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CONFLICTS OF INTEREST, INDEPENDENCE AND THE VALUER

1. INTRODUCTION

Conflicts of interest and threats to independence and objectivity occur in many situations. The valuer needs to be aware of best practice whatever the type of valuation he is undertaking. The Enron and WorldCom debacles have highlighted the failures of accountants and professional advisers to maintain a proper degree of independence and objectivity. The regulatory authorities in the United States have responded by imposing new rules which place stricter limits on the type of work that can be undertaken by firms of accountants. Valuation is one area now subject to stricter controls. This Bulletin starts with a brief overview of the new rules in the United States (which also govern United Kingdom firms who audit SEC registered companies) and then examines the position in the United Kingdom – the legal background, relevant professional guidance and the potential effects of non-compliance.

2. THE UNITED STATES

The Sarbanes-Oxley Act

In the wake of the corporate scandals which engulfed Enron and WorldCom, Congress enacted the Sarbanes-Oxley Act which became law on 30 July 2002.

Based on a set of four principles, it identifies ten specific categories of service that cannot be provided by the auditor to its client. Included within the list of prohibited services are the following which are relevant to those providing valuation services within audit firms;

- appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- expert services unrelated to the audit.

The four principles on which these prohibitions are based are as follows:

(i) The auditor, in order to be independent, should not audit its own work;

(ii) The auditor should not function as part of management or as an employee of the client;

(iii) The auditor, to be independent, should not act as an advocate for its client;

(iv) The auditor should not be a promoter of the company's stock or other financial interests.

The fundamental presumption is that these non-audit services, by their very nature, present a conflict of interest if provided by the auditor to its public company audit client.

The provision of services such as tax compliance, tax planning and tax advice to an audit client is allowed only if the service has been approved in advance by the client's audit committee. However, in certain circumstances the provision of tax services could impair the independence of the auditor and in those circumstances it is prohibited. An example given is where the 'tax service' is actually an expert service. Specifically, the Sarbanes-Oxley Act prohibits the auditor from representing his client before a tax tribunal or other court in an 'expert' capacity. The auditor needs to consider carefully with the company's audit committee whether a tax valuation is an allowed tax service or a prohibited expert service.

Securities and Exchange Commission

On 28 January 2003 the SEC tightened its rules regarding auditor independence and clarified how the rules should be applied. The revised rules (which became effective on 6 August 2003) prohibit the auditor from providing any appraisal service, valuation service or any service involving a fairness opinion or contribution-in-kind report for an audit client, *unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements.*

The rules do not prohibit the auditor from providing such services for non-financial reporting purposes (e.g. transfer pricing studies, cost segregation studies, and other tax-only valuations). Neither do the rules prohibit the audit firm from utilising its own valuation specialist to review the work performed by the audit client itself or an independent, third party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements. In those instances the auditor will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit. Additionally, the SEC believes that the quality of the audit may be improved where specialists are utilised in such situations.

Many of the provisions of the Sarbanes-Oxley Act are directed at "issuers" which are broadly defined as companies the securities of which are registered under Section 12 of the Securities Exchange Act of 1934 or that are required to file reports under Section 15(d) of that Act. Some sections of the Sarbanes-Oxley Act however apply to companies which file periodic reports under Section 13(a) or 15(d) of the Securities Exchange Act. Many United Kingdom companies fall within the definition of "issuers" and hence the provisions of this legislation have an impact on United Kingdom firms of auditors.

3. THE UNITED KINGDOM

Legal background

In considering the legal framework within which a share or business valuer must operate it is useful to look first at whether statute has anything to say about the independence and objectivity of auditors acting as valuers. Under section 103 of the Companies Act 1985 an auditor may be called upon to carry out a valuation when a public company issues its own shares in exchange for non-cash consideration. Section 108 of the Companies Act 1985 states that when a valuation of such 'non-cash consideration' is required under section 103 it *"shall be made by an independent person, that is to say a person qualified at the time of the report to be appointed, or continue to be, an auditor of the company"*. The valuer therefore does not have to be the company's auditor, but he does have to be eligible, under the Act to be appointed as its auditor. In addition to possessing the relevant professional qualifications therefore the valuer must not be an officer or servant of the company itself or of its holding or subsidiary company or a partner or employee of such an officer or servant. Section 24 of the Companies Act 1989 provides that audits must be carried out *"with integrity and with a proper degree of independence"*. Company law therefore requires a valuer, when providing an opinion to shareholders under the Act, to be independent, in the sense that an auditor is independent, and to act with integrity. The American terminology for valuations for this purpose is *'contribution-in-kind valuations'*. As already mentioned, the Sarbanes-Oxley Act prohibits the auditor from carrying out this rôle for its audit clients.

