

## LIABILITY OF AUDITORS AFTER THE CAPARO DECISION

Presentation by James Leek, FCA, Chief Executive of Caparo Group Ltd

to the London Practitioner Board, 17th April 1991

Madam Chairman, Ladies and Gentlemen,

It is with some trepidation that I thank you for asking me to address you today. I feel a little like Daniel in the lion's den. The Caparo case has rightly been a worry and concern to the accountancy profession, Caparo has conducted its claims publicly and vigorously both against the directors and the auditors of Fidelity, and here am I, coming to preach against you in the holy of holies of the accounting profession - Chartered Accountants Hall - and to tell you that there's something rotten in the state of Denmark.

I hope, however, that you will give a fair hearing to the five Caparo proposals I shall shortly put to you, and that I shall not be lynched before you have a chance to consider them.

When I asked Teresa Graham what was the price of tickets for tonight's meeting, I was astonished to learn that you had all got in free -- my seat has cost my company the best part of a million pounds in legal fees so far -- so whether you like my proposals or not you should be aware you are getting excellent value tonight.

I will divide my address into 3 parts: -

- firstly: a very brief history of the legal battles to date.
- secondly: a review of the positions which the accounting profession has adopted after Caparo.
- and finally: some thoughts on who should find a solution to the problems raised and what are Caparo's specific proposals.

1. Let me start by a very brief history of how and why we have spent the £million:

We discovered within a few weeks of acquiring Fidelity in November 1984 after a contested takeover that all was not well with the stock or the reported profitability level. Our enquiries led us to believe we were the victim of fraud by certain former directors, and negligence by the then auditors, Touche Ross. In July 1985 we issued a writ against the directors and Touche Ross jointly. Touche Ross subsequently announced the view that they did not owe any duty of care to Caparo, the acquiror of their audit client, Fidelity. The initial legal case thus became a hearing on this preliminary point of law.

We lost on this point in the High Court in early 1988, won in the court of appeal in July 1988, and then lost in the House of Lords in January 1990. The House of Lords judgement became the famous landmark case which gave rise to a range of different concerns for the accountancy profession, and for accounts users.

Subsequently to the House of Lords judgement our case alleging fraud against two former directors was decided in our favour in the High Court in February 1991. Damages in our favour are to be assessed later this year. In the meantime the directors have appealed against the judgement.

In March 1991, after the High Court agreed with our claim that we had been the victim of a significant fraud, our subsidiary company, Fidelity itself, issued a writ against Touche Ross. It is clear that the House of Lords judgement in no way prevents a company from taking legal action against its own auditors -- and the accountancy profession recognise and stands by this -- so Fidelity's case, when it eventually comes to trial, will seek to prove that its auditors were negligent and that Fidelity itself suffered significant losses as a result of its auditors' negligence.

Thus goes £1million in six years of legal battles -- and we haven't finished yet! You can be forgiven for thinking there must be a simpler and less costly way to deal with auditors' negligence, and I shall return to this later under Caparo's proposals.

2. I would now like to review the positions adopted by the accountancy profession after the House of Lords judgement.

Firstly I am disappointed that there has been no public statement of any significance from our own Institute yet. They have set up an auditing committee to examine the issues of the so called audit expectation gap, but the committee's terms of reference read rather like a PR protection exercise for our own profession, and in particular, there is no mention of the Caparo case itself.

Some firms or professional spokesmen have made statements such as "we always thought this was what the law meant -- what's all the fuss about". I believe this is the worst form of ostrich mentality, and say to them: do not be misled; Caparo is a landmark; the profession must respond and the law must change -- things will not be the same again.

Others say -- why do people always pick on the auditors -- the directors bear the prime responsibility and should be sued as vigorously as the auditors. Well we agree with that, and the history shows that we have gone for both parties.

One firm tried to make the comparison that people don't usually sue for an incorrect weather forecast, so why sue the auditors -- given the unreliability of UK weather forecasting, I found this a disturbing albeit amusing comparison.

