

CAN MAJOR ACCOUNTANCY FIRMS BEHAVE ETHICALLY?

by

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Following Enron, WorldCom, Barings, Parmalat and other headline scandals, numerous questions are raised about the governance of corporations. In contrast, hardly any attention is focused on the governance of auditing firms even though audit failures are the outcome of their organisational processes, values and culture.

The world of auditing and consultancy is dominated by just four secretive accountancy firms: PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young and KPMG. They are controlled by trusts headquartered in offshore tax havens (Bermuda and Switzerland), which do not have multilateral information sharing treaties with other countries. They enjoy the state guaranteed monopoly of the external audit function and claim to provide services through global networks and shared organisational culture. Their combined global income of US\$70 billion is greater than the gross domestic product of many nation states. After each scandal, the regulatory structure is tweaked and promises of ethical conduct are repeated, all in an attempt to disarm critics and avoid effective laws and regulation. Yet these promises always fail to check predatory behaviour.

In the prevailing political inertia, major firms do almost anything to generate fees and profits. In the year 2000, the Italian competition authority fined the then Big Six accountancy firms for operating a cartel¹. The agreements covered virtually every aspect of competition between the auditing firms, including fixing prices and deciding in advance the firm that win any competitive auditing contracts. The offences were committed despite previous warnings by the regulator.

In folklore, the firms compete but they have no qualms about getting together to hold democratically elected governments to ransom. In the early 1990s auditing firms

demanded major liability concessions, which the government was unwilling to concede. So in 1996, Price Waterhouse and Ernst & Young got together and spent £1 million of their own money to draft a Limited Liability Partnership (LLP) law. The law gave the firms considerable protection from lawsuits. The tiny island of Jersey agreed to enact the law and the firms said that if the UK government did not give them what they want they would cause economic instability by relocating to Jersey². Eventually, the UK government capitulated and enacted LLP legislation in 2000, which came into force in 2001. Ernst & Young senior partner crowed, “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 idea³”.

More recently, the Big Four firms plus Grant Thornton got together to challenge the French government over its law barring accountancy firms from auditing a company’s accounts if they have provided advisory services to the client in the past two years⁴. The same firms are now planning to make further joint challenges to the French law.

Money laundering is considered to be a major issue. A UK High Court judgement (*AGIP (Africa) Limited v Jackson & Others (1990) 1 Ch. 265et seq.*) referred to accountants and said that “Mr. Jackson and Mr. Griffin are professional men. They obviously knew they were laundering money. It must have been obvious to them that their clients could not afford their activities to see the light of the day. [They] were introduced to the High Holborn branch of Lloyds Bank Plc. in March 1983 by a Mr Humphrey, a partner in the well known firm of Thornton Baker [this is now part of Grant Thornton]. They probably took over an established arrangement. Thenceforth they provided the payee companies... In each case Mr Jackson and Mr Griffin were the directors and the authorised signatories on the company's account at Lloyds Bank. In the case of the first few companies Mr Humphrey was also a director and authorised signatory”. Despite the very strong court judgement, there has been no investigation or public report by any UK government department, regulator or a professional body⁵.

In 2001, the New York District Attorney told a US Senate Committee that “in 1996, the US regulators concluded a case involving the bribery of bank officers in U.S. and foreign banks in connection with sales of emerging markets debt, transactions that earned millions for the corrupt bankers and their co-conspirators. In this case, a private debt trader in Westchester County, New York, formerly a vice president of a major U.S. bank, set up shell companies in Antigua with the help of one of the “*big-five*” *accounting firms* [emphasis added]. Employees of the accounting firm served as nominee managers and directors. The payments arranged by the accounting firm on behalf of the crooked debt trader included bribes paid to a New York banker in the name of a British Virgin Islands company, into a Swiss bank account; bribes to two bankers in Florida in the name of another British Virgin Islands corporation and bribes to a banker in Amsterdam into a numbered Swiss account”⁶.

