

Civil approach to audit avoids the reckless penalties

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The Companies bill, soon to get its final parliamentary reading, contains two significant provisions for auditors.

First, it replaces "joint-and-several" liability by "proportional" liability, to be achieved by contract with the company and shareholder approval. Second, "knowingly or recklessly" issuing a false or deceptive audit report will be a criminal offence subject to a fine (but not imprisonment). Similar provisions apply to directors. The criminality provision is viewed as a quid pro quo for the liability concession.

In 1995, changes in US federal law eased the litigation regime for claims against professionals related to their work on listed companies. Interestingly, the quid pro quo for liability reform in the US focused on improvements in audit quality, not on criminal penalties.

The Sarbanes-Oxley Act of 2002 (Sox) changed the legal regime for US corporate reporting and auditing. Commentary on this legislation includes divergent claims, for and against, especially respecting Section 404, which requires auditors to attest to management's assessment of internal controls. Whether the additional audit work and costs are worth the benefits remains controversial.

In 2003, the UK introduced changes to improve audit quality and auditor accountability. They mirrored some of the Sox provisions, albeit with less prescription: a proactive role for audit committees; a more independent audit standard-setting body; independent inspection of audit firms; and revised civil investigation and disciplinary procedures for accountants involved in big financial scandals. This regime has powers to levy unlimited fines, withdraw audit licences and strike off accountants.

Reducing the liability of auditors cuts the insurance value of audit to shareholders. When combined with sharing responsibility for the quality of audit with audit committees and regulatory inspection, apart from other factors, this should lead to a lowering of the relative value of audit to shareholders and therefore reduce its price.

The economic effect of criminalising the "knowing and reckless" issuance of a misleading audit report needs more careful thought.

Criminal law is intended to punish transgressions against society. Those who have lost money as a result of financial statement fraud or malpractice expect to be compensated for the loss in a timely fashion.

Criminal proceedings will draw more defensive resources and cause delay. Given the higher (beyond reasonable doubt) standard of proof required for a criminal conviction, such proceedings are less likely to succeed than civil cases. Since the guilty can only be fined, and their licences or memberships cannot be withdrawn, civil proceedings and delays in compensation, will often follow.

The threat of criminal prosecution may induce auditors to pursue a legalistic, defensive, box-ticking approach. It may even create another fee bonanza, potentially worse than that which followed Sox Section 404, without adding to the value and reliability of their opinion.

This prospect runs counter to the efforts of the UK's unique and valuable Audit Quality Forum in which stakeholders are actively debating how to improve audit quality and make audit reports less defensive and more user-friendly.

The US regime is different. The Securities and Exchange Commission's in-house administrative enforcement procedures deal with most mis-statement cases, including fraud, where auditors and directors may have acted "knowingly or recklessly".

The US Department of Justice takes on only the most egregious cases for criminal prosecution. Where the right to practise before the SEC (ie to audit listed companies) is at risk, the standard of proof is the same as in UK civil disciplinary proceedings (preponderance of evidence). Where fraud is involved or where "civil" penalties are imposed via the federal courts, a higher standard of proof ("clear and convincing evidence", which is lower than criminal standard) is applied. Many cases are settled before trial.

Without the need to prove criminality, cases can be resolved expeditiously and shareholders can get on with claiming their compensation.

There is criminal process in the UK to deal with auditors and directors who commit serious fraud. Why make "knowingly or recklessly" criminal in this context? By not learning from US experience, the UK may make bring harm instead of benefit to shareholders.

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