Audit and
Assurance Faculty

AuditQuality@

Shareholder involvement – Auditor resignation statements

How can auditors' letters of resignation be made as transparent as possible? Consideration will be given to current law and developments with the draft European Directive on statutory audit of annual accounts and consolidated accounts.

AuditQuality@

Supporting shareholder involvement

The *Audit Quality Forum* brings together the audit profession, investors, business and regulators. Their purpose is to work together to generate policy proposals that will further enhance confidence in the independent audit by promoting transparency and accountability.

The Institute of Chartered Accountants in England and Wales, through the Audit and Assurance Faculty, convenes the *Audit Quality Forum*. The Institute initiated its *Audit Quality* programme in 2002 to drive thinking and practice in the field of audit and assurance. Alongside the Institute's *Information for Better Markets* campaign, the Forum is about working in the public interest to promote quality and confidence in corporate reporting.

The focus of the current agenda is to support shareholder involvement in the audit process. This is just the first stage. To quote from *Audit Quality*, 'Auditing is not a static discipline: committed professionals in any field strive for improvement and audit is no exception.'

There is more work to be done through the *Audit Quality Forum* to explore a broader agenda of issues relevant to the shareholder community.

Further information on the *Audit Quality Forum*, the current work programme and how to get involved is available at **www.icaew.co.uk/auditquality** or contact 020 7920 8493.

Anyone interested in providing feedback on this policy proposal may send comments to **louise.maslen@icaew.co.uk**.

The Audit and Assurance Faculty's publication, *Audit Quality*, identified client relationships, including the effective management of client portfolios and working with individual clients, as one of the key drivers of audit quality. Whilst auditors deal with the directors and management of the company on a day-to-day basis when carrying out their audit, their ultimate responsibility is to the shareholders. The client relationship needs to be managed effectively so that auditors can perform their audit and provide an independent opinion to the shareholders on the truth and fairness of the financial statements which have been prepared by the board.

The statutory audit is a means of addressing issues that arise from the agency relationship that exists between the shareholders and the board of directors. There are, however, perceived transparency issues for shareholders around the effectiveness of audit as a solution to agency problems, including the nature of shareholder involvement and the availability of choice in the audit market.

The *Audit Quality Forum*, launched in December 2004, identified four initial measures that may improve audit transparency and bring real benefits to shareholders as well as the longer-term issue of competition and choice. The Institute established working parties with representation from key stakeholders to take the matters forward and identify technical and practical issues for discussion at the *Audit Quality Forum* on 7 March 2005 and to report on how these matters may be taken forward to implementation.

This policy proposal considers how the information made available in audit resignation letters could be improved.

ISBN 1 84152 319 4

AuditQuality@

Shareholder involvement – Auditor resignation statements

Preface

In the light of shareholder concerns, this report sets out a policy proposal to improve transparency by disclosing more information in auditor resignation letters.

This proposal is part of a series of reports produced to enhance the statutory audit. The report was produced by a working party, details of which are included in Appendix 3. The proposal was considered by participants at the *Audit Quality Forum* on 7 March 2005. Broad consensus was reached on this proposal with the following matters being identified for further consideration:

> Auditors would still only report those matters which they consider are connected with their resignation. A question was raised as to whether this element of judgement should still be allowed. The working party had discussed this at some length but concluded that it was important that this judgement for auditors remained.

> It was suggested that all auditor changes should be published on the Regulatory News Service. The working party had considered this but believed that the reporting of changes in auditors would not necessarily constitute information to be published in this way.

> It was suggested that auditors should have a right to approach regulators in relation to the resignation, as in the banking sector. This issue was not considered by the working party.

The report has not been amended in respect of the above matters. It is being published so that the appropriate government and regulatory bodies can take such action as they consider appropriate in accordance with their own due process.

Contents

Executive summary

The *Audit Quality Forum* met in December 2004 and raised a number of issues around shareholder involvement. One of the concerns expressed by shareholders was that there was a perception that auditors were not providing information of value in their auditor resignation statements, leading to the possibility that shareholders are not being provided with critical information on the company/auditor relationship. These concerns were expressed in relation to the listed company sector only. The working party was set up to consider these issues and make recommendations to address concerns. Our recommendations are set out in this policy proposal.

Section 394 of the Companies Act 1985 (Section 394) requires departing auditors to make 'a statement of circumstances' which they consider 'should be brought to the attention of members or creditors of the company'. The current wording contains a qualification because the circumstances are only those connected with the auditors' ceasing to hold office that *the auditors consider should be brought to the attention of members and creditors*. This requires auditors to determine whether a statement needs to be provided by reference to a specific and limited set of criteria. We therefore recommend that, in the case of listed companies, the current law be amended to remove this qualification.[1] Auditors of listed companies should be required to report in all instances what they consider to be the circumstances connected with their ceasing to hold office.

By removing any qualitative test, shareholders of listed companies should receive fuller information from auditors of the circumstances that they consider are connected with their cessation of office and it is hoped that this would go some considerable way to dealing with shareholders' concerns in this area. We refer to the manner in which it may be possible to achieve this objective later in this policy proposal.

We believe that in all other respects the current law on auditor resignation statements is satisfactory and that to redraft it other than to reflect the above proposal is inappropriate and should be avoided. This is particularly important because the body of case law deals with important aspects of interpretation of the law which could be lost through further redrafting.

There were concerns about the apparent ability of a company to exploit the existing law by making an application to the court to delay the timely publication of auditor resignation statements with the consequence that shareholders and creditors do not become aware of this information until a much later date. Whilst recognising that due process needs to be followed when court applications are made, we consider that some pressure should be brought to bear on directors to ensure that such proceedings are dealt with on an expedited basis and are not pursued simply to delay providing information to shareholders that might be critical of the company.

