

Trucking On – Audit in the Real World?  
(Man v Freightliner (and Ernst & Young))

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## Man v Freightliner (and Ernst & Young)

In 2008 the House of Lords declined to hear an appeal beyond a decision of the Court of Appeal<sup>1</sup> in an action brought by Freightliner, a US subsidiary of Daimler-Chrysler, against Ernst & Young<sup>2</sup> with respect to its audit of ERF Holdings Plc<sup>3</sup> a UK manufacturer of commercial trucks which was sold by its then owner, Western Star (a Canadian based company), to MAN (a German based company) in March 2000. Freightliner had acquired Western Star in July 2000 and therefore had inherited both the potential liabilities of ERF and also the possibility of a claim against its auditors. MAN had brought an action against Freightliner with respect to representations made by Western Star in connection with the sale of ERF to MAN, and Freightliner in turn was seeking to recover from Ernst & Young essentially on the grounds that these representations would not have been made if Ernst & Young had exercised reasonable skill and care in its audit of ERF.

Although not insignificant in terms of the size of the claim, £350 million, made against Freightliner the case attracted relatively little attention beyond that which focused on the legal issues of whether Western Star was responsible for representations made within and beyond the share price agreement with MAN and whether Ernst & Young, as auditors of ERF, owed a duty of care to Western Star (and thereby to Freightliner) with respect to its audit of ERF's financial statements and in connection with the due diligence exercise carried out by the purchaser. The finding in both the lower court and the Court of Appeal that Ernst & Young did not owe a relevant duty of care to Western Star, (notwithstanding that Ernst & Young were aware at the time they signed their audit report in respect to the accounts for the year ended 30 June 1999 that these accounts would be used in the context of the takeover

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<sup>1</sup> MAN Nutzfahrzeuge AG and another v Freightliner Ltd. and another [2007] All ER D 65 Sep.

<sup>2</sup> Actions were brought against both the UK firm and the Canadian firm. In this paper Ernst & Young refers to the UK firm (described in the judgment as E&Y (UK)) unless specified otherwise.

<sup>3</sup> The main trading activity took place in one of a number of subsidiaries. In this paper ERF refers to the group unless specified otherwise.

negotiations) is worthy of further analysis and study<sup>4</sup> - but the purpose of this paper is rather to focus on the insights contained within the lower court judgment<sup>5</sup> as to the nature of the audit carried out by Ernst & Young (together with glimpses of that carried out by the firm which replaced it as auditor of ERF, Deloitte & Touche<sup>6</sup>) and to place that audit within the wider context of perceptions as to the nature of audit practice, before proceeding to discuss briefly the relevance of the case to auditor maintained notions of expertise and professionalism and the role of self regulation and disciplinary procedures within the auditing profession.

## The facts

Following its acquisition of ERF in June 1996, the Canadian parent company (Western Star) decided upon the worldwide introduction of a new IT based accounting and materials management system throughout the group. ERF was the first company to implement this (albeit initially only with respect to the accounting functions) and its introduction on 1 July 1997 without any period of parallel running proved disastrous, giving rise to endless headaches for the accounting staff who were unable to produce a trial balance or indeed the data for the monthly management reports required by Western Star. To overcome this latter problem ERF's financial controller<sup>7</sup> generated these monthly reports on the basis of estimated numbers.<sup>8</sup> In respect to the balance sheet there was an attempt to utilise internal information as to fixed assets, stock and debtors but as the judge in the case noted, he 'used trade

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<sup>4</sup> As are the brief references contained within the judgment as to issues relating to contributory negligence and disclaimers of liability.

<sup>5</sup> The Court of Appeal decision was solely concerned with duty of care and related issues and consequently all references to the judgment in this paper are to the lower court judgment reported as *MAN Nutzfahrzeuge AG & Ors v Freightliner Ltd.* [2005] EWHC 2347 (Comm).

<sup>6</sup> Now renamed Deloitte.

<sup>7</sup> The financial controller, Ellis, had worked for ERF in a financial capacity for more than twenty years but had no formal accounting qualifications (strictly speaking he was not appointed financial controller until May 1998 following the departure of the group accountant to work for the parent company in Canada).

<sup>8</sup> The judge described the process as such: 'To overcome the difficulty [the inability to produce monthly accounts from the accounting records] Mr Ellis produced monthly profit and loss accounts which, instead of containing figures drawn directly from the financial records, contained estimated figures based on his assessment of the group's performance derived from conversations with the Sales, Costs, Payroll and other relevant departments' (para 11).

creditors as a balancing figure'.<sup>9</sup> He did not, however, inform Western Star or even the management of ERF that the figures he was producing were estimates.

By the time the financial statements for the 30 June 1998 year end were being put together the new accounting system was sufficiently capable to produce both a profit and loss statement and a balance sheet. Unfortunately this threw up an adverse discrepancy of approximately £18m between these figures and those that had been reported within the management accounts – and this was reflected in both the total of the memorandum purchase ledger balances and the nominal ledger control accounts generated by the system. In order to bring the general ledger in line with the figures that he had previously reported for trade creditors the financial controller made a number of false journal entries in the control account and then, for the benefit of the auditors, conjured up a reconciliation between the purchase ledger itself and the control account – a reconciliation which explained the difference between the two in terms of payments made to suppliers before the year end but not yet entered into the purchase ledger. These payments were genuine in themselves – but they had not been made until July and therefore were invalid for the purposes of the reconciliation. The sums involved were clearly material in the context of ERF's financial statements, which for the year ending 30 June 1998 showed turnover of £218m, trade creditors of £29.4m and post tax income of £5.1m.

