

## **Accountability, Auditor Liability and the Politics of Disclosure.<sup>1</sup>**

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### **Introduction.**

The aim of the audit is to ameliorate the risk associated with company accounts. How can shareholders know whether the accounts tell the truth or not? After all, the directors who depend on a positive set of accounts to keep their jobs are also responsible for actually drawing them up. Independent gatekeepers' verifications of the directors' account of the business's success allow shareholders to discount some of the risk associated with delegating control over their investments to other people. In recent years however, auditor reputations in Ireland, the UK, the USA and elsewhere have been diminished by a series of crises. Beginning with the implosion of Enron and the collapse of Arthur Anderson in its wake and culminating in the global financial crisis from 2007-2008, the global financialised economy has seemed to founder on the back of frauds and (more significantly for the system) catastrophic corporate decisions.

Ireland's 'light touch' regulatory regime had contributed to its wealth being based on the globalisation of capitalism. The country's economy, ranked as one of the 'most globalised' worldwide, has exploited its geographic and demographic position to attract foreign direct investment and to develop export industries. Policies aimed at maintaining a competitive position had Ireland keeping the costs of doing business somewhat less than those of key competitors. As well as more explicit costs, like corporation tax, the costs of doing business in Ireland are a function of disclosure and other regulatory rules. Ireland has, perhaps more than most countries, constantly had to maintain a balance between high regulatory standards and the need to keep foreign business in the country.<sup>2</sup> This struggle takes place in the context of membership in the European Union's regulatory regime so part of the trade-off involves the Irish competing with other member states in terms of attracting investment (most notably the UK when it comes to financial services) but within the context of coordination between member states on regulatory standards.

The Irish company law and regulatory regime must be understood in the context of these dynamics. At the same time, it seeks to answer questions and

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2 This need not mean that Ireland is always engaged in a 'race to the bottom.' High regulatory standards are a key component in attracting some reputation-driven businesses to the country. This is notable in terms of the Irish implementation of the reinsurance directive for instance.

problems that recur across all Anglo-American regimes. The relationship between the audit function and corporate governance, for one thing, is not simply a matter of company law. It is also subject to how the idea of corporate accountability is formulated across the regulatory structure. This formulation is in turn not only influenced by the audit as a technical function, but by the audit *industry* as a profession and by the audit *firm* as a business. This paper aims to explore the position of the audit in corporate governance as it has developed in the Irish economy. I focus on the issue of auditor liability, in terms both of the legal shifts that have shaped the liability regime and the policy debates and positions that have sought to influence the manner in which liability has been defined. I examine the dynamics described in the paragraphs above by looking at two closely related issues: the development of liability in company law and policy, most recently through the European Union and debates over optimum levels of disclosure in Ireland in the last decade. My aim is to describe how the Irish regime has negotiated a line on the audit in the context of globalisation and Europeanisation and in the light of global dynamics in the audit industry itself. This issue is important in the context of the crisis from 2007-8 onwards because it highlights the difficulties Ireland, as a small open economy, faces in finding a path through difficult economic times. It also serves to describe some of the issues that has brought the global financialised economy, of which Ireland is one part, to the impasse it finds itself in, as the gap has widened between incentives and expectations as imagined in the dominant corporate ideology and the realities of accumulation and appropriation in corporate economies as they are.

One final note: one primary debate over the audit tends to relate to the 'expectations gap,' between the audit function in law and expectations of the audit as imagined by members of the public, or politicians, or key stakeholders. My argument here is relevant to the expectations gap debate but I am more concerned with describing the legal regulation of the audit in the context of its existence in relation to the demands of regulation, of commerce and the corporate person and in relation to the demands that the audit and auditors place on them. Before debating the proper role of the audit, we need to develop a closer sense of how the audit fits into the superstructure of any particular regime.

The remainder of the paper is divided into four sections. In the first section I address the idea of accountability in the corporation in general, especially as imagined in the 'principal-agent' theory. Then I review the auditor liability to third parties as it has developed in company law and as it continues to develop within the European regulatory regime. I focus on the tensions and problems created by the multiple pressures to maintain gatekeeping standards where the audit function is dominated by four enormous firms and where policy is driven by the fear of a catastrophic collapse in the industry (a fear, I should add, that is fuelled by the large audit

firms).<sup>3</sup> Then, third, I give an account of one area where debate over audit liability and the regulatory regime spilled over into the public sphere: the debate over the Directors' Compliance Statement (DCS) requirement in Section 45 of the Companies (Auditing and Accounting) Act 2003. I highlight the manner in which the matter of International regulatory competition came to the fore in thinking about the Compliance Statement. Finally, I make some remarks about the options open to the Irish regime in terms of the accountability components of the corporate economy.

### **Corporate Accountability.**

The public company is at base an accountability vehicle. Designed around the separation of ownership and control,<sup>4</sup> the legal, regulatory and governance regime surrounding the public corporation, at least according to the dominant principal-agent theory, enables the raising of capital and generation of revenue because it attends to the interests of diffuse bodies of shareholders while allowing managers to attend to the day-to-day running of the organisation.<sup>5</sup> Although the origins of the principal-agent model of the corporation are American, they are probably even better suited to how the corporation is imagined in the 'Anglo' company law sphere, including in the Republic of Ireland. Whereas the company maintained a distinctly public flavour in American political culture until recently,<sup>6</sup> the British, Irish and other corporate models, developing as they did from 19<sup>th</sup> Century partnership law, have to a greater or lesser extent always maintained a private tone.

As such, accountability mechanisms are imagined in company law, regulation and in corporate governance codes as flows of information from the company to the body of shareholders.<sup>7</sup> Accountability, in these terms, is

3 Although they do not have standing in Irish law, standards that apply in practice through the Irish professional bodies are generally developed in the UK under the auspices of the Accounting Standards Board (ASB) and the Auditing Practices Board (APB). Accounting standards for companies are developed through the ASB and auditing guidelines through the APB. The ASB and APB are part of the Financial Reporting Council (FRC). The FRC's task is to promote sound financial reporting and the Irish government attended its meetings as an observer (this role has been handed over to the IAASA since its inception). The APB was established in 1991. It develops definitive standards and guidance for auditing practice in the UK and Ireland.

4 A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932), 3ff.

5 For some foundational texts, see M. C. Jensen and W. H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' *Journal Of Financial Economics* (1976) 3, 305-360; E. F. Fama, 'Agency Problems and the Theory of the Firm' *The Journal of Political Economy* (1980) 88, 288-307; E. F. Fama and M. C. Jensen, 'Separation of Ownership and Control' *Journal of Law and Economics* (1983) 26, 301-325; M. C. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' *Journal of Applied Corporate Finance* (2001) 14; for a review of agency theory, see K. Eisenhardt, 'Agency Theory: An Assessment and Review' *Academy of Management Review* (1989) 14, 57-74.

6 L. E. Mitchell, *The Speculation Economy* (San Francisco: Berrett-Koehler Publishers, 2007).

7 See Financial Reporting Council, *The Combined Code on Corporate Governance* (London: Financial Reporting Council, 2008); The Institute of Chartered Accountants in England & Wales, *Internal Control: Guidance for Directors on the Combined Code (The Turnbull Report)* (London: The Institute of Chartered Accountants in England & Wales, 1999); Institutional Shareholders' Committee, *The Responsibilities of Institutional Shareholders and Agents - Statement of Principles* (London: Institutional Shareholders' Committee, 2007); OECD, *OECD Principles of Corporate Governance* (Paris: Organisation for Economic Cooperation

transparency.<sup>8</sup> The assumption is that, given their rights of control over the corporation, shareholders can discipline managers either directly by exercising their voices or indirectly by exiting the company (which, following a fall in share prices, will subject the managers to the market for corporate control).<sup>9</sup> Power, where the regime works well, lies with the shareholders.