The auditor of a private company sometimes has to value shares under pre-emption provisions in the company's articles. In these circumstances the auditor usually acts as an expert and the value determined by him is final and binding on the parties. One of the reasons that the auditor is appointed is that a company's auditors are expected, because of their statutory duties and position under the Companies Acts, to be independent. An auditor will also be bound by the ethical rules of his professional institute. Lack of independence however, or conflict of interest, is not a reason in itself to have an expert's determination set aside by the court. Actual bias must be shown. Nevertheless, it would be unwise for the valuer to accept an engagement where there was a conflict of interest, even if he were not bound by professional standards, as it would tend to create doubts about his integrity and an aggrieved party would have an incentive to try to prove actual bias.

Independence is one of the hallmarks of the relationship between the professional and his client. Independence is essentially a means of securing an objective, honest and impartial approach to the work in hand. Not only must the auditor/valuer have these attributes, he must be *seen* to have them by ensuring he is free from any obligation to or interest in the client, its management, or its owners.

In *Prince Jefri Bolkiah v KPMG (1998)* the House of Lords considered conflicts of interest and the use of Chinese Walls in the context of an accountancy firm's forensic accounting services. It was held that the duty of an accountant providing litigation services was similar to that of a solicitor in respect of former clients. The duty, following the termination of the client relationship, is to preserve the confidentiality of information imparted during the subsistence of the relationship. In *Prince Jeffri* the court's intervention was sought by a former client not an existing client. The court's jurisdiction in this case *"cannot be based on any conflict of interest, real or perceived, for there is none. The fiduciary relationship which subsists between solicitor and client comes to an end with the termination of the retainer. Thereafter the solicitor has no obligation to defend and advance the interests of his former client. The only duty to the former client which survives the termination of the client relationship is a continuing duty to preserve the confidentiality of information imparted during its subsistence."*[1]

It was the duty of KPMG to keep the information obtained from its former client confidential, not merely to take all reasonable steps to do so. In Lord Millet's words: *"Many different tests have been proposed in the authorities. These include the avoidance of 'an appreciable risk' or 'an acceptable risk'. I regard such expressions as unhelpful: the former because it is ambiguous, the latter because it is uninformative. I prefer simply to say that the court should intervene unless it is satisfied that there is no risk of disclosure. It goes without saying that the risk must be a real one, and not merely fanciful or theoretical. But it need not be substantial."*

KPMG's efforts to protect the interests of Prince Jefri by setting up *ad hoc* Chinese walls within the forensic accounting department were considered insufficient to eliminate the risk of confidential information being disclosed to the detriment of Prince Jefri:

"Once the former client has established that the defendant firm is in possession of information which was imparted in confidence and that the firm is proposing to act for another party with an adverse interest to his in a matter to which the information is or may be relevant, the evidential burden shifts to the defendant firm to show that even so

[1] Lord Millett. Prince Jefri Bolkiah v KPMG (a firm) House of Lords 1998

there is no risk that the information will come into the possession of those now acting for the other party. There is no rule of law that Chinese walls or other arrangements of a similar kind are insufficient to eliminate the risk. But the starting point must be that, unless special measures are taken, information moves within a firm... The Chinese walls which feature in the present case, were established ad hoc and were erected within a single department.....In my opinion an effective Chinese wall needs to be an established part of the organisational structure of the firm, not created ad hoc and dependent on the acceptance of evidence sworn for the purpose by members of staff engaged on the relevant work."[2]

The courts have had to consider bias and want of impartiality in the context of challenges to arbitrators' awards and judicial decisions. These decisions are worth examination because valuers are often appointed to act as arbitrators. In addition, although the legal standing of an expert and an arbitrator differs, the valuer as expert, like the arbitrator, must be fair and impartial in his approach. Section 33 of The Arbitration Act 1996 requires the arbitral tribunal to act *"fairly and impartially as between the parties, giving each party a reasonable opportunity of putting his case and dealing with that of his opponent"*. If there are justifiable doubts as to the impartiality of an arbitrator a party can apply to the court for his removal. When acting as an expert in determining a value it is best practice for a valuer to ensure that he gives each party an opportunity to put its views. The expert, unlike an arbitrator however, is not under any duty to ensure that each party's representations are put to the opposing side nor is it necessary for the expert to seek the parties' comments on his own investigations/expert opinion.

