

COMMENTS ON GOVERNMENT WHITE PAPER ON COMPANY LAW

The Association for Accountancy & Business Affairs (AABA) is pleased to respond to the Company Law White Paper published in March 2005. We are an independent not-for-profit organisation and are not funded by any accountancy or corporate interests.

Our comments relate to only some parts of the White Paper.

AN OVERVIEW

The White Paper is a disappointing document and once again postpones urgent reforms to company law and make corporations accountable to stakeholders.

Reforms are long overdue. The long list of UK scandals and corporate failures, such as Maxwell, British and Commonwealth, Bank of Credit and Commerce International (BCCI) Ferranti, BCCI, Barings, Barlow Clowes, Coloroll, Guinness, Homes Assured and London United Investments lengthened with Marconi, Transtec, Versailles, Equitable Life, Hollinger, Independent Insurance, Aberdeen Trust, the Accident Group, Mayflower, MR Rover, Shell (remember missing oil and gas reserves), BSE/CJD and the mis-selling of both pensions and endowment mortgages. In most cases, the non-executive directors were too close to executive directors, held too many jobs and did little to check corporate abuses. Many company executives massaged accounts to give themselves lavish fat cat rewards, bonuses and share options. Many companies made extensive use of tax havens to create complex corporate structures and produce opaque accounts. Auditors were in bed with management and their reports were of little use. Thousands of innocent people have lost their savings, investments, pensions, jobs and homes.

Yet the White Paper has no proposals for controlling unitary boards, executive directors, empowering stakeholders, non-executive directors or forcing auditors to give value for money. The government is once again giving in to the well-oiled corporate lobby. No link is made between the proposals in the White Paper and broad government policies. For example, the Treasury Department is keen to curb aggressive tax avoidance. Yet the White Paper does not require major companies to publish details of tax computation, transfer pricing policies or taxes paid in each country. Despite ministerial rhetoric, it is disappointing to note that the 'stakeholder' principle is downgraded in the White Paper.

DIRECTORS' DUTIES

We welcome the proposals to clarify directors' duties. However, we do not support the proposals to create new exemptions for loans, quasi-loans and guarantees to directors even with shareholder approval. Such proposals presuppose that shareholders will be given full information. This is impossible as long as directors control the information which is to be released. There have already been too many abuses.

We also oppose the idea that directors be permitted contractually to limit their liability for negligence. Companies Act 2004 has already given companies powers, subject to

some limitations, to indemnify directors against liabilities to third parties, creditors and upfront legal costs. Further liability concessions will erode all incentives for directors to act in a competent and responsible way.

CORPORATE DIRECTORS

We welcome the idea that a single person may form a company and that private companies need not have a company secretary. However, it is not clear how the corporate affairs would be reassembled if that person became incapacitated or died. Who else would have the ability to marshal the organisation and its resources to pay creditors? The government might wish to establish a size limit on the companies who can be formed and governed by a single person.

The White Paper also states that corporate directors will be permitted but at least one director must be a natural person. We are concerned about this proposal which seeks to elevate corporations to equivalent to human beings. How will the public know who is behind the corporate directorships? Under certain circumstances, individual directors can be imprisoned for wrongful conduct. How does the government propose to imprison corporations acting as directors? Only human beings can have human rights. Does the government now propose to extend them to artificial legal personalities as well?

Many corporations are also ultimately based in tax havens and their true ownership is not known. The DTI proposals would enable these secretive organisations to become directors whilst the stakeholders would have little knowledge of the organisation or their owners.

YOUNG DIRECTORS

We are also concerned that someone aged 16 years, not considered responsible enough to vote or drive a car, can become a company director and thus be responsible for other people's savings, investments and pensions. The proposal does not appear to have been properly thought through.

QUOTED COMPANIES

We welcome the proposals that quoted companies need to publish the preliminary announcement of their annual results and their full annual accounts on their websites. We also welcome the proposal that in the 15 day holding period after the publication of company accounts on the company website specified minority shareholders may requisition a resolution for the meeting at which the accounts are to be laid and that minority shareholders can also request to have the poll votes independently scrutinised. However, we believe that such rights should also be extended to bank depositors, borrowers, insurance policyholders and pension scheme members. Many scandals have shown that the brunt of the risks has been borne by individuals who have no rights to attend AGMs, table resolutions, elect directors, appoint auditors or demand any information even though their life savings are at risk.

We welcome the proposal to introduce independent scrutineers for company ballots. We also urge the government to ban the use of proxy votes by company directors.

Such a voting system was outlawed for trade unions in the 1980s and should now be adopted by companies as well. To ensure that shareholders exercise their responsibilities we would suggest that no dividend could be declared by any large company unless at least 80% of the shareholders vote as individuals.

