Audit firms and disclaimers: Is the bar set too low?

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Abstract
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AUDIT FIRMS AND DISCLAIMERS: IS THE BAR SET TOO LOW?

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ABSTRACT

This paper makes the case for the greater regulation of auditors. It argues that the courts are too sympathetic to the use of disclaimers to escape liability to investors, individual shareholders and third parties. The approach is to review the relevant court cases which established the concept of “opinions” and disclaimers as a means of protection and argue for greater recognition of the wider impact of the audit role.

The paper finds that the best explanation as to why auditors use disclaimers is Social Darwinism. The application of professional ethics as adumbrated in various codes is not relevant to this practice.

The paper is original in that it draws on a recent (2015) court case involving the audit firm Grant Thornton. Its value is that it argues for greater state audit regulation. The grounds being that adherence to legal form ignores the substance of the wider implications involved. As it is state regulation of auditors is largely a form of licensing to limit competition.
Introduction

The purpose of the paper is to consider the case for greater regulation of auditors in the light of the recent decision by the UK courts (Barclays Bank v Grant Thornton [2015] EWHC 320) to uphold auditors’ use of disclaimers to avoid liability for their opinions. The Economist (2014) in an article entitled “Dozy watchdogs” supplies several recent examples of audit failure without liability and draws the conclusion that, as defined, it is a job at which it is impossible to fail. None of these audit failures would matter if the losses impacted only on those responsible, but this is seldom the case and it is the public and economy that suffers. In New Zealand, from 2009 some 24 Finance companies collapsed entailing losses on thousands of small investors and creditors. All of these Finance companies enjoyed unqualified audit opinions, and most involved fraud or gross mismanagement by the directors.

The paper begins with an outline of the problem of audit failures and the courts response to the use of disclaimers to avoid liability. The case for greater regulation is then put forward in terms of the business case, the public benefit and the ethical obligations of the profession, if any. The latter is further examined in respect of where the ethical context of auditing mostly applies: as a deontological duty; a utilitarian exercise; or, if it is simply justifiable as a deterministic Social Darwinist activity.

Audit failure and the courts response

When Warren Buffet increased his stake in Tesco, a British Supermarket, to 5% it told the world that Tesco was a safe investment. Tesco had a clean audit from PWC but it was later found that Tesco’s income was overstated by $US 408m. According to the Economist (2014), PWC’s failure to detect the problem is hardly an isolated case. The Big 4 accounting firms receive an income in audit fees, it is estimated, of some $50 billion a year to give opinions. While auditors are not expected to uncover every crime, it is worth asking has there been a dilution of responsibility. That is, have the courts in common law countries allowed auditors too much sympathy for error in their opinions. Courts outside the common law countries are arguably even more sympathetic to auditors where, as in China, auditors are seldom subject to litigation (Economist, 2014).

A dilution of audit responsibility came about when the wording of reports ceased to provide that financial statements were correct and became instead opinions. In other words, the profession preferred to define their reports as opinions, which did not need to provide accuracy. As far back as 1896, a British judge supported this dilution of responsibility, “An auditor is not bound to be a detective ... he is a watchdog not a bloodhound”. (Lord Justice Lopes, The Law Times, Volume LXXIV, Court of Appeal, 11 July 1896).