In English law the *'lack of independence'* is not in itself considered a ground for justifiable doubts about the arbitrator's *'impartiality'*. This is in contrast to the Model Law[3] where under Article 12 an arbitrator *"may be challenged only if circumstances exist*

[2] Lord Millet
[3] In 1985 the United Nations Commission on International Trade Law (UNCITRAL) adopted a Model Law on International Commercial Arbitration. In England a Departmental Advisory Committee chaired by Lord Mustill in 1989 advised against simply adopting the Model Law in place of existing laws.

that give rise to justifiable doubts as to his impartiality or independence....” The Model Law approach was rejected by the Departmental Advisory Committee (‘DAC’) in framing English arbitration law for the following reasons:

“It seems to us that lack of independence, unless it gives rise to justifiable doubts about the impartiality of the arbitrator, is of no significance. The latter is, of course, the first of our grounds for removal. If lack of independence were to be included, then this could only be justified if it covered cases where lack of independence did not give rise to justifiable doubts about impartiality, for otherwise there would be no point including lack of independence as a separate ground.

We can see no good reason for including “non-partiality” lack of independence as a ground for removal and good reasons for not doing so. We do not follow what is meant to be covered by a lack of independence which does not lead to the appearance of partiality. Furthermore, the inclusion of independence would give rise to endless arguments, as it has, for example, in Sweden and the United States, where almost any connection (however remote) has been put forward to challenge the “independence” of an arbitrator. . . . We would further note in passing that even the oath taken by those appointed to the International Court of Justice and indeed our own High Court, only refer to impartiality”.[4]

An example which is often used in this connection is the English Bar, whose members participate in arbitrations both as advocates and arbitrators. Since barristers are self-employed, members of the same chambers may be (and not infrequently are) instructed to appear in front of their colleagues while the latter are sitting as arbitrators. In such a case, if ‘independence’ were an available ground, the strict independence of the arbitrator could be called into question and used as the basis of a challenge even where his ability to act impartially was not in issue.

Clearly, lack of independence in the arbitrator may be relevant if it is such as to give rise to justifiable doubts about his impartiality. In international arbitrations conducted under institutional rules there may be problems with the English approach. For example, Article 10.1 of the UNCITRAL Rules states that:

'Any arbitrator may be challenged if circumstances exist that give rise to justifiable doubts as to the arbitrator's impartiality or independence'.

Article 2.7 of the ICC Rules state that:

'Every arbitrator appointed…must be and remain independent of the parties involved in the arbitration.'

It would seem that the international requirement for independence exists more to ensure that fairness is seen to be done, rather than actually to achieve it.

It was held in *R v Gough*[5] that except where a person acting in a judicial capacity had a direct pecuniary interest in the outcome of the proceedings, when the court would assume bias and automatically disqualify him from adjudication, the test to be applied in all cases of apparent bias, whether concerned with justices, members of other inferior tribunals, jurors or arbitrators, was whether, having regard to the relevant circumstances, *"there was a real danger of bias on the part of the relevant member of the tribunal in question, in the sense that he might unfairly regard or have unfairly regarded with favour or disfavour the case of a party to the issue under consideration by him … "*[6]

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[4] Departmental Advisory Committee First Report.
[5] R v Gough (1993 House of Lords
[6] Lord Goff, R v Gough (1993) House of Lords

In a recent Irish arbitration concerning a valuation of shares the plaintiff sought to have the arbitrator's award set aside by the High Court[7] on a number of grounds one of which was that the arbitrator "*had misconducted himself and/or the arbitration by reason of the manner in which he dealt with the points of rejoinder…which gave rise to a reasonable perception of bias.*" The arbitrator's award was upheld and in his judgment Lavan J noted that: "*Any prejudice or bias perceived by the plaintiff (and I am not satisfied that there were any) should have been asserted during the course of the arbitration and not subsequent to the award having been made.*"

The onus is on the aggrieved party to raise objections to a perceived conflict of interest as soon as it is made known to them if they are to stand any chance of a successful challenge after the arbitrator has made his award.

