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The Role of Gatekeepers Accountants & Auditors and Rating Agencies – a ‘True and Fair View’

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An overview



- Corporate Governance, Stakeholders, and CSR Responsibility
- Gatekeepers & Corporate Scandals
- Technology

Corporate Governance

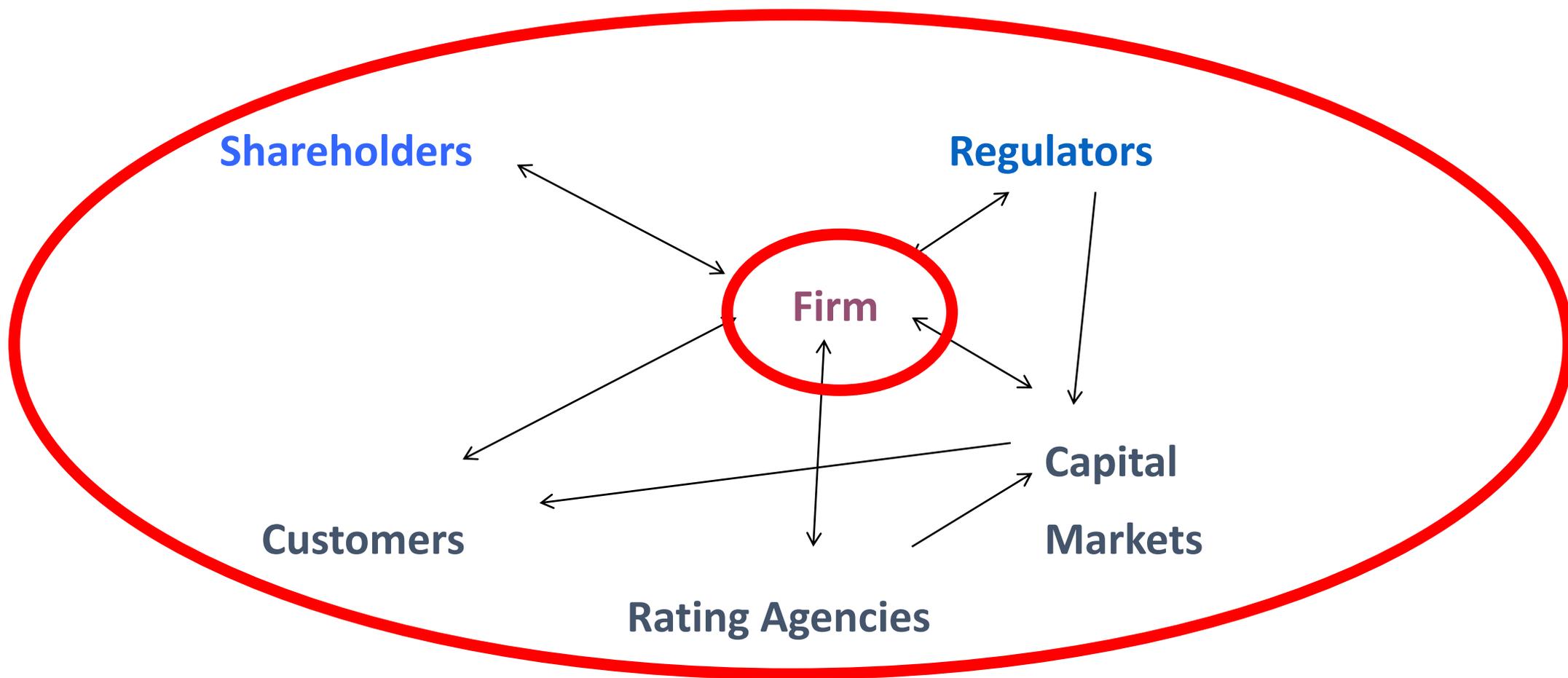
- **What it is:**
 - a system of rules, policies, and practices that dictate how a company's board of directors manages and oversees the operations of a company.
 - Principle – agent model
 - **Fiduciary duties of a director**
 - a **duty** to act in the best interests of the company.
 - a **duty** to act within the powers conferred by the company's memorandum and articles of association.
 - a **duty** not to fetter one's own discretion.
 - a **duty** to avoid a conflict of interest, and.
 - a **duty** not to make unauthorised profit.
- **Key principles:**
 - ~~transparency, accountability, and security.~~
- **Poor corporate governance:**
 - at best, leads to a company failing to achieve its stated goals
 - at worst, can lead to the collapse of the company and significant financial losses for shareholders.

