

**COMPANY LAW
DIRECTOR AND AUDITOR LIABILITY**

**SUBMISSION TO
THE DEPARTMENT OF TRADE & INDUSTRY**

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**BY
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DIRECTOR AND AUDITOR LIABILITY

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DIRECTOR AND AUDITOR LIABILITY

1. EXECUTIVE SUMMARY

1.1. Director Responsibilities and Duty of Care

SPA believes that where any stakeholder in a company can prove they have suffered loss because a Director has acted dishonestly, fraudulently or negligently, then that Director has a duty of care to that Stakeholder for the loss sustained.

A Director's culpability and contribution for losses so sustained should be left to the courts to determine.

SPA suggests that, to enable Duty of Care to be appropriately and effectively policed, specific changes to the current Director responsibilities and relationships should be introduced. Without such changes it remains probable rather than possible that the enormous and far reaching commercial disasters caused by inappropriate or illegal Director action will continue.

1.2. Auditor Responsibilities and Duty of Care

SPA believes that where any stakeholder in a company can prove they have suffered loss because an Auditor has acted dishonestly, fraudulently or negligently, then that Auditor has a duty of care to that Stakeholder for the loss sustained.

An Auditor's culpability and contribution for losses so sustained should be left to the courts to determine.

SPA suggests that Auditors, whether internal or external, may not be seen to be truly independent if they are appointed by and answer to the Chief Executive Officer or

engagement, the quality of their work may be questionable and their effectiveness limited.

1.3. Supervisory Boards in Plcs

The Cadbury Report sought to establish best corporate practice through the establishment of a Supervisory Board for Plcs. SPA believes it should be a pre-requisite for a Plc wishing to obtain a quotation for its shares that a Supervisory Board be in place. Without a properly structured Supervisory Board a Chairman or CEO may overpower his subordinates as has been demonstrated too often in recent years.

1.4. Specific Questions Posed on Director and Auditor Liability

SPA's belief is that Directors or External Auditors may be liable to a range of stakeholders where they do not act in good faith, honestly or professionally.

1.5 Methodology

This submission was compiled from discussions within SPA's Steering Committee under the guidance of the Chairman. The responses to the specific questions posed by the DTI in their Consultation Document are made in respect of Plcs where wide public interest exists, but do not consider them to be relevant or appropriate to small and medium sized enterprises.

2. BACKGROUND TO SPA

- 2.1.** SPA is a wholly independent society of small practitioners holding a qualification issued by a recognised professional accountancy institute. It was formed in early 1996 because of concerns with the perceived effectiveness, or not, of the ICAEW's support for such members. SPA's Constitution and Rules was amended in 2002 to admit practitioners from ICAI, ICAS, ACCA and CIMA. Currently there are in excess of 1,500 member practices.
- 2.2.** The Society's stated policy is to promote and improve the relationship between members and their Institutes by providing constructive criticism together with practical proposals for improvements. Further to provide commentary and proposals to other authorities influencing our practising environment.
- 2.3.** SPA's members work alongside the very many thousands of the small companies forming the nursery of our nation's economy, the vast majority of whom are now exempt from audit. Our members have many years' experience and a deep understanding of how such companies manage their affairs.
- 2.4.** Many of SPA's members served articles or similar with major accountancy firms involved with Plc audits, whilst others have served for several years in commercial managerial positions before returning to practice, and between them can draw on a very substantial experience of both professional and business activities.
- 2.5.** SPA has made submissions to the ICAEW and government bodies affecting its members' working environment, and in particular to the DTI, Company Law Reform Committee, Accounting Standards Board and Auditing Practices Board

3. COMMENTARIES

3.1. Director Responsibilities and Duty of Care

3.1.1 Within an Executive Board the Chairman and two other directors, being the Chief Executive Officer and the Financial Director, have special responsibilities:

- The Chairman or CEO sets the objectives, standards and management style for his board colleagues to follow
- The Finance Director is responsible for preparation of the statutory accounts and the maintenance of financial standards in compliance with best corporate practice. These responsibilities will involve the need for ongoing professional development or education

3.1.2 It follows that within any Plc it should be a professionally qualified accountant who is appointed to the role of Financial Director to ensure that a proper understanding of the accounting process is present and, in particular, to guide other members of the Board on issues such as income recognition and financial propriety.

3.1.3 If any of these Directors do not behave as expected, and cause losses through their dishonest, fraudulent or negligent actions, then it is reasonable they should be held responsible for such actions.

3.1.4 Additionally, any Chairman's or Executive Director's contract of engagement should provide for summary dismissal without further payment when they fail in such circumstances.

3.1.5 The DTI should pay particular heed to the replacement of Financial Directors in Plcs, as this may indicate tensions in the relationship with the Chairman or CEO that cover underlying concerns about financial practices.

