The regulatory environment after MG Rover
A whole new set of goalposts

As long ago as July 2005 the AADB launched an investigation into the conduct of accountants involved in the attempted rescue of MG Rover in 2004/5. That process ended in a hearing this summer. The tribunal has produced a decision which, in the words of Paul George, the FRC’s executive director of conduct, “should be essential reading for all members of the profession”.

It should be noted that Deloitte have applied for permission to appeal against this decision.

The background
Deloitte were MG Rover’s auditors and also provided corporate finance advice to the company. The AADB’s complaints, as finally formulated in complaints produced last year, related to two particular corporate finance projects. They alleged that:

1. Deloitte “failed adequately to consider the public interest before accepting or continuing their engagement”.

2. Deloitte failed adequately to identify potential or actual conflicts of interest and/or to make it clear which party’s interest they represented at all times.

3. In proposing a contingency fee Deloitte failed to safeguard against the self-interest threat and in relation to one of the projects failed “to consider whether such fee was appropriate, having regard the nature of the client’s business”.

The complaints together amount to a broad allegation that Deloitte lost sight of its obligation to remain objective and that Deloitte identified too closely with the interests of particular participants in the MG Rover saga. The tribunal found against Deloitte on all counts and concluded that the misconduct was serious.

Two of the findings in particular raise important points of principle and these are the focus of this note.

Public interest
The very first paragraphs of the ICAEW code of ethics read:

“Acting in the public interest involves having regard to the legitimate interest of clients, government, financial institutions, employers, employees, investors, the business and financial community and others who rely on the objectivity and integrity of the accounting profession to support the propriety and orderly functioning of commerce. This reliance imposes a public interest responsibility on the profession. Professional accountants shall take into consideration the public interest and reasonable and informed public perception in deciding whether to accept or continue with an engagement or appointment, bearing in mind the level of public interest will be greater for larger entities which are in the public eye.

Therefore a professional accountant’s responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a professional accountant shall observe and comply with this code. If a professional accountant is prohibited from complying with certain parts of the code by law or legislation, the professional accountant shall comply with all other parts of this code”. (our emphasis)

The code of ethics then sets out the “fundamental principles” which all members must observe. These are integrity, objectivity, professional competence, confidentiality and professional behaviour.

There are two natural readings of these passages:

1. that an accountant has a free-standing obligation, in addition to the ethical and professional rules to which he is subject, to “take into consideration the public interest”. This is a continuing obligation at all times and would prevent him participating in any process the outcome of which (presumably in his judgement) would not to be in the public interest; or
2. accountants should act in the public interest and are therefore required to observe the body of rules and the fundamental principles laid down by their professional bodies which are an expression of that public interest.

The tribunal in this case has construed the guidance to impose the duty set out at subparagraph 1 above. That may come as a great surprise to many practitioners. The tribunal held that “member firms, whether they are acting as auditors, corporate advisers or in any other capacity owe duties not only to their clients or employers but also to the public ... we do not accept that the only duty that a member has is to his client provided that he is acting honestly and with integrity”.

The tribunal:
1. found that MG Rover was, although not listed, a “public interest company”.
2. found that every member should “consider the public interest when accepting any assignment” (whether or not in relation to a public interest company).
3. rejected Deloitte’s contention that a corporate financier serves the public interest by properly advising his clients within the ICAEW code.
4. found that Deloitte were aware of the public interest and breached their obligations to consider the public interest before accepting the appointment.

It is implicit in the tribunal’s judgment (although their reasoning is far from clear) that the outcome of the projects in question was not in the public interest. The tribunal rely heavily upon the conclusion of the Companies Act Inspectors’ report into the MG Rover affair and they appear to take it as read that the outcome is to be regretted. There appears to be a suggestion that in relation to one of the two projects (Project Aircraft) the engagement itself may have been appropriate at one stage but at some stage it became apparent that some of the assets of MG Rover were going to be used to benefit the ‘Phoenix Four’. It is not suggested that such a result would have been in any way illegal but the tribunal held that at that point “Deloitte should have declined to continue their engagement”.

This is a very strange proposition. Let us suppose that an accountant is hired to provide corporate finance advice on a deal. He does so. The deal is completely legal and he acts with objectivity and integrity as required by his professional code. What then happens if he realises part way through the deal that the proceeds of the deal might go to party A rather than to party B and he considers that the “public interest” would be better served if party B got the money? On the tribunal’s analysis it appears that he is professionally obliged to refuse to advise further (almost certainly in breach of his contract with the client). In fact, not to breach his contract in this way constitutes serious professional misconduct.

On this analysis the accountant is under an obligation to set himself up as judge and jury as to the moral worth of a particular client or a particular transaction and is obliged to breach his contract when he decides a particular outcome is socially sub-optimal. This obligation apparently falls on every accountant but the tribunal does not explain how is an accountant to judge if he is in breach of this principle.

As it happens, the ICAEW issued, only last year (that is seven years after this investigation was launched) an 80 page discussion paper entitled “Acting in the public interest”. Nowhere in that document is there any suggestion that a free-standing duty of this sort falls upon individual accountants. The paper states that it hopes to “be of assistance to policy-makers” and is clearly focussed upon the degree to which broad public policy issues should drive the creation of the rules governing accountants’ practices. Even in such a process the paper warns that:

“The public interest is an abstract notion. Advocating something as being in the public interest involves setting oneself up in judgment as to whether an action or requirement to change behaviour will benefit the public overall – a far greater set of people than can be interacted with directly.