Key words

- Principle-Agent Problem
- Conflicts of interest
- Gatekeepers
 - Accountants & Auditors, Credit Rating Agencies, Lawyers
- Corporate Scandals
 - Enron, Worldcom, Parmalat
 - Financial Crisis
- Good Corporate Governance
- Duty of Care

Modern Securities Markets

Complexity of Agency Problem



Roadmap

- What Are Gatekeepers
- Focus on
 - Auditors
 - Credit rating agencies
- Why gatekeepers fail

Gatekeepers

- John Coffee:
«**Reputational** intermediary to assure Investors as to the quality of the **signal** sent by the corporate issuer»
- Gatekeeper failure:
The gatekeeper verifies an issuer statement that it **knows**, or through reasonable effort **could know**, is **false** or **misleading**.

Gatekeepers as watchdogs



Categories of gatekeepers

- An increasingly broad category
- Heterogeneous entities
 - Auditors
 - Credit rating agencies
 - Securities analysts & Underwriters
 - Attorneys

- Auditors & Accountants

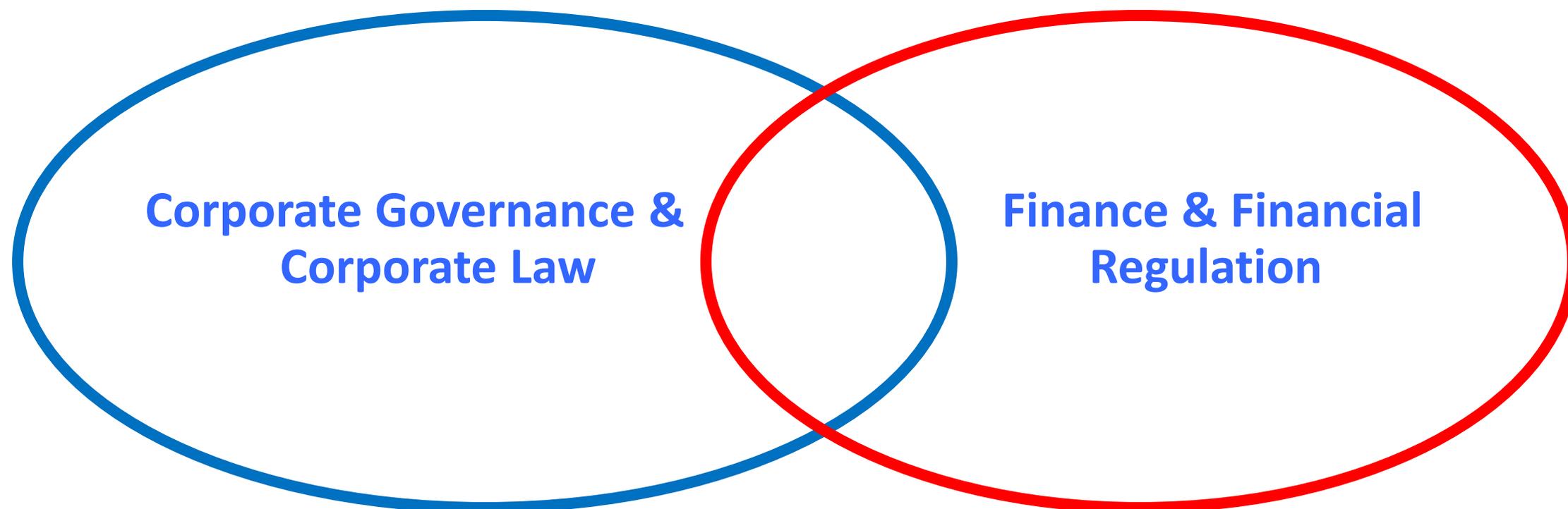


- Credit Rating Agencies



Gatekeepers

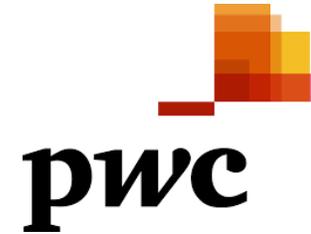
The two Dimensions of the Debate



Auditors & Accounting

Deloitte.

KPMG



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A True and Fair View

- Dynamic concept
 - ‘a true and fair view’ is not ‘the true and fair view’
 - Historical cost versus fair market (mark-to-market) value
- ‘Question of law for the Court’ (Joint Legal Opinions of Lord Hoffman and Mary Arden (1983-1984))
 - <https://www.frc.org.uk/getattachment/afba0aa1-04fa-492a-beab-35918af6d97e/T-F-Opinion-13-September-1983.pdf>
- Reasonable expectations of those who use the accounts
- Cost-effectiveness
- Information: vary in ‘comprehensiveness, usefulness and degree of precision

US – Enron Scandal (2001)