DISCLOSURE OF CONVICTIONS

We are not persuaded by the consultation documents' belief that it is too difficult to disclose criminal convictions in annual accounts (p. 47). We believe that criminal and civil convictions against the company and directors during the last ten years should be disclosed as they have a significant part of any risk assessment. Too often people have been fleeced by directors and companies with dubious past. Some companies are also engaged in bribery and corruption, both at home and abroad, and it is important that the stakeholders are made aware of their convictions.

TIME LIMIT FOR FILING ANNUAL ACCOUNTS

The proposals for revising the time limits for filing annual accounts are too timid and out of line with developments in other countries. For example, in US SEC registered companies are required to file accounts and related information within 90 days of the year end. In sharp contrast, the White paper proposes to reduce the filing period from seven months to six months for public companies and from ten months to seven months for private companies.

For any information to be useful it has to be timely. The government proposals do not fulfil this criterion. Most PLCs have internal management accounts and the information forming the basis of annual accounts is already in place. Banks and major creditors can impose covenants to demand information on a timely basis, usually within weeks of the year-end. Financial analysts, stockbrokers and others have regular meetings with company directors and have a good idea of the current state of affairs. It seems that the ordinary stakeholder is severely disadvantaged by late availability of information. With investment in IT (government is supporting paperless shares so must believe that technology for fast transactions and recording exists) companies should be able to produce and publish accounts within 90 days. US auditing firms also manage to complete audits within 90 days. Unless, the government can show that British companies and their auditors are grossly inefficient PLCs should be required to file audited accounts at Companies House within 90 days of the year-end.

AUDITORS

It is regrettable that the DTI is continuing with its policy of appeasing major auditing firms. In contrast to proposals on clarifying director responsibilities, the White Paper does not contain equivalent proposals for auditor responsibility.

We strongly oppose the granting of any further liability concessions to auditors. The White Paper fails to provide any evidence in support of its proposals. It would be useful to recall the recent history of auditor liability debates.

One Way Traffic: Brief History

The Companies Act 1948 gave auditing firms a monopoly of the state guaranteed market for external company audits. That social bargain was accompanied by a prohibition on the ability of audit firms to trade as limited liability companies and a requirement that accountancy firm partners would have 'joint and several' liability i.e. they would be liable for each other's negligence and omissions. Such an arrangement gave accountancy firm partners incentives to police each other and also enabled the firms to become major multinational businesses. However, this social bargain has been steadily diluted without any quid pro quo for stakeholders. Each dilution has transferred risks of audit failures away from highly rewarded audit firms to stakeholders who have no direct access to company books, files, invoices and records.

The Companies Act 1989 enabled auditors to trade as limited liability companies. Section 137 of the Companies Act 1989 (which became Section 310(3)(a) of the Companies Act 1985) enabled companies to buy insurance to cover their auditor's liability, should they so wish. The UK case law has also diluted auditor liability and responsibility. The House of Lords judgement in *Caparo Industries plc v Dickman & Others* [1990] 1 All ER HL 568, restricted auditor liability. It stated that generally auditors owed a 'duty of care' to the company (as a legal person) appointing them rather than to any individual shareholder. The Law Lords added decided that the audit report was prepared to enable shareholders to exercise their rights as members of the company (e.g. vote at annual general meeting), and not to enable them to make any investment decisions. The judgement narrowed the circumstances under which auditors could be successfully sued for breach of a 'duty of care'. Subsequently, the courts applied the *Caparo* principle to cases such as *McNaughton (James) Paper Group Limited v Hicks Anderson & Co.* [1991] 1 All ER 134 and [1990] BCC 891 and *Berg Sons & Co. Limited & Others v Adams & Others* [1992] BCC 661, and did not award any damages against auditors, even where they were considered to be negligent, on the ground that they did not owe a 'duty of care' to third parties.

Following a report by the Law Commission (in 1993), the UK accepted the principle of 'contributory negligence', which is a form of 'modified proportional liability'. This permits auditors to defend themselves by arguing that others (e.g. directors, bankers) contributed to their negligence and the loss suffered by the plaintiffs, and should therefore bear a fair share of the damages. The UK courts accepted the principle of 'contributory negligence', as evidenced by the House of Lords judgement in *Banque Bruxelles Lambert S.A. v Eagle Star Insurance Co. Ltd* [1997] AC 191. This has subsequently been applied in the Barings litigation to the advantage of auditors. Further liability concessions were given to auditing firms through the Limited Liability Partnerships Act 2000 was passed and came into existence on 6 April 2001.

The social bargain of the Companies Act 1948 has been eroded and no new rights have been given to audit stakeholders. Auditors do not owe a 'duty of care' to any individual shareholder, creditor, employee, pensions scheme member, or anyone else placing reliance upon audited accounts. The White Paper fails to examine the moral hazards introduced by the one-way traffic of liability concessions and indeed compounds them.

