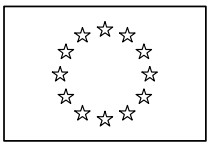

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 5.6.2008

SEC(2008) 1975

**COMMISSION STAFF WORKING DOCUMENT**

**Accompanying document to the**

**COMMISSION RECOMMENDATION CONCERNING THE LIMITATION OF THE CIVIL LIABILITY OF STATUTORY AUDITORS AND AUDIT FIRMS**

**Impact assessment**

**{C(2008) 2274}**

**{SEC(2008) 1974}**

# TABLE OF CONTENTS

## 1. INTRODUCTION

European legislation[1] requires a company's financial statements (i.e. annual or consolidated accounts) to be audited ("statutory audits"). Statutory audits must be conducted by independent, registered auditors and audit firms ("statutory auditors"). Statutory auditors should provide an independent opinion about a company's financial position, as reflected in the financial statements – this opinion is important as investors will rely on it when making decisions[2].

Corporate failure (particularly bankruptcy), and the exposure of previously undetected cases of management deception, often lead to accusations of audit failure, which in turn can lead to law suits. Individual shareholders, creditors and prospective purchasers of the audited company may suffer damages for which statutory auditors may be held liable. In the case of listed and large unlisted companies, whether national or multinational, liability risks are high and can quickly rise to several million Euros. These liability risks combined with insufficient insurance threaten the sustainability and competitiveness of the statutory audit market structure, since they may deter statutory auditors from providing audit services for such companies. European capital markets, which have become much more integrated in the last few years and which collectively represent the second largest capital market in the world (after the US), need a sustainable and competitive market for audit services, where audits for multinational companies can still be provided. Auditors' liability is the subject of debates not only in Europe, but also in the US.

## 2. PROCEDURAL ISSUES AND PUBLIC CONSULTATION

### 2.1. EU Directive on Statutory Audit [3] and its follow-up

Although the Commission did not include the issue of liability in its initial proposal for the EU 2006 Directive on Statutory Audit, the European Parliament requested that this issue be addressed in the Directive. Accordingly Article 31 of the Directive invited the Commission to present a report on:

- the impact of the current national liability rules for carrying out statutory audits on European capital markets; and

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1 Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies; Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts; Council Directive 86/635/EEC of 8 December 1986 on the annual and consolidated accounts of banks and other financial institutions; Council Directive 91/674/EEC of 19 December 1991 on the annual and consolidated accounts of insurance undertakings.

2 85% of investors assert that the annual audit adds value to them, see: ICGN (International Corporate Governance Network; representing main international investors) / GPPC (Global Public Policy Committee; representing 6 major audit networks): "Survey of investor attitudes on financial reporting and auditing", 2007 (hereafter, referred to as the ICGN/GPPC survey).

3 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

- the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations on financial liability.

In the light of the above report, the Commission may submit recommendations to Member States.

Against this background, the Commission mandated, as a preparatory step, London Economics to conduct an independent study[4] on the economic impact of auditors' liability regimes. The study also focused on the insurability of major audit firms. Simultaneously, the Commission set up a European Forum of market experts (the Auditors' Liability Forum[5]) in November 2005 in order to assist in the preparation of the study, as data on this issue was not readily available in all Member States. The Forum comprises twenty market experts, with varying professional backgrounds, (e.g. auditors, bankers, investors, companies, insurers and academics), with particular experience and knowledge of the subject. The London Economics study was completed and published in October 2006. The study considers the different options for limiting auditor liability.

In January 2007, the Commission Services launched a public consultation process to ascertain whether there is a need to reform auditors' liability and to examine possible ways forward for reforming auditor liability rules in the Member States. On the draft consultation document, SG, LS, DG COMP, DG ECFIN, DG SANCO and DG JLS were consulted. The Commission services invited stakeholders to give their views on the issues involved by March 2007 and presented four possible options for a potential reform. The four options were:

- One single monetary cap at EU level
- Cap depending on the company's size
- Cap depending on the audit fees charged to the company
- Proportionate liability

The Commission Services also presented an overview of the legal situation in Member States.

85 replies were received from various stakeholders located in 15 Member States, and included replies from the audit profession, insurers, companies, investors, academics, banks and regulators (see **Annex 1**). 66% of all respondents (of which 35% come from audit profession, representing all respondents from audit profession, and 31% from outside the audit profession) support a limitation on auditors' liability, whereas 29% rejected the possibility. Most of respondents also expressed a deep concern about lack of choice in the international audit market[6].

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4 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

5 For further information on the composition and role of the Forum, see press release on DG MARKT website: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/05/1420&format=HTML&aged=0&language=EN&guiLanguage=en

6 For further information on the results of the public consultation, see summary report on DG MARKT website: http://ec.europa.eu/internal_market/auditing/docs/liability/summary_report_en.pdf

In parallel to the public consultation, the Commission mandated OXERA to carry out a further study. The study focussed more on other topics, such as ownership and capital structures of audit firms evaluating the current situation. One of its conclusions is also relevant for this impact assessment: it confirmed that liability risks for audit firms acts as barrier for mid-tier audit firms entering the market for the audit of listed companies at international level.

### 2.2. Study on civil liability systems of statutory auditors in the EU

From a legal side, the issue of auditors' liability was already examined in a study for the Commission[7] in 2001. The purpose of the study was to determine to what extent the different civil liability systems for auditors, which exist in the Member States could constitute an obstacle to the development of a European single market for auditing services. The study found the differences between the legal regimes to be significant, but did not recommend that changes be made at that time. However the audit market has changed since the publication of the study (in particular, Arthur Andersen, one of the then five audit networks, collapsed in 2002), and these conclusions may no longer be appropriate.

### 2.3. Inter Services Steering Group

An Inter Services Steering Group was convened. The following services were consulted: SG, SJ, DG JLS, COMP, ECFIN and DG SANCO. DG COMP and SG made contributions which have been taken into account. In addition, DG COMP, DG ECFIN and JLS were consulted on the draft terms of reference for a study on the economic impact of auditors' liability regimes and the draft report of the London Economics study.

### 2.4. Impact Assessment Board

This Impact Assessment was reviewed by the Impact Assessment Board (IAB). The recommendations for improvements have been accommodated and a revised version of the report was resubmitted to the Board. The following changes were made:

- The problem statement was amended to present more the market barriers and public interest issues being addressed (changes made to sections 3.1 and 3.2).