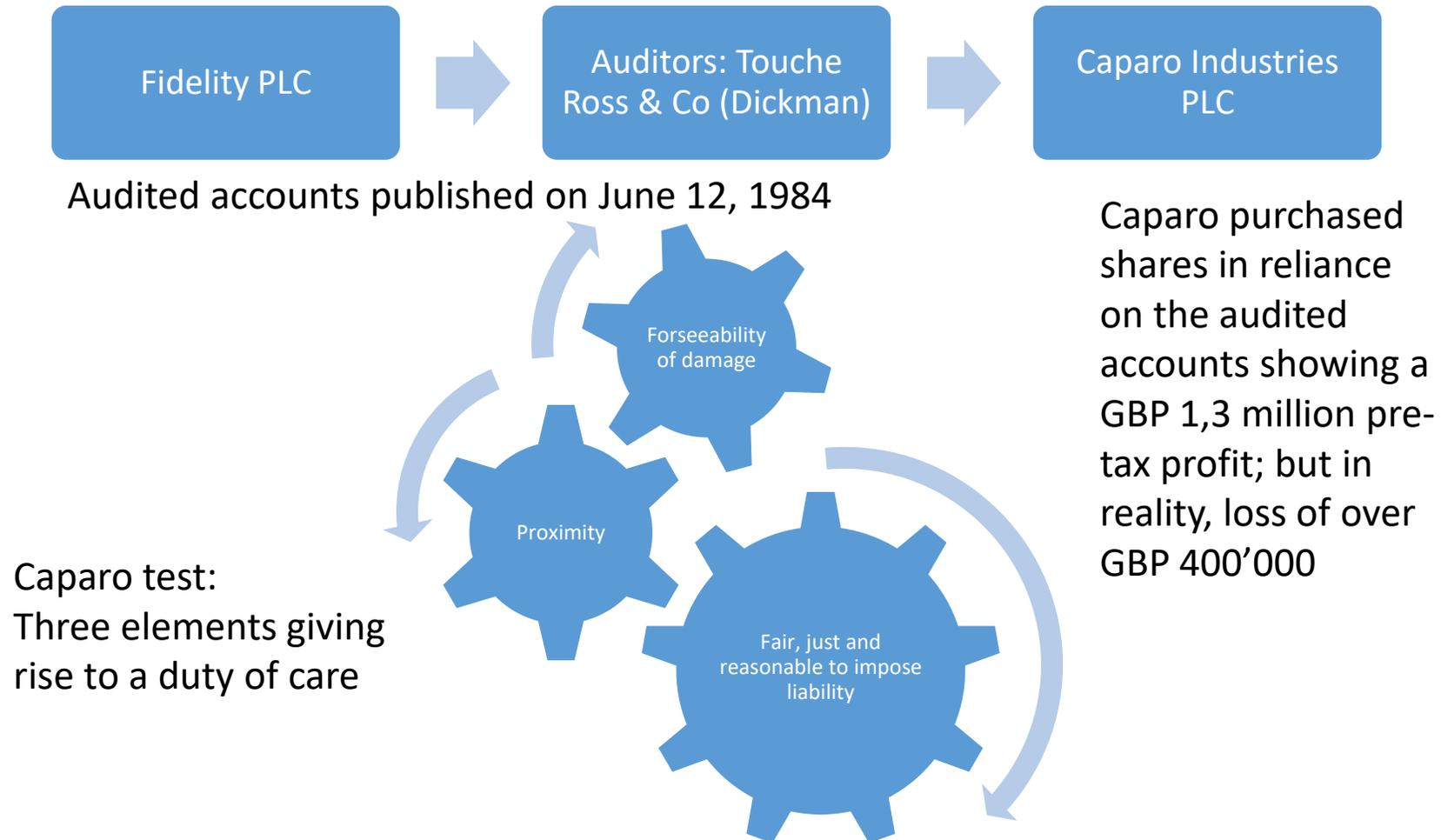


Action Civil Liability Issues

- Should the auditor be liable to the company in the interest of creditors?
 - banks that make a loan to the company based on information in the audit report?
 - Bondholders/debenture holders?
- What about when the company is insolvent?
- What about the 'one-man' company?

UK House of Lords – Civil Liability of Auditors

Caparo Industries PLC v. Dickman [1990]



Caparo Industries – Extent of Auditor/Accountant Civil Liability

- Lord Bridge:
 - “What emerges is that, in addition to the foreseeability of damage, necessary ingredients in any situation giving rise to a duty of care are that there should exist between the party owing the duty and the party to whom it is owed a relationship characterised by the law as one of **"proximity"** or **"neighbourhood"** and that the situation should be one in which the court considers it fair, just and reasonable that the law should impose a duty of a given scope upon the one party for the benefit of the other.”