We consider that useful guidance could be given by the Financial Services Authority (FSA) as regards its attitude to directors' responsibilities for the timely distribution of statements of circumstances by resigning auditors where the information is likely to be price sensitive, whether under the existing legal framework or in relation to the changes which we consider should be made. The guidance could also re-affirm directors' responsibilities regarding Listing Principles 3 and 4 to address the possibility of directors making public

[1] Whilst our recommendation in respect of a change in law refers to listed companies only, we consider that it may also be appropriate to include other significant public interest companies, such as AIM companies. The working party considers that the exact scope of the recommendations should be a matter for further consideration.

relations statements which may be designed to mislead the market in circumstances that are price sensitive. The Department of Trade and Industry (DTI) and the FSA should give further consideration to the practical implementation and the manner of enforcement of these recommendations.

We have not considered the unlisted company sector in any detail in this policy proposal. Whilst in principle the same considerations should be applied, we consider that there should be greater consultation and analysis of the costs and benefits before any conclusion is reached as to whether to change the existing law.

Historically, there has been no guidance available for auditors on the scope of their obligations to report, the sort of circumstances which may give rise to a reporting obligation and the extent to which the auditors' position is protected. We consider that it is essential to develop guidance to address this if changes are made to the current law as proposed in this document. Even if the law is not changed such guidance should be produced and in any event it would be helpful to auditors of private companies. The working party would be well placed to take the development of this guidance forward and it could be promulgated by the Auditing Practices Board or ICAEW depending on whether the law is amended and the nature of the guidance being developed.

We also considered the likely impact on the law of implementing Article 36 of the draft European Directive on statutory audit of annual accounts and consolidated accounts (referred to as the draft Directive throughout this policy proposal) which deals with auditor resignations and dismissals. In our view, Article 36 should not be seen as a substitute for the requirement for a 'statement of circumstances' in Section 394 but, if necessary, as an incremental requirement. We understand from discussions with the DTI that the Government does not intend to implement the draft Directive in a way that would diminish UK provisions in this area. We consider that the recommended change in law goes some way to meeting the expected requirements of the draft Directive but any additional legislative provisions to meet the requirements of Article 36 could result in increased costs for companies, auditors and the regulatory authorities concerned and lead to confusion. We would recommend that the Government addresses these issues on implementation in the UK.

Auditor resignation statements: the issue

Shareholders have expressed a concern that auditor resignation statements are rare and, where they are made, they generally do not provide information of actual value to shareholders. There is also a perception that auditors may resign and 'go quietly' leaving the shareholders unaware of any potential problems within the company. The key concerns expressed are in relation to listed companies, although in principle, the issues may be applicable equally to unlisted companies.

The working party was tasked by the *Audit Quality Forum* to consider:

> *Improvement in information made available in audit resignation letters.*[2]

Our focus has therefore been on the quality, timeliness, transparency and value of auditor resignation statements in the UK.

The working group has specifically concentrated on the following areas:

> the operation and effectiveness of current law;

> the company's right to take court action to prevent shareholders receiving the auditors' statement on the grounds that the auditors are attempting to seek 'needless publicity for defamatory matter' and whether it is possible to impose a deadline for resolving this;

> auditors' attitudes to making 'statements of circumstances', including the extent to which their position is protected;

> what guidance is available to auditors in relation to statements of circumstances and the factors that are relevant in considering whether 'circumstances' should be disclosed;

> the absence of any requirement to file a statement of 'no circumstances';

> the wording used in Article 36 of the draft Directive;

> the role of the FSA in relation to actions of directors and disclosure of price sensitive information; and

> the research report by Professors Moizer and Porter, *Auditor resignations and dismissals in the UK*, published in June 2004.

When considering these issues and reaching a consensus on its recommendations, we have been mindful of the need to consider the impact of any proposals on all stakeholder parties involved.

[2] ICAEW letter to DTI, 9 December 2004.

Background

Current law

When auditors resign, are dismissed or do not seek re-appointment they are required by Section 394 of the Companies Act 1985 (with a threat of criminal sanctions) to consider what information should be provided to members and creditors of the company. A detailed analysis of the current law on Section 394 statements is set out in Appendix 1 of this policy proposal. The following paragraphs provide a summary, setting out the perceived advantages and disadvantages of the current law.

Section 394 of Companies Act 1985 (Section 394)

Section 394 provides that, where auditors cease for any reason to hold office as auditors, a statement of any circumstances connected with the auditors ceasing to hold office which the auditors consider should be brought to the attention of the members or creditors, or a statement to the effect that there are no such circumstances must be deposited at the company's registered office. The company has 14 days to challenge the statement of circumstances by applying to the court. If applying to the court, the company shall notify the auditors of its application within a further 7 day period. The only ground available to a company to prevent the auditors from sending the statement to the Registrar of Companies is that the company believes the auditors are using the statement to 'secure needless publicity for defamatory matter'. If after 21 days the auditors have not been notified of an application to the court, then the auditors need to lodge the statement with the Registrar of Companies within 7 days.

