



BRINGING AUDIT BACK FROM THE BRINK: UK Institutional Response to Auditor Liability Campaign

**(Auditor liability and the need to overhaul a key investor
protection framework)**

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BRINGING AUDIT BACK FROM THE BRINK

(Auditor liability and the need to overhaul a key investor protection framework)

INTRODUCTION

This paper looks at some key aspects of the question of auditor liability in the UK, which we have been considering both as part of an ongoing scrutiny of audit, internal control and risk management practices and in light of the high-pressure campaign by the Big 4 accountancy firms to further limit their liabilities.¹

These issues are examined in the context of the perceptions of and the problems with the current audit framework and market for audit opinions. We also look at some of the effects of the Law Lords' decision in the Caparo case.² Finally a number of recommendations, some of which build on existing developments, are offered to help address the issues that exist and provide the opportunity to bring audit back from the brink.

The Investor Perspective

Our interest is driven by the valuable benefits we believe that meaningful, effective audit arrangements can offer investors. From an investor perspective, we continue to have to focus on audit, internal control and risk management issues. Over recent years, this has increasingly had to move beyond the way in which we assess companies, into taking steps intended to highlight and help address the more systemic problems (market dynamics, commoditisation of audits, conflicts etc) that are undermining the effectiveness of audit. One example of this was the document "*Institutional Position Paper: The Benchmark for Audit Committees*" (November 2002) put to the UK Financial Reporting Council's review undertaken by Sir Robert Smith (The Smith Report - now part of the UK's Combined Code) by investment institutions representing over £1.6trillion (and with other investment institutions representing as much again assisting and contributing to its development). Another example has been the increasing use of voting rights to oppose the re-election of auditors where concerns exist over their independence that are not addressed by companies' disclosed policies and practices.

The audit is both important and of significant value to shareholders. It is meant to be undertaken on behalf of and in the specific interests of investors, not least to enable us to exercise our proprietary right as shareholders. This is important in the context of the information asymmetries that exist and the potential for agency problems, where the audit has an important role to play in providing reliable intelligence on a company's affairs. It is meant to help enable shareholders to scrutinise management's conduct and exercise collective control where it is needed, which is crucial to us in terms of the role it plays in enhancing shareholders' ability to protect their investments and shareholder value on a proactive basis. That said, it is also important to investors in terms of their role in committing the capital that supports businesses individually and UK plc more broadly.

While effective audits are a fundamental aspect of a robust investor protection framework, the incidence of audit failures and the related shareholder value destruction that has been seen, provide ample reason for our concerns about the current state of play on audit.

¹ : See paragraph 3.2

² : Caparo Industries plc v Dickman, House of Lords (1990)

Main Conclusions

Given the importance we attach to the intended value of audits, we are increasingly concerned about the Big4's continual campaign to achieve further structural limitations to, or reductions in, liability. Having considered our own view on both the liability debate specifically and the broader, related concerns that exist about audit, our main conclusions from a shareholder perspective, are that:

- (i) There should be no further moves at present (see (iv) below) to increase auditors' protection from liability, whether through reform of section 310 of the Companies Act 1985 or by a move to proportional liability.
- (ii) Given the issues that exist, the priority for reform needs to be the market for audit opinions and the audit framework (see sections 4 to 8 of this paper). This needs to address the quality issue (e.g. create a move away from the increasingly formulaic approaches, back towards the exercise of judgement) and facilitate a proactive (dialogue/engagement based) rather than reactive (blame/litigation based) focus on issues of potential concern. Without this confidence will be difficult to regain.
- (iii) Most importantly, it is essential that auditors are free, indeed, required to apply their professional judgement within the context of an overarching and, importantly, overriding Duty of Care based on the Law Lords' opinion in the Caparo case (see paragraph 11.4).
- (iv) Based around (ii)&(iii) above, consideration could be given to structuring appropriate safe-harbour arrangements that incentivise accountancy firms to re-enable auditors to undertake high quality audits and offer meaningful 'intelligence' and assurance to shareholders, thereby enabling them to limit their liability.
- (v) In addition, the limitation of scope imposed in the Caparo case (see section 9 of this paper) should be revisited in light of the original policy objectives of the audit regime.
- (vi) Given the state of and consolidation in the market (see paragraphs 6.4 and 6.5), a full Competition Commission inquiry into the market for audit opinions should be undertaken.

These conclusions are supported (see section 11 of this paper) by a series of recommendations intended to help address the issues that are highlighted in the paper.

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The author would like to extend his thanks for the work, advice and feedback received from a range of practitioners, investors, academics and others over the last few years, which have helped inform and shape his thinking and have contributed to the production of this paper.

1. CURRENT LIABILITY

1.1 Starting this paper by looking at the issue of auditor liability feels somewhat akin to starting Machiavelli's 'The Prince' at Chapter 15. However, as auditor liability has been made the focus of the current UK debate by the Department of Trade and Industry's consultation,³ this paper has, albeit reluctantly, taken that as its starting point. We believe that a framework underpinned, as at present, by joint & several liability remains appropriate. In looking then at the nature of auditors' current liability, three key aspects are worth highlighting:

(i) **Auditors' joint & several liability**

Accountant's activities in carrying out the statutory audit can, within the many limitations they have already secured,⁴ create a joint & several liability that is shared with directors and/or others. Given the points that are made in sections 3 and 4 of this paper we are not convinced by the Big4 accounting firms' arguments that 'change and change now' is imperative. The problem is not in fact with liability but with the audit itself and the work and conclusions of the Law Commission on auditors' joint & several liability remain valid:⁵

"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".⁶

(ii) **Auditors' duty of care**

In considering the nature of the liability and the wider issues on audit, that this paper will come on to, it is worth considering how 'open' auditors actually are to liability. The decision in the Caparo case⁷ was explicit in restricting auditors' duty of care to: 'shareholders'. Despite how this might seem on the face of it, as Tolley's Company Law put it, in practice:

"it is clear that Caparo considerably restricted the liability of auditors and, in the absence of any contractual or other special relationship with an investor, potential investor or other third party, no duty of care will be owed."

In practice, the Caparo duty is owed only to the company, as representing the shareholders as a body. This was not always the case nor was it the original intention behind legislation introducing the audit, which raises an important issue for the public policy agenda that is looked at further in section 9 below.

With no direct duty of care owed to them shareholders, individually, generally have no direct relationship with or recourse against the auditor, not even a right to obtain information or advice on the audited company from them, beyond the limited audit opinion.⁸ It is therefore those actually subject to the audit, the Board of Directors, who 'own' the relationship with and right of recourse against the auditors.

³ : "Director and Auditor Liability: A Consultative Document" (December 2003), DTI

⁴ : See paragraph 3.1

⁵ : If anything they are thrown into sharper relief by the extensive in-roads accounting firms have made in circumscribing their exposure to liability (see paragraph 3.1).

⁶ : DTI, Feasibility Investigation of Joint and Several Liability (1996), page 35

⁷ : Caparo Industries plc v Dickman, House of Lords (1990)

⁸ : See paragraph 8.1

(iii) **The focus and standard of the duty of care**

Perhaps most important in this debate is the essential focus and standard that underpins auditors' duty of care, which was summarised in the 1990 House of Lords decision in the Caparo case, namely that:

"The central purpose of the audit report was to enable shareholders to exercise their proprietary powers as shareholders by giving them reliable intelligence on the company's affairs, sufficient to allow the shareholders to scrutinise the management's conduct and to exercise their collective powers to control the management through general meetings"

Leaving aside the issue noted in (ii) above, this standard is imperative and clearly intended to help address the information asymmetries and agency conflicts that can exist. This is also reflected in section 432(2)(d) of the Companies Act 1985, under which the Secretary of State is empowered to appoint 'DTI Inspectors'. It was, for example, a direct factor in the DTI Inspectors' adverse conclusions in the Transtec plc case⁹:

*"the company's members [had] not been given all the information with respect to its affairs which they might reasonably expect"*¹⁰

1.2 While liability is part of the wider problem, it is in fact a symptom not the root cause of the problem. The real problem derives from the way audit has evolved. At the simplest level:

- (i) Investors carry the losses from corporate failures and, in light of, for example, adverse DTI Inspectors' findings and disciplinary 'whitewashes', have taken an increasingly critical view of the role of auditors;
- (ii) this contributes to concerns amongst the accounting firms about liability risk;
- (iii) this, in turn, leads the accounting firms to seek to contain and minimise exposure to liability risk both through the legal framework and, more significantly, the approach to and transparency of audit (e.g. formulaic rather than judgement based approach and anodyne opinions);
- (iv) this leads investors to conclude that the audit is being 'dumbed' down, drives investor scepticism and criticism and, in turn, exacerbates (i).

