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AUDITORS:

HOLDING THE PUBLIC TO RANSOM

Association for Accountancy & Business Affairs

Working for an Open and Democratic Society

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SUMMARY

The UK auditing industry enjoys a statutory monopoly of the external audit function. More than 600,000 companies and numerous other organisations are required by law to submit to an audit by an accountant belonging to one of the UK's accountancy trade associations. This has enabled accountancy firms to earn millions of pounds in fees. Despite enjoying a statutory monopoly, auditors do not owe a 'duty of care' to any individual shareholder, creditor, employee, bank depositor, pension scheme member or any other stakeholder. Anyone buying mundane things, such as a packet of sweets or potato crisps, acquires statutory rights, suppliers are required to owe a 'duty of care' to current and potential consumers. But none of this applies to auditing. Seemingly, the consumer rights revolution has completely passed auditing by.

Failures of the auditing industry continue to make regular headlines. Episodes such as BCCI, Maxwell, Polly Peck, Queens Moat Houses, Wickes, Atlantic Computers, Barings and others have resulted in loss of jobs, bank deposits, pensions, savings and investments for many. The only long-term defence against negligence lawsuits is to improve the 'quality' of audits. But the auditing industry has shown little inclination to reflect upon its internal practices. Audits continue to be used as loss-leaders to secure consultancy work. Research shows that much of the audit fieldwork is also falsified.

Rather than going all out to improve 'quality', the auditing industry and accountancy trade associations are campaigning to secure further liability concessions. It claims to be an unfair victim of lawsuits though it has failed to provide any systematic evidence of *actual* legal settlements. Based upon the figures provided by the industry, we estimate that the auditor's liability costs are around 2.67% of the total revenue, considerably less than the annual PR expenses of the major firms. Most of the major lawsuits are by one accountancy firm (in its capacity as a receiver, administrator or liquidator) against another (in its capacity as an auditor), the main beneficiaries being the accountancy firms themselves.

The auditing industry is calling for liability concessions at a time when the airlines, the tobacco industry and others are being forced to owe a 'duty of care' to third parties. In common with other businesses, auditing firms already have a right to incorporate and trade as limited liability companies.

But the industry demands more concessions. It wants full proportional liability, something that does not exist anywhere. The industry wants Limited Liability Partnerships (LLPs) and a 'cap' on its liabilities as well. This hardly provides economic incentives for better audits. All of these demands have been rejected by the Law Commission and are considered to be against the public interest. The industry is holding the British government to ransom and says that unless it gets what it wants, major firms will locate in Jersey – a place that facilitates secrecy and dodgy dealings.

This monograph calls for reforms to bring auditing into line with the consumer rights enjoyed in other spheres. The auditors should owe a 'duty of care' to individuals who are shareholders, creditors and employees at the date of the audit report. The industry needs an independent regulator whose main remit will be to safeguard the interests of audit stakeholders. The audit stakeholders (or their representatives) should also have full access to auditor files to enable them to check the kind of work done by auditors. It also calls for development of alternative modes of auditing.

CHAPTER 1

NO ACCOUNTING FOR AUDITORS

Which is the most powerful and successful trade union of the late twentieth century? Not dockers, coal-miners, shipbuilders, printers, steelworkers, railway workers, haulage drivers, autoworkers, nurses or teachers. All receive less pay and job security than these. Accountants are the most successful trade union of the late twentieth century. There are no state guaranteed markets and monopolies for engineers, designers, mathematicians, scientists and other wealth creators. Yet the state guarantees and reserves the market of external auditing exclusively for accountants belonging to a few trade associations[1]. The sick are not obliged to seek out doctors. Those with legal problems are not required to consult lawyers. But around 600,000 limited companies are required to submit to a compulsory annual audit by an accountant belonging to one of the accountancy trade associations. This monopoly extends way beyond the corporate sector[2] to charities, trade unions, schools, universities, hospitals and other organisations who are all required to submit to audit by an accountant belonging to an accountancy trade association.

The state guaranteed market of external auditing has been the making of accountancy firms. It gives them easy access to top management to sell all manner of services ranging from consultancy, tax avoidance schemes, executive recruitment, advice on mergers, downsizing, business closures, printing T-shirts and badges. They can even be engaged by their clients to launder illicit money (see the High Court judgement in *AGIP (Africa) Limited v Jackson & Others (1990) 1 Ch. 265).*

Accountancy firm income and profits have been rising at spectacular rates. The UK accountancy and auditing market is estimated to be worth some £7.3 billion a year (Accountancy Age, 4 September 1997, p. 1). It is dominated by six major multinational firms. Their UK fee income is estimated to be around £3.5 billion a year. Their world-wide income is more than US $51 billion a year (Financial Times, 19 September 1997, p. 1), large enough to dwarf the income of many countries. By any measure of size and influence these are major businesses. 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. No one can sell a car, breakfast cereal, packet of potato crisps, or sweets without owing a 'duty of care' to current and potential customers. All products and services have to be 'fit for use'. But millions of people are expected to invest their pensions, savings and investments in companies whose auditors owe them no 'duty of care'.

State guaranteed markets provide good income and security for accountants. It has made accountancy an attractive career and more than 10% of all university graduates swell the ranks of accountants annually. During the last fifteen years, the number of accountants has doubled. Britain has around 9,000 barristers, 36,000 family doctors (Advertising Association, 1998) but around 250,000 professionally qualified accountants; the highest number of accountants per capita in the industrialised world and more than rest of the European Union put together. The number of accountants is set to double again over the next ten years[3]. There is no evidence that this national investment in an ever increasing accounting and auditing industry has brought economic prosperity, superior corporate accountability, or protection for the stakeholders as evidenced by growing number of scandals. Episodes such as the Bank of Credit and Commerce International (BCCI), Barlow Clowes, Dunsdale, Atlantic Computers, Ferranti, Homes Assured, Levitt, Eagle Trust, Yamaichi, Sound Diffusion, Barings, Queens Moat Houses, Wickes, Resort Hotels, London United Investments, Maxwell and Polly Peck are a visible reminder of the failures of auditors.

The poor quality of audits has played a major part in the loss of jobs, savings, investments, pensions and taxation revenues to thousands of innocent stakeholders. The Nelsonian habits of auditors played a part in a pensions crisis for 30,000 Maxwell pensioners. It played a part in the closure of Polly Peck and the loss of 17,227 jobs (Mitchell et al, 1991). The demise of Sound Diffusion resulted in losses to 11,000 shareholders (Department of Trade and Industry, 1991). At the time of the BCCI closure, it had 14,000 employees and some one million bank depositors with deposits of $1.85 billion (Kerry and Brown, 1992, page 75). They are still waiting to recover their savings. The auditing industry has never explained how it came to lose sight of the millions of pounds that went missing in these and other scandals.

Recurring audit failures might have persuaded the industry to improve the quality of its work, compensate injured stakeholders and even consider

returning the audit fees. The reverse has happened. The auditing industry is campaigning for even more liability concessions to protect it from possible lawsuits resulting from its own failures. In their soundbites aimed at disarming critics, the spokespersons for the accountancy trade associations claim that they are not trade associations but are dedicated to the public interest.

"Our institute [the ICAEW] has never been a trade association. We operate as a professional body dedicated to enhancing the public interest. .... A professional body does not represent its members in the way that, for example, a trade union does"

Source: (Lickiss[4], 1990).

The reality is quite different. The auditing industry's campaign is being led and organised by the Institute of Chartered Accountants in England & Wales (ICAEW) even though around 50% of its membership does not support the campaign (Financial Director, April 1994, p. 8).

Under the Companies Act 1989, accountancy trade associations act as regulators, being required to regulate the auditing industry and defend and advance the consumer interests. Instead they have openly sided with the 'producers' i.e. the auditing industry.

The ICAEW submitted a 122 page briefing memorandum (ICAEW, 1996) to the Department for Trade and Industry (DTI). This shows no concerns with the victims of poor audits and is silent on the absence of basic rights which would enable ordinary stakeholders to seek redress from negligent auditors.

To squeeze further liability concessions from the government, the auditing industry and its trade associations are conducting a well funded[5] major political campaign, commonly associated with cartels (Big Eight, 1994; ICAEW, 1987, 1994; 1996; Auditing Practices Board, 1992 1994a, 1996). This cartel has been joined by 25 other occupational groups who are also keen to secure liability concessions and advance their narrow economic interests (Financial Times, 17 April 1996, page 8; Accountancy, May 1996, page 13). Press coverage from advertising-dependent journalists and in-house magazines (for example see Accountancy, April 1994, p. 14; Accountancy, June 1995, p. 14; May 1996, pages 13 and 30; June 1996,

page 13; Financial Times, 17 April 1996, page 8) has been mobilised to support the industry. The same press reports have failed to interrogate the glossy press releases of the auditing industry.