The advantages of Section 394 include:

> a 'statement of circumstances' may help to alert shareholders to potential problems;

> the responsibility is laid clearly and unavoidably on the auditors to consider all that they know and decide whether or not there are circumstances connected with their cessation of office that need to be made public;

> the auditors are provided with control over the wording of the statement and are not subject to the pressures of having to agree it with the directors or management and therefore risk that it is 'negotiated' to be a less damaging statement (albeit the company may subsequently challenge it);

> the law allows defamatory statements to be made by the auditors provided this is justified and they are not seeking 'needless publicity' for such statements;

> the restriction of the grounds on which a company may apply to the court that the auditors are acting to 'secure needless publicity for defamatory matter' is a powerful protection to the auditors in the context of an onerous statutory obligation and when the nature of what may fall to be disclosed is considered;

> as a result of the statutory responsibility auditors are given a very high degree of protection;

> the burden of proof rests with the company if it applies to the court;

> it is the responsibility of the auditors to file a statement of circumstances on the company's file at the Registrar of Companies and therefore the company cannot prevent this going on the public record through its own failure to file;

> the company is obliged to distribute the statement to its shareholders and creditors who are entitled to receive copies of the financial statements of the company; and

> requiring auditors to prepare a statement of circumstances and setting out a strict timetable for its filing by the auditors and its distribution by the company should be a powerful tool for the auditors to bring to light matters of urgent interest to shareholders whereas going on to complete the audit and issuing a qualified audit opinion may result in considerable delay.

Shareholders have, however, expressed concerns that, insofar as the listed company sector is concerned, auditors may not be providing information about the circumstances of the change in auditors that would be of interest to shareholders. Whether the absence of statements of circumstances being provided is because there is no relevant information to impart (which would be required under existing law) or because of a desire to avoid saying anything critical about a former client or because of a genuine concern that, by doing so, the auditors would somehow expose themselves to liability, is difficult to assess.

The principal risk auditors face is that the company will commence proceedings to prevent publication of the statement on the basis that the auditors are using this to secure needless publicity for defamatory material. This places a very high burden of proof on the company. In the case of *Jarvis plc v PricewaterhouseCoopers* [2000] 2BCLC368, Mr Justice Lightman considered that the company would need to establish a motive on the part of the auditors bordering on the dishonest.

Insofar as auditors may fear the possibility that the company may commence proceedings for defamation, because the statement is made under a statutory obligation, the auditors would be able to rely on a defence of qualified privilege in order to defeat any such proceedings. This defence would only be unavailable if the company could show that the auditors were acting with malice. In the light of this, we consider that auditors should be in a strong position to rebut an application made to the court.

However, there is no guidance available for auditors explaining the operation of the existing law in this area, both in respect of the nature of circumstances that are relevant to disclose and the extent to which their position is protected when making such statements. The costs of obtaining legal advice when providing a statement of circumstances or in defending court action are also issues for auditors which need to be borne in mind.

Case law – *Jarvis plc v PricewaterhouseCoopers*

This case highlights some of the issues which can arise in respect of auditor resignation statements between a company, its auditors, the stock market and the financial press. It is important because it is the principal reported case which considers the detailed workings of Section 394 of the Companies Act 1985.

The details of the case are set out in Appendix 2. In summary, a fundamental dispute arose between Jarvis plc and its auditors, PricewaterhouseCoopers (PwC), over the level of the

audit fee for the 2000 accounts in relation to the amount of audit work that the auditors considered necessary for their audit. PwC had argued that some of the accounting policies adopted by Jarvis in respect of income recognition meant that the auditors needed to carry out additional audit work. Jarvis was unhappy with the resulting level of audit fee and ultimately PwC resigned from the engagement and sent a statement of circumstances to the company which the company had an obligation to distribute to shareholders and creditors. Jarvis then made an application to the courts on the grounds that the auditors were using the statement to secure needless publicity for defamatory matter. Jarvis did not, at the time of PwC's resignation, make a Regulatory News Service announcement to the Stock Exchange.

The case highlights the ability of a company to delay publication of a statement of circumstances, to brief the press whilst throughout that period the auditors had to maintain silence (given that the auditors were facing a claim that they were attempting to secure needless publicity for defamatory matter). Jarvis was then able to discontinue the proceedings immediately before the trial was due to commence. The court took a dim view of the actions of Jarvis and ordered that costs be paid to PwC on an indemnity basis. The result should be to discourage other companies from following Jarvis in using Section 394 as a delaying tactic.

The case has therefore served to strengthen the auditors' position when issuing statements of circumstances. Nevertheless there may be a lack of awareness of this amongst auditors which could be addressed through the publication of guidance to auditors.

Moizer and Porter research on auditor resignation statements

Research recently conducted by Professors Moizer and Porter on auditor resignations and dismissals in the UK (published in June 2004) statements, looked at 609 changes of auditor for listed companies in the 1990s. The conclusions reached by the report include:

> there was no direct evidence that the legislation has failed but indirect evidence does imply that auditors in the UK are not always reporting matters that the legislation intended that they should (only 7 statements of circumstances were made for 609 changes in auditors);

> the original intentions of the company law provisions may not be being realised;

> US research indicates that the SEC requirement to disclose information connected with changes in auditors does have information value; and

> consequently, the report says that it is not unreasonable to conclude that providing such information in the UK would also have information value.

It was not possible for us to assess whether, of the 609 changes of auditors for listed companies, more than the 7 referred to were deserving of a statement of circumstances. However, it is clear that these sorts of statistics result in increased concerns on the part of shareholders in listed companies that they are not being provided with important information.

Draft Directive

Article 36 of the draft Directive deals with disclosure of reasons for auditors' dismissal or resignation. The current wording in Article 36 is:

Dismissal and resignation of statutory auditors or audit firms

1. *Member States shall ensure that statutory auditors or audit firms may only be dismissed where there are proper grounds; divergence of opinions on accounting treatments or audit procedures shall not be a proper ground for dismissal.*

2. *Member States shall ensure that the audited entity and the statutory auditor or audit firm shall inform the authority or authorities responsible for public oversight about the dismissal or resignation during the term of appointment and shall give an adequate explanation of the reasons thereof.*

Whilst the draft Directive is not yet finalised, it is unlikely that this Article will change. Member States must implement the Directive no later than two years after the Directive has been adopted by the EU and published in the Official Journal. Thus, if the Directive is published around the end of this year the Government must give effect to this provision by the end of 2007.

