Sir Adrian.
CAD-01201

RECORD OF MEETING WITH MR JAMES LEEK, DIRECTOR OF CAPARO INDUSTRIES PLC, ON 1 OCTOBER 1991

Present:

James Leek
Sir Adrian Cadbury
Nigel Peace

Mr Leek made the following preliminary points:

a) Fidelity's case against the auditors had yet to come to court but would do so eventually. Fidelity still existed, albeit under a different name. It would be more difficult for the company to prove losses than for the shareholders, but it would attempt to do so. It would argue that if it had been given timely warning by the auditors about the fraud, it would have been able to remove those involved and take appropriate steps to minimise its losses. Any damages however were likely to be inadequate because the losses demonstrated for the company would be less than the amount by which Caparo had overvalued the company's shares when it acquired them, because of the multiplier effect of earnings on the share price.

b) the Government was standing firm on the line that the judgement did not change the company's ability to sue the auditors under contract law - as evidenced by the press notice attached.

c) outside the profession and government, however, there was a lot of opinion in favour of reform. For instance, Richard Fleck of Herbert Smith who had spoken after his presentation on 17 April 1991 had favoured change, although he was also in favour of capping liability.

d) Professor Likierman's report 'Professional Liability - Report of the Study Teams' contained a lot of valuable analysis. He (Mr Leek) accepted the report's conclusion that the general law in relation to joint and several liability needed to be tackled before auditors' duty of care was extended.

2 Mr Leek then discussed his five proposals for reform (set out in the extract from his presentation of 17 April 1991 attached):

i) auditors should be made liable for their negligence to accounts users who suffered loss. It was anomalous that under the Companies Act and Financial Services Act auditors should be liable for their reports appearing in a prospectus, but not for their reports appearing in normal annual accounts. He understood the legal explanation (that prospectuses were addressed specifically to subscribing shareholders), but this ignored the fact that far more people bought and sold shares on the basis of annual accounts than on the basis of prospectuses. Asked exactly where the new line should be drawn if the duty of care was to be redefined, Mr Leek he said this was a matter for the Committee to decide. He was not against capping and the joint and several liability point needed to be dealt with by statutory change. However to view the purpose of annual accounts solely within the stewardship context was no longer adequate.

ii) auditors should have a better form of defence against their increased liability exposure. He believed that more use should be made of qualified audit reports, which would provide much more of a defence. He appreciated however that auditors who gave qualified reports risked being fired the following year. Sir Adrian commented that he would in fact judge it difficult for a company to remove the auditor in such situations. Mr Peace said that there were three ways in which audit reports could be extended - by qualifying them; by explaining the respective duties of the directors and auditors; and by commenting on any particularly significant aspects of the company's accounts. The APB were examining the last two possibilities.

iii) auditors should make their Management Letters available to shareholders on request. Shareholders currently had no access to a professional view on the company's accounting and control deficiencies in a contested takeover. He noted that Brian Jenkins appeared to support his proposal (press article attached).

iv) the relationship between auditors and their clients should be made less cosy, and there should be a better mechanism for shareholders' involvement in the appointment and selection of auditors. As a minimum, audit partners might be required to rotate. He had no objection to the

concept of Audit Committees although in a small public company he did not have experience of them. He questioned their likely interest in the selection of the auditor and thought that shareholders should be involved in a specific committee for this purpose. Sir Adrian said that the problem would be finding shareholder representatives. A better alternative would be for the Audit Committee to report (through the Board) to the shareholders every few years on the internal and external audit situation. Mr Leek said that he was generally in favour of finding ways of involving shareholders more, and that it was as important to be open on the appointment of auditors as it was on the appointment of directors.

v) there should be an independent review body to hear cases of auditors' negligence, once it had been established by the court that the auditor owed a duty of care to the plaintiff. There was similarly room for making disciplinary procedures within the profession less slow and cumbersome.

3 Mr Leek concluded that he regarded it as highly unsatisfactory that the only remedy for a company in Caparo's position (ie a successful bidder that was misled by audited accounts in a contested takeover) was the one now being pursued.

NDP
8.10.91

It is interesting to note the difference between bankers (few in number, cohesive and very powerful), who have been able to get together with the accountancy profession and make some sense of Caparo -- and institutional investors -- widespread and divergent -- who do not yet appear to have got their act together as accounts users.

