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The conundrum of disagreement with the auditor

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This paper is relevant for practitioners, governing bodies and auditing scholars interested in the options available to a company which has a bona fide disagreement with its auditors.

This article considers the position where a company has a bona fide disagreement with its auditor in relation to the appropriate accounting in the annual financial statements for a specific matter material to the financial statements.

Purpose

The article explores certain of the potential actions available to the company. For the purposes of the discussion below, it is assumed that the auditor intends to issue a modified audit opinion if the relevant matter is not accounted for in the financial statements in accordance with the auditor's opinion as to the required accounting in regard thereto.

Background

The Auditing Profession Act, 2005 ("the APA") deals *inter alia* with the conduct of registered auditors in relation to practice and the conduct of an audit, and includes the following of relevance:

"41(6) A registered auditor may not –

(b) sign any account, statement, report or other document which purports to represent an audit performed by that registered auditor, unless the audit were (sic) performed … in accordance with prescribed auditing standards …

44(2) *The registered auditor may not, without such qualifications as may be appropriate in the circumstances, express an opinion to the effect that any financial statement or any supplementary information attached thereto which relates to the entity –*

(a) fairly presents in all material respects the financial position of the entity and the results of its operations and cash flow; and

(b) are properly prepared in all material respects in accordance with the basis of the accounting and financial reporting framework as disclosed in the relevant financial statements, unless a registered auditor who is conducting the audit of an entity is satisfied about the criteria specified in subsection (3).

(3) The criteria referred to in subsection (2) are –

(a) that the registered auditor has carried out the audit free f rom any restrictions whatsoever and in compliance, so far as applicable, with auditing pronouncements relating to the conduct of the audit; …"

The APA in section 1 defines "*auditing pronouncements*" thus:

""Auditing pronouncements" means those standards, practice statements, guidelines and circulars developed, adopted, issued or prescribed by the Regulatory Board which a registered auditor must comply with in the performance of an audit …"

The Independent Regulatory Board for Auditors established in terms of the APA has adopted and prescribed the entire suite of standards issued by the International Auditing and Assurance Standards Board, which includes the International Standards on Auditing ("the ISAs").

It is clear that in terms of the APA, a registered auditor may only express an opinion on financial statements if the audit was conducted in compliance with the ISAs.

ISA 200[1] provides *inter alia* that in the conduct of an audit of financial statements, the overall objective is to obtain reasonable assurance to enable the auditor to express an opinion on whether financial statements are prepared in accordance with the applicable financial reporting framework, and to report thereon (ISA 200 inter *alia para* 11). In so doing, the auditor is required to exercise professional judgement (ISA 200 *inter alia* para 16).

ISA 700[2] reiterates the auditors obligation to form an opinion as to whether the financial statements are prepared in accordance with the applicable financial reporting framework (ISA 700 (Revised) para 10, 12 and 13). ISA 705[3] requires an auditor to modify the opinion where the auditor concludes that the financial statements are not free from material misstatement. This would include accounting by the client company that, in the auditor's assessment, is contrary to the applicable financial reporting framework. (The audit opinion modification may be a qualified or adverse opinion, or a disclaimer of opinion, dependent on the circumstances).

1 International Standard on Auditing ISA 200 : Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.
2 International Standard on Auditing ISA 700 (Revised) : Forming an Opinion and Reporting on Financial Statements.
3 International Standard on Auditing ISA 705 (Revised) : Modifications to the Opinion in the Independent Auditor's Report.

Background

Fundamental to the above, of course, is the auditor's understanding and interpretation of the applicable financial reporting framework. This requires the auditor to exercise professional judgement.

In South Africa, the Companies Act requires that financial statements comply with the prescribed reporting standards, which for companies of consequence are the International Financial Reporting Standards (IFRS). (See section 29(1)(a) read with Regulation 27(4) of the Act).

The auditor's assessment of the requirements and/or the application of IFRS may be different from that of the company.

It is possible that the auditor's view on a particular interpretation or application of IFRS may be incorrect.

It is also possible that the auditor's view may involve a degree of negligence, for example if the auditor does not exercise appropriate due care and skill and consequently misunderstands or misconstrues the relevant transactions or misinterprets the requirements of IFRS and/or how these should be applied.

The question arises as to whether there is a mechanism available to the client company to prevent the auditor from issuing an opinion on the financial statements which the client company reasonably believes is incorrect and/or negligent in relation to the required accounting under IFRS.

Potential courses of action for the client company

There are rather limited courses of action available to a client which has a *bona fide* disagreement with its auditor in relation to the interpretation and/or application of IFRS.