In this monograph, we argue that the auditing industry's campaign has no moral, ethical or economic basis. On the contrary, ordinary stakeholders are disadvantaged by the current legal arrangements and their rights against negligent auditors need to be strengthened. This monograph is organised into seven further chapters. In the next chapter, the case advanced by the auditing industry is outlined. It lists the industry's demands which, if conceded, will amount to the biggest anti-consumer legislation. The third chapter argues that contrary to the auditing industry's assertions, ordinary stakeholders are not in a position to secure redress against negligent auditors. Case law and other institutional obstacles ensure that auditors cannot be brought to book. Thus the incentives and for good audits are weak. The fourth chapter notes that auditors can secure considerable liability protections by trading as limited liability companies. But most firms continue to trade as partnerships because they are opposed to public accountability obligations. They also want to hang on to their partnership tax perks. The fifth chapter argues that firms have failed to provide any evidence to show the *actual* liability settlements made by them. It shows that the liability costs of auditing firms are 2.67% of total income, considerably less than those claimed by the firms. It shows that major lawsuits are by one accountancy firm against another. The sixth chapter shows that the major demands of the industry have already been examined and rejected by the Law Commission as being against the public interest. Chapter seven shows that major firms have indulged in DIY legislation in Jersey and have given themselves numerous liability concessions without any commensurate public accountability. They are now holding the British public to ransom by demanding the same concessions here without any *quid pro quo* on accountability. Chapter eight summarises the arguments and makes some modest proposals for reform. Chapter nine puts forward an action plan enabling concerned citizens to bring auditors to account.

CHAPTER 2

NO SELF-EXAMINATION BUT PLENTY OF DEMANDS

NO SELF-EXAMINATION

A major reason for lawsuits against auditing firms is the poor quality of audits. Millions of pounds of ordinary people's savings, investments and pensions disappeared in scandals such as the BCCI, Barings, Atlantic Computers, Levitt, London United Investments, Garston Amhurst, Maxwell, Polly Peck, Sound Diffusion, Resort Hotels, Wallace Smith, Wickes, Queens Moat Houses, and other episodes, but in no case did the auditors report anything wrong. As a Conservative MP put it, "….. one of the greatest problems facing the financial services sector is the quality of auditing ……. Professional regulation does not seem adequate to stop auditors from signing rather duff tickets" (Hansard, 15 October 1990, col. 1022).

The UK regulators should have investigated the overall standards of the firms involved, particularly those criticised in the DTI inspectors' reports (see Sikka and Willmott, 1995a). They should have fined them for incompetence and/or withdrawn their licence to operate. They have done virtually nothing. When asked to explain its inaction, the ICAEW claimed "the Institute has no general powers to undertake a wholesale review of a firm's practice" (letter dated 28th May 1992). When asked to confirm this interpretation, the Minister for Corporate Affairs stated (letter dated 7th July 1992) that "the Institute has adequate powers both to investigate whether firm maintains an appropriate level of competence in the conduct of company audits and to consider any aspect of a firm's practice which is relevant to the question of whether the firm is fit and proper to audit companies". There has been no investigation or report on any of the above (and many other) real/alleged audit failures.

Auditors complain that long-suffering stakeholders might sue them for negligence. So they should. No one ever forced any auditing firm to accept Maxwell as a client even though he was described as being 'unfit' to be a company director (DTI, 1973). No one forced any firm to continue with BCCI as a client even though the US authorities were publicly expressing concerns about its operations (Kerry and Brown, 1992). No one ever forced any auditing firm to issue any audit report it did not want to. Auditors could have resigned and exercised their powers under Sections 392, 392A and 394

of the Companies Act to alert the public of dangers. None did. They just preferred to collect their fees.

In the absence of a 'duty of care' to individual stakeholders and public accountability, the auditing industry does not have strong economic incentive to improve the quality of audits. If by hook or by crook a company survives, no external party knows that audits were botched. Anyone hiring a solicitor has full access to that solicitor's working papers, but there are no equivalent rights for anyone hiring an auditor. The auditing industry is pre-occupied with fees and client appeasement. Based upon a study of socialisation of accountants in major firms, Hanlon (1994, p. 150) concluded,

> "Today the emphasis is very firmly on being commercial and on performing a service for the customer rather than on being public spirited on behalf of either the public or the state.
>
> ..... firms have finally ditched any pretence of being public spirited .... ".

The auditing firms blame others for being the targets of lawsuits but show no signs of looking at how their own values and working practices contribute to poor audits. Within firms there are pressures on audit managers and senior people to increase revenues, profits and market shares. So audits get used as loss-leaders to secure access to top management to sell consultancy services to them (Accountancy Age, 24 March 1994, p. 1; Accountancy Age, 24 March 1994, p. 1; The Times, 2 November 1995, p. 30). To maximise profits, the firms devise new ways of squeezing more productivity from their trainees. They impose tight time budgets. Everyone knows that a decent job is not possible within the time allocated, but partners don't want to know that. They hope that trainees would work free on evenings and week-ends to finish the work. Fearful of retaining their jobs, some oblige, but large numbers of audit trainees either use short-cuts or resort to falsification of audit working papers (Otley and Pierce, 1996). A survey by Willett and Page (1996) found the following:

Reasons for speeding up testing

	Have you been under so much pressure that you were tempted to speed up testing by %	*Have you encountered colleagues who have speeded up testing by* %
Rejecting awkward looking items from a sample	53.7	62.5
Not testing all items in a reported sample	26.8	45.5
Accepting doubtful audit evidence	24.1	41.1
Other	16.1	4.4.

Reasons for being tempted to speed up testing by irregular methods

	%
Budget Pressures	60.5
Boring Work	30.3
Unimportant work	41.1
Other	9.8

Source: Willett and Page (1996).

The policies and procedures within the firms do not routinely bring out such irregular auditing practices. So audit failure is institutionalised. Yet regulators (who are not independent of the auditing industry) show no concern with it. The consequences only come to light when there is a scandal. But by then the audit firms have already collected millions in fees.

AUDITING INDUSTRY'S DEMANDS

Rather than examining the practices which cause poor audits and going all out to improve audit quality, the industry wants ever more liability concessions. Its demands are being made at a time when the airline industry is being forced to accept unlimited liability (Financial Times 26 November 1996, p. 5) and the tobacco industry has offered to make a US$368 billion settlement (The Observer Business, 29 June, 1997, p. 2; The Times, 18 September 1997, p. 16) with third parties.

The auditing industry argues that it is an unfair victim of lawsuits because it has `deep pockets'. (Likierman, 1989; Ward[6], 1996) even though despite numerous documented audit failures (Sikka and Willmott, 1995a, 1995b) no regulator has ever sued them and the state has rarely taken any action. This phrase `deep-pockets' has been coined by the auditing industry to suggest that auditors are thought to have substantial assets, from which the parties injured by corporate frauds, collapses and frauds expect to be compensated. It argues that when a company collapses due to frauds and fiddles, the remaining assets are unlikely to be enough to compensate even the secured creditors (usually banks with a charge on the assets). Unsecured creditors and shareholders do not find company directors an attractive target for claims[7] because they are unlikely to have sufficient personal assets. Instead, it is argued, they turn to auditors because they choose to trade as partnerships and their partners have joint and several liability. The litigants eye the personal and business assets of auditors in the hope of securing compensation. So, allegedly, auditors are targeted by litigants, even though they may not be wholly responsible for corporate collapses and the failure to detect fraud and fiddles.

The auditing industry alleges that the number of lawsuits and claims against it are rising. This, they contend, jeopardises their operations, profitability and survival[8]. This claim has been described by one ICAEW Council member as 'facile' and 'ludicrous' (Accountancy, April 1994, page 14). As professional liability insurance costs have increased[9], the firms claim that they are obliged to carry more risks[10]. Ordinary people are hardly in a position to take action against negligent auditors (see chapter 3), but the industry continues to demand more concessions. Prior to 1989, auditing firms were required to trade as partnerships. They then demanded that they be allowed to trade as limited liability businesses and the Companies Act 1989 gave them that right. Yet this privilege is accompanied by public accountability obligations and firms are not keen on that. So most firms voluntarily continue to trade as partnerships (see chapter 4).

On the back of 'joint and several liability' of partnerships, auditing firms have become multinational firms, but now they want the law to be changed. So that (Ward, 1996; ICAEW, 1996) the principle of 'joint and several liability' of partners is replaced by the concept of 'full proportional liability', a practice which does not exist anywhere in the world.

Accountants have a history of demanding more. At the industry's behest the government introduced Section 137 of the Companies Act 1989 (to amend Section 310 of the Companies Act 1985). The industry argued that under certain circumstances, the company should buy the insurance cover for its auditors. Hardly any company has shown any inclination to do so (see chapter 7). Now the industry wants the government to further amend Section 310 of the Companies Act 1985 so that directors and auditors might negotiate limits on auditor liability with company directors. This would enable budding Maxwells and auditors to sit down and decide on ceilings for auditor liability. Hardly ethical and it certainly does not provide any economic incentives for good audits. When things go wrong and frauds come to light, the unsuspecting public will be left to carry the can. The auditing industry also wants companies to incur additional costs by taking out compulsory Directors' and Officers' Insurance so as to let auditors off the hook and persuade the innocent stakeholders to sue directors and other officers. Under such circumstances, one might wonder why anyone should bother with an audit at all. If all risks are covered by insurance (difficult as that might be) there is little sense in incurring audit costs (see chapter 7).