- More references have been added to include evidence of relevant experiences from Member States and also from the USA (changes made to sections 6.1.3 and 6.1.4. Sections 6.2, 6.3, 6.4 and 6.5 also include evidence of such experiences).

- Developing the options in greater details. Section 5.2 has been expanded. Additional text was added to section 6.4.2 to make the legal and institutional differences between implementing option 4c via a Directive or a Recommendation clearer.

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[7] Thieffry & Associates: "A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union", Report to the European Commission. Update by DG Internal Market and Services in January 2007.

- The section on Monitoring and Evaluation has been expanded to provide indicative timing and more detail on the sort of data which it would be useful to monitor. The Commission would propose the collection of information every 4 years.

- The Commission will review this information and discuss it with Member States. Further debate with private stakeholders (audit firms, investors, companies, insurers) will take place on the basis of this information.

In general, the opinion on the revised draft of the Impact Assessment was positive, and the amended version was welcomed for having identified the market failures, presented the public interest in question and for having well defined the objectives.

## 3. PROBLEM DEFINITION

### 3.1. The public interest

It is in the public interest to ensure a sustainable audit function and accordingly a competitive market for audit firms. Investments or divestments on European capital markets would otherwise be seriously constrained. Many decades ago, it became mandatory for companies to have their financial statements audited. It was decided in many jurisdictions, including those in the European Union, that audit services should be supplied by private audit firms and not by public authorities or regulatory agencies.

The purpose of a statutory audit is to give reasonable assurance that financial statements are free from material misstatements and provide a true and fair view of the company's financial position. Regulators acknowledge that the opinion of a statutory auditor cannot provide an absolute assurance but should offer reasonable assurance to the public, notably to shareholders or other investors.

The market for the provision of audit services is based on two simple premises. On the one hand, companies should be able to choose their auditors according to their needs and at a reasonable cost. On the other hand, investors should have the benefit of an independent audit opinion based on a high quality audit[8]. On balance, private audit firms should therefore be offered a workable framework for providing high quality audit services, in particular for capital markets where investors invest in large multinational companies.

Listed companies often demand (and need) an auditor present or represented in more than 50 jurisdictions in the world or even more. However, there is a market failure on the supply side as they are just four networks (the so-called Big 4[9]) capable of meeting the demand for international audit services for listed companies. Compared to 2000/2001, there is an increasing real risk that one of these networks disappears for many reasons. Prospects that another major player on the supply side enters the market are however very low. It takes time and resources to build a large international network able to respond to the demand of listed companies. Networks

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8 85% of investors assert that the annual audit adds value to them, see: ICGN/GPPC survey

9 PWC, KPMG, Deloitte, Ernst & Young

of audit firms are not global international companies but rather associations of independent local audit firms. The reason for such organisation is the unwillingness of local audit firms to share unpredictable liability risks for which no insurance cover is available with other audit firms in other jurisdictions.

Existing networks or new players are unwilling to invest in the audit firms and develop new networks structures able to compete with one of the Big 4. One of the reasons might be strict ownership rules for audit firms, requiring that majority of the voting rights in an audit firm is held by the auditors. The prevailing reason is that high liability risks render any new investments into audit firms not attractive.

As a consequence, there is a fear that the international audit market for listed companies might not be sustainable over time.

## 3.2. Issues in the international audit market

### *3.2.1. The demand side: listed companies*

Capital markets[10] can no longer be viewed purely from a domestic perspective. A much more integrated European capital market is about to emerge due to the successful implementation of the Financial Services Action Plan between 2001 and 2005 as part of the Lisbon agenda. Investors today invest in multinational companies, the securities of which are listed and traded at different stock exchanges in the EU or around the world[11]. To this end, investors rely on audited financial statements to assess the merits of investing in multinational companies[12].

Confidence in the financial statements is essential for investors to be able to decide where to allocate their capital to listed companies across borders. In 2005 international financial reporting standards (IFRS) were introduced in the EU for the financial statements of all listed companies in Europe. They establish a common accounting framework enabling investors to compare financial statements throughout the European Union and even at a global level. The role of the statutory auditor is to contribute to the credibility of these financial statements.

As at June 2006, the number of large companies listed on Europe's prime stock exchange indexes was 585[13]. The number of companies listed on Europe's main national stock exchanges is estimated at between 7.000 and 8.000[14] in 2008. The

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10 A capital market is the market for securities, where companies and the government can raise long-term funds. A capital market includes the stock market and the bond market.

11 The most important stock exchanges worldwide are the NYSE Euronext (market value: US$ 20.7 trillion, Tokyo Stock Exchange (market value: US$ 4.63 trillion), NASDAQ (market value: US$ 4.39 trillion) and London Stock Exchange (market value: US$ 4.21 trillion), figures as of October 2007, see World Federation of Exchanges – Statistics/Monthly.

12 Financial analyses based on financial statements are often used by investors and are prepared by financial analysts, thus providing them with the basis in making investment decisions.

13 London Economics study

14 As regards the importance of those companies for the EU economy (in terms of market capitalization and turnover) see annex 3

market capitalisation of listed entities in the EU-25 countries amounts to nearby € 11 trillion in 2007[15] (for details see **Annex 2**).

Although there are several thousand audit firms existing in the EU, only a few audit firms are appointed by these thousands of listed companies as their statutory auditor. Moreover, these companies rarely switch from one audit firm to another so that audit firms have few opportunities to gain clients. Due to the organisational structure and the international reach of the Big 4, capital markets are effectively dependent on them to supply the required statutory audits for multinational companies with subsidiaries, in some cases operating in more than 100 countries (see 3.2.2.). According to London Economics, on average around 4% of listed companies change their auditor per year in Europe. Often, companies keep their audit firms for decades. The following findings established by London Economics show that 1/3 of interviewed companies keeps their auditors for more than 10 years and 1/2 of companies for more than 7 years.

| **Number of years the current auditor has served as auditor of the company** | |
|---|---|
| **Number of years** | **Share of respondents** |
| 1 to 3 years | 13% |
| 4 to 6 years | 33% |
| 7 to 10 years | 20% |
| 11 to 15 years | 2% |
| More than 15 years | 31% |

**Source: London Economics survey of companies**

The international companies in essence choose their auditors according to two main criteria:

- **The first criterion** relates to the client's actual need for its auditor to have a multinational presence and a corresponding capacity to handle large audit assignments. This has also been one of the main drivers for mergers of audit firms over the last twenty years. As a result, the Big 4 networks[16] cover more than 100 countries.