The working party raised the following issues:

1. a statement of circumstances is broader than a statement of the reasons for a resignation or dismissal. Auditors may, for example, have a reason which stated on its own would not reveal the more important issues covered in a statement of circumstances. An explanation of a reason for resignation may well be significantly less detailed than a statement of circumstances;

2. the wording of the Article implies that auditors do not need to give reasons if they do not seek re-election. This is not the case in UK law. Since current UK law is more stringent it is important that the Directive is not implemented in a way which diminishes the current requirement; and

3. uncertainty as to who would be the 'authorities responsible for public oversight' in the UK, to whom the statement of reasons would need to be sent. It is unclear as to who are the public authorities and whether they would be the same for both listed and unlisted companies.

Section 394 is concerned with the provision to shareholders of relevant information whereas Article 36 is concerned with the provision of, in our opinion, possibly more limited information to 'the authority responsible for public oversight'. When implementing Article 36, we do not consider that the provisions of Section 394 should be diluted in anyway. The change in law, as recommended in this policy proposal, may go some way to meeting the currently expected requirements of the draft Directive. However, it may be the case that further provision will be needed in law in order to give effect to a reporting obligation to the authority.

Practice – circumstances of auditor resignation

Competition in the audit market is important to ensure that companies receive quality and affordable services which are tailored to their needs. There are many reasons why companies may wish to change their auditors. Some of the more frequent reasons include:

> outgrowing previous auditors;

> seeking to reduce audit fees;

> being unhappy with the quality of service;

> a change of ownership of the company; and

> attempting to avoid an audit qualification.

A change due to, e.g. new ownership or a client outgrowing its existing auditors is unlikely, as the law currently stands, to result in a statement of circumstances whereas, we consider a change arising from a desire to avoid a qualification is likely to require a statement unless appropriate action can be taken to address the auditors' concerns.

In addition, there may be other circumstances where, if no other remedial action is available, auditors might choose to resign from office. These could include:

> disputes over fees/scope of work;

> auditors aware of lack of independence;

> auditors have insufficient participation in group/are unable to service the company globally;

> concern over possible lack of probity in the Board/integrity of management, for example, the wrong 'tone at the top';

> insufficiently competent finance personnel;

> inadequate systems/controls, concerns about attitude to fraud and not reporting circumstances to the appropriate regulator; and

> disagreement over accounting issues which could include where the Board finally agrees to do what the auditors want (e.g. so as to avoid an audit report qualification). The relationship may turn sour as a result of disputes or disagreements and the Board may ask the auditors to resign, feeling that they may get a more sympathetic hearing elsewhere. Alternatively, the auditors may initiate the termination of the relationship, believing that they no longer can, nor wish to, undertake their statutory function in the prevailing circumstances.

The recommendations

Having considered the current law, practice, case law, research and concerns by shareholders around auditor resignation statements, our recommendations centre on the need to ensure that:

> useful information is communicated to shareholders about the circumstances of auditor resignations on a timely basis; and

> auditors are fully aware of the current requirements under company law and understand that they are able to state their opinions without liability provided they do so properly.

To this end, the working party makes the following recommendations:

Specific measures

1. we recommend that the existing law should be amended for listed companies so that the auditors are required to provide statements of the circumstances connected with their ceasing to hold office without the qualifying wording 'should be brought to the attention of members or creditors of the company'[3];

2. we believe that in all other respects the current law on auditor resignation statements is satisfactory and that to redraft it other than to reflect the above proposal is inappropriate and should be avoided. This is particularly important because the body of case law deals with important aspects of interpretation of the law which could be lost through redrafting;

3. we consider that the FSA should take steps to make it known to directors that, if a company makes an ill-founded application to the court as a way of delaying the publication of price sensitive information related to auditors ceasing to hold office, the FSA would in such circumstances consider taking action for a breach of the issuer's obligations to make timely disclosure. Likewise, where companies have carried out public relations communications on the issue of the auditors' cessation from holding office which give rise to concerns that the market has been misled then the FSA would also consider taking enforcement action;

4. in respect of statements of circumstances that contain price sensitive information, a mechanism needs to be established for the FSA to be aware of the existence of such circumstances and therefore be in a position to decide whether or not the company has communicated the statement appropriately;

5. in recommending a change to the law we have specifically addressed the concerns of shareholders of listed companies, as identified at the *Audit Quality Forum*. In principle, the recommendations we have made to amend company law could be equally applicable to unlisted companies but we would strongly recommend that a thorough cost and benefit analysis be conducted and soundings taken from this sector before taking the step of amending the law for these companies;

6. to ensure that auditors fully understand their responsibilities under the law we recommend that guidance be developed for auditors of both listed and unlisted companies; and

[3] Whilst our recommendation in respect of a change in law refers to listed companies only, we consider that it may also be appropriate to include other significant public interest companies, such as AIM companies. The working party considers that the exact scope of the recommendation should be a matter for further consideration.

7. we recommend that the DTI address the concerns raised in this paper in respect of the potential impact of the draft Directive on this aspect of UK law. We understand, however, that it is not the intention of the DTI to implement the draft Directive in a way that diminishes UK provision in this area.

The perceived benefits and impact of these specific measures are set out below.