Under pressure from the auditing industry, the government asked the Law Commission to investigate its demands for 'full proportional liability'. The Law Commission rejected them and indeed considered them to be against the public interest (DTI, 1996). Just as the Law Commission rejected the industry's demands, major auditing firms chose another tack by getting DIY legislation to enable them to hold the British public to ransom. Ernst & Young and Price Waterhouse spent one million pounds and drafted a Limited Liability Partnership (LLP) Bill in which they gave themselves all conceivable liability concessions, secrecy and no 'duty of care' to any stakeholder. They then asked the Jersey government to pass it and it duly obliged. The firms have not been packing their bags and abandoning their lucrative UK monopolies because the intention was to use the Jersey law as a lever to hold the UK Parliament to ransom. 'Give us all that we want or we go to Jersey', is their threat. In response, the government has submitted and indicated that it will give them some concessions in 1999 by introducing a UK version of LLPs.

Major firms are openly saying that even after the LLP legislation they will continue to seek further concessions on liability. They also want a `cap' on auditor liability so that the judges cannot award damages against negligent auditors beyond a predetermined amount, regardless of the seriousness of the

negligence or the injury suffered by stakeholders. The major firms want the best of all worlds. They want to enjoy statutory monopolies, avoid public accountability and be protected from lawsuits. They have grown so accustomed to these privileges that they regard them as their birthright. Now that their liabilities are increasing, partly as a consequence of audit failures, they are lobbying the Government to sustain their charmed existence as an alternative to putting their own house in order. The firms and their trade associations say that unless they get what they want, they will perform defensive and passive audits which is effectively business as usual for those affected by scandals (Sikka, 1992).

CHAPTER 3

THE POWERLESS PUBLIC

THE LAW IS FOR THE RICH

Taking legal action against mega-rich auditing firms, many of whom have in-house legal departments and huge economic resources, is a very stressful, expensive and time consuming task. Ordinary stakeholders have neither the resources nor the time to undertake such actions. Wealthy individuals can afford to pay lawyers. The less well-off may be entitled to legal aid though in recent years, in the name of controlling public expenditure, this has been reduced. It is estimated that some 12 million adults are unable to gain access to the courts (The Observer, 26 January 1997, p. 28). Under the UK laws, each litigant is required to pursue individual action to secure compensation. In the event of the legal action being lost, each litigant could also be forced to meet the other party's costs. Under Section 32 of the Limitation Act 1980, any case against auditors has to be brought within six years[11] of the plaintiff discovering fraud, concealment etc. giving rise to the legal claim. Discovering auditor negligence and fighting it in a world where the regulators are in the pockets of auditing firms is difficult, to say the least.

SECRECY AND COVER-UP

The secrecy enjoyed by the auditing industry places considerable burdens on ordinary stakeholders to prove auditor negligence. Under the Companies Act 1985, shareholders appoint and remunerate auditors (at least in name). Yet neither they nor their representatives are given any sight of auditor working papers. Letters of engagement, management letters and audit tenders might provide some insight into negotiations between the auditors and the directors, but they are not filed with any regulator. Regulators might shed some light on audit quality, but they are not interested in such matters (see Sikka, 1997). As the ACCA puts it,

> "the main purpose of practice monitoring is to monitor compliance with auditing standards, rather than to obtain statistical information about the quality of work being done"
> **Source**: Page 25 of the ACCA's 1992 annual report on Audit Regulation.

The ICAEW states that

> "The principal purpose of monitoring is to enable the ARC's [Audit Registration Committees] to satisfy themselves that registered auditors comply with the Audit Regulations"
> **Source**: Page 5 of the 1992 ICAEW, ICAS and ICAI annual report on Audit Regulation.

The accountancy bodies are only concerned with mechanical compliance with auditing standards (which are not independently formulated) rather than audit 'quality'. They pay no attention to conflict of interests, the use of audits as loss-leaders, falsification of audit work, the institutionalisation of audit failures and so on. They have failed to investigate the overall standards of any firm implicated in any scandal; and they never name any firm whose work is considered to be deficient[12]. The whole emphasis is on covering up deficiencies.

Some evidence could be provided by government sponsored investigations into corporate collapses and the auditor's role therein, but many of these are shelved and never see the light of day, or are published after considerable delay (Sikka and Willmott, 1995a). Even where the reports are published, the government does not take any civil/criminal action against auditors criticised in the reports. It expects the accountancy trade associations to take action and they are happy to sweep things under their dust-laden carpets. Injured parties might lodge complaints with the accountancy bodies, but complainants have no 'right of appeal'. Nor do they have access to any information used at any disciplinary hearings. The accountancy bodies do not owe a 'duty of care' to any complainant and have been consistently unwilling/unable to take firm and timely[13] disciplinary action against any auditing firms criticised in government reports (Cousins, Mitchell and Sikka, 1993; Sikka and Willmott, 1995b).

Any individual who is wealthy and persistent enough to go to the courts faces further hurdles. The UK courts are likely to attach considerable weight to the pronouncements formulated by accounting/auditing elites (Arden, 1992). Court cases such as *Lloyd Cheyham & Co. Ltd v Littlejohn & Co. [1987] BCLC 303* have shown that compliance with pronouncements made by the accountancy trade associations is strongly indicative of a good defence against charges of negligent work (Gwilliam, 1997). However, there is mounting evidence which shows that these

pronouncements are more concerned with protecting the economic interests of the auditing elites rather than meeting social needs, as evidenced by the recommendation that auditors be 'passive' (Sikka, 1992; APB, 1994b).

AUDITS OFFER NO PROTECTION

The rights of individual stakeholders against negligent auditors have been even further diluted by recent legal cases (for a review see Gwilliam, 1992, 1997). During the early 1980s, court cases, such as *JEB Fasteners Ltd v Marks Bloom & Co. [1983] 1 All ER 583 and Twomax Ltd v Dickson, McFarlane and Robinson [1983] SLT 98* indicated the possibility that under some highly restrictive circumstances auditors may be held liable to third parties. The subsequent court judgements in cases such as *Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568 and Al-Saudi Banque v Clark Pixley [1990] 1 Ch. 313* have held that in general auditors only owe a 'duty of care' to the company (as a legal entity) rather than to any individual current/potential shareholder or creditor.

Yet the public has been lulled into believing that audits offer protection. For example, during the passage of the Companies Act 1929, audits were described as more than just for the "protection of shareholders and investors, wholly or even mainly" (Hansard, 21 February 1928, col. 1523). During the passage of the Companies Act 1948, audits were considered to be "in the interests and protection of the public ...." (Parliamentary Debates, House of Lords, 18 February 1947, col. 745). During the passage of the Companies Act 1967, the then President of the Board of Trade said, "It is right, both from the point of view of efficiency and of fair distribution of rewards, that full information should be available to shareholders, employees, creditors, potential investors, financial writers and the public as a whole" (Hansard, 14 February 1967, col. 360). Another supporter of the Bill added, "modern company laws should be concerned not just with the interests of the shareholders but with the contribution of the company to the economic efficiency of the whole community" (col. 403). The Opposition benches supported the Bill and added that "We need a number of figures to be able to make that comparison, and it is this inquiry by those interested in the company, whether as an onlooker or as a shareholder in a number of companies, which is so important to improve the performance of companies in any

particular industry" (Hansard, 14 February 1967, col. 444). The accountancy bodies and firms have cashed-in on these images.

There are many reasons why audits are necessary, the more important of which are mentioned below.

(a) to provide assurance to the owners of enterprises (e.g. the shareholders of a company) or to those ultimately responsible for their operation that the financial statements presented to them by those entrusted with the running of the enterprise may be relied upon to the extent indicated by the auditor in his report on the financial statements;

(b) to provide similar assurance to other users of the financial statements such as creditors, banks, employees, the tax authorities and potential investors.

Source: Coopers & Lybrand (1984), page 1.

"[Financial statements] are prepared to enable the company's shareholders to gauge how well the directors have managed the company. In practice, financial statements are used by many people in the course of doing business with the company – for example, banks, trade creditors, customers, employees and the tax authorities. All these users are concerned that the financial information provided by the company should be reliable, and that they may look to the auditors' opinion for confirmation that the financial statements give a true and fair view, although in practice they are likely to obtain other information before making any decisions. In law, though, they cannot usually rely on auditors' report, which is addressed to shareholders"

Source: ICAEW, 1992, page 3.

The above statements suggest that auditors might owe a 'duty of care' to a wide variety of stakeholders. But the UK legal position, as summed by the Law Lords in the case of *Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568* is remarkably different. The Law Lords said,

"I see no grounds for believing that, in enacting the statutory provisions [requiring publication of audited company accounts] Parliament had in mind the provision of information for the assistance of purchasers of shares or debentures in the market, whether they be already the holders of shares or other securities or persons having no previous proprietary interest in the company ..... For my part, however, I can see nothing in the statutory duties of a company's auditor to suggest that they were intended by Parliament to protect the interests of investors.

"I therefore conclude that the purpose of annual accounts, so far as members [shareholders] are concerned is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts".

" As a purchaser of additional shares in reliance on the auditor's report, he [the shareholder] stands no different from any other investing member of the public to who the auditor owes no duty".

The judgements have diluted the possibility of redress against negligent auditors. Despite enjoying statutory monopolies, auditors have no social responsibility. The *Caparo* judgement contradicts the public policy perspective suggested by Lord Denning in his dissenting judgement in *Candler v Crane Christmas & Co [1951] 1 All ER 426*.

