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AUDITORS: KEEPING THE PUBLIC IN THE DARK

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AUDITORS:
KEEPING THE PUBLIC IN THE DARK

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ISBN 1-902384-02-4

First published in 1999
by
Association for Accountancy & Business Affairs
P.O. Box 5874, Basildon, Essex SS16 5FR, UK.

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AUDITORS: KEEPING THE PUBLIC IN THE DARK
EXECUTIVE SUMMARY

The auditing industry is the private police force of capitalism. It is hired, fired and paid by company management, very people it is supposed to invigilate. Auditors enjoy more rights than the police. Unlike the police they enjoy a constant statutory right of access to a company's books, records and vouchers. Without any court order, they are entitled to any information and explanations that they consider appropriate from a company's officers. Yet auditors prefer 'silence' and easy fees. As stakeholders in BCCI, Maxwell, Polly Peck and other scandals discovered auditors issue meaningless audit reports. None ever warned the public of any dangers.

No stakeholder group has access to auditor files. Thus audit failures remain concealed. Auditors can speak at company annual general meetings on anything that concerns them as auditors. But they rarely do. They often collude with company directors to subvert discussions at company annual general meetings. Auditors do not owe a 'duty of care' to any individual stakeholder. Neither are they subjected to any independent regulation. The institutional and market pressures to make auditors accountable are virtually absent.

The legislature hoped that at the very least a resigning auditor should speak up and draw the public's attention to matters of concern. Legislation to facilitate this was introduced by the Companies Act 1976 (now part of the Companies Act 1985). The law requires the resigning auditors to make a statement on any matters connected with their resignation which ought to be brought to the attention of the company's shareholders and creditors. The legislation was introduced in response to scandals which highlighted the auditor's abdication of duties. The legislation was designed to support the weaker brethren and encourage the auditors to report their concerns. It gave auditors qualified immunities from the laws of libel. This legislation was designed to protect auditor independence and to ensure that auditors communicate serious issues relating to their resignation. But auditors prefer silence.

This monograph looks at the statements made by auditors in their letter of resignation. These letters are filed at Companies House and were examined for this study. A study of a sample of 766 resignation letters issued by auditors of public limited companies showed that only 19 (or 2.5% of the population) contained a statement of any matters that were considered to be relevant to the shareholders or creditors. In other cases,

the auditors filed a ‘nil’ return i.e. there were no circumstances in connection with their resignation which either shareholders or creditors needed to be aware of. In 108 cases, the resigning auditors issued qualified audit reports i.e. indicated material disagreements with directors or reservations about company policies and activities, yet remained ‘silent’ in the resignation letter.

The statements containing ‘nil’ responses raise some interesting issues. Firstly, it is a matter of concern that an auditor would find it necessary to resign part of the way through an appointment which would not normally last for more than one year. Secondly, in some cases the ‘nil’ return is followed by public revelations of scandals. This suggests that the resigning auditors had been ‘economical’ with information. Yet no regulator has ever taken the auditors to task. Overall, it appears that the auditor resignation legislation is not being properly complied with. Auditors go through the motions of making statements, but rarely provide any useful information. Auditors prefer silence and keep the public in the dark.

This monograph suggests a number of reforms which have a potential to create an institutional, legal and moral environment to end auditor ‘silence’. These include:

- The Department of Trade & Industry should publish annual statistics about the number of resignation letters filed at Companies House.
- Audit regulators should be required to examine auditor compliance with the auditor resignation legislation. Those failing to comply with the letter and/or the spirit of the legislation should attract penalties.
- Company directors should be required to issue a written statement in response to auditor’s ‘statements of circumstances’ contained in the letter of resignation.
- If auditors resign without disclosing the circumstances connected with their resignation in full then they should be subject to a statutory ‘duty of care’ to any shareholder or creditor who can establish that this non-disclosure was the cause of some loss.
- The incoming auditor should have statutory right of access to the files and working papers of the outgoing auditors.
- Auditors should owe a ‘duty of care’ to individual stakeholders i.e. individuals who are shareholders, creditors, employees, pension scheme members and depositors at the date of the auditor appointment. The absence of a ‘duty of care’ does not impose any pressures on auditors who prefer to keep the public in the dark.

CHAPTER 1
EMPERORS OF DARKNESS

The auditing firms enjoy a statutory monopoly of the external auditing function. The state-guaranteed market for auditing generates huge revenues for them. It gives them easy access to senior management and helps them to sell bolt-on services ranging from consultancy, tax avoidance, downsizing, printing T-shirts, laying golf courses and even money laundering (Mitchell et al, 1998a, 1998b). In return for the privileges, the auditing industry should have embraced public accountability. Yet it has done the opposite. They have organised their own accountability off of the political agenda.

External audits function as a political technology for regulating banks, building societies, financial services, charities, local authorities and numerous other organisations. Successive governments have considered external audits to be more than just for the "protection of shareholders and investors, wholly or even mainly" (Hansard, 21 February 1928, col. 1523). Audits have been considered to be "in the interests and protection of the public .... [and] .... the interests of businesses themselves" (Parliamentary Debates, House of Lords, 18 February 1947, col. 745). Audits continue to be promoted as being for the benefit of "shareholders, employees, creditors, potential investors, financial writers and the public as a whole" (Hansard, 14 February 1967, col. 360). Yet following the House of Lords decision in *Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568*, auditors do not owe a 'duty of care' to any individual, present/potential shareholder, creditor, employee, pensions scheme member, bank depositor or any other stakeholder (Cousins et al, 1998).

Audited company financial statements should contain disclosures about related party transactions (Accounting Standards Board, 1995), but they remain silent on matters such as, company-auditor relationship, audit contract, audit tender, conflict of interests, management representations, or the nature of consultancy services provided by auditors. Despite preaching accountability to everyone else, auditing firms do not publish any meaningful information about their affairs or performance. According to the Institute of Chartered Accountants in England & Wales (ICAEW), the trade association representing the auditing industry, "..... firms have always stood out against revealing any financial information [1] except their annual fee income" (Accountancy, April 1994, p. 26). Auditors have more statutory powers than the police. Without any court order they have unrestricted access to a company's books and records and

a right of information and explanations from a company's officers, but stakeholders do not have any access to auditor working papers.

To deflect attention away from recurring audit failures, auditing firms claim that they prefer to dump their 'problem clients' and let the public know the reasons for dumping them (Financial Times, 27 August 1997, p. 7 and 8; The Times, 4 September 1997, p. 28; Accountancy Age, 4 September 1997, p. 2; Accountancy, September 1997, p. 21). Yet no firm ever dumped Atlantic Computers, BCCI, Polly Peck, Dunsdale, Barlow Clowes, Eagle Trust, Sound Diffusion, London United Investments, Levitt or other questionable clients. Robert Maxwell had 'danger' written all over him (Department of Trade & Industry, 1971b, 1972, 1973). Yet no auditor rejected his business or issued a qualified audit report. Auditing firms happily issued meaningless unqualified audit reports and collected their fees.

Ever since the Companies Act 1948 (Section 160), auditors have been empowered to speak at all Annual General Meetings (AGMs) and express their concerns about anything relating to financial statements. But auditors are not public spirited. Their main concern is to appease their paymasters, the company directors. The absence of a 'duty of care' does not give auditors adequate economic incentives to place meaningful information in the public domain.

In their report on the audit failures at Bryanston, the Department of Trade and Industry inspectors (Department of Trade and Industry, 1983) were critical of the conduct of Price Waterhouse (now part of PricewaterhouseCoopers). The inspectors said that

> "at the AGM itself Mr. Ainger [Price Waterhouse partner] despite having notice of .... questions, answered them in terms which gave the shareholders less than the full picture and conveyed an impression of certainty ...... which was not justified"
>
> **Source**: Department of Trade and Industry, 1983, p. 278.

Rather than speaking up, the resigning auditors continue to be 'economical' with information. The DTI inspectors criticised Price Waterhouse for resigning [2] and going too quietly (DTI, 1983 chapter 14). The public face was that "By mutual agreement our Auditors Price Waterhouse & Co. are not seeking re-election ...." (DTI, 1983, p. 283). But the inspectors concluded that "there was nothing mutual in Price Waterhouse's decision to go" (p. 284). There is always a possibility that

someone at the AGM might ask unwelcome questions. So the auditors and management make private arrangements to go through the rituals of providing minimal information. The DTI report on Bryanston reproduced a letter exchanged between the chairman of the company (Mr. Smith) and the Price Waterhouse partner in charge of the audit.

Dear Mr. Smith,

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

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

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

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

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

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

Yours sincerely
PL Ainger[3]

Source: Department of Trade and Industry, 1983, p. 283.

The usual response to any scandal in the UK is to look for scapegoats and quick fixes. This way the underlying institutional structures, value systems, and the relative absence of moral and ethical conduct in business affairs are shielded from enquiry. Motherhood and apple-pie statements are issued to disarm critics, journalists, academics and politicians. The regulatory deckchairs are recovered and rearranged. New legislation is introduced. Little attention is given to the effectiveness of the legislation, or compliance by accountancy firms.

The legislation relating to auditor resignation falls into this category. It was introduced in 1976 (now part of the Companies Act 1985). This requires that

> "Where an auditor ceases for any reason to hold office[4], he shall deposit at the company's registered office a statement of any circumstances connected with his ceasing to hold office which he considers should be brought to the attention of the members or creditors of the company, or if he considers that there are no such circumstances, a statement that there are none".
>
> **Source**: The Companies Act 1985, Section 394(1).

All resignation statements containing a "statement of any circumstances" need be circulated to the shareholders and debenture holders. They are also filed with the Registrar of Companies and are held at Companies House at public expense. The above developments are of particular interest since "it is the very first time in UK company law that a [auditor] responsibility towards creditors is conceded" (Woolf, 1979, p. 282).

The 1976 legislation was introduced to "strengthen the position of auditors" (House of Lords Debates, 23 March 1976, col. 550.), particularly "strengthen the hand of the weaker brethren" (House of Lords Debates, 23 March 1976, col. 578). The legislation was accompanied by immunities from 'libel' and the hope that it will "give a strong auditor a very powerful and effective threat in the event of a dispute with the directors and will force even a weak auditor to face up to his responsibilities as he will no longer be able to evade a difficult situation by quietly resigning and saying nothing" (House of Lords Debates, 23 March 1976, cols. 554-555). This monograph shows that the aims of the legislation have not been met. Despite considerable privileges and rights, the resigning auditors continue to be 'economical' with information.

THE CONTEXT OF THE MONOGRAPH

In response to questions in Parliament, the Secretary of State for Trade & Industry revealed that in a four-year period, nearly 47,000 company auditors had resigned.