Caparo Industries – Extent of Auditor/Accountant Civil Liability

- ‘[A]uditors of a public company’s accounts owe **no duty of care to members of the public at large** who rely upon the accounts in deciding to buy shares in the company. If a duty of care were owed so widely, it is difficult to see any reason why it should not equally extend to all who rely on the accounts in relation to other dealings with a company as lenders or merchants extending credit to the company.’ (p. 623)

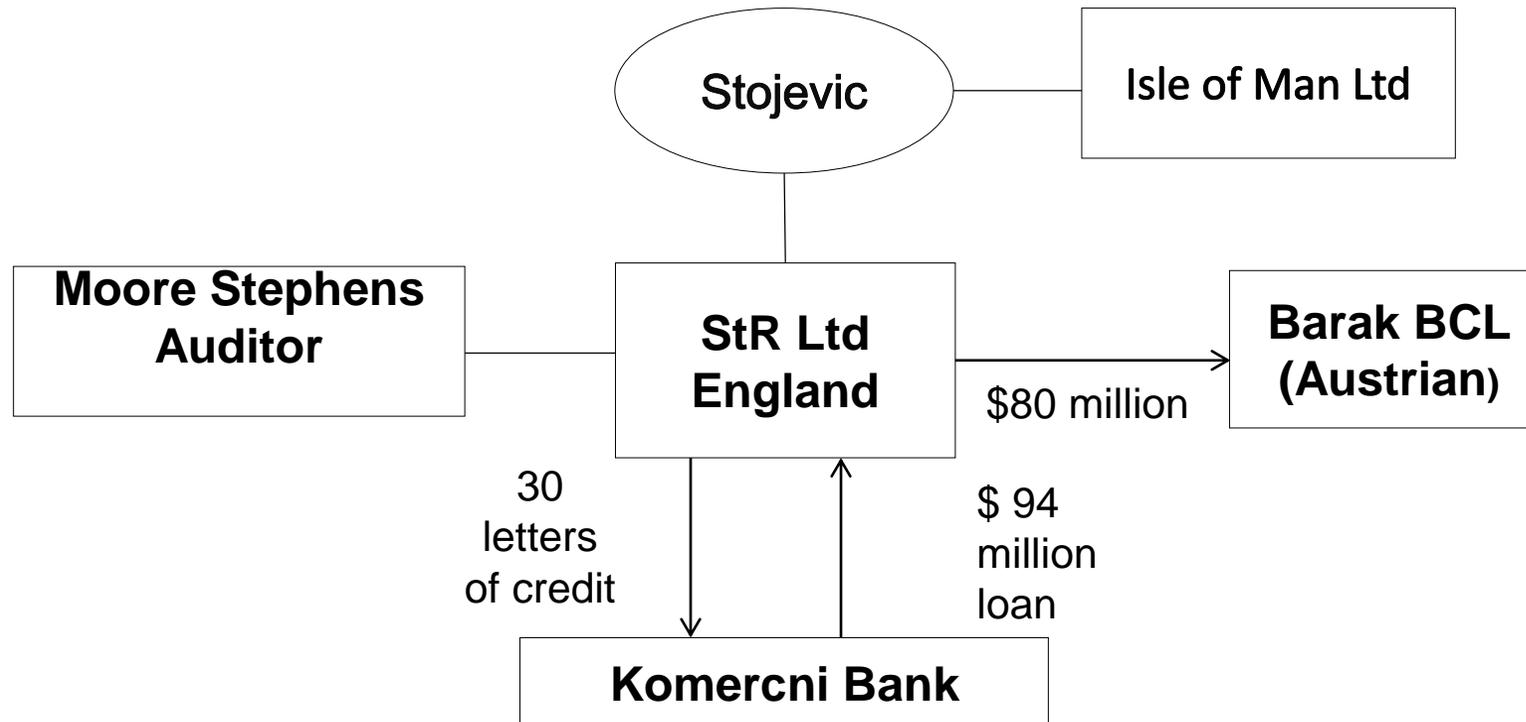
Caparo Industries – Role of Auditors

- It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to **protect the company** itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide **shareholders** with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to regard or control or remove those to whom that conduct has been confided.' (*Caparo Industries PLC v. Dickman*)

Caparo Industries – Economic Loss

- “One of the most important distinctions always to be observed lies in the law's essentially different approach to the different kinds of damage which one party may have suffered in consequence of the acts or omissions of another. **It is one thing to owe a duty of care to avoid causing injury to the person or property of others. It is quite another to avoid causing others to suffer purely economic loss...** To hold the maker of the statement to be under a duty of care in respect of the accuracy of the statement to all and sundry for any purpose for which they may choose to rely on it is not only to subject him, in the classic words of Cardozo C.J. to **"liability in an indeterminate amount for an indeterminate time to an indeterminate class"** (Ultramares Corporation v. Touche (1931) 174 N.E. 441, 444).”