The reliance upon the assumption that a self-regulatory system of accountability-as-transparency underpins a private relationship between the company's directors and its members, binding directors to their duties as well as is possible (in the context of corporate commerce) and allowing shareholders to manage their stake in the company. Furthermore, the privacy of corporate relationships is predicated on the centrality of a cadre of professional gatekeepers – auditors, lawyers and ratings agencies – who testify to the veracity of corporate disclosures.<sup>10</sup> Finally, the value of the gatekeeper system, and the shareholder primacy-oriented corporate architecture in turn, is itself dependent upon the assumption that gatekeepers are oriented towards members, that members are capable of overseeing gatekeeper relationships to the firm and that shareholders are even *inclined* to oversee those relationships.<sup>11</sup> The shareholder primacy regime collapses if these premises do not hold.

Irish (and British) company law is predicated on the auditor as the primary gatekeeper in corporate accountability: they guarantee the quality of

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and Development, 2004); see also L. Sheridan, E. Jones, and C. Marston, 'Corporate Governance Codes and the Supply of Corporate Information in the UK' *Corporate Governance: An International Review* (2006) 14, 497-503; I. P. Dewing and P. O. Russell, 'Regulation of UK Corporate Governance: lessons from accounting, audit and financial services' *Corporate Governance* (2004) 12, 107-115; R. Monks, 'Modern Company Law for a Competitive Economy: the strategic framework' *Corporate Governance: An International Review* (2000) 8, 16-24; R. A. Monks, 'Redesigning Corporate Governance Structures and Systems for the Twenty First Century' *Corporate Governance An International Review* (2001) 9, 142-147; J. Gray, 'Lessons from the BCCI Saga for the Current Accountability Debate Surrounding Northern Rock?' *Journal of International Banking Law and Regulation* (2008) 23, 3743.

- 8 For an explicit conflation between accountability and transparency, see Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework* (London: Department of Trade and Industry, 1999), 15: "A key role of company law is as a means of facilitating the operation of market forces, through contractual and other mutual relationships. These operate in markets and other arenas where accountability ('transparency') enables effective assertion of claims by external interests and appropriate response by managements and members (or shareholders)".
- 9 On exit and voice see A. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge (MA): Harvard University Press, 1970).
- 10 On gatekeeping, especially in the wake of the crisis caused by Enron's collapse, see J. Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006); for an alternative response on Enron, see M. Aglietta and A. Reberieux, *Corporate Governance Adrift: A Critique of Shareholder Value* (Cheltenham: Edward Elgar Publishing Ltd, 2005), 235-237 who argue that failures of monitoring must be seen in the light of the shareholder primacy system itself; see also L. A. Cunningham, 'Beyond Liability: Rewarding Effective Gatekeepers' *Minnesota Law Review* (2007) 92, 323-386; S. Deakin and S. Konzelmann, 'Learning from Enron' *Corporate Governance: An International Review* (2004) 12, 134-142; M. Klock, 'Two Possible Answers to the Enron Experience: Will it be Regulation of Fortune Tellers or Rebirth of Secondary Liability' *Journal of Corporation Law* (2002) 28, 69-109.
- 11 While imputed versus actual shareholder inclinations are important, I will not address them here. The focus here is on external gatekeepers.

information flows.<sup>12</sup> Although their role is not explicitly set out in Irish company law, they are responsible for verifying that the (largely financial) statements of the company represent a 'true and fair' view of the company's actual financial state. Auditors must be appointed by the general meeting and their job is to report to the body of shareholders as to whether the company's accounts have been prepared in accordance with the provisions of the Companies Acts and give a true and fair view of the state of affairs of the company.<sup>13</sup> As such, the auditor's relationship with the company is primarily focused on a duty of care to the body of shareholders.<sup>14</sup>

Unfortunately, principal-agent theory approach is predicated on two errors. First, we must understand the implications of the conflation of accountability and transparency in the principal-agent worldview. Agency theorists acknowledge that perfect corporate governance is not attainable. They aim instead to find a best fit between the alleviating of costs associated with delegated agency and the costs of enforcing compliance.<sup>15</sup> Nevertheless, the limits of the contractual or formal formulation of compliance have been shown again and again, whether it was through the disjuncture between Enron's gold-plated board-centred corporate governance standards and the actual position of the board in the company's power structures or through the collapse in the self-regulation of risk in the banking industry that preceded the global financial crisis from 2007-2008. The character of accountability in the agency frame is very narrow indeed. Rather than producing honesty, in other words, accountability-as-transparency seems on occasion to simply produce better liars.

Following from that, second, the defining relationships between auditors and companies are in fact between auditors and *directors*. This has especially been the case given the increasing centrality of non-audit services as revenue-generators for audit firms. As the Cadbury Committee put it,

Although the shareholders formally appoint the auditors, and the audit is carried out in their interests, the shareholders have no effective say in the audit negotiation and have no direct link with the auditors. Indeed the Committee can see no practicable way of establishing one. Auditors do, however, have to work closely with those in management who have prepared the financial statements which they are auditing in order to carry out their task, and audit firms, like any other business, will wish to have a constructive relationship with their clients.<sup>16</sup>

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12 For a discussion of the audit as envisaged in the consolidated Irish Companies Bill 2007, see B. Conroy, 'Revolutionising Irish Company Law: The Proposed New Companies Consolidation And Reform Act' in this volume, sec. 9.

13 *Companies Act 1990*, sec. 193.

14 Not to individual shareholders: more on that below.

15 Jensen and Meckling, 'Theory of the Firm.' supra note 3.

16 Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance (The Cadbury Report)*: 5.3b (London: Gee & Co. 1992).

"Audit firms compete on price and on meeting the needs of their clients (the companies they audit)," the report continues. "This may be at the expense of meeting the needs of the shareholders."<sup>17</sup>

From the 1990s onwards, the big five audit firms (as were) transformed the audit into a loss-leader, designed to provide access to company directors and from which taxation and management consultancy products could be sold. Formal accountability in the guise of reporting requirements and the hiring of gatekeepers does not easily translate into any substantive ceding of power over corporate governance to shareholders.<sup>18</sup>

If the gatekeeper system is captured by corporate managers, then the use of incentives to align the interests of directors with those of shareholders - stock options, bonuses etc - risks actually exacerbating the problems those incentives were designed to solve. As well as verifying the formal elements in the legal architecture of corporate reporting and governance, gatekeepers can play a role in the moderation of the necessary risk-taking activity upon which a firm must grow. Without gatekeepers, directors might be tempted to design structures that encourage combining the taking of high risks with the capacity to cash in when those risks pay off (and pass losses on to others where necessary).

The conflicts of interest produced by non-audit services lay at the root of the dysfunctional relationship between Arthur Anderson and Enron, although Arthur Anderson's Houston office was not just beholden to Enron for non-audit fees but also for the audit fees that made up 27% of their audit income from public clients.<sup>19</sup> Indeed, partners in Arthur Anderson were actively discussing the prospects for Enron becoming a \$100m client in 2001.<sup>20</sup> On this side of the Atlantic, with FTSE 100 firms paying British auditors "£3 for non-audit services for every £1 paid to them for audit fees" as of 2001,<sup>21</sup> it is no surprise that questions were raised in the wake of Enron's collapse regarding the regulatory balance required to ensure "that the financial incentives to acquiesce to management pressure never outweigh the disincentives or deterrents to acquiesce."<sup>22</sup> While this practice may have peaked at the turn of the millennium, non-audit services still provide approximately two thirds of business for the remaining four large audit firms that account for 85% of audits carried out in the EU.<sup>23</sup> Within this context, any sense of accountability being driven by a private relationship between shareholders and directors, mediated by the auditor, is simply unwarranted.

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17 Ibid, 5.3c

18 For a discussion of the difference between formal and professional accountability, see M. Dubnick, 'Sarbanes-Oxley and the Search for Accountable Corporate Governance' in *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (London: Imperial College Press, 2007) ed. Justin O'Brien.

