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Limiting audit firms' liability: A step in the right direction? (Proposals for a new audit liability regime in Europe revisited)

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ABSTRACT

This paper considers the responses of six audit firms, to the four options presented by the European Commission in reforming auditors' liability. Whilst agreeing with a limitation in audit firms' liability, it does not consider the means of limitation, as provided by the European Commission in its Recommendation, to be the best means of limiting auditors' liability. In proposing a means whereby not only a limitation of audit firms' liability can be achieved, but also one which would serve as a better means of facilitating harmonisation, the paper makes reference to the variants presented in the author's paper "Proposals For a New Audit Liability Regime", namely a combination of the first and third options. Further, the wide scope permitted by the Commission in leaving it to Member States to decide upon the appropriate method for limiting liability and the means of limiting liability, as the paper will seek to illustrate, do not present the best opportunities in realising the goal of harmonisation.

LIMITING AUDIT FIRMS' LIABILITY: A STEP IN THE RIGHT DIRECTION? (PROPOSALS FOR A NEW AUDIT LIABILITY REGIME REVISITED)

Background

In 2007, the European Commission was involved in consultations relating to the reform of the audit liability regime. Following its presentation of four options, stakeholders were invited to submit their opinions by 15 March 2007. The four options which were presented for reforming auditors' liability are:

- The introduction of a fixed monetary cap at European level
- The introduction of a cap based on the size of the audited company, as measured by its market capitalisation
- The introduction of a cap based on a multiple of the audit fees charged by the auditor to its client
- The introduction by Member States of the principle of proportionate liability, which means that each party (auditor and audited company) is liable only for the portion of loss that corresponds to the party's degree of responsibility.

On the 6 June 2008, the Commission's Recommendation on limiting audit firms' liability was issued. Amongst other aims¹, the Recommendation's main goal consists in facilitating the expansion of alternative audit firms in a competitive market.² As well as proposing three possibilities in limiting audit firms' liability³, key principles which should be adhered to when selecting a limitation method, were introduced through the Recommendation.⁴

Why a reform of the audit liability regime is so important

Whilst countries such as Austria, Belgium, Germany, Greece and Slovenia have had audit liability caps, legislation whereby an agreement could be compelled between the company and the auditor, was only recently introduced in the UK. The Companies Act 2006 has altered the situation which existed under Section 310 of the Companies Act 1985 whereby the liability of auditors was limited to the companies which they audited.⁵ In according stakeholders more protection, this relatively new law enables the parties involved, namely the stakeholders, to set the liability level according to the risk situation of the company.⁶ The auditor transfers costs attributed to his professional insurance to his client, and a higher limit of liability implies higher costs as the auditor will be understood to be taking on higher risks.⁷ It has been proposed that an agreement between the company and the auditor capping liability should only be enforced where approved by shareholders at the general meeting of the company – this being because shareholders are the eventual risk bearers and are therefore entitled to decide on the liability level.⁸

¹ Other objectives of the Recommendation are namely, to ensure: The achievement of fairer liability risk exposure for auditors, the facilitation of access to insurance for auditors, the encouragement of investment into the expansion of audit firms and; the reduction of differences in liability regimes across the EU.

² See ,Auditing: Commission issues Recommendation on Limiting Audit Firms' Liability' <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf> (last visited 8 April 2009). The Recommendation not only addresses increased litigation and insufficient insurance cover in the audit sector, but is also directed towards the protection of European capital markets.

³ Even though other alternative methods may be used

⁴ <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf>

⁵ See <<http://www.thelawyer.com/cgi-bin/item.cgi?id=120697&d=122&h=24&f=46>> (last visited April 2009)

⁶ See W Doralt and others, 'Auditors' Liability and Its Impact On The European Financial Markets' (2008) 67 Cambridge Law Journal 66

⁷ ibid

⁸ ibid

Auditors should be held more accountable for negative consequences of their actions. Generally producers of consumables owe a “duty of care” to third parties. However, it was held in *Caparo Industries plc v Dickman and Others*⁹ that generally, auditors only owe a duty of care to the company as a legal person and they do not owe a duty of care to any individual shareholder, creditor, pension scheme members or any other stakeholder.¹⁰ The Company Law Reform Bill which became the Companies Act 2006, has removed the previously existing limits on auditor liability and compelled an agreement between the company and the auditor.¹¹

The trend towards defensive auditing is also considered to be consequential of increased litigation. Huepkes¹² argues that the threat of litigation could lead to further concentration in the auditing industry and also increase the trend towards defensive auditing – whereby audit partners tend to interpret rules prescriptively rather than exercising subjective judgement. Whilst some evidence supports the fact that concentration encourages specialisation which reduces financial misstatement risk, other findings show that having a large number of audit firms reduces the risk of a dominant firm establishing practices which could encourage low standard financial reporting.¹³

The issue of further concentration in the auditing industry has also provided an interesting forum for debates relating to government intervention to bail out any of the Big Four audit firms given the potential consequences of having a Big Three. Even though Arthur Andersen was made defunct, many large audit firms still believe that they are “too big to fail” and it is not irrational for such firms to think so given the potential effects of having a Big Three.¹⁴ Apart from the moral hazard problem which could result from a “too big to fail” attitude, there is also the neglect of smaller institutions as a result of rescuing large organisations.¹⁵ The use of financial statement insurance (FSI)¹⁶ has been suggested as a means of improving the effectiveness of auditing and helping to neutralise moral hazard.¹⁷ It is also considered to be a better alternative to liability insurance.¹⁸