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

In the UK, company directors can be held personally liable for publishing

false and misleading accounts. Yet the same does not apply to auditors (Financial Times, 20 January 1991, p. 6). Auditors have been considered to be at fault in auditing financial statements (for example, see *McNaughton (James) Paper Group Limited v Hicks Anderson & Co. [1991 1 All ER 134 and [1990] BCC 891; Berg Sons & Co. Limited & Others v Adams & Others [1992] BCC 661)* but have escaped any damages on the ground that they did not owe a 'duty of care' to third parties. Following the case of *Barings plc and another v Coopers & Lybrand [1997] BCLC 427*, auditors of subsidiary companies could owe a 'duty of care' to the parent company (as a legal person) but not to any human stakeholder. Even the ICAEW Chief Executive acknowledges that "individual shareholders would normally not be in a position to take action against negligent auditors" (letter dated 14 March 1994).

The UK laws act as a warning against anyone putting their savings and pensions in companies since there is no safeguard. Those making investment in the primary markets are given some protection by Section 150 of the Financial Services Act 1986. It states that "the person or persons responsible for listing particulars or supplementary listing particulars shall be liable to pay compensation to any person who has acquired any of the securities in question and suffered financial loss in respect of them as a result of any untrue or misleading statement in the particulars". Thus individuals have recourse against firms who report on prospectuses. Much of the information included in a prospectus is derived from annual audited accounts, albeit in a revised and modified form. But auditors who reported on the accounts upon which the information in a prospectus is based still do not owe a 'duty of care' to any individual stakeholder. In subsequent years, everyone knows that audited accounts are promoted as prospectuses and are used to persuade people to invest their savings in companies. Yet auditors do not owe a 'duty of care' to any individual stakeholder.

So the current institutional arrangements are loaded against the interests of ordinary stakeholders. They do not empower innocent stakeholders to seek redress from negligent auditors and do not provide adequate economic incentives to auditors to improve the quality of their audits.

CHAPTER 4

SECRECY & TAX PERKS BUT NO PUBLIC ACCOUNTABILITY

The auditing industry claims that the joint and several liability of partners makes auditing firms an easy target for lawsuits. In fact, auditing firms too can trade as limited liability companies, like other businesses, to give their partners valuable protection from lawsuits. Such a right was repeatedly demanded by the auditing industry and its patrons (for example, see Accountancy Age, 11 July 1985; The Accountant, 30 May 1985, p. 3; Accountancy, March 1986, p. 3). They argued that partnership structures are unwieldy for UK major firms (some have more than 500 partners) and did not easily enable them to raise finance from capital markets. This, they argued, hindered their development as multidisciplinary businesses and placed them in an unfair competition with other forms of consultancy and advisory businesses, not only in the UK, but in Europe generally where auditing firms have been able to trade as limited liability companies. In response to these arguments and the lobbying of the industry, the Companies Act 1989 granted the auditing firms the right to trade as limited liability companies.

This right of incorporation[14] confers upon the auditing industry the same advantages and obligations placed upon numerous other organisations ranging from financial services, producers of food, drink and medicine. In return for incorporation, the auditing firms are expected to accept the application of the Companies Acts to their affairs. Under this, depending upon the circumstances, the affairs of the incorporated businesses can be subjected to investigation by the Department of Trade and Industry inspectors. Their directors (rather than partners) can be disqualified from holding office under the Disqualification of Directors Act 1986. They need to file statutory information at Companies House and publish fairly minimalist information about their affairs. Most firms have not availed themselves of this opportunity. They continue to trade as partnerships with the full knowledge that this obstructs regulators from investigating their involvement in major scandals (Kerry and Brown, 1992).

There appear to be two further reasons for their lack of enthusiasm about incorporation. Firstly, the auditing industry does not like publishing

worthwhile information about its affairs. According to the ICAEW:

> "…. the obligation on [auditing firms trading as] companies to publish their accounts is perceived as a considerable drawback"
> "….. firms have always stood out against revealing any financial information except their annual fee income"
>
> **Sources:** The Accountant, September 1991, p. 2; Accountancy, April 1994, p. 26.

Seemingly, firms who routinely preach accountability to others and collect huge audit fees are reluctant to have the sunlight of public scrutiny fall on their affairs. Amongst the major firms, only KPMG[15] has chosen to incorporate[16] and then only the auditing side of its business.

There is also the issue of taxation (Accountancy Age, 20 July 1989, p. 111; Accountancy, April 1994, p. 26). Auditing firms are taxed on a 'cash basis' (i.e. on the basis of *actual* cash received and paid out) rather than the 'accrual basis' (i.e. on the basis of amounts that are receivable or payable) which is applied to limited liability companies. This enables firms to delay the payment of taxes. The auditing industry wants to hang on its privileges (Accountancy, February 1998, p. 14),

Limited liability companies are generally required to pay taxes within nine months of the year-end whilst partnerships (depending upon their year-end date) have anything up to twenty-one months after the year-end to pay tax. The expense deduction for partnerships, compared to companies, is also easier. Generally sole traders and partnerships only need to show that an expense was 'wholly and necessarily' incurred but a limited liability company has to show that an expense was incurred 'wholly, necessarily and exclusively' for the purpose of a business. As a result of incorporation, firms and their partners may find that the tax deductibility of expenses and pensions contributions is somewhat restricted. In addition, the conversion from partnership to incorporation may have implications for capital gains tax[17] which are the norm for any business that incorporates as a limited liability company.

It seems, therefore, that the auditing industry wants secrecy, tax perks and liability concessions without any commensurate public obligations.

CHAPTER 5

COOKING THE BOOKS

MISLEADING STATISTICS

Accountancy firms have made a habit of crying 'wolf' about their impending impoverishment, but they are unable to provide any worthwhile evidence to support their claims.

The auditing industry claims that in 1993 (no figures have been provided for any subsequent period) some 8% of its accounting and auditing income was being used to meet liability related claims (Big Eight, 1994; Accountancy April 1994, p. 14). These claims are questionable on at least four counts. *Firstly*, the auditing industry's data is not verifiable because firms do not publish any audited details. *Secondly*, audits have been lowballed[18] and used as loss-leaders to secure consultancy work[19] (Accountancy Age, 23 May 1991, p. 1 and 11; 6 June 1991, p. 4; 10 June 1993, p. 1; Accountancy Age, 12 May 1994, p. 1; 27 April 1995, p. 3; Accountancy, June 1995, p. 13 and 30; The Times 2 November 1995, p. 30). This dilutes the industry's claims that the alleged liability costs should only be seen in the context of accounting/auditing income. *Thirdly*, some of the lawsuits relate to non-audit work. For example, Ernst & Young were being sued over the firm's involvement in a rights issue relating to the collapse of Sound Diffusion Plc (Accountancy, August 1992, p. 15; also see The Economist, 26 February 1994, p. 103). *Fourthly*, accountancy firms routinely oppose any restrictions on their ability to sell non-audit work to their audit clients on the ground that such prohibitions would damage some positive link between auditing and non-auditing work. On the contrary, the conflicts generated by the provision of non-audit work to audit clients affects the quality of audit work and hence the potential for negligence lawsuits.

The auditing industry claims that "There is no evidence - for example, in DTI inspectors' reports - that auditors' objectivity is compromised by provision of other services" (ICAEW press release, dated 4th March 1993). Yet this link is well documented in investigations of audit failures. For example, the DTI report on the collapse of Roadships Limited concluded "We do not accept that there can be the requisite degree of watchfulness

where a man is checking either his own figures or those of a colleague. ..... for these reasons we do not believe that [the auditors] ever achieved the standard of independence necessary for a wholly objective audit" (DTI, 1976, paras 249-250). Another report on the collapse of Burnholme & Forder concluded that "the principle of the auditor first compiling and then reporting upon a profit forecast is not considered to be a good practice for it may impair their ability to view the forecast objectively and must endanger the degree of independence essential to this work" (DTI, 1979, p. 271).

In view of the inter-dependency of auditing and non-auditing income, any alleged cost of meeting legal claims on audits must be seen in the context of the total income of the firm. Thus the revised data (all based upon the figures supplied by the industry) shows (table 1) that around 2.67% of the Big Eight income is used to meet liability costs.

Table 1
Liability Costs of Major Auditing Firms for 1993

	£M Acc/Aud Income	**£M Total Income**
Big Eight Fees	*932.1	**2,776.4
Less Professional liability costs (as per the firms)	* 74.3	* 74.3
Audit Liability costs as a %	* 8 .0	2.67

Sources: * Information as published by major firms (Big Eight, 1994).
** As per Accountancy, July 1993, pages 12 and 13.

Thus the auditing industry's liability related costs do not appear to be exceptional or excessive when it is noted that doctors, dentists, solicitors, surveyors and engineers routinely expect to spend some 10-20% of their income on professional liability related costs. Most probably, the auditing firms spend more than 2.67% of their revenues on glossy brochures and political lobbying.

THE ABSENCE OF EVIDENCE

A Price Waterhouse partner, spearheading the ICAEW campaign claims that "the profession is truly at crisis point. In 1982/83 Minet recorded only

three claims reported by the six largest firms. By 1992/93 the number reported by these firms had risen so high that more than 500 claims remained open at the end of that underwriting year. The estimated amount of the average of the three largest claims (excluding BCCI) increased by 12.5 times, premiums by 37.5 times and deductibles by 27 times over this period" (Ward, 1994, p. 80).

The above information cannot be verified since audited information is not available. The number of lawsuits and the amounts involved may have increased, but many lawsuits are 'protective' and are not prosecuted. The amounts mentioned in lawsuits can be contested and thrown out by the courts. The final settlements rarely bear any relationship to the amounts mentioned in lawsuits. Some press reports suggest that the *actual settlements* are considerably less than the amounts mentioned in the lawsuits.

