

Raising audit concerns at AGMs

New rights for shareholders and duties for quoted companies

Summary

The Companies Act 2006 (the Act) has introduced new rights for shareholders of quoted companies to raise concerns about the audit of a company's accounts or the departure of an auditor. The Act enables shareholders to require a company to publish on its website a statement setting out matters that the shareholders intend to raise at the next accounts meeting of the company (usually the next Annual General Meeting). The matters must relate either to the audit or to circumstances connected with an auditor ceasing to hold office. These new rights impose certain obligations on companies, though no new statutory obligations on auditors, and form part of a package of improvements in audit transparency contained in the Act¹.

Effective dates

The provision introducing these new rights is split into two parts. The first part, dealing with the right of members to require website publication of their concerns about the audit of the company's accounts, applies to accounts for financial years beginning on or after 6 April 2008. The second part, dealing with the right of members to require website publication of their concerns about circumstances connected with the departure of the auditor, applies to auditors appointed for financial years beginning on or after 6 April 2008².

Rights introduced for shareholders

The new law in this area is contained in Chapter 5 of Part 16 of the Act. Part 16 relates to audit in general, and this Chapter, which affects only quoted companies, contains five new sections. The first provides shareholders with a new power to require website publication of their audit or auditor concerns. Shareholders may send a request to the company requiring it to publish on its website a statement setting out any matter that the members propose to raise at the next accounts meeting (usually the AGM) relating to:

- “(a) the audit of the company's accounts (including the auditor's report and the conduct of the audit) that are to be laid before the next accounts meeting, or
- (b) any circumstances connected with an auditor of the company ceasing to hold office since the previous accounts meeting”.³

The right created by paragraph (b) of Section 527(1) is in addition to the new requirements in Chapter 4 of Part 16 of the Act for companies and auditors in relation to auditors ceasing to hold office (see the recent PwC / Herbert Smith briefing on auditor resignations)⁴.

¹ This is one of the topics discussed by the Audit Quality Forum, run by the Institute of Chartered Accountants in England and Wales (ICAEW). Its report on questions to the auditor can be found at <http://www.icaew.com/index.cfm?route=139479>.

² Paragraph 18 of Schedule 4 to the Companies Act 2006 (Commencement No.5, Transitional Provisions and Savings) Order 2007

³ Section 527(1)

⁴ The briefing can be found at: http://www.pwc.co.uk/eng/publications/when_auditors_leave_office.html

and <http://www.herbertsmith.com/NR/rdonlyres/56F4C7C9-B54F-4DAE-A0CD-F939B73CCDEB/4721/JointHerbertSmithPwCBriefingAug2008.pdf>

The ability to exercise these rights will depend on the size of the members' shareholding, or the number of members that submit requests. The company is required to publish the statement on its website once it has received requests to that effect from:

“(a) members representing at least 5% of the total voting rights of all the members who have a relevant right to vote (excluding any voting rights attached to any shares in the company held as treasury shares), or

(b) at least 100 members who have a relevant right to vote and hold shares in the company on which there has been paid up an average sum, per member, of at least £100.”⁵

For this purpose a “relevant right to vote” means a right to vote at the accounts meeting. The 100 member test can be met by underlying beneficial owners as well as registered holders⁶.

The Act sets out the format in which the request should be submitted to the company: it may be in hard copy or electronic form, must identify the statement to which it relates and must be authenticated by the person(s) making it in accordance with the Act. The request must be submitted so that the company receives it at least one week before the meeting at which the matter is proposed to be raised⁷.

There are some protections built in for the company and any other potentially aggrieved persons. The company will not be required to publish a statement under Section 527 if, on an application by the company or another person who claims to be aggrieved, the court is satisfied that the rights conferred by

Section 527 are being abused (for example, the request for publication relates to a defamatory statement)⁸. However, the company or another aggrieved person will only have a short time - three working days from receipt of the request(s) that triggers the publication of the statement – within which to make such an application. A court can also order the shareholders requesting website publication to pay the whole or part of the company's costs on such an application⁹. It should be noted that although the power in relation to costs under the Act does not extend to the costs of other aggrieved parties (e.g. the auditor) if they make an application, a court could make a costs order in favour of such an aggrieved party under its inherent jurisdiction.

Obligations introduced for companies

If requests have been validly made, the company must publish the statement on its website within three working days of sufficient requests being received. It must remain there until after the relevant accounts meeting has concluded¹⁰. The Act allows for the possibility of technology failures by specifying that the company will be deemed to have met the publication requirement if it is available for at least a part of this period and the failure to make it available for the whole specified period was wholly attributable to circumstances that it would not be reasonable to have expected the company to prevent or avoid¹¹.