⁹ (1990) 1 All ER HL 568

¹⁰ See House of Commons Select Treasury Committee 'Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 21

¹¹ Sections 534 – 536 Companies Act 2006 ; Subject to sections 533 and 534 – 536, the auditor will not be exempt from liability where he has been negligent, been in a breach or default of duty and other situations which would void his exemption from liability as provided under section 532. See < <http://www.thelawyer.com/cgi-bin/item.cgi?id=120697&d=122&h=24&f=46>> (last visited 15 April 2009)

¹² See EHG Huepkes, 'The External Auditor and the Bank Supervisor: “ Sherlock Holmes and Doctor Watson?”' (2005) 7 (1/2) Journal of Banking Regulation 10

¹³ L Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' Columbia Law Review, Vol. 106, 2006; Boston College Law School Research Paper No. 108 <<http://ssrn.com/abstract=928482>> pg 33

¹⁴ Arthur Andersen's demise and KPMG's survival has also encouraged many large audit firms to believe that they are too big to fail. Such belief can present moral hazard even if shared by few members of the audit engagement team. Another concern is that Arthur Andersen's exit and KPMG's survival may be doing more to impair audit quality than Sarbanes Oxley is doing to improve it. For more on this, see Ibid pp 36-38

¹⁵ *ibid*

¹⁶ Two advantages which are attributed to Financial Statement Insurance are: Firstly, in addition to the company purchasing insurance policies, the auditor's boss, who is also the insurer, pays auditors to carry out audits. Auditors are considered to have greater influence, not only in compelling managers to apply accounting standards, but also in promoting more reliable financial statements. Secondly, The reliability of financial statements is assessed and reflected in the policy premium which is charged by insurers to a particular company. For further information on this, see L Cunningham, 'The Financial Statement Insurance Alternative to Auditor Liability' (2004) 52 UCLA Law Review at page 413

¹⁷ L Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' p 58; At first it was suggested that Financial Statement Insurance (FSI) be made a voluntary rather mandatory component of US federal securities regulation.

¹⁸ *Ibid* p 59; Liability insurance constitutes a component of the general insurance system of risk financing and serves to protect third party claims.

Furthermore, legislation aimed towards promoting audit independence, namely, the EU Directive 2006 on Statutory Audit and 2002 Sarbanes Oxley Act has resulted in limited choice for companies when choosing between major firms providing audit services.¹⁹

This paper will consider firstly the advantages and disadvantages of each of the four options which were presented in 2007 for reforming auditors' liability. Against this backdrop, it will then consider the responses of major audit firms and the reasons behind these responses. The European Commission's Recommendation will be discussed and evaluated before a conclusion is arrived at. In evaluating the European Commission's Recommendation, justifications for the Recommendation along with the civil liability regimes which currently exist in various member states will be analysed. Reasons for choosing not to adopt an approach which could possibly facilitate greater harmonisation between member states will also be considered.

Advantages and disadvantages of Options presented for Consultation by the European Commission

In response to the four options put forward by the European Commission for consultation, a model based on a combination of the first and third options, namely a combination of a single monetary cap at European level and a cap based on audit fees was favoured.²⁰ The reasons given for choosing option 1 are attributed to the fact that it would facilitate harmonisation and greater cooperation between national regulators of member states. Option three was selected subject to revenue not only constituting the basis of audit fees generated by audit firms, but also fees generated from non audit services.²¹

In relation to the option of introducing a cap based on the size of the audited company, as measured by its market capitalisation, and the fourth option which involves the principle of proportionate liability, these were considered to be too subjective.²²

Advantages and disadvantages of options based on the objectives of the Recommendation.

Two general objectives are stated in the Impact Assessment document: Firstly; the reduction of the risk (to capital markets) that statutory auditors who are able to audit listed companies, may no longer be available and secondly, the facilitation of access to the international statutory audit market (in order to encourage more auditors to enter the market for large and listed companies)²³ The achievement of these objectives is facilitated by further specific objectives which are as follows:²⁴ Achieving fairer

¹⁹ See page 15 of 79 http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf

²⁰ M Ojo 'Proposals For a New Audit Liability Regime', 'The Role of the External Auditor in Bank Regulation and Supervision: A Comparative Analysis' 2008 Verlag DM

²¹

Reasons for a choice based on revenue, instead of operating profit include the fact that operating profit is more subjective as costs are deducted (administration and distribution costs) in order to arrive at a profit figure. These deductions can provide a leeway for creative accounting, that is, the manipulation of accounts to achieve a desired figure (for purposes of taxation, for instance). Ranges of audit revenues chosen by national regulators or the European Commission, to which different fines are assigned, in the event of audit liability, should also take into account the fact that some audit firms may generate the same revenue but not the same profit. The selected ranges could also determine the extent to which some firms would be inclined to manipulate their accounts in order to benefit from a more favourable range.

²² Difficulty in drawing a distinction between negligent acts and those acts committed intentionally, apportioning liability for those acts which are merely negligent but which have resulted in greater losses than grossly negligent acts, apportioning according to the losses incurred by the company or on the basis of the nature of the act since unintentional acts could attract more severe punitive sanctions than intentional ones whose commission resulted in less losses.

²³ See <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf> at page 28 of 79

²⁴ *ibid*

liability risk exposure for auditors, facilitating access to insurance for auditors, encouraging investment into the expansion of audit firms and , reducing differences in liability regimes across the EU.

Two of the options which will be considered against the objectives of the Recommendation are liability based on proportionality and cap based liability.