Secondly, still on the topic of the profession's position post Caparo, many people talk of the expectation gap and what to do about it. The expectation gap has a lot to do with accounting standards and the presentation of accounting statements. In this connection I welcome the arrival of the new Accounting Standards Board, and what appears to be a new "get tough" policy. But there is an important distinction here: the expectation gap in the Caparo case was not about erudite matters of accounting presentation or judgement -- it was primarily about plain old fashioned fraud -- the invention by certain directors of stock which did not exist -- and we claim the auditors should have discovered this fraud.

Thirdly, I strongly believe that the ethics of a profession require it to stand up and answer for its work. It should not shelter behind, for example, two fairly fine legal distinctions saying either:

- a shareholder who loses money as a result of my negligent auditing cannot sue me, but the client company can

or

- you can sue me on a prospectus but not on a set of audited accounts.

These are in my view equivalent to the small print in a contract, and cannot be readily understood by accounts users.

3. Let me now turn to the question of who should find a solution and what are Caparo's own proposals.

In terms of who - I strongly believe consensus is needed between Government, the accountancy profession and accounts users on what reforms are needed.

- Government alone will do too little or too much. It presently opposes the EEC 5th Directive which seeks to make auditors liable to accounts users. I should, however, like to say that Mr John Redwood, the Minister for Corporate Affairs at the DTI, is taking an unusually detailed and concerned look at the issues. John Watts may shortly enlighten us on what the Government may actually do.
- The accounting profession on its own should not be allowed to reform itself.
- Accounts users should definitely have a major say
  - investment institutions
  - private shareholders
  - bankers as lenders
  - companies as suppliers, ie unsecured creditors.
  - companies active in acquisitions market.

At this point, having mentioned bankers, I would like to pay tribute to an excellent little booklet, just published by the Auditing Practices Committee of the CCAB, entitled "Reliance by Banks on Audited Financial Statements." It is in my view the first worthwhile attempt by the accounting profession to come to terms with the Caparo case, and gives to bankers, as important accounts users, some guidance on the general circumstances under which auditors might be responsible to them.

I was not, however, quite so delighted by a little tailnote item in this weeks Accountancy Age which refers to the "Curse of Caparo" and humourously suggests that Caparo has been responsible for the subsequent demise of both the Committee of London and Scottish Bankers, and the Auditing Practices Committee, both of which have been disbanded after publishing this new practice note. We may be tenacious -- but not quite so powerful as that suggests!

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 issue 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 .

In our own case it is a matter of great regret that it will be at least six years before our case against Touche Ross will have a hearing. This is no way to inspire confidence in a profession.

These then are the "Caparo Five" - five proposals which if adopted would, we believe, make the financial world a safer place for accounts users to live in. I thank you for listening to them, and do hope that some -- or maybe all of them -- will find your support.

Sir Adrian

Definitely worth reading, even though it did  
not go down at all well with Michael  
Gardner of KPMG!

Nigel  
4/7

**ICAEW ANNUAL CONFERENCE  
EASTBOURNE 25-27 JUNE 1992**

**CORPORATE GOVERNANCE AND THE AUDIT**

**BRANDON GOUGH  
CHAIRMAN, COOPERS & LYBRAND**



## **CORPORATE GOVERNANCE AND THE AUDIT**

### **Introduction**

The 1980's were a decade of unprecedented growth for practising firms, large and small. A whole series of developments at home and abroad combined to fuel a massive demand for accounting and consulting services. To outsiders it must have seemed like one continuous party.

But if the eighties were party time, the nineties feel distinctly like the hangover. Like many of our clients the practising firms are suffering the effects of the recession - although I have to admit that we are still better off than many other businesses. But the real headache is our core activity, auditing.

Auditing and auditors are under fire. It was not a total surprise. Every recession has brought audit into the spotlight as companies have failed and bull market optimism has evaporated. What is different this time, however, is the aggressive tone of the criticism in the press and elsewhere. We are being threatened with quarantining of audit from other services. We are told that we have surrendered our professional principles. We have found ourselves on the receiving end of writs.

All of us must be asking ourselves, what has gone wrong? Is our auditing really less effective than it was ten or twenty years ago? Are the techniques we use less good, our people less able? Have we possibly lost sight of our professional principles as we chase new business opportunities? To all these questions my answer is "no". Our entry standards are as high as ever, our partners and staff just as committed to professional standards. And yet there clearly is a problem which requires a response. The difficulty is that we have an inadequate understanding of the problem as perceived by outside commentators.

