

# Ingredients for a successful audit negligence claim

With the UK's long-awaited audit reforms still not in sight, **Robert Rothkopf** shares his recipe for how IPs can successfully claim against a negligent audit firm

**A**uditors continue to find themselves under pressure following accounting scandals at Carillion, Patisserie Valerie, NMC Health and Wirecard, to name but a few. Not only is there an increasingly muscular response from the UK's Financial Reporting Council in its investigations and the fines it issues, but also an uptick in litigation against audit firms for damages caused to businesses by negligent audit practice. Claims usually arise from the auditors' failure to identify fraudulent activity within, or affecting, the business.

In this article, I share five key ingredients for a successful audit negligence claim, although – like a Jamie Oliver '5 ingredient recipe' – you might argue there are more than five ingredients here because we assume you already have the basic seasoning, such as a creditworthy defendant audit firm.

## Evidence of negligence

Whilst this may seem obvious, it helps to have a preliminary view from an audit expert (an ex-auditor themselves versed in audit standards) on whether the audit was negligent, by comparing what the auditors did against what a reasonable auditor should have done. Inevitably, there is information asymmetry at early stages of litigation before disclosure of the audit files makes this difficult. However, an FRC investigation, independent reviews by other accounting firms and investigative journalism can each provide helpful information. Glaring omissions, such as a failure to issue bank confirmation letters to independently confirm cash balances (as has been reported in the Wirecard scandal), are encouraging starting points.

## Large quantum of loss that can withstand contributory negligence discounts

Showing negligence alone is not enough. These cases are only proportionate to the legal budgets they require if you can prove significant damages caused to the business by the negligence. This requires large headline numbers that can withstand prudent discounts

arising from: (i) contributory negligence (some percentage of the loss will be discounted to reflect the fault of the directors themselves); and (ii) other causation uncertainty.

It is important to understand what loss is being claimed. Dividends that would not have been authorised and distributed if the true position had been known are generally the most robust losses as they are readily quantifiable and subject to established accounting rules around distributable cash. If you are claiming the loss of business value itself, then this prompts further key questions. Was the business doomed to fail anyway, or would it have pivoted to save itself if the audit had been done properly and the directors knew the real picture? How will this be proven? Which factual and expert witnesses? Which documents? How will you reconstitute what the actual financial statements should have shown?

## Innocent and effective directors to support the counterfactual

Overlapping with the points above, quantum and causation stand or fall on the counterfactual – what would have happened if the true position of the financial controls and the financial statements had been reported at the time to those charged with governance of the company?

For these cases to work, we need to understand the roles of the company directors other than the fraudsters. You need innocent and effective directors during the relevant period who can credibly show what they would have done if the auditors had given them the real picture, or at least spotted the red flags and drawn them to their attention. What changes to trading plans would they have executed? To what extent are the acts of third parties relevant? Their witness evidence and credibility will be crucial.

Without innocent and effective directors, the case on causation will be hard to make and the hit from contributory negligence will be large.

## Lawyers with stamina and the ability to work to a budget

Audit negligence cases are complex and likely to run long. Defendants will inevitably deploy

tactics that cause delay, and put pressure on claimant legal teams and funding budgets. Funders and claimant legal teams need the experience, stamina, and budget contingencies to cover the twists and turns of high stakes litigation. Whilst not essential, if all parties take some of their fees on risk there can be better alignment between the funder, the liquidators and the legal teams.

## Efficient audit and quantum experts with a clearly defined remit

Audit and quantum experts have a difficult job in these claims. They may have to work with deficient or unreliable records, and still try to rebuild what a proper audit would have revealed or what the true value of the business would have been if the issues had been uncovered promptly. These are complex forensic exercises on limited information, particularly if a defendant audit firm does not volunteer, or is not compelled to provide, its audit files at an early stage.

This is where it helps to have a counsel and solicitor team who can clearly define for the expert the questions they need to opine on and the evidentiary standard they need to meet, bearing in mind the dual challenges of discharging their duties to the court, and working within reasonable time and financial constraints.

Many hope that there will be effective (and long-awaited) audit reforms in the UK and elsewhere given their foundational importance to financial markets. It remains to be seen whether the recent spate of audit-related business failures, robust regulatory response and the ensuing litigation for audit negligence to return cash to creditors will usher in a new era of improved audit practice.



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