Benefits and impact

A change in the law

The working party, which consisted of representatives from the investor community, business, regulators and the auditing profession agreed that whilst Section 394 places a clear duty on auditors to consider whether or not there are any circumstances that should be brought to the attention of shareholders and creditors, the terms of Section 394 enable auditors to take a particular view of whether or not a statement of circumstances is required. In most cases this results in no statements of circumstances being made. This is because it is only where there are circumstances connected with their ceasing to hold office which the auditors consider *'should be brought to the attention of the members or creditors of the company'* that a duty to make a statement of circumstances arises.

Whilst guidance alone on the scope of the auditors' obligation would undoubtedly assist, we consider that a change in the law to remove this qualifying test would make the obligation more far reaching. This will ensure that shareholders are always given the auditors' opinion of the circumstances that have led to their ceasing to hold office. It is inevitable that this will result in shareholders in many instances being made aware of information of little consequence. However, it should also see a rise in the number of statements which contain information of substance to shareholders. Whilst the purpose of this policy proposal is not to redraft existing statutory provisions, one possible and apparently simple reformulation of Section 394 which would address this point is to change the word 'any' to 'the' in respect of circumstances and to remove the final qualifying words so that it would read as follows:

> *'394(1) Where an auditor ceases, in the case of a listed company, for any reason to hold office, he shall deposit at the company's registered office a statement of the circumstances which he considers are connected with his ceasing to hold office.'* [4]

This raises the question of whether all statements of circumstances would then need to be circulated to members and creditors. This may be excessive and result in unnecessary costs to companies. This is an issue that the DTI will need to consider further. This issue might be resolved by requiring the auditors to judge which statements that they consider should be brought to the attention of shareholders and creditors. Alternatively, the costs could be reduced if companies circulated a statement to all shareholders through a Regulatory News Service Announcement. However, consideration should be given as to whether such an announcement would be equally visible to private as well as institutional shareholders and creditors.

Implications for directors and companies

The working party agrees that whilst there may be legitimate reasons for companies applying to the courts, the procedure should not be used for the primary purpose of delaying the publication of properly prepared statements of circumstances.

We agree that where an application to the court is made, the due process of court proceedings should be respected as the provision of information to shareholders prior to a Judgment would leave the company without any effective remedy. However, directors should be encouraged to deal with this process as expeditiously as possible. The role of the FSA and the listing rules are felt to be extremely important in this respect.

---

[4] Consideration would also need to be given to the need for consequential amendments to other provisions, for example Section 392A of the Companies Act 1985.

Unlisted companies

The concerns which have been expressed to us were made in the context of listed companies. Insofar as unlisted companies are concerned, the working party expressed concerns about the potential administrative costs for auditors of smaller entities and possible increase in court action or the need to take legal advice in complying with any change in the legislation as recommended for listed companies. The working party would not, therefore recommend changes be made to the existing legislation for this sector until there has been an opportunity to take soundings from those parts of the profession and companies and shareholders which are most likely to be affected by any amendments and to assess the costs and benefits through a regulatory impact assessment.

Guidance

Any change in the law will need to be subject to detailed guidance in order that the profession is made fully aware of its obligations. The guidance should provide auditors with an explanation of the law and the protection they have. It should include examples of issues for auditors to consider when preparing statements of circumstances and also provide wording that could be adopted in particular circumstances. This will achieve an element of consistency in the market where this is appropriate and allow it to focus on changes in auditors that may be of some significance.

Even in respect of the current law guidance would help auditors to understand and meet their responsibilities and would help to ensure that shareholders receive useful information from statements of circumstances drawn up on a more consistent basis. Guidance would be particularly useful to smaller practitioners who might otherwise need to seek external advice at a cost.

The working party would be well placed to take the development of this guidance forward and it could be promulgated by the Auditing Practices Board or ICAEW depending on whether the law is amended and the nature of the guidance being developed.

Draft Directive

One of the recommendations of the working party was for the DTI to address concerns over the potential impact of implementing the draft Directive proposals in this area on current law.

The working party believes that Article 36 should not be seen as a substitute to Section 394. Additional regulation to address the new EU requirements might be needed and this could have cost consequences for companies, auditors and the regulatory authorities concerned. We recommend that the DTI consider this when implementing these provisions in UK law.

Other considerations

Impact on other audited entities

A change in the law may have an indirect impact on other entities such as charities or pension schemes as well as other 'public interest' companies that might have similar requirements for notification of changes in auditors.

This issue has not been addressed in this policy proposal but we recommend further consideration and consultation before any change to company law.

Provisions to prevent companies using Section 394 solely for the purpose of delaying publication of a statement of circumstances

The working party debated whether a change in the law might be required to prevent directors from using the protection afforded by law just to delay publication of a statement of circumstances. It was agreed that the Jarvis case sets a clear precedent here and the FSA could also make it clear to directors that it intends to use its powers in circumstances where it appears that the circumstances contain price sensitive information and that the directors are unjustifiably making applications to the court for the primary purpose of delaying the publication of price sensitive information. The working party felt there was, however, some merit in including provisions in law to require companies (and auditors) to seek an expedited hearing. In the absence of a change in the law, guidance to auditors should at the very least point out that an expedited hearing is an option that may be available to them.

The working party also considered the potential costs to auditors of seeking legal advice with regard to information to include in statements of circumstances and in defending court action should there be an amendment to the law. These costs could be quite significant. Whilst it was recognised that the Jarvis judgment set a useful precedent for auditors in claiming indemnity costs we would suggest that further consideration be given by the DTI to making companies pay the indemnity costs of auditors where the court finds in the auditors' favour.