Like you, I care deeply about auditing. It meets a real public need. It is perhaps the one service that differentiates us from other business advisers. It is the hallmark of our professionalism. And at the personal level it is the activity to which I have devoted much of my professional career. I would like to restore the prestige and standing of audit. I won't claim to have all the answers but today I would like to highlight some of the reasons leading to the present situation. I would also like to propose a way forward.

## **Developments impacting the audit environment**

I suggest that there were five developments during the eighties that have a profound impact on auditing:

First, changing perceptions of the governance of companies and similar bodies:

Second, recognition of the need to respect the interests of a wide grouping of stakeholders in enterprises:

Third, an expectation of greater accountability to stakeholders:

Fourth, the globalisation of business activity.

Fifth, more aggression in seeking recompense for actual or perceived losses.

I will comment on each of these developments in turn because we have to understand their impact if we are to reposition auditing for the nineties.

## **Governance**

Let me start with Corporate Governance: the theme of this Conference and very much in the news because of the publication of the Cadbury Report. Never mind that the remit of the Cadbury Committee was rather narrow. The fact that corporate governance was addressed in such a way was a real breakthrough and I for one am delighted that our Institute was so actively involved.

I define governance as the direction and control of an enterprise. Much business activity is carried on by public companies. Those responsible for their direction and control are accountable to shareholders and other stakeholders in the business. In turn auditors provide independent confirmation of the fairness of the account that is rendered.

Audit activity is driven very much by the prevailing rules for corporate governance. During the eighties we became aware of growing dissatisfaction with some aspects of the governance process. Some companies seemed to be run for the benefit of the managers with little regard for the interests of other stakeholders, but short of a takeover it seemed impossible to do anything about it. Too often auditors took the blame, ignoring the fact that the auditors job was largely confined to reporting on the annual financial accounts. Commentators ignored the fact that it is the directors, not the auditors, who buy businesses they don't understand, or borrow imprudently or pay themselves too much. That's why the redefinition of the governance process is so important. Stakeholders will understand where the responsibility really lies and auditors will be able to report within a much clearer framework.

Looking into the nineties, the governance issue will extend far beyond the corporate sector. Privatisation is impacting on many services that have belonged for years in the public sector. Services like education and health are being restructured to raise efficiency and to introduce a stronger sense of accountability to consumers. I believe that auditors have a major role to play in ensuring that the right standards of reporting are established from the outset by our Schools, Universities and Hospital Trusts.

### **Stakeholders**

The subject of governance naturally leads on to stakeholders, the people who have a legitimate interest in the conduct of the company or enterprise. As accountants we are very much influenced by the rules for financial reporting and audit. Too easily we assume that reports are solely for the benefit of the shareholders in a company. We are not alone in that view. I'm surprised by the frequency with which directors say that their only obligation is to shareholders, not to other groups.

Whatever the law might say - and I suggest that the law is not entirely clear on the point - society now expects that enterprises will take a broad view of the stakeholders to whom they are accountable.

Enterprises are expected to recognise the interests of such groups as employees, customers and suppliers. On issues like environmental protection they should consider the public at large. If it is right that the enterprise has a responsibility to this group which is wider than shareholders, it follows that it should account for its performance in a way which meets the differing needs of its various stakeholders.

This is highly relevant to auditors. Much of the criticism of auditors has been to the effect that their present responsibility is too narrow, hence the excitement caused by Caparo. I suggest that the issue is less about audit and more about the accountability of the enterprise to its stakeholders. But of course the auditor can add a valuable level of assurance to such stakeholder reports as are made.

It is relevant to note in passing the rather exciting developments that are likely to result from implementation of the Citizens Charter. Local authorities will be required to publicise performance indicators and to have them audited. This is a highly relevant example of the way in which stakeholder interests are being recognised. I, for one, am pleased that auditors will be involved.

### **Accountability**

The publication of performance indicators is a very practical way of responding to pressure for more accountability. This pressure is quite widespread in its impact. There is a wide presumption of a right to information, rather than a right to privacy. The tendency is particularly marked in the United States, but we also see it in this country in the Press. Even the Institute has responded, with its review of openness.