15 Stock market capitalisation of the most representative stock exchanges in EU-25 Member States in September 2007, see European Central Bank: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=EU_MAIN_TREE&root=EU_MAIN_TREE/economy/main/shorties/euro_mf/mf090

16 The Big 4 are by far the largest auditors both globally and in most individual jurisdictions. They are followed by a group of audit firms loosely referred to as the 'mid-tier' firms, some of which also have significant international networks, but are overall much smaller in size.

- **The second criterion** relates to the acquired reputation of the auditor. Many studies show that listed companies choose the auditor on the basis of its reputation[17]. This is particularly true for large listed companies (defined in terms of turnover exceeding € 100m, see columns 2-4 in the following table). In contrast, the reputation of the audit firm is less important for smaller companies (defined in terms of turnover less than € 100m, see column 1 in the following table). Large listed companies effectively tend to favour the Big 4 firms because their reputation makes such a choice easier to explain and defend towards investors and capital markets in general.

A company survey organised by London Economics in 2006 supports these two findings:

**Importance of factors in choice of a provider of audit services in a company's home country - company responses[18] broken down by turnover in 2005–**
**average rating from 1 (least important) to 5 (most important)**

| | Breakdown by company turnover | | | |
|---|---|---|---|---|
| Factors | **<€100m** | **€100m-€1,000m** | **€1,000m-€10,000m** | **>€10b** |
| Size of the audit firm | 3.8 | 2.9 | 4.1 | 3.7 |
| Multinational presence of the audit firm | 3.2 | 3.9 | 4.4 | 3.8 |
| Reputation of the audit firm | 3.7 | 4.3 | 4.7 | 4.3 |
| Previous experience of the audit firm | 4.0 | 3.7 | 3.9 | 3.8 |
| Audit firm's knowledge of the company | 3.8 | 3.5 | 3.6 | 3.5 |
| Audit firm's knowledge of the company's sector(s) | 3.6 | 3.4 | 3.4 | 3.7 |
| Previous experience of the company with the audit firm | 3.3 | 3.9 | 3.6 | 3.3 |
| References from other about the audit firm | 2.6 | 2.4 | 2.4 | 2.8 |

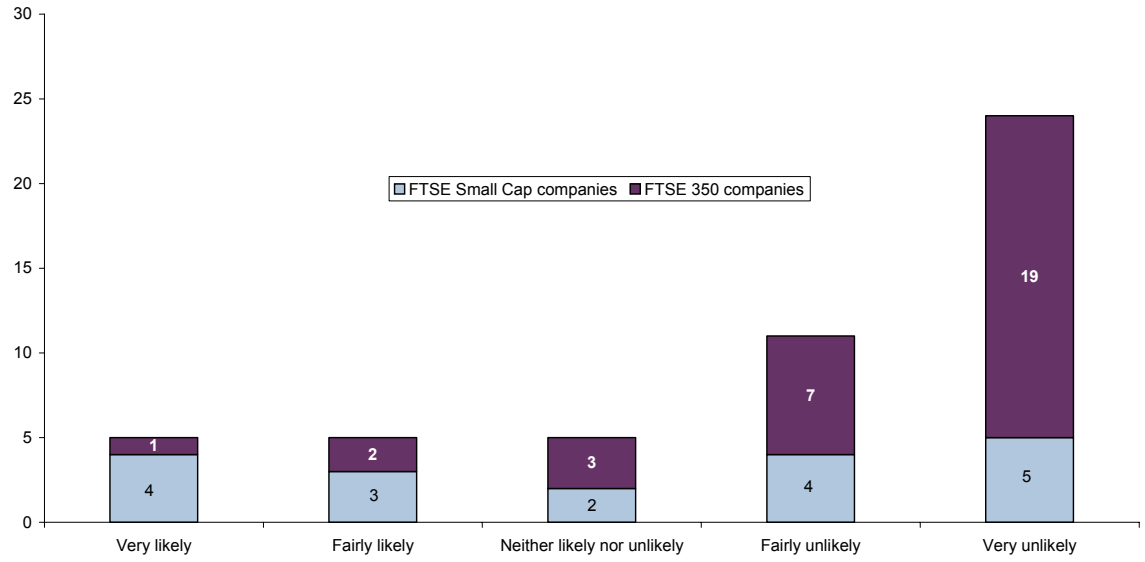
**Source: London Economics survey of companies**

At present, it does not appear that listed and international companies see any other audit firms as a possible alternative to the Big 4 networks. The following survey in the largest audit market in the EU (the UK) also indicates that mid-tier audit networks are not viewed by companies as a real alternative.

17 Oxera Competition study ; London Economics study

18 For each of the EU-25 Member States the survey sample includes all companies included in the main index of the main domestic stock exchange as well as a random sample of other companies listed on the stock exchange. In addition, in case of Euronext and the London Stock Exchange, a number of firms listed on the "unregulated markets" (Alternext and AIM) were also surveyed. Furthermore, a number of unlisted European companies with an annual turnover in excess of € 500m were also surveyed. Altogether, 146 responses from companies from all Member States (except of Czech Republic, Estonia, Cyprus, Latvia, Slovenia and Slovakia) were received.

**Likelihood of considering a mid-tier audit firm network for the company's audit (number of companies, based on UK survey)**




**Base: 50 responses by UK audit committee chairs for the whole sample, 32 for FTSE 350 companies and 18 for FTSE Small Cap companies.**

**Source: Oxera (2006), op. cit., Figure 3.9.**

### *3.2.2. The supply side: the type of players*

a) Need for multinational players operating in an integrated structure

Audit firms willing to address the demand of international companies forge networks at international level under a common brand, such as the names used by the Big 4. These international network structures bring together individual member firms which are located in many jurisdictions. The integration of a network is in practice implemented by an umbrella organisation. Such an umbrella organisation is a legal entity typically owned by member (individual) audit firms. Where firms participate in such an umbrella organisation, they are asked to provide a financial contribution. However, the umbrella organisation does not provide any audit services to any outside clients. Instead, it co-ordinates the overall business development and manages liability risks across all audit firms belonging to its network. Such networks are the response to the demand of companies, but imply due to their nature a high degree of fragmentation. Effectively, auditors do not operate on the basis of large multinational companies, but a puzzle of local firms within a common network.