TABLE1
Auditor Resignations Filed at Companies House

Year	Resignations
1988	9,167
1989	9,452
1990	12,494
1991	15,787

Sources: Hansard, 29 March 1990, col. 276; 15 July 1992, col. 783.

Table 1 shows that between 1988 and 1991, the rate of auditor resignations increased by some 72%. It should have prompted the DTI to investigate the reasons, but the Minister for Corporate Affairs said, "My Department does not routinely enquire into the reasons why auditors resign ..." (letter dated 21 July 1992). Further correspondence requested the statistics for subsequent years, but the Minister was unwilling to provide these on the ground that the information was costly to collect.

The UK government has failed to publish any systematic details of the auditor resignation statistics. For example, they do not form any part of the annual report published under Section 729 of the Companies Act 1985 by the Department of Trade and Industry. Following the Companies Act 1989, the accountancy trade associations act as regulators for the auditing industry. In their capacity as the Recognised Supervisory Bodies (RSBs), they have failed to secure, publish and examine any aspect of the statements issued by the resigning auditors.

Table 1 also shows that auditor resignation is a relatively common occurrence even though the resignation can easily be avoided. Under the Companies Act, an auditor is normally appointed to serve until the next annual general meeting. Thus both the company and the auditor have an annual opportunity to reflect on whether they wish to continue with each other. If either party felt the need for change then it would be simpler and less disruptive for the directors to propose the appointment of another firm from the conclusion of the current incumbent's term of office.

All auditor resignations involve some costs. The company will probably have to search for a suitable replacement and may have to bear a share of the incoming auditor's setting up costs. This will probably make additional demands on management time while the new audit team collects information about systems and inherent risks. The uncertainty created by the resignation may signal negative messages to the markets and may adversely affect the share price of a quoted company (Dunn, Hillier and Marshall, *forthcoming*; Wells and Loudder, 1997). The resigning auditor suffers cost in the form of the loss of future audit fees [5] and the possibility of selling lucrative consultancy services. It is, therefore, reasonable to expect that neither party would initiate a resignation without some serious reasons.

Auditors might resign because of conflict with the management, or due to lack of confidence in the management's integrity (Auditing Practices Board, 1995b, paragraph 19; Auditing Practices Board, 1995c, paragraph 15). Resignation could be motivated by professional considerations, such as the discovery of an impediment to independence or because of some doubts about the firm's ability to provide a satisfactory quality of audits. The auditor could be asked to step down to make way for another firm because of a change in the company's ownership or because management feel that another firm could better serve the company's needs. The auditor might feel compelled to resign because of some problem which threatens to compromise the firm's integrity.

The possibility that the auditor might resign quietly in order to escape their responsibilities led to the introduction of a statutory duty for the auditor to report the circumstances associated with his/her departure from office (see chapter 2). The statements from the Institute of Chartered Accountants in England and Wales (ICAEW) claim that

> "the auditors' obligation [to express their opinion] is inescapable. It would be inappropriate, for instance for auditors to seek to avoid it by resigning before the expiry of their term of office because they are dissatisfied with the position disclosed by their audit. ..."
>
> **Source**: The Accountant 3 February 1972, pp. 133-135.

The Auditing Practices Board (APB) advises that withdrawal from an audit engagement may be desirable.

The auditors may conclude that withdrawal from the engagement is necessary in certain circumstances, for example if they consider that the shareholders have not been given information they require and see no opportunity for reporting such information to the shareholders whilst continuing as auditors. Factors that may affect the auditors' conclusion include the implications if the highest authority within the entity is suspected of involvement with the suspected or actual non-compliance, which may affect the reliability of management representations, and the effects on the auditors of continuing association with the entity. In reaching such conclusions, the auditors may need to seek legal advice.

Resignation by auditors is a step of last resort. It is normally preferable for the auditors to remain in office to fulfil their statutory duties, particularly where minority interests are involved. However, there are circumstances where there may be no alternative to resignation, for example where the directors of a company refuse to issue its financial statements or the auditors wish to inform the shareholders or creditors of the company of their concerns and there is no immediate occasion to do so

Source: Auditing Practices Board, 1995d, paragraphs 72-73**.**

The accountancy trade associations have no difficulty in issuing pious statements. As always, 'the proof of the pudding is in the eating'.

This monograph examines the public statements issued by the resigning auditors[6]. It focuses upon auditor resignations for the period 1988-1992, based on the listing for that period as supplied by Companies House. During this period the auditors of 766 public limited companies (PLCs) resigned. The statements made by these resigning auditors were extracted from their respective microfiche records at Companies House. Only 19 of the 766 auditors chose to bring any matters to the attention of the shareholders and creditors. In every other case the auditors filed a 'nil' return i.e. stated that there were no such matters. This led to a further analysis of the information contained in the information lodged with the registrar to determine whether there appeared to be *prima facie* circumstances which might have triggered the resignations that are not disclosed in the resignation letters. In some cases the 'nil' returns were filed even though the companies had highly questionable circumstances.

The remainder of this monograph is organised into five further chapters. Chapter two examines the emergence of the auditor resignation legislation which was originally introduced by the Companies Act 1976. It required that the resigning auditor give details of the circumstances relating to his/her resignation. Much of the debate took place against a background of highly visible episodes which showed that the auditors took an easy way out when faced with an awkward situation. Rather than reporting matters of concern to stakeholders, they preferred silence and a quick resignation. The legislation was designed to strengthen auditor position and independence. Chapter three explains the research methods employed and shows how we came to collect our data. Chapter four gives detailed results of our examination of 766 useable microfiches. It shows that in only 19 cases (2.5% of the population), the auditors specified a reason for resigning. Our sample contained 108 cases of qualifications in audit reports, possibly enabling the outgoing auditors to protect themselves from lawsuits. Yet auditors remained silent in their letter of resignation and claimed that there were no matters in connection with their resignation shareholders or creditors needed to be aware of. Without this information, the outgoing auditors cannot really be questioned. Chapter five examines the possibility that there is at least some *prima facie* doubt that full disclosure is being made of all resignation circumstances which should be brought to the attention of company members or creditors. It is noted that some of the cases in which auditors had stated that there were "no circumstances in connection with their resignation which shareholders and creditors need to be aware of", were soon followed by major scandals. Chapter six concludes the report with a summary and proposals for reform.

CHAPTER 2
GIVING BACKBONE TO THE WEAKER BRETHREN

The legislation relating to auditor resignations was introduced by the Companies Act 1976. It is part of a trend under which audit deficiencies [7] are glossed over by strengthening legislation and introducing new laws. The auditor's ability to deliver effective surveillance of capitalist enterprises is rarely scrutinised even though auditors' are dependent upon the very same enterprises for their income.

The 1976 legislation was designed to strengthen auditor's position vis-à-vis company directors. For the first time, it required auditors to inform shareholders and creditors of the circumstances relating to auditor resignations. It formally marked the end of an era when some argued that a strong auditor is willing and able to stand on his integrity and speak his mind. In a world of increasing commercialisation such attitudes had little substance and the new legislation was ushered in.

The chapter is divided into four parts. The first part consists of two case studies. The first case study relates to The City of London Real Property Company Limited (CLRP) whose directors tried to force the auditor to resign. In view of the considerable press publicity, the auditors were able to resist management pressures. The CLRP case study virtually marks the end of an era when a large firm tried to take a stand on its position. The second case study relates to the affairs of the Pinnock Finance Company, considered by some to be the trigger point (Woolf, 1979, p. 281-282) for the enactment of statutory provisions relating to auditor resignations. It coincides with a period of state-sponsored expansion of the UK financial sector and a widespread public concern about auditor responsibilities. Pinnock's auditors resigned, after taking legal advice, rather than complete the audit. The auditors were, however, severely criticised in the Department of Trade inspectors' report (DoT, 1971a). The second part of the chapter refers to the discussions between the accountancy trade associations and the state over the kind of reform that was seen to be necessary. The third part refers to the Parliamentary passage of the auditor resignation laws, as part of the Companies Act 1976, and the ethos which underpinned the legislation. The legislation was designed to strengthen the weaker brethren and ensure that they do not resign quietly and abdicate their responsibilities. The fourth part briefly summarises the chapter.

THE STATE OR THE MARKET: TWO CASE STUDIES

The City of London Real Property Company Limited

In the 1960s, the City of London Real Property Company Limited (subsequently, part of Land Securities) was a major property company. It was audited by Messrs Turquand Youngs & Co. The company and its auditors became embroiled in a dispute (see The Accountant, 22 June 1963, pp. 816-819; 29 June 1963, pp. 842-847; 6 July 1963, p. 15; 13 July 1963, pp. 39-40; 20 July 1963, pp. 73 and 83; Accountancy, July 1963, pp. 571-572 and 652; The Accountant, 12 October 1963, pp. 442-443; Accountancy, September 1964, p. 773, de Paula, 1970, Waldron, 1963, Napier and Noke, 1992, p. 53) about the treatment of share premium arising from CLRP's acquisition of the remaining minority interest in City & Victoria Property Company Limited. CLRP issued 170,600 ordinary shares of £1 each to acquire the remaining minority interest. These shares had a market value of £580,040. The directors of CLRP considered that the cost of the purchase (apart from the stamp duty) was the nominal value of that stock i.e. £170,600. The auditors were of the opinion that the correct figure was the market value of £580,040 and that this should be the basis of the accounts [8] for the year to 12th April 1963. The auditor's view would have given rise to a share premium of £409,440. Under this method the 'goodwill' in the consolidated balance sheet would have been around £565,359.

CLRP's directors appointed Cooper Brothers to advise it on the dispute [9] and the firm's report supported the management's arguments. This advice was also supported by the opinion of a lawyer (The Accountant, 29 June 1963, pp. 845-847). However, Turquand Youngs could not be persuaded to accept management's proposed accounting treatment and threatened to qualify the accounts. In turn, the CLRP's Board was unwilling to accept a qualified audit report on the ground that, "It was not proper for a company of our size and standing to allow its annual accounts to go to stockholders with a qualified audit report" (The Accountant, 29 June 1963, p. 847). After further discussions, the company agreed to prepare its accounts in the form recommended by the auditors and the resulting 'goodwill' was written off against existing reserves of the group. At the same time, the chairman of the CLRP indicated that the stand taken by Turquand Youngs was likely to seriously endanger their position as the company's auditors. After the approval of the accounts in question, the chairman invited Messrs Turquand Youngs to resign and facilitate the appointment of new auditors. The CLRP's chairman argued that, "It is the right and duty of a board if it feels that a change of auditors is in the best

interest of shareholders so to advise them" (The Accountant, 29 June 1963, p. 847). The CLRP Board proposed Cooper Brothers as the new auditors.