Before its acquisition by Western Star, ERF had been a listed company and was audited by KPMG, a major international audit firm. KPMG were retained as auditors for the fifteen month accounting period ending 30 June 1997 but were replaced, on the recommendation of Ernst & Young (Canada) the auditors of Western Star, quite late into the next accounting year, by Ernst & Young (UK). Ernst & Young (UK) carried out fieldwork on the audit for the twelve months ended 30 June 1998 in August and September and no doubt provided clearance for consolidation purposes shortly after (or before),<sup>10</sup> although they did not finally sign off on the group accounts

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<sup>9</sup> *ibid*

<sup>10</sup> In respect to the following year's audit Ernst & Young (Canada)'s audit report on the Western Star group accounts for the year ended 30<sup>th</sup> June 1999 was signed off on 24 August 1999 'which was the date on which the audit was substantially completed' (para 512). Para 28 of the judgment states that the audit fieldwork for ERF had been completed by 20 September 1999, although para 391 suggests that Ernst & Young (UK) were still carrying out, or perhaps considering the implications of, fieldwork at that date.

until May of the following year. However, in the course of their audit they did not pick up the falsified nature of the purchase ledger control reconciliation and indeed appear to have accepted the bona fide nature of the reconciliation on trust. As the judge noted, perhaps with a degree of understatement: ‘Unfortunately Ernst & Young (UK) failed to verify the reconciliation by reference to the underlying documents and therefore failed to detect that it was invalid.’<sup>11</sup> A similar situation held at the 30 June 1999 year end where again Ernst & Young did not carry out any verification work with respect to a schedule produced by the financial controller reconciling a difference of £21.4 million between the control account figure and that obtained from summation of the balances in the purchases ledger. Under pressure to sign off on the financial statements so that they could be used for the purpose of the due diligence exercise being conducted by MAN (the prospective acquirer) and (on their behalf) Deloitte & Touche (an exercise which commenced on 2 November 1999) a clean audit report was provided on the statutory accounts on 4 November 1999.<sup>12</sup>

Separately from this, the financial controller was also falsifying the VAT returns provided to HM Customs and Excise – primarily for the purpose of improving ERF’s cash flow. The first instance of this in March 1996 was apparently an isolated incident but as the judge noted ‘by his own admission from the middle of 1997 onwards he falsified the VAT returns month by month, thereby enabling ERF to receive regular repayments of tax to which it was not entitled.’<sup>13</sup> Although not as large as the balancing figures in the purchase ledger reconciliation these sums too were substantial. Despite not finding agreement in entirety it was common ground between the expert witnesses for both sides that these frauds led to an understatement of the VAT liability of at least £4m at year end 1998 and that this had risen to at least £7m by year end 1999. Unfortunately no detail is provided in the judgment as to the manner in which this fraud was conducted – if it was merely alteration of the returns then one might have expected the differences between the claimed VAT position and that thrown up by the accounting system to have manifested themselves once the accounting system was functioning in a reasonably conventional manner. If however alterations had been made to the underlying records then again one would have

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<sup>11</sup> para 29

<sup>12</sup> The report and accounts were collected by ERF representatives from the local office of Ernst & Young and taken directly to the location where the due diligence exercise was being conducted.

<sup>13</sup> para 10

expected that these might be picked up either by ERF's own accounting personnel or by the auditors.

During the course of the 1998 audit Ernst & Young had introduced to ERF two members of its firm with 'expertise' in VAT, apparently for the purpose of bringing to ERF's attention the scope of other services provided by Ernst & Young to their clients.<sup>14</sup> Although these personnel became aware of the pattern of reclaimed VAT it did not appear to strike them as particularly unusual. More importantly the audit team carried out little or no work on the VAT figure as they believed that it had been covered for audit purposes by the VAT specialists from their own firm. Furthermore in the following year they appear to have been under the impression that the specialists were continuing to be associated with ERF's VAT computations – although they were not – and again carried out no specific work on the VAT returns. Here again perhaps the judge was being mildly ironic when he noted in respect to the 1999 audit that: 'Ernst & Young's Global Release Audit Manual called for the company's tax position to be one of the matters taken into account at the planning stage of every audit, but in this case, for some reason not explained in the audit papers, it was considered unnecessary to do so.'<sup>15</sup>

Following its acquisition by MAN, ERF gained new directors including *inter alia* a Dr Schubert and a Mr Wagner.<sup>16</sup> More importantly to the tale, new auditors, Deloitte & Touche, were appointed.<sup>17</sup> Deloitte & Touche carried out a statutory audit for the year ended 30 June 2000, but also appear to have failed to detect at the time the audit work was conducted either the false nature of the reconciliation between the purchase ledger and the control account or the continuing nature of the VAT fraud. In relation to these accounts ERF took advantage of the exemption now available to it as a wholly owned subsidiary of a company registered in the European Union not to provide group accounts.<sup>18</sup> However, following a change of accounting year end, so as to bring that of ERF into line with the year end of its German parent it was during the

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<sup>14</sup> para 368

<sup>15</sup> para 372

<sup>16</sup> One might surmise that as, over time, the complete saga unfolded, the boardroom mood music became more *Gotterdammerung* than *Lied* in style.

