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Attention: Julian Rose
Financial Reporting Council
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July 31st 2006

Dear Sir

Expose Auditors as not being independent
[September 14 additions colored mauve]

This is a response to the Financial Reporting Council (FRC) “Discussion Paper: Choice in the UK Audit Market” of May 2006.

In response to your Question 1, I do not agree with that the focus of debate should be on the degree of choice in the market for audit services to large public companies.

This is because it is little use having an audit if it lacks quality, integrity and creditability in achieving the objectives specified in the Caparo Judgment of 1990. Indeed, the present system has such low quality, integrity and creditability one can argue that Audits should not be mandated by government as was the case in the US prior to the 1933 legislation creating the SEC.

At that time market forces created a demand for companies to have their financial statements audited and perhaps it might be better to allow markets for audit quality, integrity and creditability to develop by the government repealing the need for companies to have their financial statements audited?

Without an auditor, Directors could become exposed to even greater liabilities and so this could provide the incentive to appoint auditors who could share their exposure. It would serve them little protection to appoint an auditor who had their liabilities limited.

As a result market forces could be created for directors to obtain Financial Statement Insurance (FSI) to protect them from liability and provide investor confidence in their company. The proposal to introduce FIS is based on *the insurance company appointing the Auditor* as put forward by US scholars Ronen (2003) and Cunningham (2004) and compared with other alternatives by Shapiro (2004). The shortcomings of FIS for the UK that do not exist in the US are discussed in my article “‘How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles’ (Turnbull 2005).

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A less radical approach that is recommended is set out below:

Recommendation 1.

Eliminate the monopoly of auditing being carried out by accounting firms by allowing allows other professions and/or organizations to undertake audit work.

This could overcome the problem of there being only four firms to undertake the work. Investment banks, trading banks, insurance companies and specialized organizations could use their reputations and expertise to compete with the current big four firms for assessing the integrity of financial records and statements. They could engage small accounting firms to undertake the specialized accounting work and add value by organizing various independent small firms globally as required and through their own expertise in other areas like risk management, IT, and so on.

Audit committees are part of the problem not the solution

Implicit in your consultation paper is the acceptance of audit committees to engage the external auditor. The reason why auditors are required is because the law recognizes the possibility of directors “cooking the book”. In considering the role of the Auditor, Lord Bridge stated that “No doubt he is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them” (Caparo 1990: 11).

Auditors are appointed because the law accepts that directors can cook the books and so directors are treated like “the accused” in a law court. In a court of law it is assumed that the judge is independent of the accused. Justice cannot be done or can not be seen to be done if the Judge is engaged and remunerated by the accused. But this assumption of independence does fit the facts with directors who engage and remunerate the Auditor who judges them. It is then misleading and deceptive conduct for auditors to describe themselves as “independent” in the context of reporting to shareholders.

The whole rationale for appointing auditors is lost if the directors and their audit committee engages and remunerates the Auditor. The Auditor is approved by shareholders to report to THEM. Auditors cannot serve two masters, especially when the purpose of their appointment is to correct any distortions, biases, omissions or errors in providing, in the words of Lord Justice Oliver, “shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided” (Caparo 1990:16).

The appointment of so called “independent” directors to constitute an audit committee does not remove the conflict. If non executive directors wish to engage an external auditor to check management then they should appoint a different auditor to the one that reports to shareholders on the directors. The use of the shareholder auditor to check management creates a conflict of interest for the auditor serving two masters as pointed out above but also introduces a conflict of interest for the directors.

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Directors have a fiduciary duty to the company as whole. When they also get involved in engaging and remunerating the auditor approved by shareholders they take upon themselves the role of a fiduciary agent for the shareholders. Directors are then placed in the position of having a duty to two masters who could have conflicting interests. Directors are supposed to avoid putting themselves into a conflict of interest situation.

The encouragement by the Combined Code for directors to form Audit Committees to engage and remunerate the external auditor creates conflicts for both directors and the auditor. It not only negates the purpose for having an audit but results in reducing audit quality to the degree that the utility of mandating audits becomes highly questionable, especially when there are limited suppliers of the service.