There are two problems for auditors in this development. First, auditors are frequently blamed for failure to provide information when the provider should be the company. Critics often fail to appreciate that the auditor has only limited powers to compel publication of data not specifically required by law or accounting standards. Second, publication of more and more information can create a data blackout, distracting the reader from the main points and creating more opportunity for error.

Neither of these problems is insuperable. As accountants it is very much in our own interest that we should find ways of meeting the clear public expectation of more meaningful accountability by companies and other enterprises. And it is highly desirable that our audit should extend to these new forms of information and disclosure, rather than be confined to what could become an elitist set of formal financial statements.

### **International**

The fourth development I want to talk about is the impact of globalisation. We now take it for granted that companies of all sizes, not just the giants, will trade across borders and set up subsidiaries in other countries. Globalisation of trade is paralleled by globalisation of our securities markets, which has created a growing demand for harmonisation of financial reporting. The last year, for example, has seen a marked shift towards international financial reporting standards by the conservative Swiss Corporate sector, as Swiss companies have realised the benefits of trading their securities globally.

British auditors have long been international in outlook and activities. We are proud of our history of leadership in establishing international auditing standards. The growth in global financial reporting has now given fresh impetus to the need for a common international language of auditing. It would be a serious strategic error for the UK profession to ignore this opportunity.

But in addition, there are important practical reasons why we should press for international audit harmonisation. International scale companies need international scale audits. Differences in national audit practice make it more difficult to carry out a reliable and effective assignment on a cross border basis. Differences in scope will be misunderstood, audit effort will be misdirected, reports will be wrongly focused and the result will be customer dissatisfaction or worse. The international accounting firms have developed their own uniform practices and procedures to overcome these risks. It may now be time to give more formal recognition to this body of knowledge and experience when developing international audit standards.

## **Risk**

The last development I want to review is the much more aggressive way in which people who believe they have suffered loss try to pass the burden to someone else. Recently a distinguished public figure bemoaned the growing tendency for people to try to pass the blame to regulators for losses suffered in financial markets. While I agreed with his view that this is an abdication of personal responsibility for decisions taken in a free market I also thought "join the club". Because auditors are even more embattled than the regulators and our potential burden more onerous.

The United States in particular has seen an avalanche of mega settlements in the past two years and we have seen some big ones in this country, and elsewhere, too. In addition there have been numerous private settlements which are little more than green mail. The costs of even a successful defence, let alone the risks of failure, are now so high that firms are often tempted to pay up and have the problem go away.

You don't have to go into the details of every claim and settlement to know that the cost to practising firms is rising out of all proportion to the degree of culpability involved. None of us expects to get off scot-free when mistakes are made, but it doesn't make sense to "bet the firm" every time a partner signs an opinion. The public interest lies in a balance between fair penalties on the one hand and, on the other, encouragement to the professional to give his opinion in an independent and unconstrained way. That balance will disappear if the auditor liability situation deteriorates further.

## **Time to change**

The five developments I have outlined, embracing governance, stakeholders, accountability, globalisation and risk, amount to an audit environment in the nineties which will be very different from that of the seventies when many of our present attitudes were formed. I say the seventies rather than the eighties because, looking back, not much has changed in auditing during the last ten years.

More than ten years ago I was a founder member of the Auditing Practices Committee and eventually served as its Chairman. During the same period I headed up the audit development activity of my firm internationally. I have the impression that the audit agenda has not changed much since then, except that Bill Morrison is now creating a new and welcome sense of change within the Auditing Practices Board.

It seems to me that for once in our history we have been overtaken by events. The world in which we practice, and its expectations, have changed faster than perhaps we would have wished, but so it has for other enterprises. But unlike others we have been slow to adapt. We have become defensive and resisted change. The profession may now face the greatest challenge of its history if it is to retain its relevance and influence in society.

And yet there is much on the positive side of the equation. We have a history of successful innovation, particularly by individual firms. We have a higher level of individual skills than ever before. We have many practitioners who are deeply committed to audit and to the recovery of its prestige. Above all we have an opportunity because of Cadbury and the new agenda which it has created. We must not miss that opportunity, because it may not come again.

Cadbury has proposed a two year period after which the effectiveness of the proposed Code of Best Practice will be reviewed and, I hope, extended. I suggest that we should use that two year period to revisit the fundamentals of our audit activity and establish a vision for audit that will carry us through the nineties and beyond.