19 J. Coffee, *Gatekeepers*, supra note 8, 29.

20 Ibid, 11 fn.11.

21 The Auditing Practices Board, *APB Ethical Standards Consultation Paper: Draft Revised Ethical Standards for Auditors*: 3 (London: Auditing Practices Board 2007).

22 D. Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' *Journal of Law and Society* (2006) 33, 390.

23 J. Hughes and B. Masters, "Audit firms uneasy to be held to account" *Financial Times*, 8 December 2008.

Gatekeepers are of course businesses. They have an interest in revenue and profit and reward systems within the organisations are directed towards that end. The modern audit business is in a sense a constant trade off between a conservative reputation-based accountability model and an aggressive revenue-generation model. Not only is it very difficult to strike an appropriate balance, if such a balance exists, but it does seem that, increasingly, other market players are not happy to accept that the balance has been struck, that accountability can be defined in terms of or reflected by the audit function. The rise in litigation must in part reflect this.

In this section I have pointed to the audit as imagined in the dominant theory of company law and the complex reality within which the audit works in financialised capitalism as it has formed. Identifying the discord between the two is crucial if we are to understand the context within which Irish corporate governance is formed and within which law and policy is to be made.

The next section sets out the background to the way that auditor liabilities to third parties are imagined in courts. This takes the argument on a step by setting out one important aspect of company law as it formulates the audit. It also shows how policy is formulated around concerns for the audit as a gatekeeping function as described above and the audit articulated as part of an industry that is subject to substantial and serious risks.

### **Auditor Liabilities and Company Law.**

Audit liabilities have to be defined very carefully if the viability of the audit function is to be maintained. Otherwise, the auditor risks being subject to unjust costs and the audit will not be viable in anything like its present form. The primary principal by which courts have worked, in this light, is that the auditor is not expected to actively seek out error or fraud, although it should be noted that, should they come across evidence of wrongdoing, they ought to pursue a line of enquiry to establish what has happened.<sup>24</sup> In the words of Lopes J., the auditor is expected to be “a watch-dog, but not a bloodhound.”<sup>25</sup> The auditor “is justified in believing tried servants of the company in whom confidence is placed by the company.”<sup>26</sup> Given this, as Lord Denning has it in *Fomento v. Selsdon*, the auditor’s “vital task is to take care that errors are not made, be they errors of computation or of omission or commission, or downright untruths. To perform this task properly he must come to it with an inquiring mind – not suspicious of dishonesty, I agree – but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.”<sup>27</sup>

While the auditor owes duties in law to the body of shareholders, the

<sup>24</sup> *Re Thomas Gerrard* [1967] 3 W.L.R. 84; On the Thomas Gerrard decision, see for instance R. Baxt, *The Modern Company Auditor. A Nineteenth-Century Watchdog?*, *The Modern Law Review* (1970), 33, 413-431.

<sup>25</sup> *In Re Kingston Cotton Mill Company* (No. 2) [1896] 2 Ch. 279: 288.

<sup>26</sup> *Ibid*, 289.

<sup>27</sup> *Fomento (Sterling Area) Ltd. v. Selsdon Fountain Pen Co. Ltd. and Others* [1958] 1 W.L.R. 45: 61.

liabilities arising from that duty have to be limited. Otherwise, as Justice Cardozo famously put it in 1931, auditors would be exposed to “liability in an indeterminate amount, for an indeterminate time, to an indeterminate class,” where aggrieved shareholders seek to hold the auditor responsible for every corporate failure.<sup>28</sup> For such an extensive liability to be introduced, as Lord Bridge put it in *Caparo v. Dickman*, would entail “a legislative step which it would be for Parliament, not the courts, to take.”<sup>29</sup> It is doubtful that the audit industry could survive in these circumstances.

The concern about the introduction of an ‘intolerable burden’ has led courts to develop a very narrow perspective on proximity, through which they decide on whether an auditor does or does not owe duties to, say, a creditor or an individual shareholder (as opposed to the body of shareholders). In a dissenting judgement to *Candler v. Crane*, on the question of whether an accountant could owe duties to parties with whom they did not have a contractual or fiduciary relationship, Lord Denning argued that auditors and others, namely those “whose profession and occupation it is to examine books, accounts, and other things, and to make reports on which other people – other than their clients – rely in the ordinary course of business,”<sup>30</sup> owe a duty “to their employer or client; and also I think to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them.”<sup>31</sup> They do not owe duties to “strangers of whom they have heard nothing and to whom their employer without their knowledge may choose to show their accounts .”<sup>32</sup> Finally, the duty of care extends “only to those transactions for which the accountants knew their accounts were required.”<sup>33</sup> Denning’s dissent has become the authoritative definition of the threshold past which a duty-creating relationship exists between auditors and third parties.

Arguments over auditor liabilities in the British financial sphere were played out across the 1980s, as a leveraged buy-out boom hit the UK and potential investors based their investment decisions on audited accounts.<sup>34</sup> Most notably, in *Caparo v. Dickman*, the courts confirmed that close proximity or neighbourhood was required between plaintiff and defendant for a duty of care to be recognised.<sup>35</sup> The *Caparo* ruling followed Denning’s

28 *Ultramares Corp. v Touche* [1931], 174 N.E., 441 (1931). See also C. O’Leary, ‘Auditors’ liability to third parties - the door remains open,’ *Managerial Auditing Journal* (1998), 13, 521-524: 521..

29 *Caparo Industries plc v Dickman & Ors* [1990] 2 A.C., 623.

30 *Candler v. Crane, Christmas & Co.*, 179.

31 *Ibid*, 181.

32 *Ibid*.

33 *Ibid*, 182. The majority decision in *Candler* was overruled in *Hedley Byrne v. Heller* and Denning’s dissent was adopted into law. *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1963] UKHL 4.

34 See M. Percival, ‘After Caparo. Liability in Business Transactions Revisited,’ *The Modern Law Review* (1991), 54, 739-745.

35 *Caparo Industries plc v Dickman & Ors*, supra note 28, 605; *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1963] UKHL 4; See also K Barker, ‘Wielding Occams Razor: Pruning Strategies for Economic Loss’, *Oxford Journal of Legal Studies* (2006) 26, 289-302, Kevin Nicholson, ‘Third Party Reliance on Negligent Advice’, *International Company Law Quarterly* (1991), 40, 551-582.

argument from *Candler*, and sought to move slightly away from the more generous (to shareholders) *Anns* ruling by developing “novel categories of negligence incrementally and by analogy with established categories, rather than by a massive extension of a prima facie duty of care restrained only by indefinable considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed.”<sup>36</sup> Auditors, as *Caparo* has it, only have duties towards third parties if they know the information they audit will be used by specific third parties in order to pursue some action or other and that the advice the auditor gives “must be relied upon for the purpose of the particular transaction for which it was known to the advisers that the advice was required.”<sup>37</sup>

So, while auditors may have duties to the body of shareholders as a class, they certainly do not have obligations towards individual shareholders. Arguably, as Percival puts it “the House of Lords intended that a *caveat emptor* principle should always apply to transactions involving the acquisition of shares, irrespective of the type of document which had been relied upon.... the prudent would-be predator should conduct its own investigation into a target company rather than rely on information produced by the target company’s advisers.”<sup>38</sup> By these lights, the information flow in the audit is of a very limited and formal character. In a sense, the audit is not a verification of truth – about accountability in terms of fidelity to truth – but is a formal device designed to generate bases for discussion in general meeting. *Caparo* imagines the audit as a process that ought strictly speaking not be relied upon for investment decisions, even by the company’s individual shareholders.<sup>39</sup> Given this, while in some circumstances the trend in the courts towards restricting duties has not been entirely useful in restricting actual auditor liability,<sup>40</sup> shareholders’ capacity to hold auditors to account for perceived or actual misdeeds has been substantially diminished.<sup>41</sup>

Auditors’ duties to third parties in Ireland can be defined along similar lines to those developed in English courts. Auditors owe duties to the body of shareholders. Duties to individual third parties only arise where there is a direct and tangible arrangement by which the auditors opinion is – with the auditor’s knowledge – given with the aim of a specific third party using the

36 Brennan J. in *Sutherland Shire Council v. Heyman* (1985) 60 A.L.R. 1, 43-44; *Caparo Industries plc v Dickman & Ors*, supra note 28, 618

37 Ibid, 617.

38 Mary Percival, ‘After Caparo’, supra note 33, 739.

39 Conor O’Leary, ‘Auditors’ liability to third parties’ supra note 27, 522

40 Given the prevalence of tactics among powerful third parties, including ‘privity letters’ between banks and auditors, which serve to act as “an acknowledgement by the auditors of the fact that the lender will rely on the audited accounts.” Mary Percival, ‘After Caparo’ supra note 33, 744 September, 1991; See also Doreen McBarnet & Christopher Whelan, ‘The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control’ *The Modern Law Review* (1991), 54, 848-873. Moreover, auditors have agreed a range of out of court settlements with third parties in the last number of years. See Gerald McHugh & David Rowe, ‘The Audit Gap’ in Gerald McHugh & David Rowe eds. *Financial Reporting and Auditing: Bridging the expectations gap* (Dublin: Oak Tree Press 1996): 71.