Ernst & Young were facing lawsuits of US$10 billion over their involvement in the BCCI audits, but various court judgements have reduced the lawsuit amounts (actual settlements may be for even less) to $1.7 billion (Accountancy, March 1997, p. 14).

David Ashton (Arthur Andersen partner) cites two US (considered to be a far more litigious society) examples in which auditors were sued for $200 million and $30 million respectively, but the actual settlements were for $1 million and $2.5 million respectively (Ashton, 1996).

Ernst & Young were sued for £200 million by Butte Mining (Accountancy Age, 28 March 1996, page 1), but the final settlement is that "Butte and Ernst & Young will drop claims and counter-claims against each other. Butte agreed to pay E&Y £50,000 within 90 days, while E&Y will drop efforts to claw back more than £300,000 in fees and interest charges" (Accountancy, March 1997, page 14).

Coopers & Lybrand are alleged to have made an out-of-court settlement of £32.5 million to settle a £120 million lawsuit arising out of fraud at Wallace Smith Trust (Accountancy Age, 26 June 1997, p. 1).

Most legal actions are settled out-of-court, not least because the auditing industry and its insurers are often unwilling to set unfavourable legal precedents[20]. The full cost of actual settlements is not necessarily directly

borne by partners or their firms as larger settlements are probably made by insurers who are able to spread the risk over many policyholders. Whilst this may give rise to increased insurance premiums, the fact remains that there is little public evidence to support the auditing industry's assertions.

As the campaign for liability concessions is spearheaded by the accountancy trade associations, it could be anticipated that they would publish some information about *actual settlements* whether by partners, firms or insurers. When requested, none could provide any evidence.

"Statistics of this nature are hard to come by. Neither the insurers nor their insured seem willing to put statistics into the public arena and plaintiffs appear reluctant to disclose the extent to which they have been successful" (letter dated 1 July 1996).

Source: Letter from the ICAEW Chief Executive, date 1 July 1996.

The President of the Association of Chartered Certified Accountants (ACCA) replied "It is not for ACCA to supply you with details of these matters. In any case, most of the information will be confidential to the parties concerned"

Source: Letter from the ACCA President, dated 1 July 1996.

"We do not have the information you seek. I suspect that much of it is simply not available"

Source: Letter from the President of ICAS, dated, 2 August 1996.

The auditing industry clearly expects to secure further liability concessions without producing evidence or facilitating much evidence or public debate about its claims and demands.

SUING EACH OTHER IS HIGHLY PROFITABLE

In the UK, the biggest lawsuits are by one accountancy firm (in its capacity as a receiver or liquidator) against another (in its capacity as an auditor).

Touche Ross (now Deloitte & Touche) have issued a lawsuit of around US$8bn (The Independent, 28 September 1993, page 22) against Price Waterhouse, the auditors of the failed Bank of Credit and Commerce International (BCCI).

Price Waterhouse have issued a £1bn lawsuit against Touche Ross over the collapse of Atlantic Computers (Accountancy Age, 21 April 1994, page 1).

Price Waterhouse, liquidators of the collapsed bank Barings, have issued a £460 million lawsuit against former auditors Deloitte Touche and Coopers & Lybrand (The Accountant, July 1996, page 2).

Coopers & Lybrand have issued a £400 lawsuit against BDO Stoy Hayward, the auditors of Polly Peck (The Accountant, September 1994, p. 3).

KPMG has sued Coopers & Lybrand for £120 million over the alleged audit failures at Wallace Smith Trust (Accountancy Age, 12 June 1997, p. 1).

The above situation has been repeated numerous times. It is facilitated by the UK insolvency laws (the Insolvency Act 1986) and by the rapacious appetites of accountancy firms' greed. Under this, the insolvency practitioners usually only owe a 'duty of care' to the party appointing them (normally a secured creditor, e.g. a bank). They are expected to recover as much cash as possible by selling businesses as going concerns, or through piecemeal asset realisation and by making legal claims against various parties (including auditors). The recovered funds are applied for the benefit of secured creditors and the remaining amounts, if any, can be distributed to other creditors. Insolvency practitioner's fees have a priority over the claims of unsecured creditors, employee etc. They are remunerated either on the basis of cash recovered (at least ten percent) or time spent. Some of the major insolvencies may be complex and many

take years to complete. Insolvencies cannot be finalised until all litigation has been resolved. Meanwhile, the accountancy firms acting as insolvency practitioners continue to receive fees. For example, BCCI liquidators, Deloitte & Touche, have received $219 million in fees (The Times, 12 June 1997, p. 27) and the prospect is for much more as many aspects of the insolvency (including lawsuits against auditors) are yet to be finalised. One of the Maxwell receivers recovered assets totalling £1.67 million, but charged fees of £1.63 million, something described as "shameful" by a High Court judge (Accountancy Age, 14 August 1997, page 2). In short, there are economic incentives for insolvency practitioners (which are also usually the auditing firms) to sue auditors as this maximises the fee income of auditing firms and helps senior people to receive bonuses, salary increases and other perks. Employees, shareholders and unsecured creditors rarely benefit from such strategies pursued by insolvency practitioners.

To sum up, there is little evidence to support any of the claims being made by the auditing industry. Its liability costs are low. It has been unable to supply any worthwhile information about the amounts of *actual settlements*. Most of the lawsuits are by one accountancy firms against another. The only winners from this are accountancy firms themselves. The ordinary stakeholders are unable to sue negligent auditors and rarely receive any compensation from them.

CHAPTER 6

THE ANTI-SOCIAL DEMANDS OF THE AUDITING INDUSTRY

REJECTION OF FULL PROPORTIONAL LIABILITY

The auditing industry's campaign pressurised the government to commission a feasibility study (as a prelude to a full investigation) into the replacement of joint and several liability of partnerships by a system of full proportional liability. What is 'full proportional liability'? The idea can be illustrated with an example. Suppose someone buys a sandwich from a local partnership of retailers and is taken ill after consuming it. Later on, the sandwich is found to be contaminated or of poor quality. A normal reaction would be to seek compensation from the retailer and expect the retail business owners (perhaps, partners in a partnership) to share the losses. They share the profits of the firm, so why not the losses.

Someone might argue that all partners might not have been negligent to the same degree, or that the suppliers of other products (bread, cheese, ham, tomato etc.) might be at fault. So the bright idea is to introduce full proportional liability. Under this, the consumer would be forced to issue lawsuits against the supplier of the bread, lettuce, cucumber, tomato, cheese, meat, relish and everything else, since all of them might have contributed to the production of the sandwich. This further assumes that the consumers can identify all the parties. The costs of issuing multiple lawsuits would, of course, be very high for an innocent consumer, especially when there is no guarantee of success. Eventually, the consumer might win the case against one (or more) of the faulty suppliers. But suppose that before that supplier can pay compensation s/he is declared bankrupt. So the innocent consumer has been served a poor product, suffers a loss, wins a court case, but gets no compensation. Not surprisingly, the Law Commission rejected the auditing industry's demands (DTI, 1996, Burrows, 1996).

The Law Commission's report, produced at considerable cost to the taxpayer, cited four major reasons for rejecting the auditing industry's demands. Firstly, it argued that full proportional liability is unfair to plaintiffs because it shifts the risk of a defendant's insolvency from other defendant(s) to legally blameless plaintiffs who may have to bear the costs

associated with a defendant's insolvency. Secondly, the Law Commission felt that the joint and several liability principle rests on standard, well-accepted, principles of causation that present a formidable hurdle for plaintiffs. It described the auditing industry's claims that 'defendants can be called on to provide 100 per cent of damages even though they are only 1 per cent at fault' as "misleading" since the present principle of joint and several liability is that relative to the plaintiff each defendant is responsible for the whole of the loss. (DTI, 1996, p. v, chapter 3). Thirdly, it argued that proportionate liability would produce the odd result in that a plaintiff would be less likely to recover full damages by being victim of two wrongs than if s/he had been the victim of just a single wrong by a solvent defendant (Burrows, 1996). Fourthly, even if someone were to argue that the law operates harshly against a wrongdoer who is only trivially blameworthy, relative to the fault of other wrongdoers, it seems unacceptable that, in a situation where the peripheral wrongdoer becomes insolvent, the risk of that wrongdoer's insolvency should be borne by the blameless plaintiff rather than the principal wrongdoer. For all these reasons, the Law Commission rejected the possibility of full proportional liability and concluded that "we regard the policy objections to joint and several liability to be at worst unproven and, at best, insufficiently convincing to merit a departure from the principle" (DTI, 1996, page 35).

Of course, the present legal position does not prevent auditing firms (or other professionals) from joining other parties or from taking action against other parties who may have contributed to any losses suffered by auditors/accountants.

Ernst & Young have issued writs against merchant bank Kleinwort Benson for £4.5 million over its role as professional adviser to Sound Diffusion, a failed leasing company in which Ernst & Young were involved as auditors and reporting accountants (Sunday Business, 5 May 1995, p. 4; Accountancy, June 1996, p. 16).

Coopers & Lybrand have sued two law firms over their involvement in Wallace Smith Trust, a failed investment bank (Accountancy Age, 26 June 1997, p. 1; 25 September 1997, p. 1).