More recently, there have been judgements which have led to the use of disclaimers by accounting firms, to protect themselves from claims by third parties. The most notable of these are Caparo Industries Plc (Caparo Industries plc v Dickman and others, [1990] 2 AC 605) and Royal Bank of Scotland (RBS) vs Bannerman Johnstone MacLay [2003] SLT 31 (OH). The first of such judgements citing a duty of care to third parties was in the Caparo case. The claim against the auditors was unsuccessful. The House of Lords concluded that the accounts were prepared for the existing shareholders as a class for the purpose of exercising their class rights and that the auditor had no reasonable knowledge of the purpose that the accounts would be put to by Caparo (ACCA, 2009).
In 2003, judgement in the Bannerman case reinforced for auditors protection from third parties who rely on their opinions. The RBS alleged to have lost over $13m in unpaid overdraft facilities to an insolvent client APC Ltd. They claimed that Bannerman had been negligent in failing to detect a fraudulent and material misstatement in the accounts of APC. The judge in the Bannerman case also, and crucially, concluded that the absence of any disclaimer of liability to third parties was a significant contributing factor to the duty of care owed to them. One of the outcomes of the Bannerman case was the potential exposure of auditors to litigation from third parties to whom they have not disclaimed liability. As a result it became common to include a disclaimer of liability to third parties in the wording of the audit report (Taylor, 2015).

Thus, recent news that the Grant Thornton (Barclays Bank v Grant Thornton [2015] EWHC 320) has escaped action over a $51m claim for negligence damages brought by Barclays Bank following an auditor’s report which did not identify fraudulent activity at the Von Essen Hotel Group reinforces a trend. Justice Cooke ruled the bank had no case (Faculty, 2015).

Under the headline: “Bannerman clause an effective disclaimer against third parties” Taylor (2015) states that “Auditors will welcome the important decision of the Commercial Court in Barclays Bank plc v Grant Thornton UK LLP [18 February 2015] which is the first authority on a Bannerman disclaimer negating duties to third parties arising out of audit work”. The court made clear that sophisticated commercial parties relying on an auditors’ report are bound by a third party disclaimer. It is not unreasonable for auditors to include a disclaimer stating that auditors do not accept or assume a responsibility to anyone other than the addressees of the audit report (Taylor, 2015).

Grant Thornton sought summary judgment on the claim on the basis that Barclays had no real prospect of success because the reports contained a Bannerman disclaimer. Barclays argued that the disclaimer had not been brought to the bank’s attention (although it was included in the audit report) and that it constituted an unreasonable exclusion clause caught by the Unfair Contract Terms Act 1977 (UCTA). The High Court found in favour of Grant Thornton. Cooke J held that the claim had no realistic prospect of success “in the face of the disclaimer” and there was “no good reason” why the action should proceed to trial.

As to bringing the disclaimer to Barclays’ attention, the judge said it was “hard to see what else Grant Thornton could be expected to do save for capitalizing underlining or red lining that part of the report, something which would be considered wholly unnecessary when dealing with sophisticated bankers and business people who can be expected to read documents put before them and to be familiar with notices of disclaimer in auditors’ reports.

Further, the disclaimer was reasonable under UCTA. Cooke J concluded that there was “nothing unreasonable in that stance, as between two sophisticated commercial parties, where the approach of auditors limiting their responsibilities is well known and, in the statutory context, is the subject of a standard form ICAEW clause” (Audit - Bannerman disclaimer here to stay?, 2008).

This is a significant decision for the profession. It confirms the importance of Bannerman disclaimers to protect auditors against the risk of third party claims. There may be scope for arguments as to UCTA reasonableness for small companies or consumers, but certainly sophisticated third parties (such as banks) can expect to be bound by their terms (ACCA, 2014).
The Business Case Argument

There are three main objections to the courts offering protection to auditors who armour themselves with disclaimers. First, there is the business case. If investors and individual shareholders stop trusting financial statements because they offer no reliable endorsement by way of audit, then the cost of capital rises as a function of risk. Free of concern for third parties, auditors may more readily bow to the demands of management and be more easily swayed when only their fees are at stake. The long term result will reduce the funds available for investment and slowing of economic growth. For this reason as the Economist (2014) observes, “Only substantial reform of the auditors’ perverse business model can end this cycle of disappointment” (p. 21). Recognising the potential reputational hazard, the UK professional accounting body, ACCA declares that it does not encourage the use of standard disclaimer clauses in audit reports. Such clauses could have the effect of devaluing the report in the eyes of many and should not be necessary in order to protect auditors’ interests if the audit has been properly carried out. Paradoxically, while it follows from these rulings that the auditors in question did not owe a duty of care either to individual shareholders or to potential investors, auditors will continue to have a duty to shareholders as a group, presumably as represented by the company. In other words, shareholders are not protected - only the company as a class – meaning in practice the management. Thus, in practice the most likely plaintiffs are blocked from action by disclaimers.