The US experience

The requirements for disclosure of changes in auditors in the US were also considered by the working party. The position in the US is very different to the UK. In the US when the auditors resign, a listed company is required to complete Form 8-K which is an SEC disclosure requirement and the auditors complete specific sections of the form.

US academic research (quoted by Professors Moizer and Porter in their research report) suggests that Form 8-K has information content and therefore US users of audited financial statements are better informed about changes in auditors than their UK counterparts. The research paper quoted the US approach as a possible way forward.

The US position incurs the risk that it is more managed with the company and auditors agreeing the process for completing the form. The basis on which matters are included in an 8-K is much more rules-based. The working party agreed that the overall effect runs the risk of taking some of the power out of the hands of auditors and could lead to a tick box approach.

The UK approach places the onus on the auditors alone and so it should ensure that the auditors are solely responsible for this statement without the need to agree it with the company. The regulatory inspection regime allows for auditors' statements prepared on ceasing to hold office to be examined and referred for disciplinary inspection if questions arise. There are also criminal sanctions for auditors failing in their duties under Section 394.

Next steps

We recommend that:

> the current law should be amended for listed companies so that there is a greater obligation on auditors to file statements of circumstances. The other provisions in law should remain;

> the FSA, in conjunction with the DTI, should consider the steps necessary to highlight, monitor and enforce its responsibilities with regard to the disclosure of price sensitive information by issuers in relation to auditor resignation statements and the provision of information by companies where it is designed to mislead the market;

> when considering any amendments to the law for unlisted companies, the DTI should carry out a cost and benefit analysis and take soundings from these companies, their shareholders and auditors;

> the working party would be well placed to take the development of guidance forward; and

> the DTI addresses the issues identified with regard to the implementation of the draft Directive in the UK to ensure that the current (and future) law on auditor resignation statements is not diluted and does not become burdensome or confusing for the parties involved.

These recommendations are made to address concerns from shareholders over the usefulness of information provided in auditor resignation statements. Amending the law, providing guidance to auditors and emphasising the responsibilities of the directors and the powers of the FSA should help to ensure that this objective is achieved.

Appendix 1

Section 394 of the Companies Act 1985

Section 394(1) is in the following terms:

> *'Where an auditor ceases for any reason to hold office, he shall deposit at the company's registered office a statement of any circumstances connected with his ceasing to hold office which he considers should be brought to the attention of the members or creditors of the company or, if he considers that there are no such circumstances, a statement that there are none.'*

It is not an option for the resigning auditors to do nothing: they are bound by statute to consider whether there are any circumstances which should be brought to the attention of the companies' members or creditors and to make an appropriate statement. Not only is this the statutory duty but a failure to comply with Section 394 is an offence: S394A (1). Thus, a failure to deposit any statement or the deposit of a statement that there are no relevant circumstances when the resigning auditors consider that there are such circumstances involves the auditors in the commission of an offence.

By imposing a clear duty (first imposed by the Companies Act 1976) on resigning auditors in this way and making non-compliance an offence, the clear statutory purpose is to force auditors to make statements of what they, the auditors, consider to be relevant circumstances.

Section 394(1) makes the resigning auditor the judge of whether there are relevant circumstances: Section 394(1) requires the auditor to deposit a statement of any circumstances which '*he considers* should be brought to the attention of the members or creditors', or 'if *he considers* that there are no such circumstances' a statement that there are none.

Mr Justice Lightman, in his judgment in *Jarvis plc & others v PwC (A firm)* of 13 July 2000 referred to the nature of the auditor's duty in the following terms:

> *'Section 394 imposes upon auditors an important duty in the public interest and in the interest of the persons interested [the shareholders and holders of debentures] and indirectly of creditors and the investing public to make a statement. Indeed it is a duty of such importance that a failure to comply constitutes a criminal offence. The auditor is the judge of whether there are relevant circumstances: he must exercise his judgment and, uninfluenced by any collateral considerations, make up his own mind and state whether he considers that there are circumstances which ought to be brought to the attention of the persons interested to whom for this purpose he must owe a duty of care. He is uniquely placed to judge. The requirement is not designed to protect the auditors or give the auditors an opportunity to say something which protects their goodwill or reputation when they cease to be the auditors, and the court will presume that the auditors who make a statement under Section 394(1) are acting in faithful discharge of their duty and not in pursuit of any private or collateral interest unless the contrary is shown.'*

Section 394(2) requires that, in the case of resignation, the statement should be deposited along with a notice of resignation. In the case of failure to seek reappointment, the statement should be deposited not less than 14 days before the end of the time allowed for next appointing auditors. In any other case, the statement should be deposited no later than the end of the period of 14 days beginning with the date on which the auditor ceases to hold office.

Section 394(3) provides that, if the statement is of circumstances which the auditor considers should be brought to the attention of the persons interested, the company shall, within fourteen days of the deposit of the statement, either send a copy to the persons interested or apply to the court.

Section 394(4) requires the company to notify the auditor of the application if it applies to the court.

Section 394(5) requires the auditor, unless he receives a notice of such an application to the court by the end of 21 days from the date of the deposit, within a further seven days to send a copy of the statement to the Registrar of Companies. The notice to be given by the company within Section 394(5) must be of a valid application, namely one made within fourteen days of the deposit of the statement. An application made on the fifteenth day was held not to be a valid application for the purposes of Section 394(3) by Mr Justice Ferris (see his decision in *P&P Designs plc and PricewaterhouseCoopers*).

Sections 394(6) and (7) read as follows:

'(6) If the court is satisfied that the auditor is using the statement to secure needless publicity for defamatory matter –

(a) it shall direct that copies of the statement need not be sent out, and

(b) it may further order the company's costs on the application to be paid in whole or in part by the auditor, notwithstanding that he is not a party to the application; and the company shall within fourteen days of the court's decision send to the persons [interested] a statement setting out the effect of the order.