This self-perpetuating, circular dynamic has contributed to a damaging, downward spiral in the quality of audit, as well as in investor and public confidence. Accounting firms' actions have turned their concerns about liability into a self-fulfilling prophecy. The reasons for this are discussed in more detail in sections 4 to 9 of this paper.

2. PROPOSED ALTERNATIVES TO JOINT & SEVERAL LIABILITY

2.1 Before moving on to the actual problem that needs to be addressed, its causes and the solutions, this section touches on the two main alternatives to joint & several liability that have been put forward for consideration in the DTI consultation. Broadly speaking, these are reform of section 310 of the Companies Act 1985 ("section 310"), to enable liability to be limited by contract and the introduction of a proportional liability regime.

⁹: 'Transtec plc - Investigation under Section 432(2) of the Companies Act 1985' (2003) by Hugh Aldous FCA and Roger Kaye QC

¹⁰: The Transtec report found that the events underlying this involved "lack of integrity, deception, lies, cover up and financial misstatements" and that the case was "a fascinating example of audit failure".

- 2.2 Back in the 1990s, again as a result of the large accounting firms lobbying to change and reduce their liability, the Law Commission undertook a feasibility study¹¹ for the Government on whether joint and several liability should be replaced by proportional liability. That study considered both of these options.

Capping liability by contract

- 2.3 Given the agency problem, risk of conflicts and effects of contractual capping we oppose the reform of section 310. The Law Commission study itself concluded: “we can find no principled arguments for a capping system”.¹²
- 2.4 Reform of section 310 would enable auditors to cap liability by means of a contract entered into with the company, i.e. with the directors whose stewardship and disclosures are being scrutinised by the auditors and who are also key clients for the accounting firms’ wider commercial services. Three forms of contractual cap have been suggested:
- (i) *an absolute cap* – this would be arbitrary and have a high likelihood that the cap bore no relationship to any loss the auditors caused or were responsible for. In addition, limits that were appropriate, even meaningful in the context of the Big 4 firms, would be unduly punitive to smaller firms. The effect would be to further entrench the Big4 firms; a point well recognised within the Tier A firms.¹³
 - (ii) *a fee multiple* - this would again prove arbitrary and have a high likelihood of having no bearing on any loss the auditors caused or were responsible for. It would also add further downward pressure to that which has already been seen on the audit fees and further upward pressure on the relative importance of other commercial revenue from audit clients. It would also unduly penalise those firms placing more emphasis on quality of audit and less emphasis on the sale of non-audit services to their audit clients.
 - (iii) *proportional liability limitation* – this retains all the problems associated with proportional liability, which were addressed by the Law Commission and are summarised below (see paragraph 2.6).
- 2.5 Another un-intended consequence of a reform of section 310 is the potential, in a group of companies, that liability could be suppressed. The large part of the audit within a large group is usually at subsidiary level. Technically the ‘shareholders’ of a subsidiary would be the immediate holding company, or a chain of holding companies. There is a risk that reform of section 310 would enable management and auditors to collude to firewall entities used in, say, off-shore, off-balance sheet transactions. In effect this would result in only the auditor’s responsibility for the holding company audit being truly exposed to the duty owed to the real shareholders and owners of the Group.

Proportional liability

- 2.6 Proportional liability again raises concerns for investors and we note that the Law Commission recommended “firmly against such a solution”. The reasons behind this remain valid and are reinforced by the later developments noted in paragraph 3.1 below. Amongst the reasons cited by the Law Commission were:

¹¹ : DTI, Feasibility Investigation of Joint and Several Liability (1996)

¹² : Page 49

¹³ : See for example “Liability of Auditors in the Light of Parmalat” J.Newman, Managing Partner of BDO Stoy Hayward, RREV Newsletter (Feb 2004)

- (i) The joint and several liability principle rests on standard, well accepted principles of causation that already present a formidable hurdle for plaintiffs.
- (ii) Full proportional liability is unfair to plaintiffs because it shifts the risk of a defendants insolvency from other defendants to the legally blameless plaintiffs, who may have to bear the costs associated with a defendant's insolvency.
- (iii) Proportional liability would produce the odd result that a plaintiff could be less likely to recover full damages by being the victim of two wrongs than if they had been the victim of just a single wrong.

3. THE REALITY OF AUDITOR LIABILITY

3.1 In addition to the formidable hurdle the principle of causation presents (see paragraph 2.6(i) above), it is important to recognise that the accounting firms have already seen their exposure to liability dramatically curtailed:

- (i) The Caparo case limitation (see paragraph 1.1(ii) above), which means that any plaintiff would have to demonstrate: (a) foreseeability - that the loss would result from a failure of the duty; (b) proximity - a tangible (contractual or special) relationship with the auditor other than just their role as auditor; and (c) fairness - that it is just and reasonable to impose the duty in that case.
- (ii) The introduction of Limited Liability Partnerships (offering the protections of limited companies without the same transparency and disclosure obligations).¹⁴
- (iii) The principle of contributory negligence, which enables auditors to make a defence based on the negligence of other parties.¹⁵ The ICAEW itself has acknowledged that this would have "a dramatic effect on limiting the effect of negligence".¹⁶
- (iv) The right of action by auditors against other parties (e.g. in the Wallace Smith Trust or Sound Diffusion cases).
- (v) The use of formulaic guidance, such as on risk models,¹⁷ to leverage defences off the back of legal concepts articulated in the likes of Lloyd Cheyham & Co. v Littlejohn & Co. [1987] BCLC 303.¹⁸
- (vi) Other operational tactics (selection of jurisdiction, limitation statements¹⁹ etc.
- (vii) As well as the statutory right to obtain relief from liability from the Courts.²⁰

3.2 The Law Commission described the accounting firms' claims about the catastrophic unfairness of unlimited liability as "misleading". This view was re-confirmed in a report²¹ by The Alberta Law Reform Institute in 1998, which concluded that the profession's claim was "notable more for its audacity than its accuracy as a description of either the theory of joint and several liability or its likely effect" (page 35). In the words of the Managing Partner of one of the UK's leading audit firms: "It should ... be noted that no major accounting firm has collapsed because of unlimited liability".²²

¹⁴ : See the 'Limited Liability Partnerships (LLP) Act 2000' and associated regulations, available in the Company Law and Investigations section of the DTI website (www.dti.gov.uk).

¹⁵ : See House of Lords Judgement in *Banque Bruxelles Lambert v Eagle Star Insurance* (1997) AC 191

¹⁶ : *The Accountant*, August 1996 (page 11)

¹⁷ : See paragraph 8.6

¹⁸ : In this case, although the Statement of Standard Accounting Practice were accepted as not being rigid rules, they were held to be very strong evidence as to what was the proper standard to be adopted. While a departure from them might, therefore, be regarded as a breach of duty unless there was some justification, conformity to them might also be used as a defence that the duty of care was satisfied.

¹⁹ : See ICAEW Technical Release: Audit 1/03 'The Audit report and Auditors' Duty of Care to Third Parties' on the recommended wording to use in a disclaimer in the audit report to avoid the effect of the Bannerman judgement (see paragraph 9.3)

²⁰ : Section 727 of the Companies Act 1985

²¹ : "Limited Liability Partnerships and Other Hybrid Business Entities" (March 1998)

²² : "Liability of Auditors in light of Parmalat" RREV newsletter (Feb 2004)

- 3.3 Not only have auditors already seen their exposure to liability dramatically reduced, but this has happened in the context of an increasingly flawed framework (see sections 4 to 9 below). We have already gone too far down this route.

