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Commission Recommendation on limitation of auditors' liability: Frequently asked questions

Why has the Commission issued the Recommendation?

Liability reform is an international issue where Member States should take action. It is in the public interest to ensure sustainable audit capacities and a competitive market for audit firms at international level. In the light of the current audit market structure, liability risks arising from the increasing litigation trend combined with insufficient insurance cover may deter auditors from providing audit services for listed companies. If these structural obstacles (liability risks/lack of insurance) persist, mid-tier audit firms are unlikely to become a major alternative to the "Big 4" audit networks[1] on European capital markets. But there is also a risk of losing some of the existing players. One of the reasons might be that catastrophic claims cause the collapse of one of the major audit networks. More details are given in the related impact assessment.

How did the Commission arrive at this conclusion?

The debate on auditors' liability limitation was initiated during the discussions on the adoption of the Directive on Statutory Audit. The European Parliament and the Council of Ministers agreed that the Commission should examine the problem and issue where appropriate a Recommendation. As a direct follow-up, the Commission mandated London Economics to conduct an independent study[2] on the economic impact of auditors' liability regimes. The study also focused on the insurability of major audit firms. At the same time, the Commission set up a forum of market experts (the Auditors' Liability Forum). The study shows that large claims may put at risk an entire auditing network. This could lead to difficult consequences for the wider economy, such as a significant reduction in statutory audit capacity for large companies, which could possibly create serious problems for companies whose financial statements need to be audited. The study considers the different options for limiting auditors' liability.

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1 Deloitte, Ernst&Young, KPMG, PricewaterhouseCoopers

2 London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany: "Study on the Economic Impact of Auditors' Liability Regimes", September 2006 (hereafter, referred to as the London Economics study): http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

On the basis of the results of the study, in January 2007, the Commission Services launched a public consultation on the need to reform auditors' liability in Member States and presented four options for a possible initiative. A major concern expressed by stakeholders during this consultation was the lack of choice when selecting an audit firm. This is particularly acute in the market for audit engagements of listed companies. According to the study the "Big 4" account for 85% of audits of listed companies in the EU.

In parallel to the public consultation, the Commission also commissioned a further study to examine whether removing the current ownership rules for audit firms[3] could have positive effects allowing more players to enter the international audit market. External capital as well as capital from audit partners could accelerate this process. The study[4] was published in October 2007. It highlighted upsides and downsides of such an external capital model. In addition, it emphasised that liability risks for audit firms act as a barrier for mid-tier audit firms entering the market for the audit of listed companies at international level. The impact of liability risk on the cost of capital can be significant and may lead to capital rationing even in the case of audit firms allowed to raise capital externally.

Will a liability limitation not have a negative impact on audit quality?

Audit quality is fundamental and investors should have full confidence in the auditor. Therefore, the limitation should not apply in case of intentional breach of auditor duties, such as collusive behaviour with management in committing fraud. It should apply only in a case of a negligent behaviour by the auditor.

During the public consultation in early 2007, a majority of respondents (including investors) from countries where a liability cap already exists (e.g. Germany, Austria or Belgium) supported a Commission initiative and did not believe that their domestic cap had had adverse effects on audit quality. On their side, UK investors also support the possibility to agree proportionate liability by contract provided that the shareholders are asked and give their consent.

Therefore, the Commission has not suggested one single method of limitation of auditors' liability (such as a cap) at the EU level.

Furthermore, audit regulators - not judges or courts - will in future play a pivotal role in maintaining the high audit quality which companies and investors deserve. In this regard, in addition to the requirements of the recent Directive on Statutory Audit, the Commission adopted on 6 May 2008 a Recommendation strengthening the robustness and independence of inspections of firms auditing listed companies. Such regular inspections provide better guarantees for the quality of the audits compared to unlimited civil liability rules which constrain access to this highly concentrated market. Audit quality should be driven more by sound regular inspections whilst liability should complement such efforts but not make the audit business unattractive.

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3 Article 3 of the Statutory Audit Directive requires that the majority of the voting rights in audit firms should be held by statutory auditors.

4 Prepared by Oxera

What will be the rights of damaged parties to obtain compensation?

In determining the limitation, Member States should take account of injured parties' rights to appropriate compensation. Therefore the damaged parties will have the right to be fairly compensated, under the limits of the method chosen by their Member States. Even without any existing method of limiting liability, the expectations of third parties to obtain compensation face practical limits, corresponding to the financial capacities of the audit firms. In this respect, the advantage of limiting auditors' liability would be that the rules are fixed in advance and hence potential plaintiffs would not expect audit firms to be able to compensate them for unlimited amounts.

Why is the scope of the Recommendation so narrow? Why is the limitation applicable only for the audit of listed companies?

The Commission recommends that the limitation of liability applies in the case that an auditor or an audit firm performs a statutory audit of a company listed in the EU. It includes statutory audits performed by the group auditor of a company listed in the EU.

The scope of the Recommendation arises from Article 31 of the Directive on Statutory Audit, which represents a mandate agreed by the European Parliament and the Council of Ministers in 2006. However, this Recommendation does not prevent Member States from taking action also in relation to the audits of other limited companies. Experiences in Member States which introduced a cap, such as Germany or Belgium, have shown that liability limitations for the audit of unlisted companies are set at a lower level compared to the audit of listed companies. Member States such as the UK which allow for contractual solutions are not opposed to a cap for the audit of unlisted companies.

Should Member States impose a limitation or should they leave the decision to an agreement between companies, shareholders and the auditors?

Both options are possible, depending on the legal environment. Before choosing a method of limitation, Member States should examine with the concerned stakeholders the impact on financial markets and investors, the impact on conditions for access to the statutory audit market for listed companies, as well as the impact on audit quality, insurability of risks and the companies to be audited.

Why has the Commission not recommended a specific method, such as a cap?

The London Economics study already concluded that it is unlikely that a one-size-fits-all EU-wide approach is the most useful. There are considerable variations between civil liability systems in the Member States. In general, respondents to the consultation also considered that the Commission should leave it to Member States to develop their own methods for limiting liability.

Therefore, Member States may choose a method of limitation that best suits their legal environment but is in line with the principles of the Recommendation. Three methods which are actually used by Member States (cap, proportionate liability or a contractual limitation) are given as possible examples but any other equivalent method might be used.

Member States which already have a limitation of liability in place can keep the limitation, but their system might need to be adapted to the principles of the Recommendation, such as application of the limitation to third parties or fair compensation of the damaged parties.

Is there not a risk that the Recommendation has positive impacts mainly for the 'Big 4'?

The major networks will not receive "immunity" against their audit failure and they will continue to pay compensation to the damaged parties that can still be very high in many cases. A liability limitation should however benefit new market entrants and especially the mid-tier audit firms, as these firms may not have the same ability to establish self-insurance, which was established by the Big 4 more than a decade ago. Furthermore, lower liability risks would provide a stronger incentive for new investment into mid-tier audit firms, which could help them to compete with the major audit networks.

If the Recommendation has no practical results, will there be a need for a Directive promoting further harmonisation?

The Commission will closely monitor and evaluate the impacts of the Recommendation on the audit market and the way the Recommendation was implemented by Member States, as well as the effects of the implementation.