AUDITORS’ LIABILITY AND ITS IMPACT ON THE EUROPEAN CAPITAL MARKETS – ABI RESPONSE TO EUROPEAN COMMISSION DG INTERNAL MARKET CONSULTATION PAPER

INTRODUCTION

In January 2007 the EU Commission published a consultation on its staff working paper addressing the case for reform of auditor liability at the EU level in the light of concerns over viability of audit firms and the risks this would have for competition in the market for audit services.

This paper is the response of the Association of British Insurers (ABI) to this consultation. ABI members, as institutional investors with some Euros 1.8 trillion of funds under management, have a strong interest in ensuring the effective functioning of a market in quality auditing services. As providers of insurance services they are well aware of the importance of a sound environment for the operation of the market and of the likely implications of options for change canvassed in the consultation document.

GENERAL COMMENTS

Auditor liability cannot be considered in isolation from the vitally important subjects of audit quality, competition, and the capital structure of firms conducting audit and other business. Indeed ultimate conclusions on the appropriate liability regime cannot be reached until concerns in those other areas are addressed.

The case has not been made, either in the consultation paper or in the London Economics Study for action to be taken at a European level. At present there is a permissive regime which allows Member States to impose a cap if they wish. This enables the liability regime in different Member States to reflect the different legal background. We see no reason why this should not be permitted to continue. We are dismayed that the consultation paper seeks to suppress this argument by failing to offer a “no action” choice.

If there were a real and widely accepted need for a cap on liability all Member States would have already introduced one at national level. That they have not done so reflects doubts as to whether a cap would really assist in preventing a further collapse of an audit firm, encourage new market entrants or enhance quality. To impose regulation, or to encourage it by way of a recommendation would run contrary to the EU current priority of “better regulation.”
We are concerned that the London Economics Report and the consultation paper fail to address the problem of concentration on a suitably broad basis. Concentration is a problem in our view, not least because it puts large auditors in a position of being seen as “too big to fail” and therefore able to insist on regulatory concessions (including the award of a right to cap liability). We are concerned that fear of the failure of a large firm could place regulators in the EU and elsewhere under unfair pressure to withhold disciplinary action from large auditors in circumstances where they have failed to meet standards accepted of them. This is deeply worrying when the product provided by the auditors is all about securing and maintaining confidence.

Addressing the problem of lack of competition requires a concerted effort to find ways of broadening the market and improving access to new entrants. It is also essential that the audit firms are not perceived as being above competition law. For this reason we are copying our response to this consultation to DG Competition.

The justification given for considering reduction of auditor liability is the adverse impact on competition within the market for audit of the collapse of even a single major firm as the result of litigation against it. Given that concentration within the market for audit has been driven by the desires and business preferences of audit firms and their partners, reform cannot be predicated on their deserving protection. Neither is it clear that the litigation environment they face is becoming more onerous.

The greatest alleged litigation threats are considered to come from the US. However, the environment is very different there and solutions to US liability concerns much be addressed in that context. If the viability of global audit firm networks is a function of exposure to US liability then reform within the EU will not be relevant to the outcome.

Liability reform may have a place in the context of a broader package of reforms designed to increase competition and choice and enhance quality and confidence. We have strongly welcomed the efforts of the Financial Reporting Council to stimulate debate around these issues in the UK. The discussion also needs to take place also at European level and consensus reached around a package of measures before any decisions are taken on liability reform.

Liability must also be seen in the context of the national law under which it operates. These regimes vary significantly. Accordingly efforts towards harmonisation of liability that did not recognise these differences would run the risk of being, at best, ineffective, or at worst, leading to perverse and undesirable outcomes.

We consider that any form of monetary cap is inappropriate – inevitably arbitrary and therefore unfair. The effect on liability of directors needs to be considered, including the impact on directors’ and officers’ liability insurance. Our Members conclude that capping will have adverse consequences whereas limiting liability along proportionate lines gives some prospect of a
better functioning insurance market, provided that this is not a one-sided concession to auditors and is introduced in the context of other measures designed to improve choice and enhance quality.

**Comments On The London Economics Report**

The Report prepared for the Commission does not provide a sound basis for concluding that liability for auditors should be reduced. The Report correctly identifies that imposing a monetary cap will have undesirable consequences either in acting as a barrier to entry of mid-tier firms if it is set at the level necessary to provide the appropriate incentives on a Big 4 firm to maintain audit quality.

Moreover the report cites a number of other factors, such as the inertia of companies in changing their auditor, which contribute, more than any lack of liability limitation, to the problem of concentration in the market. This confirms our view that the problem of concentration needs to be addressed on a more holistic basis. The European Commission is in a strong position to lead a much broader debate than we have seen to date.

Nor does the report properly consider the impact on competition of a cap. We would draw the Commission’s attention to the report prepared by the UK Office of Fair Trading on the audit market in 2004 which suggested that capping liability would reduce rather than encourage competition.