DTI for Sale

Writers such as Joseph Stiglitz have directly linked recent US accounting scandals to the dilution of auditor liability via LLPs and 'proportional liability'. Reformers there are calling for changes to "counter the weakening of self-policing resulting from a shift in the legal form of most professional firms – from partnerships to limited liability partnerships. Under the joint and several liability arrangements, each partner was liable for all acts by all partners, a powerful incentive to enforce compliance with the law. Under the new form, the liability of each partner for misconduct by other partners is limited or even eliminated, provided that he remains unaware of the misconduct" (New York Times, 29 December 2003). Indeed, the Consumer Federation of America is campaigning for changes to the Private Securities Litigation Reform Act so that accountants receiving large fees are held responsible for the opinions that they give.

The EU position is summed up by Frits Bolkestein, Commissioner of Internal Market and Taxation. He said¹ that "The Commission considers auditor liability primarily as a driver of audit quality and does not believe that harmonisation or capping of auditor liability in general is necessary" (Bolkestein, 2003). He went on to add that there are four clear reasons for not limiting auditor liability. These are:

Unlimited auditor liability is a quality driver. If the auditor delivers permanently high quality he has no liability exposure. There is no more effective liability risk management than delivering high quality audits.

Liability systems exist for the protection of the persons who suffered damage not for the convenience of those who may be at fault. Therefore, the "deep pocket" approach is principally sound because someone who has suffered damage should not have to shoulder the burden of suing separately all parties which have a partial responsibility for proper financial statements. In any case, all Member States have the concept of joint and several liability as a fundamental element in their civil liability systems.

Increased auditor liability is partly a self-created problem. Here, there are two considerations. The growth of audit firms and the branding of one name one firm world-wide has significantly increased the potential damage to the whole network in case of a potential audit failure committed by one of the local firms. This drives the willingness of networks of audit firms to settle for higher amounts. Trends in liability claims should not be considered in absolute terms but relative to the increased turnover and profit of audit firms, figures that are not easily available worldwide.

Claims from potential audit failures have been settled too easily out of Court. As a consequence there is very little case law clarifying the boundaries of auditor liability. An unanswered question for me is whether out of Court settlements are initiated by the audit firms' desire to limit the damage to the brand name or by the risk judgement of insurance companies.

¹ Bolkestein, Frits, (2003). *Auditor Liability: An EU Perspective*, Address at The London Underwriting Centre, 24 March 2003; (<http://europa.eu.int/rap/id/pressReleasesAction.do?reference=SPEECH/03/151&format=HTML&aged=0&language=EN&guiLanguage=en>).

Audit is by its very nature a function which is carried out in the public interest. This implies that 3rd parties should be able to rely on the correctness of companies' financial statements and be in a position to claim damages in case of fraudulent financial reporting. EU company law specifically recognises the protection of third parties such as creditors as one of its major objectives. In this context the Commission is somewhat concerned about the recent modification to some UK audit reports which seem, in response to the ruling in the Bannerman case, to try to limit auditor liability to third parties via wording in the audit report.

The UK government has failed to conduct any research into the impact of liability concessions (see above) on audit quality. Anecdotal evidence suggests that since the passing of the LLP legislation, major firms have reduced time budgets for audits i.e. less time is spend on audits. The white Paper has failed to provide any evidence about auditor liability costs, number of lawsuits, settlements, insurance cover or anything else. The efficiency of the insurance market for pricing risks has not been examined.

The government seems to have an unhealthy policy of appeasing auditing firms. In 1996, the Law Commission rejected the auditing firms' demand for a 'cap' and 'full proportional liability' which considered it to be against the public interest. It added that "we regard the policy objections to joint and several liability to be at worst unproven and, at best, insufficiently convincing to merit a departure from the principle". The Law Commission also rejected the call for a 'cap' on auditor liability by concluding that "we can find no principled arguments for a 'capping' system". Yet ministers continue to be keen to award the same to accountancy firms. In July 2004, the Trade Minister announced her keenness to 'cap' auditor liability (Accountancy Age, 6 July 2004). Eventually, the Treasury Department forced the DTI to consult the Office of Fair Trading (OFT). The OFT concluded that the "Arguments that allowing caps would be pro-competitive are not compelling. Some forms of cap design could distort competition" It added, "Alongside regulation and reputation, liability acts as a discipline on audit quality in a context where shareholders and other third parties rely on information from an audit which is paid for by the company being audited. We are not aware of evidence suggesting that the courts in the UK have made, or are liable to make, excessive damages awards against auditors. Professional indemnity insurance is available, and LLP status – the chosen corporate form of many audit businesses – exists to protect partners' personal assets". The DTI has never provided any evidence to challenge this.