Turquand Youngs declined to resign and were informed that a resolution to replace them would be proposed by directors at the annual general meeting in July 1963. Upon becoming aware of the management's proposals, the auditors exercised their rights under Section 160 of the Companies Act 1948 and made representations to shareholders (The Times 13 June 1963, p. 21). The Institute of Chartered Accountants in England and Wales (ICAEW) issued a statement suggesting that the directors' actions threatened auditor independence (The Accountant, 22 June 1963, p. 816). The episode received considerable press coverage and generated considerable support for auditors. The Times (19 June 1963) argued that

> "Company auditors are shareholders' watchdogs …… Auditors should have complete independence and should be free to act as they think fit in the interests of shareholders they represent" (page 16) [and] "there is no compelling reason why directors and auditors should not disagree on specific points and yet continue to work harmoniously together"
>
> **Source**: The Times[10], 25 June 1963, pp. 16 and 19).

Following considerable press publicity, institutional investors indicated that they would not support the management's proposal for change of auditors (The Accountant, 6 July 1963, p. 15; Accountancy, July 1963, p. 572; The Times 3 July 1963, p. 14). Under pressure, CLRP's directors did not move the resolution because, "in the light of the conflicting opinions..... it is the board's view that it would not be desirable for a resolution of this character to become a subject of controversy ....." (Accountancy, July 1963, p. 572; also see the Times, 5 July 1963, p. 16). Thus Turquand Youngs remained the auditor of CLRP.

The above episode[11], amongst other things, raised questions about resignation and displacement of auditors, especially those auditors who did not wish to yield to management pressures, or those who held different views. CLRP's auditors were able to resist pressures and stood their ground. Their position was supported by institutional investors. For some, the episode vindicated the belief that a strong auditor would be defended and that force of argument and mobilisation of shame was a sufficient safeguard. It is interesting to note that the Companies Act 1967,

that followed the CLRP episode, did not contain any legal provisions relating auditor resignations. However, the social, political and economic environment had already begun to change and a few years later, the issues surrounding auditor resignation were again in the public eye when one of the auditors of Pinnock Finance quietly resigned rather than taking a public stand.

The Pinnock Finance Episode

Prior to the Pinnock Finance episode there was little explicit framework for formal regulation of auditor resignations. Under the guidance issued by the accountancy trade associations, incoming auditors were advised to seek clearance from an outgoing auditors, and as part of this, they may become aware of some of circumstances surrounding auditor resignations. However, the guidance rules did not require the resigning auditors to make public statements about the circumstances of their resignation. Under Section 160 (relating to appointment and removal of auditors) of the Companies Act 1948, the outgoing auditor could make representations to shareholders which might have illuminated the circumstances, but there were no statutory responsibilities for informing creditors or public filing of resignation notices.

The Pinnock episode received publicity at a time when industrialists and accounting academics were subjecting auditing and accounting practices to critical commentaries (Robson, 1991). With the support of the state, the UK accountancy bodies initiated a formal programme of issuing accounting standards. At the same time, they resisted any tightening of auditor regulations (Sikka, Willmott and Lowe, 1989; Sikka and Willmott, 1995b). The changing social and political environment increased pressures for changes in auditor regulation.

Since the late-1960s, the British economy had been going through a considerable decline in its traditional manufacturing base and had experienced a major decline in rates of profitability (Coakley, 1984; Armstrong, Glyn and Harrison, 1984; Harris, 1988). In this context, the state sponsored a drive to promote London as an international financial centre (Reid, 1982, Clarke, 1986). This drive was accompanied by minimalist regulation. Rather than developing any specific institutional structures or reporting rules, the state officials relied upon the normal audited financial statements and audit reports (addressed to shareholders rather than to bank depositors and government departments) to alert them of any financial problems in the emerging financial sector enterprises (DoT, 1971a).

In the laissez-faire environment of the day, Pinnock Finance (GB) Limited was formed[12] with share capital of £15,000 and was permitted to accept deposits from the public. Pinnock's financial base was not broad, but it expanded and diversified through take-overs. By the mid-1960s, it operated through 80 companies in most parts of the world, including UK, Eire, Australia, USA, Canada, France, Belgium, Holland, Switzerland, Denmark, Germany and Sweden. The group's affairs were not easy to understand as it had a complex group structure. The financial statements of all the companies were not easily available.

The company remained solvent by offering high rates of return to investors and it attracted deposits of £13 million during the period from 1959 to 1967. The company used receipts from new deposits to pay interest on the previously held deposits. Thus there was a constant need to attract more deposits. The group's manufacturing arm was insolvent, but it was kept going by falsifying accounting records books and by the continuing inflow of further deposits. By 1964 the group had accumulated losses of £2 million, which increased to £3 million in 1965 and £5.6 million in 1967. Much of the money was lost due to what was described as a "gigantic fraud in the history of private business" (Hansard, 28 May 1971, col. 773). Its director, a Mr. Wright was felt to have "engineered the complex structure of the Pinnock group as part of a deliberate policy to hide the true affairs from the depositors and potential depositors" (DoT, 1971a, paragraph 13).

On 1st August 1967, the government appointed Department of Trade (DoT) inspectors to investigate the affairs of 11 Pinnock companies operating in the UK. The resulting report (DoT, 1971a) found little evidence to show that the original share capital of £15,000 was ever subscribed in cash. The group had inadequate accounting and bookkeeping systems and indulged in inter-company transactions to cover up cash deficiencies. At the time of its collapse, Pinnock owed £9,161,352 to its 9,000 depositors (4,000 in Britain and 5,000 overseas). But its assets amounted to only £1,219,732. Around £6.7 million of the losses were due to loans to associated companies whose identity and affairs were not always known. Another £962,242 was due from a Mr. Wright, who disappeared three days after Pinnock announced that it was not in a position to accept any further deposits from the public.

The Pinnock fraud raised important questions about "the protection of unsophisticated investors from the unscrupulous and the incompetent" (The Times, 8 May 1971, p. 9). It also highlighted "a defect in the

auditing requirements, the only nominally independent safeguard provided by law. The auditor's responsibility to the creditors and shareholders of a company is to convince himself that the accounts give a true and fair view of the state of the company" (The Times, 8 May 1971, p. 9). As the DoT inspectors felt that the company's accounts for a number of years had been misleading, attention focused [13] on the role of Pinnock auditors. The company had three auditors in the period from its incorporation in 1959 to its announcement in 1967 that it could not repay its depositors. The first auditors, Scottish chartered accountants P. Ellison & Co., completed their report on the 1960 accounts and started work on the audit of the accounts for 1961. They raised a number of points with Pinnock's directors, including: disregard of exchange control regulations, failure to adhere to their publicly declared investment policy, the overstatement of assets, window dressing of accounts and the overstatement of solvency. The auditors were unable to secure satisfactory explanations. They sought legal advice and resigned. Thus the first auditors resigned without completing the audit for 1961. The DoT inspectors observed that had the original auditors completed the 1961 audit and used the audit report to indicate their dissatisfaction, the Pinnock group's subsequent activities might have been curtailed.

As part of the professional etiquette rules, the incoming auditor communicated with the outgoing auditor who explained the reasons for their resignation. This information was not (and under the contemporary laws could not be), however, made available to the group's shareholders, bank depositors or to the public. The second auditor, Mr. J.N. Irvin, the former secretary of the Pinnock group in Australia was brought to the UK in 1962. He was able to operate in the UK under Section 161 of the Companies Act 1948 and audited the financial statements of Pinnock for the period 1961 to 1964. He issued unqualified audit reports on the accounts for each of the four years from 1961 to 1964. The inspectors felt that this auditor had been negligent (DoT, 1971a, paragraph 645). The Times described him as "tame and grossly negligent" (27 May 1971, p. 1). The third auditor (Mr. L.A.J. Shute) reported on the accounts for one year only and issued an unqualified report for 1965. The DoT inspectors were inclined to the view that this auditor was very much out of his depth when dealing with the affairs of the company.

In a subsequent debate, the Secretary of State for Trade and Industry informed Parliament,

"These events raise important questions. The first is whether the first auditor was right to resign without alerting anyone other than his successor. No doubt, on the legal advice he received, he acted correctly. But wider questions of his responsibility to depositors arise. Had he informed the Department of his suspicions, it is likely that action would been taken back in 1962. The second point is that the second auditor was, to quote the report, "grossly negligent", and the third auditor was out of his depth. One asks how they came to be allowed to practise. Again, a hint from either of these auditors would have alerted the Department.

The Government are not satisfied on either of these matters, and I intend to discuss them with the professional bodies in the near future, with a view to possible action.

........The inspectors' report suggests to the Government certain lessons which can be learned for the future. They are, first, the matters concerning the auditors ......".

Source: Hansard, 28 May 1971, cols. 785-787.

The Pinnock episode could have elicited a number of diverse regulatory responses. For example, it could have problematised the ethics of finance capitalism, the laxity of regulation of the financial sector, the secrecy enjoyed by auditing firms and companies, the operations of 'free' (or relatively 'free') markets and/or structures of corporate governance. Instead, the episode was portrayed as the acts of a 'fraudulent individual' rather than anything indicative of any systemic problems (Hansard, 28 May 1971, cols. 773-787). By emphasising the traditional role of the auditor as a 'watchdog', the government, the Department of Trade inspectors and the media translated the issues as relating to the role, position and independence of the auditor. No attempt was made to persuade auditors to accept any obligations to bank depositors or borrowers, but the ensuing legislation, for the first time, formally recognised that under certain circumstances, auditors should formally address matters to creditors rather than merely to shareholders.

Indulging the Accountancy Trade Associations

After the Pinnock episode, discussions and negotiations took place between the major accountancy bodies and the DTI. In response to a government invitation (letter dated 22 June 1971) the ICAEW and the

Institute of Chartered Accountants of Scotland (ICAS) submitted a joint response. They stated that,

> "There are three issues. First, is it right for an auditor to be empowered to resign assuming that there are occasions when such a course is the correct one? Second, how should resignations be implemented? Third, what should be the relationship between the resigning auditor and his successor? The law is silent as to whether an auditor is entitled to resign before his duty of reporting on the accounts but the view of the two Institutes is that an auditor should normally complete his term of office and discharge the responsibility he has assumed in accepting office. The English Institute has advised its members that 'the auditors' obligation [to express their opinion] is inescapable. It would be inappropriate, for instance for auditors to seek to avoid it by resigning before the expiry of their term of office because they are dissatisfied with the position disclosed by their audit. .....
>
> ….. the law should be amended to provide that within a specified period of receiving notice from an auditor of his intention to resign at any time other than at a general meeting to which are presented the accounts on which he has reported, the directors shall notify the members and hold general meeting at the conclusion of which the auditor's resignation shall become effective. The retiring auditor should have the same right to have written representations circulated to members of the company as under section 160(3) of the Companies Act 1948, and should be obliged to state his reasons for resigning .... the auditor should be placed under statutory duty to inform any proposed successor of the circumstances attending his resignation or his non-appointment at the annual general meeting."
>
> **Source**: The Accountant, 3 February 1972, pp. 133-135.

