of which a dividend can properly be paid, and therefore no dividend ought to be paid this year. A dividend of 7 per cent. was, nevertheless, recommended by the directors, and was resolved upon by the shareholders at a meeting furnished with the balance-sheet and profit and loss account certified by the auditors, and at which meeting the auditors were present, but silent. Not a word was said to inform the shareholders of the true state of affairs. It is idle to say that these accounts are so remotely connected with the payment of the dividend as to render the auditors legally irresponsible for such payment. The balance-sheet and account certified by the auditors, and shewing a profit available for dividend, were, in my judgment, not the remote, but the real operating cause of the resolution for the payment of the dividend which the directors improperly recommended. The auditors's accounts and certificate gave weight to this recommendation, and rendered it acceptable to the meeting. It was wholly unnecessary for the official receiver to call a shareholder to say that he was induced by the auditors' certificate to concur in the resolution to pay a dividend. As to this part of the case *res ipsa loquitur*. A point was made that the form of the order was wrong. But there is nothing in this. Mr. Theobald could obviously be sued alone in an action at law for breach of his statutory duty as auditor, and for damages resulting from the breach of duty, and the measure of damages would be the sum which he has been ordered to pay. Whether a similar action at law could be maintained against him and the directors jointly is more open to question. I am by no means satisfied that it could not, seeing that the wrongful payment of the dividend was caused by his improper certificate and accounts, and by the use made of them by the directors. But, be this as it may, there was a clear breach of trust by the directors, facilitated, and, indeed, only rendered possible, by the auditor who failed in discharging his own duty to the shareholders; and I have no doubt that in equity both he and they could be properly declared jointly and severally liable for the misapplication of the company's money which constituted that breach of trust".

¹⁸ See the very old but always valid *London and General Bank (No 2.)* Court of Appeal, 6 August 1895 [1895] 2 Ch. 673: "An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of the company is being conducted prudently or

However, there is a difference as far as auditors are concerned. This is because the opinion, firstly, does not alter rights and obligations, and, secondly, as assessment, with all the subjectivity that goes with it, leaves some margin of appreciation to the person expressing the opinion¹⁹. The transposition of private auditing methods into public auditing was gradual and accompanied by, and often dictated by, the transposition of private-sector management practices into State management. Reference to the whole was initially applied to a limited subject area in thematic audits. In such audits it was deemed that sampling to an extent that was sufficient to allow reference to the whole of the subject matter under scrutiny was sufficient to support a more general conclusion. As already mentioned, thematic audits are actually selected on the basis of the criterion of the interest they may hold, but they do not provide an overall picture of the management under scrutiny within the framework of the parliamentary procedure of granting discharge to the Government in respect of the financial year under review and offer only limited information for decision-making.

The Treaty on the functioning of the European Union assigned the European Court of Auditors (ECA) with the task of expressing a global opinion each year on only the reliability of the accounts and the legality and regularity of the underlying

imprudently, profitably or unprofitably. It is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question, How is he to ascertain that position? The answer is by examining the books of the company. But* 683 he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books themselves shew the company's true position. He must take reasonable care to ascertain that they do so. Unless he does this his audit would be worse than an idle farce. Assuming the books to be so kept as to shew the true position of a company, the auditor has to frame a balance-sheet shewing that position according to the books and to certify that the balance-sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do shew, but also for the purpose of satisfying himself that they shew the true financial position of the company. If he did, he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care of his part, by the fraudulent concealment of a book from him. His obligation is not so onerous as this. Such I take to be the duty of the auditor: He must be honest –i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but, still, an auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

¹⁹ « The ability of auditors to arrive at professional decisions and opinions, and the cognitive process by which they do so, varies according to a variety of environmental and personal factors. », in Porter et al., *Principles of External auditing, second edition*, Porter et al, Wiley, 2003, p.61.