Moore Stephens v. Stone & Rolls Ltd (in liq) [2009] UK Supreme Court



- StR Ltd's liquidator claimed against the auditor \$174 million for failing to detect Stojevic's dishonest behaviour. Auditor argued 'illegality defence' and that public policy should not allow company to recover losses from its own fraud
- Does *ex turpi causa* (illegality) defeat the company's claim of breach of contract?

Moore Stephens v. Stone & Rolls Ltd (in liq) [2009] UK Supreme Court



- Auditor (moore stephens) applied to have the company's (per liquidator) claim struck out arguing that the company was villain, not a victim.
 - The company had carried out the fraud against third party banks.
 - The Company was controlled by its sole shareholder and principal architect of the fraud – Mr Stojevic – as it was a case of the company being imputed with the knowledge of Stojevic and itself perpetrating the fraud.
- It was argued successfully (by Lord Sumption) that the company was a villain (fraud pierced the corporate veil in this case) and therefore the company could not as a matter of law bring a claim against the auditor.

Swiss Law – Auditor Civil Liability

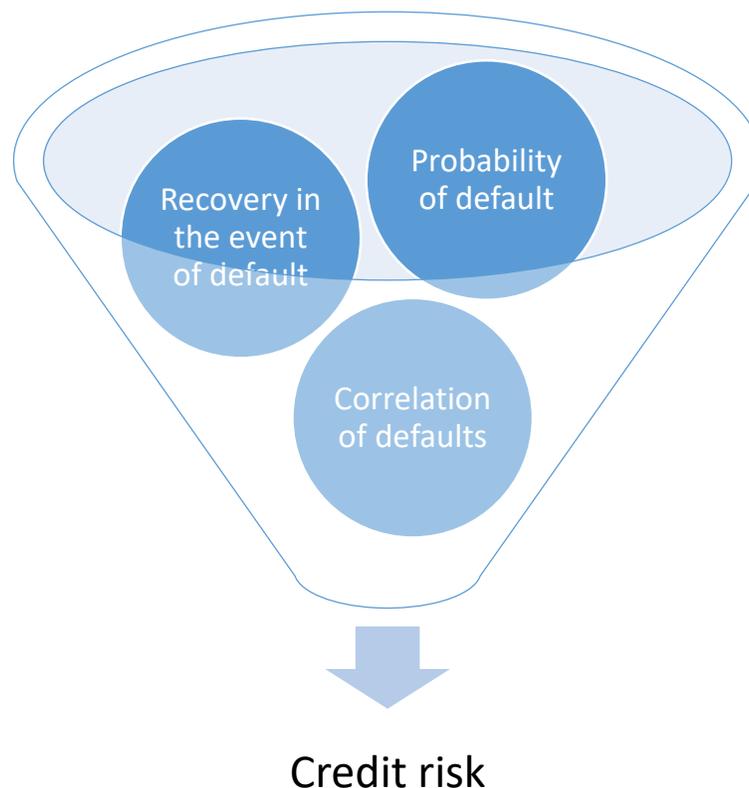
- Art. 755 CO - IV. Auditor liability
- 1 All persons engaged in auditing the annual and consolidated accounts, the company's establishment, a capital increase or a capital reduction are liable both to the company and to the individual shareholders and creditors for the losses arising from any intentional or negligent breach of their duties.
- Elements: Duty of care, damage, causality, fault
- Types of claims
 - Direct claims
 - Derivative claims

Credit Rating Agencies (CRAs)



Credit Rating Agencies as Gatekeepers

- Professionals assessing the creditworthiness of borrowers and the risks associated with the full and timely payment of debt securities
- Big Three
 - Moody's
 - Standard & Poor's
 - Fitch
- Issuing credit ratings
 - Corporate ratings
 - Sovereign ratings
 - Structured finance ratings