One advantage exhibited by the principle of proportionality as opposed to cap based liability is attributed to the fact that proportionality would result in similar consequences for large and medium sized firms whilst cap based liability would favour large firms.²⁵ Furthermore, cap based liability is restricted in its application owing to differences which prevail in the legal and economic infrastructures of member states. It would therefore be difficult to stipulate a cap which would take into consideration all factors which are necessary to ensure that aggrieved parties are afforded their due compensation.

Liability caps: Advantages²⁶

- 1) In those member states where joint and several liability regimes exist, liability caps would serve as vehicles in protecting auditors from excessive claims. Furthermore, depending on the cap level, the risk of a major firm collapsing would be reduced.²⁷
- 2) Since claims would be capped by a fixed amount or a method to calculate an amount, a cap at EU level would assist insurers in predicting the outcome of their claims.
- 3) Even though a cap which is set at a level which is too high would favour the Big Four, that which is not too high could be considered to be of benefit to those medium sized audit firms who would like join the market for large public companies.²⁸

Proportionate Liability

In contrast to liability caps, the facilitation of insurability for auditors would not be as effective since proportionate liability would not limit liability risks in their entirety.²⁹ However, in relation to the objective of encouraging investment into the expansion of audit firms, the results of the consultation exercise revealed that mid tier audit firms considered proportionate liability to be a more appropriate solution to a cap. Proportionate liability is also advantageous than a system based on liability caps when considered against the objective of reducing differences in liability regimes across the EU since proportionate liability would effectively eliminate discrepancies between liability regimes across the EU – owing to member states having the same rules.³⁰ However, difficulties still persist with the application of an approach based on proportionate liability.³¹

European Commission's Recommendation

Three principal means whereby the limitation of liability could be achieved were put forward by the Commission and these are:³²

Harmonisation on the basis of capping liability (*Option 4a*)

This option is favoured in my proposal in combination with the introduction of a cap based on a multiple of audit fees.³³

²⁵ See page 53 of 79 http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf>

²⁶ ibid at page 42 of 79

²⁷ ibid; However the cap may not reflect the degree of negligence attributed to the auditor.

²⁸ All EU Member States where caps exist appear to have rather low caps in order to encourage middle sized audit firms to enter the market – hence facilitating low concentration rates in the market for large public company audit; ibid

²⁹ ibid at page 43 of 79

³⁰ ibid

³¹ See supra note 22

³² See page 31 of 79 http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf>

³³ See M Ojo 'Proposals For a New Audit Liability Regime'

Harmonisation on the basis of proportionate liability (*Option 4b*)

Due to the reasons stated in the previous section and other reasons which will subsequently be discussed, and even though the key principles to be followed (when limitation method is selected by Member States) include the pre requisite that the limitation of liability should not apply in the case of intentional misconduct, this option is not favoured.

Convergence of national liability regimes (*Option 4c*)

The table below illustrates that tort law accounts for the basis of auditors' liability, in respect of third parties, in most of the EU member states featured. As a result, harmonisation at European level, on the basis of contractually arranged caps, would not be feasible.³⁴ Furthermore, contractual limitation as is the case with the UK, is not favoured since in many other member states, auditors owe a duty of care not only to the company and its shareholders, but to other third parties.³⁵ Harmonisation could be achieved through statutory means.

Legal base (contractual or tort law) for auditors' liability in EU-15 Member States

Country	Audited company	Third party
Austria	Contractual ¹²¹	Contractual/tort ¹²²
Belgium	Contractual/tort	Tort
Denmark	Contractual	Tort
Finland	Tort	Tort
France	Tort	Tort
Germany	Contractual/tort	Contractual/tort
Greece	Contractual	Tort
Ireland	Contractual/tort	Tort
Italy	Contractual	Tort
Luxemburg	Contractual	Tort
Netherlands	Contractual	Tort
Portugal	Contractual/tort	Contractual/tort
Spain	Contractual	Tort
Sweden	Contractual	Tort
United Kingdom	Contractual/tort	Tort

Source: Impact Assessment Document³⁶

³⁴ See page 32 of 79; *ibid*

³⁵ Third parties such as banks, creditors, individual shareholders or groups of minority shareholders and even potential shareholders. Auditors would not be able to contractually limit their liability with these third parties.

³⁶ <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf> page 75 of 79

Key Principles to be followed when Limitation Method is selected by Member States

- The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor
- A limitation would be inefficient if it does not also cover third parties
- Damaged parties have the right to be fairly compensated

The Recommendation appears to permit a wide scope in prescribing how Member States should implement a limitation of audit firms' liability. Even though this could be aimed at ensuring greater flexibility due to differences in audit liability regimes operating in various states, the degree of guidance provided by the European Commission is also vital for purposes of compliance and enforcement of the Recommendation. This contrasts with the 2006 Directive on Statutory Audit³⁷ which sets out more detailed guidelines to be followed by Member States. Furthermore, the 2006 Directive appears to have as one of its objectives, the goal of harmonisation. Section 32 of its preamble reads:

- “Since the objectives of this Directive — namely requiring the application of a single set of international auditing standards, the updating of the educational requirements, the definition of professional ethics and the technical implementation of the cooperation between competent authorities of Member States and between those authorities and the authorities of third countries, in order further to enhance and harmonise the quality of statutory audit in the Community and to facilitate cooperation between Member States and with third countries so as to strengthen confidence in the statutory audit — cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and effects of this Directive, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty.”

