

A Comment on the DTI’s “Review of the Regulatory Regime of the Accountancy Profession”

by

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I am very happy to comment upon the issues arising out of the Post-Enron regulation of the UK accounting/auditing industry. Fuller proposals for regulating auditing formed part of my monograph (co-authored with Austin Mitchell MP) titled “Dirty Business: The Unchecked Power of Major Accountancy Firms”. The monograph was submitted to Chancellor of the Exchequers, Gordon Brown MP, and has probably been forwarded to the DTI. Another copy is attached.

The proposals are a long line of posturing by the DTI when reforms are supposedly in the air, but little actually happens. The DTI’s consultation document is remarkable for notable omissions. For example, it seeks to set the agenda for possible reforms rather than investigating the full extent of the malaise. The document contains no proposals for scrutinising the ‘corrupt’ relationships between the DTI and the auditing industry. The DTI appointed inspectors to investigate frauds at Maxwell and Guinness but did not appoint any inspectors to investigate frauds at BCCI, Polly Peck, Levitt or Resort Hotels. Despite the revelations in the US, the DTI has not mounted any investigations of the operations of Enron, Worldcom or Xerox in the UK. In the US, SEC forced many companies to restate their accounts. The DTI did nothing. The British government failed to mount an investigation into the frauds at the Bank of Credit and Commerce International (BCCI), but an investigation by the US Senate concluded that auditors were a party to a “cover up” and caused “*substantial injury to innocent depositors and customers of BCCI*”¹. When the US regulators demanded to see Price Waterhouse’s files relating to the audit of the BCCI, the firm’s US office refused to co-operate by claiming that the work was done by the UK office and this was a separate entity owned by Price Waterhouse Worldwide, based in Bermuda (PwC

¹ 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.

headquartered in Bermuda, but enjoys numerous privileges in the UK). So Price Waterhouse (UK) did not open its files to the regulators. After the discovery of frauds at Barings, the Bank of England (BoE) sought access to the audit files held by Cooper & Lybrand and Deloitte & Touche, but this was thwarted. The firms claimed that offices in Singapore did the audits and also did not allow the BoE to interview key audit personnel. The DTI brought forward no proposals to change the conditions of the licence to practice auditing. Perhaps, a convenient way of suppressing unwelcome facts, or is this indicative of the way the DTI supports British business? Instead, it just aped the three unwise monkeys. The DTI rarely commissions any critical research or takes any notice of published research. It continues to legitimise the self-serving interests of major accountancy firms.

In the case of Maxwell, the DTI took ten years to publish the inspectors' report and then most of the blame is conveniently placed on audit partners who died in the intervening years. The report on Queens Moat Houses is still awaiting publication. In the US, the SEC successfully mounted a criminal conviction against Arthur Andersen within five months of the Enron scandal, but here the DTI Ministers simply wring their hands in the belief that public confidence is best secured through cover-up, delay and obfuscation rather than not through investigations or public information. Such an environment offers no chance of curbing, or even understanding audit failures. The DTI is the sponsor of the accountancy industry, but shows no concern with the anti-social activities of major firms. There is an urgent need to have an independent inquiry into the DTI's relationship with the accountancy industry.

Accountancy firms (a misleading title) are engaged in anti-social activities. Over the years sufficient evidence has been sent to the DTI show that major firms operate cartels and are engaged in money laundering, bribery, tax avoidance, evasion, abuse of insolvency laws and large scale organised mugging of ordinary people that has resulted in loss of jobs, pensions, savings, investment and homes. The DTI has been sent copies of invoices showing the fees that major firms charge for setting up and operating shell companies through which money is laundered, but the DTI did nothing. The UK accountancy bodies admit to misleading the courts (paper already supplied to the DTI, http://www.essex.ac.uk/AFM/about_us/workingpapers/WP-01.pdf) but the DTI has done nothing. With the full support of accountancy firms, a

corporate elite has been engaged in organised looting. Whilst the government has no difficulty in coming out with proposals for dealing with petty theft, it has failed to do much for the bigger problems. People are taken to courts and prosecuted for parking their cars in wrong places, but accountancy firms that are part of the organised looting are not prosecuted for woeful and often ‘corrupt’ practices. Instead, the government allows the accountancy firms to operate their own private courts (known as disciplinary panels) in the belief that only those versed in anti-social practices can deal with accountancy firms.

