

TOO EASY FOR AUDITORS?

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A fundamental law of market economies is that producers should have economic incentives to produce high quality goods and services. Therefore, producers are required to ensure that their goods and services are of merchantable quality, owe a 'duty of care' to the consumers and bear the full consequences of any assumed shortcomings. Such considerations are increasingly being diluted in the field of external auditing and thus raise significant questions about its usefulness and future of company audits.

Auditing firms want protection from lawsuits. Ironically, most of the large lawsuits against auditing firms are launched by other accountancy firms acting in their capacity as liquidators. The liquidators' fees often depend on the time taken to complete the liquidation and/or a fraction of the cash realised. This gives liquidators enormous incentives to sue auditors. The actual settlements, however, tend to be a small fraction of the original claim. Ordinary shareholders rarely receive anything significant from such lawsuits.

In response to pressure from accountancy firms the Companies Act 2006 has introduced "proportionate liability". Under this auditors and company directors can negotiate a contract that effectively places limits on auditor liability long before any knowledge of alleged negligence, auditor culpability and its consequences. Such arrangements also affect the creditors rights (e.g. on liquidation) but they will have no say. Proportionate liability was unveiled in the US by the Private Securities Litigation Reform Act of 1995 which provided protection to auditors and other professionals. It was the only legislation vetoed by President Bill Clinton during eight years in office. Critics had argued that lower liability would encourage auditors to be more cavalier, take unnecessary risks, reduce audit effort and be more willing to become party to aggressive accounting practices. Major firms persuaded Congress to overturn the presidential veto. The law became a major factor in the subsequent scandals¹, such as Enron, WorldCom, Global Crossing, Qwest and others that engulfed the US and eventually led to the demise of Arthur Andersen.

Major firms now want a statutory 'cap' on their liabilities and have received favourable nods from the European Union and some US regulators. This has persuaded a former member of the US Securities and Exchange Commission (SEC) to argue that the "idea of capping liabilities, which is gaining traction, brought me to the conclusion that a profit-seeking enterprise doing this kind of work – auditing – is very

¹ Stiglitz, Joseph, (2003), *The Roaring Nineties: Seeds of Destruction*, London, Allen Lane.

difficult to pull off There is an inherent tension between doing a good audit job and maximizing your profits. The tension between those two is too great. You can't expect both objectives to be well served by a single institution²." So he has called for a government department to conduct audits of public companies.

External auditing has moved well away from the long established social bargain. The UK's Companies Act 1948 gave accountants, belonging to a select few professional bodies, a monopoly of the state guaranteed market for external company audits. That social bargain was accompanied by a prohibition on the ability of audit firms to trade as limited liability companies and in accordance with the partnership law of the time, accountants conducting company audits needed to have 'joint and several' liability i.e. partners would be liable for each other's negligence and omissions. Such an arrangement gave accountancy firm partners incentives to police each other and also enabled the firms to become major multinational businesses.

As accountancy firms became larger and more influential, they demanded changes to their liability position even though relatively few cases involving alleged auditor negligence reached the courts. Their concerns were deepened as client companies were becoming big and alleged negligence could lead to very large damages. Auditors also argued that the availability of the assets of the firm, individual partners and insurance cover made them an attractive target for lawsuits. The UK law was changed and the Companies Act 1989 permitted auditing firms to trade as limited liability companies. Very few exercised this option as they were not keen to publish audited financial statements or relinquish the tax perks associated with partnerships.

Developments in case law also diluted auditor liabilities. The House of Lords judgement in *Caparo Industries plc v Dickman & Others* [1990] 1 All ER HL 568 stated that generally auditors owed a 'duty of care' to the company (as a legal person) appointing them rather than to any individual shareholder. The judgement narrowed the circumstances under which auditors could be successfully sued for breach of a 'duty of care'. Subsequently, the courts applied the *Caparo* principle to cases such as *McNaughton (James) Paper Group Limited v Hicks Anderson & Co.* [1991] 1 All ER 134 and [1990] BCC 891 and *Berg Sons & Co. Limited & Others v Adams & Others* [1992] BCC 661, and did not award any damages against auditors, even where they were considered to be negligent, on the ground that they did not owe a 'duty of care' to third parties.