4. **IS LIABILITY REALLY THE ISSUE?**

- 4.1 It is important to remember that the ultimate failure of Andersen was not a result of its financial liabilities but of the damage done to its reputation. In the context of their protection under limited liability partnerships, it is also worth bearing in mind that the Big 4 audit firms are not in fact global entities but rather brand franchises linked by co-operation agreements, i.e. they are in fact a loose confederation of separate entities. Within that each entity is effectively firewalled from the others. In practice the only real form of catastrophic risk, such as is continually being alluded to by the Big 4, is in fact not so much about joint & several liability but about the issue of reputational risk. The very emotive liability campaign being pursued by the Big4 is something of a red herring, the same one dismissed by the Law Commission in the mid-90s.²³
- 4.2 So what is going on? In truth it is hard to make an independent and objective assessment of all the factors at play given the still fairly opaque structure of partnership firms. However, other significant internal factors certainly seem to be at play.²⁴
- 4.3 From an investor perspective, the real drivers in terms of reputational risk have been the failure of audits,²⁵ the lack of transparency and the lack of accountability to shareholders. The audit is no longer clearly seen as embracing the spirit of the auditors' Duty of Care. The argument has been made that the problems and failure of Andersen reflected the fact that it was an 'outlier' amongst the big firms in terms of its practices and procedures. However, Andersen's shared a broadly similar business model with the other Big4 firms and there was no surprise at the speed with which other firms were willing to absorb the fragmenting pieces of Andersen.
- 4.4 Looking at the incidence of financial restatements, empirical analysis of 1000 large companies by Professors from Cornell and Yale Law Schools²⁶, from 1997 through 2001, shows no evidence that Andersen's performance differed significantly from the other large firms. This was despite increased scrutiny over the period and the number of companies restating their results increasing dramatically.
- 4.5 Looking even further, at some more fundamental issues that are current, just a few examples involving the remaining 4 big firms, include:
- *Parmalat* – a UK institutional investor unsuccessfully demanded a full investigation into the accounts of Parmalat a year before the Italian dairy group collapsed in a multi-billion pound fraud. Despite the investor effort the auditors continued to sign off the accounts.
 - *HealthSouth* – US Congressional investigators revealed in June 2003 that the auditors were warned in 1998 of the multi-billion dollar fraud, but had concluded that the "issues raised did not affect the presentation of HealthSouth's financial statements".²⁷

²³ : See paragraph 3.2 above.

²⁴ : e.g. see paragraphs 6.1 & 6.4 below.

²⁵ : i.e. to evidence the focus and standard that underpins the Duty of Care, as per Caparo.

²⁶ : Centre for Law, Economics and Public Policy, Research Paper No. 287: "Was Arthur Andersen Different - An Empirical Examination of Major Accounting Firms' Audits of Large Clients" (Nov 2003) T.Eisenberg and J.Macey.

²⁷ : FT, 23 June 2003

- *Tax Shelters* – all the Big4 firms are understood to be under investigation over questionable tax practices (e.g. on tax shelters), with one in particular now subject to a criminal probe by the US Justice Department.²⁸
- *NextCard* – one audit partner has pleaded guilty and another has been arrested on criminal charges over the alteration and destruction of working papers.²⁹
- *Overcharging clients*³⁰ – audit firm fined in Arkansas for destroying documents relating to a lawsuit in which the firm was accused of fraudulently overbilling clients.³¹
- *Xerox* – following a criminal investigation by the US attorney's office into a multi-billion pound accounting fraud, 5 partners of the audit firm have been arrested.
- *Freightliner (DaimlerChrysler subsidiary)* – the High Court refused to throw out the negligence case against the auditor, with Mr Justice Cook indicating that the company “has a real prospect of success on each of its claims”. The company was insolvent, the accounts falsified and the auditor failed to follow up on fraud tip-offs in both the UK and Canada.³²

4.6 There are plenty of other examples where questions could be asked; its not just the above or the Elan/Enron/Accident Group/Worldcom/Tyco/Atlantic Computers/Mirror Group Newspapers/Waste Management/Polly Peck/Reliance Insurance/Transtec/BCCI/Barings/Queens Moat Houses/Resort Hotels/ Wickes/Ahold/Cable & Wireless/Adecco/SSL/Equitable Life's of this world.

5. **WIDER PERCEPTIONS**

5.1 These concerns are not isolated ones, nor are they new, rather they are increasing and widely shared. In some discussions we have had amongst investors, even the merit of maintaining an entrenched and fatally flawed audit framework has been questioned.³³ We believe that this is wrong, but firm action is needed if audit is to be brought back from the brink.

5.2 These concerns are also recognised and shared far more widely than just the investment community and, again, are not new. The following are just a few illustrations from the many that have been published or reported in the press:

- Article entitled “Europe’s auditors should give us the bad news” by Paul Koster, Executive Board member of the Netherlands Authority for the Financial Markets.³⁴
- “The Enron scandal is not an isolated accounting failure. Over the past five decades, accountants have changed from watchdogs to advocates and salespersons” Prof. Jay Lorsch, Harvard Business School.³⁵
- “The days when the auditors used to carry out stringent checks are well gone. These days the auditors ask questions to the company accountant and accept their word” Pareash Samet, Croner Consulting.³⁶
- The Autumn 2003 survey of 200 finance directors by Accountancy Age, indicated 54% of FDs felt that the quality of audits in the UK had diminished, with only 30% disagreeing. The article noted that “some alleged auditors quoted low to get a foot in

²⁸ : FT, 20 February 2004

²⁹ : US Department of Justice, 25 September 2003.

³⁰ : Interestingly a Big Question survey by Accountancy Age in November 2002 found that “80% of FDs believed auditors padded their bills”.

³¹ : The Times, 20 November 2003.

³² : FT, 8 October 2003.

³³ : Also reflected in an Accountancy Age article ‘Audit is totally pointless’ back in October 1999.

³⁴ : FT article, 18 January 2004.

³⁵ : FT article, 10 April 2002.

³⁶ : Accountancy Age, 6 November 2003.

the door and get consultancy work³⁷, while others were unhappy at the seniority of staff sent by the firms to carry out the work". Illustrative quotes from the Accountancy Age survey, included:

- "the quality of audits has declined markedly over the last few years"
- "due to time restraints many auditors have in completing an audit, certain areas of the business are overlooked"
- The Autumn 2003 Accountancy Age findings are not new as is illustrated by the quotes taken a Survey of *Financial Director* subscribers the year before:
 - "Auditors used to check that things were right. Now they look at trends and pretend to be business advisors. They should get back to basics"
 - "In general the last 20 years have witnessed a considerable drop in ethical standards ... presentation is more important than content".
 - "Auditors should remember that they are acting on behalf of shareholders and not directors and need to perform their duties diligently"
 - "I would be prepared to pay auditors more for a more thorough scrutiny, provided they also accepted or were forced to accept a high degree of responsibility for the accuracy of their audit opinion."
 - "My experience of working in large corporations is that they use large accounting practices that are more interested in collecting large fees than in carrying out detailed audits."
 - "The Big5 are a cartel that must be broken up. Their market strength works against the best interests of their clients and it is un-competitive."
 - "I believe companies do not get good value for money from their audits....auditors spend far too long form-filling to ensure the PII requirements are met....critical systems reviews are rare....often audit staff are so inexperienced they wouldn't spot a fraud if it bit them....I speak as one who has been on both sides of the fence".
- Accountancy Age, Reed Accountancy Big Question (July 2002): "UK finance directors have narrowly voted in favour of an OFT investigation into the implications of the Big 5 being reduced in to the Big4", with the level of support rising to 75% amongst Scottish FDs.

5.3 These views again point to the fact that the real problem that needs to be addressed, has more to do with the market for audit opinions and the effectiveness and 'quality' of audit, than it has to do with liability.

6. THE MARKET FOR AUDIT OPINIONS

6.1 One reason for the decline in the quality of audit can be attributed to the forces at play in the market for audit opinions. The applicability of the Akerlof Model³⁸ to this market has not gone un-noticed, and not without reason. It only requires some 'bad' audit opinions to create the dynamic that forces high quality audit opinions out of the market:

*"Consequently honest auditors are unable to compete in [the] market unless they decrease the quality of their own audit or supplement their (lack of) audit income with other revenue streams (e.g. non-audit services), which results in undermining auditors' independence."*³⁹

³⁷ : In an interview with the FT (5 September 2003) Kieran Poynter, UK senior partner at PwC, made clear that the firm had, over the past year, sought assurances from prospective audit clients that they would also be prepared to give it consulting work. Where a company would not give the firm consulting work they would "think long and hard" before they would be prepared to pitch for the audit.