During the period 1994 to 2000, contrary to the US rules on auditor independence, Ernst & Young (EY) entered into a business venture with one of its audit clients. Despite assurances to the contrary to the Securities and Exchange Commission (SEC), the firm allegedly continued its business relationship with its audit client. Eventually, the SEC prosecuted the firm for violating auditor independence regulations. In April 2004, in a sixty-nine page judgement the judge said that “EY has an utter disdain for the Commission’s rules and regulations on auditor independence. EY committed repeated violation of the auditor independence standards by conduct that was reckless, highly unreasonable and negligent. They were committed by professionals throughout the firm, who exhibited no caution or concern for rules on auditor independence in connection with business relationships with an audit client The firm paid only perfunctory attention to the rules on auditor independence in business dealings with a client, and that EY reliance on a “culture of consulting” to achieve compliance with the rules on auditor independence was a sham. EY has offered no promises of future compliance. EY partners acted recklessly and negligently in committing wilful and deliberate violations of well-established rules that govern auditor independence standards in connection with business relationships with an audit client. EY’s misconduct was blatant and occurred after the Commission and a court accepted EY’s representations that it would observe the same independence

rules, that it now claims are too vague to be followed”⁷. The firm was banned for six months from securing any new audit clients and put on probation.

The US government loses over \$300 billion each year due to organised tax avoidance. Major accountancy firms are at the forefront of such activities. Faced with governmental inertia, the US Senate Committee on Governmental Affairs decided to investigate the activities of KPMG. Following public hearings, the Committee concluded that “KPMG has devoted substantial resources to, and obtained significant fees from, developing, marketing, and implementing potentially abusive and illegal tax shelters that U.S. taxpayers might otherwise have been unable, unlikely or unwilling to employ, costing the Treasury billions of dollars in lost tax revenues⁸” The Senate hearings obtained internal memos, letters and emails of the firm and found that senior officials had decided deliberately not to comply with the law that required them register tax avoidance schemes with the US tax authorities. One internal document noted that “Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. ... For example, our average OPIS [this is an acronym for a scheme] deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000⁹”. Other documents available to the Senate Committee showed that a senior tax professional also warned that if KPMG were to comply with the tax shelter registration requirement, this action would place the firm at such a competitive disadvantage in its sales that KPMG would “not be able to compete in the tax advantaged products market.” In short, he urged, as the Senate Committee noted, “KPMG to knowingly, purposefully, and willfully violate the federal tax shelter law”. Through such strategies KPMG received more than \$120 million in fees whilst the US Treasury lost billions in tax revenues.

Subsequently, the US Department of Justice charged the firm with criminal conduct. In June 2005, KPMG admitted that its partners had been engaged in “unlawful conduct¹⁰” for a number of years. Rather than closing down the firm, the US authorities levied a record \$456 million fine on the firm. Several KPMG (now ex) partners, mostly professional accountants, are facing what the US Department Justice describes as “the largest criminal tax case ever filed”¹¹. In March 2006, one of its ex-partners told a court, “I willfully aided and abetted the evasion of taxes¹²” and that the

“object of the conspiracy was to help wealthy taxpayers significantly and illegally reduce their tax liability¹³”. Other major firms are also facing lawsuits for selling questionable tax avoidance schemes.

Some of the firms have also applied the US methods to their UK operations. They cold-call on clients to sell dubious tax avoidance schemes¹⁴. A number of these have been found to be unlawful¹⁵. Yet this does not deter firms. Within hours of budget statement from the Chancellor, major firms devise new tax avoidance schemes to negate the will of parliament. Britain loses nearly £100 billion of tax revenues each year to organised tax avoidance, but a partner of one firm was bold enough to say, “No matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken”¹⁶.