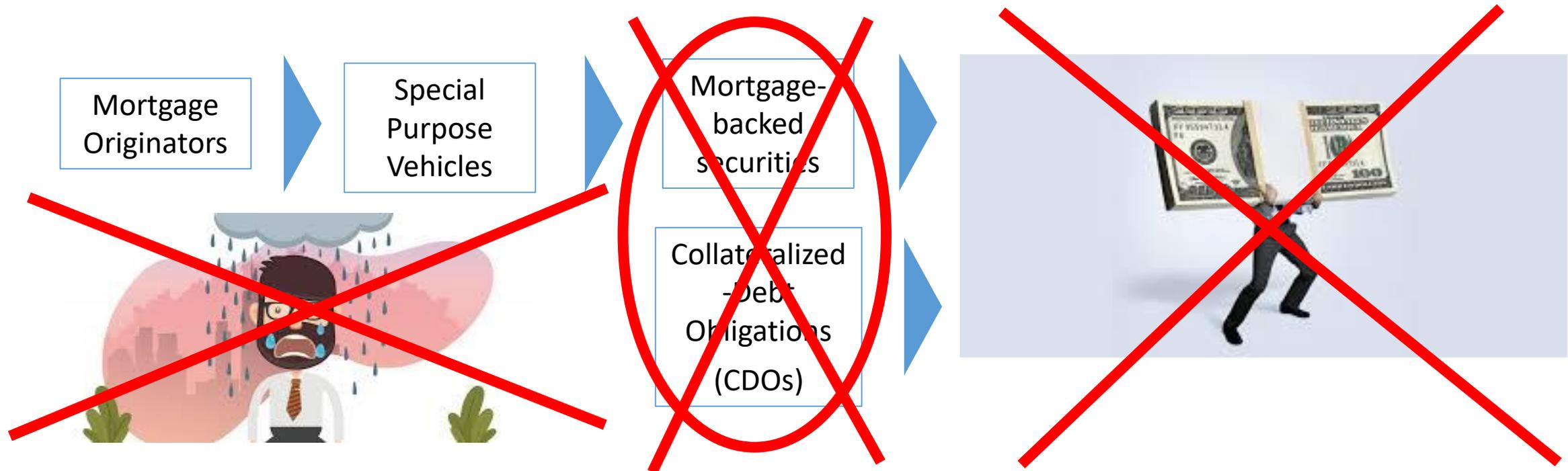
Rating Symbols

S&P	Interpretation	Threshold
AAA	Highest grade - Prime	Investment grade
AA	High grade	
A	Upper medium grade	
BBB	Lower medium grade	
BB	Non-investment grade- Speculative	Non-Investment – Speculative grade
B	Highly speculative	
CCC	Extremely speculative	
CC	In default with little prospect for recovery	
C	In default with little prospect for recovery	
D	In default	

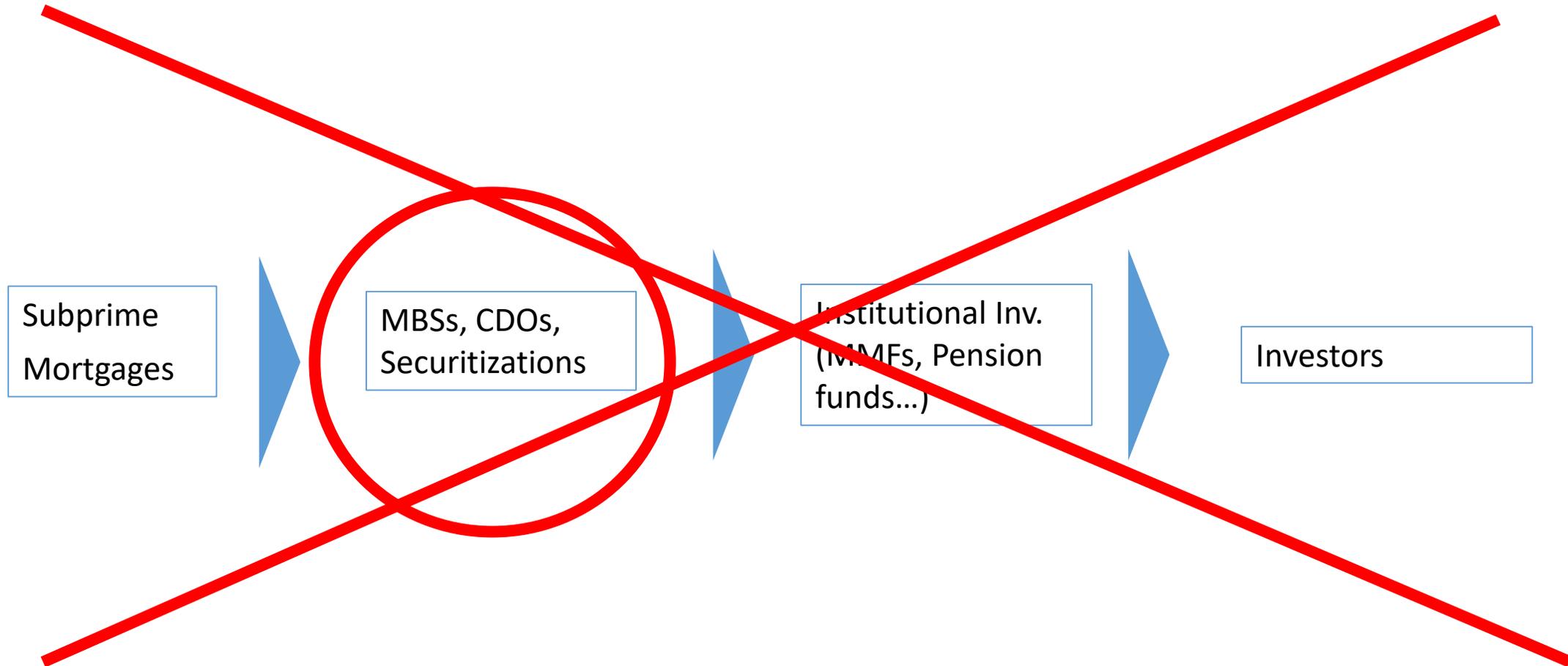
Subprime Mortgage Crisis of 2007-2009

The Role of Gatekeepers

- Mortgage originators (MO) provided large amounts of money to **subprime borrowers** to purchase **real-estate assets**.
- MO & Investment banks arranged **securitizations (MBSs) and CDOs**