41 Iain MacNeil, Enforcement of Capital Markets Regulation: The United Kingdom and its International Markets *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation*: 133 (Justin O’Brien, Ed.) London: Imperial College Press 2007).

opinion in order to make an investment decision or the like. So creditors or potential investors cannot assume that the auditor is liable to them for any opinion given on the state of a company's finances.<sup>42</sup>

While the various attempts to keep auditor liability in a narrow frame are borne from good motivations – the risks described in Cardozo's maxim, that a move towards unlimited liability would be a move towards unlimited litigation – the preservation of the narrow liability frame might mean that, without the disciplinary effects of litigation we run the risk that auditors might align themselves more with directorial power than with shareholder interests. That said, Irish auditors (as with elsewhere) have been made subject to a number of disclosure obligations over the last decade, designed to preserve the company from liability to the state by adding to auditor obligations. To take a number of instances, under section 1079 of the Taxes Consolidation Act 1997, if an auditor uncovers breaches of a company's statutory tax obligations, they are required to draw the attention of the company's officers to the offences. They must request that the company rectify the situation or notify the Revenue Commissioners within six months. If the company does nothing, the auditor must resign as auditor and must notify the company of the cause of their resignation and copy the notice to the Revenue Commissioners.<sup>43</sup> This whistleblowing obligation was introduced to in section 172 of the Finance Act 1995, after the DIRT scandal, described below, unfolded.<sup>44</sup> Auditors also have reporting obligations under section 194 of the Companies Act 1990, updated by the Company Law Enforcement Act 2001,<sup>45</sup> where they are under an obligation to report a suspicion that books are being kept improperly or that other breaches of the Companies Acts are taking place to the Director of Corporate Enforcement. Finally, the Companies (Auditing and Accounting) Act 2003 stipulated that auditors certify the ill-fated DCS, on which more below.<sup>46</sup>

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42 For some consideration of third party liability in the Irish courts, see *Ward v. McMaster* [1988] IESC 3; *Glencar Exploration plc v. Mayo County Council* [2001] IESC 64; and *Wildgust & anor. v. The Governor and Company of the Bank of Ireland & anor.* [2006] IESC 19.

43 *Taxes Consolidation Act 39/1997: 1079*. As of the publication of *the report of the Review Group on Auditing*, "No reports have been received by the Revenue Commissioners under obligations imposed on external auditors who have become aware of material tax offences. Yet the Revenue Commissioners discover irregularities in the affairs of companies the financial statements of which have been audited by an external auditor. This raises the question of whether there was wilful non-compliance with Section 1079 of the Taxes Consolidation Act 1997. No reports have been received by the Revenue Commissioners under obligations imposed on external auditors who have become aware of material tax offences. Yet the Revenue Commissioners discover irregularities in the affairs of companies the financial statements of which have been audited by an external auditor. This raises the question of whether there was wilful non-compliance with Section 1079 of the Taxes Consolidation Act 1997." *The Revenue Commissioners, Review Group on the Operation of The Auditing Profession: Submission by the Revenue Commissioners* (Revenue Commissioners: Dublin 2000).

44 *Finance Act 8/1995 (1995)*; On whistle blowing in Ireland, see ICAI, *Blow the Whistle, Who, Why, When and Where? The 'Whistleblowing' Obligations of Accountants in the Republic of Ireland* (Dublin: The Institute of Chartered Accountants in Ireland 2005); See also N. Brennan & J. Kelly, 'A study of whistleblowing among trainee auditors' *The British Accounting Review*, (2007), 39, 61-87.

45 *Companies Act 33/1990 (1990)*; *Company Law Enforcement Act 28/2001*.

46 *Companies (Auditing and Accounting) Act 44/2003: 45*

*Caparo* went some way towards solving the perceived 'litigation crisis' in the UK's regime.<sup>47</sup> Nevertheless, the audit industry has continued to press for reform. Despite recent high profile suits,<sup>48</sup> and presumably with many more to come,<sup>49</sup> it is difficult to know the extent either of increased litigation or increased litigation costs. For Cousins et al, writing before the Enron collapse, litigation was at that moment "virtually non-existent."<sup>50</sup> Enron and the subsequent 2002 Sarbanes-Oxley Act may have changed the litigation environment worldwide however. It certainly was a key part in the story of the diminishing reputation of audit's liability, a reputation that is surely not helped by the audit's narrow position in law. According to the London Economics report on audit liabilities to the European Commission, the number of claims is not rising in the EU, but the cost of claims is. Most importantly, averages are skewed by a few very costly liability claims against auditors.<sup>51</sup> This may confirm the big fear for European policymakers: rather than being entirely responsive to any perceptions about litigation volume, they may be motivated more by fear of another Anderson-style collapse in one of remaining the big four.<sup>52</sup>

In Britain the Companies Act 2006 saw the introduction of limited liability agreements, whereby, through transparent agreements between companies and auditors, and subject to a range of provisions, potential liabilities could be capped.<sup>53</sup> The Institute for Chartered Accountants in Ireland have lobbied both for the incorporation of audit firms and for a statutory cap to be placed on liabilities.<sup>54</sup> A variety of initiatives at the EU level have produced shifts towards the capping and limiting of auditor liabilities. The Transparency (Directive 2004/109/EC) Regulations 2007 (S.I. No. 277 of 2007), as well as regulating disclosure through the production of a range of new company reports, allow auditors, the Central Bank and the Irish Auditing and Accounting Supervisory Authority (IAASA) to disclose and share information without creating liabilities for the auditors.<sup>55</sup> The 2006 statutory audit directive (2006/43/EC) seeks harmonisation on ethical standards in European auditing. The directive also invited the Commission to study the economic impact of unlimited auditor liability. This study pointed to liability risks as

47 For an account of the 'litigation crisis,' see C. Pacini et al., 'Commonwealth Convergence Toward a Narrower Scope of Auditor Liability to Third Parties for Negligent Misstatements' *Abacus* (2002) 38, 425-464.

48 T. Thorniley, "Equitable Life to sue ex-auditor for £2.6bn" *Daily Telegraph*, 15 April 2002.

49 A. Jolis, 'Madoff investors to sue UBS, HSBC, Medici and E&Y' *Reuters*, 4 February 2009.

50 J. Cousins, A. Mitchell, and P. Sikka, 'Auditor Liability: the Other Side of the Debate' *Critical Perspectives on Accounting* (1999) 10, 285.

51 European Commission, London Economics, and R. Ewart, *Study on the Economic Impact of Auditors' Liability Regimes Final Report to EC-DG Internal Market and Services* (Brussels: London Economics, 2006), 82ff.

52 C. McCreevy, *Speech by the European Commissioner for Internal Market and Services to the JURI Committee of the European Parliament Presenting the Statutory Audit Package* (Brussels: European Parliament, 2007).