The lack of audit quality can be explained by the experiments into power and authority by Professor Stanley Milgram (1975). Milgram showed how good people can do bad things like those in Nazi Germany or in a Baghdad prison, through the system of authority in which people are placed. Experiments by Bazerman, Loewenstein, and Moore, (2002) confirmed the Milgram experiments specifically for auditing. The reason why good auditors do bad work was explained in an earlier paper Bazerman, Morgan, and Loewenstein, (1997) who conducted the experiments to prove their point. The lesson of their findings is that to change audit quality one needs to change the power relationship of who controls the auditor.

My paper 'How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles' (Turnbull 2005) identifies how the problem arose as is summarized in its abstract that follow:

This paper considers how auditing practices became muddled in the US and the UK to create muddled corporate governance principles. The US 1933 law that required corporations to appoint an auditor was based on the prospectus provisions in the UK 1929 Companies Act to protect investors from fraud. However, this is not the purpose of UK statutory audits whose legal role is to protect the company and provide shareholders with intelligence for voting on the election and remuneration of directors whether or not the company issues shares or whether it has shares publicly traded. The UK statutory auditor only reports to the shareholders who approve his appointment. The US auditor is appointed by the directors and reports to both directors and shareholders to subrogate the reason for having an auditor to identify conflicts between them.

The establishment of an audit committee with independent directors cannot remove the conflicts. These are exacerbated by the Sarbanes-Oxley Act and the UK Combined Code that require audit committees to provide oversight of the auditor. Some European countries avoid these conflicts by having the auditor controlled by a shareholder committee or "watchdog board". Audit practices were muddled by corporations not establishing a shareholder audit committee as provided in the model constitution attached to the UK 1862 Companies Act. There are compelling arguments to conclude that convergence of audit practices on those found currently in the US or UK are not in the best interest of directors or auditors in reducing their

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conflicts or safeguarding investors, the proprietary rights of shareholders or self-governance.

As noted in the abstract some European jurisdictions avoid introducing conflicts of interests for the auditor and directors by having the auditor appointed by a shareholder panel. However, for a shareholder panel to be independent of any dominant shareholder it would need to be appointed by the minority shareholders as discussed in my paper.

Rather than specifying what should be done, I recommend that the FRC simply specifies what not should be done as recommended below:-

Recommendation 2:

No external auditor who is approved by shareholders should be allowed to describe themselves as being “independent” if they are engaged and remunerated by the directors whose accounts they audit.

This may require a change in the law to allow auditors who do not meet the test of being independent to carry out audit work. Shareholders would at least be warned by auditors stating that they were not independent. Market forces could then prevail upon companies to introduce arrangements to make auditors independent.

No change in the law is required for companies to appoint a shareholder panel to engage and remunerate auditors as explained in my articles quoted above.

The existing system is untenable as it is false and misleading conduct for auditors to claim independence when they are engaged and remunerated by the directors whose accounts they audit. Auditors are prostituting the English language by claiming to shareholders that they independent. Their claims are also not consistent with the empirical evidence provided by Milgram, and by Bazerman, Loewenstein, and Moore and the other authorities cited in my paper referred to above.

Its time to bite the bullet and admit that auditors cannot be independent with the current arrangements as specified in the Combined Code. Its time for the FRC to follow the example of the little boy who pointed out that the Emperor was wearing no cloths when every one else thought he was wearing clothes. **The FRC cannot remain party to misinformation. It should require corporations and/or Auditors to disclose in their reports to members that the meaning of the word “independent” in reference to Auditors needs to be qualified along the lines suggested in my article attached as an Appendix “How can auditors lie about being independent?”**

The FRC will fail its own philosophy of promoting a well informed market if it does not inform shareholders that auditors are not independent with the current arrangements. The FRC cannot afford to be party to the fraud being perpetuated on shareholders by auditors claiming to be independent.

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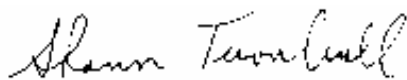
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Yours faithfully



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Principal

APPENDIX

How can Auditors lie about being independent?

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Posted on Henry Thornton web site at http://www.henrythornton.com/article.asp?article_id=4252
and Ethical Markets web site at <http://www.ethicalmarkets.com/EthicalMarketsAuditorLies.pdf>

Why do we accept that Auditors are “Independent”?

Have we been brain washed by the repeated statements in their audit reports that they are an “independent auditor”?

Is it because we do not dare to consider the possibility that the law, regulations, regulators, auditing standards, stock exchange rules, corporate governance codes and the professional code of conduct for accountants have got it wrong”?