Professional guidance

Acting in accordance with the technical and ethical requirements of the professional bodies is evidence in court of 'good practice'. Failure to accord with them is, on the face of it, 'bad practice' and might leave the valuer vulnerable to legal action for negligence. Many valuers are members of the Institute of Chartered Accountants in England and Wales ('the ICAEW'). Its best practice guidance is considered below.

The ICAEW has codified as best practice many of the legal principles identified above in its *Guide to Professional Ethics*. Its statement on *Conflicts of Interest and Confidential Information* identifies a number of fundamental principles which its members must comply with. These include the following:

- **Integrity**: A member should behave with integrity in all professional and business relationships. Integrity implies not merely honesty but fair dealing and

[7] John McCarthy v Enda Keane, Eireann International Financial Brokers Limited, Warrantell Limited and Desmond Peelo [24 July 2003]

truthfulness. A member's advice and work must be uncorrupted by self interest and not be influenced by the interests of other parties.

- **Objectivity**: A member should strive for objectivity in all professional and business judgements. Objectivity is the state of mind, which has regard to all considerations relevant to the task in hand but no other.
- **Competence**: A member should undertake professional work only where he has the necessary competence required to carry out that work, supplemented where necessary by appropriate assistance or consultation.
- **Performance**: A member should carry out his professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member.

Other professional bodies require similar ethical standards from their members. The International Valuation Standards Committee publishes a code of conduct for valuers and requires valuations carried out under its standards to be provided by *"honest and competent professional valuers, free of bias or self interest….."*

The ICAEW statement identifies two types of conflict of interest and how these might be dealt with:

a) a conflict between the interest of a member [of the ICAEW] or his firm and that of their client; and
b) a conflict between the interests of two or more clients.

A conflict between the interests of a member and that of his client will threaten the objectivity of the member. There is also the threat that confidential information received from the client might be used by the member or his firm for his personal or firm's benefit or for the benefit of a third party. Such threats might be eliminated by the use of 'safeguards' such as:

- disclosure to the client/potential client of the circumstances of the conflict and the obtaining of their informed consent to act;
- establishing information barriers ('Chinese walls')
- disengagement or declining to act for a potential client.

Where there is a conflict between the interests of two or more clients the concern generally relates to the client's fear that confidential information will be passed to another client of the firm. The obligation of the member/firm in these circumstances is to safeguard the information received by them in confidence. The member *"should never disclose or use, outside his firm, whether in his interest or that of another party, information received by him in confidence unless he has a right or obligation to do so or he has received informed consent from the party to whom the duty of confidentiality is owed".*

The ICAEW has elaborated on what is meant by integrity and independence in its Statements 1.201 *"Integrity, Objectivity and Independence*" and a supplementary statement *"Additional Guidance on Independence for Auditors"*. These provide a framework within which members can identify actual or potential threats to objectivity and assess the safeguards which may be available to offset such threats.

Actual lack of integrity and want of objectivity are difficult to demonstrate and for this reason the guidelines identify instances where these fundamental principles may be threatened. Five potential threats to auditor objectivity are identified. The first three of these threats however may equally be applied to members whose practices involve valuation work where the valuer is required to provide an independent opinion.

1. The self-interest threat

A threat to [the auditor's] objectivity stemming from a financial or other self-interest conflict. This could arise, for example, from a direct or indirect interest in a client or from fear of losing a client.

2. The self-review threat

The apparent difficulty of maintaining objectivity and conducting what is effectively a self-review, if any product or judgement of a previous audit assignment or a non-audit assignment needs to be challenged or re-evaluated in reaching audit conclusions.