The 2006 Directive on Statutory Audit (in particular Article 2 No 7) provides a definition for such a network meaning a *"larger structure:*

– *which is aimed at co-operation and to which a statutory auditor or an audit firm belongs, and*

– *which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, a common business strategy, the use of a common brand name or a significant part of professional resources."*

Network definitions exist in other jurisdictions in the world. The network definition has become necessary to reach two objectives:

- First, the coordination of all business activities across an international network should not impede the independence of the individual auditor auditing the financial statements of a company. Article 22 of the 2006 Directive on Statutory Audit implements this objective;
- Second, local audit firms use the international brand to gain new clients. For this reason, Article 40 of the 2006 Directive on Statutory Audit provides for transparency by requiring audit firms of listed companies to provide a description of the network to which they belong as well as of the legal and structural arrangements in the network.

b) Unwillingness to share liability risks with other audit firms at international level

There is a contradiction in the current international audit market caused by an important market failure on the supply side: on the one hand, the demand side requires the presence of an auditor in all countries where a company has subsidiaries in order to provide an integrated service. On the other hand, the supply side structure is fragmented: independent ownership of domestic audit firms seems to prevail because of the unwillingness of such firms to share liability risks with other audit firms in other jurisdictions. This even seems to apply to the Big 4 firms, which do not set up transnational firms offering audit services to multinational companies. However, the more the networks are integrated, the better they satisfy the companies demand for international audits.

In addition, differences in liability regimes at international level are an important barrier to cross-border integration of the networks of audit firms[19]. These differences can make risk management within an international network (i.e. by an umbrella organisation) a very costly task. However, such a cost is easier to manage for the Big 4 than for the mid-tier audit firms. The high level of integration amongst their network partners allows the Big 4 networks to cover audit risks by captive insurances.

*3.2.3. The supply side: the Big 4 – too few players?*

a) The market share of the Big 4

Although there are several thousand audit firms operating under different names and brands, the statutory audit market for companies listed on capital markets is highly concentrated in major economies in the world[20] such as the US[21], Japan[22], Germany[23], France[24], Italy[25] and the UK[26].

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19 Oxera Ownership Study page 102 and further

20 For a general overview, see International Accounting Bulletin, 21.12.2005, IAB survey, "A common interest in the future", p. 6ss

Similarly, the results of London Economics' survey show that the statutory audit market for companies listed on the European capital markets is highly concentrated and dominated by the Big 4 networks in all the Member States. In 2004 the market share of the four largest audit firms, for companies of the main stock exchange index across Member States[27], ranged between 83% and 100% (see table in **Annex 3**). In the EU financial services sector, the Big 4 hold around 90% of the statutory audit mandates of financial institutions (banks and insurance service providers). In a number of countries, the Big 4 firms hold all statutory audit mandates from financial institutions.

The market has become significantly more concentrated over the last ten years. Specifically, the merger between the second-largest audit firm (Coopers & Lybrand) and the fourth largest audit firm (Price Waterhouse) in 1998 reduced the then Big-6 audit firms to the Big 5. Subsequently, the demise of Arthur Andersen in 2002 (following bankruptcy of the energy company Enron in the US) reduced the number of global networks to the current Big 4[28].

b) The risk of a Big 3 scenario

The limited number of players might shrink further for different reasons. The Big 4 assert that a catastrophic claim could lead to the collapse of one of them. Another risk might be that major audit firms could implode due to an immediate loss of confidence and reputation by client companies who become aware of a major audit failure by an individual audit partner inside the international network, as is commonly held to be the reason for the collapse of Arthur Andersen in 2002. A third risk might be an indictment or removal from a register in a major country harming the brand of the entire network.

Other recent examples confirm the threat of a Big 3 scenario. KPMG, under investigation in the US for selling questionable tax shelters, was at the brink of an indictment action by the US Department of Justice, but finally paid a fine in 2005

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21 The Big 4 firms audit over 78% of all U.S. public companies and 99% of all U.S. public companies with sales greater than US$ 5 billion; see: US General Accounting Office (GAO): "Public Accounting Firms. Mandated Study on Consolidation and Competition. Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services", July 2003

22 According to Daiwa Securities SMBC, the market share of the Big 4 amounted to 94% in 2005.

23 Grothe, J.: "Branchenspezialisierung von Wirtschaftsprüfungsgesellschaften im Rahmen der Jahresabschluss-prüfung. Ergebnisse einer empirischen Untersuchung des deutschen Prüfungsmarktes", IDW Verlag, Düsseldorf 2005. A study published in September 2007 by Luenendonk on the German audit market shows the 5th largest audit network BDO far behind the smallest Big 4 network in terms of turnover: PWC: € 1.2 billion; KPMG: € 1.1 billion; E&Y: € 0.9 billion; Deloitte: € 0.5 billion; BDO: € 0.1 billion, see: http://www.luenendonk.de/presse.php

24 Study of the Autorité des Marchés Financiers (AMF) in 2005

25 M. Longo/A. Macchiati, Quality in Corporate Auditing, Banca, Impresa e Societa, 1999, p. 259 i

26 Oxera: "Competition and choice in the UK audit market. Report prepared for Department of Trade and Industry and Financial Reporting Council", April 2006 (hereafter referred to as the Oxera Competition study)

27 For instance, in 2004, 971 companies listed in Germany were audited by 198 audit firms; see Wirtschaftsprüferkammer: "Anbieterstruktur und Mandatsverteilung im Wirtschaftsprüfermarkt", WPK-Magazin 1/2006. Meanwhile, the number of audit firms present in this market has dropped to 150; see WPK-Magazin 2/2007.

28 Oxera Competition study

and accepted an outside monitor of its operations under terms of an agreement that heads off prosecution. In 2006, ChuoAoyama, the former PwC representative firm in Japan had its auditing license suspended for July and August as punishment for its involvement in the accounting scandal at Kanebo; ultimately PwC decided to leave the Japanese market and to wind up ChuoAoyama.