Subprime Mortgage Crisis of 2007-2009



ABN AMRO Bank NV v. Bathurst Regional Council [2014] Federal Court of Australia

- ABN Amro created Constant Proportion Debt Obligations (CPDO) rated by Standard & Poor's (S&P). S&P knew that ABN Amro would use the rating to promote the product to investors.
- ABN Amro made clear that the AAA was sought: sell the securities to local councils attracted to high interest rates but subjected to strict investment guidelines
- To whom did S&P owe a duty of care?
- Proximity requirement: Given the class of investors to whom a duty was owed, is there any risk of indeterminate liability? In case, limited number of local councils
- Question regarding the lack of independent valuation: Was reliance reasonable?

ABN AMRO Bank NV v. Bathurst Regional Council [2014] Federal Court of Australia

- S&P's lack of knowledge of the investors meant liability was indeterminate.
 - **Court:**
 - the **class** of investors and the foreseeable loss were determined by the function S&P undertook.
 - S&P knew that a characteristic of the **class** was that each member of the class was an **investor** in the rated products
 - S&P knew the **foreseeable type of loss**
- No duty arose because there was no contractual fiduciary relationship.
 - **Court:**
 - S&P was aware of the rating being relied upon by **persons other than ABN AMRO**
 - S&P knew that ABN AMRO obtained and paid for the rating for the **sole purpose** of communicating the rating to «**interested parties**»

EU – Civil Liability Regime in the CRA Regulation (art. 35a)

- New cause of action
- Where a rating agency committed, intentionally or with gross negligence, any infringements listed in Annex III having an impact on a credit rating
- Liability if investor reasonably relied on a credit rating
- Investors may claim damages from rating agencies where there is no contractual relationship or other relationship giving rise to a duty of care between them
- Departure from the traditional English approach?

Why Gatekeepers fail

- Agency problems
- Imperfect competition
- Reduced Value of Reputational Capital
- Reduced Risk of Liability

Why Gatekeepers Fail: (1) Agency Problems

- The increasing nature of Gatekeepers' Agency Problems
- The weakening of Agent Self-Policing
 - Identification with the public purposes of the profession
 - Identification with the firm
- Other ways to Control gatekeeper Agency Problems by firms
 - Identifying the best candidates for reducing reputational damages
 - Ex Ante monitoring of firm verifications to prevent agents from providing faulty gatekeeper verification
 - Ex post investigations & sanctions (loss of job, promotions, compensations) against agents who do not make decisions in the best interest of the firm

Why Gatekeepers fail:

(2) Imperfect Competition

- Collusion or consciously parallel behaviours act differently than they would under competition

- Accountants

Deloitte.

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- Credit rating Agencies



«In a competitive industry with a dozen firms available, any firms involvement in a major financial scandal might inflict severe reputational damage. But in a heavily consolidated industry, all firms may have experienced a similar level of embarrassing episodes»

Why Gatekeepers Fail:

(3) Reduced Value of Reputational Capital

- Reputational capital may have become less valuable to gatekeeper firms relative to current earnings than before.
- What remains the same:
 - Reliable information to investors
 - Hiring a reputed gatekeeper is positive for the issuer manager
- What is changing:
 - Increased share-price-based compensation
 - Broader range of services provided by firms acting as gatekeepers
- Consequence: **More Lenient Verification Standards**

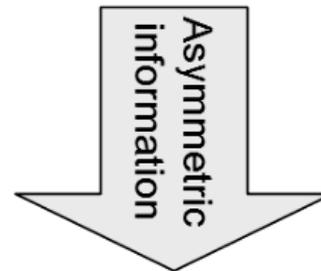
While Gatekeepers Fail: (4) Reduced Risk of Liability

- Could Investors act themselves as gatekeepers?
 - Fundamentally impractical idea.
 - The alternative:
 - Liability will create an incentive for the gatekeeper to approach its verifications in a way that minimizes failures even where, in the absence of the threat, the gatekeeper and the managers would implicitly agree on a more lenient approach.
- However, Liability has declined sharply.
 - The case of accountants:
 - Political reasons

