

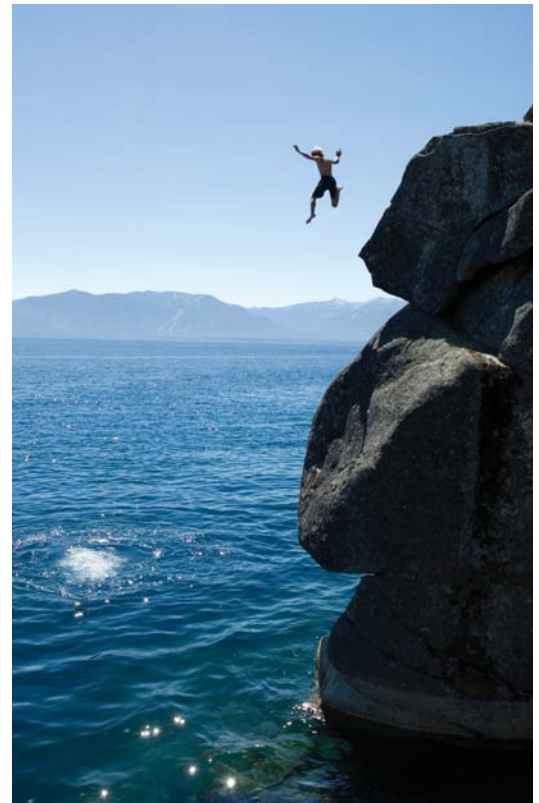
Accountancy Update

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Taking the plunge - agreeing LLAs with audit clients

Liability Limitation Agreements (LLAs) were introduced under the Companies Act 2006 to address concerns that the audit market could be seriously damaged by the collapse of one of the remaining large international audit firms. Unfortunately, the requirement for shareholder approval appears to have caused a degree of paralysis, as firms wait to see what their competitors are doing.



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Ambiguity in the 2006 Act has not helped the situation, as it has been left to the courts to determine whether or not agreed limitations will be enforceable, thus adding to the uncertainty. In this article **Jane Howard** and **Ross Goodrich** consider some of the issues which have led to the current state of affairs and offer some thoughts on possible solutions.

The Companies Act 2006 provides that companies may enter into LLAs to limit an auditor's liability to it for negligence, default or breach of duty or trust in relation to the audit of the company's accounts. LLAs will only be effective to limit

an auditor's liability to such an amount as is "*fair and reasonable in all circumstances of the case*". It is immaterial how an LLA is framed. In particular, the limit on the amount of an auditor's liability need not be a sum of money or a formula specified in the agreement. This provision has ostensibly opened the way for methods of liability limitation beyond mere proportionality. This goes beyond what was originally intended and has created uncertainty as to what may, in a given case, be deemed to be "*fair and reasonable in all the circumstances*".

The Financial Reporting Council (FRC) final guidance on LLAs,

which was published on 30 June 2008, sought to clarify matters. The guidance outlined the principal changes brought about by the 2006 Act and noted that in theory, contractual limits could be set in a number of different ways:

- a proportionate liability approach, where the auditor's liability is limited to the extent that the auditor was responsible for the loss
- by reference to the "fair and reasonable" test
- a cap on liability expressed as a monetary amount or by an agreed formula, and
- a combination of some or all of the above.

The guidance made clear that the institutional investors canvassed would only accept LLAs which sought to limit liability “proportionately”, with the “fair and reasonable” and “capping” approaches only to be considered in exceptional circumstances. Furthermore, other entities have expressed misgivings at any form of liability limitation. In its submission to the FRC on 14 March 2008, the International Corporate Governance Network noted that it found difficulty in supporting either a proportionality and/or a “fair and reasonable” limitation when there were a number of questions outstanding regarding the legal meaning and practical interpretation and implementation of these terms. It is this latter point more than anything else that has created the current uncertainty and with anecdotal evidence suggesting that many firms are understandably adopting a “wait and see” approach rather than taking the plunge, it is difficult to determine what the future holds for LLAs.

This state of affairs is unfortunate for the profession as a whole, since LLAs can offer firms real benefits in what is likely to become an increasingly litigious environment. Whilst limitations on liability have become widely accepted in relation to non-statutory audit work, the Achilles heel of the 2006 Act is arguably the requirement that LLAs be approved by the company. Directors may fear that they would be acting in breach of duty in recommending LLAs to shareholders. However, there are a number of good arguments that can be raised to justify LLAs, at the very least on a proportionality basis, and there is nothing stopping auditors from using them in their dialogue with clients. Some suggested arguments that might help counter concerns include:

- The advent of LLAs has come about after years of extensive consultation with the auditing profession, the investment community and other interested parties; LLAs are the result of a long and reasoned debate