³⁸ : "The Market for Lemons: quality uncertainty and the market for lemons" George Akerlof, Quarterly Journal of Economics 1970

³⁹ : "Audit Opinions or Lemons? Insights from Andersen and the Enron Audit" P.Roush and L.Thorne, University of Central Florida and York University Ontario (see **Attachment 1**).

The shorter, less thorough audit implied and the pursuit of increased revenue from other services are all part of the wider perception that is reflected in paragraph 5.2 above. Findings by Otley & Pierce⁴⁰ (e.g. use of short-cuts) and Willett & Page⁴¹ (quantifying the incidence and reasons behind 'speeding up of testing'), emphasise the concerns that exist within this dynamic and from the increasingly formulaic approaches used.⁴² This is also further exacerbated by the Big4's complex monopoly referred to below.

- 6.2 Beyond this, rather than repeat much of what has already been well articulated about the applicability of the Akerlof Model, the paper by Pamela Roush, Associate Professor at the University of Central Florida's School of Accounting and Linda Thorne, Associate Professor at York University's Schulich School of Business is attached (**Attachment 1**).
- 6.3 We share concerns about the market dynamics outlined in the paper and see merit in considering many of its conclusions in terms of the steps that might allow audit to be brought back from the brink, for instance:

"To ensure a full and permanent remedy to audit failure, audit quality must be transparent to investors and 'honest' sellers of audit opinions must be assured.(page 5).....For example, investor insight into audit quality can be achieved through timely and detailed public disclosure which could include: (1) detailed and truthful reporting of reasons for audit turnover; (2) detailed, non-generic audit opinions including disclosure of auditors significant concerns; (3) identification of 'grey' interpretations of financial reporting choices; and (4) disclosure of key guidelines determined and followed by auditors including materiality guidelines used on a particular client.(page 22)"

A complex monopoly

- 6.4 As noted we are concerned about the increasingly concentrated (complex) monopoly situation that has developed. The Big4 now control 100% of FTSE 100 audits and 96% of FTSE mid-250 audits.⁴³ The UK data speaks for itself. Monitoring by Glass Lewis⁴⁴ in the US indicates that where large accounting firms are choosing to cede audit clients to smaller accounting firms, these tend to be the smaller companies (ones which offer less scope for cross-selling and scale). The conclusion reached was that the firms appeared to be applying a different risk model to large and small companies. Much as is the case in the UK when there is a switch of auditors in large companies (>\$100 million in revenue) then in the majority of cases the switch is between large firms.
- 6.5 Work⁴⁵ by J.Macey and H.Sale, Professors at Cornell Law School and the University of Iowa College of Law respectively (see **Attachment 2**), underlines the concern that the combined effect of concentration in the Big4 and the nature of regulation, has effectively prevented companies from utilising small, independent accounting firms. This operates against the public interest in that it has reduced competition and the big accounting firms' incentives to differentiate their audit product on the basis of quality:⁴⁶

⁴⁰ : "Auditor time budget pressure: consequences and antecedents" D.Otley and B.Pierce (1996) Accounting, Auditing & Accountability Journal

⁴¹ : "A Survey of Time Budget Pressure and Irregular Auditing Practices Amongst Newly Qualified UK Chartered Accountants" (1996) C.Willett and M.Page, British Accounting Review, Vol 2, No.2

⁴² : e.g. see paragraph 8.6 below.

⁴³ : "The Annual Audit Fee Survey" Financial Director (January 2004)

⁴⁴ : FT, 8 February 2004

⁴⁵ : "Observations on the Role of Commodification, Independence and Governance in the Accounting Industry" (Nov 2003) J.Macey and H.Sale, Villanova Public Law and Legal Theory Working Paper No. 2003-18

⁴⁶ : The priority and main driver from an investor perspective is quality, not price.

“The modern accounting industry operates more like a business than a profession. The decline in professionalism is a problem that goes beyond Enron, Worldcom and other recent corporate scandals. The problem is deeper than the concerns about the simultaneous provision of audit services and consulting..... the internal corporate governance structure of the big accounting firms is fundamentally flawed.... The incentive structure within accounting firms makes it virtually impossible for auditors to be independent of significant clients like Enron. This flaw has led to a gradual, but fundamental, change in the basic balance of economic power between accounting firms and their audit clients.”

7. **AUDIT CONFLICTS**

7.1 Much has already been said publicly on specific facets of audit conflicts. Beyond what is noted above and with the exception of non-audit fees and their effect on investor perceptions, I do not propose to revisit all the arguments on the practical aspects of these, such as:

- Loss leading and pricing pressure.
- Use of rule based, formulaic processes⁴⁷ and the subsequent effect on quality⁴⁸.
- Increasingly short sign-off times.⁴⁹
- Commercial business models, piggy backing on audit.⁵⁰
- Linked to that are non-audit fees, both in the UK⁵¹ and more globally.⁵²
- Following on again, the issue of independence.⁵³
- The widespread imbalance perceived in the relationships between management, audit committees and auditors (re: management control of the auditor relationship,⁵⁴ with only retrospective and sometimes nominal monitoring by audit committees⁵⁵).

7.2 A then groundbreaking study⁵⁶ by the Business School's of Stanford, MIT (Sloan School) and Michigan State University in 2001 linked the provision of non-audit services to the impairment of an auditor's independence, an increased incidence of aggressive earnings management and found that it "dangerously stretches the bounds of accepted accounting practice".⁵⁷ Significantly, the study also examined the extent to which investors had regard to levels of non-audit fees. Their results showed a "statistically significant" share price drop on the day the fees were disclosed by the top 25% of companies ranked by level of non-audit fees:

⁴⁷ : See paragraph 8.6.

⁴⁸ : See paragraph 8.2.

⁴⁹ : 2003 FTSE100 range: 30 days to 136 days (the turn around before sign-off has fallen by around 22% since 1997)

⁵⁰ : In an interview with the FT (5 September 2003) Kieran Poynter, UK senior partner at PwC, made clear that the firm had, over the past year, sought assurances from prospective audit clients that they would also be prepared to give it consulting work. Where a company would not give the firm consulting work they would "think long and hard" before they would be prepared to pitch for the audit.

⁵¹ : In 2003 the Big4 firms saw FTSE100 non-audit fees that on average were approx. twice the audit fee and in some cases nearly six times as much (e.g. Diageo £18.9m versus £3.3m)

⁵² : Global turnover of the Big 4 firms exceeds \$55bn, the majority for non-audit work.

⁵³ : A survey of 292 UK city analysts by consultancy Brand Finance found 94% of those with an opinion believed significant non-audit fees would lead to audit independence being compromised (Accountancy Age, August 2000) e.g. see paragraph 8.10

⁵⁴ : e.g. see paragraph 8.10

⁵⁵ : The Financial Reporting Council's Smith Report (now part of the UK's Combined Code on Corporate Governance) will have an important role to play in helping to address this if its adopted in both word and spirit.

⁵⁶ : "The Relation Between Auditor's Fees for Non-Audit Services and Earnings Quality" M.Johnson; K.Nelson and R.Frankel (Accounting Review, October 2002 Supplement, Vol. 77 Issue 4, pp. 71-105)

⁵⁷ : News Release, "Stanford Business School Study Finds Consulting Contracts Impair Auditor Objectivity" 1 August 2001

“These results are consistent with arguments that the provision of non-audit services strengthens an auditor’s economic bond with the client and that investors price this effect.”

8. DO AUDITS PROVIDE MEANINGFUL ASSURANCE ?

- 8.1 A quick comparison between the kind of approach suggested in paragraph 6.3 above and the anodyne, boiler-plate audit opinions that shareholders saw in the cases referred to in paragraphs 4.5 and 4.6 above, makes a powerful statement. By way of example, the following is the audit opinion preceding the crisis in one of those cases:

“Opinion

In our opinion the accounts give a true and fair view of the state of affairs of the company and the Group as at 31 December 2001 and of the loss of the group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.”