Closer examination of the three methods put forward by the Commission in limiting liability reveals that the goal of harmonisation still constitutes a focal point. However, harmonisation would be made the more difficult given the degree of flexibility allowed by the European Commission in permitting Member States to decide on the appropriate method for limiting liability. Even though the above mentioned key principles would still serve to provide some guidance to Member States, the methods to be applied by such states in limiting liability could have been stipulated by the Commission according to the prevailing legal basis for auditors' liability in those member states.

In addition to stipulating methods which would apply, and which are based on the prevailing legal basis for auditors' liability, consideration should also be given to those countries where liability caps presently exist. This would have been considered by the European Commission based on the response from these jurisdictions. The response³⁸ obtained from the countries (see below) indicated that 74.1% of respondents from outside the audit profession and from countries where audit limitation caps are in place (including the UK, Germany and Austria) favoured reform on European basis - provided significant amendments would not be required to their national laws. As a result of the Commission's Recommendation, would (and should) substantial amendments to the national legislation in such countries be required?

³⁷ DIRECTIVE 2006/43/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC

³⁸ See page 61 of 79 of the Impact Assessment Document

JURISDICTIONS WHERE LIABILITY CAPS EXIST³⁹

COUNTRY	CALCULATION	AMOUNT OF THE CAP	CONDITIONS
AUSTRIA	Per audit (audits of group accounts and individual accounts being counted separately)	<p>€2 million : statutory audit of a small or medium sized company (§ 221 (2) HGB)</p> <p>€4 million : statutory audit of a large company (§ 221 (3) HGB)</p> <p>€8 million: statutory audit of a company; if the fivefold of one of the size characteristics expressed in Euro of a large company is exceeded</p> <p>€12 million: statutory audit of a company, if the tenfold of one of the size characteristics expressed in Euro of a large company is exceeded</p> <p>Special amounts apply to banks and insurance companies</p>	Scale not applicable to intentional conduct; applicable to claims by the audited company and claims of third parties
BELGIUM	Per mandate	<p>€3 million (unlisted company)</p> <p>€12 million (listed company)</p>	No cap in case of fraud or intentional conduct
GERMANY	Per audit or per group audit	<p>€1 million (unlisted company)</p> <p>€4 million (listed company)</p>	Cap not applicable to intentional conduct
GREECE	Per breach	Five times the total of the annual emoluments of the President of the Supreme Court or the total of the fees of the liable Certified Auditor in the previous financial year provided that the latter exceeded the former limit	In case of audit firm cap refers to each shareholder or partner separately; cap not applicable to intentional conduct
SLOVENIA	N/A	€150,000	Cap applicable only to audited company and shareholders. In case of intentional tort or gross negligence the court may disregard

³⁹ SOURCE: <http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf> page 78 of 79

General Response of Audit firms to Recommendation on Limiting Audit Firms’ Liability

Whilst limited liability was favoured by most respondents in their response to the European Commission's proposals,⁴⁰ it has been argued that proportional auditor liability is unlikely to address audit market failure.⁴¹ Furthermore, it is contended that the distortion of market incentives in audit markets can be traced to government intervention and that a solution can be found by replacing government intervention with competition.⁴²

Opinions of major audit firms⁴³

A total of 85 responses which consisted of opinions from the audit profession, companies, banks , regulators and other stakeholders were obtained.⁴⁴ 66% of the responses were in favour of a limitation on auditors’ liability - with the audit profession accounting for slightly over half of respondents who supported a limitation on auditors’ liability.⁴⁵

6 of these responses will be considered. Even though the sample may at first appear to be non representative, given its size, it is considered to be sufficient for the purposes at hand, namely, an estimation of the general opinion of audit firms. This is so, since the Big Four, which account for the ‘lion’s share’ in the provision of audit services are included in the sample. Furthermore, all the audit firms being investigated are major audit firms. The audit firms whose responses will be investigated are as follows: Deloitte, Ernst and Young, Institut der Wirtschaftsprüfer, Institute of Chartered Accountants in England and Wales, KPMG, and PricewaterhouseCoopers.

Indicative overall reaction of the respondents towards a possible reform of auditors' liability regime

In favour of limitation	N°	%
yes (audit profession)	30	35 %
yes (outside the profession)	26	31 %
no	25	29 %
neutral	4	5 %
TOTAL	85	100%

Source⁴⁶

⁴⁰ Vital argument against unlimited liability consists in the fact that it cannot be insured sufficiently/at all. See page 3 of 5 of IDW’s report.
⁴¹ See B Köhler, ‘Audit Market Failure’ (2009) Economic Affairs, Vol 26 (3) at 67- 69
⁴² ibid
⁴³ Responses of respondents can be found at:
http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=abschlussprfung/abschlussprfern&vm=de_tailed&sb=Title (last visited 27 April 2009)
⁴⁴ See http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf (page 6 of 79)
⁴⁵ ibid; Of the 66%, 35% consisted of the audit profession and 31%, the non audit profession. The figure attributed to those who were not in favour of a limitation on auditors’ liability was 29%.
⁴⁶ See http://ec.europa.eu/internal_market/auditing/docs/liability/impact_assessment_en.pdf (page 61 of 79)

The notable differences in the responses obtained from the audit firms relate to option 3, that is, a variable cap based on audit fees. Whilst basically all the firms supported the option of a variable cap based on audit fees, the Institut der Wirtschaftsprüfer did not favour this option because it was considered to generate inappropriate results. Even though KPMG regarded this option as being a more flexible approach which responds to changing audit and capital market characteristics across the EU, it highlighted the need for careful consideration in its basis of calculation. Most of the firms preferred a variable fixed cap as opposed to a fixed monetary cap. Even though proportionate liability was generally supported, it was considered to be insufficient as a remedy on its own.⁴⁷