transactions²⁰; mandate to issue a global opinion includes neither systems for preventing waste nor special investigations to ascertain cases in which criminal acts have been committed or instances of maladministration, poor performance and uneconomic choices²¹. The ECA's work on evaluating the European Union Institutions' internal control systems or its publication annually of some 15 special reports dealing with sound financial management in specific policy areas do not enable it to change the picture just described²². This is because the internal control systems are examined mainly with regard to their capacity to prevent or remedy issues of legality, while the special reports deal with specific issues and do not provide a global answer to the question of whether the public money, in the manner in which it was used in the previous year, had an effect. In France, the "*Cour des comptes*" attests to the reliability of the State annual accounts, but it does not attest to the legality and regularity of the underlying transactions, nor to sound financial management. Special audits are carried out periodically in connection with these matters, the substance of which is published in the French institution's annual report. The British National Audit Office carries out audits of the accounts of national departments and bodies, which are limited to such, and each year publishes special reports concerning performance. The Canadian Auditor-General issues an *opinion* every year on the reliability of the Federation's accounts and on the legality of the financial authorisations, along with special reports on performance. The picture that emerges from the above comparative examination of

²⁰ CALDEIRA Vitor. 'The European Court of Auditor's perspective on the management and control of EU funds : an overview of the current situation and the prospects for EU budget reform', in *Revista de Estudos Politecnicos*, 2008, n. pp. 7-27. ALONSO UNICA Manuel. 'Le contrôle technique des finances de l'Union européenne : les différents contrôles, leurs méthodes et la situation à fin 2003', *Mémoires présenté auprès de l'Institut européen de l'Université de Genève*. Genève, septembre 2005, pp. 335-348. LELONG Pierre. 'La Cour des comptes des Communautés et le contrôle externe des finances publiques européennes', *Revue française de finances publiques*, 1983, n. 4, pp. 99-118.

²¹ O'KEEFE David. 'The Court of Auditors', in *Institutional dynamics of European integration: essays in honour of Henry G. Schermers*, vol. II, pp. 177-1994. MARTY-GAUQUIE Henry. *Le contrôle externe des finances publiques européennes*, Bruxelles, Collection Europe, 1988. LAFFAN Brigid. *Becoming a 'Living Institution' : the evolution of the European Court of Auditors*, *Common Market Studies*, vol. 37 (1999), pp. 251-268. BERNICOT Jean-François. 'La Cour des comptes européenne a trente ans', *Revue française de finances publiques*, 2007, n. 100, pp. 269-286. INGHELDRAM Jan. 'The European Court of Auditors : current legal issues', *Common Market Law Review*, vol. 37/(2000), pp. 129-146. DESMOULIN Gil. 'La problématique du contrôle des finances publiques de l'Union européenne : entre crainte et volonté', in *Mélanges en hommage à Guy Isaac : 50 ans de droit communautaires* (ed. par. Marc Blanquet) 2004, pp. 925-948. BERNICOT Jean-François. 'La Cour des comptes européenne'. *Revue du Trésor*, 6 (juin 2007), pp. 555-558. BUGNOT Patricia. 'La Cour des comptes des Communautés européennes : premier bilan', *Revue du marché commun*, 1982, n. 262, pp. 609-623 DESMOND Barry. *Managing the finances of the European Union: the role of the European Court of Auditors*, Dublin, Institute of European Affairs, 1996. BARKER Patricia. 'Big ticket auditing: a review of the structures of the European Court of Auditors'. *Irish Accounting Review*, Vol. 13 (2006), Issue 2, pp. 1-20.

²² See however European Court of Auditors Annual Reports 2010, Chapter 8 on getting results from the EU budget.

the responsibilities of the audit institutions is almost the same: every year a general judgement is delivered solely with regard to the reliability of the accounts, while the soundness of financial management is examined on a piecemeal basis. However, only the ECA verifies legality and regularity in general and on the whole.

A different approach to auditing has already been taken in the United States' national audit body, the GAO²³. The GAO appears to have succeeded in satisfying what was stated earlier as being required of modern auditing and, at the same time, what the average citizen seeks with regard to the substance of annual financial information, i.e. the annual publication of a general judgement on the whole of the financial management covering all the important aspects of that management²⁴. Since 1993 it has issued the *High Risk Series* reports on inspections of all ministries and government departments, which are aimed at detecting areas in which there is a high risk of corruption, maladministration, waste, and abuse of power. Since 1999 it has produced the *Performance and Accountability Series* reports on inspections of government departments, which are aimed at identifying their shortcomings in meeting the more general challenges of the times. These *Series* are not issued strictly on an annual basis. They appear at the same periodicity as renewals of Congress and reports monitoring interim progress are issued in the intervening years. The distinctive feature of these *Series* is that they cover all government departments, they follow on from each other year by year and they cover the most important aspects of what, in Europe, would be termed an audit of legality and regularity and an audit of sound financial management. This is because, on the one hand, the *High Risk Series* reports pinpoint shortcomings in financial organisation that could or do result in material infringements with regard to legality (corruption, abuse of power) or the principles of sound financial management (waste, maladministration). On the other hand, the *Performance and Accountability Series* pinpoint shortcomings of national authorities in providing citizens with the public services they really need.