- 8.2 Does the above ‘opinion’ truly satisfy the focus and standard expected in the House of Lords summary of the auditor’s duty of care (see paragraph 1.1(iii) above)? The absence of reliable intelligence, meaningful assurance and disclosures evidences the kind of dynamic explored in the paper by Roush and Thorne⁵⁸ and which is referred to by Macey and Sale.⁵⁹ Rather than a dynamic that leverages professional judgement and focuses on improving quality, assurance and transparency of the audit opinion, the reverse has happened and rather than developing and enhancing the old form of non-standard audit opinion, they have been sanitised. As paragraphs 8.3 and 8.4 suggest, these can have a positive long-term effect. It not clear what has happened to the alternative opinions that seemed to be used, albeit too infrequently, until the mid-1990s. These non-standard audit reports broke down into 4 types:

- (i) Inability to give an opinion because of a fundamental matter of uncertainty, i.e. a total disclaimer.
- (ii) Inability to give an opinion on a material issue of uncertainty, i.e. subject to caveats confirmation could be given.
- (iii) Inability to give an opinion on a fundamental issue of disagreement, i.e. in light of said issue confirmation could not be given.
- (iv) Inability to give an opinion on a material issue of disagreement, i.e. excluding said issue, confirmation could be given.

A healthy, vibrant audit market would have built on and enhanced this framework rather than reducing it to the point illustrated in paragraph 8.1 above. The nature of audits (tick-box audit procedures)⁶⁰ and the opinions produced have been run down, leading to precisely the kind of tragically ineffective statement that is being seen in problem cases.

- 8.3 One of the arguments that has been made in private is that qualified accounts would damage the business rather than allowing the exercise of influence to be used to address concerns. Clearly in the context of the cases referred to in paragraphs 4.5 and 4.6 that will provide little comfort to shareholders. More fundamentally though we don’t really

⁵⁸ : See paragraph 6.2

⁵⁹ : See paragraph 6.4

⁶⁰ : See paragraph 8.6 below and paragraph 2.50(b) of the DTI Inspectors’ report on Transtec plc.

- agree with the proposition that qualified accounts damage a business. Rather it has risked creating the perception that things are being swept under the carpet. While there may be some short-term volatility while the market adjusts to negative news, in truth it is necessary to enable a proper valuation of the company and risks associated with it. That is not all there is to it though; more importantly, it should provide an important catalyst for shareholder engagement and for change.
- 8.4 The problem of getting effective audit reports and opinions is not new. A study by the ACCA⁶¹ in 1999 of 124 companies that failed between 1987 and 1994, found that only one in seven was qualified on a going concern basis in the last annual report and accounts prior to the failure, despite the related APC Audit Guideline⁶² that has been issued in 1985. While audit standards were subsequently updated,⁶³ the study's findings on the effects of qualification remain interesting. They found that:
- “Contrary to the self-fulfilling prophecy argument, in particular, we have found that 80% of audit reports qualified on a going concern basis are followed by a subsequent set of accounts rather than company failure. Moreover, two out of five qualified companies enter into major financial restructuring or a rescue rights issue, showing that receipt of a [going concern qualification] does not pose an insurmountable obstacle to raising new finance.”*
- 8.5 Taking this a step further, where there are ‘issues’ sufficient to lead to an auditor’s resignation, investors have a reasonable expectation that the letter of resignation should contain a statement about the circumstances in question. Indeed section 390 of the Companies Act 1985 specifically provides for this. However, work undertaken by the University of Strathclyde and University of Essex, again illustrates why there is so much scepticism about audit practice. In a sample of 766 resignation letters issued by auditors of public limited companies only 2.5% contained a statement. In 108 cases, the resigning auditors issued qualified audit reports and still remained ‘silent’ in the resignation letter.⁶⁴
- 8.6 The cornerstone of the process by which auditors decide on the scope of their work is a risk model.⁶⁵ There are questions on the effect of this in terms of ensuring a quality audit and the use of a formulaic model approach as a defence against the need to undertake fuller due diligence.⁶⁶ More worrying have been the doubts raised⁶⁷ about whether some of the approaches to risk assessment used by large audit firms have been fully compatible with the SAS 300 risk model. This is linked to concerns, that we share, that the profession is using formulaic guidance of this kind to leverage defences⁶⁸ off the back of court cases such as *Lloyd Cheyham & Co. v Littlejohn & Co.* [1987] BCLC 303. This trend in the profession away from the use of judgement towards formulaic rule orientated approaches is disturbing. It appears to us that the profession is gradually moving itself towards the type of approach that has been seen in the US. This risks widening the expectation gap⁶⁹ and further undermining the perceived credibility of the audit.

⁶¹ : “Audit Report Disclosures of Going Concern Uncertainties: A Continuing Puzzle” (1999) ACCA Research Note No.60, Citron and Taffler (Chartered Association of Certified Accountants).

⁶² : “The Auditor’s Consideration in Respect of Going Concern” APC Guideline, 1985/1.

⁶³ : e.g. SAS600 and SAS 130.

⁶⁴ : “Auditors: Keeping the Public in the Dark” (1999) P.Sikka and J.Dunn.

⁶⁵ : SAS 300 “Accounting and Internal Control Systems and Audit Risk Assessments” March 1995

⁶⁶ : e.g. of the kind required, say, of a reporting accounting in a Class 1 transaction under the Financial Services Authority’s Listing Rules, where proximity vis-à-vis individual shareholders and hence liability, is clearer.

⁶⁷ : “Developments in Audit Methodologies of Large Audit Firms”(2000) W.Lemon, K.Tatum and W.Turley.

⁶⁸ : “Auditor Liability: The Other Side of the Debate” J.Cousins, A.Mitchell and P.Sikka

⁶⁹ : The gap between a direct interpretation of the duty of care in paragraph 1.1(iii) and what the written standards appear to be used to limit and convert that into.

- 8.7 Do, for example, the current arrangements really provide comfort or meaningful assurance about the dynamics and risks involved in companies that do or have made potentially significant use of off-balance sheet vehicles? Companies where such concerns might arise are not restricted to the US and the Enron's of this world. Examples of companies who have or are using complex, opaque off-balance sheet arrangements can be found in most markets in both large, better known companies and smaller ones.
- 8.8 The same question can be asked about those companies using aggressive or 'fluid' accounting policies and practices. The ASB has recently had to produce guidance tackling this in relation to revenue recognition.⁷⁰ In introducing the Application Note, Mary Keegan, the ASB Chairman, indicated that "...reports of questionable practice have highlighted the need for us to set out best practice." Aggressive or opaque practices are not limited to revenue recognition. They can extend to company practice in unwinding provisions, shifting (even disappearing) segmental or divisional disclosures, use of exceptional items, changing to depreciation rates and cost of capital figures, selective capitalising of costs, to name but a few.
- 8.9 While the standards bodies continue the often thankless but essential task of trying to both harmonise and keep standards and guidance up-to-date, investors should be able to look to auditors to help plug any gaps where poor or questionable practice occurs or has been 'normalised' by corporates. Audit opinions, which should be helping shareholders by sign-posting issues warranting consideration and their implications, simply don't. To address this, auditors need to be re-empowered so that they can evidence the judgement, level of objectivity, critical approach and ability to expose management 'weakness' that will be necessary in some cases.
- 8.10 There is, for example, a strong body of academic work⁷¹ that illustrates how audit reports are poor indicators of financial distress, even compared to predictions of bankruptcy models. Given auditors have access to internal information not available to those running the models, this is, frankly, a source of some dismay for investors. The work⁷² by the University of London on bankruptcy and auditor switching found that "Managers used the decision [on switching auditors] to avoid receiving qualified accounts and a switch exogenously reduces the accuracy of reports." Separately this illustrates the kind of dynamic that can arise where management 'own' the audit relationships, i.e. there is only a nominal or retrospective audit committee role.
- 8.11 It came as no real surprise to investors that the FRRP was reported to have found that 8 out of the first 20 sets of accounts it was proactively reviewing had problems and that in 3 cases the issues were material. In this context, the move of many aspects of regulation to the Financial Reporting Council has been a welcome development. Following on from that we look forward to seeing the results of the review of its membership and that of its constituent bodies. Beyond this, however, the profession's regulation itself must be seen to be effective.⁷³ Past suggestions of 'whitewashes', of the kind that was perceived to have taken place in the Sound Diffusion case, would undermine efforts to re-establish the credibility of the profession. There is a clear need to ensure that failings are addressed

⁷⁰ : ASB Issues Standard on Revenue Recognition - PN 226 (13 November 2003).