In the notice of the accounts meeting sent out to shareholders (starting with the notice which accompanies the first accounts for a financial year beginning

on or after 6 April 2008), the company must draw attention to the possibility of a website statement being posted pursuant to a request under Section 527¹². Specifically, the notice must state that:

- (a) members satisfying the thresholds in section 527 of the Act can require the company to publish a statement on its website setting out any matter relating to (i) the audit of the company's accounts (including the auditor's report and the conduct of the audit) that are to be laid before the meeting; or (ii) any circumstances connected with an auditor of the company ceasing to hold office since the last AGM that the members propose to raise at the meeting;
- (b) the company cannot require the members requesting publication to pay its expenses;
- (c) any statement placed on the website must also be sent to the company's auditor no later than the time the company makes the statement available on its website¹³; and
- (d) the business which may be dealt with at the meeting includes any statement that the company has been required to publish on its website.

As noted in (c) above, the company is required to forward the statement to the company's auditor (and possibly the former auditor, discussed further below). By contrast, there is no obligation under the Act to forward the statement to any other interested third parties (for example those implicitly or

⁵ Section 527(2)

⁶ Section 153

⁷ Section 527(4) and Section 1146 (in relation to authentication)

⁸ Section 527(5)

⁹ Section 527(6)

¹⁰ Section 528(4)

¹¹ Section 528(5)

¹² Section 529(1)

¹³ Section 529(3)

explicitly criticised by the statement). The company should accordingly consider whether it has any separate contractual obligation to do so, or whether it wishes to forward it to any other third parties, for example its lawyers, actuaries, brokers or financial advisers, in any event. In such circumstances, it would be prudent to consider how confidentiality should be maintained.

Having required a company to publish a statement on its website, it is very likely that the shareholder(s) making the requisition will then raise that matter at the meeting – although there is no obligation under the Act on the shareholder(s) to do so, as Section 527 refers to matters which the members “propose” to raise at the meeting.

To avoid any argument as to whether any matter contained in a published statement can properly be dealt with at the meeting, the Act specifically provides that the business which may be dealt with at the accounts meeting includes any statement that the company has been required under Section 527 to publish on its website¹⁴. Nonetheless, there is no requirement in the Act for the company to include the matters from the statement in the agenda for, or notice of, the accounts meeting. Indeed, the request that triggers the publication of the statement may be received after the notice of meeting has been sent out.

If a company fails to comply with the requirements as to website publication, or its supplementary duties in relation to a request for website publication (which include forwarding the statement to its auditor), then a criminal offence is committed by every officer of the

company who is in default¹⁵. An “officer” includes any director, manager or company secretary who will be “in default” if he authorises or permits, participates in, or fails to take all reasonable steps to prevent, the contravention¹⁶. The maximum penalty for these offences is, on conviction on indictment, an unlimited fine and, on summary conviction, a fine not exceeding the statutory maximum (currently £5,000)¹⁷.

This highlights the need for the company to put in place a policy or protocol for dealing with requests under Section 527; this might include, for example, having a specified contact at the company to whom requests should be sent and having a process for monitoring requests so that the company can establish when the 5% or 100 member threshold has been reached (see below for further discussion on this point).

Relevant definitions from the Companies Act 2006

Quoted company

Under Section 531 a company is a quoted company if it is a quoted company in accordance with Section 385 (quoted and unquoted companies for the purposes of Part 15) in relation to the financial year to which the accounts to be laid at the next accounts meeting relate.

“Quoted company” means (Section 385) a company whose equity share capital:

- (a) has been included in the official list, or
- (b) is officially listed in an EEA State, or
- (c) is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

Accounts meeting

“Accounts meeting”, in relation to a public company, means (Section 437(3)) a general meeting of the company at which the company’s annual accounts and reports are (or are to be) laid in accordance with Section 437.

¹⁴ Section 529(4)

¹⁵ Section 530(1)

¹⁶ Section 1121

¹⁷ Section 530(2)

Practical considerations

Who should respond to questions raised under these new provisions?

It is the company's meeting and the company should deal with any questions from shareholders. The company chairman, or the chairman of the audit committee, will usually answer any such questions raised, but in fact there is no statutory compulsion for them to do so. All directors answer questions at AGMs of their own volition.

As explained above, the obligation created by the new law is on the company to publish the shareholders' statement of concerns on its website. There is likely to be an expectation that the company will answer any questions that have been publicised in the statement and that members actually raise at the AGM, notwithstanding that there is no legal obligation to do so. In practice, it is difficult to envisage that the chairman would not wish to respond to a relevant question raised.