Reasons for rejection of a single uniform monetary cap

EC Commission – Danger that medium sized audit firms might be at a disadvantage as a result of an extremely high amount at EU level. Furthermore, an extremely low amount might have negative impact on the quality of auditing. This claim is considered to be “technically unfounded”.⁴⁸

- Responses from firms: Differing national circumstances⁴⁹ which embrace the economic circumstances and legal environments, inflexibility in responding to different audit markets make a variable monetary cap more preferable to a fixed monetary cap.⁵⁰

An EU cap is favoured due to its potential to improve the insurer’s ability to assess the maximum exposure in the event of a claim.⁵¹ Despite the differences which exist in Member States, an absolute maximum cap at European level is considered to be a possible way of achieving harmonisation depending on the monetary amount of liability.⁵² It is also considered to have the potential of creating “a pan-European level playing field regarding auditor liability.”⁵³ Reports also reveal that no evidence exists to corroborate the fact that absolute monetary caps have a negative impact on audit quality.⁵⁴

Deloitte

Limitation on auditors’ liability:

In supporting the limitation on auditors’ liability, reasons put forward by Deloitte are attributed to the level of auditor liability insurance and the number of immensely large possible or actual claims which

⁴⁷ According to the responses obtained from KPMG and Deloitte (see pages 2 and final paragraph respectively), a combination of proportionate liability with a form of absolute cap (to protect against ‘catastrophic claims’), which could be tailored by EU member states to fit their economic environments, is recommended. In Deloitte’s view, this option was not considered to be an effective approach for many European Union Member States; see page 4 of their response.

⁴⁸ See IDW’s comments in its response (page 3 of 5)

⁴⁹ As a result of national differences in legal systems, a principles-based framework is supported. See *ibid* at page 2 of 5

⁵⁰ The responses from PWC and KPMG illustrate with the dual-cap model which is favoured in Member States such as Germany or Belgium where one cap is used for private companies whilst a larger cap applies to companies with shares listed on a stock exchange.

⁵¹ See page 3 of PWC’s response. It also argues that smaller firms would not be placed at a disadvantage since different caps for the audits of listed companies, as opposed to those of unlisted companies, have the tendency to generate greater liability exposure for the larger audit firms and lower exposure for mid tier audit firms.

⁵² See IDW’s general comments on the Commission Staff Working Paper: Consultation on Auditors’ Liability and its Impact on the European Capital Markets. The IDW is also of the opinion that an absolute maximum cap can be stipulated at European level, which would not be exceeded by Member States. Further it states that so long as the member states comply with the maximum monetary cap at European level, they should have the final say over the foundations of their regulatory framework. For further information on this, see page 2 of the comments.

⁵³ See page 3 of KPMG report

⁵⁴ see *ibid* and the London Economics report published by the European Commission in November 2006

audit firms face.⁵⁵ In their view, the risk faced by the audit function would decrease through a limitation on auditor liability.

Achieving harmonisation

This is considered to be a long term goal given the difficulty of achieving a single Pan-EU limitation on auditor liability – which is attributed to differences in audit markets.⁵⁶

Main factors which should be taken into consideration in designing a method for limiting auditor liability are as follows:⁵⁷

The need to avoid the distortion of competition in the audit market through a liability limitation; the maintenance of a level of liability which is reasonable enough to ensure that the appropriate level of damages is awarded to parties affected as a result of the auditor's failure to act with reasonable care; the need for an appropriate and effective method of limiting auditor liability; and the possible consequences of such liability limitation on the insurability of an auditor's statutory audit risk; possible measures which would ensure that limitation of liability would be effective outside the European Union; and how any limitations should be calculated over time.

Advantages and disadvantages of a single monetary cap at EU level

Advantages include:⁵⁸ relative simplicity, transparency and consistency of the system; flexibility afforded to Member States; the consideration of different criteria relating to the company - which means that liability reflects the public interest profile of the company being audited; the existence of caps – which prevents catastrophic losses attributed to a single claim; certainty and greater stability relating to the level of risk - which should enhance insurability; and the inability of the auditor or company to influence the amount of liability. The disadvantages of the system include the lack of a constant and proportionate increase of liability – a feature which exists with options 2 and 3; and the 'theoretical' lack of willingness by auditors to audit companies in higher brackets – depending on the maximum levels of liability within this regime.⁵⁹

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

Liability could be linked consistently to the size of the company and potential damage, the existence of transparency, flexibility afforded to member states, and other advantages which are similar to those listed above in relation to a single monetary cap at EU level.⁶⁰ The disadvantages lie in the complexity of the system and the variety of liability caps which exist.⁶¹

Proposal

An overall preference for multiple maximum caps at EU level, which would differ in accordance with the size bracket, and which is based on several criteria, to which audited company belongs, is indicated.⁶² Options 2 and 3, namely, a cap based on the size of the listed company as measured by its market capitalisation and a cap based on a multiple of the audit fees charged by the auditor to its

⁵⁵ Furthermore, Deloitte makes reference to the 2006 'Study on the Economic Impact of Auditors' Liability Regimes', the 'London Economics Study' whose results revealed that the audit function for large companies is at risk. See opening remarks at page 1 of the response to the Commission Staff Working Paper.

⁵⁶ See page 3 of the response to the Commission Staff Working Paper.