In the early 1990s, UK accountancy firms were facing the possibility of lawsuits arising from allegations of audit failures at Polly Peck, Maxwell, Bank of Commerce and Credit International (BCCI), Levitt Group of Companies and other high profile companies. Some further liability relief was provided by the Law Commission's recommendation of the principle of 'contributory negligence', which permitted auditors (and other professionals) to defend themselves by arguing that others (e.g. directors, bankers) contributed to their negligence and the loss suffered by the plaintiffs, and should, therefore, bear a fair share of the damages. The UK courts accepted the principle of 'contributory negligence', as evidenced by the House of Lords judgement in *Banque Bruxelles Lambert S.A. v Eagle Star Insurance Co. Ltd* [1997] AC 191 and the informed legal opinion was that the judgement would have a dramatic effect on

² <http://www.corporatecrimereporter.com/longstreth021207.htm>

limiting the consequences of negligence. This became evident from the subsequent litigation relating to the collapse of Barings Bank.

In 2001, some seven years after the collapse of Barings Bank, liquidator KPMG sued auditors Coopers & Lybrand and Deloitte & Touche Singapore for alleged negligence and demanded over £1 billion in damages. Coopers & Lybrand brokered an out-of-court settlement for an undisclosed amount, but the liquidator pursued Deloitte & Touche for £200 million. In 2003, the High Court eventually ruled that Deloitte & Touche was negligent in its audit work at the Singapore arm of merchant bank. However, auditors only had to pay £1.5 million because the bank, its directors and poor internal controls contributed to the frauds, collapse of the bank and auditor negligence.

The firms demanded more. A 1996 report by the Law Commission³ rejected the firms' demands for a 'cap' and full proportional liability by arguing that such concessions weakened consumer protection and were against the public interest.

Following the development of Limited Liability Partnerships (LLPs) in the US, major firms began demanding the same for the UK. The general rule for LLPs is that the liability claims would be met by the assets of the firm and any applicable liability insurance, followed by the assets of the partner responsible for the action/inaction creating the liability. Thus, the assets of the other partners were protected, even though they shared in the profits generated by all partners. In 1995, the UK arm of Ernst & Young and Price Waterhouse (now part of PricewaterhouseCoopers) spent £1 million to draft a LLP Bill, which gave firms considerable protection from lawsuits with no formal regulation or public accountability. They asked the government of Jersey to enact this Bill, with a threat that if the UK government did not do the same they would move their operations to Jersey.

However, the Bill encountered considerable difficulties in Jersey and did not become fully operational until 1998⁴. Eventually, the UK government capitulated and introduced the Limited Liability Partnership Act 2000. The firms agreed to publish audited financial statements in return for liability concessions and also retained partnership tax perks. No firm migrated to Jersey. An Ernst & Young senior partner added that "It was the work that Ernst & Young and Price Waterhouse undertook with the Jersey government that concentrated the mind of UK ministers on the structure of professional partnerships.The idea that two of the biggest accountancy firms plus, conceivably, legal, architectural and engineering and other partnerships, might take flight and register offshore looked like a real threat I have no doubt whatsoever that ourselves and Price Waterhouse drove it onto the government's agenda because of the Jersey idea" (Accountancy Age, 29 March 2001, p. 22).

³ UK Department of Trade and Industry, (1996), *Feasibility Investigation of Joint and Several Liability*, HMSO, London.

⁴ Cousins, Jim, Mitchell, Austin, and Sikka, Prem, (2004), *Race to the Bottom: The Case of the Accountancy Firms*, Association for Accountancy & Business Affairs, Basildon.

There has been a long procession of concessions on auditor liability without any attention to obligations to consumers of audit opinions. Many of the major audit failures occurred during what auditors regarded as an onerous liability regime. How many more will occur with new lower liability regimes? Lower liability thresholds remove economic pressures to deliver good audits and make audit failures more likely. As the inevitable scandals emerge confidence in contemporary external auditing practices will be badly shaken and is unlikely to recover. So the debate now needs to focus on alternative mechanisms to secure corporate accountability and protection for stakeholders.