53 Companies Act 2006, sec. 534-536. See also Financial Reporting Council, *Guidance on Auditor Liability Limitation Agreements* (London: Financial Reporting Council, 2008). The FRC regards agreements as very much desirable.

54 CLRG, *Report of the Company Law Review Group 2007* (Dublin: Company Law Review Group, 2007), 47.

55 Iris Oifigiúil, *Transparency (Directive 2004/109/EC) Regulations 2007*.

one of the issues preventing middle-tier audit firms from competing with the big four. It also pointed to the increasing risk of a catastrophic claim against one of the big four. The report recommended some limitation of liability across the Union that would protect auditors from 'deep pocket' syndrome, where, in joint and several liability regimes, plaintiffs view audit firms as having the largest resources" and therefore the audit firm becomes "the target of complaints irrespective of the contribution and responsibility of the firm to the event"<sup>56</sup>

The Commission's moves have been driven and matched by advocacy by audit firms in Ireland and in the rest of Europe. Irish audit firms point to the competitive disadvantage they are at, especially in the context of the limited liability agreements under the UK's Companies Act 2006.<sup>57</sup> As such, they are seeking legislation placing caps on liability as soon as possible.<sup>58</sup> The CLRG is examining auditor liability in the context of Ireland's legal regime.<sup>59</sup> The Commission's recommendations for action were published in mid-2008.<sup>60</sup> At the same time, a debate has been taking place about establishing Irish audit firms as limited liability partnerships and a review is taking place.<sup>61</sup> On non-audit services, a debate is ongoing, with Irish auditors lobbying against.<sup>62</sup>

Again, the motivations behind the limitation of auditory liabilities are laudable. As Commissioner McCreevy has pointed out, the European market is characterised by a lack of competition and is exposed to the risk of an litigation-borne failure of one of the big-three audit firms in the Union.<sup>63</sup> At the same time, given the imbalances inherent in the various director-shareholder-gatekeeper relationships, the limitation of liability, especially through negotiation between company and auditor, risks widening to the gap between accountability as imagined in company law and actual fidelity to shareholder interests in the corporate body.

The environment within which the audit and regulation of the audit takes

56 European Commission, London Economics, and Ewart, *Study on the Economic Impact of Auditors' Liability Regimes*, supra note 51, 205ff.

57 Competitive disadvantage is also a major theme in the response to the Directors' Compliance Statement, as described in the next section.

58 Consultative Committee of Accountancy Bodies, *Remarks by the Consultative Committee of Accountancy Bodies - Ireland, on the proposed new EU Auditing Directive, to the Joint Oireachtas Committee on Enterprise and Small Business* (Dublin: Dáil Éireann, 2004); T. O'Rourke, *Remarks by Terence O'Rourke, Chairman of the Consultative Committee of Accountancy Bodies - Ireland, on the proposed new EU Auditing Directive, to the Joint Oireachtas Committee on Enterprise and Small Business* (Dublin: Dáil Éireann, 2004); S. Heaphy, 'ICAI Welcomes McCreevy Remarks on Limiting Auditor Liability' *accountingnet.ie*, 2007.

59 Department of Enterprise, Trade and Employment, *Minister Michael Ahern refers current auditor liability regime to the Company Law Review Group (CLRG)* (Dublin: DETE, 3 January 2007).

60 Commission Recommendation *Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms Recommendation* (Brussels: European Commission, 2008); for some background, see 'Commission plans to cap auditors' liability' *EurActiv.com*, 2007 <http://www.euractiv.com/en/financial-services/commission-plans-cap-auditors-liability/article-161024>.

61 For a good background piece on the pros and cons of the introduction of LLPs in Ireland, see CLRG, *Report 2007* supra note 54, 33ff.

62 Consultative Committee of Accountancy Bodies, *Remarks by the Consultative Committee*, supra note 57.

63 McCreevy, *Speech Presenting the Statutory Audit Packages* supra note 54; see also S. McGinley, 'Charlie McCreevy on Auditor Liability and Other Issues for the Profession' *Accountancy Ireland* (2005) 37.

place is obviously going to undergo serious change in the next few years. The audit industry has been proactive in protecting the audit from liabilities, even if the problems are themselves somewhat overstated. Regulators seek to innovate towards not altogether compatible concerns. They sit between a fear for the audit industry and the detrimental effects of collapse and a fear for the audit function and the detrimental effects of the conflict between the audit business and the audit function, especially in the midst of the global financial crisis. The question of how these questions are resolved at a broad level will not primarily be answered by Irish policymakers, or at least not directly. Nevertheless, Ireland will still have to develop the details of policy through trade-offs between industry, global capital and the regulatory regime. As we see in the next section, we have some experience of how these trade-offs can occur in Ireland.

### **Gatekeeping and the Audit Industry.**

As the section above shows, the fact that auditors trade in reputation does not imply that they are spared the same market forces and pressures to innovate as other enterprises suffer.<sup>64</sup> Auditors are obviously subject to diverse and simultaneous expectations in terms of their role as gatekeepers and as businesses. Standards must compete with commercial gain. The challenge for Irish company law is to maintain a viable audit function *and* a viable audit industry. In markets characterised by diverse and diffuse shareholding bodies, there can be insufficient pressure to maintain independence from the directors to whom, after all, auditors are financially beholden.

One instance of mobilisation by the Irish audit industry was over the DCS, which constituted one major component of state's response to the DIRT scandal in the late 1990s.<sup>65</sup> When DIRT was introduced, fears were raised about the effect the tax would have on the deposits of non-residents (largely emigrants) who kept savings in Ireland. As a result, the tax was not levied on non-resident accounts. At the same time, people expressed concerns that examination of personal details of non-residents would discourage those non-

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64 As McBarnet and Whelan note, pointing to one accountant saying "Now a client will ask, 'how can I capitalise my costs? How can I keep liabilities off the balance sheet?' If I don't tell him he'll go to a solicitor down the road who will." McBarnet and Whelan, 'The Elusive Spirit of the Law,' *supra* note 40, 870; See also John Coffee, *Gatekeepers* *supra* note 8; The value of reputation can be seen most clearly where it fails. One knock-on effect of Enron's collapse, for instance, was the downgrading of the shares of other companies audited by Arthur Anderson. See P. Chaney and K. Philipich, 'Shredded Reputation: The Cost of Audit Failure' *Journal of Accounting Research* (2002), 40, 1221-1245; See also K. Houghton and C. Jubb, 'The Market for Financial Report Audits: Regulation of and Competition for Auditor Independence' *Law & Policy* (2003), 25, 299-321; S. Krishnamurthy, J. Zhou and N. Zhou, 'Auditor Reputation, Auditor Independence, and the Stock-Market Impact of Andersen's Indictment on Its Client Firms' *Contemporary Accounting Research* (2006), 23, 465-490.