Over the years, the DTI has been more concerned about appeasing the accounting industry rather than properly regulating it. So we have ended up with a real mish-mash where some 23 overlapping and ineffective organisations are concerned with regulation. The DTI has never explained the logic of this structure, which resembles a complex wiring diagram rather than anything that might call the barons of accountancy firms to account. Ministers routinely stonewall questions in Parliament. None of these 23 organisations meets in the ‘open’ or owes a ‘duty of care’ to anyone affected by their decisions. The rules of the self-regulation club can’t constrain major accountancy firms. Coopers & Lybrand violated the professional rules to secure the £30 million receivership of Polly Peck. The firm was fined a grand sum of £1,000. The SEC found that in a one-month period, PwC had more than 8,000 violations of auditor independence rules and concluded that the firm had “serious structural and cultural problems”. The UK government does not even mount investigations. Polly Peck auditors were fined £75,000 after a ten-year period, not even a fraction of the fees that the firm collected. Maxwell auditors were fined which amounted to £6,000 per partner. The auditors do not owe a ‘duty of care’ to any individual shareholder, creditor or employee affected by their opinion. Such an environment does not give auditors any economic incentives to do good audits. Yet the DTI has been content with this position, as it does not wish to offend the auditing industry. In jest (perhaps not), major accountancy firm partners claim that they regulate the DTI.

Accountancy firms have reaped major dividends from their investment in New Labour. Arthur Andersen was brought back into the public fold whence the Tories had expelled it for audit failures that enabled John DeLorean to rob the public purse. Labour introduced the Limited Liability Partnership (LLP) legislation to protect the

Big Bean Counters from the consequences of their own negligence. It could not find the legislative time or the political will to reverse the *Caparo* judgement. It abandoned its 1997 manifesto promise of independent regulation of accountancy and audit, but opened up new swathes of business in consultancies, performance reports, contracts and advice. The DTI has asked no questions about the accountability of major firms. By a coincidence, former Labour Trade and Industry spokespersons Stuart Bell and Peter Mandelson secured lucrative consultancy jobs with Ernst & Young. Perhaps, the current Ministers (and senior civil servants) are making provisions for the post-Ministerial days.

People are encouraged to rely upon audited company accounts, but the auditing industry has different priorities – profits and income. The basic auditing model is flawed as it expects one set of capitalist entrepreneurs (accountancy firms barons) to regulator another (company directors). Their success/failure is measured by profits and fees. Serving the public interest does not form any part of their obligations. Yet rather than having public debate about such matters, the DTI has sought to suppress it by creating a spurious agenda for reform.

Major accountancy firms receive as much as 73% of their income from selling consultancy services to their audit clients (Accountancy, October 2001, p. 7). They hire company directors and management, create systems of internal control, director remuneration packages, transactions (e.g. tax figures), operate internal audits, form subsidiaries and design complex financial schemes, and then pretend to audit the same. Audits are used as loss-leaders to secure non-auditing work, with the big firms sometimes undercutting the medium-sized firms by as much as a third to get a foot-in-the-door and sell other services. Price Waterhouse (now part of PricewaterhouseCoopers) undercut the incumbent auditor of RAC by nearly 50% to secure the audit. Outgoing auditors, BDO Stoy Hayward, claimed, “We believe that this demonstrates a determined approach to price their audit work on a predatory basis so as to secure an appointment which might enable them to introduce higher priced consultancy services to RAC in due course” (Accountancy, June 1995, p. 13). To increase profits, audit work is often falsified or not done at all. Auditor independence is a joke. Auditing standards are poor. The economic incentives for delivering good audits are weak. Unlike the producers of sweets and potato crisps, auditors do not owe

a 'duty of care' to any individual stakeholder affected by their negligence. Yet the DTI shows no concern and Ministers oppose the modest reforms introduced by the Sarbanes-Oxley Act in the US, claiming that British firms and companies are too tender to accept any public responsibilities or clean up their act.