(7) If the court is not so satisfied, the company shall within fourteen days of the court's decision –

(a) send copies of the statement to the persons [interested], and

(b) notify the auditor of the court's decision; and the auditor shall within seven days of receiving such notice send a copy of the statement to the Registrar.'

In order for the company to establish a case under Section 394(6), it must establish that:

(a) a statement contains defamatory matter;

(b) the auditor 'is using the statement to secure needless publicity' for the defamatory matter.

It is only if the court were to find that the statement is in some respect defamatory that the court would need to go on to determine whether the company can establish an improper purpose on the part of the auditors in making a statement.

The principles to be applied when the court is called upon to decide the meaning to be attributed to the words used and whether they are defamatory were summarised by Sir Thomas Bingham MR (as he then was) in *Skuse v Granada Television Limited [1996] EMLR 278* (cited with approval by Neil LJ in *Gillick v BBC [1996] EMLR 267*). In general terms, they are as follows:

(a) the court should give to the material complained of the natural and ordinary meaning which it would have conveyed to the ordinary reasonable reader reading the statement once;

(b) the hypothetical reasonable reader is not naïve but he is not unduly suspicious. He can read between the lines, he can read in an implication more readily than the lawyer and may indulge in a certain amount of loose thinking but he must be treated as being a man who is not avid for scandal and someone who does not, and should not, select one bad meaning where other non-defamatory meanings are available;

(c) while limiting its attention to what the defendant has actually said or written, the court should be cautious of an over-elaborate analysis of material in issue. In deciding what impression the material complained of would have been likely to have on the hypothetical reasonable reader, the court is entitled (if not bound) to have regard to the impression it made on them;

(d) the court should not be too literal in its approach; and

(e) a statement should be taken to be defamatory if it would tend to lower the claimant in the estimation of right thinking members of society generally, or be likely to affect a person adversely in the estimation of reasonable people generally. This principal requires qualification in relation to a trading company which may only sue for defamation if the words reflect on its trading reputation or in the way of its business.

Whilst the provisions of Section 394(6) closely parallel the law on qualified privilege in cases of defamation, as mentioned above, Mr Justice Lightman considered that the words 'using the statement to secure needless publicity' required there to be focus on purpose or motive of the auditor behind making the statement which he considered to be tantamount to an allegation of dishonesty. In the earlier judgment of Mr Justice Ferris in *Frint Holdings Limited v KPMG*, he stated:

> *'...it seems to me that it can only be said that KPMG are using or have used the statements to give needless publicity to the defamatory material if it can be said that they have incorporated needlessly into their statements matter which it was not relevant for the members or creditors of the company to have drawn to their attention, under sub-section (1). At that stage, as I have indicated, I take the view that the question of what ought to be communicated is by the sub-section left to the determination of the auditors and the determination which was made by KPMG in this case as one which they were entitled to make.'*

In terms of the costs of proceedings under Section 394(3), Mr Justice Lightman held that there were the following special considerations which applied:

> *'(1) the auditor (unless in the proceedings the court holds otherwise) is acting solely for the benefit of the persons interested. His role is analogous to that of a trustee. There is no reason in justice why the auditor should be out of pocket if the company increases the costs of the discharge of his duty by commencing proceedings under the section which fails. Indeed there are substantial reasons of policy why the auditor should not be deflected from discharging his duty by any concern that he will be out of pocket if he acts properly and if the company improperly reacts by instituting proceedings. It must be borne in mind that payment of costs on the standard basis is likely to leave the auditor very substantially out of pocket;*
>
> *(2) in any proceedings instituted under Section 394(3), the company must allege that the auditor acted in bad faith in using the statement to secure needless publicity for defamatory matter. Counsel for Jarvis submitted that the section requires no allegation of bad faith: it is sufficient to allege that the statement (however innocent the mind of the auditor) in fact secures needless publicity for defamatory matters. That is plainly wrong.*

The critical words of Section 394(6) are 'using the statement to secure needless publicity' focusing on the purpose or motive behind the making of the statement. This is a most serious allegation, tantamount to an allegation of dishonesty, against professional accountants. When such an allegation is made and not substantiated, the court has long shown itself ready to respond by ordering payment of costs on an indemnity basis;

(3) the opportunity afforded by Section 394(3) to companies to delay the dissemination of statements by commencing proceedings is susceptible of abuse by the unscrupulous. The court must be alert to question whether the decisions taken to commence and subsequently to continue the proceedings were made in good faith and not for some ulterior purpose, for example to put pressure on the auditor or prevent the statement being disseminated at an inconvenient time or to obtain a breathing period to prepare a counter or response to the statement. If an ulterior purpose is found to underline the decision-making, again the court may be expected to express its disapproval vigorously by appropriate orders against those responsible.'

Mr Justice Lightman's judgment in the Jarvis case is broadly consistent with the earlier judgment of Mr Justice Ferris in the case of *Frint Holdings Limited v KMPG* 15 November 1996.

Accordingly, the following points arise in relation to the auditor's duty and position:

(a) the auditor is the sole judge of whether there are relevant circumstances. Absent a showing of bad faith, or unreasonableness judged to a high standard, the court will not likely interfere; and

(b) there is no real guidance, either in legislation or in material produced by the auditors' supervisory body, as to what are relevant circumstances.

Insofar as the possibility of separate defamation proceedings being commenced against the auditor who makes a Section 394 statement, the auditor would be able to rely on the defence of qualified privilege in circumstances where the statement is made pursuant to a statutory duty and it would only be actionable if the claimant could prove that the statement was made with malice, i.e. that the auditor was not using the statement honestly for the person contemplated by the statute but made the statement knowing it to be untrue or with some improper motive.