I recently asked four different investment management firms how the Caparo case had affected their use of and reliance on audited accounts. My heart sank when three of them did not seem to know what I was talking about -- but the fourth one -- a very important UK investment manager -- actually took the trouble to write back to me, and I think it's instructive to quote you their views verbatim:

> "As shareholders and potential investors in many companies, we continue to regard Annual Reports and Accounts as very important documents. We believe that the information contained therein should be of high quality. We were, therefore, surprised by the Caparo Industries v Dickman and others judgement, and we believe that audited accounts should give an accurate description of a company's financial position. In this context, 'true and fair' should mean what it purports to represent! It is difficult to see how this can be achieved in a meaningful way if company auditors do not recognise their duty of care to all users of the accounts."

4. Finally we get to the point where the victim speaks. I would now like to present you with Caparo's five proposals for reform:

Firstly: we believe auditors should be made liable for their negligence to accounts users who suffer loss. Since the House of Lords judgement so severely restricts their duty of care, it will require a legislative change. It is an anomaly that the Companies Acts and the Financial Services Act make auditors (and other professionals) liable for their reports appearing in a prospectus (for example on a rights issue or a new isue of shares), but not for their reports appearing in normally published Annual Accounts. People do buy and sell shares based on accounts and not just as a result of subscribing under a prospectus.

Secondly: we believe auditors should have a better form of defence against their increased liability exposure. That defence is the abolition of the present three line "true and fair" audit report. It has become meaningless and leaves so much unsaid.

Instead, auditors should be encouraged to use qualified audit reports more frequently, where there is reasonable ground for discomfort on either the accuracy or presentation of the figures or of the accounting systems. At present, a qualified audit report is such a rarity and a stigma that both the company and the auditor try hard to avoid it, and undoubtedly undesirable compromise is involved in this process. If qualified audit reports become more acceptable, then investors would be better informed on the stewardship of their directors, and auditors might have a valid legal defence against liability claims.

Thirdly: Auditors should be encouraged to make available to shareholders, on request, a summary of their "Reports to Management". These comprise an auditor's statement of accounting and control deficiencies and its client's response to them. This would enable shareholders to judge the quality and standard of accounting and control in their company. Shareholders can of course also question directors at an AGM on these reports and should now consider doing so.

Fourthly: The relationship between auditors and their clients should be made less cosy. To reinforce the auditor's independence there should, for publicly quoted companies, be a limit on the number of years for which an auditor may be re-appointed, and the amount of fee income from services other than audit and taxation.
It would also be helpful to find a better mechanism for shareholders' involvement in the actual appointment and selection of auditors. At present they are merely a rubber stamp for the directors recommendation. It is rather like asking the accused man to nominate his own judge and jury.

Fifthly and last of all, there should be an independent review body to hear cases of auditors' negligence.

The law is a blunt, unpredictable and expensive instrument in both time and money. There may be cases where a duty of care under revised legislation is established, but one or other of the parties cannot afford the costs and risks of a legal hearing to establish negligence and assess damages. There should therefore be an independent body drawn from the profession, industry and accounts users, who, by agreement between the parties, could rule in timely fashion on claim of auditors' negligence .

File

(1)

dti

press notice

NOT FOR USE BEFORE 19.00 HRS, 8 OCTOBER, 1990.

P/90/595

8 October 1990

THE AUDITING PROFESSION MUST TRY TO LIVE UP TO THE PUBLIC'S EXPECTATIONS SAYS JOHN REDWOOD

The public expects accountants to watch out for business fraud, John Redwood, Corporate Affairs Minister, said today.

Mr Redwood told the Joint Council Conference of the three Institutes of Chartered Accountants: "Company auditors will in future be required to register with supervisory bodies recognised by the DTI and responsible for ensuring that auditors meet good standards of professional skill and integrity.

"The Government will bring into force early next year Part II of the Companies Act 1989. We expect to receive applications soon from the three Institutes and other accountancy bodies that wish to be recognised for the new status of supervisory bodies.

"We intend to examine the applications rigorously to ensure that the new arrangements meet the stringent requirements of the Act. We shall be taking a particular interest in the applicants' plans for the new requirement to monitor the way auditors carry out their work.

"There have been worries that the judgment in the Caparo case means that auditors need no longer exercise their utmost care and skill in carrying out their work. I believe such concern is groundless. The judgment clarified those to whom auditors owe a legal duty of care. It does not prevent a company or a liquidator suing a negligent auditor or the shareholders as a body insisting that the directors do so.

ACCOUNTANCY COLUMN

Close relationships produce successful audits

By Brian Jenkins

ON APRIL 25 this column carried a series of proposals for change in the auditing regime suggested by Mr James Leek of Caparo Industries. Similar proposals have in recent months been put forward with renewed enthusiasm by various individuals, including Mr Austin Mitchell, the indefatigable Labour MP for Great Grimsby. If we are to improve auditing rather than run the risk of destroying much that is good, we must identify the real problems, their causes and the actions needed to address them.