### **Manifesto for Change**

Let me start with a proposed vision statement for audit, a statement of what I would like audit to be. That vision should, of course, take account of the significant developments I have already outlined. We currently define audit in the following arid way:

"An audit is the independent examination of, and expression of an opinion on, the financial statements of an enterprise".

To get the debate going I suggest a vision statement for audit - not a definition - on the following lines:

"Audit is a necessary support to the system of governance of corporate and other enterprises, providing independent assurance to stakeholders that they have received a proper account of those activities of the enterprise that are relevant to the particular interests of the class of stakeholders concerned".

To take that vision forward I propose a manifesto of five issues which should be subject to a fundamental re-examination. The issues are: Stakeholders; Scope; Skills; Standards and Sanctions. I will elaborate on each in turn. I'm not going to provide all the answers; after all I have just suggested that a two year study is needed. But I will indicate the factors that need a fresh look.

### **Stakeholders**

I will start with stakeholders. Much of the criticism levelled at auditors stems from the fact that our formal reports are addressed to a restricted audience - in the case of companies their members. There are, of course, advantages to this. If the reporting class is defined in a limited way then the form of reporting can be more precisely tailored and the risk of mistakes can be better contained.

There are two offsetting disadvantages. First, discontent among a widening group of other stakeholders who feel that they are not receiving reports to which they are entitled from the company or enterprise. This is, of course, a reporting issue rather than an auditing issue. Second, lost opportunity. Auditors are failing to respond to a pent up demand for service which could provide valuable opportunities for firms willing to develop along new lines.

Of course expanding the class of stakeholders to whom we report presents many problems. First we have to identify which stakeholders will be involved. We then have to determine the kind of report they should receive. Only then can we address the specific audit issues including the scope of audit that is appropriate and the level of sanction which is fair in the event of audit failure.

I'm not suggesting that we should accept an open ended liability to all comers. I am suggesting that there is a role for auditors in such areas as company reports to employees; the local authority performance indicators required by the Citizens Charter; or environmental reports published by large enterprises. These new forms of report will happen. There will be a demand for independent verification. If we don't offer the service someone else will and we will then be on a slippery slope because we will have surrendered our almost unique independent attest role.

### Scope

Discussion of stakeholders leads on to consideration of the scope of our audit. Here again we are on contentious ground. We have tried to hold the line that the statutory company audit is limited to the financial statements. However in practice we have extended audit scope into the control area and this position has been formalised in such diverse areas as banking and local government. Frankly we are in a bit of a muddle on audit scope.

Back in 1985 when I last addressed this conference I identified four requirements of an audit so far as the public was concerned:

First, the certification of accounts.

Second, assurance of proper administration.

Third, assurance of fair stewardship.

Fourth, giving confidence that no hidden problems existed - the going concern issue.

In 1985 I made this analysis in order to identify possible opportunities for growth in the auditing profession. I concluded that we were not then meeting all of the expectations I identified. I said that there were considerable opportunities to expand the scope of our audit. We did not move forward. Now the Cadbury report has made similar suggestions and it becomes imperative that we produce a response.

However, this is only a first step. We need a change in mind set, away from trying to limit audit scope because of legitimate concerns about liability, towards a willingness to provide a wide scope of examination and report. This is a major challenge, because it demands a more generalised concept of audit examination than currently exists. It is a challenge that we have to tackle because some elements of even the wider scope I envisaged in 1985 could fall out of our control. Developments in information technology, for example, will alter the ground rules for obtaining assurance about internal controls. So scope expansion is a challenge, but it is a necessity not an option.

### **Skills**

The third subject for re-examination is the skill set needed by the auditor in the nineties. Much attention has already been given to skill enhancement at both the prequalification and post-qualification stages. I am aware also of the wide ranging review of education and training that is currently taking place. However, I would like to address the skill issue from a different angle.

I have thought for some time that a strong audit team could be constructed using multidisciplinary specialists in addition to chartered accountants. Think, for example, of a team which included:

- a manufacturing expert who could evaluate the inventory implications of the manufacturing process used by the client;
- an information technology expert who could review the control effectiveness of the client's systems;
- a financial analyst to deal with analytical review;
- a lawyer to cover legal compliance;
- an actuary to deal with pension fund issues.