The Association of Certified and Corporate Accountants (ACCA)[14] recommended that

"When the auditor proposes to resign at any time other than at an annual general meeting, the Registrar of Companies should also be informed, with copies of any papers circulated to members".

Source: The Accountant, 23 March 1972, p. 369.

The 1973 White Paper on Company Law (Cmnd 5391), contained proposals for regulating auditor resignations. Clause 66 of the Companies Bill published later that year required that an auditor's resignation will not be effective unless it includes either (a) a statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company; or (b) a statement of any such circumstances as aforesaid. Furthermore, clause 67(1) strengthened the position of the auditor by granting new powers and rights. It provided that a retiring auditor, who considers that matters exist which should be brought to the notice of members and creditors, could requisition an extraordinary general meeting of the company for the purpose of receiving and considering such explanation of the circumstances connected with his resignation. The progress of the Bill was halted by the general election of 1974 and another Bill was introduced by the incoming Labour administration in 1976.

The Companies Act 1976

By the time the Companies Act 1976 came to Parliament, the auditing industry was under further critical scrutiny as a result of criticisms of auditors contained in the Department of Trade and Industry (DTI) inspectors' reports (Sikka, Willmott, and Lowe, 1989; Sikka and Willmott, 1995a). In this environment, the Companies Bill of 1976 affirmed the previous "far-reaching" (The Accountant, 11 March 1976, p. 289-291) proposals on auditor resignation. In justifying the various regulatory changes, the Secretary of State for Trade and Industry stated that they need to be understood "against a background of criticism of auditors made in a number of inspectors' reports recently which have given rise to serious problems ..." (Hansard, 19 October 1976, col. 1253). The government position was that the legislation was designed to

"strengthen the position of auditors.... "who come across evidence of malpractice or are in dispute with the directors about the propriety of particular transactions"

"…… strengthen the hand of the weaker brethren … and give a strong auditor a very powerful and effective threat in the event of a dispute with the directors and will force even a weaker auditor to face up to his responsibilities as he will no longer be able to evade a difficult situation by quietly resigning and saying nothing"

Sources: House of Lords Debates, 23 March 1976, col. 550; col. 554; col. 578, cols. 554-555.

Clause 15 of the Companies (No.2) Bill 1976 dealt with the position of an auditor who chose to resign his/her office in mid-term. It was designed to

"prevent a weak auditor from resigning in mid-year - in fact, half way down the course - without saying anything and completing his audit because he has discovered something which suggests that things are going wrong and he is not ready to face up to his responsibilities in such a situation...... He [a weak auditor] may qualify the accounts, but the accountancy professions believes that members of the company ...... should have a statement in writing from the retiring auditor giving his reasons for retirement"

Source: House of Lords Debates, 5 April 1976, cols. 1486-1487.

Clause 15 was drafted to safeguard the interests of "shareholders and creditors" (Hansard, 20 July 1976, col. 354). It introduced a requirement (subsection 2 of the clause) stating that the auditor's resignation could not be effective unless it contained either, (a) a statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company, or (b) a statement of any such circumstances as aforesaid. In recommending this requirement to Parliament, the Secretary of State for Trade and Industry explained that the clause "deals with the situation where an auditor resigns in mid-term because things go wrong with the company's affairs and he wants to avoid resorting to qualify the accounts and to any further responsibility for the company's affairs. In this situation, the interests of shareholders and creditors require that the auditor should not be able to resign quietly without saying anything.

Clause 15, therefore, requires the auditor to make a statement. This will not only protect shareholders and creditors but will give an auditor who is in dispute with the directors, a powerful sanction and put some backbone into a weak auditor who might otherwise fail to face up to his responsibilities" (Hansard, Proceedings of Committee C, 20 July 1976, cols. 353-354).

Clause 16 of the Bill gave the resigning auditor a right to requisition a meeting of that company. It was said to "represent a radical change that will be for the benefit of shareholders, investors and creditors" (Hansard, 19 October 1976, col. 1253). However, there was a concern that statements made by auditors in their notice of resignation and any accompanying (oral or written) statements may be construed as libellous and that this may prevent auditors from communicating the matters openly and honestly with members and creditors. In response, the government explained that

"unless the auditor uses a statement for some improper purpose - for instance, he is malicious in the legal sense - no person who is criticised will be able to sue him successfully for libel".

Source: House of Lords Debates, 5 April 1976, col. 1488.

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

The above arguments were again repeated during the Report Stage (Third Reading) of the Bill when the Minister added that the legal provisions are designed to "bring to light any relevant facts which may have led to the auditor's resignation and to prevent the auditor who comes across fraud or malpractice from taking the easy way out by resigning and remaining mute" (Hansard, 19 October 1976, col. 1247). No dissenting voices were publicly raised by the auditing industry. It was stated that "the profession are full of praise for the Government in taking the measure very seriously ... auditors in general welcome these provisions" (House of Lords

Debates, 23 March 1976, col. 564). The Companies Act 1976 was given Royal Assent in early 1977 and came into force the same year.

SUMMARY AND CONCLUSIONS

The Companies Act 1976 (now part of the Companies Act 1985) introduced a new framework for regulating auditor resignations. It was enacted against a background of scandals and auditor 'silence'. The legislation required that the auditors' letter of resignation needs to be accompanied by a statement stating, either a) that there are circumstances connected with their resignation which shareholders and creditors need to be aware of, or b) that there are no circumstances in connection with their resignation which shareholders and creditors need to be aware of. The legislation was designed to strengthen auditor independence and put some backbone into weaker auditors.

The auditor resignation legislation also marked the end of an era in which, as exemplified by the CLRP case, a strong confident auditor was willing to make a public stand against management. It was thought that integrity and mobilisation of public shame could provide adequate checks. Such quaint notions could not stand the heat of the commercialism of the late 1960s and the early 1970s. Unlike the CLRP case, the Pinnock episode suggested that matters of auditor resignation could not just be left to markets and peer pressure. As a way of restoring confidence in auditors, a statute-based framework for dealing with auditor resignations was developed. Rather than merely having a 'right' to report matters to shareholders (as per Section 160 of the Companies Act 1948), the Companies Act 1976 imposed a 'duty' upon auditors [15] and required that in addition to traditional obligations to shareholders, auditors also need to report matters relating to auditor resignations to creditors.

The auditor resignation legislation was introduced to strengthen the 'weaker' auditor. The hope was that with considerable immunities from the laws of 'libel' auditors would discharge their public responsibilities. However, no attention was paid to how auditor compliance with the legislation would be monitored. Nor has there been any independent regulator to enforce compliance with the legislation. The subsequent chapters will show that in the absence of independent and effective institutional structures for regulating auditors, they continue to be 'economical' with information and keep the public in the dark.

CHAPTER 3
GETTING BEHIND AUDITOR SILENCE

So how did we go about shedding some light on auditor 'silence'? The answer is - by looking at the auditors resignation statements actually filed at Companies House.

All statutory returns, including auditor resignation statements, delivered to Companies House are recorded on the agency's database. Despite the DTI's unwillingness or inability to take stock of the information filed, it is possible to run a computer program to count the number of occurrences of a specific type of document, such as an auditor's statement of resignation. In return for the payment of a large sum of money, Companies House prepared a special computer program to interrogate its database and provided a listing of the names of companies whose auditors had resigned.

The file generated by Companies House contained approximately 60,000 names of companies whose auditors had resigned during the period 1988-1992 i.e. it also contained information shown in table 1 (see page 8) and more. We obviously do not have the resources to look at the auditor resignation statements for all 60,000 companies. We decided to look at the resignation statements issued by the auditors of public limited companies (PLCs). So another computer program was commissioned to produce a list of PLCs whose auditors had resigned. This was partly because PLCs are more likely to involve matters of public concern because they tend to be larger and may be quoted. It also reduced the extent of double counting in respect of groups. Resignation from the audit of a holding company would normally trigger further resignations in respect of each of that company's subsidiaries. This means that one substantive resignation could be counted several times, once for each group member. Removing private limited companies from the file automatically excluded most subsidiary companies. The data published by the Recognised Supervisory Bodies in their annual report shows that some small audit firms are voluntarily de-registering i.e. they are relinquishing their audit licences because they consider the costs to be prohibitive. Such firms often audit small companies. The focus on PLCs probably eliminated resignations by small audit firms.

The list of PLCs was then filtered manually to remove any companies which were subsidiaries of other companies in the sample. This left a total of 793 companies.

A microfiche for each of the 793 companies was purchased from Companies House. Each fiche was manually examined to identify events of interest before and after the resignation date. The following information was collected for each company:

- The name of the outgoing auditor and auditor size (Big-Six, Top 20 or smaller)
- The name and size of the incoming auditor.
- The date of the auditor resignation notice.
- Whether the auditor's letter contained a statement of any circumstances in connection with the resignations which should be notified to the company's shareholders and creditors.
- The date of the resigning auditor's final audit report and whether that report had been qualified.
- The date of the incoming auditor's first report and whether that report had been qualified.
- On an *ad hoc* basis, any other relevant details, such as the fact that the company had suffered the resignation of more than one auditor in preceding years.

There was one final filtering of the companies at this stage. The Companies Act requires a statement of circumstances from all auditors who resign their term in office. Any cases where the auditor did not make an explicit reference to resignation were excluded from the study. The vast majority of the auditors claimed to be resigning rather than simply ceasing to hold office. Excluding cases where there was no explicit statement of resignation left a final total of 766 companies.

The most immediate observation from this data was that very few, only 19, of the resignations had resulted in any declaration of the circumstances, which the auditors felt could be drawn to the attention of shareholders and creditors of a company. The next chapter describes these cases and also provides some basic statistics about the types of companies involved and their auditors.

CHAPTER 4
SHEDDING LIGHT ON AUDITOR SILENCE

This chapter describes the results of our examination of the auditor resignation statements held at Companies House. Our analysis begins with a list of the firms that resigned most often. Big-Six who dominate the audit market gave reasons for their resignation in only 1% of the cases. The chapter provides a summary of the cases in which auditors express some reservations in their letter of resignation. However, the vast majority of statements did not refer to any circumstances even though auditors were issuing qualified audit reports. The chapter goes on to discuss some of the circumstances surrounding resignations. These include the distribution of resignations by firm and by size of firm, the incidence of qualified audit reports both before and after resignation and the factors which might affect the tendency of an auditor to make a statement of circumstances.