65 On DIRT, see Committee of Public Accounts: Sub-committee on Certain Revenue Matters, *Parliamentary Inquiry into D.I.R.T. (First Report)* (Dublin: Irish Oireachtas 1999); for the ICAI's narrative, see Percy, J.P., *Report of Professor J P (Ian) Percy into the Sub Committee Inquiry into DIRT (the Percy Report)*: (Dublin: ICAI 2001); for a journalist's account, see L. Collins, *The Great Irish Bank Robbery: The Inside Story of Conflict, Betrayal and Corporate Greed in Irish Banking* (Dublin: Mentor 2007).

residents from maintaining accounts in Ireland, so the Revenue Commissioners were instructed by government not to examine the documents supporting declarations of non-residency.<sup>66</sup> Unsurprisingly, the consequence of a complete lack of state oversight was that the evasion of the tax became an instrument for competition between banks. Evasion through 'bogus non-resident' accounts developed into a massive scam.<sup>67</sup> In the case of the Allied Irish Bank (AIB), indications suggested that, in 1991, just short of 50% of non-resident DIRT accounts were bogus.<sup>68</sup>

The investigation into the evasion revealed not only widespread evasion, but apparent auditor acquiescence. The Public Accounts Committee of Dáil Éireann found in their 1999 report that "there were a number of serious defects and weaknesses in relation to the statutory external audit function, which contributed to the continuance of the bogus non-resident problem, and these require to be addressed urgently."<sup>69</sup> Given that the amnesty most likely did not exist in fact, the Public Accounts Committee asked:

how precisely were the financial accounts for the year just ended approved by the two relevant parties - the Directors and the External Auditors? How did they arrive at their separate decisions to provide for no liability for arrears of DIRT? Critically, did the External Auditors, as they were required, reach their conclusions independently?<sup>70</sup>

The nub of the issue, as the Public Accounts Committee saw it, was the risk of an unhealthy alignment of interests between the auditors and the directors of AIB. This alignment of interests, as it turned out, was to the detriment of both the body of shareholders and the Revenue Commissioners. Auditors had relied on assurances from executives rather than on the reports of internal auditors or had even, in the case of ACC, withdrawn a report estimating huge tax liabilities after directors criticised it.<sup>71</sup>

Widespread and systematic evasion of DIRT by the banks, combined with other issues led to the Company Law Enforcement Act in 2001, which established the Director of Corporate Enforcement to regulate Company Law in the country. The DIRT scandal specifically led to the Companies (Auditing and Accounting) Act 2003, which established the Irish Auditing and Accounting Supervisory Authority and introduced the DCS.<sup>72</sup> This was itself a

<sup>66</sup> Based on Superintending Inspector's Memorandum SIM 263. Committee of Public Accounts, *Parliamentary Inquiry into D.I.R.T.*, 2.2; Indeed, Collins reports that one bogus non-resident account holder gave his address to the bank as 'Main Street, New York, America.' L. Collins, *The Great Irish Bank Robbery*, 32.

<sup>67</sup> Committee of Public Accounts *Parliamentary Inquiry into D.I.R.T.* Supra note 63.

<sup>68</sup> Percy, J.P., *Percy Report* supra note 63, sec. 3.50.

<sup>69</sup> Committee of Public Accounts *Parliamentary Inquiry into D.I.R.T.* Supra note 63, sec. 6.

<sup>70</sup> Committee of Public Accounts *Parliamentary Inquiry into D.I.R.T.* Supra note 63, sec. 8.14

<sup>71</sup> Committee of Public Accounts *Parliamentary Inquiry into D.I.R.T.* Supra note 63, sec. 1.3

<sup>72</sup> *Companies (Auditing and Accounting) Act 44/2003* Sections 4-33 on the IAASA and section 45, amending the Companies Act 1990 through the introduction of new sections 205E and 205F on the Directors' Compliance Statement. Responses to other scandals had included the whistle blower provisions in the *Taxes*

response to the recommendations of the Review Group on Auditing, established to develop solutions to the gatekeeping problems the Public Accounts Committee identified in the tax evasion. The review group published its report in 2000.<sup>73</sup> The Review Group was asked to assess whether the self-regulation of the audit industry was working effectively and consistently.<sup>74</sup> Other terms of reference (of a total twelve) included “whether any new or revised structures and arrangements are necessary to improve public confidence, and if so, what form they should take.”<sup>75</sup> The group was also asked to examine independence issues around non-audit services, auditor terms and the like.<sup>76</sup>

Of the eighty recommendations in the Review Group’s report, the IAASA and the DCS were most notable.<sup>77</sup> The IAASA would be tasked with supervising the self-regulatory aspects of the professional bodies.<sup>78</sup> This ‘oversight board’ would be responsible for recognising accountancy bodies, for approving each body’s constitution and standards and for the bodies’ supervising disciplinary procedures. Second, the Review Group recommended that company directors be compelled to

report on an annual basis to the shareholders on the company’s compliance with its obligations under company law, taxation law or other relevant statutory or regulatory requirements. The report should confirm that any instances of non-compliance have been reported to the relevant regulatory authority and that in all other respects the company has complied with its obligations under company law, taxation law and other relevant statutory or regulatory requirements. The report should be appended to the annual financial statements.<sup>79</sup>

The review group argued that auditors ought to report on whether, in their opinion, the DCS is reasonable. Their report would address whether the directors have made an appropriate disclosure of any issues and, if they feel the directors have not made an appropriate disclosure, the auditors ought to include such information in their report.<sup>80</sup>

This proposal went quite a bit further than the ICAI would have preferred. The Report of the Commission of Inquiry into the Expectation of Users of

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*Consolidation Act 39/1997* mentioned above.

73 The Review Group on Auditing, *The Report of the Review Group on Auditing* (Dublin: Stationary Office 2000).

74 *Ibid*, 17

75 *Ibid*, 18.

76 *Ibid*, 21-27

77 Other recommendations acted fleshed out these two, or attended to the activities of audit committees, the relationships between auditors and client firms etc. Although all listed companies must have audit committees in order to comply with Irish Stock Exchange requirements, the requirement was introduced in law for non-listed companies in 2003 *Companies (Auditing and Accounting) Act 44/2003*: 42, introducing section 205B to the *Companies Act 1990*.

78 The Review Group on Auditing, *The Report of the Review Group on Auditing*, *supra* note 71, 129ff.

79 *Ibid*, 218.

80 *Ibid*.

Published Financial Statements (the Ryan Report), commissioned by the ICAI in 1992, recommended that a 'responsibility statement' be introduced, where directors would acknowledge their responsibility for the maintenance of the company accounts.<sup>81</sup> The Ryan report, it seems, focused on the expectations gap: that the primary problem with the audit was the inordinate expectations on people's parts that auditors would detect corporate wrongdoing.<sup>82</sup> The responsibility statement would help directors, shareholders and the general public see where responsibilities actually lie and expectations of auditors to detect fraud would revert to a more reasonable level.<sup>83</sup>

Given this, the reception by the professional accountancy bodies for the Review Group's report as a whole was somewhat mixed. The ACCA was relatively positive in its response for instance, citing the industry's interest in maintaining public confidence in the audit process. Roger Acton, the head of the ACCA, was quoted as saying that "at last there is a willingness to tackle serious issues and create an appropriate platform for effective professional governance. Previous failures in regulation can now be overcome and a coherent - and efficient - system introduced. Proper professional governance is no longer a possible option, it is a requirement."<sup>84</sup> The ICAI, on the other hand, had proposed a body to supervise self-regulation in its submission to the Review Group on Auditing, and was not particularly sceptical about it, though it did lobby to have greater representation on the IAASA's board.

The DCS was not greeted with much enthusiasm at all.<sup>85</sup> Speaking in the Seanad, Michael Ahern, the Minister for State at the Department of Enterprise, Trade and Employment described the DCS's as being designed to require that "directors have to satisfy themselves that they know what their company's obligations are, have in place procedures designed to secure compliance and give their opinion regarding compliance with these obligations." These requirements he said "are entirely reasonable and should not create difficulties for directors who are committed to due diligence in the execution of their duties as directors, and this fact has been acknowledged in many quarters. It is neither the intention nor in my view, the effect, of these provisions to impose draconian requirements on company directors, as some would seek to suggest."<sup>86</sup> This view was not universally held, however, with

81 Institute of Chartered Accountants in Ireland, *Report of the Commission of Inquiry into the Expectation of Users of Published Financial Statements (the Ryan Report)* (Dublin: ICAI, 1992).

82 For some different perspectives on the expectations gap, see D. Guy and J. Sullivan, 'The Expectation Gap Auditing Standards' *Journal of Accountancy* (1988) 165, 36-46; C. Humphrey, P. Moizer, and S. Turley, 'The audit expectations gap--plus ça change, plus c'est la même chose?' *Critical Perspectives on Accounting* (1992) 3, 137-161; P. Sikka et al., 'The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence' *Critical Perspectives on Accounting* (1998) 9, 299-330.

83 On the Ryan Report, see Paul O'Connor 'Financial Reporting Reforms - An Irish Perspective' in McHugh and Rowe eds *Financial Reporting and Auditing* supra note 40.