There are three real issues.

- Companies occasionally fail soon after the publication of accounts that give no warning of impending disaster.
- Estimates and values reported in accounts are on occasion found to be badly wrong.
- Those suffering loss are sometimes frustrated by their inability to gain restitution.

The third complaint is different in nature from the other two; any allocation of loss is properly a matter for resolution by the courts.

We firmly believe that auditor independence, or rather a supposed lack of it, does not lie at the root of these ills. We are not aware of any cases in which the auditor of a public company has been found not to be acting independently of management. The strength of the UK accounting profession, its very high ethical standards, the independence and scepticism inculcated through the auditor's training – and awareness of the public need – ensure that concerns over independence are of no practical significance except in the rarest of cases.

We are not alone in that view. Successive commissions and congressional hearings in the US have considered and rejected precisely those proposals for change in the audit regime which are re-emerging from some quarters.

We must work together, however, to deal with the real troubles, which we identify as follows. First, and of most significance, there are difficulties in reflecting the realities of modern, complex and rapidly changing businesses in the snapshot provided by the annual report. Uncertainties over the ultimate outcome of unfinished business are often at the root of those handicaps.

There is rarely much to be gained by discovering fraud after the event

Some of the obstacles stem from limitations in the accounting process. The Accounting Standards Board is pursuing improvement vigorously. In particular, it is placing greater emphasis on the value of accounts for forward-looking decision makers.

Management and auditors need to work together in determining how best to portray the realities of complex businesses in the annual report. The auditor faces a challenge of needing to get a close knowledge of the business and the confidence of its senior management, while retaining independence of viewpoint. Distancing the auditors from the business and replacing them regularly would only increase the likelihood that they would fail to understand and spot any shortcomings.

There is a second, and far less common, problem: deliberate misrepresentation on the part of management. We cannot build an audit regime around the assumption that all management is crooked just to try to catch the tiny minority that is.

In the nature of management fraud, there is rarely much to be gained by discovering it after the event. The loss will have already been incurred.

What is required is to work with the corporate sector in developing a control environment that minimises the opportunities for fraud. Getting close to, but not cosy with, the company is the answer because the last thing the fraudster wants is someone of integrity getting close to his or her operations. Companies with a weak control environment are exposed to undue risk and the shareholders should be told.

So much for the general nature of the issues. What specific actions can be taken to respond? Two constructive proposals were made in the Dell report sponsored by Coopers & Lybrand Deloitte in 1987, entitled The Audit Judgment and its Communication.

First, in response to the need to give as much warning as possible of impending trouble, we recommended that the directors' report should contain a formal statement that the directors have reviewed properly prepared internal budgets and other relevant information, and are reasonably satisfied that the company will be able to continue in operation for the foreseeable future. The auditors should be required to review that statement and to report if they believe it to be unjustified.

Second, in order to ensure a control environment that minimises the risk of fraud, the directors and auditors could report on the adequacy of all the company's key financial information systems used in planning and managing the business. Care would be needed to establish a practical yet worthwhile regime. Developments on those lines are being pursued in the US.

The value of an audit is not dependent on who can sue to recover a loss

That leaves the third difficulty of those people who have suffered a loss and are seeking restitution. That is a different case because there is an important distinction between the confidence to rely on a good audit having been done and the ability to sue in the rare event that it has not. Auditors will continue to pursue the highest standards both because of the damage to their reputation if they do not and because it is open to the company to sue them for any negligence.

The question of who else may be able to sue auditors if they have also suffered loss should be considered and decided in the light of developments generally in civil law. It has long been established that it would be unreasonable to expose providers of services to negligence claims from anyone and everyone who may be able to argue that a loss could in part be traced back to faulty provision of that service. There must be boundaries, and those may change with time and circumstance, but the value of the audit is in no way dependent on who can sue to recover loss in the rare event of shortcomings in the provisions of that service.

I conclude that in facing up to the questions of inadequate accounts, far from distancing auditors from the company, we need a close working relationship between auditors and senior management.

In the vast majority of cases, both are seeking to improve reporting, and the accounts will be better for working together. In those few where management misrepresent, the auditors will discover that more easily the closer they are to the company's affairs. Professional auditors are specifically trained to handle such relationships properly and positively – the evidence shows that, overwhelmingly, they succeed.

Brian Jenkins is head of audit at Coopers & Lybrand Deloitte, the chartered accountants and management consultants.

ACCOUNTANCY APPOINTMENTS