In the UK, the Law Commission has advanced the concept of 'contributory negligence' which is a form of 'modified proportional liability'. (Law Commission, 1993). This permits auditors to defend

themselves by arguing that others (e.g. directors, bankers) contributed to their negligence and the damages suffered by the plaintiffs. "Contributory negligence is available in contractual actions where the contractual obligation is expressed in terms of a duty to take reasonable care and skill, and this coexists with a liability in the tort of negligence irrespective of the existence of the contract" Gwilliam, 1997, p. 121).

The principle of 'contributory negligence' is accepted by the UK courts. The House of Lords judgement in the case (not involving accountants) of *Banque Bruxelles Lambert S.A. v Eagle Star Insurance co. Ltd [1997] AC 191* (also see The Accountant, August 1996, p. 11) has established that a wrongdoer will be responsible for all of the consequences of his/her wrongful act, but only for those consequences attributable to the wrongful feature or characteristic of the act – that which made the act wrongful. Where liability arises for negligently providing inaccurate information, this means that liability will extend only to that information being inaccurate. The informed legal opinion is that the ruling "will act as a check on the range of losses which clients can claim from their professional advisers when things go wrong. ..... the House of Lords has moved significantly towards proportionality of responsibility for professional advisers" (Simmons and Simmons, 1996) A spokesperson for the ICAEW accepts that the ruling will have a "dramatic effect on limiting the consequences of negligence" (The Accountant, August 1996, p. 11). However, the ICAEW wants full proportional liability legislation and continues to press for the anti-consumer legislation.

THE 'CAP' DOES NOT FIT

Imagine hiring the services of professional person, such as a doctor, dentist or a pensions-broker, with the full expectation that s/he is a professional and competent person. Subsequently, it is discovered that the person was negligent and your life has been blighted. Your pensions and savings are wiped out. A reasonable principle of law is that the damages secured should have regard to the circumstances of the case and should be based upon the loss directly attributable to the alleged negligence. Yet the auditing industry does not believe in such principles. It says that regardless of the extent of damages suffered by the stakeholders, auditor liability should be 'capped'; with the 'cap' being a multiple of the audit fee. Such arrangements not only harm the public, but do not give the auditors any economic incentives to do good audits.

The accountancy trade associations want a 'capping' of auditor liability, because they claim that it would "provide auditors with some protection from Armageddon claims while giving plaintiffs a realistic view of what they can expect from the auditor" (Accountancy Age, 21 March 1996, page 1). The Law Commission also commented on this public policy option and concluded, "We can find no principled arguments for a 'capping' system (DTI, 1996, page 49). The main reasons for rejection were that it "cuts across a principle that a wrongdoer should compensate the plaintiff for loss caused by its tort or breach of contract ..... [and that it] would put the plaintiff at a disadvantage, since the cap would represent the upper limit in negotiations for a limit" (DTI, 1996, page 48).

Undeterred, the ICAEW (1996, page 11) continues to pursue its demand for 'capping', albeit in another guise. The industry is now seeking another reform to Section 310 of the Companies Act 1985 (also see below) which currently prohibits auditors from limiting liability in respect of statutory audits[21]. It wants such restrictions lifted to enable auditors to negotiate the limits on their liability with company directors. It gives them liability concessions, but no more obligations towards individual stakeholders (e.g. a duty to detect and report material fraud). For the reasons given by the Law Commission (DTI, 1996), the auditing industry's demands should not be conceded. There are also further public policy problems. Firstly, the present requirement for company audits is not a private contract in any sense. It is a statutory requirement and is not freely negotiated between auditors, directors, employees, pension scheme members, bank depositors, savers, shareholders, creditors and other stakeholders.

Secondly, audits have long been described as more than just for the "protection of shareholders and investors, wholly or even mainly" (Hansard, 21 February 1928, col. 1523). They have been considered to be for the benefit of "the public" (Parliamentary Debates, House of Lords, 18 February 1947, col. 745) and for the benefit of "shareholders, employees, creditors, potential investors, financial writers and the public as a whole" (Hansard, 14 February 1967, col. 360). As company directors are not appointed by employees, creditors, pensions scheme members, bank depositors or other stakeholders, they have no mandate to negotiate on behalf of a variety of stakeholders whose interests may well be in conflict.

Thirdly, the contractual limit cannot easily be fixed as the impact of a

company's activities on society and stakeholders is constantly changing. One can imagine a situation where auditors, Robert Maxwell and BCCI directors can sit around a table granting concessions to each other. But when the business collapses and questions are asked about auditor responsibility, the auditors are able to hide behind the liability limits. In the event of a scandal, any artificial limit would probably prove to be totally inadequate and the resulting shortfall would fall upon the rest of society. The auditing industry is demanding changes which have wealth transfer implications. Fourthly, with artificial limits on liability, auditors will have little economic incentive to perform good audits. The industry's proposals seek to disadvantage innocent plaintiffs. Under its proposals, a plaintiff may be able to win a case against a negligent auditor, but could then be unable to secure the damages that the circumstances warrant because an artificial limit had been imposed.

ADDITIONAL INSURANCE IS NOT THE ANSWER

The auditing industry is demanding revision of Section 310 of the Companies Act 1985 to enable companies to buy insurance for their officers (including the auditors). There are two aspects to this. Firstly, following lobbying from the auditing industry, Section 310 of the Companies Act 1985 was amended by Section 137 of the Companies Act 1989 (and welcomed by the ICAEW, press release dated 10 July 1989; Accountancy June 1994, page 25) to enable companies to buy insurance for its Directors and Officers (which includes auditors). Following the Companies Act 1989, a number of companies revised their constitutions to enable them to buy insurance for auditors. The enactment of these powers has drawn hostile public comments and hardly any company has bought insurance for its auditors. (Accountancy, June 1994, p. 25).

Instead of expecting companies to volunteer, the auditing industry now wants laws requiring compulsory insurance for Directors and Officers (D&O). The ICAEW chief executive explained that "if the law were to require the introduction of compulsory directors' and officers' insurance then the sum total of protection available to clients would remain unchanged, but would be moved towards those who in most situations of corporate failure are likely to have contributed most to the situation i.e. the directors and management. ..... if the proposals to reform S.310 were enacted, it is difficult to argue that the rights of shareholders would be diminished" (letter dated 14 February 1994).

The auditing industry wants to have its cake and eat it. Firstly, it claims that there is a liability problem because insurance cover is scarce. It then says that the solution is to buy more insurance. The industry's demands would force companies to incur costs not only for the traditional audit, but also for additional insurance. Yet there would be no additional benefit to companies or their stakeholders. The industry's proposals would also play havoc with public expenditure and taxation levels because officers of public bodies and local authorities would also be required to have additional insurance. Not surprisingly, the government is opposed to the principle of compulsory D&O insurance (Department of Environment, 1995, para 54). The industry's proposals would raise issues about deciding the appropriate level of cover. This would need to be sufficiently high to protect the innocent plaintiffs but, of course, this proposal also creates more 'deep pockets', the very thing it complained about in the first place (DTI, 1996, p. 38).

Regardless of the public consequences, the accountancy trade associations want the law changed even though one accounting litigation expert heading an ICAEW Committee has described it as "completely and utterly irrelevant to the majority, if not all, of the profession excluding the giant firms. ..... audit liability was a crisis for just six of the 9,330 English ICA-registered audit practices" (Accountancy Age, 28 April 1994, p.9).

To sum up, the auditing industry's demands have been evaluated by the Law Commission and rejected on the grounds that they are against the public interest. Yet the industry persists on pursuing anti-social policies

CHAPTER 7

THE JERSEY RANSOM

In the USA, the auditing industry elicited the support of friendly politicians, business allies, academics and journalists to advance its claims for liability concessions. It used its enormous resources to run television commercials. It lobbied to secure modified proportional liability and Limited Liability Partnership laws (Ashton, 1996; King and Schwartz, 1997; Goldwasser, 1997). Auditing firms then targeted the UK for the same treatment. Here, however, their strategy was different. The industry knew that following the Caparo judgement, the law already favoured the auditing industry. As a consequence the government might not be too inclined to give it even more concessions. So the masterstroke of the industry was to indulge in DIY legislation and ask Jersey to enact its wishes. This move was made at a time when the industry already enjoyed the right to trade through limited liability companies. At its behest Section 310 of the Companies Act 1985 had also been reformed (see above). Following the *Caparo* judgement it did not owe a 'duty of care' to current/potential individual shareholders, creditors, employees or any other stakeholder. It made its Jersey move at the very time when the Law Commission (DTI, 1996), at its request, was conducting a feasibility study on the possibility of replacing joint and several liability with full proportional liability.

Jersey, as part of the Channel Islands, is a British Crown dependency. Geographically, it is closer to France, but it is neither part of the UK nor a member of the European Union and is not subjected to any British and/or European Union laws. Under the constitutional arrangements, Jersey is supposed to be responsible for its internal matters and the UK is responsible for its external affairs though in a fast changing world such distinctions are often blurred. Though Jersey is a small island, a large number of multinational companies are based there in "brass plate" operations to avoid taxation in their host countries. Corporate laws in these Islands are relatively lax. Secrecy and lack of public accountability (de Smith and Brazier, 1994; The Register, Autumn 1993, pages 8-10; Stuart, 1996) facilitate covert dealings. As the New York Assistant District Attorney. John Moscow, who started the investigation which eventually led to the closure of BCCI noted, "My experience with both Jersey and Guernsey has been that it has not been possible for US law

enforcement to collect evidence and prosecute crime. In one case we tracked money from the Bahamas through Curacao, New York and London, but the paper trail stopped in Jersey ..... it is unseemly that these British dependencies should be acting as havens for transactions that would not even be protected by Swiss bank secrecy laws" (The Observer, 22 September 1996, page 19). Not surprisingly, the UK government has announced a "wide ranging review of the financial legislation and regulatory systems in Jersey, Guernsey and the Isle of Man" (Home Office Press Release, dated 20 January 1998). These are the places that major auditing firms are seeking to locate in.