84 M. Canniffe, 'ACCA Ireland welcomes accountancy regulation plan' *Irish Times* July 13, 2000.

85 For another discussion of the Compliance Statement, see Conroy, "Revolutionising Irish Company Law," this volume, sec. 5.5.

86 Office of the Houses of the Oireachtas, *Dáil Debates Official Report*: 1151-2 October 16, 2003.

one senator describing the proposed Statement as “impractical, unnecessary and unwieldy”<sup>87</sup> and the Minister acknowledged a great deal of correspondence and debate over the Statement. Certainly, the business and auditing communities lobbied hard to prevent it being enacted.

The accountancy bodies, notably the ICAI, expressed concern that the Compliance Statement as proposed would have required auditors to report every technical breach of the Companies Acts to the relevant authorities, obviously increasing their exposure to liabilities.<sup>88</sup> It would have required auditors to act as “judge and jury” despite their not being in the business of committing this level of surveillance on their clients.<sup>89</sup> It would also lead to a loss of international competitiveness for Irish industry.<sup>90</sup> American businesses, it was argued, would favour the UK’s more light touch regime when making investment decisions. Moreover, there was a fear that the regime would be too costly for small and medium-sized enterprises.

Ceding to intensive industry lobbying, the Taoiseach referred the Compliance Statement<sup>91</sup> to the Company Law Review Group for a Regulatory Impact Analysis in April 2005.<sup>92</sup> The CLRG reported back that “a clear majority of the CLRG considered that it was simply not feasible to commence 45/2003 because of the additional unnecessary costs it causes for companies and the negative and disproportionate effect on national competitiveness and the likelihood of dysfunctional behaviour that would see companies registering outside of Ireland and so unaccountable to the Irish authorities.”<sup>93</sup> The CLRG concluded, based on estimates supplied by legal and accountancy firms and by the Irish Business and Employers Confederation (IBEC) that the DCS would have a one-off set-up cost for Irish businesses of between €90,000 and €1,000,000 and ongoing costs of between €40,000 and €600,000 per annum.<sup>94</sup> This would lead, the CLRG estimated, to a set-up cost to Irish business of €377m and ongoing costs of €202m per annum: a high price to pay for an enhanced international reputation for corporate governance.

In these circumstances and in the light of legislative innovations that placed obligations on directors to obey company law<sup>95</sup> and on auditors to

87 Ibid 1160.

88 B. Walsh, ‘Accountants argue in public interest’ *Irish Times* May 16, 2003.

89 Ibid.

90 D. Downes, ‘Companies (Auditing & Accounting) Bill: Boardroom Soundings’ *Accountancy Ireland* (2003), 35; J. Smyth, ‘ICAI critical of audit review group recommendations’ supra note 84.

91 That is, *Companies (Auditing and Accounting) Act 44/2003*: sec. 45

92 For one report see Audit Committee Institute Ireland, ‘Compliance Statements to be Reviewed’ *Audit Committee Quarterly* (2-3 May 2005), 6.

93 CLRG, *Report on the Directors’ Compliance Statement*, (Dublin: Company Law Review Group 2005), 5. The Office of the Director of Corporate Enforcement’s guidance on the Directors’ Compliance Statement envisaged the DCS not being imposed on foreign-registered companies. As a result, the CLRG foresaw many firms incorporating outside Ireland in order to avoid the regulation.

94 The legal and accountancy bodies envisaged a set-up cost of between €90,000 and €750,000 with ongoing costs of between €40,000 and €210,000 per annum. IBEC envisaged a set-up cost of between €140,000 and €1,000,000 with ongoing costs of €50,000 and €600,000 per annum. CLRG, *Report on the Directors’ Compliance Statement*, 59. The CLRG speculated that the higher costs reported by IBEC reflected the fact that IBEC represents large firms whereas the clients of legal and accountancy firms range in size from larger to smaller firms.

95 *Company Law Enforcement Act 28/2001*: 100.

report wrongdoing,<sup>96</sup> and given the regulatory activities of the Director of Corporate Enforcement, the CLRG recommended that the DCS be significantly reformed. In the CLRG's revised form, the Director's Compliance Statement would involve a statement of compliance with tax obligations and indictable offences under the Companies Acts and an acknowledgement of responsibilities under the Acts. Company directors are obliged to adopt a compliance policy and make a statement about the policy, on a 'comply or explain' basis.<sup>97</sup> The requirement for auditors to verify the statement is dropped.<sup>98</sup> These proposals were welcomed by industry,<sup>99</sup> though not entirely by international regulators<sup>100</sup>.

This revision of the DCS was not welcomed by the Irish Congress of Trade Unions, the Revenue Commissioners or the Office for the Director of Corporate Enforcement, each of whom attached dissenting appendices to the CLRG report. In his reservations, Paul Appleby, the Director for Corporate Enforcement wrote that the Compliance Statement was "a self-review framework for directors which adopts standard 'comply or explain' principles in seeking to engage them with their duty to ensure that their company fulfils its primary legal obligations"<sup>101</sup> and so did not present much of a departure from standard practice in the British model. Furthermore, the ODCE, as with the other two dissenters, suggested that the model for estimating the costs of the Compliance Statement was fundamentally flawed. No effort had been made to estimate how much of the costs cited by the ICAI and IBEC - the only two sources for costs - were a direct result of the incremental change represented by the Compliance Statement over an above costs associated with oversight under the combined code. Appleby also pointed out that the costs as cited represented less than 1% of annual profit for set up and far less for ongoing costs. Furthermore, the study had neither estimated the opportunity costs of the Compliance Statement nor had it verified the accuracy of the ICAI's and IBEC's figures.<sup>102</sup>

Appleby pointed out that, moreover, that if the costs of the DCS were actually low, then the impact on global competitiveness would also be low. Apart from the fact that competitiveness is multifaceted, and so direct regulatory costs were only one factor, "in the absence of any analysis which

<sup>96</sup> *Company Law Enforcement Act 74e*.

<sup>97</sup> CLRG, *Report on the Directors' Compliance Statement*, supra note 94, 130-2

<sup>98</sup> *Ibid*, 132

<sup>99</sup> See for instance A. Lambe, 'Directors' Compliance Statement - Section 45 - CLRG Shows Common Sense' *Accountancy Ireland* (2006), 38; KPMG and McCann Fitzgerald Solicitors, *Directors' Compliance Statements* (Dublin: KPMG/McCann Fitzgerald 2006); John Greely, 'Review group proposals welcomed' *Irish Times* November 4, 2005.

<sup>100</sup> OECD Directorate for Financial and Enterprise Affairs, *Ireland: Phase 2 - Report on the Application of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the 1997 Revised Recommendation on Combating Bribery in International Business Transactions: 73-74* (Paris: OECD 2007).

<sup>101</sup> CLRG, *Report on the Directors' Compliance Statement*, 141; for a discussion of the Office of the Director of Corporate Enforcement, see John Heneghan and David O'Donnell, "Governance, Compliance and Legal Enforcement: Evaluating a Recent Irish Initiative," *Corporate Governance International Journal of Business in Society* 7, no. 1 (2007): 54-65.

<sup>102</sup> CLRG, *Report on the Directors' Compliance Statement*, 141.

would satisfactorily justify the indicated assumption that the present DCS would reduce the inflow of FDI by 10%, it appears to the ODCE that 0.01% is as valid a speculative assumption of likely impact as any other number.”<sup>103</sup>

Nevertheless, the key driver of criticisms of the DCS was that Ireland is not in a position to pursue high regulatory standards if those standards have too high a price-tag attached. As Tom Courtney, head of the CLRG put it, the original introduction of the DCS had revealed

“a certain naivety in thinking that a country of our size could punch so much above its weight in raising the bar for corporate compliance without the result that FDI would vote with their dollars and exit. Ireland was going to be unique amongst developed countries in seeking to impose such a costly compliance verification procedure; uniquely stringent is something to which I believe we should not aspire.”<sup>104</sup>

The Irish state has a limited space for manoeuvre when it comes to regulation. Given all of this, Ireland finds itself between two great powers. The economy is imagined as relying on global, primarily American capital for its survival (a situation that has taken on a worrying tone at present). As a result governments and elites maintain a keen eye on Ireland existence as a leader on price. At the same time, the United Kingdom looms large as a direct competitor on regulatory costs. The imperative for Ireland seems to be the maintenance of its historically British character - its ‘light touch’ regulatory regime - in an effort to attract American capital that would otherwise cross over on its way to London.