The essence of modern financial auditing is expressing a reasoned global opinion on the quality of the management audited. This opinion takes the form of a declaration concerning the reliability of the management. The contents of such a declaration can be positive or negative. However, public management can hardly be entirely faultless or completely irregular. There are several reasons why an audit institution issuing a statement of assurance uses many types of wording situated somewhere between the entirely positive and the entirely negative to express its global audit opinion.

The expression of a global audit opinion is particularly important in situations where the audit institution's report is used in the parliamentary procedure of granting

²³ Until 2004 the acronym stood for *General Accounting Office*, but it now stands for *Government Accountability Office*.

²⁴ See the GAO web site

discharge to a Government in respect of its financial management in the preceding financial year²⁵. In this case, the institution's report comprises a crucial element, but it does not determine whether the Parliament's judgement will be positive or negative. The Parliament will not adopt the conclusion reached by a non-political body without examining the grounds on which that conclusion is based and evaluating those grounds on the basis of its own criteria and policy rationale. This is also why reports prepared by public audit institutions differ from those of auditors of private enterprises, where the prevailing view is "the less said, the better", given in particular that general assembly of shareholders rely on the auditors' technical judgements and further information is not sought. A Parliament does not act in the same manner. It is not satisfied by a conclusion; it wants to know the justification for it and, quite logically, examines the extent to which the conclusion presented is that which Parliament would have drawn in the light of the information set out in the report.

The background to the European *Statement of Assurance* is a clear case of an audit opinion that has developed continuously in line with parliamentary needs²⁶. Since 1994, when the *Statement of Assurance* as to the reliability of the European Union's accounts and the legality and regularity of the underlying transactions was first drawn up, the European Court of Auditors has declared that it could not attest to the legality and regularity of the transactions underlying the accounts because of the many errors it had detected. This refusal has created a political problem for the European

²⁵ 465 U.S. 805 (104 S.Ct. 1495, 79 L.Ed.2d 826) UNITED STATES, Petitioner, v. ARTHUR YOUNG & COMPANY et al.No. 82-687.March 21, 1984. FOOTNOTE13 An unqualified opinion, the most favorable report an auditor may give, represents the auditor's finding that the company's financial statements fairly present the financial position of the company, the results of its operations, and the changes in its financial position for the period under audit, in conformity with consistently applied generally accepted accounting principles. See 1 AICPA, Statement on Auditing Standards §§ 510, 511.01 (1973). Alternatively, the auditor may give a qualified opinion, which states that the financial statements are fairly presented except for, or subject to, a departure from generally accepted accounting principles, a change in accounting principles, or a material uncertainty. Id., at § 512. An adverse opinion is a reflection of the auditor's determination that the corporation's financial statements do not fairly present the financial position, results of operations, or changes in financial position of the company in conformity with generally accepted accounting principles; an adverse opinion is issued when the auditor determines that the corporation has materially misstated certain items on its financial statements. Id., at § 513. Finally, a disclaimer of opinion expresses the auditor's inability to draw a conclusion as to the accuracy of the corporate financial records. A disclaimer of opinion generally issued when the auditor lacks sufficient information about the financial records to issue an overall opinion. Id., at § 514. See generally A. Arens & J. Loebbecke, Auditing: An Integrated Approach 643-660 (1976). (Footnote 14)The inclusion in an audited financial statement of anything less than an unqualified opinion could send signals to stockholders, creditors, potential investors, and others that the independent auditor has been unable to give the corporation an unqualified bill of financial health. Such a public auditor's opinion could well have serious consequences for the corporation and its shareholders.