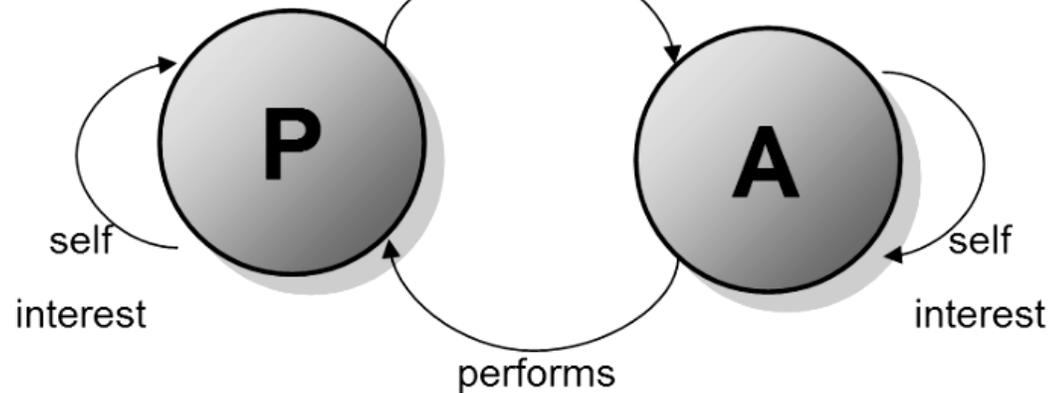
Principle-Agent Model



Moral Hazard



hires



Shareholders

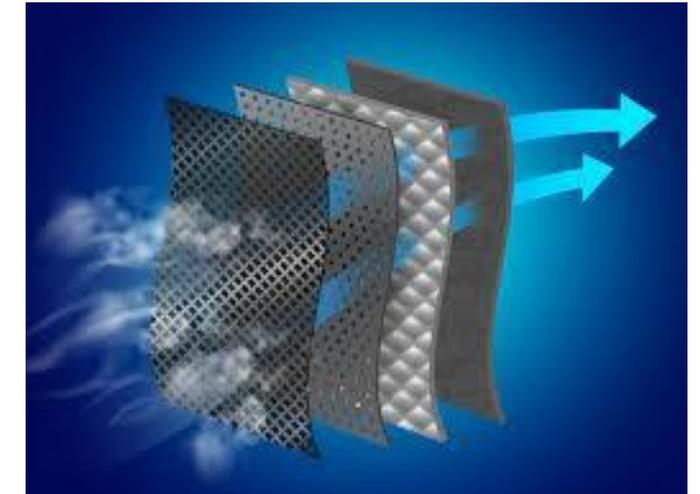
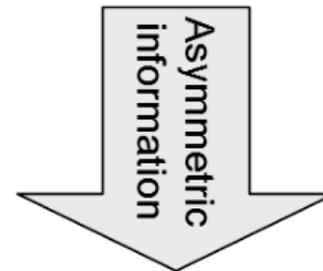
Directors

Adverse Selection

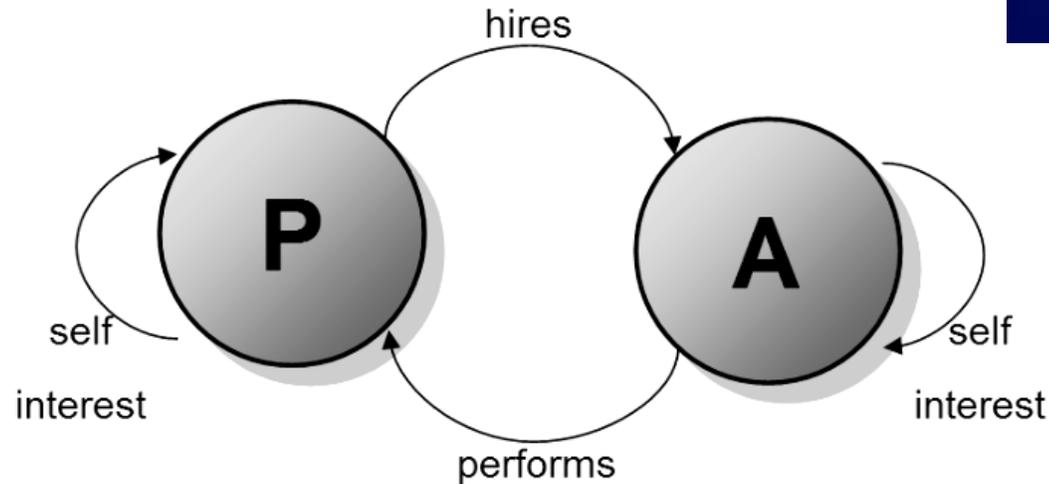
Principle-Agent Model



Moral Hazard



**Shareholders
Investors
Directors?**



Gatekeepers

Adverse Selection

Evaluation:

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