Accordingly, it will only be in very exceptional cases that the company will be able to prevent publication of the statement.

Appendix 2

The case of Jarvis plc and its auditors

Jarvis was founded as a building and decorating business in 1850. The company went public in 1959 and in 1988, the company J Jarvis and Sons plc was effectively replaced by Jarvis plc which became a listed company. Ernst & Whinney were the auditors at the time (subsequently Ernst & Young) and they continued as auditors until 1995 where Coopers & Lybrand were appointed. Coopers & Lybrand (and subsequently PricewaterhouseCoopers) were auditors until 3 March 2000.

According to the judgment, since the date of appointment, PwC had had differences with Jarvis as to how its income was recognised in the accounts. Matters came to a head for the 1999 accounts. The issues centred around the aggressive approach to the recognition of income and profits on long-term contracts in the accounts. As a result, PwC had to devote a substantial amount of time to dealing with a number of material issues, not anticipated when the audit fee was agreed. The audit fee had been agreed in advance and this had led PwC to make a higher claim for the fee for the 1999 accounts.

For the 2000 accounts, PwC were wary of incurring costs that had not been budgeted for and therefore asked for a much higher estimated fee. PwC eventually concluded that the fee that Jarvis was prepared to pay for the 2000 accounts was not adequate to enable it to carry out a full audit and accordingly PwC wrote a letter on 3 March 2000 giving notice of resignation as auditors and included a statement of circumstances as required by Section 394(1) of the Companies Act 1985.

Jarvis brought proceedings under Section 394(3). This section provides that a company must within 14 days of receipt of such a statement either send a copy to the Company's shareholders or apply to the court. Where an application is made to the court, it is then up to the court to decide if the auditor is using the statement to secure needless publicity for defamatory matter (see Appendix 1 which sets out a summary of the law).

The effects of this application was therefore to suspend Jarvis' obligations to send the statement to persons interested (and the auditors' obligation to send a copy to Companies House) until after the conclusion of the court proceedings.

PwC was subsequently replaced by Ernst & Young, who were clearly in a much stronger position than PwC as Jarvis could not be seen to lose two auditors in such a short time frame.

There had been no public acknowledgement of the resignation or new appointment until a journalist wrote a report in the Contract Journal on 27 April, noting that Jarvis had not announced the resignation of PwC or the appointment of Ernst & Young on the Stock Exchange regulatory news service.

Jarvis issued a statement on the Regulatory News Service the following day and met with a drop in its share price.

Press articles written at the time quoted from representatives of Jarvis. PwC were unable to provide comments as they had been charged with attempting to seek needless publicity for defamatory matter.

According to the judgment, on 18 May, PwC applied for an order to expedite the hearing and Jarvis therefore had to support their application. The order for expedition was duly made and the hearing was scheduled to begin in the week of 3 July. In the meantime, Ernst & Young signed their audit report on the annual accounts for year ended 31 March 2000 on 12 June, and the preliminary results of Jarvis were announced on 13 June. The announcement explained a change in accounting policy relating to recognition of revenue and profits which highlighted a less aggressive approach to income and profit recognition.

According to the judgment, Jarvis subsequently issued a letter enclosing a note of discontinuance to PwC with the effect that there was no longer any prohibition on filing their statement of circumstances. PwC and Jarvis then debated whether a decision of the court was now required. According to the judgment, PwC maintained that a hearing was required so that a decision required by Section 394(7) could be obtained and so the court could decide whether Jarvis should pay PwC's costs on an indemnity basis.

The case was heard on 4 July and on that day Jarvis made an announcement on the Regulatory News Service that it was sending shareholders a letter concerning the resignation of PwC as auditors.

Mr Justice Lightman delivered his judgment on 13 July. He decided that as there had been a service of the notice of discontinuance the proceedings had been brought to an end and no further decision was required in this respect. In terms of costs, the Judge was critical of Jarvis. For PwC to be awarded costs on an indemnity basis, the Judge needed to consider whether exceptional circumstances had been established that justified such an order. The judge noted that the opportunity afforded by Section 394(3) to delay dissemination of statements of circumstances was susceptible to abuse by the unscrupulous and that the court must question whether decisions have been taken in good faith and not for some ulterior purpose.

He said:

PwC at all times acted with total propriety.... The proceedings were discontinued only at the very last moment and no reason was then given. Jarvis refused to cooperate in obtaining the expedited hearing of the proceedings, again until the last minute. On these grounds alone, I think that justice requires that an order should be made that Jarvis pay the costs of PwC on an indemnity basis and I so order.

Appendix 3

Working party

We are grateful to the following people for their input to this policy proposal issued to the *Audit Quality Forum*. Their input does not necessarily reflect the views of the organisations they work for or are attached to.

Tim Pope – Chair
PricewaterhouseCoopers

David Atkinson
Gerald Edelman

Felicity Banks
Business Law Department, ICAEW

Martin Crane
KPMG

Stephen Flaherty
Herbert Smith

Richard Fleck
Herbert Smith and Chairman of the Auditing Practices Board

Julie Ford
The Department of Trade and Industry

Beatrice Geissler
Deloitte

John Grewe
The Professional Oversight Board for Accountancy

Paul Lee
Hermes

Tony Little
Gartmore Investment Management Plc

Louise Maslen
Audit and Assurance Faculty, ICAEW

Stephen Prior
BT Group Plc

Gerald Russell
Ernst & Young

Patricia Sucher
The Financial Services Authority