MUSICAL CHAIRS

During the period covered by our investigation, all limited liability companies required an audit by an accountant belonging to one of the select few accountancy trade associations. The audit market is highly segmented in which quoted and large companies tend to be audited by major firms. Table 2 shows that major firms (and their constituents) such as Coopers & Lybrand, KPMG, Price Waterhouse, KPMG, Ernst & Young, Deloitte & Touche, Arthur Andersen, Grant Thornton, BDO Binder Hamlyn and Stoy Hayward have been responsible for submitting a large number of resignations. As these firms have a large fee base, and a diversified clientele, one might expect them to come clean and tell the public why they are resigning the audit. Perhaps, in return for the state guaranteed markets, fee earning opportunities and privileges, the accountancy firms would be public spirited and place their concerns on the public record. Or, perhaps, the lure of fees is too strong and firms prefer silence.

TABLE 2
AUDITOR RESIGNATIONS BY FIRMS

AUDITOR	NUMBER OF RESIGNATIONS
Arthur Andersen	21
Arthur Young	1
Baker Tilly	4
BDO Binder Hamlyn	24
Clark Whitehill	5
Coopers & Lybrand	13
Coopers & Lybrand Deloitte	46
Deloitte Haskins & Sells	19
Dennis Chinoy & Associates	13
Ernst & Young	51
Grant Thornton	25
Hacker Young	6
Hodgson Impey	7
Kidsons	3
Kidsons Impey	3
Kingston Smith	3
KPMG Peat Marwick	42
KPMG Peat Marwick McLintock	30
Leigh Carr	6
Levy Gee	2
McIntyre Hudson	2
Moore Stephens	2
Moores Rowland	6
Neville Russell	12
Pannell Kerr Forster	18
Price Waterhouse	45
Robson Rhodes	9
Saffrey Champness	1
Solomon Hare	2
Spicer & Oppenheim	11
Stoy Hayward	37
Touche Ross	41
Other Firms	256
Total	766

The data in table 2 was further analysed to highlight the size of the firms giving reasons for resignations or otherwise.

TABLE 3
FIRM SIZE AND REASONS FOR RESIGNATION

	No reason given		Reason given		Total	
	No.	%	No.	%	No.	%
Big-Six	301	39.3	8	1.0	309	40.3
Top 20	182	23.7	5	0.7	187	24.4
Other	264	34.5	6	0.8	270	35.2
Total	747	97.5	19	2.5	766	100.0

Table 3 shows that in only 8 cases out of 309 resignations did the Big-Six specify any reasons for their decision to relinquish the client even before the expiry of the normal term in office (i.e. from one AGM to the next). Firms of other size did not do any better. Only 2.5% of the auditor resignation letters were accompanied by any statement listing the reasons for the resignation. Almost all filed a ‘nil’ return.

Perhaps, the firms may be willing to go on public record, once their disputes and reservations about management are given some public airing. This is done by issuing a qualified audit report. Our sample of 766 PLC auditors who resigned showed that 108 had issued a qualified audit report immediately prior to their resignation. So the data was further analysed whether there was any relationship between the qualifications in the final audit report and the statement of any reasons for resignation. Table 4 presents an analysis of the data.

TABLE 4
REASONS FOR RESIGNATION GIVEN AFTER ISSUING A QUALIFIED AUDIT REPORT

	No reason given		Reason given		Total	
	No.	%	No.	%	No.	%
Big-Six	33	30.6	5	4.6	38	35.2
Other	68	63.0	2	1.9	70	64.8
Total	101	93.5	7	6.5	108	100.0

In 108 cases, the auditors had some material reservations about company policies which they communicated to shareholders (audit reports are not

addressed to creditors). In the light of these reservations auditors could have chosen to clarify the position by providing information in their letter of resignation. But when subsequently the auditors resigned, only 7 resignation letters gave any reasons for the resignation.

REASONS GIVEN FOR RESIGNATION

Informal discussions with company auditors and directors prior to the detailed analysis of the microfiches revealed a strong belief that very few letters would contain a statement of the matters leading to auditor resignation. The reasons for this are economic i.e. auditor dependency upon management for appointment and fees. In general, company directors preferred auditors to be 'economical' with information. Auditors were not too keen to say much about the matters leading to resignation because they did not want to jeopardise the possibilities of further fee earning opportunities (auditing and non-auditing) by acquiring the reputation of being troublesome. Both parties were aware that resignation letters rarely attracted any press or regulatory attention. The economic incentives for drawing shareholder and creditor attention to the 'circumstances of resignation' are also not very strong as auditors do not owe a 'duty of care' to any individual stakeholder. In addition, neither the DTI nor the Recognised Supervisory Bodies (RSBs) have shown any inclination to monitor or check the resignation letters. Thus the institutional and market pressures are relatively weak.

Unsurprisingly, of the 766 useable resignation letters, only 19 (2.5%) contained anything other than a nil response. A synopsis of these cases is presented in Table 5.

TABLE 5[16]
REASONS FOR AUDITOR RESIGNATIONS

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
1. The company alleges negligence in the audit of a subsidiary	TGI Group Plc	Coopers & Lybrand Deloitte	Unqualified	KPMG Peat Marwick	Unqualified
2. The directors withheld information needed for the last three years' statements. They also failed to make provisions for bad debt, NRV of stocks and amortisation of intangibles. The company failed to keep proper books. It is unable to meet its liabilities.	Cosmerique Plc (formerly Bronzeleaf Plc)	Touche Ross	'Subject to'	No audited financial statements on record	No audited financial statements on record

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
3. The directors refused to withdraw a preliminary announcement. The auditors were refused access to proper documentary evidence. The directors did not give sufficient notice of replacement. The auditors remind directors of s394 CA 1985.	Swan Yard Plc	Stoy Hayward	Disclaimer	Lubbock & Fine	No audited financial statements on record

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
4. The company threatened to take proceedings against auditors for alleged negligence in connection with a circular. It had not paid audit fees from October 1988 to January 1990.	City & Westminster Group Plc	Price Waterhouse	Subject to	No audited financial statements on record	No audited financial statements on record
5. The auditor was owed significant fees The company was insolvent.	Globe Petroleum Plc	Moore Stephens	Unqualified	Casson Beckman	Disclaimer
6. The company is bringing legal proceedings against the auditors.	SEET Plc	Moores Rowland	Unqualified	Neville Russell	Unqualified

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
7. The board requested the resignation. The company was taking legal proceedings against the auditor because of allegations concerning a subsidiary	Greenbank Group Plc (formerly Walker Greenbank Plc)	Arthur Young	Unqualified	Touche Ross	Unqualified
8. The composition of the Board was in dispute. The directors had not submitted statements for signature or for the audit report to be signed.	Kelgate Manor Estates Plc	Price Waterhouse	No audited financial statements on record	Aitken Brown	Disclaimer

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
9. Differences in opinion over the revaluation of investments. The problem appeared to be over a report filed under SEC rules in the US.	Senetek Plc	KPMG Peat Marwick McLintock	Subject to	Price Waterhouse	Unqualified
10. The husband of one of the company's directors was an undischarged bankrupt who was construed to be effectively managing the company while disqualified.	Associated Retail & Commercial(Holdings) Plc	BDO Binder Hamlyn	No audited financial statements on record	No audited financial statements on record	No audited financial statements on record

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
11. The company had not paid its audit fees. The conduct of the firm's affairs may have been prejudicial to the interests of creditors and employees. The firm had done no audit work since its appointment.	Keltic Holdings Plc	Francis Clark	No audited financial statements on record	No audited financial statements on record	No audited financial statements on record

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
12. The matters relevant to resignation are said to be fully dealt with in the financial statements for the year ended 31 March 1990.	Energy & Marine Industries Plc	Reeves & Neylon	Disclaimer	No audited financial statements on record	No audited financial statements on record
13. Non-payment of audit fees and non-co-operation in the provision of information to the auditor's queries.	London & Provincial Financial Management Plc	John Cumming & Partners	No audited financial statements on record	No audited financial statements on record	No audited financial statements on record

TABLE 5 (Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
14. The auditors were unable to obtain information from the directors and did not wish to continue as the auditors.	Trendyset Plc	King Mead & Co.	No audited financial statements on record	No audited financial statements on record	No audited financial statements on record
15. The Board appears to believe that auditors missed a liability from the employee share scheme. The auditors claim that they advised the company and that their advice was ignored	Essex Radio Plc	Kidsons Impey	Unqualified	Richard Keen & Co.	Unqualified

TABLE 5(Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
16. The most recent audit was for the year ended 31 March 1991. No statements were presented for 1992 and no audit work carried out on that year. Three new directors have since been appointed. The auditors refused a request from the board for their resignation. The board held an EGM and replaced auditors.	Waterglade International Holdings Plc	Touche Ross	Subject to	Stoy Hayward	Subject to

TABLE 5(Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
17. The letter says that there are no circumstances connected with resignation. It goes on to say that the directors should be aware of qualification in subsidiary statements concerning the need for bad debt provision and doubts about viability of the business.	British Equipment Leasing Plc	Deloitte Haskins & Sells	Subject to	Touche Ross	Unqualified

TABLE 5(Continued)

REASONS GIVEN	COMPANY	RESIGNING AUDITOR	RESIGNING AUDITOR'S FINAL REPORT	INCOMING AUDITOR	INCOMING AUDITOR'S FIRST REPORT
18. The firm was asked to resign. A former partner of the firm was a director of the company. The firm cannot find any audit working papers or check the accuracy of the accounts for year ended 30 April 1990.	Huntston Holdings Plc	Carlines	No audited financial statements on record	Barber Harrison& Platt	Unqualified
19. Lack of communication between management and others.	FSV Group Plc	Johnsons	No audited financial statements on record	No audited financial statements on record	No audited financial statements on record

The resignation statements listed in Table 5 vary in length from three lines to three pages. Some are very vague about the matters which supposedly form the substance of the report. For example, the auditors of Keltic Holdings (item 11) simply say that

> "apart from the non payment of our fees, we are of the opinion that the conduct of the company's affairs in recent months may be prejudicial to the interests of its creditors and employees".

The reasons for the above opinion are not clear and no details of the "prejudicial" matters are given. Item 19 simply mentions "lack of communication" and provides no details. In item 17, the auditors (Deloitte Haskins & Sells) say that there are no circumstances in connection with resignation which members and creditors need to know but then draws attention to some aspects of financial statements. Such disclosures are unlikely to be of much help to any stakeholder group.

Some of the letters appear to be written in a code which only a Kremlinologist could decipher. For example, Touche Ross resigned the audit of Cosmerique PLC (item 2 in table 2), claiming that the directors:

> "have not provided the information and explanations needed to us to finalise our audit procedures for the years ended 30 June 1988, 1989 or 1990;
>
> have failed to make proper allowance in the draft accounts for doubtful debts, stocks write downs and amortisation of intangible assets;
>
> have failed to keep proper books of accounts, particularly in the period ended 30 June 1988;
>
> have been unable to secure the financial resources necessary to discharge the group's liabilities as and when they fall due".