²⁶ Jean-François BERNICOT Évolution des contrôles : l'expérience communautaire in *Innovations, créations et transformations en Finances Publiques* L.G.D.J., 2006, p. 149-159.

Commission, given that it is the European Union's executive body and most of the budget is implemented under its responsibility, as well as for the European Parliament, which, according to the Treaty and upon the recommendation of the Council of Ministers, is responsible for granting discharge to the Commission in respect of its management. The entire matter is complicated by the fact that, even though the Commission implements its entire budget in accordance with the Treaty, pursuant to the more specific Union's legislation applicable, more than 80 % of that budget is implemented via the Member States' administrations. The errors relating to legality and regularity that have been detected are directly attributable to the national administrations. The Commission's responsibility lies in the fact that it has not prevented the errors or, once they have occurred, it has been slow to find out and correct them. However, the view that the Commission is responsible for any errors made by the national administrations in their allocation of Union's funds seems as wrong as charging a Minister for Public Order with all the offences committed in his country. There is an institutional problem that should be resolved. The subject matter of the European Court of Auditors' audit for its preparation of the *Statement of Assurance* comprises the accounts and the underlying transactions. The Court's focus is not on *who* carried out the transactions concerned. The main matter of concern is whether or not *transactions* connected with the allocation of the Union's money that are recorded in the Union's accounts, are regular. On the other hand, the Parliament grants discharge to the Commission. The Commission's responsibility is a crucial factor. The Parliament, which is a political body, cannot act on the basis of presumed responsibility or legal "*fiction*". It has to be able to justify its judgement on the basis of criteria of common understanding of the law. To attribute the liability to the Commission, when dealing with national administrations within a given legislative framework, seems unjust.

The first *Statement of Assurance* was followed by a sustained effort to make the statement more analytical, more useable and fairer, without lowering the high validity criteria that the European Court of Auditors applies in its activities. On the one hand, the *Statement of Assurance* came close to meeting the Parliament's information needs and, on the other, was adapted to meet demands for fairer treatment of the Commission, an institution that implements less than 20 % of the Union's budget directly. The *Statement of Assurance* began to appear more analytical on three levels. *Firstly*, while it remained a global expression of an opinion regarding all revenue, nevertheless, as far as each large expenditure category was concerned, i.e. agriculture, coherence, external aid, etc., it began to be broken down into assessments on specific policy areas. The Parliament was thus placed in a position where it could better identify problems and make recommendations on safer ground. *Secondly*, the European Court of Auditors expressed its view on progress made since the preceding year from the point of view of error reduction or the taking of action expected to result in error limitation. Hence, while the Parliament was faced with yet another negative Statement of Assurance, it could still grant discharge to the Commission in recognition of the progress that had been achieved. *Thirdly*, the European Court of Auditors introduced differentiation between problems in the system of internal control and errors detected

in the individual transactions underlying the accounts. This differentiation enabled the Parliament to identify the Commission's responsibility more clearly with regard to implementation of the budget by limiting this responsibility to cases of the failure to implement effective prevention or containment systems, within the framework of what is economically feasible and reasonable.

The above example indicates the need for adaptation of the audit mandate to specific social needs. The audit work forms part of an institutional perspective; it is a factor in the attainment of a broader objective and, in this sense, it should be adapted to this objective. The information given to the Parliament must not give rise to unjust conclusions, and must be relevant, i.e. provide the user with the information needed in the light of the user's role and function²⁷.

Modern financial auditing, which has no legal consequences, bases its effectiveness on the fact that its results are a useful tool in the parliamentary control procedure, thus enhancing financial affairs and raising public awareness, so that sounder financial management is demanded. A valid, objective, useable and readable report by the audit institution, and consequently one that persuades the press and public opinion, can argue that the political authority should take action to carry out reforms when political debate is polarised or there is an absence of information based on facts, instead of on conjecture or dogmatic ideas.