Price Waterhouse and Ernst & Young, allegedly, spent more than a million pounds in preparing an initial draft of a Jersey LLP Bill. In this Bill (subsequently an Act), the major firms gave themselves virtually all the concessions they have been looking for - secrecy, limited liability and proportional liability. Under the registration conditions specified in the Act, only major accountancy firms could take advantage of LLPs in Jersey. The exact details of negotiations are a state secret but the Jersey establishment assured the firms that the Bill would simply "be nodded through" (Accountancy, September 1996, p. 29).

This Jersey LLP legislation abandoned the principle of 'joint and several liability' (Morris and Stevenson, 1997). Any partner not directly connected with a negligent audit or assignment is protected and the liability is instead attached to the LLP itself and individual partners who have been guilty of a negligent act or omission. The Bill contained no public accountability requirements although the eventual Act required firms to file names and addresses of each partner. There was not even a requirement for the firms to state on their letterheads and invoices that they were registered in Jersey. In particular Article 9(2) stated that "Subject to the partnership agreement, it shall not be necessary for a limited liability partnership to appoint an auditor or have its accounts audited". The Act contained no provisions for investigating errant auditors and offered no rights to audit stakeholders. It contained little, if any, provisions relating to the insolvency of the LLPs, but following considerable public disquiet, some moves were being made in December 1997.

After being given a so called 'fast track passage', the Jersey LLP Act received its Royal Assent on 19th November 1996 and came into force on

10th January 1997. To date, no major firm has relocated to Jersey. In practice, there are a number of difficulties inhibiting the firms from carrying out their threat of abandoning the UK in favour of Jersey (Sikka, 1996). There was never any possibility that the firms would sack all their UK staff, close their offices and re-open afresh in Jersey. To do so would have invited enormous complications with the UK employment, taxation and other laws. Their method of business would not have changed. They would have audited their normal audit clients with UK based staff from normal UK offices. To move to Jersey, the firms would need to renegotiate all contracts with existing clients and suppliers and persuade them that in the event of dispute, all matters would be resolved according to the Jersey laws. This is hardly a practical proposition as UK citizens want disputes heard according to UK laws. At best, the firms are more likely to set-up 'brass plate' operations whilst retaining their statutory monopolies and lucrative fees in the UK. To operate in the UK (regardless of the place of their domicile), the firms would need to be licensed by a UK regulator[22] and be subjected to its monitoring visits, on the same basis as that applicable to all other UK based auditing firms. As there is unlikely to be any real change in the trade by major firms, the UK courts may well decide that the Jersey move is a 'sham' deliberately designed to disadvantage creditors (Accountancy Age, 19 September 1996, p. 3).

The second major obstacle to any Jersey migration is taxation. The Inland Revenue has stated that the firms moving to Jersey will be taxed as limited liability companies rather than partnerships. This would require them to pay tax earlier rather than later and make deductibility of some expenses harder, possibly raising their tax bill by as much as 10% (Accountancy Age 29 May 1997, p. 1). The partners of Jersey based firms may also be liable to pay capital gains tax as they would be deemed to have dissolved a partnership, realising a large gain on their initial investment, and commenced a new corporate and overseas business. Major firms are contesting the Inland Revenue's interpretations of tax laws and are seeking a judicial review (Accountancy, July 1997, p. 17; February 1998, page 18). Yet even if the auditing industry secures a favourable judicial result, there is nothing to prevent the UK government from enacting primary legislation that could make it harder for the firms to migrate, or changing the terms of auditing licences in such a way that the desired social aims can be achieved.

The Jersey Bill, however, did what it was intended to do. It alarmed the

British government which promised legislation within a week (Financial Times, 28 June 1996, p. 22; 24 July 1996, p. 9). Eventually, the government gave in to the auditing industry and accepted that LLPs should be made available (DTI, 1997), though subject to "appropriate safeguards to protect interests of those doing business with the limited liability partnership" (Hansard, 7 November 1996, col. 700). A Bill is likely to be presented to Parliament in 1999. It is likely to require the firms trading as LLPs to publish audited financial information about their affairs. The government has also announced that to

"keep a level playing field with companies and partnerships registered in the UK, limited liability partnerships registered abroad but operating from a place of business in the UK will be required to file financial information equivalent to that to be required from limited liability partnerships registered in this country"

Source: Hansard, 7 November 1996, col. 700.

Unlike the Jersey version, the UK LLPs would make the firms subject to much of the company law. The UK proposals will also envisage tough 'insolvency' requirements for LLPs. In common with limited liability companies, the affairs of LLPs could be investigated, their partners could be made liable for wrongful trading and disqualified by specific legislation rather than by the whims of the accountancy trade associations. The UK version attaches substantial conditions to the LLP status. Major firms are not enthusiastic about this and Price Waterhouse has threatened to move to Delaware (Accountancy, August 1997, p. 11).

No major auditing firm has moved to Jersey though some continue to indicate their keenness to locate there (Financial Times, 25 September 1996, p. 11; Accountancy, November 1996, p. 19). Jersey has been used as a pawn to squeeze concessions from the UK government.

CHAPTER 8

CONCLUSIONS AND PROPOSALS FOR REFORMS

The auditing industry has got used to its public privileges. It enjoys statutory monopolies which generate billions of pounds of fees. Yet it complains about its liabilities. No one ever forced any firm to settle out of court, to accept a client it did not want, or to issue an audit report it did not want to. Firms happily collect fees. Any buyer of a packet of sweets or potato crisps is entitled to statutory rights and a 'duty of care' from the producer. Those suffering from poor audits have no such rights. Auditing firms do not owe a 'duty of care' to any current or potential shareholder, creditor, employee or any other stakeholder. This dilutes any economic incentive to improve the quality of audits. There is no case for exempting the auditing industry from the pressures faced by producers of other goods and services. Yet successive governments continue to indulge the auditing industry.

The only real defence against lawsuits is to improve the quality of audits. Instead the industry favours 'passive' audits that minimise audit effort (Sikka, 1992; APB, 1994b). It has no independent regulator who can enforce proper public interest measures. Instead of striving to minimise audit failures, the auditing industry demands ever more liability concessions. The industry's campaign is being lead by accountancy trade associations who, under the Companies Act 1989, are supposed to advance and safeguard the interests of consumers. They have abdicated this responsibility. Through the financial press, the auditing industry has been making all kinds of claims about its liability claims. The evidence does not support its claims. Contrary to the industry's assertions, the firms are spending only 2.67% of their revenues on liability costs. Due to the legal and institutional stakeholders, most UK citizens are not even in a position to seek redress from negligent auditors. In its press campaigns, the industry draws attention to major lawsuits from BCCI, Maxwell and other failures. It fails to mention that in these and other episodes one accountancy firm is usually suing another. For the first time in British history, a business (auditing industry) has used its economic and political muscle to buy legislation in other places (e.g. Jersey) in a bid to hold Parliament to ransom. It is the shape of things to come. The auditing industry wants it all: secrecy, statutory monopolies, tax concessions and no public accountability.

The auditing industry has presented the debate in legalistic terms. In reality the debate is about the distribution of income, wealth, risks and accountability of a major multinational industry. Anything given to the auditing industry cannot easily be denied to engineers, doctors, dentists, surveyors, architects, manufacturers of food, drink and medicine. Any concessions to the auditing industry will set a precedent for a deluge of demands for anti-consumer legislation. The auditing industry goes for people's heart-strings by arguing that without liability concessions, major firms would be driven out of business. It is akin to someone producing cars which are faulty, refusing to improve the 'quality', refusing to owe a 'duty of care' to any individual and insisting that the public be forced to buy the product and then claim increased liability concessions. No one will ever accept such pleas. Yet the auditing industry has been indulged.

In the past, the auditing industry has opposed modest proposals that required companies to publish financial statements. It has opposed any need for companies to publish replacement costs of assets, turnover, fees paid to auditors for non-audit work and any need for companies to have independently elected audit committees (Puxty et al, 1994). During the mid-1980s, the industry opposed government attempts to require auditors to detect/report material fraud to the regulators to financial sector regulators (Sikka et al, 1992). Even in the aftermath of the BCCI fraud, the ICAEW argued against the imposition of any statutory 'duty' upon auditors to report material fraud to the regulators. However, the government inquiry recommended that a "statutory duty should be imposed" (Bingham, 1992, page 189, para 3.45). The auditing industry has no credentials for being treated as a special case.