The above is only part of the mounting evidence¹⁷ that shows that in pursuit of profits major accountancy firms are not constrained by any code of ethics, claims of social responsibility, professional discipline or self-regulation. Their activities show little concern for the welfare of stakeholders, taxpayers, the state or citizens. What for ordinary people may be a matter of shame is somehow considered to be a badge of professional pride. Codes of ethics have failed to constrain major firms. Effective laws and enforcement are the only way to check major firms. Yet effective regulation is unlikely because the firms use their financial might to colonise policymaking through lobbying, the façade of professional regulation, funding for political parties and consultancies for past and future ministers. In the 2004 US presidential elections, major firms funded both Republican and Democrat parties. Upon coming to office, the UK Labour Party rehabilitated the now defunct Arthur Andersen by dropping the DeLorean lawsuits. Despite involvement in scandals, major firms continue to receive lucrative government contracts.

Successive UK governments have failed to commission any independent investigations into the real or alleged audit failures at Polly Peck, Bank of Credit and Commerce International (BCCI), Levitt Group of Companies, Resort Hotels, or the UK parts of the Enron, WorldCom, Ahold, Parmalat, WestLB, Hollinger and Xerox episodes. Major UK based accountancy firms routinely refuse to co-operate with overseas regulators safe in the knowledge that national regulators will do nothing¹⁸.

The recent UK Companies Bill dilutes auditor liability by enabling firms to negotiate a ‘cap’ or ‘proportionate liability’. There is no economic theory or evidence which shows that by reducing liability and disabling the injured party’s redress, the suppliers of goods and services somehow have better incentives to improve the quality of their goods and services. As the saying goes, “those who do not learn from history are destined to repeat it, first as tragedy, then as farce”.

NOTES

¹http://www.agcm.it/agcm_eng/COSTAMPA/E_PRESS.NSF/0/991a5848bc88040dc125688f0056851d?OpenDocument

² Cousins, J., Mitchell, P., and Sikka, P., 2004, *Race to the Bottom: The Case of the Accountancy Firms*, Basildon, Association for Accountancy & Business Affairs (available on <http://visar.csustan.edu/aaba/publications.html>).

³ Accountancy Age, 29 March 2001, p. 22.

⁴ The Times, 28 March 2006 (<http://business.timesonline.co.uk/article/0,,9073-2106802,00.html>).

⁵ Mitchell, A., Sikka, P., and Willmott, H., 1998, *The Accountants Laundromat*, Basildon, Association for Accountancy & Business Affairs (available on <http://visar.csustan.edu/aaba/publications.html>).

⁶ http://www.senate.gov/~gov_affairs/071801_psimorgenthau.htm

⁷ <http://www.sec.gov/litigation/aljdec/id249bpm.pdf>

⁸ The Senate Committee report is available on <http://levin.senate.gov/newsroom/supporting/2003/111803TaxShelterReport.pdf>

⁹ See page 15 of the Senate Committee report.

¹⁰ http://www.us.kpmg.com/RutUS_prod/Documents/8/KPMGStatement_DOJ_06_16_05.pdf

¹¹ <http://www.usdoj.gov/usao/nys/Press%20Releases/October%202005/KPMG%20Superseding%20Indictment%20PR.pdf>

¹² http://www.signonsandiego.com/uniontrib/20060409/news_1b9kpmg.html

¹³ http://uk.us.biz.yahoo.com/ap/060327/kpmg_tax_shelters.html?.v=2

¹⁴ For example see

<http://www.financeandtaxtribunals.gov.uk/decisions/documents/vat/17914.pdf>

¹⁵ Sikka, P., and Hampton, M.P., 2005, “The Role of Accountancy Firms in Tax Avoidance: Some Evidence and Issues”, *Accounting Forum*, Vol. 29, No. 3, 2005, pp. 325-343.

¹⁶ The Guardian, 18 March 2004.

¹⁷ More on www.aabaglobal.org

¹⁸ This is documented in Mitchell, A., and Sikka, P., 2002, *Dirty Business: The Unchecked Power of Major Accountancy Firms*, Basildon, Association for Accountancy & Business Affairs, 2002 (available on <http://visar.csustan.edu/aaba/publications.html>).