⁵⁷ *ibid*

⁵⁸ See appendix of response to Commission Staff working paper: consultation on auditors' liability and its impact on the European capital markets

⁵⁹ *ibid*

⁶⁰ See appendix

⁶¹ *ibid*

⁶² *ibid* at page 4

client, are also supported subject to the existence of some form of absolute cap.⁶³ Although a support for the general principle of proportionality is expressed, in their opinion, such an approach would not be effective for many EU member states.⁶⁴

Ernst and Young

Limitation on auditor liability: According to Ernst and Young, unlimited auditor liability is considered to be the greatest single threat to the audit profession's sustenance.⁶⁵ It is therefore not surprising that the European Commission's initiatives in reforming unlimited auditor liability is welcomed.

Advantages and disadvantages of a single monetary cap at EU level

In line with responses obtained from other respondent audit firms, the option of a single monetary cap at EU level is considered to be too inflexible owing to differences in the cultural and legal environments which operate in the EU. A flexible monetary cap is considered to be a better alternative.⁶⁶ Reference was also made to the London Economics study which highlighted the risk of a single "catastrophic" claim to one of the major accounting networks and as a result, a method which was not established at a level which left an audit firm vulnerable to failure owing to a subsequent claim was recommended in establishing a cap on an auditor's liability.⁶⁷

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

This option is considered appropriate where it applies equally to listed and unlisted companies.⁶⁸ Furthermore, a different measurement is considered necessary since unlisted companies, by definition, do not have a "market capitalisation".⁶⁹

Advantages and disadvantages of a variable cap based on audit fees

In supporting a liability limitation based on audit fees, advantages of this method, when compared to a "one size fits all" or a cap based on a company's size, were also listed. These are as follows:⁷⁰ It is flexible enough to respond to reservations which are attributed to a "one size fits all" approach, the cap would accord a degree of liability protection which corresponds to the size of the entity through a reflection of the size of the audit engagement, transparency would be facilitated as a result of the requirement in Article 49 of the Statutory Audit Directive 2006/43/EC whereby all companies are now required to disclose their fees, fourthly member states should be able to use different audit fee multiples based on whether a company is listed or unlisted and fifth, a more reasonable link between the risks and rewards of undertaking a statutory audit is derived – in contrast to the situation which exists under that of a sized based cap.

Opinion on the option of proportionate liability

This is a preferable option to that of joint and several liability in that it is considered to be a more equitable way of apportioning potential damages. However, the assertion that "proportionate liability might help prevent catastrophic claims against audit firms in the European Union" is disputed by Ernst and Young.⁷¹

⁶³ ibid

⁶⁴ See page 4

⁶⁵ See opening remarks of Ernst and Young's response to the European Commission's proposals

⁶⁶ ibid at page 2

⁶⁷ ibid at page 3

⁶⁸ ibid at page 4

⁶⁹ ibid; Ernst and Young also made reference to consideration of an alternative of the Austrian model which employs turnover and balance sheet totals on the basis of the EU Company Law directives.

⁷⁰ ibid

⁷¹ see page 5 of response to consultation on auditor's liability and its impact on the European capital markets

Proposal

The two means whereby proportionate liability could be introduced, in their opinion are firstly, where proportionate liability is not only coupled with some form of absolute protection, but also for this to be incorporated into EU legislation.⁷² However, they foresee difficulties resulting from the possibility that many member states would be unwilling to make the required change to their national liability regimes. As a result, a second option whereby liability limitation is undertaken through statute, is favoured. Contractual limitation as is the case with the UK, is not favoured since auditors in many other member states where the duty of care is not as narrow⁷³, would not be able to contractually limit their liability with these third parties. As a result, Ernst and Young consider it preferable for any liability limitations to be applied by statute. Furthermore, they consider a contractual approach as being an unlikely means of according the same level of protection against the threat of catastrophic claims, as compared to that offered by statute.

Institut der Wirtschaftsprüfer (IDW)

Achieving harmonisation: With respect to the monetary amount of liability, the *Institut der Wirtschaftsprüfer* considers harmonisation to be a possibility.⁷⁴

Advantages and disadvantages of a single monetary cap at EU level

In supporting a single monetary cap at EU level, IDW rejects the claims made by the Commission as justification for not choosing to accept a single monetary cap on liability at a uniform level.⁷⁵ The claims made by the European Commission are namely, that the danger exists that an excessively highly stipulated cap might be disadvantageous to mid tier audit firms whilst a cap which is too low might have detrimental consequences for the quality of auditing. It rightfully argues that a careful consideration of the insurability of the amount of damages to be covered is vital in stipulating a maximum cap. Such consideration would be required to ensure that middle sized audit firms do not encounter greater difficulties in entering the audit market - owing to high insurance premiums. Further it argues that the Commission's views regarding a negative impact on the quality of the audit where a cap was stipulated at a level which was too low, has been discredited by the London Economics study. The Study revealed that unlimited liability did not guarantee improved quality of auditing.

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

In the IDW's opinion, a cap based on the company's size is not a wholly suitable means of determining a maximum cap as they do not see any link between the market capitalisation and the level of damages attributed solely to an auditor.⁷⁶ In their view, the criteria stated in Articles 11 and 27 of the Fourth EU Directive, which have been constructed to address the issue of statutory audit, would constitute a better basis.