At the international level, the International Organisation of Securities Commissions (IOSCO) initiated a debate in 2007 around issues related to audit quality and audit market, including scenarios for contingency planning should one of the major audit firms fail. Along the same line, the new International Forum of Independent Audit Regulators (IFIAR) has been discussing since 2007 if and what emergency planning should be put in place to deal with a situation where one of the Big 4 audit networks is no longer available for large international audit assignments. This means that these organisations believe that the risk of a Big 3 Scenario is sufficiently tangible as to warrant further consideration.

c) Choice can be even more limited due to independence rules

In the last decades, audit networks have developed a wide range of additional non audit services (business consulting, IT services, bookkeeping …) in order to increase their profitability. This is a natural development for private business. However, regulators intervene where the independence of an individual auditor towards the company to be audited might be impaired. The auditor's opinion on financial statements should in particular not be biased by conflicts of interests due to the fact that they also provided other services, such as IT or consulting, to the same company: in such a case the auditor could even be obliged to step down and not carry out the audit for the company in question. As audit business activities are co-ordinated across a network, independence rules have been extended to the networks to which auditors belong.

Independence rules have been reinforced in the last years both in the European Union (under the 2006 Directive on Statutory Audit) and in the US (under the 2002 Sarbanes-Oxley-Act) in order to prevent auditors to provide non audit services to their audit clients.

The consequence however is that companies in practice do not have a choice between four major suppliers but between even fewer. International companies also select Big 4 firms for the provision of these non audit services (tax advisory, consulting, …) and are therefore prevented from appointing the same firm as their auditor. If more networks were available on the supply side, there would be fewer problems. Again, this is a new development since the legal situation was reviewed in 2001 when the Commission decided not to take action on auditor liability (see chapter 2.1)

Opening up the independence rules would certainly promote wider choice amongst the Big 4 audit networks. However, it is not likely to be an acceptable (nor appropriate) way of addressing the market failure. Independence rules were strengthened in 2002 to respond to major public concerns arising in recent years that too flexible independence rules effectively led to audit failures and corporate scandals such as Enron in the US.

### *3.2.4. Failures preventing the entry of new players*

a) Ownership rules and capital structures

In order to develop well integrated network structures able to compete with the Big 4, mid-tier audit firms or completely new entrants would need to significantly invest.

One of the key findings of the OXERA study[29] is that external ownership (owners which are not auditors) might contribute positively to a decision by a mid-tier audit firm to expand into the larger audit market for international listed companies.

However, Article 3 of the Directive on Statutory Audit requires that the majority of the voting rights in audit firms should be held by statutory auditors. The Directive also requires that auditors control the management body in their firms. Accordingly, under these rules, outside investors could only ever hold less than 50% of the voting rights in an audit firm and would be prevented from controlling the firm's management body.

One particular solution for mid-tier audit firms might be to open up ownership rules and control structures within an audit firm. This would also require modification of the 2006 Directive on Statutory Audit, to allow external parties throughout the EU to invest and provide the necessary capital for sharing liability risks whilst increasing profits when auditing listed companies. However, there are significant potential downsides, relating to issues such as the independence of auditors and the need to attract and retain human capital in such audit firms. DG Internal Market has therefore decided to launch a public consultation on the issue of ownership rules for audit firms.

b) Negative impact of liability risk and insurance conditions on investment in mid-tier audit firms

Another finding of Oxera was that any change of ownership rules would however still be dependent on how liability risks for new investors are addressed. If these risks are not insurable, investments in an audit firm will not be attractive for investors coming both from outside and inside the audit profession.

The Oxera study stresses that liability risk is a barrier to audit firms raising external and internal capital. To the extent that large statutory audits are associated with substantially greater liability risks, potential investors and partners in mid-tier audit firms would judge liability risks to be too high. The impact of liability risks on the cost of capital might be significant and lead to capital rationing.

London Economics[30] also found that liability risks, combined with the very limited insurance capacity are barriers for major mid-tier firms seeking to enter the statutory audit market for large companies listed on capital markets.

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29 Oxera Ownership study

30 London Economics study, P.xxviii

The barriers to entry to the market for large audits have also been at the centre of a recent debate about choice in the audit market, launched by the regulator for audit firms in the United Kingdom, the Financial Reporting Council (FRC)[31]. Their first recommendation was to encourage opening up ownership rules. This debate was only launched after the UK's decision in 2006 to introduce under its national company law act a possibility for auditors to limit their liability by contract.

To conclude, the risk exposure of the audit profession and the lack of insurance coverage are key for explaining the current shortages on the supply side. These issues are explained in more detail below.

## 3.3. Risk exposure for the audit profession

Both London Economics[32] and Oxera[33] found that liability risks combined with a very limited insurance capacity are barriers for major mid-tier firms or other players seeking to enter the statutory audit market for large companies listed on capital markets.

### *3.3.1. The liability regimes*

The statutory auditor is liable to his client for damages caused by the auditor's negligence or even wilful misconduct. In general, liability actions might be either in contract[34], tort[35] or both. However, auditors might also be liable to other parties.

Auditors are liable for their audits in case of fault. Strict liability for auditors does not apply in relation to their audit work. In the overwhelming number of claims against auditors, the issue is whether the auditors have been negligent. Accordingly, the discussion in this impact assessment does not seek to address the question of limiting liability where there has been wilful misconduct of an auditor (which includes collusive behaviour with management in committing corporate fraud).

a) Liability towards third parties

Individual shareholders, creditors and prospective purchasers of an audited company rely on the statutory auditor’s report and may, as a result, suffer damages.

In a majority of Member States, any third party could seek to recover damages from the statutory auditor upon proving the elements of the liability claim, usually fault (intentional conduct or negligence in any degree), damage and causation. This causal

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31 Financial Reporting Council: "Choice in the UK Audit Market. Final Report of the Market Participants Group", October 2007

32 London Economics study, P.xxviii

33 Oxera Ownership study, section 7.2.5., P. 174

34 A contract is a legally binding exchange of promises or agreement between parties that the law will enforce. Breach of contract is recognised by the law and remedies can be provided. Under contractual law, a statutory auditor is liable for a breach of his duties under a contract (e.g. of the audit contract concluded between the statutory auditor and the audited company).