It seems to me that our audit teams could be strengthened by introducing a broader range of skills than is currently general practice. And in fact the benefits have already been demonstrated in particular situations. I suggest, therefore, that rather than try to create a multi-skill capability in all individual chartered accountants, we should encourage multi-skill capability on a firmwide basis.

However, introducing more variety of staffing, in the context of broader scope and reporting responsibilities, would put much more onus on the audit team partner and manager. They would have to take a strategic view of the audit, particularly to handle the differing requirements of the various stakeholders. They would need broad business knowledge, team management skills, skills in communication. And of course, outstanding judgement. In short the team leaders would have to be audit experts, not generalists.



Taking these two thoughts together, there is an exciting opportunity to diversify our staffing, introducing more expert knowledge into our audit teams and reducing our dependence on an uncertain student market. There is also an opportunity to emphasise the role of the audit expert, perhaps by introducing a higher level of specialist membership earned through qualification. This would be a strong message of the commitment of this institute to audit practice.

### **Standards**

I want now to turn to standards, and to concentrate on ethical standards. I have been rather stung by the press allegations that we have surrendered our professional integrity in the pursuit of commercial gain. I don't believe it is true of my firm and I don't believe it is true for other firms either. Nevertheless, the mud is starting to stick and we have to develop a response.

A lot has been written about independence and the steps that might be taken to reinforce its perception. I am nervous about possible knee-jerk responses. We have to remind ourselves and others of two points. First, the need is not so much for independence in the abstract but for lack of bias in the opinions we give. Absolute independence is arguably impossible to achieve. Even if a company auditor were paid by someone else - perhaps the State - the fact that he would inevitably build a relationship with the people he audited could be said to be an impairment of independence.

My second point is about our history. Our British profession has always had a business advisory mission. We have been auditors for a long time but we have always offered other services in parallel, particularly taxation and general business counselling. We have a different history from our Continental counterparts and with respect I suggest that we have made a greater contribution to our national economy. Our multidisciplinary character is of real public interest and it must be taken into account when looking at the independence issue.

In summary, I suggest that we should take very seriously any suggestions that our professional integrity has been impaired. However, before reacting we should take more time to analyse and understand the situation, we should have regard to the public benefit of the wider services we provide and we should communicate very clearly why we act in the way we do.

### **Sanctions**

My last subject concerns the sanctions that should be exercised against individuals and firms who fail to discharge their responsibilities properly. The sanctions are of two kinds, those imposed by the regulator or professional body and those imposed by the Court.

Professional discipline has recently been reviewed by the Institute and I do not want to say much about it today. I will confine myself to one point, which is that the desire to show the public that wrongdoers are being punished should not be at the expense of the rights of the member in the dock.

I spoke earlier about professional liability for negligence. Let me repeat that an excessive burden is being placed on all professionals, not just auditors. It is encouraging to note the excellent progress being made on this issue in Australia and the emerging campaign for tort reform in the United States. We need to act in this country, too.

Reducing the threat of professional liability is crucial to taking forward the kind of developments I have outlined. I have indicated my enthusiasm for extending the scope of audit and for reporting to a wider group of stakeholders than is currently the case. But let me make it clear that I am contemplating an integrated package in which increased auditor responsibility is balanced by a more rational approach to risk and liability. There cannot be progress on scope without a deal on sanctions.

### **Conclusion**

Let me close by summarising the main points I have made in this address. Audit and auditors are under fire. My impression is that the criticisms arise, not so much from a decline in standards of performance, but because we have failed to recognise significant changes in the environment in which we operate. Those changes particularly relate to corporate governance, the needs of stakeholders, expectations of accountability, business globalisation and attitudes to risk and compensation.

Cadbury has given us the opportunity to respond and to re-establish the prestige of audit. We need to agree a vision for audit and we need to work on a manifesto for reform which is responsive to the environment of the nineties. My suggestion is that we should particularly address the five issues of stakeholders, scope, skills, standards and sanctions.

The bottom line is, do we have the will to make the changes that are necessary? I do, and I hope you do, too. In that case the only remaining question is, when can we start?

Brandon Gough  
June 1992