3.2. Auditor Responsibilities and Duty of Care

3.2.1 It appears to SPA that failures in External Auditors' duty of care may have arisen because their independence of thought and action was pressurised by both their financial relationship, i.e. the total fee income obtained from their client, and because their appointment is by the Executive Board to whom they duly report. In the section at (3.3) SPA suggests how this relationship should improve if it were the Supervisory Board that were ultimately responsible for this activity.

3.2.2 Until such arrangements were to become obligatory SPA believes that External Auditors will have a duty of care to a range of stakeholders in the company where it can be proved they have failed to act professionally or on known information, i.e. do not qualify their reports to warn of financial irregularities. The only defence to such claims for professional failure would appear to be that reliance at the time was placed on information provided by the Directors that subsequently proved untrue or incorrect.

3.2.3 It is not SPA's belief that External Auditors should be the first to be sued by stakeholders as a soft target because they provide indemnity insurance, but that the order of claims should be against the company, then specific directors and/or the Auditors. External Auditors' culpability or contribution to losses incurred by a company's stakeholders should remain the remit of the Courts.

3.3. Supervisory Boards in Plc's

- 3.3.1 SPA maintains that a Supervisory Board, comprising non-executive directors and a non-executive chairman to whom the Chairman or CEO of the operating company will report, should be established for each Plc before requesting a quotation for its shares. It seems fundamental to the security of public funds and investment that effective checks and balances be in place.
- 3.3.2 Very relevant to this control mechanism is the role of both Internal and External Auditors, who should both be appointed by and answerable to the full Supervisory Board.
- 3.3.3 SPA suggests that executive directors should not be members of any Supervisory Board, but that they would be expected to attend such meetings routinely or on request.
- 3.3.4 It appears to SPA that a non-executive Supervisory Board may have a duty of care to a company's stakeholders for losses where they have acted dishonestly or fraudulently. We remain concerned about the possibilities of suing non-executive directors for negligence, where it seems the test should be set at a considerably higher level than that for executive directors. Culpability or contribution to losses so caused should be left to the courts to determine.
- 3.3.5 In SPA's view continuous Internal Audit is a greater need and a more effective deterrent than a fragmented external statutory audit. It seems essential that financial activity be monitored as it happens against laid down internal control arrangements and established financial policy, which might involve the Supervisory Board in reviewing certain levels of proposed action before commitment.
- 3.3.6 SPA suggests that Internal Audit should be recognised as an essential part of Corporate Governance answerable to a Supervisory Board. Statutory External Auditors' role should be to review Internal Control arrangements and Internal Audit

4. RESPONSES TO SPECIFIC QUESTIONS POSED

In the following replies SPA refers only to Public Limited Companies and has drawn on actual experience or knowledge of the members of its Steering Committee, however where there was no relevant experience or view available on certain questions then the response is shown as such.

Q1 Should investors in a company be able to claim against the directors and/or auditors? If so, on what basis and why?

R Yes, where it can be demonstrated that either directors or auditors have not acted in good faith, or have lied or acted fraudulently or negligently, and whose liability would be the original cost of the investment made.

Q2 Should potential investors in a company be able to claim against the directors and/or auditors? If so, on what basis and why?

R Yes, where it can be demonstrated that either directors or auditors have not acted in good faith, or have lied or acted fraudulently or negligently, and whose liability would be the original cost of the investment made.

Q3 Should an ability to claim in respect of a breach of duty of care in preparing accounts be extended to any other group? If so, who and why?

R Yes, where it can be demonstrated that either directors or auditors have not acted in good faith, or have lied or acted fraudulently or negligently, and whose liability would be the extent of the unpaid contractual arrangements with the company.

Q4 Should criteria be set by statute to determine whether an auditor owes a duty of care to a particular person?

Q5 Should any action seeking recompense for a loss be against the auditors, the directors, the company or some combination? Why?

R No, in the first instance it should be against the company, then specific directors, then the auditors.

Q6 (a) On what basis should any loss be assessed? For example, should liability be limited to the difference between the value of shares as at the date of purchase and the value they might have had if the audit had been correct? Or should it be the loss suffered?

R For shares it should be the historical cost of investment. In other instances it might be unpaid contractual sums or actual historical loss suffered.

Q6(b) Is this a matter for legislation, or is it for the courts to determine in any particular case?

R For the courts to determine.

Q7(a) What would be the implications of any overall limit of liability for the rights and obligations of third parties to each other? For example, would the first person who claims have to share any recompense with the last person to claim?

R Yes, any money received should be distributed in the same order of priority as in a winding up.

Q7(b) If the company brings an action, does that rule out claims by others?

R No

O8 If the auditors' duty of care were to be extended should the extension apply

knows (or ought to have known) about the company? For example, in addition to the annual Report & Accounts, a bank or fund manager is likely to have access to a wide range of relevant research materials that might be used in support of an investment decision. In contrast a private investor might only have access to the historical Report & Accounts.