The cost of the DTI's negligence (or is it a could not care less attitude?) is always borne by employees, investors, pension scheme members and taxpayers. Audit failures played a part in a crisis for 30,000 Maxwell pensioners. They played a part in the closure of Polly Peck, valued at £1.7 billion, and the loss of 17,227 jobs and facilitated losses to 11,000 shareholders of Sound Diffusion Plc. Audit failures at BCCI were associated with the loss of 14,000 jobs and losses to over one million bank depositors with deposits of US\$1.85 billion. Following audit failures at Barlow Clowes, British taxpayer also paid £153 million in compensation to investors. Deloitte & Touche and Coopers & Lybrand, auditors of Barings, had no idea of the frauds that brought the bank down. Auditors did not notice the \$750 million fraud at the Allied Irish Bank. Despite a long list of audit failures, no UK auditing firm has been closed or prosecuted for negligence. The government leaves the messy discipline to the accountancy trade associations who always sweep things under their dust-laden carpets. To date, no action has been taken against the auditors of Transtec, BCCI, Kwik-Fit, Queens Moat Houses, Cable & Wireless, Equitable Life, or Independent Insurance. Perhaps, the DTI is waiting for some audit partner to die before doing anything. Those affected by audit failures receive no compensation as the accountancy bodies pocket all the fines to further lubricate their affairs.

The smug British response to the Enron and WorldCom scandals, orchestrated by the Department of Trade and Industry (DTI), the Institute of Chartered Accountants in England & Wales (ICAEW) and the Confederation of British Industry (CBI), has been the usual "it couldn't happen here". In fact, it can and much of it already has, though less spectacularly in a smaller economy, less publicly because of the culture of concealment and doing nothing or at little as possible. The British scandals usually come to light when recession exposes all the scandals and sleaze concealed by higher profits and share growth in the good periods. Even so Equitable Life and Britannic Insurance are on the brink of collapse, Marconi has almost vanished, NTL has announced a £45 million hole in its accounts, MyTravel is teetering, under the burden

of debt Telewest is looking to restructure and Cable & Wireless share price has collapsed.

Many of the accounting shenanigans associated with Enron, WorldCom, Xerox, Global Crossing and Tyco are available and practised in the UK because either the UK law, or the business dominated secretive Accounting Standards Board (ASB) permits, or auditors always keen to appease company directors, accept them. British accounting practices have more holes than Swiss Cheese as stakeholders in Kwik-Fit, MyTravel, Bulmer, Amey, Podia, Tiny Computers, Deep-Sea Leisure, Invensys, Sodexo Land Technology, RGB Resources, Cable & Wireless, NTL, Slug & Lettuce, Wiggins, Wickes, Swiss Life and other companies have learnt. The 2,500 pages of UK accounting standards are not full of principles. They are the outcome of politics dominated by major companies and accountancy firms. Many of the accounting standards (e.g. goodwill, leasing, foreign currency translations) are remarkably similar to the US standards. The UK companies have adopted the US standards on revenue recognition as the UK has nothing on it. Company accounts are no substitute for industrial democracy or accountability of accountancy firms.

Enron used more than 900 Special Purpose Vehicles (SPVs) in secretive offshore havens to keep troublesome debt and transactions off its balance sheet. Almost all of the FTSE 100 companies are using SPVs to obscure their financial risks, making it almost impossible to make sense of their published accounts. The web site of auditors PricewaterhouseCoopers (<http://www.pwcglobal.com>) says that the “use of offshore Special Purpose Vehicles (SPV's) has become an essential tool for off balance sheet financing in recent years. The Channel Islands are an ideal location for such structures, due to a combination of the available technical expertise and a regulatory environment aimed at encouraging the growth of quality business in this area. We are able to draw on the knowledge and expertise of our international network to work with local legal specialists to provide a co-ordinated solution to your needs in structuring, implementing and administering SPV's”. PwC partner Mary Keegan is head of the UK Accounting's Standards Board (ASB) and no doubt other grandees from the same firm would also be elevated to major regulatory positions. The government's White Paper on company law does not contain any proposals for forcing companies to show details of their offshore operations.

In the accounting bazaars, there is little consistency or comparability of accounting information. For a fee, almost anything passes as 'true and fair'. By omitting the costs of share options from profit and loss accounts, British companies have inflated their profits by more than £5 billion, providing a veritable bonanza in bonuses to some. Everyone knows that paying interest on a loan is an expense, yet British Nuclear Fuels Limited (BNFL) has been capitalising it (i.e. treating it as an investment) for years. The UK telecommunications industry uses the accounting policies used by Global Crossing, the disgraced American firm. The companies sell each other their surplus capacity. Often no cash changes hand, but it improves profits. They treat the sale as revenue and boost profits, and treat the purchase as a long-term investment and leave it in the balance sheet.