35 The tort law applies, when one harms another's legal rights, or breaches a duty owed under statutory law. Under tort law, a statutory auditor is liable for a breach of his duties under statutory or common law of individual jurisdictions (e.g. breaches of the professional standards set under Community or national law).

link between the damage and the fault might sometimes be difficult to establish for the third parties. In a minority of Member States, actions by third parties are restricted: the statutory auditor has to owe a duty of care to the third party in question, i.e. the auditor knew or ought reasonably to have known that his work or report would be relied on by the claimant for a particular purpose. (The different regimes relating to third party claims are presented in more detail in **Annex 4**).

b) Joint and several liability

The liability of the auditor and the audited company towards third parties (shareholders, creditors) and of the advisors of the company (auditors and other advisors) towards the company is joint and several in almost all Member States (see **Annex 4**). Under the system of joint and several liability, the auditors might be held financially liable "in solidum" with other parties, towards the victim for the whole damage. In the case of a failed company, therefore, third parties may decide to sue the directors of the company (who carry legal responsibility for the financial statements of the company). They may also sue the statutory auditors, who have provided an unqualified audit report for the company prior to its collapse, even if the auditor's fault and contribution to the damage is of minor importance. In contrast, under proportionate liability, damages are only allocated among wrongdoers in proportion to their level of responsibility.

c) Liability risks in a cross-border context

Cross-border liability risks stem primarily from client companies: multinational companies are commonly organised as a group having separate subsidiaries in many countries. The auditor of the group financial statements is required to co-operate with other auditors, who perform the audit work on the financial information of many foreign subsidiaries. The group auditor may therefore face risks arising not from the work at the group audit, but as a result of being accountable in certain circumstances for the audit of those foreign subsidiaries spread over 50 to 100 countries.

A further liability risk at international level comes from the investor side: investors are located in different jurisdictions and therefore may not be in the same jurisdiction where the company and its auditor are located. Accordingly, there is a risk that auditors can be sued in different jurisdictions by different plaintiffs in relation to the same audit and the same company.

*3.3.2. Deep pocket syndrome*

Unlimited liability is often considered by potential plaintiffs as insurance against any and every deficiency detected in financial statements. Yet, auditors can only give a reasonable, and not an absolute assurance to the public that the company's financial statements provide a true and fair view of the company's financial position (see Art. 51 1 (a) of the 4th Company Law Directive). This is due to the fact that financial statements, which are prepared by the audited companies, include inherent limitations[36] which cannot be overcome by the statutory auditor.

[36] The preparation of financial statements in accordance with the entity's applicable financial reporting framework involves judgement by management in applying the requirements of that framework to the facts and circumstances of that entity. Further, certain financial statement assertions may be of such a nature that the related audit evidence

A liability regime under which a statutory auditor is perceived to be liable for any damage caused by the failure of the audit client creates the expectation amongst potential plaintiffs that statutory auditors are gatekeepers against any corporate fraud or other corporate malpractice. Joint and several liability reinforces this "expectation gap" for plaintiffs. Thus, statutory audit firms frequently risk being viewed as having "deep pockets"[37].

*3.3.3. Predictability of litigation costs*

In the 59 cases concluded between 1998 and 2005 for which relevant information is publicly available, the average settlement was slightly less than 12% of the damages sought by a plaintiff. In almost one fifth of the cases, the award or settlement ratio ranged from about 25% to almost 40% of the initial claim[38]. This could imply that plaintiffs simply attempt to claim large amounts, but are restricted to more "realistic" amounts in the actual settlements.

It is however not only the final settlement costs which are significant. The costs involved in dealing with claims are also considerable, as liability claims may take a very long time to be resolved. It is not uncommon for larger claims to take between five to ten years to finalise. Litigation costs increase over time and may fluctuate considerably from year to year.

Between 1999 and 2004, the gross costs of awards and settlements incurred by Big 4 firms in the U.S. (where data is available) rose from 7.6% to about 11% of total audit revenues. Net costs in the US, including insurance premiums and recoveries from insurance companies, rose even more sharply, almost doubling from 7.7% of total audit fee revenues in 1999 to 14.2% in 2004[39].

The London Economics Study[40] stated that it had not been possible to obtain comparable data for the European audit firms in individual countries. On the basis of interviews with audit firms[41], it has been estimated however, that the total costs of awards and settlements as percentage of revenues is probably lower in the EU than in the US. Over the period 1981 to 2003, the average cost of individual claims[42] against

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available can only be persuasive rather than conclusive, or involve subjective decisions or assessments by management or a degree of uncertainty relating to the reliability of their measurement. For example, the estimation of the outcome of uncertain events that may only be confirmed in the future, as may also be the case with the estimation of amounts reported on the basis of fair value.

37 Under the "deep pocket" syndrome, the audit firm is typically viewed by plaintiffs as having the largest resources and is therefore the target of complaints irrespective of the contribution and responsibility of the firm to the event giving rise to the complaint. Similarly, wealthy individuals or large corporations are often referred to as having "deep pockets", since it is assumed that their wealth will not be affected materially if the risk event occurs.

38 London Economics Study, p. 83

39 London Economics Study, p. 83

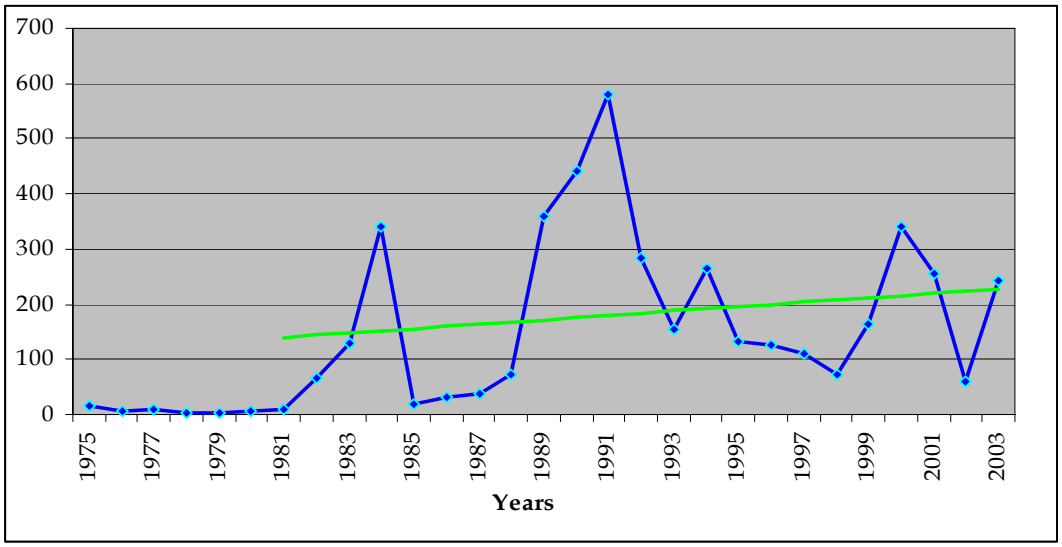
40 London Economics Study, pages 84 and 85