Britain's financial regulator, the Financial Services Authority, stated "We do not believe that a convincing case has been made for allowing auditors to limit their liability contractually" (Financial Times, 21 May 2004). The DTI consultation paper (in 2003) had rejected the option of proportional liability. The Trade and Industry Minister told parliament that the consultation exercise "did not set out an overwhelming or universally accepted case for urgent [auditor liability] reform" (Hansard, House of Commons Debates, Standing Committee A, 14 September 2004, col. 39). Yet the same Minister announced the "possibility of limiting liability on a proportionate basis by contract, which can be demonstrated significantly to enhance competition and to improve quality in the audit market". (Hansard, House of Commons Debates, 7 September 2004, col. 642; also see col. 107WS). Without

examining the impact of LLP legislation on audit quality, the government proposed auditor liability ‘cap’, albeit by contract. The audited financial statements published by the Big Four firms do not show any hint of liability problems.

The White Paper suggests that shareholders should agree any limits on auditor liability. Yet case law states that auditors do not owe a ‘duty of care’ to individual shareholders. The UK company law recognises that under certain circumstances auditors owe a ‘duty of care’ to creditors, e.g. upon resignation, yet no rights are proposed creditors. Scandals show that other stakeholders (e.g. bank depositors) are affected by audit failures. Yet no rights are proposed for them. Since directors rarely provide full information to stakeholders, one assumes that they can be sued for recommending inappropriate agreements to shareholders? What if the directors have a previous relationship with the auditing firm or after leaving the company intend to join the audit firm – how would these conflicts of interest be managed and avoided? How is the public to know whether auditors have misbehaved especially when it is embedded within the organisational culture? For example, research shows that due to inadequate audit time budgets, audit staff routinely falsifies audit work i.e. claims to do the work which has actually never been done. The DTI has not conducted any feasibility study, examined the social impact of its proposals or even looked at the impact of similar proposals in other countries. It is often stated that Australia has similar laws, but the proponents fail to mention that as a quid pro quo, the Australian profession cannot set auditing standards to define its own responsibility. Yet there are no proposals to tackle such issues in the UK. The White Paper does not appear to support the any advance limit on auditor liability but expects companies to disclose such amounts (pp. 26-27). How will that happen?

The White Paper fails to provide any evidence to support its policy of awarding liability concessions to auditing firms and does not explain why some of the risks of audit failures need to be transferred from multinational audit firms to stakeholders or explain how the new moral hazards created by even more liability concessions are to be managed. Therefore, AABA opposes any further liability concessions to auditing firms. Ironically, the government policies lead to reduced stakeholder rights and also enable auditing firms through their control of the Auditing Practices Board to define their own work and responsibilities. This is a recipe for disaster.

AUDITING MYTHS

It is a matter of serious public concern that a government department charged with regulation of the auditing industry continues to promote myths about the industry to advance its economic interest at the expense of wider public concerns. We highlight two instances:

- 1) The present White Paper continues to promote myths such as “auditors may bear 100% of the compensation”. No evidence is provided to support the DTI assertion. Can it name a single case where the alleged has occurred? The auditing industry’s myth was rejected by Law Commission in its 1986 report, published by the DTI², and described as “misleading” since the present

² Department of Trade and Industry, (1996). Feasibility Investigation of Joint and Several Liability, London, HMSO.

principle of joint and several liability is that relative to the plaintiff each defendant is responsible for the whole of the loss.

The truth is that most of the major lawsuits are by one accountancy firm (as a liquidator) against another. The actual settlements are a tiny fraction of the headline amounts. The biggest winners are the liquidators and the White Paper does not contain any proposals to curb their ability to retain a substantial portion of any cash that they recover. Those suffering from audit failures have little recourse against negligent auditors.

2) The DTI promotes myths about auditor competition yet totally ignores how major firms collude and has failed to investigate the industry. For example, Price Waterhouse and Ernst & Young colluded to hold the UK government to ransom and secure LLPs in Jersey³. Major auditing firms have colluded to fix prices and share of the market. For example, in February 2000, the Italian authorities concluded the following⁴:

The Competition Authority, at its meeting on 20 January, resolved that Associazione Italiana Revisori Contabili (Assirevi), and its members, the auditing firms Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, KPMG, Price Waterhouse, Reconta Ernst & Young (the so-called Big Six), had committed offences under section 2(2) of the Competition Act by concluding agreements to substantially restrict competition on the auditing services market in Italy, designed in particular to standardize fees and coordinate client acquisition. In view of the serious nature of these offences, the Authority imposed fines on the six firms totalling 4.5 billion lire: 1.223 million on Arthur Andersen, 840 million on Coopers & Lybrand, 788 million on Reconta, 687 million on KPMG, 539 million on Price Waterhouse and 470 million on Deloitte & Touche.