Advantages and disadvantages of a variable cap based on audit fees

This option was considered to be inappropriate owing to the fact that entities whose accounting systems are well arranged would be placed at a disadvantage in respect of the amount of potential claims. Such entities would also correspondingly be able to claim reduced compensation owing to lower audit fees.⁷⁷ Furthermore, since the level of audit fees could not be predicted in advance, the auditor would find it more difficult to ensure that insurance cover is adequate for each engagement.

⁷² *ibid* at pages 5 and 6

⁷³ Where third parties include not only the company and its shareholders, but other third parties such as banks, creditors, individual shareholders, and also potential shareholders.

⁷⁴ See general comments of their response

⁷⁵ See pages 3 of 5 of their response

⁷⁶ *ibid* at page 4 of 5

⁷⁷ See page 5 of 5

Opinion on the option of proportionate liability

According to the IDW, proportionate liability has the potential to generate a reasonable auditors' liability limitation result in legal systems where third parties are able to claim directly against auditors and where an entity's contribution to the suffered loss has not been taken into consideration. They however indicate that caution is required in establishing the connection between the loss incurred and the auditor's responsibility. This is necessary in order to ensure proportionate allocation of damages and that such allocation is attributable to the cause of the damages suffered.

In their opinion however, a single monetary cap at EU level and a cap depending on the company's size, are options which should and cannot be discounted.

(Institute of Chartered Accountants England and Wales) ICAEW

A single monetary cap at EU level

In view of the diversity and variation in size of European capital markets, the ICAEW considered a single monetary cap at European level to be appropriate.⁷⁸ They also expressed the need and the difficulty of stipulating the monetary cap at a level, which whilst not allowing auditors unreasonably to evade the consequences of their actions, would not only benefit those performing large audits. Furthermore, the stipulated level should be such that it would facilitate competition.

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

According to the ICAEW, a cap which is based on market capitalisation is advantageous since it does not discriminate on the basis of different sizes of audit firms. Furthermore, it is equally applicable to all sizes of audit markets. Whilst such an approach was also considered to be advantageous due to the fact that it addressed the difficulties attributed to a single monetary cap, namely, the level at which such a cap should be fixed, several advantages were noted as follows: It was not well suited for the audit of unlisted companies or the audits of public interest entities which were other types of organisation since no clear indicator of market capitalisation existed. Even where market capitalisation existed, this was vulnerable to fluctuations due to external economic factors.

Advantages and disadvantages of a variable cap based on audit fees

A cap which is based on a multiple of audit fees, was considered by the ICAEW to be appropriate having regards to the size and risk profile of the audited entity.⁷⁹

Opinion on the option of proportionate liability and the two modes whereby proportionate liability could be introduced

Proportionate liability is supported in the ICAEW's response as it is considered to be an approach which would yield the most equitable result - since auditors would continue to account for their own acts and not for other's actions. However, they were of the opinion that since the effectiveness of proportionality depends on relatively robust legal protection against liability to third parties, it should comprise part of the reform package and that it should be coupled with an instrument which would lend support to its effectiveness, for example, a contractual agreement.

⁷⁸ See page 3 of the Response of the ICAEW to the European Commission's Staff Working Paper: 'Consultation on Auditors' Liability and its Impact on the European Capital Markets.

⁷⁹ See page 4, *ibid*

KPMG

A summary of KPMG's recommendations are as follows:⁸⁰

- i) Recommendation of an end to unlimited liability across the EU
- ii) Its support of the present limitation of liability which exists across several member states of the EU
- iii) A recommendation to those member states where current liability limitation does not exist, that they adopt such an approach. A combination of proportionate liability with a form of absolute cap which is individually tailored by EU member states in order to accord with local economic conditions, is also prescribed.

Advantages and disadvantages of a single monetary cap at EU level

Whilst a single monetary cap was favoured for its potential to generate a pan-European level playing field as regards audit liability, a variable cap was considered to offer greater flexibility in addressing the needs of domestic audit and capital markets in the EU.⁸¹

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

Even though this approach would facilitate a reference to the size of companies and hence was considered a flexible approach which could address the changing capital market characteristics across the EU, the difficulties presented by large listed companies with market capitalisations worth billions of euros was considered. This resulted from the fact that an overall cap would have to be a negligible fraction of such an entity's size - in order for the goal of enhancing the viability of audit firms to be realised.⁸² Further, the approach was considered disadvantageous in view of the determination of auditor liability for unlisted companies - given that no equivalent of market capitalisation would exist.

Advantages and disadvantages of a variable cap based on audit fees

Even though this was considered to be a flexible approach which addressed changing audit and capital market characteristics across the EU and also had the potential to provide a more realistic basis of calculating a cap - in contrast to the method based on market capitalisation, the basis of calculation required careful consideration.⁸³

Opinion on the option of proportionate liability

On the basis that proportionality facilitates allocation of damages proportionally to the extent of blame, the general principle of proportionality is supported. As regards the ways in which proportionality might be introduced, the risk that the EU Council of Ministers would not support such a substantial legislative change, given that the EU Treaty already embodies the general principle of proportionality, was highlighted. An alternative proposal, whereby proportionate limitations on a contractual basis between a company and its auditor was permitted, was advanced. Even though the UK was used as an illustration of this, the fact that its understanding of the auditor's duty of care is much narrower⁸⁴ than in other member states, was highlighted. As a consequence, a coupling of the

⁸⁰ See page 2 of KPMG's comments and response to Consultation on Auditor's Liability and its Impact on the European Capital Markets

⁸¹ See page 3 of response to consultation on auditor's liability and its impact on the European capital markets. Variable monetary caps were illustrated using examples of the dual-cap model which operates in Member States such as Belgium and Germany and the multiple cap system which has been adopted in Austria.