R Yes, equally to all those who have suffered loss.

Q9 If the auditors' duty of care were to be extended, what would be the most effective way of preventing abusive actions (for example, seeking to recover losses from bad investment decisions)?

R Proof must be demonstrated that the claim satisfies the conditions set out in the responses (1) to (3) above.

Q10 The directors are responsible for the contents of the company's Report & Accounts. Do you think therefore that any extension of the auditors' duty of care should be matched by an equal extension of the directors' duty of care in relation to the accounts? What would be the consequences?

R Yes, but probably to Financial Directors, Chairmen and Chief Executive Officers only as other Directors do not generally have the same technical competence or authority.

Q11 Is there evidence that the cost of Directors' and Officers' (D&O) liability insurance is increasing in real terms and that coverage is becoming less comprehensive? If there is, is this a fair reflection of the market pricing in increased risk?

R No relevant experience or knowledge available.

Q12 The Combined code has been amended to refer to the need for companies to arrange appropriate insurance cover in respect of legal action against

should be provided for directors. Is there need for more to be done? If so what?

R No relevant experience or knowledge available

Q13 Is there evidence that suggests that issues relating to potential liability are affecting the recruitment of able non-executive directors?

R No relevant experience or knowledge available.

Q14 Might it be appropriate to permit companies to indemnify non-executive directors even in circumstances where this is not considered appropriate in respect of executive directors? If so, in what circumstances?

R No, non-executive directors should not be held liable for actions of executive directors unless their actions satisfy the conditions set out in the responses (1) to (3) above.

Q15 To what extent is the length of court proceedings adding to the concern of directors about their potential liabilities?

R No relevant experience or knowledge available.

Q16 Does section 727 currently allow the courts sufficient scope to grant relief at an interim stage?

R No relevant experience or knowledge available.

Q17 Which of the three main options for reform of director's liability should the Government adopt?

R Option B – Implementation of the CLR'S recommendations.

Q18 In relation to the CLR's ideas:

- (a) Are there particular aspects of the CLR's recommendations that you believe are either especially important or that should not be pursued?**

R No.

- (b) Do you support the recommendation by Derek Higgs that a company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself without trying to establish in advance the prospects of success of the case?**

R No, Executive Directors are paid to act in good faith and should be liable to the company only for any personal gains made as a result of their improper or illegal acts.

Q19 In relation to the US model:

- (a) is there a case for the introduction of a statutory business judgement rule?**

R Yes.

- (b) should any other of the US provisions be considered further? If so, should they be subject to shareholder approval?**

R No

- (c) should any such shareholder approval need to be renewed (for example, every year or every 5 years), and should the same requirement in respect of shareholder approval apply to all types of company?**

R No

Q20(a) Do you see substantive barriers to entry to, and expansion within, the audit market? If so , what are they?

R No relevant experience or knowledge available.

Q21 Is the only way to maintain competition to legislate (such as through reform of section 310 of the Companies Act 1985), or are there other options that can be pursued? If the latter, please describe them.

R No relevant experience or knowledge available.

Q22(a) Can you provide any evidence as to whether the prohibition on limitation of liability set out in section 310 is interfering in the proper operation of the market?

R No relevant experience or knowledge available.

Q23 What evidence is there that appropriate levels of insurance cover at competitive prices are increasingly difficult to obtain?

R No relevant experience or knowledge available.

Q24 How is the current law on liability affecting recruitment to the profession and retention of appropriately qualified individuals?

R No relevant experience or knowledge available.

Q25(a) Are you aware of, or do you anticipate, a trend towards defensive auditing?

R No relevant experience or knowledge available.

Q26 Given that no audit firm has yet collapsed as a result of a claim successfully made against it in the UK, how real is that threat to the largest firms?

R No relevant experience or knowledge available.

Q27 Would you favour minimal law reform? Why?

R No, see Commentaries at Section 3 of this submission.

Q28 Would you favour simply allowing auditors to limit their liability contractually? Why?

R No, External Auditors are aware of the reliance placed on accounts they certify, and if they fail to satisfy the test outlined at R(1) above then they may be liable for loss caused.

Q29 Do you favour allowing auditors to limit their liability contractually, subject to rules made by the Secretary of State? Why? If so, what should be the basis of the rules made by the Secretary of State.

R No, External Auditors are aware of the reliance placed on accounts they certify, and if they fail to satisfy the test outlined at R(1) above then they may be liable for loss caused.

Q30 Is the existing law on contributory fault and contribution adequate or is specific provision required to deal with these issues? If so, what?

R No relevant experience or knowledge available

Q31 What arrangements would you like to see for disclosure and/or shareholder consent? Why?

R None, we do not feel that such arrangements are safe or required.