The agreements related to the statutory corporate audit services market and the voluntary audit services market, on which the Big Six hold a market share, respectively, of 86 percent and 74 percent. The agreements covered virtually every aspect of competition between the auditing firms.

Firstly, the agreements set the fees for auditing. Until 1995 Assirevi had circulated an annual benchmark audit fee and working hours table according to the size and the sector of activity of the client firms. The agreement also laid down rules to be followed when acquiring new clients in order to protect the market positions of each firm. In particular these rules prohibited any form of competition in relation to each audit firm's "client portfolio". By applying these rules, the auditing firms were able to agree, for example, on how to respond to requests for discounts from client companies, and to establish in advance the firm that would be awarded auditing contracts, in many cases making competitive tendering a mere formality.

³See <http://visar.csustan.edu/aaba/Noaccountingfortaxhavens.pdf>

⁴http://www.agcm.it/agcm_eng/COSTAMPA/E_PRESS.NSF/92e82eb9012a8bc6c125652a00287fbd/991a5848bc88040dc125688f0056851d?OpenDocument&Highlight=2,kpmg

Other agreements were also designed to ensure anti-competitive behaviour by the auditing firms for public tenders and when establishing agreements with the authorities. The agreements concluded by the Big Six, and particularly their coordination to acquiring clients, had the effect of stabilizing the market positions of each firm for a long period of time.

The anti-competitive conduct of Assirevi and the Big Six were deemed to be particularly serious because they were forms of horizontal coordination of prices and other contractual conditions which could have otherwise been individually negotiated by the auditing firms with their client companies. Furthermore, the agreements were implemented by the main auditing and certification firms operating in Italy. These offences were committed despite the Authority's earlier measure resolved on 26 August 1991, in which it annulled a fee-setting regulation issued by Assirevi setting fee scales and working hours.

Assirevi and the Big Six, according to the investigation, committed these offences between 1991 and at least 1998.

Unlike Assirevi, however, during the investigation the Big Six not only admitted that they were liable for the alleged conduct but also provided additional information making it possible to identify and appraise their anti-competitive conduct, and the Authority took account of this when imposing the fines.

Lastly, the Authority noted out that the investigation found no evidence to show that Consob had implicitly, let alone explicitly, consented in any way to the anti-competitive conduct of which Assirevi and the Big Six have been found liable.

If there was proper competition amongst auditing firms, we should observe evidence showing that compared to their competitors, some auditing firms accept greater responsibility, liability, accountability, disclosures, transparency or even co-operation with regulators. However, no such evidence can be found and the firms continue to operate as a cartel.

AUDITOR ENGAGEMENT LETTERS

In the age of transparency, information about company-auditor relationship has been organised off the political agenda. Therefore, we welcome the possibility of providing information. We believe that major companies should file letter of engagement, audit tenders, management letters and other documents with Companies House as part of their annual return. Audit firms should also supply information about composition of the audit team, audit time budgets and transcripts of meetings with company directors and advisers.

QUESTIONS TO AUDITORS

The White Paper mentions rights for shareholders to question auditors. However, such rights already exist and are frequently stymied by auditors who are keen to appease

directors to secure fees and profits. An extract from the DTI inspectors' report on Ramor Investment⁵ includes a letter from Price Waterhouse partner to the client company chairman:

Dear Mr. Smith,

As arranged I am writing to let you know in advance of the Annual General Meeting on 26 July the replies I will give if I am asked by a shareholder for the reasons why my firm is not seeking re-election as auditors. If no questions are asked, then of course, no further information in addition to that contained in the Annual Report need be provided.

However, if a shareholder asks further information I propose to reply as follows:

"In recent years we have experienced certain difficulties in obtaining necessary information for our audit and being sure that all relevant explanation have been provided to us. In the final outcome we have been satisfied that we have received all such information and explanation; otherwise this would have been reflected in our audit report. However the situation created by these difficulties caused us to agree with the directors that we would not seek re-election at this meeting, a step we are permitted to take under the provisions of the Companies Act."

If there should be a follow-up question asking for more information about the difficulties referred to in the foregoing statement I would propose to reply as follows:

"There was no one matter which in itself caused us to reach this agreement with the directors. In view of this, there is nothing more that can be added to the answer that has already been given".

I would not intend to give any more information nor to respond to any other question.

Yours sincerely
PL Ainger⁶

Given the above behaviour, which is not too uncommon, the government needs to look at the reality of director-auditor relationships. What incentives would auditors have to treat any questioner in a fair way? The legislation should require that all company-auditor correspondence should be available for inspection and auditors should expressly state that with respect to questions at the AGMs they have not entered into any prior understanding with directors.

⁵ Department of Trade and Industry, (1983). Ramor Investments Limited; Derriton Limited, London, HMSO.