Modern financial auditing relies on its findings being evaluated by Parliament and the press²⁸. The possession of a legally-binding nature, which is actually not the

²⁷ [2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr. JUSTICE EVANS – LOMBE, BARINGS Plc552It is instead necessary to decide whether, in the circumstances of which the auditor should have known, the procedures which he followed gave him reasonable assurance that the financial statements were accurate. Only if a risk of which he should have known should have indicated to him that those procedures did not give such reasonable assurance was he required to carry out other procedures to cater for that risk. Clearly the size of the risk is relevant to that assessment. This seems to me the planning process laid down in the D&T manual and in my judgement was the correct approach.[2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr. JUSTICE EVANS – LOMBE, BARINGS Plc558As is clear from SAG 4, quoted at paragraph 496 above, an auditor is concerned to obtain reasonable assurance of the completeness of the information in the financial statements, particularly where he is conducting a substantive audit. Mr Swinson gave evidence that, when auditing a futures broker, this required an auditor to obtain reasonable assurance that the brokers' records agreed both with the exchange and with customers (to the extent that the broker was not trading on its own account). This was true for open positions as well as balances. Mr Spence agreed with the requirement to obtain reasonable assurance of the completeness of the records, and I think with its application to open positions, although he disagreed as to what test should be done to achieve that assurance.

²⁸ WHITE Fidelma, HOLLINGSWORTH Kathlyn. Audit, accountability and government, Oxford, Clarendon press, 1999. CIPRIANI Gabriele, The EU budget, Responsibility without accountability? 1st edition, Centre

case with audit reports, is replaced by the influence the audit findings have on public opinion and by the conclusions drawn in general by Parliament with regard to measures that are needed to prevent repetition of or rectify any errors detected by the audit²⁹. The Parliament, press and public opinion create a system for promoting measures for the improvement of financial management which is fuelled by information, arguments and recommendations taken from the audit institution's reports. The audit institution exercises its influence through the power of its message. Persuasion, the essence of democratic procedures, is the basic reason for using audit findings. This is why the audit institution's findings must be readable and useable, so that they can be incorporated smoothly into the democratic procedure of public debate.

In many democratic countries, the institution for external financial control is considered to be a body that is subsidiary to the Parliament and which the Parliament can order to carry out audits or from which the Parliament draws information in order to carry out its role of exercising political control³⁰. The Parliament's approval of the financial management effected by the Government, if based on an audit of the accuracy of data supplied by the Government to the Parliament and on the basis of which the Government is seeking discharge, is supported by the audits carried out by the institution for external financial audit. Where the audit institution's report does not contain any findings or the findings are insignificant, the Parliament may vote and approve the past financial management without any difficulty. However, if serious problems have been highlighted in the report that relate either to items contained in the management accounts or to the regularity of the underlying transactions, the Parliament cannot vote to grant discharge to the Government without first examining the measures taken by the Government to prevent repetition of or rectify the errors and shortcomings detected³¹.

In countries where the Government is supported by a solid party majority in Parliament, a political procedure that would place the Parliament at odds with the Government might seem utopian. However, there is no question of such an occurrence. If an audit institution's report has been drawn up in such a way that it is clear and convinces the press and if the observations set out can constitute a basis for fruitful discussion and useful intervention, then the report cannot pass unnoticed by the Parliament. It cannot pass unnoticed because the press would have raised awareness

for European Policy Studies, Brussels, Belgium, 2010. FONDATION ROBERT SCHUMAN, L'argent public de l'Europe. Quel contrôle ?, Fondation Robert Schuman, Paris, France, 5 November 2007.

²⁹ FLIZOT Les relations entre les institutions supérieures de contrôle financier et les pouvoirs publics dans les pays de l'Union européenne LGDJ 2003p. 211.

³⁰ Jean Pierre CAMBY Le contrôle parlementaire des dépenses budgétaires in *Innovations, créations et transformations en Finances Publiques* L.G.D.J., 2006, p. 164. FLIZOT Les relations entre les institutions supérieures de contrôle financier et les pouvoirs publics dans les pays de l'Union européenne LGDJ 2003p. 229, 347.

³¹ FLIZOT Les relations entre les institutions supérieures de contrôle financier et les pouvoirs publics dans les pays de l'Union européenne LGDJ 2003p. 347, 377.

and apply pressure while waiting for solutions. In fact, on many occasions, the Government itself will seek the audit institution's support so that it can take initiatives to carry out reform in politically sensitive areas, especially those where the vested interests of the few are affected, but those of the majority have no means of dynamic expression.