Scottish & Newcastle chooses not to recognise brands (Foster's, Millers, Becks, John Smiths', Kronenberg) separately in its balance sheet. In contrast, Cadbury Schweppes (Dr. Pepper, 7 Up and various chocolates) and Diageo (Guinness, Smirnoff) do and boost their balance sheets by £2.7 billion and £5.3 billion respectively. J.Sainsbury's capitalises £35 million of pharmacy licences and amortises them over 15 years. In contrast, Alliance Unichem does not amortise the £297 million value assigned to its licences. If it followed the Sainsbury's practice, its retained profit for 2001 would have declined from £36.5 million to £16.5 million. Computer software giant Sage leaves goodwill of £836 million in its balance sheet by claiming that it has indefinite life. If amortised over a 10-year period, it would result in a hit of £83 million against profits. If WPP, the advertising agency, amortised the goodwill on its major acquisitions, its pre-tax profits of £411m could have been as little as £96.9m.

In 2002, IT services company Xansa recognised assets and liabilities of an employee trust in its annual accounts, whereas previously it did not. Ernst & Young did not notice that the 2001 accounts of McLeod Russel had neglected to disclose the liabilities and assets associated with its pension scheme, as required by the transitional arrangements in place for the adoption of FRS 17 'Retirement Benefits'. By complying with the contemporary accounting rules, Aston Villa Plc has made its £21 million convertible loan disappear from its balance sheet. It now forms part of shareholders' funds and vastly improves measures of its financial risks.

For the period 1995-2000, the Wiggins Group improved its profits by playing with the timing of its revenue recognition and capitalising some development costs. When restated, the £25.1 million profits became a loss of £9.9 million. DIY chain Wickes inflated its profits by advance booking of "golden hello" deals with suppliers. This helped to raise the share price from 30p in September 1990 to 132p in August 1995, and resulted in handsome dividends, share options and fat cat salaries.

London Underground Limited did not properly show the grants that it received from the government. Had it done so, its 1999 capital employed and net assets would have been reduced from £7,628 million to £2,722 million. In 2000, Carillion, which rebuilt the GCHQ intelligence centre in Cheltenham, reclassified its PFI assets from fixed to current assets. This way it does not have to depreciate them.

In the US, after Enron, the SEC's pressure persuaded hundreds of companies to come clean about their financial engineering and restate their accounts, or face the consequences. In the UK, Ministers just wring their hands. Effective regulation of auditing has been organised off the political agenda. The DTI's consultation document is a sham. The writing is on the wall. The DTI will do as little as possible. It will not sweep away the 23 overlapping and ineffective regulatory organisations and replace them with a single independent regulator. These would continue to be dominated by representatives of big companies and accountancy firms, the same organised concerns that have consistently short-changed the British public. The past evidence suggests that the DTI is unlikely to do more than rearrange the deckchairs.

The DTI is unlikely to follow the Sarbanes-Oxley Act and prevent auditors from selling a large number of non-auditing services to client companies. Instead, it will take its cue from major accountancy firms and argue that such contracts should be decided by non-executive directors (in reality directors' mates). The non-executive directors at BCCI, Maxwell, Polly Peck, Enron, Worldcom, Xerox, Tyco and Cable & Wireless are hardly the models of accountability. The DTI will wash its hands off the corporate accountability problems by repackaging these failed solutions. Rather than introducing democracy in companies, the DTI will fudge the issues by claiming that some accounting disclosures (e.g. an Operating and Financial Review) would suffice.

Such is the spell of ‘accounting think’ that Ministers cannot see beyond the solutions proposed by accountancy firms. The result would be more accountants (at 250,000 professionally qualified accountants Britain already has more accountants per capita than any other country and more than the rest of the EU put together) and fee earning opportunities for accountancy firms. But no justice, democracy, openness and accountability to help ordinary people. The DTI might throw in the odd sweetener like saying that companies should also publish details of the non-audit fees paid to auditors, but will not address fundamental questions about sleaze that is rampant in the auditing industry.

The outcomes of the DTI’s ‘corrupt’ relationship with the accountancy industry affect every citizen. A corporate elite will continue to plunder companies. People are entitled to know why the DTI does not care about their loss of jobs, savings, homes, pensions and investments. They would be right to attach little/no confidence to audited company accounts.

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