⁶ The Department of Trade & Industry (DTI) appointed Peter Ainger as an inspector to investigate the affairs of Gilgate Holdings Limited. At the same time, Peter Ainger's conduct of the audit of Ramor Investments was also being investigated by other DTI inspectors. The DTI eventually suppressed the final report relating to Ramor Investments.

AUDITOR RESIGNATION

We do not see anything new in these proposals and instead the government should focus on effective compliance with the law already in place.

The White Paper fails to acknowledge that the DTI has failed to conduct any research into the effectiveness of auditor resignation law, introduced by the Companies Act 1976. Independent research⁷ shows that auditors have been very cavalier in compliance with the legal requirements and the DTI and the ICAEW has ignored such non-compliance.

In addition to submitting written statements to shareholders and creditors, providing details of the reasons for resignation, the Companies Act 1976 gave the resigning auditor a right to requisition a meeting of that company. It was said to “represent a radical change that will be for the benefit of shareholders, investors and creditors” (Hansard, 19 October 1976, col. 1253). However, there was a concern that statements made by auditors in their notice of resignation and any accompanying (oral or written) statements may be construed as libellous and that this may prevent auditors from communicating the matters openly and honestly with members and creditors. In response, the government explained that

“unless the auditor uses a statement for some improper purpose - for instance, he is malicious in the legal sense - no person who is criticised will be able to sue him successfully for libel” (Hansard, House of Lords Debates, 5 April 1976, col. 1488.

The Parliamentary Secretary to the Law Officers’ Department explained that,

“statements by auditors are already subject to the law of qualified privilege unless they are motivated by express legal-malice, that is, by spite, ill-will or some other improper motive. auditors have a statutory duty, certainly a moral and social duty to report their findings and misgivings to the company and the company has a duty to receive that information” (Hansard, Proceedings of Committee C, 22 July 1976, cols. 364-365).

So the DTI is not proposing anything new. Auditors already have all the legal rights and privileges that can possibly be given to them. Rather than investigating the auditor failures to comply with the law, the White Paper seeks to obfuscate auditor responsibilities. The emphasis should be on compliance and enforcement.

AUDIT REPORT SIGNATURE

Audits are manufactured by the processes instituted within accountancy firms. Therefore, we fail to understand what is to be gained by having a partner sign the report. Even if s/he does, it should not absolve the firms from their responsibility. It is the firm that is appointed as an auditor rather than a named employee or partner and this responsibility should be acknowledged. Since an audit is jointly produced by

⁷ <http://visar.csustan.edu/aaba/dunn&sikka.pdf>

audit partners, technical partners, legal advisers, training partners and audit team, it is difficult to see how a single partner can be named. Often a firm's affiliate from another country also audits some part of the company or its subsidiaries. Under these circumstances one assumes the name of the appropriate partners from each country would need to be added to the audit report. What purpose does all this serve?

The DTI proposal and the related liability implications would inevitably further dilute any desire on the part of the firms and partners to police other partners. We can see no evidence, argument or analysis in the White Paper showing that the identification of the public partner will somehow magically transcend the culture of the firm, its concern for profits, fees and pressures to appease directors, reduce time budgets, sell consultancy services and somehow lead to an improvement in audit quality⁸. In the event of an audit failure, it might help to further individualise audit failures but will do nothing to address the issues about the manufacturing of audits and reforms of the process involved.

TRANSPARENCY OF AUDITING FIRMS

We welcome the DTI's concerns about transparency in auditing though we are sceptical that the department will do anything that the auditing firms veto

We believe that all audit reports, as well as the annual accounts of auditing firms trading as LLPs, should indicate their ownership structure. Big Four firms are ultimately owned by secretive trusts in tax havens. This means that their true ownership and resource position is not known and the public does not know the identity of the parties that is dealing with. Too often, audit firms have been able to claim that they are 'global' to win business and then abandon these pretences when met with pressures to co-operate with regulators. For example, an investigation of the Bank of Credit and Commerce International (BCCI) by New York state banking authorities was also frustrated by the auditors' lack of co-operation. The New York District Attorney told the Congress that

"The main audit of BCCI was done by Price Waterhouse UK. They are not permitted, under English law, to disclose, at least they say that, to disclose the results of that audit, without authorization from the Bank of England. The Bank of England, so far -- and we've met with them here and over there -- have not given that permission.

The audit of BCCI, financial statement, profit and loss balance sheet that was filed in the State of New York was certified by Price Waterhouse Luxembourg. When we asked Price Waterhouse US for the records to support that, they said, oh, we don't have those, that's Price Waterhouse UK.

We said, can you get them for us? They said, oh, no that's a separate entity

⁸ See Sikka, P., (2004). "Some questions about the governance of auditing firms", *International Journal of Disclosure and Governance*, Vol. 1, No. 2, pp. 186-200.

owned by Price Waterhouse Worldwide, based in Bermuda”⁹.