⁷¹ : e.g. Altman & McCough (1974), Deakin (1977), Kob (1991) and Lennox (1998).

⁷² : "Bankruptcy, Auditor Switching and Audit Failure: evidence from the UK 1987 - 1994" C.Lennox, University of London.

⁷³ : This is consistent with the EU's (i) short-term priority of "strengthening public oversight of the audit profession"; and (ii) medium term priority of "improving disciplinary sanctions". Company Law and Corporate Governance – 10 Point Audit Plan (21 May 2003)

and that, for example, any critical findings of DTI inspectors report⁷⁴ are seen to be properly followed up. In that regard the follow up to the findings of the Transtec Report⁷⁵ will be watched with interest.

9. REVISITING THE SCOPE OF AUDITORS' DUTY OF CARE

9.1 Before moving on to the recommendations for revitalising the audit, this section looks in more detail at the scope of auditors' duty of care. This follows on from the issue noted in paragraph 1.1(ii) above. The current, very limited scope is clearly not the original intention behind the legislation that introduced the audit. There is a good case to be made that the scope achieved by the accountants in the Caparo case needs to be revisited. Looking back at the intent behind audit legislation:

- During the passage of the Companies Act 1929, audits were described as more than just for the "*protection of shareholders and investors, wholly or even mainly*".⁷⁶
- During the passage of the Companies Act 1948, audits were considered to be "*in the interests and protection of the public*".⁷⁷
- During the passage of the Companies Act 1967, the then President of the Board of Trade said, "*It is right, both from the point of view of efficiency and of fair distribution of rewards, that full information should be available to shareholders, employees, creditors, potential investors, financial writers and the public as a whole*".⁷⁸
- Another supporter of the Bill added, "*modern company laws should be concerned not just with the interests of the shareholders but with the contribution of the company to the economic efficiency of the whole community*".⁷⁹
- The Opposition benches also supported this adding that "*We need a number of figures to be able to make that comparison, and it is this inquiry by those interested in the company, whether as an onlooker or as a shareholder in a number of companies, which is so important to improve the performance of companies in any particular industry*".⁸⁰

9.2 How true and how relevant this still is in the current situation where the need for responsible share-ownership and investor engagement are so clearly a priority. It is perhaps appropriate then that policy makers should now take on board the opinion expressed by Lord Griffiths⁸¹ and look to redress the situation:

"My Lords, I have long thought that the time had come to change the self-imposed judicial rule that forbade any reference to the legislative history of an enactment as an aid to its interpretation.... If the language proves to be ambiguous I can see no sound reason not to consult Hansard to see if

⁷⁴ : The DTI report on Sound Diffusion (1991) had found that the auditors had either failed to identify or had otherwise accepted serious defects in the Company's accounting practices and did not adequately audit the revenues from the principal assets. No disciplinary action ensued. Another example, again debated in Parliament related to the findings of the DTI inspectors' report (1990) on Bryanston Finance.

⁷⁵ : "Transtec plc: Investigation under Section 432(2) of the Companies Act 1985" Report by Hugh Aldous FCS and Roger Kaye QC (see paragraphs 13.41 to 13.37)

⁷⁶ : Hansard, 21 February 1928, col. 1523

⁷⁷ : Parliamentary Debates, House of Lords, 18 February 1947, col. 745

⁷⁸ : Hansard, 14 February 1967, col. 360

⁷⁹ : Hansard, 14 February 1967, col. 403

⁸⁰ : Hansard, 14 February 1967, col. 444

⁸¹ : Pepper v. Hart [1993] A.C. 593, 617

there is a clear statement of the meaning that the words were intended to carry....material that bears upon the background against which the legislation was enacted. Why then cut ourselves off from the one source in which may be found an authoritative statement of the intention with which the legislation is placed before Parliament?"

- 9.3 The more recent "Bannerman" case⁸² in the Scottish Court of Session, which took a divergent view to the House of Lords decision in the Caparo case, also emphasises the need to revisit the scope of auditors duty of care. This need for a review of the scope element of the Caparo judgement (we otherwise believe the nature of the duty of care it articulates to be both correct and essential) picks up a similar public policy perspective suggested by Lord Denning:⁸³

"the law would fail to serve the best interests of the community if it should hold that accountants and auditors owe a duty to no one but their client. There is a great difference between the lawyer and the accountant. The lawyer is never called on to express his personal belief in the truth of his client's case, whereas the accountant, who certifies the accounts of his client, is always called upon to express his personal opinion and he is required to do this not so much for the satisfaction of his own client, but more for the guidance of shareholders, investors, revenue authorities and others, who may have to rely on the accounts in serious matters of business. In my opinion, accountants owe a duty of care not only to their clients, but also to all those whom they know will rely on their accounts in the transactions for which those accounts are prepared".

- 9.4 As has previously been indicated, the audit is one of the key elements of a robust investor protection and stewardship framework and is, potentially, of great significance in maintaining and protecting shareholder value. It helps to tackle both information asymmetries between the board and outside investors and agency conflict. This conflict between the information that a board might wish to release and the information or reliable intelligence that the investor needs, creates 'a potential for abuse', in terms of Lord Bingham's appraisal of the Caparo case at the Court of Appeal (1989).
- 9.5 It is worth also noting that in modern capital markets, the financial statements provide the cornerstone for much of the analysis, modelling and research that is undertaken. Alternative sources of information simply cannot be dis-aggregated from the statutory financial information. They represent value-added rather than alternative/replacement information. It is true that the value added can be significant, as demonstrated by and tested (by PwC) against the very interesting work that has been undertaken on 'Value Reporting'.⁸⁴
- 9.6 There is very clearly a secondary market role for and impact of statutory financial information and the assurances that are supposed to go with it. Existing and prospective investors, as well as creditors rely on audited financial statements in making their investment or lending decisions. The opportunity to reflect the valid secondary market interest could sensibly form part of a revitalised and effective audit framework, which offers qualitative (assessment based) disclosures and meaningful assurance that are underpinned by balanced safe-harbour provisions.

⁸² : Royal Bank of Scotland v Bannerman Johnstone Maclay and others [July 2002]

⁸³ : Candler v Crane Christmas & Co [1951] 1 All ER 426

⁸⁴ : The Value Reporting™ Revolution: Moving Beyond the Earnings Game" (2001) R.Eccles, R.Herz, M.Keegan and D.Phillips

10. **CONCLUSIONS**

- 10.1 We conclude that a number of destructive dynamics (see, for example, paragraphs 1.2, 6.1, 6.5, 7.1 and 8.6) are undermining the perceived quality of audit, particularly when it is most needed (see paragraph 4.5 and 4.6).
- 10.2 Were liability to be addressed in isolation to wider reform it would address the symptom of the problem for the accounting firms, without addressing the root causes of problem and the issues on audit quality and effectiveness that investors have to contend with.
- 10.3 The approach being taken to 'focussing' (i.e. the perceived 'dumbing down')⁸⁵ of audits seriously underrates the ability and potential of auditors, circumscribes their use of judgement and, hence, their effectiveness. A contrast can be made between the nature of the role undertaken by auditors in their statutory function and, say, their reporting accountant function on Class 1 transactions, under the Financial Services Authority's Listing Rules. Anecdotal evidence from discussions with auditors indicates that the latter kind of work is welcomed and found to be more interesting. This is despite the fact that the work creates proximity to shareholders (see paragraph 3.1(i)) and hence a potentially greater exposure to liability. Given the considerably greater protections that the statutory role benefits from as a result of Caparo, why then is catastrophic liability risk of such concern. As has been noted (see paragraph 4.1), the catastrophic risk alluded to is, in practice, more to do with reputational risk than it is to do with liability. This arises because of the perceptions that exist about the stewardship of the statutory audit, the adaptation it has been subject to, its perceived weakness and the methods of its implementation.
- 10.4 Having considered the issues our main conclusions from a shareholder perspective, are that:
- (i) There should be no further moves at present (see (iv) below) to increase auditors' protection from liability, whether through reform of section 310 of the Companies Act 1985 or by a move to proportional liability.
 - (ii) Given the issues that exist, the priority for reform (see section 11 of this paper) needs to be the market for audit opinions and the audit framework (see sections 4 to 8 of this paper). This needs to address the quality issue (e.g. create a move away from the increasingly formulaic approaches, back towards the exercise of judgement) and facilitate a proactive (dialogue/engagement based) rather than reactive (blame/litigation based) focus on issues of potential concern. Without this confidence will be difficult to regain.
 - (iii) Most importantly, it is essential that auditors are free, indeed, required to apply their professional judgement within the context of an overarching and, importantly, overriding Duty of Care based on the Law Lords' opinion in the Caparo case (see paragraph 11.4).
 - (iv) Based around (ii)&(iii) above, consideration could properly given to structuring appropriate safe-harbour arrangements that incentivise accountancy firms to re-enable auditors to undertake high quality audits and offer meaningful 'intelligence' and assurance to shareholders, thereby enabling them to limit their liability.