Rather than indulging the auditing industry, we advocate some alternative reforms:

1. **Independent regulation of the auditing industry:** To advance and defend the interests of a broader and more inclusive range of stakeholders, the auditing industry needs independent regulators (Mitchell and Sikka, 1996). Under the Companies Act 1989, accountancy trade associations act as public regulators. They have been unable to combine their trade association and public regulator role. As the liability debate shows, they have unashamedly sided with the 'producers' of audit reports. An independent regulator coupled with

greater rights for audit stakeholders has the potential to make auditors improve the quality of their work.

2. **A 'duty of care' to individual stakeholders:** The *Caparo* judgement needs to be reversed, by legislation. It has diluted economic incentives for good audits. Auditors should owe a 'duty of care' to all individual stakeholders (whether investors, employees, or creditors) of the business, at the date of the audit report. This does not open up auditors to liability to an indeterminate number of parties since the identities of the individuals can be known with reasonable certainty. Producers of mundane consumer goods have to owe a 'duty of care' to third parties. Why should the 'producers' of audit opinions be exempt?

3. **Rights for audit stakeholders:** Anyone buying any product is entitled to assume that the product is 'fit' for some purpose. Their rights are enshrined in legislation. Similar legislation should be enacted for audits.

4. **Class Actions:** The possibility of legal redress provides economic incentives, but ordinary stakeholders are not always in a position to sue negligent auditors. Ordinary individuals should be empowered by allowing them to bring 'class actions'.

5. **Public Sunlight:** The culture of secrecy surrounding the auditing industry does not permit public scrutiny of its workings. Individual stakeholders and/or their nominees should have a right to examine audit files and ask questions about the conduct of audits. What do audit files contain that those hiring auditors are not allowed to see?

6. **Develop alternative public policies:** Much of the liability debate has taken place on the agenda and terms advanced by the auditing industry. It is like a government with non-existent opposition. To redress that imbalance, alternative perspectives should be developed. These need to have regard for the changing social, economic and political circumstances.

For example, the 1980s and 1990s are characterised by a major shift (in the Western world) from industrial capitalism to finance capitalism where money itself has become a commodity. Due to technological developments, money can easily roam the world. Rather than directly investing in the production of goods and services, corporations make

money by placing clever bets on interest rate movements, exchange rates, security prices, commodities and land speculation. Under such circumstances, traditional ex-post audits are of limited use. Not surprisingly, many of the major scandals and audit failures have occurred in the financial sector (BCCI, Savings & Loan, Levitt, Barlow Clowes, Wallace Smith, Barings, Dunsdale).

These socio-economic changes call for the development of real-time audits. Faced with the changing social context, auditors have sought refuge in the traditional 'duty of confidentiality' to client. This prioritising of the 'private' interest over the 'public' interest has hurt numerous bank depositors, pension scheme members and other stakeholders. Clearly new institutional and legal practices are required. These could include the performance of audits by the staff of the regulators. Taxation authorities are already empowered to conduct independent audits of specific aspects of business. There is no reason why this jurisdiction should not be extended. The employees of the regulators, such as the Financial Services Agency, could conduct audits. Unlike the BCCI auditors, they would not easily be able to hide behind the veil of 'confidentiality' and refuse to co-operate with regulators (Kerry and Brown, chapter 10). Neither shall they be able to act as consultants to the audit clients and acquire a vested business interest. Such policy proposals may also be welcomed by the auditing industry since they might encourage it to vacate troublesome auditing arenas.

7. **Dilute the statutory monopoly of external auditing:** Subject to safeguards, it does not matter who conducts audit or forces corporations to be accountable. Therefore, there is no reason why the auditing industry should continue to be confined to current providers. The auditing industry could be restructured and opened up to competition by inviting other players to enter the auditing market. After all, the auditing industry routinely enters other markets and sells financial services and consultancy. It could hardly object if other suppliers wished to enter its traditional jurisdictions.

CHAPTER 9

THE ACTION TO TAKE

Anyone concerned with safeguarding their pensions, savings and investment could do the following:

1. Write to the company auditors, let them know that you are making or have made honest investment on the basis of audited accounts.

2. Every time you vote on an auditor appointment or remuneration make it clear that as an individual you are doing so upon the understanding that the auditor owes a 'duty of care' to you.

3. Remind company directors of the *Caparo* judgement and ask them to explain what safeguards the company audit offers you. Do not, under any circumstances, agree to a 'cap' on auditor liability.

4. Ask questions at the annual general meeting, and require auditors to explain why they do not owe a 'duty of care' to individual stakeholders.

5. Form pressure groups with like-minded individuals and continue to ask questions.

6. Write to your MP and Ministers at the Department of Trade and Industry (DTI). Ask them to explain why an individual who is owed a 'duty of care' when buying mundane things like sweets and crisps is not owed a 'duty of care' by auditors.

7. Ask MPs and Ministers why you should invest your earnings and savings in company securities (e.g. to provide pensions) when the law does not provide you with adequate safeguards.

8. Remind MPs and Ministers of the iniquities of the present state of affairs. For example, following pressures from the auditing industry, the government has granted auditors a right to trade as limited liability companies, Section 310 of the Companies Act 1985 has been modified, Limited Liability Partnership (LLP) laws are being proposed and the government has asked the Law Commission and other bodies to

investigate audit firm demands. In contrast, nothing has been done to meet the demands of audit stakeholders.

9. Urge MPs and Ministers to introduce legislation to reverse the *Caparo* judgement.

10. Examine audit firm manuals (e.g. Coopers & Lybrand, 1984), publications by the Accounting Standards Board and the Auditing Practices Board. Note whether they run contrary to the judgement delivered by the *Caparo* Law Lords. Use any such material to assert your rights against auditors.

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Notes

[1]The UK has six major accountancy bodies. These are the Institute of Chartered Accountants in England & Wales (ICAEW), the Association of Chartered Certified Accountants (ACCA), the Institute of Chartered Accountants of Scotland (ICAS) and the Institute of Chartered Accountants in Ireland (ICAI), the Chartered Institute of Management Accountants (CIMA) and the Chartered Institute of Public Finance & Accountancy (CIPFA). Members of the ICAEW, ACCA, ICAS, ICAI enjoy the statutory monopoly of external audits (Sikka, 1997).

[2]Dormant and most small companies up to a turnover of £350,000 per annum are exempt from audits.

[3]The membership of the ACCA increased by 14.2% during 1997.

[4]Michael Lickiss was the 1990-91 President of the ICAEW.

[5]The ICAEW s estimated to have an annual PR budget of £500,000 (Accountancy, September 1997, p. 26). Major auditing firms have millions of pounds at their disposal.

[6]Price Waterhouse partner and Chairman of the ICAEW's Liability Steering Group (press release dated 25 October 1993).

[7]In the UK, company directors can be held personally liable for the debts of a company which has traded whilst known to be insolvent.

[8]This, the industry alleges, would lead to increase in audit costs, less competition and choice. In reality, auditor choice has been reduced by firm mergers.

[9]Almost everyone's car and household insurance costs have increased. This has not persuaded any person to campaign for liability concessions.

[10]New initiatives by insurance providers could save up to 20% of the cost of professional indemnity insurance (The Times, 7 August, 1997, p. 22).

[11]The House of Lords has extended the limit beyond the six years where relevant information has been deliberately concealed (Financial Times, 13 July 1995, p. 10).

[12]Instead, the accountancy bodies publish an annual report which provides overall statistical information.

[13]They took more than nine years to conclude disciplinary actions arising over the frauds at Barlow Clowes (Accountancy, March 1997, p. 13).

[14]Such a right has considerable support from company directors who wish to see greater public accountability of auditing firms (Accountancy, November 1996, p. 16).

[15] Some small audit firms have also chosen incorporation.

[16]Institutional investors are concerned that this will dilute the economic incentives for good audits. A major institutional investor has voted against KPMG's appointment as auditors for major companies (Financial Times, 5 September 1996, page 6).

[17]For tax purposes, it may be assumed that the current business (i.e. a partnership) has been dissolved. Assuming that the termination value of the business is greater than the original investment, a taxable capital gain may arise. However, the effect of such calculations may be mitigated as a number of 'reliefs' are available.

[18]Price Waterhouse's 1991 audit tender for the audit of Prudential Assurance was leaked to the press (Accountancy Age, 12 May 1994, page 1). In it, the firm offered a discount of £900,000 on the proposed audit fee of £2.3 million plus a write-off of £600,000 initial investment. The same document also stated that "Price Waterhouse has an acknowledged track record in constructive accounting solutions. ..... Our experience and expertise in financial reporting will enable us to contribute to your discussions on how best to present your results and balance sheet ....". In 1991, Price Waterhouse received only £400,000 from other services. In 1993 total fees paid to Price Waterhouse were £5.4 million; £3.7 million of this was for other services.

[19]An ICAEW backed working party could not find any evidence of lowballing (Accountancy, December 1995, page 11). Seemingly, it expected the firms to voluntarily own up to lowballing.

[20]There may also be economic reasons. In recent years, the auditing industry has been willing to go the House of Lords (UK's Supreme Court) to secure favourable judgements, as evidenced by the case of Caparo Industries plc v Dickman & Others [1990] 1 All ER HL 568.

[21]The practice of limiting liability for non-audit work has become common. In recent years, major firms have banded together (like a cartel) and have set identical limits on their liability (Daily Telegraph, 24 January 1997, page 24). At the time of writing, such issues were being examined by the Office of Fair Trading (OFT), a body responsible for overseeing fair competition.

[22]Confirmed by the Minister for Corporate and Affairs, letter dated 9 December 1996.