“The use of the concept of the public interest as justification will present a challenge. It should be used only where it needs to be used and where it can be supported.”
If the concept is difficult to apply for policy makers it is, with respect, an absolutely unworkable concept in the context of individual engagements. At present accountants serve the public interest by following a tolerably clear set of rules. Thus auditors are required to report accurately to the shareholders, whatever the wishes of management, and they do so because the rules have been framed to serve that particular policy objective.

Policy dictates that all parties to a corporate finance transaction should be able to obtain professional advice. It appears that point was put to the tribunal and rejected. Rather it is serious professional misconduct to act for a client on a lawful transaction if the outcome proves (in the judgement of a tribunal some years later) not to be for the greater good.

It must, on the basis of this judgment, be unclear whether an accountant is able:

1. to advise a client in relation to tax planning and lawful tax avoidance;
2. to advise (or to be employed as an accountant) by a tobacco company;
3. to act for (or be employed by) a foreign company which buys a UK company promising not to close a factory but then changes its mind.

If some or all of these activities are to be deemed improper, rules must be written to make them so. The principle sponsored by the tribunal is inherently subjective and depends on an individual’s judgement as to an abstract notion of the public good. This is no basis upon which to build a disciplinary regime.

The tribunal might argue that the Rover saga was unusual and these sorts of events will arise very infrequently. Unfortunately they have failed to provide any clear guidance as to how the apparently far reaching implications of this principle are to be limited.

Contingency fees

The second substantive point of interest relates to contingency fees. Deloitte proposed various contingency fees for different aspects of the work including a fee on one project of £7.5 million plus an equity stake. The case put to the firm was that it had failed to safeguard against the self-interest threat: Deloitte had an obvious incentive in completing the deal. That was said to be a breach of the ICAEW Fundamental Principle to act with integrity, objectivity and independence. The tribunal upheld the complaint.

Fees charged on a contingent basis are of course common place in corporate finance work. There is nothing very surprising in the point that a firm should take particular care to ensure that contingent fees do not threaten independence and objectivity. That is the gist of the guidance underlying the Fundamental Principles. Whether contingent fees are appropriate will depend, most importantly, on the type of engagement. Thus an audit appointment would not ordinarily be suitable for contingency fees.

Deloitte’s position was that it was standard practice for corporate finance work to be done on a contingent basis; clients would accept nothing else. The tribunal acknowledged that accountants would be at a competitive disadvantage to, say, corporate financiers at a bank, if they could not offer contingency fees – but that was no answer to the allegation in itself.

Presumably (although it is not clear from the judgment) the tribunal did not mean that it was necessarily inappropriate for an accountant to take on corporate finance work on a contingent basis. But what, then, are the factors which a firm should consider? On this, the judgment is unhelpfully silent.

Deloitte’s case was that the amount of the contingency fee was driven by the market. It was enough, they said, that the fees were negotiated to align the interests of client and firm. That was, importantly, to reflect the risks that the transaction (and the fee) may come to nothing at all.

The tribunal considered that that was not sufficient as there was no evidence that the fee was justified in light of the work done or the result of the transaction. In short, the fee was too high. What a reasonable fee might have been is not clear.

So where does that leave contingency fees? First, the judgment casts genuine doubt on whether contingent fees in corporate finance...
work are appropriate at all for accountants (as opposed to bankers). It leaves such fee arrangements open to challenge after the event - whether in regulatory proceedings or in litigation with a disgruntled client. Secondly, it is clear from the decision that firms should be able to demonstrate – after the event – that there was a coherent rationale at the time for the calculation of any contingency fee. Presumably, that will have to be done by reference to the potential time value of the work, the size of the transaction and the risks of the deal not proceeding at all.

Both factors point to caution in offering contingency fees. Whether that is helpful for clients looking for firms to share risk in an uncertain corporate market is another matter entirely.

The sanction

The other notable feature of this case was of course the fine. At £14m it is ten times the size of the previous largest fine imposed by the AADB. It is also the first fine imposed since the new sanctions guidance was issued.

There may be a number of reasons why even under the new guidance awards of this size might be unusual

1. The tribunal felt that there was an intentional failure on the part of the relevant partner to comply with professional standards and a deterrent sentence was warranted.

2. The tribunal felt that a substantial financial benefit was derived from this intentional conduct and it was therefore appropriate that the fees were returned. The great bulk of the fine appears to have represented the reimbursement of those fees. The fine itself was probably less than £2 million and not therefore greatly out of line with earlier awards.

3. Most cases pursued by the AADB (now the FRC Conduct Division) will involve allegations of error and the reimbursement of fees is much less likely to be appropriate.

That said, the FRC have made no secret of the fact that they have long felt that the fines imposed by various tribunals have been too low. Whatever the particular circumstances behind this fine, the FRC will be hopeful that the scale of reference of future tribunals will be radically altered by the fact of a sanction on this scale.