The chairman is in charge of the meeting and takes control of the progress of the meeting. If shareholders address questions directly to the auditor and a dialogue ensues, it may become difficult for the chairman to regain control of the meeting. The company chairman's role is not set out in the Act, but case law suggests that it includes the following: ensuring that the meeting is conducted fairly; preserving order; ensuring that the business of the meeting is conducted in a proper and efficient manner; determining the views of the members on the questions being considered; ensuring that all points of view are heard; and accepting all legitimate amendments to resolutions.

It may be that the most appropriate person to deal with questions about the audit would be the audit committee chairman, who would have been engaged in discussions with the auditors throughout the audit process. The Combined Code on Corporate Governance recommends that the chairmen of the audit, remuneration and nomination committees should attend the AGM to answer questions. Clearly, the auditor should be prepared to brief the audit committee chairman on audit issues likely to arise at the meeting, and to consider any shareholders' published statement along with the audit committee chairman, assisting him in developing responses in advance of the meeting. To a large extent, this happens already in relation to questions likely to be raised at AGMs about audit-related matters such as auditor independence. The introduction of the new obligation for companies to pass through to the auditors, in advance of the meeting, statements setting out audit-related matters which shareholders propose to raise at the AGM, may make for more interesting and in depth dialogue than has traditionally been the case.

Can auditors voluntarily answer questions at the company's AGM?

It is important to recognise that the new provisions in this Chapter of the Act do not provide a mechanism for questions to be asked of, and answered by, auditors at AGMs. Section 527 simply lays down a procedure for the shareholders (under certain conditions) to require publication, on the company's website, of a statement about certain audit-related matters which they propose to raise at the AGM. During the passage of the Company Law Reform Bill, debate took place in the House of Lords Grand Committee¹⁸ around the

aims of this part of the legislation, and it was made clear that the Government did not intend to introduce new obligations for auditors in this part of the Act.

It has not been unknown in the past for some auditors to seek to be helpful by answering audit-related questions at AGMs usually, however, only if the chairman invites them to do so. This is not something that happens often and it bears a significant amount of risk for the auditor because of the absence of a clear legal framework, for example in relation to the auditor's duty of confidentiality to the company.

The Act introduces no obligation on the auditor either to attend the AGM or to answer any questions, whether contained in the shareholders' published statement or raised by members at the meeting. The Act does however preserve the auditor's *right* to attend general meetings of a company and to be heard at any general meeting which he attends on any part of the business of the meeting which concerns him as auditor¹⁹.

The auditor's duty of care to the shareholders is to the shareholders as a body. Auditors should not be required to take on an expanded duty of care to the particular shareholder(s) who asks a question or raises an audit-related matter at the AGM, and a company should not put pressure on its auditor to answer in situations where it could expose them to risk of an expanded duty of care.

In the future, in the event that an auditor opts voluntarily to answer a question about the audit at the AGM, he is likely to wish to avail himself of the protection afforded by the usual disclaimer contained in the audit report,

¹⁸ <http://www.publications.parliament.uk/pa/ld200405/ldhansrd/pdvn/lds06/text/60314-47.htm>

¹⁹ Section 502(2)

by citing that disclaimer as a preface to his response. That is a disclaimer both as to (a) any liability to shareholders beyond the “general audit duty” discussed in the recent Court of Appeal decision in *Freightliner/Ernst & Young* (see Herbert Smith e-bulletin 17 September 2007²⁰) and (b) any responsibility to third parties.

The auditor’s duty of confidentiality to the company operates notwithstanding (and is independent of) its duty of care to the shareholders. An auditor is thus under an ethical duty of confidentiality to the company as his client, which he is not able to waive without express permission²¹. It could potentially put the auditor in breach of his contractual or common law duties of confidentiality to the company and/or his ethical obligations if he were to answer questions about the audit. For example, if the question calls for information which (a) goes beyond the audit report and (b) is not in any other published company documents, and is therefore still confidential, there is likely to be a breach of the duty of confidentiality to the company, unless the company gives its consent to the auditor answering the question. In addition, the auditor could also be faced with a potential breach of his ethical duties.

The question of whether the auditor will be requested or permitted by the company to answer questions at its AGM should be discussed and considered in good time, in advance of the meeting, with the directors with whom the auditor is accustomed to deal and it would be sensible for the chairman of the company’s audit committee to be included in such discussions. The discussion should encompass any matter relating to the audit included in a statement which has been published on the company’s

website. If possible, it would be sensible to decide ahead of the meeting who is to answer any questions on such a matter and what the proposed response should be. If it is proposed that the auditor be invited to respond to such matters, he should seek in advance a release from his duty of confidentiality and explain that he may need to preface his remarks as set out above. The auditor could take this opportunity to brief the directors on topical matters that the chairman might wish to plan for. The Act has introduced extra visibility in relation to the audit; shareholders will now see and may ask questions about issues that were previously considered privately by the board.