The Public benefit

The second objection relates to the aspect of supplying a public benefit or a social contract argument. In many countries, governments regulate to restrict the audit market to members of the accounting professions. Such restrictions by governments usually, when conferring a monopoly, involve an expectation of a public benefit. In New Zealand, more recently a licensing system for auditors has been introduced, which arguably further advantages the Big 4 monopoly of audit work among first tier companies and public entities. According to Dellaportas (2005) the social contract concept should be perceived to be a duty of the professional accountant. So what is the public benefit? In the case of doctors, nurses, teachers, and lawyers the public benefit from restricting these occupations to members of a profession is obvious. But, for auditors it is less obvious when their work is restricted to those who can pay, and any negative impact to the general community is excluded by disclaimer. The courts by upholding disclaimers of a duty of care to third parties are excluding the public benefit aspect of auditing from the wider community. The recent collapses of many finance companies in New Zealand provide suitable exemplars of this denial of a wider public benefit. Hanover Finance collapsed after receiving a clean audit to the benefit its few shareholders, while its thousands of “Mum and Dad” investors lost their savings. The few shareholders were happy as the auditors did what they had paid them to do, that is endorse inflated reports to gull unsophisticated investors (Erikesen, 2008).

Ethical Considerations

The final objection to the courts upholding the practice of auditors’ disclaimers is ethical and philosophical and holds the least prospect a providing an acceptable legal argument based on legal form and practice. Griffiths (2002) observes, with respect to the use of disclaimers by PWC, “Privately, some senior accountants say the PWC move could be interpreted as an
attempt by auditors to protect their backs in the post-Enron environment …There has to be a worry that this will be taken the wrong way. It may be seen as devaluing the integrity of the accounts. The timing is not good” (http://www.theguardian.com/business/2002/dec/06/10). If professional audit ethics are driven by either deontological, consequential or Social Darwinist goals, then disclaimers fall most easily into the latter.

The Deontological position

The philosopher Immanuel Kant argued that rational beings should abide by the maxim, “Act only on that maxim through which you can will that it should become a universal law for all rational beings” (Kant, 1993, p. 30). In other words, according to Russell (1947), Kant maintains an ethical position of “Do as you would be done by” (as cited in Russell, 1947, p. 737). Kant argues that certain actions or behaviour cannot be justified as moral based on the outcomes from such actions. For example, an auditor is honest because he knows that it will attract more customers and increase profits. He is not genuinely moral because his intention to be honest is to increase profits (Kant, 1993, p. 36). Kant’s ethics are non-consequentialist. It is a deontological approach, which focuses on duties rather than consequences. Kant’s maxim is thus a law which applies to everyone. No one should exempt himself from the maxim but expect others to abide by it. In other words, Kant’s deontological approach emphasised a sense of duty. In other words, auditors should work as if they were the shareholder or investor and not be swayed by the arguments of managers, who on behalf of shareholders pay them.

From Kant comes the element of reason necessary to understand issues, think, and arrive at an ethical judgement, while virtues add ethical motivation, allowing individuals to place the interest of others before themselves. Mintz (1995) believes that virtues in accounting are linked to the requirements of accounting professional codes: trustworthiness, benevolence, altruism, honesty, integrity, impartiality, open-mindedness, reliability, dependability and faithfulness. Thus, the concept of “duty”, become virtue in practice.