As Conroy points out, the new statement as incorporated in s.7, Part A5 of the Companies Consolidation Bill 2007, focuses on a compromise position with far less onerous reporting obligations.<sup>105</sup> The new statement seeks to strike a balance between business costs and oversight. It also reworks the balance between auditor exposure to liabilities, their obligations and their

<sup>103</sup>Ibid., 142.

<sup>104</sup>Daisy Downes, “In Conversation with Tom Courtney, CLRG” (2007), [http://www.accountancyireland.ie/dsp\\_articles.cfm/goto/1376/page/In\\_Conversation\\_with\\_Tom\\_Courtney,\\_CLRG.htm](http://www.accountancyireland.ie/dsp_articles.cfm/goto/1376/page/In_Conversation_with_Tom_Courtney,_CLRG.htm).

<sup>105</sup>See Conroy, this volume sec. 5.5; Department of Enterprise, Trade and Employment, *Minister Michael Ahern Announces Reform of Directors’ Compliance Statement* (<http://www.entemp.ie/press/2005/20051201b.htm>); See also Company Law Review Group, *Company Law Review Group Welcomes Proposed Reform of Directors* (<http://www.clrg.org/about/pressarticle.asp?NID=43&T=N>); Daisy Downes, In Conversation with Tom Courtney, CLRG, 39 *Accountancy Ireland*, 2007; Department of Enterprise, Trade and Employment, *Regulatory Impact Analysis: The Company Law Consolidation and Reform Bill*; CLRG, *Report on the General Scheme of Companies Consolidation and Reform Bill* (Dublin: Company Law Review Group 2007).

relationships with directors. How this pans out in the new consolidated act, of course, remains to be seen.

## Conclusion.

The lessons of the DIRT do not lie in wrongdoing, fraud or negligence on the part of directors or auditors. Rather, the important thing is to attempt to discover some of the underlying systematic issues that produced the problem in the first place. Furthermore, a question remains over whether the DCS and other innovations in the Irish regulatory regime have, or could have, resolved any structural problems in Irish capitalism that might have contributed to the problem. The Irish are in a difficult position given their limited freedom to manoeuvre and innovate in the context of their globalised economic model. While the 2007-8 crash in the global economy leaves major questions as to what the character of financialised capital will be in future years, the Irish will be faced with very similar questions to those they faced over the DCS: how to regulate but maintain an attractive regime. I do not argue that the DCS was or was not in fact too onerous for Irish capital. The important thing to note is that that the question became the major fulcrum for debate, even among those who dissented from the CLRG's conclusions. It is unlikely that this sort of question will disappear in the future.

Part of the reason for this is that the new capitalism has allowed for the development of conflicts of interest to a greater degree than that imagined by company law or by law and economics theorists. These conflicts of interest ought not to be regarded as a simple externality associated with transaction costs. They reflect fundamental shifts in how one part of capitalism works: fundamental because the orientation of business has turned to such a degree towards the provision of financial and consultancy services. Auditors and other gatekeepers are to a greater degree than ever central to corporate financial management and financial planning in all layers of the relationships that form around corporations but they have been asked to oversee a range of products systems that, though articulated as alleviating risk, have actually been employed for speculative accumulations of risk. That this creates challenges for all parties to the relationship ought to come as no surprise. Neither ought it be a surprise that company law, with its relatively simple articulation quasi-partnership model corporate form, is ill-equipped to describe the challenges that capitalism faces.

So, what is to be done in the Irish context? The new companies bill has to be relatively conservative, given that its primary focus is on the private companies that make up the vast majority of the Irish corporate economy. Difficulties experienced in 2008 and 2009, primarily involving the near-collapse of the Irish banking sector, highlight the problems with auditors either helpless or unwilling to intervene in unorthodox practices. Moreover, very many of the practices that led to the slump of 2007-8 were verified by gatekeepers - ratings agencies in terms of American mortgage-backed

securities and auditors in terms of Irish, British and other banks' exposures to the wholesale banking markets (and to the housing markets). The crash was not caused, in the main, by illegal activities. It was caused by a system where incentives pointed directly away from long-term corporate health and instead pushed people towards short-term share returns and fees-based accumulation. The Anglo-American legal and theoretical model for imagining business is no longer in step with the manner in which business is done. Despite its being provoked in immediate terms by a classical housing bust,<sup>106</sup> the crash was rooted in the Anglo-American corporate governance model. It is unclear, as of yet, if and how the model can be reconciled with the realities of contemporary capitalism.

In general, then, the Irish are at sea when it comes to major questions about the globalised financial model. How that model evolves is not a question that will be answered in Ireland, but the answer will be the primary driver of the Irish economy as time goes on. As we saw in the previous two sections, the audit function itself highlights the way in which gatekeeping in the current model for company law and regulation acts as a meeting-point for pressures over standards, industries and public and private interests. Shifts in the behaviour of gatekeepers are themselves one part of the transformation of corporate governance in recent years. The focus on corporate governance has, perhaps not accidentally, coincided with the financialisation of markets; the decline of the professions and of their insulation from commercial pressures; with the deregulation of government control and finally with technological changes leading to the commodification of complex financial information flows.<sup>107</sup> Perhaps the explicit turn to corporate governance is as much a reflection of the failures of legal and regulatory regimes as it is a reflection of discussions around good governance.

In this sense, corporate governance, especially where its worth is conceptualised in the context of comparative measure of economic success,<sup>108</sup> leaves imagined accountability in the corporation so distant from the

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106 On boom and bust cycles over time, see C. P. Kindleberger and R. Z. Aliber, *Manias, Panics and Crashes: A History of Financial Crises* (Basingstoke: Palgrave Macmillan, 2005), 5th ed.

107 There are a vast number of studies on each of these issues. Some interesting perspectives include J. Froud et al., *Financialization and Strategy: Narrative and Numbers* (London: Routledge, 2006); J. Froud, A. Leaver, and K. Williams, 'New Actors in a Financialised Economy and the Remaking of Capitalism' *New Political Economy* (2007) 12, 339-347; K. Williams, 'From shareholder value to present-day capitalism' *Economy and Society* (2000) 29, 1; I. Erturk, J. Froud, and K. Williams, 'Corporate Governance and Disappointment' *Review of International Political Economy* (2004) 11, 677-713; J. Froud and S. Johal, 'Questioning Finance': A Special Issue of Competition Change' *Competition and Change* (2008) 12, 107-109; for an early report, see Committee on the Global Financial System, *Recent Innovations in International Banking (The Cross Report)* CGFS Publications (Geneva: Bank for International Settlements, 1986); see also Committee on the Global Financial System, *Ratings in Structured Finance: What Went Wrong and What can be Done to Address Shortcomings?* CGFS Publications (Geneva: Bank for International Settlements, 2008); E. Hüpkes, M. Quintyn, and M. Taylor, *The Accountability of Financial Sector Supervisors: Principles and Practice Working Paper* (Washington D.C.: International Monetary Fund, 2005).

108 See for instance H. Hansmann and R. H. Kraakman, "The End Of History For Corporate Law" *Georgetown Law Journal* (2001) 89, 439-468.

relationships, structures and processes that produce wrongdoing as to be more or less meaningless. As such, we are faced with a serious lag between the corporate economy and the legal and regulatory architecture under which it functions. The excesses of global financial capital are not reconcilable through reinforcing company law: company law was simply not written with these processes in mind.