The potential responses of a client that are considered below are:

(a) seeking an interdict to prevent the auditor from issuing the impugned audit opinion;

(b) removal of the auditor.

Interdict

A potential response in the circumstances postulated above would be for the client to apply to court to seek an order restraining the auditor from publishing the impugned audit opinion in the auditor's audit report on the financial statements.

It is unnecessary for present purposes to deal in detail with the legal principles in relation to the granting of an interdict. In brief, it is clear that courts have set a high threshold for the granting of an interdict and, in general, require "*exceptional circumstances*"[4].

It is also necessary that the party seeking the interdict be able to demonstrate that it will suffer irreparable harm and has no appropriate alternative remedy[5].

The recent case of *The Road Accident Fund v The Auditor-General of South Africa and Others 2022 JDR2817(GP)* is instructive, although it dealt with an application for an interdict against the Auditor-General, a state institution.

In this case, the Fund sought a court order restraining the Auditor-General from publishing or disclosing the audit report and opinion on the Fund's financial statements. The application for a restraining order failed on the basis that the Fund did not satisfy the requirements for such an order. The judgement reiterated the requirement for an interdict, that an applicant must *inter alia* have a "*well-grounded apprehension of irreparable harm which will be suffered should the interim relief not be granted*".

The court found that the Fund had failed to demonstrate objectively that imminent harm would befall it if the audit report was issued and that there were no "*weighty or exceptional circumstances justifying such interference*" (the "interference" being the restraining order sought by the applicant).

Having regard to the case law, in the circumstances of an auditor holding a *bona fide* opinion regarding an interpretation or appropriate application of IFRS, it seems that there would be little prospect of a court interfering with the publication of the audit report, considering *inter alia* that, if the audit opinion is negligently expressed, the company could have an alternative remedy against the auditor to recover a loss suffered as a consequence of such negligence.

An extreme scenario could be postulated that could potentially reach the threshold of "exceptional circumstances" that might cause irreparable harm which could not be practicably addressed by say, an action for damages. For example, if the (negligent) qualified audit opinion would automatically result in the liquidation of the company.

However, even in such an extreme scenario, at a practical level, the question would arise as to how the impasse between the auditor and the client would ever be resolved, considering that the auditor and client would naturally already have engaged with each other prior to the impasse. Moreover, there is the obligation of the company to issue, within the requisite statutory timeframes, the company's annual financial statements, which in terms of section 30(3) of the Companies Act must include the audit report.

For a listed company, the act of seeking to interdict the auditor from issuing the opinion would almost inevitably mean that the disputed accounting and its effect on the financial statements would then be in the public domain. As a result, some of the harm that the company may contend would befall it if the audit report were to be issued would, arguably, not be avoided by the interdict.

Even for an unlisted or private company, it seems that the seeking of an interdict may not be a viable alternative, considering the significant legal hurdles that the company would have to overcome.

Notably, despite the requirements of the Companies Act (and the JSE Listings Requirements) for the timing of the publication annual financial statements, the actual timing of publication of the financial statements (which include the audit report) is entirely under the control of the directors of the company. Thus, by simply delaying the publication of the annual financial statements, the issuing and publication of the audit report is prevented. However, for a listed company, a failure to publish the annual financial statements within the requisite timeframes may lead to suspension and imposition of a fine by the JSE.

4 See *inter alia* Taveta Investments Limited v Financial Reporting Council, 2018 WL03219852 (2018).
5 See *inter alia* Setlogelo v Setlogelo 1914 AD 2022 and National Treasury v Outa 2012 (6SA223/CC).

Removal of auditor

Another potential action from the aggrieved client could be to remove the auditor prior to the auditor issuing the impugned audit report with the auditor's opinion on the financial statements.

As a matter of decades of experience, at a practical level, a mere request to the auditor by the directors that the auditor resign normally results in the resignation of the auditor, particularly in relation to private companies.

However, in terms of s90 of the Companies Act, it is the shareholders at the annual general meeting, not the directors, who appoint the auditor. An auditor, having been appointed at the last annual general meeting is not obliged to resign pursuant to a request by the directors to do so (or indeed even pursuant to a mere request by the shareholders).

In particular circumstances an auditor may, for bona fide reasons, choose not to resign or the auditor might consider it professionally inappropriate to resign in response to a request to do so. As an example, this could occur in the context of a listed or unlisted public company, or where there is dissent between the shareholders of a private company, and especially where most of the actual audit work has already been completed by the auditor.