41 The survey sample includes firms belonging to the Big 4 networks as well as 20 mid-tier networks. In addition, a number of larger independent audit firms in France, Germany, Italy, Netherlands, Sweden and UK were surveyed. In total, 154 responses were received, of which 90 emanate from firms belonging to the Big 4 networks and 64 from mid-tier firms and a few large, independent firms.

42 Such costs cover both actual payments and the reserve set aside by insurance companies in Europe to cover claims of audit firms which have not been yet been resolved (figures at 2005 prices).

EU firms amounted to € 3.9 m (US$ 4.8 m). However, the total cost for liability claims faced by the major EU audit firms by policy year shows a very slight upward trend and considerable fluctuations in this period, reaching a peak of almost € 400 m (US$ 600 m) in 1991:

**Total cost of claims against Big5[43]/4 in the EU by policy year –millions of US$ at 2005 prices**




**Source: AON**

## 3.4. Lack of insurance capacity

The extent of liability risks can best be measured by assessing their insurability. Any unlimited civil financial liability claim is basically manageable if the parties who are potentially liable can obtain adequate insurance coverage. However, statutory auditors do not have access to such insurance coverage.

### *3.4.1. Professional indemnity insurance for smaller audits*

In nearly all Member States, professional indemnity insurance is required by law or under the membership rules for professional associations of statutory auditors (see **Annex 5**). Such mandatory insurance is coupled with additional voluntary insurance. Such insurance remains widely available but only for statutory audit mandates for entities which are not listed on a capital market. Statutory auditors do not appear to have major difficulties in finding insurance cover for these audits. However, this category of insurance does not offer effective cover against the risks associated with statutory audits for large and listed companies, particularly those involving international audits.

### *3.4.2. Self-insurance*

For large audit assignments, the Big 4 audit networks organise insurance cover themselves inside each of the networks. The difficulty in obtaining insurance cover

[43] Comprises the existent Big 4 firms (Deloitte, E&Y, KPMG, PwC) and Arthur Andersen (demised in 2002)

from outside began in the mid 1980s when the re-insurer (Munich Re) who had provided most of the reinsurance capacity for the auditors' professional indemnity insurance market (especially the then Big 6[44]), withdrew from the market following big losses.

From 1981 to 1992, there were only two years during which underwriting auditor liability, in the world (excluding the U.S.), was profitable. In the U.S., there was only one profitable year during this period[45]. The commercial insurance market, having sustained losses in excess of US$ 3 billion up until 1992 alone, no longer provided adequate professional indemnity insurance cover for statutory auditors in the international audit market on a conventional "risk transfer" basis. The main reason has been that liability claims have become impossible to predict.

In the 1990s, the then Big 5 (including Arthur Andersen), faced with this situation, established "captive" insurance companies to cover international audit mandates. "Captives" are mutual insurance entities owned by the member firms of an international network, who share risk by pooling premiums to meet their individual claims over a long period of time. The captives are licensed and regulated by recognised EU (e.g. Ireland and Malta) and international (e.g. Bermuda and Cayman Islands) insurance regimes which are amongst the principal insurance domiciles in the world. Each individual firm insured by the captive covers the lower levels of risks itself, through its own contributions to the captive. At higher levels of liability all the participating firms help meet claims from other firms belonging to the same network. Thus, significant claims adversely impact all member firms regardless of their individual record of claims. However, even these captives can no longer provide the levels of insurance cover needed in today's international audit market.

Previous studies carried out in the U.K. confirm such two-tier phenomenon, with the larger audit firms receiving only limited insurance cover for particular bands of risk and a second tier for which the audit firms can receive effectively full insurance[46]. Today, the current level of commercial insurance is such that it would cover less than 5% of the larger claims which some firms face in some EU Member States[47]. Moreover, the lack of predictability of future claims - in terms of both probability and magnitude – makes it difficult to assess the risk that would be assumed by insurance companies potentially interested in this market. Given these characteristics, insurers have difficulty in pricing audit liability risk and, hence, in providing adequate insurance coverage.

### *3.4.3. Reducing audit risks by imposing higher audit fees?*

One might assume that higher audit fees would allow audit firms to pay higher insurance premiums to obtain the required insurance coverage. Insurance premiums have to be sufficient to cover the expected cost of claims and all other overheads of

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44 Deloitte, E&Y, KPMG, Price Waterhouse and Coopers and Lybrand (which merged in 1998: it is called PwC after the merger), and Arthur Andersen (demised in 2002)

45 Information received from AON, see: London Economics study, p. 101

46 Moizer, P., Hansford-Smith, L.: " UK Auditor Liability: An Insurable Risk?", in: International Journal of Auditing 197-213, 1998

47 Information received from Swiss Re Sigma, see: London Economics study, p. xxi

the insurer and still leave a small profit. Insurance capacity might be possible, even for high sums, if the liability situation is clear and the price appropriate. But in the case of auditors, due to the long tail exposure of the underwritten risk (i.e. the risk of a claim can exist for many years after the audit was carried out), insurers would have to provide an extremely long commitment of equity. The loss data of auditing companies relating to litigation are helpful only to a limited extent. Although the number of claims is low, the severity of the settlement is very high. There is an absence of reliable statistics with a clear split between the management cost (legal & appraisal fees) of claims and the pure liability costs. Indeed, in many historical cases, the insurance cover has been used to pay additional audit and legal fees in order to demonstrate that the original (insured) auditors were not liable rather than to compensate the actual loss as a result of negligence.