Consequentialist ethics

In contrast to Kant’s deontological perspective, Jeremy Bentham (1748 – 1832) developed utilitarianism. Utilitarianism introduces the idea that whether an action is ethical is based on the outcomes resulting from that action. Using the same example as above, an auditor is honest because he knows that is the way to increase profits. Because the consequence is to increase profits and acting honestly is a way to achieve this consequence, the auditor is considered to be morally right. In contrast to Kantian ethics, the intention of being honest is irrelevant as long as it achieves the ends. Mill (1861) declares: “Utility, or the Greatest Happiness Principle holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness ” (p. 257). If the outcomes of action or behaviour lead to greatest happiness, which is calculated as the sum of the happiness of all affected people in a given situation, that action or behaviour is ethical. Under utilitarianism, consequences can justify the means. For example, in the iconic New Zealand case of Hanover Finance, the large audit firm involved gave an unqualified audit shortly before its collapse. It subsequently emerged that large dividends had been paid to Hanover’s seven shareholder/directors when the company was insolvent and revenues had been boosted by interest from loans to the directors that were due but not received. Thousands of small
investors lost their savings making the actions of the audit firm from a utilitarian perspective unethical.

The concept of utilitarianism relies on legislators, who prescribe sanctions, knowing what is in the community’s interests while ignoring their own interests or desire for pleasure (Preuss, 1998). But, this paper questions whether legislators and the courts will act in the community interest. Moreover, will auditors ignore the interests of their own paymasters to pursue a community’s interest (Tinker, 1991).

The Social Darwinist Perspective

From the context of this paper it seems that the Social Darwinist perspective best suits the current position of the use of disclaimers by auditors and their endorsement by the courts. Herbert Spencer (1820-1903), a liberal utilitarian, first enunciated the concepts of Social Darwinism. Social Darwinism may be defined as “the attempt to justify or promote human competition for scarce resources as a necessary, natural phenomenon fostering biological progress” (Weikart, 2009, p. 21). It has two central assumptions. First, it suggests that there are underlying and irresistible forces acting in societies, which are like natural forces that operate in the animal and plant kingdoms. Second, these social forces are of a deterministic kind to produce evolutionary progress through natural conflict between social groups. The best adapted and most successful groups survive these conflicts (Abercrombie, Hill, & Turner, 1994). Indeed, to support those unfit to survive can be argued to be morally incorrect (Hawkins, 1997). Social Darwinism introduces a laissez-faire approach to business (Weikart, 2009). “The business of business is business” is a quote attributed to Milton Friedman, an advocate of laissez-faire economics. Taking this observation as the hallmark of Social Darwinism, the relevance of this philosophy is that it justifies ruthless competition and argues that it is both natural, in a deterministic sense, and such natural determinism progresses by taking from the weak (Bergman, 2001). Echoes of Social Darwinism arguably resound whenever the concept of “the business of business is business” is used to reject suggestions of business social responsibility and may be applied to audit firms who justify disclaimers to third parties on the grounds that they owe only a duty of care to those who pay them. Again, the exemplar provided by the failed New Zealand finance company Hanover illustrates the concept of Social Darwinism in audit practice. The clean audit served the interest of the directors but failed to alert the thousands of investors to the company’s insolvency. On deontological or utilitarian grounds the audit cannot be justified but viewed as natural product of deterministic behaviours competing for scarce resources, then it is explainable. Social responsibility or a duty of care does not apply any more to audits than it does to a fox entering a chicken coop.

Neimark (1995) observes that, “What constitutes ethical behaviour at any time is socially constructed; it is a product of time and place” (p. 94). Such behaviour may be constructed from concepts of legitimacy, whether pragmatic, moral or cognitive according to current values. To explain the dominance of Social Darwinism today, Neimark (1995) argues that social, economic and political structures, collectively and inevitably, produce patterns of behaviour that are not ethical even by contemporary Western standards:

“We must consider the relationship between what individuals do and the institutional structures and the ideological underpinnings of capitalism, including its emphasis on Social Darwinism, individualism, competition, and material acquisitiveness” (p. 93).
The use of disclaimers by auditors to avoid a duty of care other than to care for what their paymasters require, mostly reflects Social Darwinism (Stackhouse, 2004).