Leaving aside the practical difficulties of having to engage a new auditor to start the audit of the annual financial statements *de novo*, it is necessary to consider whether it is possible to remove an auditor who refuses to resign in response to a request to do so by the directors and/or the shareholders.

For a public company, the removal and replacement of the auditor would have to occur before the next annual general meeting, as section 61(8)(a)(ii) of the Companies Act requires the presentation of the audited financial statements at the annual general meeting. (which include an audit report, as dealt with above).

Section 91 of the Companies Act provides that:

"91(6) Section 89, read with the changes required by the context, applies with respect to an auditor of a company, but a reference in that section to 'company secretary' must be regarded as referring to the company's auditor.

Section 89 of the Companies Act deals with the resignation or removal of a company secretary, and Section 89(2) provides *inter alia* that:

"89(2) If the company secretary is removed from office by the board, the company secretary may require the company to include a statement in its annual financial statements relating to that financial year, not exceeding a reasonable length, setting out the company secretary's contention as to the circumstances that resulted in the removal …"

Although the Companies Act does not explicitly provide for the removal of an auditor prior to the annual general meeting, it appears from section 91(b) read with section 89(2) that shareholders – not the board – could remove an auditor at any time by ordinary resolution, and that it is not necessary to wait until the next annual general meeting. This is based on section 89(2) specifically contemplating removal, and making the changes to section 89(2) that are required by the context as provided for in section 91(6), and in particular taking into account that the auditors are appointed by the shareholders not the board.

In the context of a listed company, such an action may create the very publicity and focus on the accounting dispute between the client and the company which the company would seek to avoid. However, in a private company, it could be viable for the shareholders to remove the auditor in the circumstances postulated and avoid the issuance by that auditor of the impugned audit report and opinion.

Based on section 91(6) read with section 89(2) of the Companies Act, if there was such a removal of the auditor by the shareholders, it appears that the outgoing auditor would have the right to require the company to include a statement in the company's annual financial statements setting out the circumstances that resulted in the auditor's removal. If the auditor that was removed elected to exercise that right, the very problem which the company was attempting to avoid might, in any event, be disclosed in the annual financial statements via this mechanism.

Removal of auditor

A further issue that would warrant attention in this scenario would be the appointment of a new auditor. A new auditor, in accordance with the ISAs is obliged to undertake appropriate procedures prior to the acceptance of a new client, including communicating with the erstwhile auditor regarding *inter alia* any non-compliance by the client (see i*nter alia* para A55 of ISA 220 (Revised)[6].

In addition, as contemplated by ISA 220 (Revised), the IRBA Code of Professional Conduct for Registered Auditors requires client acceptance procedures be undertaken, which specifically include communication with the predecessor auditor regarding information which the proposed auditor needs to know before accepting appointment (See IRBA Code section 320.4 A4). The Code provides an example as being any undisclosed disagreements between the client and the auditor. An incoming auditor would have to be willing to accept appointment as auditor against the backdrop of the historic dispute with the erstwhile auditor in relation to IFRS.

6 ISA 220 (Revised) Quality Management for an Audit of Financial Statements.

Conclusion

There are rather limited actions which a client can realistically pursue where there is a *bona fide* disagreement with its auditor in relation to the appropriate accounting in its financial statements.

An application to court seeking an interdict to prevent the publication of an impugned audit opinion does not seem to be viable, absent rather exceptional circumstances (and even then, it seems unlikely to succeed).

Particularly for a private company, a removal of the auditor prior to issuing the impugned opinion could be viable, although a fairly extreme action. Although removal and replacement of the auditor will involve a duplication of audit fees for the company in respect of the annual financial statements, this approach will avoid the costs in relation to an application to court seeking an interdict, as well as the significant uncertainty as to the outcome thereof.

It appears clear that the auditor has untrammelled power in relation to the audit report, which includes the auditor's assessment of the appropriate accounting under IFRS.

Future research

Related matters for potential future research include:

- the nature and extent of potential liability of an auditor who issues a modified audit opinion as a result of the auditor's incorrect assessment of the requirements of IFRS in particular circumstances;
- the position where the auditor acts *mala fides* or recklessly in relation to the audit opinion, with which the client company disagrees;
- the position where a company has a *bona fide* disagreement with its auditor in relation to a reportable irregularity reported by the auditor in terms of section 45 of the APA, and in particular, potential actions available to the company to attempt to ensure that the auditor records in the auditor's second report to the IRBA in terms of section 45 that no reportable irregularity has taken (or is taking) place;
- the nature and extent of potential liability of an auditor in relation to an auditor's incorrect identification of a reportable irregularity.

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