<sup>17</sup> The MAN Group was audited by Deloitte & Touche's German associate

<sup>18</sup> Deloitte & Touche appear to have given clearance on the (unpublished) group accounts in August 2000 (para 279).

audit work conducted by Deloitte & Touche for the period ending 31 December 2000 that concerns raised by the auditors as to the nature of this reconciliation first alerted MAN to the existence of significant accounting issues at its subsidiary. Deloitte & Touche never signed off on the 31 December 2000 parent company financial statements (a heavily qualified audit opinion on these accounts was subsequently provided by BDO Stoy Hayward – thereby giving ERF the dubious distinction of having had four different auditors across five separate accounting periods - in May 2002), but they did sign off on the 30 June 2000 company accounts in April 2001 notwithstanding that they had already raised their concerns as to the 31 December 2000 reconciliation with the German parent. In that these problems lay in a subsidiary, presumably Deloitte & Touche were able to satisfy themselves that, at the minimum, the relevant issues did not impact on the carrying value of the ‘investment in subsidiary’ balance in the parent company accounts, although a year later, when the full extent of the ERF debacle had become clear, BDO Stoy Hayward did not consider themselves able to provide an unqualified opinion on the company accounts.<sup>19</sup>

The reporting of Deloitte & Touche’s audit concerns to the German parent company set in chain the course of events which, after one or two false starts, led to the realisation that the problems at ERF were not, as Deloitte & Touche had thought, of a merely technical nature but were far more serious.<sup>20</sup> In late July 2001 the financial controller was suspended and by early August it had ‘become apparent that there was a deficiency of approximately £100 million in the balance sheet of ERF.’<sup>21</sup>

## Negligence

Although, because of his findings in respect to the duty of care issue, it was not necessary for the judge to consider further issues of negligence, nevertheless he did so

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<sup>19</sup> Although they were no longer auditors of ERF Deloitte & Touche retained the audit of the MAN group.

<sup>20</sup> Investigation by a member of the German parent’s internal audit team had been hampered by the general confusion relating to ERF’s purchase ledger. On 1 June 2001 ERF employed a qualified accountant (previously employed by Deloitte & Touche and who had worked on the most recent Deloitte & Touche audit of ERF) to assist Mr Ellis (who was still financial controller). This individual was charged with the specific task of sorting out the problems with the purchase ledger and it was her inability to produce a valid reconciliation between the ledger and the control account which led to the suspension of Mr Ellis.

<sup>21</sup> para 45

stating: ‘In these circumstances it is both unnecessary and inappropriate to consider whether Ernst & Young (UK) was in breach of any duty of care to Western Star, but since the question was fully debated in argument, I shall express my views on it as briefly as I can.’<sup>22,23</sup>

Having covered both the issues relating to the reconciliation of the purchase ledger control account (in respect to which Ernst & Young admitted negligence) and the failure to detect the understatement of the VAT liability (where the judge was satisfied that in both 1998 and 1999 the work of Ernst & Young fell below the standard to be expected of reasonably competent auditors and that they were negligent),<sup>24</sup> the judge then proceeded to consider issues in respect of : overstatement of cash<sup>25</sup>; the provision for warranties; failure to report concerns about ERF; and failure to respond adequately to a tip-off received as to the possibility of the auditors being provided with false information.

In respect to the possible overstatement of cash the facts were, on the face of it at least, straightforward. A bank reconciliation prepared as at 30 June 1999 showed a difference of £9.7m between what the judge described as the bank control account and the cash book, the difference representing four batches of cheques posted on 30 June. During the preparation of the accounts one of the finance assistants had recredited<sup>26</sup> these cheques on the grounds that, although written, they had not been sent out before the year end, but inadvertently, he or she, had failed to make a corresponding adjustment to the purchase ledger. This resulted in net assets being overstated by £9.7m. Expert witnesses for both parties agreed that ‘a competent auditor exercising reasonable skill and care would have identified this discrepancy’<sup>27</sup> and the judge was satisfied that Ernst & Young had been negligent in failing to do so.<sup>28</sup>

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<sup>22</sup> para 361

<sup>23</sup> In fact the judge proceeded to devote paras 361-394 of the judgment to these issues

<sup>24</sup> paras 371 and 373

<sup>25</sup> Or alternatively, as contended by the expert witness for Ernst & Young, understatement of creditors.

<sup>26</sup> Although the judge termed them to have been recredited presumably, strictly speaking, they were debited to cash in the double entry system.

<sup>27</sup> para 375

<sup>28</sup> Although one might assume that the difference on the bank reconciliation and on the purchase ledger reconciliation were in fact linked it is not clear from the judgment that this was in fact the case. In particular there is no reference in the judgment to any difference on the bank reconciliation in 1998.