BCCI’s auditors refused to co-operate with the US Senate Subcommittee’s investigation of the bank. Although the BCCI audit was secured by arguing that Price Waterhouse was a globally integrated firm, in the face of a critical inquiry, the claims of global integration dissolved. Price Waterhouse (US) denied any knowledge of, or responsibility, for the BCCI audit which it claimed was the responsibility of Price Waterhouse (UK). Price Waterhouse (UK) refused to comply with US Senate subpoenas. It added,

“The 26 Price Waterhouse firms practice, directly or through affiliated Price Waterhouse firms, in more than 90 countries throughout the world. Price Waterhouse firms are separate and independent legal entities whose activities are subject to the laws and professional obligations of the country in which they practice ...

No partner of PW-US is a partner of the Price Waterhouse firm in the United Kingdom; each firm elects its own senior partners; neither firm controls the other; each firm separately determines to hire and terminate its own professional and administrative staff.... each firm has its own clients; the firms do not share in each other’s revenues or assets; and each separately maintains possession, custody and control over its own books and records, including work papers. The same independent and autonomous relationship exists between PW-US and the Price Waterhouse firms with practices in Luxembourg and Grand Cayman”.

Therefore, it is difficult to see how the firms can claim any responsibility for auditing global corporations.

The audit reports should also state whether the firm or the partners responsible have faced any regulatory action within the last five years, together with any lawsuits, related settlements and undertakings.

A number of scandals have shown that auditor independence was compromised by the longevity of the term in office. Therefore, the report should say the period for which the firm has been an auditor.

PUNISHMENT FOR RECKLESS AUDITORS

We believe that auditors who knowingly and recklessly issue misleading or deceptive reports should be deemed to be committing a criminal offence. Such a law is long overdue and matches the requirements of the Companies Acts applicable to employees, officers and directors of a company. For example, under Section 389A of the Companies Act 1985 auditors are entitled to such information and explanations as they consider necessary for the performance of their duties as auditors. Knowingly or recklessly providing misleading, false or deceptive information or explanations is a criminal offence. This was considered to be weak and the Companies Act 2004

⁹ See page 245 of United States, Senate Committee on Foreign Relations (1992). The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, Washington DC, USGPO.

further strengthened the position. The Act retained the criminal offence of knowingly or recklessly failing to supply information or explanations required by an auditor. It extended the same to any person who knowingly or recklessly supplies to an auditor information which is 'misleading, false or deceptive in a material particular'. Thus the offence has been extended to cover the telling of a half-truth by way of omission of significant facts.

The phrase 'knowingly and recklessly' is now well established in the UK company law and should apply to auditors. The issuing of any audit report which is knowingly or recklessly misleading or deceptive, or tells half-truths or omits significant facts shall make the auditor liable to a criminal offence. Too often auditors are content with an unsatisfactory situation. Consider the case of Versailles Group and its auditors Nunn Hayward. A 2004 report from the Joint Disciplinary Scheme¹⁰ noted the following:

There were several warnings that all was not well at Versailles, which were ignored:

- In 1996, Mr Clough arranged for publication of the Versailles accounts, and their circulation to shareholders, before the audit was completed. The published accounts contained a false audit certificate. When this was discovered, Nunn Hayward signed an audit certificate on unchanged accounts after little further work, and these were re-circulated to shareholders. In the face of this obvious dishonesty, Nunn Hayward acquiesced in a circular to shareholders describing what had happened as "*an oversight*". The reality was that Versailles was too important a client for Nunn Hayward to risk losing: when resignation as auditors was mentioned by Nunn Hayward's solicitors, Mr Dales responded that this was "*a big fee account*" and his firm did not want to resign. Astonishingly, and despite what had happened in 1996, Nunn Hayward and Mr Dales never completed the audit in the following year, 1997, a very serious matter in itself.
- Mrs Jill Long, an extremely able Manager who worked for Nunn Hayward for a short period on the 1998 Versailles audit, immediately picked up a significant number of matters of concern. These included a lack of access to Versailles's accounting records; Versailles's reluctance to produce fundamental accounting information; its complex accounting system and the amount of control which Mr Cushnie was able to exert over it; and the lack of information about Traders in the British Virgin Islands. She wrote two memoranda, the first to Mr Ian Nunn, the senior partner, and Mr Dales, and the second to all the Nunn Hayward partners, detailing her concerns. These were ignored, and she was shortly moved off the audit.
- Mr Douglas Brown, the Nunn Hayward tax partner, assisted Mr Cushnie and Mr Clough in an investigation by the Inland Revenue Special Compliance Office. He minuted Mr Dales that Mr Clough was impossible to obtain information from, Mr Cushnie had "*lost interest*", and he (Mr Brown) wondered whether he was simply being used as a delaying mechanism to