Might we be proving the experiments of Professor Stanley Milgram¹ who showed how good people can do the wrong thing from “peer pressure and the power of authority”?

Have we been conditioned to believe that auditors are independent like the citizens of the apocryphal country where everyone believed that the Emperor was wearing clothes when he was not? Might it be possible that this situation exists today with the claim by auditors that they are “independent”?

Could it be that the usual meaning of the word “independent” has become lost in the thicket of convoluted words used to define “independence” in regards to Auditors in the law, regulations, auditing standards and professional codes of conduct? As a result Auditors are allowed to state that they are independent but in reality they are not when the commonly accepted meaning of the word is applied.

It is commonly accepted that a Judge in a court of law is independent of the accused. Indeed, many Judges will excuse themselves from presiding over a case if there is a perception that she may not be independent. This meaning and application of the concept of independence is so widely accepted and used in a court of law that there is no need to describe a Judge as “independent” in a way auditors are described.

Auditors are appointed to judge if the accounts prepared by the directors are true and fair. Any such judgment loses its integrity and creditability if the auditor is not independent of the

¹ Milgram, S. (2004). *Obedience to Authority: An Experimental View*. New York: HarperCollins. Refer also to ‘Lessons in depravity, peer pressure and the power of authority’ at <http://www.new-life.net/milgram.htm>

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directors whose accounts are being judged. However, it is the directors who engage and remunerate the Auditor that judges them. No Judge in a court of law would be considered independent if they were engaged and remunerated by the accused! To describe the auditor as independent in such a situation is simply a lie.

However, the law, regulations, regulators, auditing standards, stock exchange rules, corporate governance codes and the professional code of conduct for accountants have allowed this lie to become accepted. It shows how the law can be wrong.

What is to done when there is so much power and authority supporting such a brazen lie?

First the lie needs to be exposed in a way that does not excessively offend the sensibilities of the great and the good who have been party to accepting the deception. One way would be for regulators or professional standards to require the use of the word “independent” to be qualified in audit reports.

Another way would be for ethical directors who did not want to become party to the misleading and deceptive conduct of their Auditors to publish in their annual accounts the following explanation:

‘As the constitution of the company has not made provision for shareholders to appoint an audit committee to engage and remunerate the Auditor their report is prepared with a conflict of interest for the both the Auditor and ourselves. The conflict for the Auditor arises because we engage and remunerate the auditor appointed by shareholders to judge our accounts as true and fair. However, notwithstanding that the Auditor is not independently engaged and remunerated by the shareholders the auditor is allowed by law, regulations, the regulators, auditing standards and the professional code of ethics of accountants to be described as “independent”.’

‘Directors normally have a fiduciary duty to the company but in engaging the Auditor we also accepted the conflict of acting on behalf of shareholders as well as the company, both of whom can have different interests to ourselves. The need to appoint auditors arises because these different interests can affect how the accounts are prepared.’

Ideally, directors would get shareholders to amend the corporate constitution to establish a shareholder audit committee. No change in the law or qualification of the meaning of auditor independence would then be required. The need to expose the lie would be avoided.

However, the present situation can very much suit directors as it gives them the opportunity to negotiate with the auditor over their engagement and remuneration and so outcomes achieved. So exposing the lack of independence of Auditors may require the involvement of regulators and/or law makers. If the existing arrangements are not reformed then Auditors who described themselves as “independent” could be required to qualify their report to shareholders with the following words:

‘As the constitution of the company has not made provision for shareholders to appoint an audit committee to engage and remunerate our services this report is prepared with a conflict interest

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for the both us and the directors as we are engaged and remunerated by the directors whose accounts we have judged to be true and fair for shareholders. Notwithstanding that we are not engaged independently of the directors, as we would be with a shareholder committee, we are allowed by law, regulations, the regulators, auditing standards and our professional code of ethics to describe ourselves as “independent”.’

‘Directors normally have a fiduciary duty to the company but in engaging us they have also accepted the conflict of acting on behalf of shareholders as well as the company who can have different interests to that of its directors. The need to appoint auditors arises because these different interests can affect how the accounts are prepared.’

The problem in introducing any reform is that Company Directors and Auditors can be more effective than shareholders in lobbying regulators and Law Makers. In 1844, before such lobby groups formed the UK companies Act required that the remuneration of the Statutory Auditor be paid by the Government who were reimbursed by the company². The auditor had to be a shareholder but not necessarily an accountant. The 1845 Company Clauses Act allowed the shareholder to employ an accountant. A model company constitution attached to the Companies Act of 1862 made provision for shareholders to appoint an audit committee separately from the Directors as referred to in the suggested disclosure statements above.