The position as to the warranty provision was that ERF provided three different types of warranty: a basic two year warranty against defective workmanship and materials; a similar optional warranty ‘Suredrive’ for up to three years beyond the expiry of the basic warranty and, from 1 September 1998, a ‘Driveline’ warranty covering the engine, gearbox and transmission only for a period of a year beyond the expiry of the basic warranty. In addition ERF sometimes paid on a discretionary basis for repairs to vehicles under five years old. The 1998 accounts contained a warranty provision of £2.15m, by far the greater part relating to first year warranty costs (calculated systematically based on prior year experience) together with a round sum provision of £0.15m for second year warranty costs<sup>29</sup> Ernst & Young did review this provision but the judge held that they were far too ready to accept management explanations as to the low level of provision for second year claims. This was justified by the management on the grounds that any such claims were normally offset by ERF’s own claims against its suppliers – but the judge noted the existence of an Ernst & Young audit document indicating that in practice recovery was frequently impracticable or not pursued.<sup>30</sup> Furthermore Ernst & Young had failed to identify, or at least raise any concerns, as to the absence of any allowance relating to the optional Suredrive warranty or (in 1999) the newly introduced Driveline warranty.

In this context and in relation to the 1998 audit the judge opined: ‘If an auditor decides to verify a provision of this kind by reviewing and testing the procedures used by management to develop the estimate, it is necessary to follow through the whole of the procedure in question. Ernst & Young (UK) did not do that in this case because they failed to test the allowance made for the second year. Moreover, I think that they can be properly criticised for failing to identify the fact that management made no allowance for the costs of claims arising during the third year under the ‘Suredrive’ warranty. I am satisfied that in these respects Ernst & Young (UK) failed to meet the standards to be expected of reasonably competent and careful auditors and were negligent’<sup>31</sup> With reference to the 1999 audit he noted that ‘In formulating their work plan for the 1999 audit Ernst & Young (UK) recognised the need for a detailed

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<sup>29</sup> Included in the total were also amounts, apparently much smaller, relating to export sales and intercompany warranties. In 1999 the provision was £1.94m again including a round sum £0.15m for year 2 claims.

<sup>30</sup> para 379

<sup>31</sup> para 380

evaluation of the provision put forward by management, but failed to carry it through<sup>32</sup> However, in respect to both years the judge did not consider the difference between the correct provision and that contained in the accounts was material.<sup>33</sup>

The Ernst & Young (UK) partner responsible for the ERF audit had, from an early stage of the 1998 audit, raised concerns as to the capabilities of ERF's financial controller and his reluctance to admit the scale of the problems associated with the difficulties experienced operationalising the new financial systems. In October 1998 she recorded these concerns in response to a request from Ernst & Young (Canada) for observations on the draft Audit Observations report they had prepared as part of their audit of Western Star. In her memorandum of comments she raised a number of serious questions about the integrity and competence of the financial controller: 'In particular, she cast doubt on his willingness to bring unwelcome information to the attention of senior management, referred to a tendency on his part to withhold information and to be evasive in his dealings with the audit team, and questioned his competence in handling the technical aspects of the accounting and control procedures'<sup>34</sup> More generally she was concerned that: 'an unwillingness on the part of the senior management of Western Star to tolerate underperformance was creating a risk that the accounts might be manipulated in order to give an impression that the group was doing better than was really the case.'<sup>35</sup>

In these circumstances the plaintiff argued that the audit partner was at fault in failing to bring these concerns to the attention of the (part-time)<sup>36</sup> managing director of ERF. Notwithstanding Ernst & Young's contention that the views of the audit partner were both preliminary and evolving, the judge was of the opinion that the audit partner should have taken steps to raise her various concerns about the operating and control function within ERF with its managing director – but he did not consider that her failure to do so materially affected the course of events. ERF's managing director had

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<sup>32</sup> para 382

<sup>33</sup> The figures would have been material if the judge had held that appropriate provision should have been made for discretionary repairs – but here the judge preferred the view of the expert witness for Ernst & Young that, in the absence of any contractual commitments, no such provision was necessary.

<sup>34</sup> para 384

<sup>35</sup> *ibid*

<sup>36</sup> He combined his role as managing director of ERF with that of managing director of a bus company (also owned by Western Star) based in Toronto.

an engineering rather than a financial background and in the opinion of the judge he would have asked the audit partner to take up her concerns with the chief financial officer of Western Star. In June 1998 this individual had become aware from other sources that ERF was unable to obtain a trial balance from its accounting systems – and when told shortly afterwards that a trial balance had been obtained and accepted by Ernst & Young had not raised any particular concerns as to the fact that he had not been informed of this until all but the end of the financial year, or indeed that for the whole of the financial year the information provided to management had been based at least in part on estimates. Furthermore his department was aware that ERF's financial controller was prone to being over-optimistic and 'in a general way' of other matters raised in the audit partner's memorandum of comments. Consequently criticisms levelled by Ernst & Young against the financial controller of ERF would have added little to what Western Star already knew.

On the 20<sup>th</sup> September 1999 ERF's audit partner received a telephone call from a retired banker whose daughter worked at ERF, a call which raised concerns of a general nature as to the possibility that Ernst & Young were being provided with misleading information by the management of ERF. The audit partner made a note of this conversation and this formed the basis for a file note written in November some two months later. Unfortunately the original note was lost and this added to a degree of uncertainty as to the nature of the conversation between the retired banker and the auditor. The November file note referred to information as to the sales and margins on second hand vehicles acquired under 'buy-back' arrangements but the judge was satisfied that here the audit partner's recollection was mistaken, perhaps influenced by the fact that at the time of the conversation the audit team was working on the treatment of buy-backs in the accounts. Although the original documentation is missing, it is clear that the audit partner did respond in a timely manner to the receipt of this telephone call. On 21 September she contacted the Ernst & Young (Canada) partner with overall responsibility for the Western Star audit who in turn passed the information on to Western Star's chief financial officer. On 23 September she (the ERF audit partner) discussed the issues raised with the ERF audit team and together they considered areas in which critical information had been provided by ERF's management. However as they did not appreciate that the purchase ledger control

account reconciliation (and presumably the bank reconciliation) ~~constituted to be~~ such a management representation these were not included in this review.