¹⁰ Joint Disciplinary Scheme, (2004). Versailles Group Plc – Nunn Hayward and Others, London, JDS.

enable Mr Cushnie and Mr Clough to gain time. He remarked that Mr Clough *"could not tell me what income he had had."*

The most serious Complaints against Nunn Hayward and Mr Dales were that they signed false "comfort letters" required by the banks which had lent money to Versailles. These letters certified that certain tests had been carried out by Nunn Hayward and Mr Dales to verify the amount of Versailles's debtors, when in truth no such tests had been carried out. It is these Complaints which display a lack of integrity. The gravity of what Nunn Hayward and Mr Dales did lies in the fact that the banks relied on the information in the letters to assess the safety of their loans and thus to continue lending to Versailles. Without bank lending, Versailles could not have survived as long as it did. There is evidence that several comfort letters were simply faxed to Nunn Hayward by Versailles's accountant with the request: *"...please type the enclosed letters on your letter head...and fax them across to Fred [Clough] a.s.a.p. and post hard copy to him direct."*

The 1998 and 1999 audits were not conducted with the professional skill care and diligence and proper regard for technical and professional standards expected of chartered accountants and a firm of chartered accountants. In particular:

- Nunn Hayward, Mr Dales and Mrs Dodd treated the business as one of buying and selling goods rather than providing trade finance.
- Despite the warnings set out above, no or grossly insufficient regard was had to the possibility of fraud.
- In two cases, Versailles was asked to select the audit samples itself.
- Nunn Hayward, Mr Dales and Mrs Dodd relied on photocopies rather than insisting on seeing original documents – this enabled bank statements, for example, to be altered before being produced to the audit team.

The Tribunal described Nunn Hayward's work for the 1998 and 1999 audits as *"lamentably poor."*

One can only wonder about what counts as good audit. If by hook or crook a company continues to survive all the audit failures remain covered. Auditors too easily get away with poor audits. We believe that auditors are held to too low a standard of performance, public accountability and recourse and this should be changed in line with the above.

ROLE OF THE FINANCIAL REPORTING COUNCIL

We are concerned that the FRC may take a leading role in matters of audit quality (p. 28), especially when it is funded and dominated by the Big Four firms. We note that the recent Ethical Standards were drafted by a committee of the Auditing Practices Board, solely populated by the Big Four firms. We believe that matters of audit quality have a bearing on distribution of income, wealth, risks, corporate governance and affect a wide variety of stakeholders, not just shareholders. Therefore, we would urge that the Trade and Industry Select Committee should be mandated to examine

such issues. We do not feel that the FRC has the necessary independence or the democratic mandate to make decisions for stakeholders with competing interests.

AUDIT QUALITY FORUM

Throughout the country many groups and organisations are concerned about audit quality and auditor responsibility. However, the White Paper singles out the Institute of Chartered Accountants in England & Wales (ICAEW) for a mention, even though it fronts an international ‘cartel’ (a phrase used by the DTI Minister during the parliamentary debates on Companies Act 2004). It is a trade association of the auditing industry and is funded and populated by major auditing firms. It has no independence from their economic interests. For these reasons, it cannot represent the public interest or adjudicate on socially desirable policies.

The White Paper refers to the Audit Quality Forum (AQF) situated within the ICAEW. Such a reference seeks to legitimise the AQF even though it does not represent audit stakeholders. For the record, it should be noted following the White Paper’s endorsement the Investors Association (representing small shareholders), individual shareholders and NGOs, such as AABA and Tax Justice Network, and individual MPs have sought to attend the AQF meetings but had been denied access to the meetings. Only selected stakeholders, major firms and institutional investors, were allowed to attend. There have been no limits on the persons who the Big Four could take but attendance by others was controlled through tickets. Clearly, the intention has been to filter out critical concerns and then present the carefully selected views to the DTI as some preferred policy options. Some institutional investors have been unhappy with the conduct of the AQF and have directly reported their concerns to the DTI. The AQF does not have any mandate to speak for a variety of audit stakeholders and has no independence from the auditing industry. Its publications are flawed and totally ignore a considerable amount of research, including AABA publications¹¹, that challenges its preconceived agenda. For these reasons, we urge the government not to be swayed by the partisan work of the AQF.

CONCLUSION

Overall, the White Paper is very disappointing. It does not address any of the major issues. It is a mish-mash of deregulatory efforts with little coherence. It is continuing with the recent trend of giving more liability concessions to auditing firms without addressing any of the moral hazards that inevitably arise. By reducing auditor liability, it is paving the way for major accounting scandals. In a market economy, producers and suppliers need economic incentives and legal pressures to improve quality of their products and services. The government is proposing to reduce them. The proposed policies will not improve audit quality.

Prem Sikka
AABA Director

¹¹ Available on <http://visar.csustan.edu/aaba/publications.html>