The practice of shareholders establishing an audit committee to engage and remunerate the auditor is found in a number of continental European jurisdictions³. A practice suggested for the UK by: the UK Auditing Practices Board in 1992; Professor Hatherly⁴ a former Board member in 1995, and in 2004 by the National Association of Pension Funds⁵. In 2003 a former Audit partner of a one of the big four UK firms stated that: “There are two fundamental problems with independent audit. The first is that it isn’t independent at all...”⁶

As pointed out by US scholars⁷, “The impossibility of audit independence” is explicit in the US where it is the directors, not the shareholders/members who approve the Auditor appointment. Notwithstanding this difference, the UK Cadbury Report⁸ of 1992 recommended that Board audit committees developed in the US be adopted in the UK. This led Professor Hatherly to state

² O’Connor, S.M. (2004: 14), “Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence”, *Boston College Law Review*, Volume 45, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=587502

³ Turnbull, S. (2005: 64) ‘How US and UK Auditing Practices Became Muddled to Muddle Corporate Governance Principles’. *The ICAI Journal of Audit Practice*, Volume II, No. 3, pp. 49–68, (July), The Institute of Chartered Financial Analysts of India, Hyderabad, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=722385.

⁴ Hatherly, D. J. (1995: 541), “The case for the shareholder panel in the UK”, *The European Accounting Review*, 4:3, pp. 535–553.

⁵ *AccountancyAge* (2004), ‘NAPF urges Auditor shake-up, December 13, <http://www.accountancyage.com/news/1138949>.

⁶ Hayward, J. (2003), *Thinking not ticking: Bringing competition to the public interest audit*, Centre for the Study of Financial Innovation (CSFI), London.

⁷ Bazerman, M.H., Morgan, K.P. & Loewenstein, G.F. (1997), ‘The impossibility of auditor independence’, *Sloan Management Review*, Summer, Issue, 38:4.

⁸ FACG (1992:6), The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd. <http://www.ecgi.org/codes/documents/cadbury.pdf>

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that: “As a means of facilitating the current statutory role whereby the auditor is accountable to members, the audit committee is both conceptually unsound and practically difficult”⁹.

Not with standing that director audit committees exacerbate the conflicts they have been mandated by the Sarbanes-Oxley legislation¹⁰ in the US and in other jurisdictions and promoted by codes of so called “best practice” in the UK and elsewhere. Such arrangements remove the purpose of appointing auditors by making their engagement subject to the power of directors on whom they are supposed to blow the whistle. It does not make common sense; it is inconsistent with how humans behave in practice and has allowed major unexpected corporate failures¹¹.

There are numerous ways that accounting standards and principles can be interpreted. It is because of this and the power of directors to bias accounts that the law requires accounts to be audited. Experiments in the US have shown that Auditors can accept the biases desired by directors who engaged by them¹². These experiments were consistent with those of Professor Milgram in showing how good people can do bad things. It is only natural for the general public to believe that “Who pays the Auditors calls the tune”¹³.

The experiments also show that the problem cannot be solved by improved accounting standards, director audit committees, auditor rotation, and ever more convoluted definitions of auditor independence but by Auditors being engaged and remunerated by the shareholders they are appointed to serve¹⁴. The first step is to disclose how Auditors lie in stating that they are independent.

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⁹ Hatherly, D. J. (1995: 541), op. cit.

¹⁰ Romano, R. (2004), ‘The Sarbanes-Oxley Act and the Making of Quack Corporate Governance’ Yale ICF Working Paper No. 04-37; ECGI – Finance, http://papers.ssrn.com/paper.taf?abstract_id=596101.

¹¹ O’Connor, S.M. 2002, “The Inevitability of Enron and the Impossibility of ‘Auditor Independence’ Under the Current Audit System”, Washington University Law School Working paper, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=303181,

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¹³ Shapiro, A. (2004), ‘Who pays the auditor calls the tune?: Auditing regulation and clients’ incentives, Legal Studies Research Paper Series, paper No. 04-014, Cornell Law School, forthcoming *Seton Hall Law Review*, Vol. 30, June 2005, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587972.

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