⁸⁵ : e.g. see paragraphs 3.1(v), 6.5, 8.1, 8.5 and 8.6

- (v) In addition, the limitation of scope imposed in the Caparo case (see section 9 of this paper) should be revisited in light of the original policy objectives of the audit regime.
 - (vi) Given the state of and consolidation in the market (see paragraphs 6.4 and 6.5), a full Competition Commission inquiry into the market for audit opinions should be undertaken.
- 10.5 The three studies attached to this paper each provide a stand alone review and insight into the nature of the audit market the dynamic and problems that exist.

11. **RECOMMENDATIONS**

Safe-harbours

- 11.1 Avoidance of liability is clearly claimed to be a powerful motivator for the accountancy firms. In seeking a compromise arrangement, accounting firms will need to be offered a reasonable way to mitigate their risk by carrying out their public interest duties effectively, without providing blanket protection regardless. Investors need high quality audits and a mechanism that helps make them effective, to enable them to tackle risks that may threaten their investments and any agency conflicts and information asymmetries.
- 11.2 In this context an obvious *win-win* approach, which we recommend, would be the adoption of a carefully crafted safe-harbour regime. By this we do not mean the rather broad, general provisions that are sometimes seen, rather a more carefully structured approach explicitly underpinned by the duty of care in paragraph 11.4 below. This supports our view that further moves to limit liability must not be made in isolation from the steps needed to address the underlying issues.
- 11.3 Clearly, careful consideration needs to be given to the crafting of such safe-harbours to ensure their effectiveness, underpinned by the right Duty of Care, the right breadth of role and the right reporting and disclosure requirements.

Auditors' Duty of Care

- 11.4 The current approach to the duty of care appears to move increasingly towards reliance on formulaic or procedural approaches and needs to change. We recommend that it be made explicit that auditors must be free, indeed, required to apply their professional judgement within the context of an overarching/overriding Duty of Care based on the Law Lords' opinion in the Caparo case – which should be more explicitly set out:

Auditors must act on behalf of and in the interests of shareholders, to ensure that shareholders can exercise their proprietary powers as shareholders, by giving them reliable intelligence on the company's affairs, that is timely, relevant and sufficient such as to allow the shareholders to scrutinise the management's conduct and to exercise their collective powers to control the management through general meetings. In doing so they must evidence the necessary professional judgement, critical approach, level of objectivity and ability to expose [management 'weakness'], that may reasonably be expected of them in this role.

- 11.5 In this context and in addition to the enhanced disclosure arrangements referred to below, we recommend that:
- (i) The effectiveness of the provisions under section 390 of the Companies 1985 are reviewed and that necessary enhancements are made to ensure they achieve their intended objective, e.g. if auditors resign without an appropriate statement of relevant circumstances they should be subject to a statutory 'duty of care' to any shareholder who can establish that this non-disclosure led to a loss).
 - (ii) The company should be required to issue a written response to an auditor's statements of circumstance in the letter of resignation.
 - (iii) Annual statistics about the number of resignation letters/statements filed at Companies House are published.
 - (iv) Arrangements are introduced to enable shareholders to question auditors, either in writing or at Annual General Meetings, on their report and on issues falling within their locus.
- 11.6 In addition, we recommend that the effective limitation of scope imposed in the Caparo case should be revisited in light of the original policy objectives (see section 9 of this paper) of the audit regime.

Ethical standards

- 11.7 We are supportive of the work that has been done by the Auditing Practices Board to start enhancing Auditor's Ethical Standards. Their proposals were a welcome development for investors and, with some refinements (e.g. in relation to working up the overarching principles, including the duty of care noted above), should help improve this vital element of the framework. We look forward to seeing the outcome of the consultation and would highlight the importance of this first step, in particular on independence and non-audit work, not being watered down. Robust new ethical standards are a key part of the wider process of bringing the audit framework up-to-date and for addressing perceived concerns on issues such as independence.

Restructuring audit

- 11.8 Given the systemic nature of the problems and dynamic that exist, some consideration has been given between investors as to whether the audit can be reformed sufficiently to re-capture its intended purpose. Given the potential value of and importance we attach to audit we believe that it has to be reformed. In particular, thought has been given to what might be done to open up the audit market and make it more competitive and innovative:
- (i) As indicated in the paper (see paragraphs 6.4 and 6.5), we believe that there is a complex monopoly that exists in the market for audit opinions and through that for non-audit services. We believe that this operates against the public interest for the reasons referred to in this paper and its attachments and should be the subject of a full Competition Commission inquiry.
 - (ii) A direct route to addressing this might involve limiting the number of companies that an individual firm could audit (e.g. 20 to 25). This would require the larger firms to dis-aggregate the various parts of their partnership networks, increasing the independent entities competing in the market.
 - (iii) A more sophisticated route would be to re-cast the structure, to split the audit role. This route held particular appeal, despite problems in some companies with more than one auditor. Were there to be an appropriate framework,

structured to create the right balance between parties, these issues might be addressed. These deliberation led us to look further at the analysis and proposals put forward in “*Thinking not Ticking: Bringing competition to the Public Interest Audit*” (April 2003) J.Hayward, Centre for the Study of Financial Innovation. We believe that this has made an important contribution (e.g. in relation to analysing what has happened to the audit and on disclosure and independent evaluation). Given where we find ourselves, we recommend serious consideration is given to the proposals in ‘Thinking not Ticking’ in structuring an effective solution. To that end a copy of the paper has been included as **Attachment 3**.

- (iv) Another, if rather tangential, approach might be found in the formation of a standing Council of Institutional Investors. This would offer the opportunity to explore proposals for greater shareholder participation in, for example, the appointment of auditors. Such an overarching body could be charged with responsibility for Shareholder Panels or Committees, which have been a matter of debate for some time (e.g. “The case for the shareholder panel in the UK” (1995) by David Hatherly of the University of Edinburgh’s Department of Accounting and Business Method). This concept was raised again more recently in a letter to the FT on 9 January 2004 (“Path to auditor independence” by Shann Turnbull), which noted a similar approach had been suggested by the APB in 1992 and had, at one point, been raised by Sir David Tweedie (now Chairman of the International Accounting Standards Board).

Audit Coverage

11.9 The most frequent problems underlying audit failure and catastrophic corporate failures relate to internal control, risk and fraud. We recommend that the Financial Reporting Council undertake a full review of the audit related arrangements in these areas, with a view to substantially overhauling the review, assurance and disclosure arrangements that exist to ensure that they are effective and meaningful. In addition at a mundane level:

- (i) *Disclosure* – despite recent corporate scandals and internal control failures and despite shareholder letters to hundreds of listed company chairmen, only three companies spring to mind that have shown particular initiative in moving towards more meaningful disclosure for shareholders. Last year, Barclays and Unilever made initial moves towards the production of audit committee reports, something we welcomed. HBOS have for the last few years provided factual disclosure of how their audit committee and risk management frameworks are set up and linked through the Group which is, again, helpful. Beyond this the approach by companies to paragraphs 36 (additional information) and 40 (meaningful disclosures) of the Turnbull Report (Internal Control: Guidance for Directors on the Combined Code) that supports the UK’s Combined Code on Corporate Governance, has been poor.
- (ii) *Audit Committee oversight* – common boiler plate disclosures suggest limited activity (e.g. all too common are audit committees that appear to meet only three or four times a year involving nominal with only retrospective oversight of the auditors and audit relationship). Going forward we will be looking for companies to adopt and be seen to adopt both the word and the spirit of the best practice guidelines established by the Financial Reporting Council’s Smith Committee (now linked a to the Combined Code). We also recommend that all members of listed company audit committees, in particular, have regard to the following:
 - “Appraising Your Auditors: A Guide to the Assessment and Appointment of Auditors” (June 2003) The Institute of Chartered Accountants of Scotland.