The terminology used by the Act refers to a “statement” setting out any “matter” which the members propose to raise at the next accounts meeting, rather than a “question” as such. The section is very widely drawn and the request to publish could traverse a very wide range of matters to do with the audit. It could, for example, encompass a request for information or documents. Therefore, one could envisage a situation where, for example, a shareholder requests copies of the minutes of the audit closing meeting, identifying the key audit issues and how they were resolved, or the management letter sent by the auditor to the directors, identifying issues that need to be addressed by the company. Such requests should be considered in the light of the following:

- a) any minutes prepared by the company are the property of the company and there is no obligation on the company to disclose them, nor would it be usual for a company to do so;

- b) the audit working papers are the property of the auditors, not the company; the company is not, therefore, in a position to disclose such papers itself and there is no obligation on the auditor to make disclosure of them or to allow the company to do so; and
- c) the audit working papers are, in any event, subject to the auditor’s duty of confidentiality to the company, so the auditor would not himself be able to disclose such papers without the company’s permission.

Requests for disclosure of papers relating to the audit are thus unlikely to be granted; the shareholder will need to raise more specific questions about the audit in its statement. Alternatively, a statement could include a more general comment as a “matter”, for example general criticism of the auditor and/or the directors where the company is in financial difficulty, or questions directed at an auditor’s reliance on third parties, for example valuers, in carrying out the audit.

Questions relating to an auditor ceasing to hold office

The rights in the Act to require website publication of audit concerns extends to statements setting out any matter relating to any circumstances connected with an auditor of the company ceasing to hold office since the previous accounts meeting²². This right will apply in respect of auditors appointed for financial years beginning on or after 6 April 2008²³.

Section 529(3) requires the company to forward a copy of the statement to be published to “the company’s auditor”. It is unclear from the drafting of this

²⁰ <http://www.herbertsmith.com/NR/rdonlyres/1B095F9B-C44D-4C19-ABA8-44514AF30E06/4643/MANFreightlinerlitigation171007.html>

²¹ See paragraph 8 of Ethical Standard 1 “Integrity, Objectivity and Independence” issued by the Auditing Practices Board.

²² Section 527(1)(b)

²³ Paragraph 18 of Schedule 4 to the Companies Act 2006 (Commencement No.5, Transitional Provisions and Savings) Order 2007

section whether this refers to the auditor of the accounts to be laid at the AGM or, if this auditor has ceased to hold office, to the company's current auditor²⁴. In the absence of clarification from BERR, and as failure to forward the statement to the correct auditor could result in the commission by the directors and the secretary of a criminal offence, the prudent course would be for the company to ensure that it forwards the statement to both its current auditor and any relevant former auditors. Auditors should ensure that any contractual requirement on the company, usually in the audit engagement letter, to deliver a copy of any statement (and any related request(s)), extends to cover the period immediately after the auditor has ceased to hold office. This point is discussed further below.

It will be inappropriate at an AGM for the current auditor to answer questions or comment on the reasons for, or circumstances relating to, the predecessor auditor's departure. However, the current auditor will naturally have an interest in any question about a previous audit or auditor.

An auditor who has ceased to hold office and is the subject of the statement will continue to have the right to attend and to be heard at the relevant accounts meeting on any part of the business of the meeting which concerns him as a former auditor²⁵.

Where such a statement is to be published, the company will need to be mindful of what it has said at the time of the auditor's resignation or removal (see the recent PwC / Herbert Smith briefing on auditor resignations²⁶).

Preventing publication

The Act provides a right for the company "or another person who claims to be aggrieved" to apply to court for an order that the company should not be required to place a statement on its website, on the grounds that the rights conferred by Section 527 are being abused. The timing requirements for publication in the Act are such that any application must be made within three working days of the receipt of the request(s) that trigger the publication of the statement.

A company is required to publish a statement on a website "once it has received requests to that effect" from members holding at least 5% of the voting rights or at least 100 members (as described above). Accordingly, the company will need to have arrangements in place so that it is able to keep track of requests as they are received from members and so be able to establish when one of those thresholds has been reached, thus triggering the requirement to publish and the commencement of the three working day period during which any court application must be made. The company will also need to monitor requests as they are received, to determine whether a particular request relates to the same matter as another request or requests already received and therefore whether, and at what point, the thresholds referred to above have been reached.