⁸² *ibid*

⁸³ Such consideration would warrant a reflection of the amount of audit fees charged to the entity or entities in the country where litigation is instigated; *ibid* at page 4

⁸⁴ This view was also shared by Pricewaterhouse Coopers in its response to the Commission's Consultation Paper on Auditors' Liability and its Impact on the European Capital Markets. See page 5

general principle of proportionality with one of the above mentioned liability approaches would be required.

PricewaterhouseCoopers (PwC)

Limitation on auditor liability

In their response⁸⁵, Pricewaterhouse Coopers supported a limitation on auditor liability not only because of its ability to reduce the risk of a major firm collapsing significantly and to reduce the level of concentration at the top end of the audit market in a number of member states, but also because it would encourage middle sized audit firms to enter the market for listed company audits.⁸⁶

Advantages and disadvantages of a single monetary cap at EU level

In accordance with the generally favoured opinion, a variable cap was considered preferable to a single cap at European level as it provides greater flexibility in addressing the needs of the domestic audit and capital markets. Furthermore, since different caps for audits of listed companies, as contrasted to unlisted companies have the tendency to generate higher liability exposures for larger audit firms and lower exposure for middle sized audit firms, smaller firms were not placed at a disadvantage.

Advantages and disadvantages of a cap based on the size of the listed company as measured by its market capitalisation

Even though this option was considered to offer a more flexible approach by responding to the changing audit and capital market characteristics and also addresses needs of smaller audit firms by relating the size of their exposure to the size of the entity being audited, an overall cap will have to be a negligible proportion of the entity's size for large listed companies with market capitalisations of billions of euros.⁸⁷

Advantages and disadvantages of a variable cap based on audit fees

This is considered to be a more flexible approach which addresses more appropriately, changing audit and capital market characteristics.⁸⁸ Its ability to address the needs of smaller audit firms through an association between the size of their exposure and the size of the entity being audited (which is based on the audit fee), contributes to its merits. Furthermore, it is considered a better indicator of audit risk through a reflection, in the fee, of the amount of audit work carried out. However, careful consideration of the basis of calculation will still be required. Owing to the fact that litigation is instigated at national level, multiples of the audit fees charged to the entities in the jurisdiction where litigation proceeded from, should be reflected in the resulting exposure to liability.⁸⁹

Opinion on the option of proportionate liability

The general principle of proportionality is supported owing to its ability to allocate damages on a more equitable basis, based on the degree of culpability.

⁸⁵ As a result, such contractual limitations in those EU member states were considered inadequate in protecting an audit firm against excessive third party claims; *ibid*

⁸⁶ see page 2; *ibid*

⁸⁷ For other disadvantages of this option, please refer to page 3 of the response

⁸⁸ For further advantages, please refer to page 4; *ibid*

⁸⁹ *ibid*

Evaluating the European Commission's Recommendation

Having considered the responses of all six firms, a recurring response was the opinion that proportionate liability should not operate in isolation as this could place mid tier audit firms at a disadvantage. This is due to the fact that they may not have the financial resources required to respond to claims of excessive amounts. Whilst a combination with some form of absolute protection such as limitation by contractual agreement has been considered, difficulty in implementing such a proposal is foreseen since in many other member states, unlike the UK, the auditor's duty of care is much wider.⁹⁰ In such a situation, it would be difficult to limit their liability contractually with such third parties.

Difficulties are also anticipated in implementing the proposal that proportionate liability be combined with absolute protection and enshrined in EU legislation. In this respect, the fact that liability caps already exist in some member states like Austria, Belgium, Germany, Greece and Slovenia needs to be considered. Proportionate liability by law as from 1st Jan 2008, was introduced in Hungary whilst contractual limitations of liability applied in the UK as from June 2008.

However, the reforms in these jurisdictions only apply within local boundaries. Reform is required in order to introduce a law which can apply at European level. Based on the results obtained from the consultation, 74.1% of respondents from outside the audit profession and from countries where audit limitation caps are in place (including the UK, Germany and Austria) favoured reform on European basis - provided significant amendments would not be required to their national laws. On the other hand, 76.5% of the respondents from outside the audit profession and in those countries where liability caps do not presently operate, do not favour liability caps.⁹¹

Given the high percentage of respondents in those countries where liability caps do not presently operate and who do not favour liability caps, and considering the fact that significant amendments to national laws would not be welcomed in those countries where liability caps presently exist, the flexibility afforded by the European Commission in its Recommendation on Limiting Auditors' Liability, is justified. However, a price will be required in allowing for **such a degree** of flexibility. The success of harmonisation and enforcement at European level despite prevailing differences in national regimes, will require that resulting immense challenges, be overcome by supranational authorities.

A variant of a fixed monetary cap at European level and the introduction of a cap based on a multiple of the audit fees charged by the auditor to its client⁹², would have presented a better opportunity for harmonisation and that - without the need for (as many) significant changes to the national legislation of several EU member states.

⁹⁰ In these jurisdictions, the auditor owes a duty of care not only to the company and its shareholders, but also to other third parties such as banks, creditors, individual shareholders and in some cases, potential shareholders.

⁹¹ See page 61 of 79 of the Impact Assessment Document

⁹² For detailed information on this, please refer to M Ojo, 'Proposals for a New Audit Liability Regime' <<http://mpira.ub.uni-muenchen.de/10068/>> and 'The Role of the External Auditor in Bank Regulation and Supervision: A Comparative Analysis' 2008 Verlag DM