There is no indication of the kind of 'information and explanations', or the possible 'amounts' involved. Company directors could have clarified the situation, but the Companies Acts do not require directors to respond to the contents of the auditor's resignation letter.

Another example of inadequate disclosure is the Coopers & Lybrand Deloitte resignation letter relating to the audit of TGI Group Plc (item 1 in table 2). The letter made the following points:

“(a) The company alleges that we have been negligent in our role as auditors of the financial statements of its subsidiary company Tannoy Audix Limited (“Audix”) and states that it holds us liable for the loss which it claims to have suffered as a result. We deny these allegations.

(b) Relationships between the company and us as auditors, have thus broken down and in these circumstances we believe that we should resign in order to avoid any potential conflicts of interest”.

The resignation letter fails to provide any details of dispute and the allegations. It does not enable any stakeholder to call auditors and/or the management to account.

THE MERRY-GO-ROUND

So far, we have reported that of the 766 public limited company auditors who resigned only 19 listed any circumstances associated with their resignation which they wished to communicate to shareholders and/or creditors. What happened to the companies whose auditors resigned? Did they become pariahs, or did the economics of the auditing industry ensure that none had difficulty in finding an auditor. After all, organisations such as BCCI and Maxwell had no difficulty in finding an auditor. Unsurprisingly, all companies managed to find replacement auditors. The loss of an audit client for one firm is a business opportunity for another. If anything auditors stand to make more money from resignations as the incoming auditors claim that they incur extra costs in making themselves familiar with the new client’s affairs. Unless there are barriers to recovering the extra costs, the familiarisation costs are passed on to clients in the guise of higher fees.

The auditing market is highly segmented. Larger companies are serviced by large auditing firms and medium and small companies are serviced by medium and smaller firms. The segmentation is accompanied by particular cost structures and work technologies enabling firms to build particular specialisms and clientele. Therefore one would expect the companies to primarily seek replacement auditors from the same audit market.

Table 6 summarises the changes in auditor size after the resignations. One noticeable trend is that, broadly, companies who lost either large or

small audit firms tended to appoint a replacement firm in that same category. Companies who had lost medium sized audit firms tended to move to within the same market segment, but are not averse to appointing either a larger or smaller firm of accountants as auditors.

TABLE 6

AUDITOR CHANGES BY SIZE OF FIRM

		Incoming Audit Firms			
		Big-Six	Top 20	Other	Total
		%	%	%	%
Outgoing Audit Firms	Big-Six	21.8	7.7	10.8	40.3
	Top 20	11.1	3.9	9.5	24.5
	Other	8.5	5.6	21.1	35.2
	Total	41.4	17.2	41.4	100.0

Many of the larger companies switching auditors tend to seek out larger firms as they provide the required global coverage and the perceived level of public assurances. Or, perhaps the switch to larger firms is based upon the perception that larger firms help to create an aura of greater credibility. The firms are, of course, willing to manufacture and encourage such perceptions as this enables them to charge above average fees to their clients (e.g. Palmrose, 1986).

The figures in table 6 were analysed to see whether there was any relationship between the incidence of qualified audit reports by the outgoing auditor and the direction of any change in the size of the replacement audit firm. The size of the incoming auditors was then partitioned into two sets in two different ways. Method 1 distinguished switches to the Big 6 from all others. Method 2 distinguished switches to either one of the Big Six or one of the other top 20 firms. The results of this partitioning are provided in tables 7 and 8.

TABLE 7
COMPANIES SWITCHING TO BIG-SIX

	Resigning Auditor's Report		
	Unqualified	Qualified	Total
	%	%	%
Switch/Remain with Big-Six	45.1	4.4	49.5
Other	40.4	10.1	50.5
Total	85.5	14.5	100.0

No. of valid observations = 594

TABLE 8
COMPANIES SWITCHING TO BIG-SIX OR TOP 20 FIRMS

	Resigning Auditor's Report		
	Unqualified	Qualified	Total
	%	%	%
Switch/Remain with Top 20	60.8	8.6	69.4
Other	24.7	5.9	30.6
Total	85.5	14.5	100.0

No. of valid observations = 594

Whilst the data collected is not large enough to reach any definitive conclusions, tables 7 and 8 suggest that despite the warning signs posted by the resigning auditor, both the Big-Six and the top twenty firms have little difficulty in accepting the company concerned as a client. The decision to accept/reject a client may also be based upon discussions between the outgoing and the incoming auditor, but stakeholders are not made aware of any information that the two parties exchange.

Table 7 shows that in the instances where the auditors issued an unqualified audit report prior to their resignations, 52.7% of the companies remained with or switched to a Big-Six firm. Of the cases where a qualified audit report had been issued only 30.3% did so.

Table 8 shows that of the cases where auditors issued an unqualified report prior to their resignation, 71.1% of the companies remained with or switched to a Top 20 firm. Of the cases where a qualified report had

been issued prior to auditor resignation, 59.3% did so. These statistics could suggest that either the Big-Six are more choosy, or that the companies concerned shop around for various advantages, or that, in a market where their overall share is declining, the medium-sized firms are prepared to hang on to their PLC audit clients.

AUDIT QUALIFICATIONS

Our sample of 766 PLCs showed that in 108 cases the resigning auditors issued a qualified audit report i.e. indicated material reservations but then proceeded to say that there were no circumstances in connection with their resignation which shareholders and creditors needed to be aware of. How does this affect the conduct of the incoming auditor? We decided to look at the nature of audit reports issued by the incoming auditor who under the rules issued by accountancy trade associations has an opportunity to discuss some matters with the outgoing auditor. Stakeholder are, however, not made aware of the information so given by the outgoing auditor.

Our sample contained a large number of companies whose annual accounts contained an audit qualification either before or after the auditor switch (or both). This appears to be a far larger proportion than in the population of companies as a whole, where typical qualification rates amount to 2-3% of companies surveyed (Skerratt and Tonkin, 1994). The numbers for the set of companies whose auditors resigned is given in Table 9.

TABLE 9
AUDIT QUALIFICATIONS BY RESIGNING AND REPLACEMENT AUDITORS

Audit Report	Resigning Auditor		Replacement Auditor	
	Number	%	Number	%
Unqualified	535	69.8	556	72.6
Emphasis of Matter	8	1.0	13	1.7
'Subject to'	84	11.0	81	10.6
Disclaimer of Opinion	16	2.1	15	2.0
Disagreement	4	0.5	5	0.7
Adverse	1	0.1	0	0.0
Multiple Qualifications	3	0.4	1	0.1
No information on Companies House fiche	115	15.0	95	12.4
	766	100.0	766	100.0

Table 9 excludes a number of cases because the relevant information was not on the microfiches supplied by Companies House. The proportion of reports which are qualified is, however, high in comparison to, say, the annual incidence of qualifications as reported in the ICAEW's annual survey of published accounts (see Skerratt and Tonkin, 1994). The vast majority of the 108 audit qualifications are in respect of uncertainty, including several 'fundamental' qualifications. In 16 cases, the resigning auditors issued a 'disclaimer of opinion' i.e. the matters involved were so material and fundamental that they were unable to form an opinion on the 'truth and fairness' of financial statements.

The qualifications expressed in the audit report may be indicative of the difficult relation between auditors and management, possibly persuading the auditor to resign. The matters, however, remain serious enough to persuade the incoming auditors to also continue to issue qualified audit reports. These are based upon discussions with outgoing auditors, company directors and the findings of the field work.

Table 9 shows that 102 of the replacement auditors also issued a qualified audit report and in 15 cases a 'disclaimer of opinion' was issued. Further analysis revealed that, three of these 15 cases related to ongoing problems which had also led to a 'disclaimer' in the previous year. In three of the cases involving a 'disclaimer', there was no mention of the circumstances in the resigning auditor's report or letter of resignation. All

three cases there involved serious issues which received attention in the replacement auditor’s report. These related to the case of a director of one company was being pursued by the police; another company had held no physical stock count; and the third company was unable to confirm the recoverability of a material sum loaned to a former director. The cases where the incoming auditor was forced to ‘disclaim’ also include three in which the disclaimer arose because of severe problems with the company’s accounting system and one in which the Inland Revenue had not agreed the Corporation Tax liability for any year. It seems unlikely that these problems could have arisen for the first time during the incoming auditors’ first terms of office. Despite this, only one of these companies’ resigning auditors had listed any matters for the attention of the shareholders or creditors and that was a comment that the firm’s audit fees were overdue and that the company was insolvent.

The cases in which both the outgoing and incoming auditors disclaimed opinion involved two instances of inadequate accounting records and one of severe doubts about the ability of the company to remain a going concern. None of the resignation letters made any reference to these circumstances. It should be recalled that the Companies Act requires that in discharging their duties the resigning auditors explicitly consider the interests of creditors. The audit report is not formally addressed to creditors and the inclusion of matters in it at the expense of specific statements to creditors is tantamount to non-compliance with legislation.

SUMMARY AND DISCUSSION

This chapter reported the results of our examination of 766 microfiches relating to public limited companies whose auditors resigned during the period 1988-1992. Only 19 resigning auditors provided a reason for resignation which, in their opinion, the shareholders and creditors of those companies needed to be aware of. The reasons cited in those statements frequently raised more questions than they answered. Auditors are highly ‘economical’ with information.

The record of major firms in giving the reasons for their resignations is little better than that of other firms. One might have thought that after issuing a qualified audit report, auditors might be more willing to explain the reasons for their resignation. But this does not appear to be the case either. The absence of an independent regulator and a ‘duty of care’ to individual stakeholders do not seem to provide auditors adequate economic incentives to report concerns to shareholders and creditors.

The replacement auditors also issued a high proportion of qualified audit reports. Their reservations are due either to ongoing inherent problems with these companies which makes it impossible for any auditor to express unqualified opinions or to new problems which have only just come to light. If the problem is due to chronic uncertainties then it has already been established that these are not being highlighted in the resigning auditors' resignation letters. If the problems are fresh ones then it begs the question of why they were missed by the resigning auditors. Only 19 of the letters filed by the resigning auditors felt that there were any circumstances in their resignation which either shareholders and/or creditors needed to be aware of.

Despite the much hyped claim that auditing firms want to give up 'problem' clients, none of the companies affected by auditor resignations had any difficulty in finding a replacement auditor. There was a high incidence of qualified audit reports by outgoing auditors, suggesting that auditors and management disagreed about material matters. However, this is accompanied by 'silence' in the resignation letters. Amongst some auditors, there may be a belief that once matters are signalled in the audit report, this somehow absolves them from saying anything in their resignation letter. This view is mistaken. Whereas the financial statements are driven by accounting aspects, the letter of resignation is driven by a need to consider the interests of shareholders and creditors. In any case, the mention of matters in the audit report does not in any way discharge auditor obligations to creditors.