- It is in the interests of the business community to reduce the prospect of major accounting firms being forced to leave the market as a result of a catastrophic claim. If this were to occur, the choice in the market would be more limited.
- Depending upon the circumstances, the widespread adoption of LLAs across the board (in due course) may well benefit the company as the auditor could be more likely to have the ability to pay out on more than one claim (should there be an unfortunate series of claims at any one time)

“most firms appear to be adopting a “wait and see” approach”

- In the event of a catastrophic claim (which could well exceed an auditor’s available resources) the company would be unlikely to recover the entirety of its losses from that one source in any event
- Limitations on liability are well established and accepted in other areas of work undertaken by the larger accountancy firms, for example, in due diligence and tax work
- Similarly, other suppliers of services will often seek to limit their liability as part of their contractual arrangements
- Proportionate liability is fair and just. Absent such a regime, auditors face the prospect of potentially having to meet 100% of a loss in circumstances where their conduct was but one (possibly a minor) contributory factor
- A proportionality approach could use wording approved by the FRC (following extensive consultation with all sections of the business community). A number of leading industry groups have already publicly indicated that their members may well support the introduction of proportionate liability in the majority of circumstances
- Under the 2006 Act, auditors are only able to limit their liability to the extent that any limitations are “fair and reasonable” in the particular circumstances. If they are not, a company would have the ability to ask the court to vary

the agreement so as to achieve “a fair and reasonable” result in the event that claims were to be made

- Given that LLAs have to be re-approved annually for each audit, they could actually have a positive effect on dialogue and provide a natural basis for discussing audit quality and satisfaction issues annually
- In certain instances, it may be arguable that an LLA is an essential element of the arrangements under which the company is able to secure the appointment of auditors who the company believes are

particularly well suited to audit a company’s affairs by virtue of, for example, specialist industry expertise, geographic coverage and knowledge of a business.

There are clearly a number of good reasons for audit firms to seek to enter into LLAs. If firms are awaiting further guidance/clarification from the FRC, they may have a while to wait as the FRC has already indicated that it does not expect to review the impact and content of its June 2008 guidance until the second half of 2010. We also know that under s535 of the 2006 Act, the government has reserved the right to legislate, by means of statutory instrument, with a view to preventing adverse effects on competition. However, the government has indicated that it does not intend to make such regulations immediately. Therefore, if individual firms and the audit profession generally are to benefit from LLAs they may need to give serious consideration to taking the plunge. The key question is when - any takers?



Casenotes

Two recent decisions highlight issues for accountants when valuing shares in a business

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In the first case¹ the claimant director (M) claimed damages against a firm of auditors (N) on the basis that N had negligently undervalued his shareholding in a company (L).

M was a minority shareholder in L, holding 5% of the class B shares. He left the board and company in acrimonious circumstances in December 2003. Under the Articles of Association of the company, he was required to relinquish his shares to the other shareholders, the price to be fixed by L's auditors (N) for a fair value, which the shares might reasonably be expected to fetch in the open market. In so doing, N were to be considered experts and not arbitrators.

N produced a valuation of £128 per share as at 15 June 2004. M submitted that this was an under valuation. M relied on the fact that N was also the auditor for Trustco and had valued Trustco's 2.1% of L's shares at £620 per share at the time of the 15 June valuation.

At trial, N admitted negligence but denied liability on the basis that the £128 per share valuation fell within the range of values that could have been determined by a reasonable valuer acting properly.

The judge found it difficult to reconcile how N had valued M's shareholdings at £128 per share whilst approving a figure of £620 per share in Trustco's accounts. This was symptomatic of N's negligent willingness to submit to pressure from the directors of L to keep the value of M's minority shareholding as low as possible, and a failure to keep an independent balance between the interests of the remaining directors of L on the one hand and M on the other.

The second case² concerned the valuation of a share in a firm of

estate agents (the partnership) on the retirement of one partner. Harwood Hutton (H) were the partnership's accountants. Mr Carr (Carr) was the retiring partner.

The partnership agreement contained a leaving provision such that a departing partner would be paid a sum which included a share of the goodwill of the partnership, to be determined by H in their absolute discretion. H's letter of engagement included a limit of liability to a maximum of "twenty-five times the fee charged for each segment of work done".

In October 1999, Carr considered retiring from the partnership and approached H for advice on how much he might receive. H provided a valuation (the initial valuation) to him. Carr then informed the other partners of his intention to retire and gave them copies of the initial valuation.

After Carr had given his formal notice of retirement, H prepared a further draft valuation (the February valuation) for the remaining partnership. Carr obtained a copy of that valuation and sought independent advice which concluded that the February valuation had undervalued his interest.

The claimants (the remaining partners in the partnership) submitted that the initial valuation was incorrect, and that H's provision of the initial valuation to Carr in a personal capacity was a breach of H's fiduciary duty to the rest of the partnership. As a result of this breach, Carr's expectations were incorrectly raised, resulting in dispute and legal costs, which they sought to recover.