Counsel for Ernst & Young submitted that it would be impossible for auditors who had received ‘a somewhat vague tip-off of this kind’ to revisit every representation made to them by management throughout the whole period of the audit – and that what starts as a representation may be considered to be fact once properly verified. Whilst appreciating the force of this argument, the judge considered that it is important for auditors to retain a clear sight of what constitutes verification and what does not. Ernst & Young should have recognised that the purchase ledger control reconciliation was ‘nothing more than a management representation which had not been verified and ought therefore to be reviewed’.<sup>37</sup> Intriguingly the judge noted ‘In this case, however, it appears that a member of the audit team responsible for verifying the reconciliation had wrongly marked the record in such a way as to indicate that it had been verified to the underlying documents’.<sup>38</sup> In such circumstances the judge was of the opinion that even if the audit team had extended the scope of their review to encompass all unverified representations made by management, ~~that~~ they could not have been criticised for treating this item as one of established fact rather than a mere representation.

## Audit insights

What can we learn from this case as to the nature and practice of audit? In seeking to establish this it is necessary to recognise that we have an imperfect knowledge of the manner in which the audit was conducted. We do not have access to the audit working papers in their entirety or in part – we do not even know the number or level of seniority of the personnel engaged on the audit (although there are references in the judgment to an ‘audit team’) - as such we are seeing through a glass darkly, and furthermore a glass through which the light is filtered almost entirely via the perspective of a judge whose knowledge of accounting and audit procedures must inevitably be ~~a limited one~~. However, it is contended that there is sufficient information in the judgment (which is more than 100 pages long and comprises 523

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<sup>37</sup> para 394

<sup>38</sup> *ibid*

paragraphs) to build up a picture of an audit process which is some way removed from the template of an audit as contained in both auditing standards and the audit manuals of the large firms, and also to reflect briefly on wider issues relating to the audit approach, governance and professional regulation,.

## Planning and Execution

The proper approach to planning and executing an audit is covered in a range of auditing standards including *inter alia* ISA (300)<sup>39</sup> and ISA (500)<sup>40</sup>. Deficiencies in the ERF audit in terms of both planning and execution included the failure to ensure that significant items were identified as needing to be covered during the audit process - for example VAT. There was also a failure to ensure that items identified at the planning stage as requiring attention were in fact covered appropriately, for example in respect to the 1999 warranty audit. The execution of the audit was manifestly deficient with respect to the failure to verify the purchase ledger control reconciliation in 1998 and 1999 and also the bank reconciliation in 1999 and, although the evaluation of likely warranty claims is not always straightforward, there was also a failure to follow through concerns as to the provision figures contained within the financial statements.

## Review and Quality Control

Review is a key part of the audit process. Many areas of audit work cover financial statement elements where, notwithstanding the fact that the audit procedures are normally routine, there is nevertheless the potential for significant error. The primary audit work on these elements, which for a manufacturing company such as ERF might include cash and bank balances, trade creditors and trade debtors, is frequently conducted by relatively junior and inexperienced staff. In such circumstances a thorough process of review is essential to ensure that these staff have both understood the nature of the work that they are required to carry out and also executed it appropriately. There is little if any reference to the review process within Ernst & Young's audit of ERF - but it clearly failed to pick up the weaknesses with respect to

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<sup>39</sup> ISA 300 *Planning an audit of financial statements*. References to International Standards on Auditing (strictly speaking Auditing Standards UK and Ireland as they are applicable in the UK) are to the October 2009 versions available at <http://www.frc.org.uk/apb/publications/pub2085.html> - these versions would not have been in force at the date at which the relevant audits were carried out – but it is contended that there is little significant difference between the present day requirements and those applicable at the time. In fact there is surprisingly little reference to auditing standards in the case - a lack of judicial interest in engaging with auditing standards was noted in a review of the legal actions relating to the audit of Elton John's management companies (see Gwilliam, 'Audit Quality and Audit Liability: a musical vignette' PN, 2006, 22(1), 59-64) .

<sup>40</sup> ISA 500 *Audit evidence*.

the quality of the audit work carried out on both trade creditors and on cash. Whilst there may be an explanation for the failure of senior audit personnel to appreciate the lack of audit work on the creditors reconciliation if indeed the audit file had been marked up in a misleading fashion,<sup>41</sup> it is not clear that this was the case for both 1998 and 1999 nor that there was a similar explanation with regard to the bank reconciliation. Nor did the review process identify the weaknesses of the audit procedures and the failure to adhere to the audit plan with respect to warranties and VAT.