The Act includes an obligation on the company to give the auditor a copy of the statement *not later than* the time when it publishes the statement on its website. The auditor, however, may himself feel aggrieved by the statement

and so may wish to apply to the court to prevent publication, or he may wish to discuss with the company the possibility of the company making such an application; if the auditor only receives the statement at, or very shortly before, the time the statement is to be published, he will effectively be prevented from doing so.

Auditors should, therefore, consider including in their audit engagement letter a requirement on the company to deliver a copy of any such statement, together with the request(s) to which it relates, to them as soon as it is received by the company, so that they have time to consider what action they may wish to take and to discuss this with the company. As already noted, it will be important for any such requirement to continue and cover the period after the auditor has ceased to hold office, in the event that the matter which is raised relates to any circumstances connected with the auditor ceasing to hold office.

Audit firms will also need to have policies and mechanisms in place to enable them to consider, at short notice, what action they may wish to take in any particular case. Such decisions would need to be taken by the firm, rather than by the relevant audit partner in each case, to ensure consistency of approach across the firm and, where appropriate, involving the firm's insurers.

As already noted, the company should also consider providing a copy of the statement (and any request(s) to which it relates) to any potentially aggrieved third parties, for example its lawyers, actuaries, brokers or financial advisers, so that such parties also have the

²⁴ Although rare, it is possible that a third auditor may be involved, who neither audited the last accounts nor holds the current appointment.

In such circumstances, the company should notify the third auditor in the same way as any other auditors involved.

²⁵ Sections 502(2), 513 and 518(10)

²⁶ See footnote 4.

opportunity to discuss the statement with the company and to consider whether they wish to make, or join in, an application to the court. If the statement is published (either because the application to court fails or because no application is made) then the company should consider whether it should invite any such interested parties to the relevant AGM, as such parties will not have the benefit of the rights which are afforded to auditors by the Act, to attend and speak at general meetings of the company²⁷.

Where an application to the court to prevent publication of a statement is successful, it is likely that there would then be good grounds for the company to refuse to answer questions relating to the proposed statement at the meeting itself.

Is use of the company's website and the AGM the best way for shareholders to raise audit-related matters?

The purpose of an AGM is essentially to provide shareholders with an opportunity to exercise their voting rights which include the right to vote on the accounts and on the appointment or re-appointment of directors and auditors.

In practice, this clearly involves questioning by the shareholders of the directors and often an ensuing lively debate. However, the sparring match that the AGM can become is simply that, and the true power of the shareholders lies in their ability to cast their votes. If they are dissatisfied with the outcome of any debate, it is open to them to vote against the accounts and/or the appointment or re-appointment of directors and auditors.

There is nothing currently in law to stop shareholders raising matters at AGMs about the audit or the auditors, and indeed this particular area has in the past been quite a popular topic for questions and debate. What this new requirement does is to give the concerns raised more publicity. Shareholders are not an homogenous group and, to a significant extent, the large institutional shareholders will often prefer to raise audit-related matters outside of the AGM in direct dialogue with the company chairman, the CEO or other directors, including the audit committee chairman.

Conclusion

It is unclear the extent to which shareholders or groups of shareholders will wish to take advantage of their new rights to have issues publicised in advance of AGMs on companies' websites. Quoted companies and audit firms will need to establish procedures to deal with the administration that such requests will entail. Also, directors, and perhaps particularly audit committee chairmen, will need to consider how best to prepare themselves to address any matters proposed to be raised.

There is a wider debate underway at present, regarding reporting by both auditors and audit committees to shareholders. In the case of reporting by auditors to shareholders, proposals developed by the Audit Quality Forum of the ICAEW²⁸ around clarifying and enhancing communications via the statutory audit report are being considered by relevant parties, including the Auditing Practices Board²⁹. More recently, the Financial Reporting Council has issued a report³⁰ on proposals to update the Smith Guidance, which assists audit

committees in understanding how to fulfil the recommendations of the Combined Code on Corporate Governance in relation to their remit. The proposals cover the section of the Smith Guidance which focuses on the annual report to shareholders about how the audit committee has discharged its functions during the period.

It is likely that these debates will result in improvements in transparency around audit-related matters in the market, and these, along with the changes to the Act discussed above, will represent an additional piece of the puzzle in the overall push towards better accountability and reporting.

²⁷ Sections 502(2), 513 and 518(10)

²⁸ <http://www.icaew.co.uk/index.cfm?route=145078>

²⁹ <http://www.frc.org.uk/apb/press/pub1466.html>

³⁰ http://www.frc.org.uk/corporate/review_smith_guidance.cfm

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