Discussion and Conclusion

The courts have held that use of disclaimers by auditors relieves them of a duty care to third parties including individual shareholders. The 2015 case outlined, involving the audit firm Grant Thornton, establishes that a clear disclaimer in the audit report will provide protection from actions by third parties, individual or groups of shareholders seeking remedies for negligence. The paper argues that such auditor protection is unjustified when the wider implications of the business case, the community interest and some ethical positions are taken into account. It is admitted that these wider implications have little bearing on legal form and practice but that is not to say they are irrelevant.

The wider implications are not irrelevant because licensed auditors occupy a privileged position granted to them, in many countries by state sanctioned regulation. Such regulation, as applies in New Zealand removes possible competition and creates an oligopoly for the major audit firms. If the audit profession has only a duty of care to those who pay for their services, why should they enjoy restricted entry to the market by a state sanction? Ostensibly, the licensing is to protect the public from under-qualified practitioners, in the same way that teachers, nurses and doctors are regulated. But, the latter professions do have a duty of care to those who do not pay them: students, patients, etc. There is discussion in New Zealand about licensing brothels and massage parlours and such licensing would have more in common with the licencing of auditors as the oldest profession does not have a duty of care other than to those who pay them. It is difficult to see how a respectable profession can operate with state sanction and have no duty of care to the wider public or should even want to be seen to have no duty of care. The disclaimers not only advertise this fact but, as ACCA observes, somewhat undermine confidence in the audit.

In defence of the audit firms, it may be advanced that shareholders, investors or others seeking compensation for any consequent losses, may target the audit firm, who may be asset rich and possess professional indemnity insurance, for financial compensation. This may be unfair when the company involved may be just as responsible for an inadequate audit but not unexpected when companies are facing financial difficulties, as any individuals involved are unlikely to possess insufficient assets to settle the liabilities,

From an ethical and philosophical perspective, the paper argues that the position taken by auditors who use disclaimers and the courts that endorse their use is one of Social Darwinism. As evolved animals, Dawkins (2006) explains, we are the product of blind, deterministic forces. Moreover, Crick (1995) writes that humans are mere collections of fundamental particles of nature. “You, your joys and your sorrows, your memories and ambitions, your sense of personal identity and free will, are in fact no more that the behaviour of a vast assembly of nerve cells and their associated molecules” (p. 3).

From such established scientific conclusions, Polkinghorne (1998) asks, that as deterministic beings, what can validate the claim that our utterances constitute rational discourse? “Would not the sounds issuing from mouths, or the marks we made on paper be simply the actions of automata” (p. 58). The consensus of science is that our pretence at being rational beings with free choice is an illusion, and, as a consequence, the professions’ code of ethics, which suggest an ethical choice, is an illusion. In other words, accountants and auditors as products
of Darwinist evolution will do whatever is in their best interest to corner scarce resources and the pretence to be otherwise amounts to no more than a veneer of hypocrisy. Only regulation can hope to curb the excesses of the market.

By licensing auditors in New Zealand, the state is imposing some kind of regulation in the market but as the objective is narrowed to making sure they are suitably qualified to do the job, the regulation falls short in that there is no further protection for shareholders, investors, third parties or the public interest. The licencing system introduced restricts the supply of auditors while adding no ostensible public benefit. Unchanged by regulation, the marketplace will continue be subject to what Keynes (1936) called “animal spirits” and in that respect a jungle (p. 161).

However, the practical point that this paper argues is that the 2015 finding in the Grant Thornton case sets the bar too low. Existing government regulations ignores the problem of auditors being all “but impossible to fail at their jobs, as they define them” (Economist 2014, p. 20). Disclaimers provide an escape clause against the most likely plaintiffs and such protection can lead to a situation where, what the Economist (2014) describes as having “dozy watchdogs” prevails and that defeats the point of having an audit (p. 22).
REFERENCES