ISA 220<sup>42</sup> requires for listed companies the appointment of an 'Engagement Quality Control Reviewer'. Although this requirement may not have been in force at the time over which the relevant audits were carried out there is no doubt that the manuals and procedures of all the large firms at the time would have required a second party opinion/review for any but the most straightforward audit engagement. Surprisingly there is no mention in the judgment of any consultation internally within the Manchester office of Ernst & Young – this does not mean to say that such consultation did not take place, but, if it did, it failed to generate the appropriate audit judgement.<sup>43</sup>

#### Co-ordination between Ernst & Young (UK) and Ernst & Young (Canada)

Whilst auditing standards (in particular ISA 600<sup>44</sup>) devote significant attention to the issues surrounding the use of the work of another auditor, the standards are essentially

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<sup>41</sup> Whilst this aspect is not explored further in the judgment there is a significant literature stretching back over many years on the propensity of audit staff to claim credit for tasks that they have not done - whether because of time and budget pressures internal to the audit firm or because of a lack of understanding of the task that needs to be carried out. One of the earliest studies of this phenomenon was that of Rhode, J. G. (1978), 'The Independent Auditors' Work Environment: A Survey', CAR Research Study No. 4, summarised in Commission on Auditors Responsibilities (CAR), 1978, Report, Conclusions and Recommendations, New York: AICPA. A more recent literature review can be found in Soobaroyen and Chengabroyen, 'Auditor perceptions of time budget pressure, premature sign offs and under-reporting of chargeable time: evidence from a developing country', *International Journal of Auditing*, 2006 10(3), 201-218.

<sup>42</sup> ISA 220 *Quality control for an audit of financial statements*.

<sup>43</sup> There is reference in the judgment, para 505, to the Canadian engagement partner discussing the tip-off as to misrepresentation in the ERF accounts with a senior E&Y (Canada) partner.

<sup>44</sup> ISA 600 *Special considerations – audits of group financial statements (including the work of component auditors)*.

couched in terms of the use of another firm of auditors<sup>45</sup> and are largely silent on co-ordination within one firm. Whilst the large multi-national firms have for many years sought to portray themselves as homogenous global professional service entities the reality is that this image lies uneasily with the actuality of separate national firms and also of separate offices within individual national firms. Although there was interaction between the Manchester office of Ernst & Young (UK) and the Canadian firm, there are snippets in the judgment, as in the example referred to below of the failure of the Canadian engagement partner to respond to the UK engagement partner's request for advice and the significant watering down of the audit observations letter, which might be interpreted in the context of [Ernst & Young \(Canada\)](#) the Canadian firm was not being anxious to hear 'bad news' about the UK audit - and that this might have constrained the UK firm from putting such news forward as forcibly as it might otherwise have done.

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<sup>45</sup> For a particularly disastrous audit outcome consequent ~~to~~on reliance upon the work of other auditors in the context of Polly Peck, see Gwilliam and Jackson, Ch.18 in [Creative Accounting, Fraud and International Scandals](#) ( M. Jones ed), [Creative Accounting and Fraud](#), Wiley (2010)).

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## Response to the whistleblower

Ernst & Young is currently under fire in both the US and the UK because of its reaction, or lack of it, to the concerns raised by an employee of Lehman Bros as to the accounting treatment that Lehman's was employing in order to reduce its reported gearing levels. These concerns, like those of Sherron Watkins the Enron whistleblower, were raised rather late in the day and it remains to be seen whether Ernst & Young's response was, or was not, appropriate in that particular instance.<sup>46</sup> However in the case of ERF, concerns were raised and communicated to Ernst & Young (UK) more than two months before the 1999 audit was signed off - albeit after the primary fieldwork on the audit had been completed. Furthermore the source of the information was someone with financial experience, who could have been expected to consider carefully whether he was acting appropriately in contacting the auditors, and an individual who was only indirectly associated with the company. In these circumstances, notwithstanding the rather general nature of the information conveyed (apparently no one other than the financial controller, Ellis, at ERF knew the specifics in relation to the adjustment to the purchases ledger reconciliation) and its slightly tangential relationship to the underlying issues, it is perhaps surprising that Ernst & Young did not seek to follow up the concerns raised in more detail.

## The Audit Approach

In an earlier commentary on PricewaterhouseCoopers's (PwC) endeavour to audit Elton John's management companies<sup>47</sup> it was suggested that the downplaying of the importance of audit as compared to the provision of other services to clients in the 1980s and 1990s, together with the perceived change in the nature of audit methodology and audit approach in the 1990s, could have affected the manner in which those particular audits were conducted. It might be argued that similar considerations apply in respect to Ernst & Young's audit of ERF. The 1990s saw a well documented shift toward what was termed a 'business risk' audit approach with

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<sup>46</sup> An outline of Ernst & Young's response to these allegations can be found at <http://www.reuters.com/article/idUSTRE62L62D20100322>

<sup>47</sup> Gwilliam, 'Audit Quality and Audit Liability: a musical vignette' PN, 2006, 22(1), 59-64.

the audit emphasis being placed on an assessment of the integrity of management, assessment of the quality of high level controls and the adequacy of the control environment, and a reliance on the client's own systems of internal control and check to ensure the accuracy of routine transaction processing. Such an approach greatly reduced the attention given to traditional audit testing of routine controls and to actual testing of transactions. It also fitted in well with the idea that the audit role was to add value to the client, and indeed audit firms were anxious to portray themselves as nesting comfortably in a quasi-consulting capacity within the client's overall risk management framework rather than promoting the more traditional perspective that the auditor was there to provide a check on management for the benefit of the shareholders and other parties.<sup>48</sup>