The judge found no fault with the initial valuation but noted that whether a valuation was correct was not determinative of negligence. Negligence

depended on whether H had undertaken the task with the care and skill to be expected of a reasonably competent member of the profession. No criticism had been made of the methodology used and accordingly the negligence claims failed.

On the issue of breach of fiduciary duty, the judge agreed that it was the nature of the leaving provision, that it would place the firm's accountants in a position of conflict between the departing partner who would want a high valuation and the remaining partnership who would want a low valuation.

At the time of the October 1999 valuation, H were in a potential conflict position, but because all the partners knew and agreed that H:

- were the partnership's accountants
 - would undertake a valuation if one of the partners were to leave and
 - acted personally for each of them in relation to their tax affairs,
- none of the partners could complain, because each one was informed and had consented to that potential for conflict.

In considering the limit of liability, the judge accepted that the reasonableness test contained in s11 of the Unfair Contract Terms Act 1977 applied in substance even though the multiplier was not a "specified sum". As the defendants had submitted no evidence to support its reasonableness, H had failed to discharge the burden of establishing that the provision was reasonable.

¹ *McKinlay v Nexia Smith* [2008] EWHC 1963 (CL)

² *John Arthur Simpson and others v Harwood Hutton and other* [2008] EWHC 1376 (QB)



Stop Press

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New conflict rules for Company Directors

The next tranche of Companies Act 2006 provisions come into effect in October. These include stricter rules on directors' conflicts. Directors will be required to avoid any situation in which they have direct or indirect interests which conflict, or could conflict with those of the company. Where a conflict is identified, the director will require formal authorisation to avoid the possibility of a claim for damages by the company for breach of duty. From October, that authorisation may be granted by the board of public companies if the company's articles permit such conflicts and by the boards of private companies if an appropriate shareholder resolution has been passed. Companies which are likely to be affected by these changes should be encouraged to start making the necessary changes to their articles or to pass a special resolution as soon as possible, if they have not already done so.

FRC Consultation Paper on Guidance for Directors on Going Concern Reporting

On 29 August, the FRC published a Consultation Paper setting out its proposals to revise the Guidance for Directors of Listed Companies on Going Concern and Financial Reporting. The proposals incorporate some of the more onerous requirements of the international financial reporting standards under which a greater degree of disclosure of issues underlying directors' statements will be necessary. For example, companies will be required to provide justification for a directors' statement which deals with a period of less than 12 months going forward, to outline any defaults on their banking covenants, to disclose any

financial risks they face and the strategy they are adopting to deal with those risks. Comments on the proposals are invited by 24 November 2008.

New APB Exposure Draft of Auditor's Report and Financial Statements and Bulletin on Auditor's Reports for Short Accounting Periods

The APB has published an Exposure Draft of proposed revisions to ISA (UK and Ireland) 700 "The Auditor's Report on Financial Statements". The Draft is intended to reflect the requirements of the Companies Act 2006 and other responses to the AFB's 2007 discussion paper on how auditors' reports should be changed. The Exposure Draft envisages a far more concise report. This is achieved by transferring much of the current standard text on the auditor's responsibilities and the basis of the auditor's opinion into a statement which will be posted on the APB's website to which the auditor's report will refer.

Comments on the Exposure Draft are invited by 28 November 2008 with a view to the revised ISA 700 being effective for accounting periods ending on or after 5 April 2009. In the meantime, to assist with compliance with the Companies Act 2006, the APB has published Bulletin 2008/8 which provides illustrative auditor's reports for short accounting periods commencing on or after 6 April 2008 and ending before 5 April 2009.

Changes to CPR 6 - Service of Documents

The new Civil Procedure Rules Part 6 comes into effect on 1 October bringing changes to the rules for service of documents in court proceedings. The purpose of the changes is to improve,

clarify and codify the existing rules to balance claimants' and defendants' interests. The key changes to CPR 6 are:

- deemed service can only take place on a business day
- where documents are delivered on a non-business day, service will be deemed to take place on the next business day
- claim forms will be deemed to be served two days after the date of despatch, regardless of the means of the despatch
- other documents will be deemed to be served two days after despatch if by post or DX, or on the same day if delivered before 4.30pm by hand, fax or email, or the next business day if served after 4.30pm
- deemed service for documents served by electronic means will be the same as for faxes
- claimants will be required to take reasonable steps to discover defendants' current address where they have "reason to believe" the defendant is no longer at the intended address for service.

An important consequential change to CPR Part 7 is that the time limit for *servicing* the claim form will instead be a time limit for *despatching* the claim form.

RPC news

Our next Breakfast Briefing is on Tuesday, 7 October. Jonathan Davies, Ian Gordon and Richard Burger will be discussing the role and powers of the Accountancy and Actuarial Disciplinary Board and offering tips on how to deal with its investigations and proceedings. For more information, please contact us at seminars@rpc.co.uk

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Accountancy Update is a summary of recent developments. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the editors.

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