CHAPTER 5
SILENCE IS NOT GOLDEN

The previous chapters indicated that the statements included in the auditor's resignation letter rarely report any matters for the attention of the shareholders or creditors. One response might be that this is not necessarily a matter of concern in itself because an auditor might wish to resign for reasons which have little significance for either the shareholders or creditors. However, the evidence presented in this monograph does not support the 'all is well' thesis. The high incidence of qualified audit reports by incoming auditors raises doubts about the fullness of the public disclosures by their predecessors.

This chapter supplements the statistical analysis presented in chapter four with a more qualitative description of a small selection of cases involving resignations. These have been selected to illustrate the reasons for doubting the quality of the disclosures in this area and it is not claimed that they are representative of all resignations. They do, however, provide a *prima facie* case for discussion of the auditors' tendency to be 'economical with information'.

In this chapter we further report on four cases. Three of these, CLF Holdings, MTM Plc and LEP Group Plc, are drawn from our sample. The fourth, Queens Moat Houses Plc, is a slightly more contemporary case which has been included to demonstrate the possibility that the concerns described above are ongoing issues. All four cases suggest that the manner in which the auditors interpret their social responsibilities is very narrow and contrary to the letter and the spirit of the legislation which was designed to "prevent a weak auditor from resigning in mid-year - in fact, half way down the course - without saying anything and completing his audit because he has discovered something which suggests that things are going wrong and he is not ready to face up to his responsibilities in such a situation......" (House of Lords Debates, 5 April 1976, cols. 1486-1487).

CLF HOLDINGS

CLF Holdings was audited by Clark Whitehill until 1988. Clark Whitehill issued an unqualified audit report in that year. Subsequently, Price Waterhouse were brought in to investigate the group's affairs and reported a £12 million irregularity relating to stocks and debtors (Accountancy Age, 11 May 1989, p. 3). Clark Whitehill did not seek reappointment and left office without stating any matters for the attention

of shareholders or creditors. Price Waterhouse took over the audit. Their final audit report, dated 6 October 1991, disclaimed opinion while referring to going concern uncertainties. Price Waterhouse resigned on 7th October 1991, stating that

> "There are no circumstances connected with our resignation which we consider should be brought to the notice of the shareholders or creditors ...".

They were replaced by KPMG Peat Marwick whose first audit report, dated 13 August 1992, was unqualified but contained an 'emphasis of matter' (at that time considered to be a minor audit qualification) in respect of a note to the accounts which explained that the financial statements had been prepared "on the basis that funding will be available ... to enable the group to wind down its activities in an orderly manner".

CLF Holdings suffered the loss of two audit firms in a relatively short period. Its financial statements appeared to be subject to serious doubts about going concern (i.e. the ability of the company to continue to trade). Despite the importance of these matters, neither of the outgoing auditors felt the need to make any kind of explicit statement.

MTM PLC

MTM's auditors, BDO Binder Hamlyn, gave an unqualified audit opinion (dated 5th June 1992) on the financial statements for the year to 31st December 1991. On 8th September 1992 they resigned and stated that

> "There are no circumstances connected with our resignation which we consider should be brought to the attention of the members or creditors of the company".

The very next day, the company announced an interim loss of £28 million and its new chief executive claimed that the previous year's accounts were materially overstated (Financial Times, 10 September 1992, p. 20).

Price Waterhouse took over the audit. Their first audit report, dated 28 April 1993, related to the financial statements for the year to 31st

December 1992. This contained a ‘subject to’ qualification, indicating material uncertainty. The audit report referred to the fact that

> “the company is co-operating with the Serious Fraud Office and the North Yorkshire Police in relation to an investigation being carried out concerning matters relating to the profit shortfall announced in the 1991 Reports and Accounts ...”.

There were also references to going concern problems and also uncertainty created by the fact that the opening balances had been audited by another firm.

Prior to BDO Binder Hamlyn’s resignation, the company had issued two profit warnings and its share price had plummeted from 286 pence to 26 pence (Financial Times, 1 May 1992, p. 20). Richard Lines, MTM’s chairman and founder, resigned early in March 1992 (Financial Times, 11 March 1992, p. 11). There were considerable disagreements between BDO Binder Hamlyn and the Board and the announcement of the 1991 financial results was delayed. The new chief executive sought to restructure the company and looked for a substantial cash injection (Financial Times, 10 September 1992, p. 20).

Against the City expectations of a profit of £23 million for 1991, the company reported a loss of £20.6 million. It was subsequently reported that the Serious Fraud Office (SFO) and the North Yorkshire Police had been invited to investigate the shortfall in the company’s 1991 accounts. A report prepared by auditors BDO Binder Hamlyn and revealing “incorrectly recorded” transactions in 1991 and the previous years which had boosted sales and possibly profits, was forwarded to the authorities (Financial Times, 14 May 1992, p. 22). The SFO inquiries continued in 1993 (Financial Times, 10 April 1993, p. 10) and in 1994. Richard Lines and Thomas Baxter, another former MTM director, were formally charged with false accounting, conspiracy to commit false accounting or furnish false information, and making false and misleading statements under the Financial Services Act. It was alleged that they recorded bogus transactions for 1990 and 1991 in order to meet profit forecasts. One allegation was that the company sold plant and machinery to a supplier for a profit of £700,000 with an agreement to repurchase the assets so that there was no net cost to the supplier.

Both former directors were convicted of fraud and Richard Lines was sentenced to two years imprisonment and Thomas Baxter to six months. BDO Binder Hamlyn were criticised by the judge Geoffrey Grigson (Financial Times, 4 February 1997, p. 12).

LEP GROUP PLC

During late 1991, the company revealed that its profits for the first half of the year had fallen fivefold (Financial Times, 24 September 1991, p. 25). Some of the financial problems were related to the company's policies on off-balance sheet property finance which subsequently had to be brought on to the balance sheet (Financial Times, 7/8 March 1992, p. 8). To avoid a charge to the profit loss account, the company did not amortise its security alarm business contracts over the contract lives. These were revalued on the balance sheet as new business replaced old until new accounting rules forced the company to change its accounting policies. The company found itself with more than £500 million of borrowings. The company secured a refinancing package of £470 million from 30 major banks (Financial Times, 12 October 1991, p. 10).

In early 1992, the company appointed a new chairman and chief executive to restructure the group. Further plans for restructuring involved a £180 million debt-for-equity swap. The company also sought to dispose of its US subsidiaries and reduce the reported gearing ratio of 188 per cent (Financial Times, 27 June 1992, p. 28). In the restructuring 12,000 jobs were in jeopardy and the employees' pension fund was also under threat (Financial Times, 4 August 1992, p. 18). At an extraordinary meeting, the proposed restructuring plans were approved (Financial Times, 25 August 1992, p. 15). The group's 1991 accounts reported a loss of £235.1 million. Press reports indicated that auditors, Touche Ross, would stand down (Financial Times, 29 September 1992, p. 28). Touche Ross issued a qualified audit report on 5 October 1992. It referred to unquantified legal claims against the company in the USA. On 15 October 1992 Touche Ross resigned the audit of LEP Group PLC. The resignation letter stated that

> "There are no circumstances connected with our not seeking re-appointment which should be brought to the attention of the members or creditors of the company".

The incoming auditors Price Waterhouse issued a qualified audit report (dated 9 June 1993) for the same uncertainty and used virtually the same wording as that of Touche Ross.

QUEENS MOAT HOUSES

Queens Moat Houses Plc was the third largest hotel chain in the UK. Through an aggressive acquisition policy, it expanded and its profits grew from £24.8 million in 1987 to £94.1 million in 1990. The company's accounts attracted unqualified audit reports until 1991. In 1993, just a week before its 1992 financial statements were to be published, the company asked (on 31st March 1993) the London Stock Exchange to suspend trading of its shares (The Times, 1 April 1993, page 23). Major banks were asked to devise a financial package to rescue the company (The Times, 8 April 1993, p. 25). Grant Thornton was asked to investigate the company's affairs. This investigation soon revealed (April 1993) that the company was likely to report a substantial loss (The Observer, 23 May 1993, p. 30). A large number of directors either resigned or left. The new Board had the task of restructuring the company.

Amidst these events, on 18 May 1993, Queens Moat Houses auditors, Messrs Bird Luckin resigned. Their letter of resignation stated,

> "we confirm that there are no circumstances connected with our resignation which we consider should be brought to the notice of the members or creditors of Queens Moat Houses plc".

The company's financial statements for the year to 31st December 1992 were finally published on 29 October 1993. In it, the 1991 pre-tax profit of £90.4 million was restated as a loss of £56.3 million. The £146.7 million difference included £50.9 million of depreciation that the group had not previously provided for and maintenance expenditure which had been capitalised. Other changes related to overstatement of profits on fixed sales, expenses which had been capitalised and misclassification of finance leases. Whilst analysts were predicting a profit of some £90 million for 1992, the actual published accounts revealed that the company made a pre-tax loss of £1.04 billion. Much of it was due to exceptional items and a write-down of property values. The 1992 balance sheet showed net debt to be £1.17 billion and a negative net worth of £388.9 million.

For the last two years the company had been operating with virtually no financial controls (Financial Times, 30/31 October 1993, p. 8). It was alleged that the company had paid unlawful dividends for 1991, 1992 and 1993 (Financial Times, 30/31 October 1993, p. 1; The Observer, 31 October 1993, p. 2). The finance director's report explained that "there were no monthly consolidated management accounts to enable the board to monitor the progress of the group". In particular there were minimal group cash forecasts and no clearly defined treasury function. It was reported that one of the company's directors was a former partner of the audit firm.

Incoming auditors, Coopers & Lybrand, issued a heavily qualified audit report on the financial statements for the year to 31 December 1992 (issued on 29 October 1993). On 12 November 1993, the Department of Trade and Industry appointed inspectors under section 432 of the Companies Act 1985 to investigate the affairs of the company. At the time of writing, the inspector's report had still not been published

SUMMARY AND CONCLUSIONS

In this chapter, we have examined only four instances where auditors indicated that "there were no circumstances". Hopefully, regulators with considerably more resources at their disposal will undertake further investigations. We invite the reader to look at the details and ask whether there were any circumstances in connection with auditor resignation which should have been brought to the attention of shareholders and creditors. Similar question may also be asked of many other notices of auditor resignation in which auditors make similar claims. Auditors appear to be 'economical with information'.