The suggestion that a cut in income for Big 4 auditors might be “bearable” but that anything in excess of this would lead to partners leaving “in droves” and the collapse of the firm shortly afterwards is an extraordinary basis for proposing legislative action to protect those businesses. Where liability is incurred it should attach to those who had the ownership interest in the entity at the time that culpable actions took place. It should not be permitted for individuals to evade their responsibilities in this way and if this were to be made clear this would help prevent an exodus leading to the collapse of the firm. Rather, the partners of the firm should be expected to commit appropriate capital resources or other guarantees that ensured both that audit firms operate with appropriate capital and also that it remains committed until such time as it can be safely released from the business.

**The Role of Insurance**

As providers of insurance our members are concerned that the introduction of any cap will be used to place them under pressure to provide insurance for liabilities that are outside the cap. The willingness of the industry to provide insurance will, however, reflect the availability of reinsurance cover and the assessment of risk. These factors will operate independently of the level of any cap and it should not therefore be assumed that the introduction of a cap on liability would of itself re-open the market for insurance.

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1 An assessment of the implications for competition of a cap on auditors’ liability – Office of Fair Trading July 2004
The consultation paper suggests that the concentration of the market in the Big Four makes insurance for auditors harder to obtain than it is for directors where the risks are less concentrated. Insofar as there is truth in this assertion, then an appropriate response is to step up efforts to broaden the market. Moreover, the large firms can do much more to reduce the risks inherent in their own businesses through stronger governance, more transparency, rigorous internal controls and employee incentives which are less focused on the generation of audit fees as opposed to the maintenance of quality.

We also remain concerned that capping the liability of auditors will increase pressure on directors and therefore lead to distortions in the market for directors’ and officers’ liability.

SPECIFIC COMMENTS

Q1 Do you agree with the analysis of the option of fixing a single monetary cap at EU level?

Yes. We agree with the analysis that makes clear that this option is undesirable and impractical. However, other reasons for its rejection must also be recognised. In particular, legal frameworks relevant to this subject differ greatly between Member States. The scope of liability differs such that in the UK the parties who have been able to take legal action for redress against auditors have been limited by virtue of legal judgments including the Caparo case which have established that the auditors are accountable to the company and its shareholders but not generally to a wider audience. Different hurdles may also exist regarding proof of reliance on audit opinions and this may have a major impact on the weight of litigation to which audit firms are exposed. Imposing a single monetary cap would be an inflexible and inappropriate solution giving the impression of maximum harmonisation whilst delivering nothing of the kind. Not only is maximum harmonisation undesirable and unnecessary, but attempting to impose it would also be counterproductive.

Q2 Would a cap based on the size of the listed company, as measured by its market capitalisation, be appropriate?

The significance of an audit relates to the size but also to the complexity of the audited company. However, the case for relating any cap on liability to market capitalisation is neither appropriate in principle nor workable in practice. The auditor does not underwrite the market value of a company on an arbitrary date, whether balance sheet date, the date on which the accounts are signed off, or the date on which the company’s shareholders receive and approve them in general meeting. Still less would it be appropriate to use the market capitalisation at a date when a claim is brought as the market capitalisation would by then be very low or even zero. More importantly, the market capitalisation benchmark would fail entirely to take into account the
complexity of company where total liabilities might be large and uncertain. Using enterprise value and not just market capitalisation of equity would be less inappropriate but it is unclear why debt instruments should be treated differently to other liabilities in this regard.

Other measures of company size have not been considered by the consultation paper but all have serious deficiencies. Using gross or net audited assets of the company would move the focus to numbers that the auditor is responsible for validating but would entirely fail the complexity test in that the importance of the audit is greatest where total assets are low and liabilities contingent or uncertain, an increasingly prevalent situation especially in sectors such as banking and finance where accurate measurement of the value of derivatives is particularly important.

Q3 Would a cap based on the audit fees charged to the company be appropriate?

This option would be entirely inappropriate as it would increase the incentives on accounting firms to treat audit engagements as a loss leader to capture lucrative consultancy business. The subsequent consultancy business would then be used to cross-subsidise the audit business unless the accountancy firms were to reduce the level of resources devoted to the audit thus reducing its quality.

Q4 Do you agree with the analysis of the option of the introduction of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?

Of all the options, this is the only one that, being based on reasonableness, is not objectionable in principle. It is also less likely to create distortions of the type inherent in all the other approaches discussed in the consultation paper. The ABI has long considered that this is the only principled basis for reform, addressing directly the "deep pocket" arguments that are the basis of concern.

We believe that Member States should remain free - but not required - to implement proportionate liability in either of the manners outlined. We consider, though, that shareholder consent is an important safeguard and that the second approach, which reflects the way in which the law is in the process of changing in the UK, therefore has the greater merit.

CONCLUSIONS

The case for EU level reform has not been made. We are concerned at the timetable whereby the Commission appears likely to produce a recommendation before it has received the results of its current study on the possibility of introducing outside capital to audit firms. A liability cap can be seen as a substitute for capital and access to capital may well therefore have a bearing on the need for liability reform. A recommendation to Member States should not be issued without further consultation or in the absence of
broader consensus on competition and choice. To proceed on the basis outlined in the paper would not be in the interests of companies, shareholders or of the promotion of quality audit.

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