- The work of Ernst & Young (“Managing Risk to Protect and Grow Shareholder Value”) and Oxford Metrica (“Improving risk quality to drive Value”), which captures the nature of enterprise risk management that we look for and value as investors.
- (iii) *Auditors* – we believe that the current role of auditors in relation to internal controls is woefully inadequate. This is merely a requirement to review the Combined Code compliance statement, which encompasses the review of the effectiveness of internal controls under Combined Code provision D 2.1 (final part of paragraph 12.43A of the Financial Services Authority’s Listing Rules). In the same way the auditors role in relation to risk and fraud need to be strengthened. On internal controls, for example, despite instances where companies have failed to make any kind of compliance statement, we have seen Big4 auditors give clean audit opinions. Both the Listing Rule provision and the related APB Bulletin (2000/1, as amended) need an overhaul.

Some related recommendations to help address the themes touched upon above are covered under the recommendations on disclosure.

Disclosures

- 11.10 This paper has also alluded to the role of other parties (both in this section and in, say, paragraph 7.1 - last bullet point) in the process that audit is an integral part of. This is important as creating an effective audit framework has to be linked to effective frameworks applying to management, who have the primary responsibility for disclosure. The audit committee has a fundamental responsibility, on behalf of the board of directors as a whole, for internal monitoring and scrutiny of management to enable informed and independent participation in the Unitary Board framework. The role of auditors is to step ‘inside’ the company or group, on an independent basis, acting on behalf of and in the interests of investors, to provide appropriate assurance given the potential agency conflicts and information asymmetries that can exist.
- 11.11 Key to many of concerns that exist is the perceived lack of meaningful disclosure, whether it be internally or externally. Some current initiatives, if taken forward effectively, will help contribute to the broader solution that is required. In particular we have in mind the new arrangements for the Operating and Financial Review (OFR) that is being introduced and the audit committee report now included in the UK’s Combined Code.
- 11.12 In that context, the development of the appropriate (overall) disclosure frameworks, around which to base and revitalise the auditor’s role and hence offer appropriate safe-harbours, is important. This framework should ensure that:
- management make the right primary disclosures (We also recommend that the issue of chief executive and finance director/CFO certification should be kept under review as an option).
 - Auditors have a clear dual role: (i) reporting and advising the audit committee and (ii) reporting and providing assurance to shareholders.
 - The audit committee have a dual responsibility: (i) in terms of their oversight of relevant policies and practice, as part of an informed and independent participation in the Unitary Board framework and (ii) in terms of reporting to shareholders.
- 11.13 In terms of audit reports, we recommend that the Financial Reporting Council and APB review the standards applying to audit opinions to:

- Identify enhancement that can be made to the range and nature of non-standard audit opinion that should be given, e.g. on matters of uncertainty (see paragraph 8.2 above).
- Address the shortcoming in the framework to ensure such opinions are properly used.
- Require the audit opinion to be specifically made on behalf of and in the interests of shareholders, clearly linked to the Duty of Care (see paragraph 11.4 above).
- Require that the supporting audit report contain meaningful disclosures, again linked to the duty of care.
- Ensure that 'statements of circumstances under section 390 of the Companies Act 1985 are made and are sufficient.

11.14 We recommend that the following disclosure proposals (we have not removed duplication) form the focus of this deliberation:

From “Thinking not Ticking: Bringing competition to the Public Interest Audit” (page 44) J.Hayward:

- Disclosure of material uncertainties affecting the accounts and the effect of making different assumptions.
- The principle risks affecting the sustainability of the business and information concerning how those risks are managed.
- Reasons for the selection of the accounting policies used, and the effect of using alternatives.
- Details of any matters which the auditor believes to be incorrect or inadequately described.
- Any areas where the auditor could not obtain all the information that he required.
- A review of how what was said in the previous year’s audit report turned out in practice.
- An explanation of the difference between cash-flow and profits
- An explanation of the relationship between the management reward system and the reported profits.
- Details of the time spent by audit staff of different skills and experience levels.
- A summary of how this time was spent.
- The actual audit fee for the year, an explanation of any difference from the fee estimated at the start of the year and an estimate for the forthcoming year.
- The name of the individual partner taking responsibility for the report.

“Audit Opinions or Lemons? Insights from Andersen and the Enron Audit” (page22) P.Roush and L.Thorne:

- Detailed and truthful reporting of reasons for audit turnover.
- Detailed, non-generic audit opinions including disclosure of auditors significant concerns.
- Identification of ‘grey’ interpretations of financial reporting choices and their implications.
- Disclosure of key guidelines determined and followed by auditors, including materiality guidelines used on a particular client.

“The Canadian Market of Audit Opinions: A critique of the Canadian Institute of Chartered Accountants’ response to the Ontario Securities Commission” The Capital Markets Institute (Canada) Policy Comment

- The materiality guidelines used in the course of an audit. Disclosure of materiality thresholds provides investors with information regarding auditors’ judgement on the accuracy of financial statements and provides valuable insight into the scope of the audit testing.
- Detailed audit opinions that include auditors’ key concerns, disclosure of crucial guidelines and grey interpretations made in the course of the audit. This will allow users to gain insight into the level of confidence auditors have in the financial statements as presented.
- Information regarding the scope and timing of the audit, including disclosure of audit hours, audit plans, and levels of staffing.
- Detailed disclosure on the frequency of and reasons for auditor turnover that in fact provides insight into the underlying reasons why change of auditors took place. This level of disclosure is one that would facilitate investor understanding for auditor turnover and for the evaluation of the audit quality that results.

Illustrative US disclosures

- **SEC rules** on ‘Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies’ covering accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an accounting policy that has a material impact on its financial presentation.
- **Section 204 of the Sarbanes Oxley Act:** The auditor must report to the audit committee all "critical accounting policies and practices to be used...all alternative treatments of financial information within [GAAP] that have been discussed with management...ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm
- **Section 103 of the Sarbanes Oxley Act:** - re: a standard requiring the auditor evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transactions of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.
- **Section 404 of the Sarbanes Oxley Act:** management’ assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
- **Section 404 of the Sarbanes Oxley Act:** Each issuer’s auditor shall attest to, and report on, the assessment made by the management of the issuer.

Additional suggestion:

- Disclosure of changes to accounting policies and practices, the reasons for and an assessment of the effects of each of them.
- A firmer obligation on management to draw to the auditors’ attention to any and all matters relevant to the audit (linked to certification).
- As part of the audit process, auditors should consult leading shareholders on any company practices or risks that the auditor should have regard to in undertaking the audit.
- Inconsistencies between comparable assumption used by management and the reasons for and effects of them.

- As appropriate, other relevant information (e.g. in relation to the treatment, policies and practice vis-à-vis off-balance sheet or joint venture arrangements or other material issues (e.g. C&W's cash) or potential liabilities (e.g. Marconi's option hedging)) in light of the possibility and significance of the risk.
- In the absence of an appropriate disclosure or assessment by the company's management or audit committee, the audit report should highlight that fact.
- Incoming auditors should have statutory right of access to the files and working papers of the outgoing auditors.

11.15 These recommendations illustrate the nature of disclosures that would be deemed to contribute to a robust audit and disclosure framework. We recommend that they be used to develop a new and meaningful framework. While the primary focus of this paper has been the UK the framework, the recommendations, in particular the Duty of Care and disclosures it envisages are as, if not more, applicable across the EU.

(February 2004)