CHAPTER 6
CONCLUSIONS AND RECOMMENDATIONS

This monograph has been concerned with auditor accountability and discharge of auditor responsibilities to stakeholders. Auditors have a long history of contrived silence. Occasionally, a scandal triggers events and leads to the introduction of new legislation in the hope that the auditing industry will pay a little more attention to its social responsibilities. However, with the absence of independent regulators and a 'duty of care' to any individual stakeholder, the market and institutional pressures to persuade auditors to discharge their responsibilities are relatively weak.

The Pinnock Finance scandal reminded the state that the auditor 'silence' affects a wide variety of stakeholders ranging from bank depositors, investors, pension scheme members and a variety of other creditors. In the aftermath of the scandal, the state sought to reconstruct the aura of auditor independence and accountability by creating a new framework for auditor resignations. This was introduced by the Companies Act 1976 (now part of the Companies Act 1985). It required that the resigning auditor shall deposit at the company's registered office a statement of any circumstances connected with his resignation which he considers should be brought to the attention of the shareholders or creditors of the company, or if he considers that there are no such circumstances, a statement that there are none. The legislation was designed to strengthen auditors and ensure that they don't keep silent and abdicate their responsibilities.

Our research was prompted by a sharp increase in the number of auditor resignations. We looked at the statements filed by 766 auditors of public limited companies. Of these only 19 listed any circumstances which they felt should be brought to the attention of shareholders and/or creditors of the company. The vast majority of auditors filed a 'nil' return even though they were issuing heavily qualified audit reports. The incoming auditors also issued a large number of qualified audit reports and cited on-going problems. In some cases, the auditors filed a 'nil' return which was soon followed by revelations of major scandals. It appears to us that the legislation has failed to persuade auditors to discharge their social obligations. Auditors prefer 'silence' whilst the regulators have made no attempt to monitor auditor compliance with the legislation.

The Companies Act 1985 imposes specific obligations on auditors. They need to specifically consider the interests of shareholders and creditors and list the circumstances connected with the resignation, if any, for the

attention of both parties. The contents of an audit report are not a substitute for satisfying the requirements of the Companies Act. In any case, the audit report is not addressed to creditors and cannot fulfil the requirements of the auditor resignation legislation.

The consequences of auditor silence have wealth distribution, income distribution and risk assessment consequences for many stakeholders. With this in mind, we sketch out some proposed reforms.

PROPOSALS FOR REFORM

- Currently little public information is available about the increase/decrease in the number of auditor resignations. The Department and Trade and Industry's annual report statistics, suitably analysed between public, private, small, large, medium, dormant, financial and other companies. The extent of changes in auditor resignation is capable of signalling changes in relationships between auditors, directors and other stakeholders.

- A thorough review of the Companies Acts requirements relating to auditor resignation should be undertaken at the earliest possible opportunity. The review should clarify the legislation. The auditor should also be required to consider the interests of employee. The present legislation is unashamedly discriminatory. It requires auditors to consider the interests of the providers finance capital (shareholders and creditors), but completely neglects the welfare of the providers of human capital (employees) without which organisations cannot generate wealth.

- Audit regulators should be required to examine auditor compliance with the auditor resignation legislation. Those failing to comply with the letter and/or the spirit of the legislation should attract penalties.

- The topic may also be worthy of an auditing standard.

- There should be a formal regulatory mechanism which routinely investigates situations in which there is *prima facie* reason to doubt that an auditor has made full disclosure of all circumstances connected with a resignation. Examples of such indicators would include serious audit qualifications, apparent differences of opinion between the resigning auditor and incoming auditor and the failure of a company to submit audited financial statements within the statutory time limits

in any year following a resignation. Such cases should be referred to the auditors' supervisory bodies for investigation.

- Auditors are a major 'related party' entering into numerous 'related party transactions' (see Financial Reporting Standard 8) with the company. Yet the financial statements rarely provide much information about company-auditor relationships. To facilitate effective communication and questioning of the auditor and management, the statements produced in connection with auditor resignation should be reproduced in the annual report and/or should be circulated to individual shareholders, creditors and anyone else entitled to receive notices of such meetings. In addition, copies of management letters and audit contract should also be publicly available. The availability of information will enable stakeholders to call auditors and management to account and assess whether the financial links with companies encouraged them to be 'economical with information.

- Company directors should be required to issue a written statement in response to auditor's 'statements of circumstances'. To make informed judgement, stakeholders need to hear the other party's response. This statement will help to secure dialogue and management accountability. It should be filed at Companies House and also be circulated to the relevant parties.

- If auditors resign without disclosing the circumstances connected with their resignation in full then they should be subject to a statutory 'duty of care' to any shareholder or creditor who can establish that this non-disclosure was the cause of some loss.

- At each AGM auditors should give details of any prior agreements with the management. This will help to prevent a situation (page 6) in which both management and auditors have agreed to be 'economical' with information. This 'management' of affairs thwarts the spirit and the letter of auditor accountability.

- The incoming auditor should have statutory right of access to the files and working papers of the outgoing auditors. This will enable them to make a better and informed assessment of the desirability of the client and also appreciate the validity, or otherwise, of the statements issued by the resigning auditor.

- Audit stakeholders (or their representatives e.g. an audit committee) should also have right to see auditor files and determine whether the resigning auditors have been economical with information. There appears to be no moral reason for denying this right.

- The details of any discussions that take place between the resigning auditor and the incoming auditor should be filed at Companies. This will ensure that all stakeholders have access to identical information.

Finally, there is a big question about whether the current institutional structures can ever persuade company auditors to discharge their social responsibilities, especially as auditors are hired and fired by management. To earn fees auditors have to ensure that the client companies also remain in existence thus auditors are under pressure to be 'economical' with information. To secure clients, auditors also have to convince buyers/management that they are not troublesome. In addition, using audit as a market-stall from which many other services are sold also compromises auditor independence. The present auditors are expected to serve company directors, shareholders, creditors, state regulators (e.g. banks), whilst simultaneously pursuing their own narrow economic interests. The consequences are failure and 'silence'.

In the above circumstances, the tightening and refining of legislation will have very limited results. A durable solution to such problems is beyond the scope of this monograph. The issues require that consideration be given to developing alternative institutional structures of auditing.

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DEDICATION

This monograph is dedicated to the memory of Tony Puxty, a much-missed friend, colleague and a gentle human being.

ACKNOWLEDGEMENT

We are grateful to the Institute of Chartered Accountants in England & Wales (ICAEW) for the financial support for acquiring the data used in this monograph.

Auditors: Keeping the Public in the Dark examines auditor compliance with the requirements of the Companies Act 1985. The legislation requires that the resigning auditors give reasons for their resignation. These need to have regard for the interests of company shareholders and creditors. The monograph looks at the statements issued by the auditors of 766 public limited companies. Of these, only 19 gave any reason for their resignation. In all other cases, the auditors filed a 'nil' return. In some cases, the 'nil' return is soon followed by major scandals. The monograph concludes that company auditors are 'economical' with information and are not complying with the requirements of the Companies Act 1985.

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AUDITORS: KEEPING THE PUBLIC IN THE DARK

ISBN 1-902384-02-4

£8.95

NOTES

[1]Following the introduction of the Limited Liability Partnership (LLP) legislation, accountancy firms choosing to trade as LLPs may be required to publish audited financial information about their affairs.
[2]Auditors are normally appointed from one AGM to the next.
[3]The Department of Trade & Industry (DTI) appointed Peter Ainger as an inspector to investigate the affairs of Gilgate Holdings Limited. At the same time, Peter Ainger's conduct of the audit of Ramor Investments was also being investigated by other DTI inspectors. The DTI eventually contrived to suppress the final report relating to Ramor Investments (for details see Sikka and Willmott, 1995).
[4] Following the Companies Act 1989, similar requirements also apply to auditors who choose to terminate their appointment at the AGM i.e. by not seeking re-election. They are also required to file the statement indicated here. However, the nature of the information filed by auditors not seeking re-election does not form part of this monograph. We concentrate on the statements filed by auditors who actually resign i.e. terminate their term in office before the expiry of their term in office.
[5] Although this will not always be so if the auditor was resigning from a loss-making appointment or one was likely to damage the firm's reputation by more than the value of the fees foregone.
[6] Most of the literature on auditor resignation and auditor change is U.S. dominated (for example see, Beddingfield and Loeb, 1974; Burton and Roberts, 1967; Carpenter and Strawser, 197; Chow and Rice, 1982; De Berg et al, 1991; Dye, 1991, Eichenseher, 1983, 1985; Francis and Wilson, 1988; Healy and Lys, 1986; Krishnan, 1994; Smith, 1986a, 1986b. The UK research has so far focused on the possible reasons for auditor change (Beattie and Fearnley, 1994, 1995) rather than looking at the legally mandated statements issued by the resigning auditors.
[7] The rights and obligations of auditors need to seen in a historical context in which the state has nurtured external audit as a mechanism for calling companies to account and informing shareholders (and others). Many of the negotiations about auditor rights, power and obligations have often occurred against a background of public disquiet stemming from some highly visible episodes.
[8]At that time, the UK did not have a formal programme for issuing accounting standards.
[9] Turquand Youngs claimed that they were not informed of this until much later i.e. Coopers were asked to give advice in February 1963, but Turquand Youngs only became aware of this in May 1963 (The Accountant, 29 June 1963, p. 844).

[10] The Times hinted at other reasons for proposed auditor changes, including the company's relationship with Cooper Brothers. Also see the editorial comments in The Times, 2 July 1963, p. 15.

[11]Similar episodes, however, continued to be reported in the press. For example, after some disagreements, the directors of S& K Holdings invited Price Waterhouse to resign in favour of Pannell Fitzpatrick & Co (The Accountant, 22 April 1971, p. 511). Price Waterhouse refused to resign on the ground that auditors are appointed by the shareholders.

[12]The company started life in the 1920s in Australia and had become an international company by the 1950s. In 1959 the group expanded its operations in the UK.

[13]At that time, the banking industry was very lightly regulated (see Reid, 1982, for further details). The government departments claimed (whether justified or otherwise) that they looked for signals contained in audit reports to alert them of any problems.

[14] It is now known as the Association of Chartered Certified Accountants.

[15] A similar situation occurred in the aftermath of the closure of the Bank of Credit and Commerce International (BCCI). Previously (Banking Act 1987), financial sector auditors had a 'right' to report irregular transactions to the regulators. However, after the BCCI collapse the government imposed a 'duty' upon auditors to report irregularities to the regulators even without client knowledge (Hansard, 15 February 1994, cols. 852-875).

[16] The information in table 5 is incomplete because of gaps in the fiche records. This may be partly attributable to the fact that the records held by Companies House are themselves notoriously incomplete. Surveys have indicated that compliance rates have been as low as 42% in the 1980s (Morris, 1991). The directors are responsible for filing the annual reports with the Registrar. The gaps raise questions about the efficiency of Companies House.