In order to comply with best practice as set out in Statement 1.201 the *Additional Guidance on Independence for Auditors* explains that *"no adequate safeguards are available to counter the self-review threat that would arise from the provision of valuation services which lead to the valuation of amounts that are directly material in relation to the financial statements being audited and where the valuation involves a significant degree of subjectivity."* Since all share and business valuations involve a significant degree of subjectivity this guidance precludes the auditor from giving a valuation opinion in respect of any material asset or liability in the financial statements of an audit client.

The meaning of the term *valuation* in the guidance note is wider than simply the provision of a value. It is defined as:

"the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole. The underlying assumptions of such a valuation may relate to interpretations of the

present or expectations of the future, including both general developments and the consequences of certain actions taken or planned by the audit client or anybody within its close business environment."

Not only are auditors prohibited from providing a valuation opinion which would subsequently be subject to audit, they cannot give a range of figures, nor provide a valuation model, from which the directors can derive their own view of value to be included in the financial statements subject to audit.

The auditors are however, allowed *"to review or to issue an opinion on valuation work performed by others, or to collect and verify data to be used in a valuation performed by others (e.g. due diligence work in connection with the sale or purchase of a business)".* Such assignments are not considered to be valuation services.

3. The advocacy threat

There is an apparent threat to an auditor's objectivity, if he becomes an advocate for (or against) his client's position in any adversarial proceedings or situations. Whenever the auditor takes a strongly proactive stance on the client's behalf, this may appear to be incompatible with the special objectivity that audit requires.

The overriding duty of an expert witness in United Kingdom is to the court and in his report he should *"maintain professional objectivity and impartiality at all times"*[8] This does not mean that the expert is not entitled *"to advance the case of the party calling him, so far as it can properly be advanced on the basis of the information available to the expert in the professional exercise of his skill and experience*"[9]. The advocacy threat would therefore seem to be present for an auditor acting as expert witness for an audit client. It is noteworthy that The Sarbanes-Oxley Act (see above) prohibits auditors

[8] Code of Guidance on Expert Evidence, Working Party established by the Head of Civil Justice [December 2001]

subject to its rules from providing expert opinions or other services to an audit client or a legal representative of an audit client for the purpose of advocating that audit client's interests in litigation or regulatory investigations or proceedings.

4. EFFECTS OF NON-COMPLIANCE

The Sarbanes-Oxley Act/SEC

Under the SEC's rules, an auditor providing a prohibited service, such as valuation services, to an audit client would not be considered independent with regard to that client, unless it is reasonable to conclude that the results of the services would not be subject to audit procedures during an audit of the client's financial statements. Certain tax valuation services may be permissible but they must be approved in advance by the issuer's audit committee. Such approvals must be publicly disclosed in the issuer's Form 20-F.

The Public Company Oversight Board, set up under the Sarbanes-Oxley Act to regulate the accountancy profession, is empowered to conduct investigations and disciplinary proceedings (including imposing appropriate sanctions) against registered accountancy firms (i.e all firms that prepare audit reports for issuers). The Oversight Board is empowered to act against non-US firms of accountants as well as US firms. An audit firm which is not considered to be independent in relation to an audit client will presumably be unable to continue to act as its auditor.

[9] Polivitte Limited v Commercial Union Assurance [1987]

The United Kingdom

The legal consequences

If an expert fails to act impartially it will provide a valid ground for his determination to be challenged in the courts. There is an implied term in a contract to act as an expert that the parties will not seek to interfere with the expert's independence and it is important for the expert not to appear to assume the rôle of an advocate. For example, allegations of improper interference or partiality may be made where meetings take place between the expert and only one of the parties.[10]

Where an auditor carries out a valuation under an audit client's articles of association an allegation that that he has not acted impartially may provide an arguable basis for a claim of unfair prejudice under section 459 of the Companies Act 1985.[11]

Regulatory

When a complaint is made against a member of the ICAEW the Investigation and Disciplinary Committee may have regard to the ethical code of practice laid down and approved by the Council of the ICAEW.

A member is normally expected to follow the guidance contained in the ethical standards of the Institute. Failure to follow such ethical guidance may not, of itself, make a member liable to disciplinary action. However, a member may be called upon to justify any departure from the guidance.

[10] Macro v Thompson (No. 3) [1997] 2 BCLC 36
[11] Re Robor Cartons Limited, unreported, 31 March 2000.

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