Clearly aspects of this approach can be seen in the ERF audit, in particular the desire to introduce the VAT 'experts' who not only failed to uncover what appears to have been, as far as we know, a rather basic fraud (albeit not one uncovered by the (then) HM Customs and Excise either) but whose presence also led to confusion as to who was responsible for the audit of the VAT numbers in the financial statements. There is little detail in the judgment as to how Ernst & Young perceived the audit in terms of risk – one might have thought that a client with unqualified staff, a malfunctioning financial records system, in rather uncertain financial health and which was itself a takeover target would have been perceived as a high risk client. However whatever the risk category allocated it is worthy to note is that the problems at ERF would have been uncovered by basic audit testing competently conducted. Bank reconciliations and the reconciliation of debtors and purchase ledger control accounts have been standard audit techniques back into the nineteenth century.<sup>49</sup> Enhancement in IT technology has no doubt removed the likelihood of routine arithmetical error, omission etc, and perhaps reduced the perceived importance of such test procedures

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<sup>48</sup> For a description of these developments see Bell T., Marrs F., Solomon I., and H. Thomas (1997), 'Auditing through a Strategic-Systems Lens: The KPMG Business Measurement Process', Montvale, New Jersey: KPMG LLP; Jeppesen K., 'Reinventing auditing, redefining consulting and independence' *European Accounting Review*, (1998) September, pp. 517-539; Lemon W., Tatum K. and S. Turley (2000), 'Developments in the Audit Methodologies of Large Accounting Firms', ABG.

<sup>49</sup> As the judge in the case noted: 'it is usual therefore, for there to be a discrepancy between the aggregate balance on the purchase ledger and the balance on the purchase ledger control account. In order to ensure that a discrepancy of that kind can be properly accounted for it is necessary to prepare a reconciliation by which the difference is satisfactorily explained. This exercise forms a standard part of any audit of a company's accounts.' (para.364)

(and possibly the understanding of junior audit staff as to the nature and relevance of the procedures) – but if the tests had been properly carried out and followed up it is difficult to believe that the very material misstatements in the financial statements would not have been uncovered at a much earlier date. Even if detailed audit testing was not carried out on the VAT balances (and some at least should have been), simple analytical review would have raised question marks as to the persistent ability of the company, which had very limited export activity, to recover VAT from HM Customs and Excise.

### Governance aspects

As Gwilliam and Marnet (2006)<sup>50</sup> note, from the late 1980s onwards there has developed a paradigmatic approach to ‘good’ corporate governance for companies in terms of an overall focus on appropriate internal control and risk management procedures within the relevant entity. Responsibilities for such procedures lie with board members (both executive and non-executive) supported by a formal structure of board committees; audit committee, nomination committee, remuneration committee and also by increased emphasis given to the role of audit, both internal and external, as a mechanism for ensuring appropriate governance procedures.

Again the information available as to the workings of these governance mechanisms in this case is sketchy in the extreme. Having been a listed company presumably ERF had both non-executive directors and an audit committee, but these are not mentioned at all in the judgment. Nor, until after the takeover by MAN, is there any reference in the judgment to internal audit – and it is unclear how effective ~~that~~ that, head office based, function was in unravelling the murky underpinnings to the ERF financial statements – although it was following a visit by a MAN internal auditor to ERF in April 2001 that the decision to appoint an additional qualified accountant with particular responsibilities to investigate the purchase ledger was taken.<sup>51</sup> There is however some discussion in the judgment as to whether the concerns, expressed by

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<sup>50</sup> Gwilliam and Marnet (2006) *Audit within the corporate governance paradigm* working paper University of Exeter Business School available at <http://business-school.exeter.ac.uk/research/areas/topics/accounting/outputs/>

<sup>51</sup> paras 44,45.

the ERF engagement partner, as to the suitability of Ellis to act as financial controller, concerns which were conveyed to [the Canadian partner Kendrick](#), the group engagement partner, at the conclusion of the 1998 audit, should have been passed on to the audit committee of the parent company in Canada. Expert [testimony witness](#) in respect to this was, predictably, divided – the expert witness acting on behalf of Freightliner being of the opinion that [the Canadian partner Kendrick](#) should have brought these concerns to the attention of both senior management at Western Star and, independently to the parent company’s audit committee, whereas the expert witness acting on behalf of Ernst & Young took the view that it was the responsibility of the UK engagement partner to take matters further forward if she wished to do so. In the outcome the judge decided that [the Canadian partner Kendrick](#) had not been negligent in failing to bring the matter to the attention of the audit committee.<sup>52</sup>

Following the completion of the 1998 audit Ernst & Young (Canada) produced an ‘Audit Observations’ memorandum. A first draft of this, made reference to the difficulties experienced by ERF in utilising its accounting records system (including the inability through the year to generate a trial balance). Subsequent drafts ‘which made less of the problems with the BaaN system’<sup>53</sup> were sent to the ERF audit partner (and it was in response to these that [the UK engagement partner Mrs Sinderson](#) faxed through her wider concerns as to the suitability of Ellis). Comments on the draft were received from Ellis, comments which, whilst accepting that there had been problems with the accounting system during the year, contended that these problems had not impacted the final year results. ~~He stated:~~ ~~stating:~~  
‘To ensure that a full fair and accurate trial balance was available at the year end and every line item was reconciled to give both ERF and E&Y total comfort in the year end result produced.’<sup>54</sup>

The ERF audit partner was asked to comment on Ellis’s comments and she replied that they were ‘by and large all right’ and the Audit Observations memorandum which was presented to Western Star’s audit committee in January 1999 contained the following (heroically inaccurate) passage:

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<sup>52</sup> paras 491-496

<sup>53</sup> para 498

<sup>54</sup> para 499

'ERF accepts that during the year a number of estimates were put forward in the production of the monthly accounts. However, at the year end, a complete and accurate trial balance was made available where every line item was reconciled, therefore giving both ERF and Ernst & Young complete comfort in the year end result produced'.<sup>55</sup>

In February 1999 the ERF audit partner e-mailed [Canadian group engagement partner Kendrick](#) to inform him that she was due to meet ERF's managing director in two days time, and again she both raised concerns as to Ellis's performance and looked for advice as to how to proceed. Such advice was not forthcoming - as the judge noted: 'She asked Kendrick to call her when he got in. He failed to do so.'<sup>56</sup>

In April 1999 there was a further meeting of Western Star's audit committee at which progress in dealing with the recommendations contained [within the Audit Observations memorandum therein](#) was considered – but no detail is provided in the judgment as to what action, if any, was taken by the audit committee.

#### Expertise and professionalism of auditors

From the nineteenth century onwards accountants and auditors have as professional people claimed to possess specific levels of expertise – and in turn that this expertise justifies special treatment in terms of: the statutory requirement for audit, the relatively light touch regulatory regime which has prevailed from the inception of the profession to the present day, and the acceptance by society of rewards for the pursuit of their work which are, arguably, patently out of line with those [obtained by others](#) possessing skills at least as demanding as those entailed in the nature of accounting and audit work (and, again arguably, of greater social value). Whilst it is not intended in this article to develop relevant arguments as to the actuality of those particular skills, it has to be questioned whether wider commercial and institutional factors have over the years acted to reduce the importance of professionalism and skill within the profession in favour of qualities more associated with marketing and client relations.

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<sup>55</sup> para 501

<sup>56</sup> para 502

A linked issue relating to the professional status of accountants and auditors is the existence of a separate disciplinary process which acts to ensure appropriate standards of work. The nature of the efficacy of this process – and indeed in the manner in which it has changed and evolved over the years – is the subject [foref](#) a separate paper but notwithstanding the clear finding of negligence on a number of counts in the high court (and in circumstances where Ernst & Young escaped financial penalty because they were held not to have owed a duty of care to the third party plaintiffs), there has been no apparent interest by the various disciplinary bodies under whose jurisdiction the matter might have fallen in pursuing any enquiries into how Ernst & Young’s audit of ERF fell so significantly short of the standards expected of a professional firm.<sup>57</sup> Similar to the case brought by Elton John against PwC (where PwC were unable to recall how they came to their particular audit decision and, prima facie at least, would appear to have been in breach of a number of auditing standards – albeit [that](#) the judge, perhaps a little idiosyncratically, held that this did not constitute negligence within the meaning of the law) there does appear to be a degree of reluctance by the disciplinary bodies to act against errant firms. Reasons for this can be conjectured: lack of resources, the institutional importance of the large firms – in particular in respect to the ICAEW disciplinary scheme - and their overwhelming financial and legal fire power, as for example evidenced in the first decided case brought by the AIDB.<sup>58</sup> Conjecture as to the reasons apart, the fact is that in a case involving some hundreds of million of pounds in which an audit firm has been found to have been negligent on a number of counts but escaped penalty because of the legal framework under which they operate, there has been no censure of, or indeed apparent interest in, the quality of their working procedures by those charged with regulating the accounting and auditing profession.<sup>59</sup>

## Conclusions

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<sup>57</sup> Standards claimed in one of E&Y’s annual reports for the relevant period: ‘The relentless pursuit of the highest quality in our professional work remains one of the cornerstones in our firm’s continuing success. Our focus on quality in everything we do encompasses the values of our people. Nowhere is this more important than in our work on audit assignments where we recognise the public interest in maintaining standards and objectivity.’

<sup>58</sup> See <http://www.frc.org.uk/aadb/tribunal/pub1248.html> for details.

<sup>59</sup> A situation which might perhaps be contrasted with ICAEW’s [interest in enthusiasm for](#) taking action against a provisional member who had completed a ‘mock’ examination paper with the aid of the examiner’s answer paper. (See *Accountancy*, September 2010, p.104.)

At one level this brief case study tells us what we already knew – [accounting and audit](#) is not, as is popularly assumed, a neutral, quasi scientific technocratic process, conducted by ‘experts’ in a world free of commercial, institutional and social influence. Clearly the pressure placed by Western Star on the need for its subsidiaries to generate appropriate results was a factor which contributed to the falsification of the financial statements (and very probably the VAT fraud too). The fact that two international audit firms failed, over a three year period, to detect the misstatements in the financial statements is undeniable, why it should have been the case is less clear. However, it may be inferred that a range of factors including: an inadequate audit approach, specific failures by audit personnel (failures which might have been influenced by the culture and pressures within the audit firm), the disruptive impact of the introduction of non-audit service personnel, lack of co-ordination and understanding between separate offices of the same international firm, all played a part.

Beyond this wider questions may be asked including *inter alia* those [relating as](#) to the nature and indeed actuality of the ‘expertise’ claimed by accounting and audit professionals, the almost complete ineffectiveness in this instance of the paradigmatic approach to governance now espoused enthusiastically worldwide, and the relevance, if any, of disciplinary and regulatory procedures which are supposed to ensure appropriate standards of accounting and audit in the UK.