In particular, new players willing to enter the international audit market would not be in a position to charge such high fees, corresponding to the liability risks, to their clients. There would have to be a tailored pricing system for each client to reflect the level of business risk that an auditor assumes when taking on a new client. Otherwise, in the absence of risk-adjusted billing rates, low-risk clients must subsidise high-risk clients[48]. German insurers estimate that if the remuneration asked by auditor was adjusted to include the compensation for risks incurred, this would require such an increase in audit fees that it could not/would not be borne by principal clients. German insurers estimate that the volume of all audit fees would need to be increased by at least 30%, which is not realisable.

Accordingly, it is not feasible to obtain a premium that truly reflects the loss exposure or the premiums are disproportionate to the work undertaken by the auditor.

*3.4.4. Financial capacity of the audit firm and the individual audit partner*

The limited company structure for audit firms is allowed in Europe[49] and audit firms in general use this structure. An exception is the UK, where the large firms are set up as limited liability partnerships. Nevertheless, partnership-like corporate structures are also commonly adopted by audit firms across the EU Member States. For example, a firm having a limited liability company legal form often have ownership distributed among senior managers with no outside shareholders, as in the case of partnerships. In fact the majority of audit firms in the EU are employee-owned[50]. The ownership of audit firms is typically evenly distributed between the senior employees of the firm.

However, the limited company structure only helps in protecting the personal assets of individual auditors. It is not a means for ensuring that an audit firm and even a network can survive a major audit claim.

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48 Moizer, P., Hansford-Smith, L.: " UK Auditor Liability: An Insurable Risk?", in: International Journal of Auditing 197-213, 1998

49 See Annex 1 to the 2007 OXERA study on ownership structures which provides an overview for 18 Member States: Austria, Belgium, Cyprus, Czech Republic, Denmark, France, Germany, Greece, Hungary, Italy, Luxembourg, Netherlands, Poland, Portugal, Ireland, Spain, Sweden, United Kingdom; Oxera Consulting Limited, Oxford, UK: "Ownership rules of audit firms and their consequences for audit market concentration ", October 2007 (hereafter, referred to as the Oxera Ownership study)

50 Oxera Ownership study

Audit firms have limited financial resources[51]. They do not possess a capital base for:

- coping with significant liability claims; and
- building a financial buffer against the volatile liability exposures.

Instead, firms may have to ultimately rely on contributions by individual partners. However, would such partners still have an incentive to pay contributions, particularly if there were to be a very significant claim or would partners let the audit firm collapse? London Economics concluded that the risk that such a *catastrophic claim* could wipe out an audit firm is real. Whilst an audit network might be able to deal with one claim, a second claim of sufficient magnitude might not be covered soon afterwards, as it would take time to build up the necessary reserves and hence the audit network might fail. London Economics presented the following simulation[52]:

51 See Oxera ownership study.

52 London Economics Study section 17, page 106

| Estimates of award/settlement threshold above which a major UK firm[53] would fail – in € millions | | | | | |
|---|---|---|---|---|---|
| **Threshold assumptions[54]** | **Deloitte** | **E&Y** | **KPMG** | **PwC** | **Hypothetical firm with €200m in turnover** |
| 15% cut in Partner income over 3 years and 10% reduction in profitability | 325 | 170 | 240 | 365 | 28 |
| 20% cut in Partner income over 4 years and no reduction in profitability | 480 | 255 | 355 | 540 | 42 |

**Source: London Economics**

Against this background, audit firms in the EU report that they face a considerable number of high-value, actual or potential claims for damages arising from statutory audits. These claims would put audit firms at risk if they materialise. As of 31st October 2005, EU audit firms from the six biggest networks (the Big 4 as well as Grant Thornton and BDO) indicated that their risk managers were dealing with 28 outstanding matters that could give rise to individual claims each in excess of € 75 million; 16 of these claims each exceeded € 160 million and in five cases, the individual amounts being demanded were in excess of € 750 million. According to the audit firms, six of the 28 outstanding matters fell under US jurisdiction. The remaining matters originated from cases within the EU[55].

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53 Representatives of the Big 4 firms informed London Economics that it would be reasonable to assume that the capacity of absorption of each firm is broadly proportional to the number of partners in the firm. Thus, for example, in case of PwC, the capacity of absorption of the German firm would be about half of that of the UK firm and that of the French firm about a tenth of the UK firm.

54 In the first scenario, in which the partners accept to take an income cut of 15% for 3 years and the profitability of the firm falls by 10%, estimates of the capacity of absorption of a Big 4 firm range from € 170m to € 365m depending on the firm. This would be the maximum amount (either one single claim or multiple claims not exceeding this amount in total) which a firm could afford to pay in award or settlement without gravely endangering its survival once the limited insurance cover provided through the captive is exhausted. It would not be able to sustain a second claim of such size in the immediate period following the settlement of the first claim, as its resources and that of the captive would need to be rebuilt over a number of years. In the second scenario in which partners make a greater contribution, the absorption capacity ranges from € 255m to € 540m. Such funds would be available to settle any number of claims, but obviously, the larger the number of claims to settle, the smaller the amount per claim a firm can afford. Currently, in the UK, there are six claims or potential claims in excess of € 250m.

55 AON – Actual Claim Data by policy year – 1975-2005, EU figures by policy year 1975-2005, 2005

Significant claims against European auditors reported in the past were Lernout & Hauspie (KPMG Belgium)[56], Postabank (Deloitte and Andersen Hungary), Finance Credit (KPMG Norway), Banque Cantonale de Genève (E&Y Switzerland) and Equitable Life (E&Y UK) and the Parmalat case (Deloitte Italy[57]).

Respondents to the Commission consultation paper were much more divided on the existence of the risk of catastrophic claims facing audit firms. Some of them accepted the issue, noting that catastrophic claims can drive settlements[58], which is clearly an unattractive feature for insurers. However, others were not convinced that catastrophic claims might actually lead to the failure of an audit firm. For instance, in their opinion the ultimate failure of Arthur Andersen resulted not from its financial liabilities, but because companies switched to other major audit firms as they immediately lost confidence in Arthur Andersen and its reputation[59]. But either which way, loss of reputation or catastrophic claim, or a mix of both could reduce the Big 4 to Big 3 and that would affect the choice of some international companies.

### 3.5. Which market participants are affected?

*Audit profession*

The high audit risk exposure, combined with a lack of insurance cover for statutory audits of large companies makes the audit profession less attractive[60]. In particular the major audit firms, which are exposed to high audit risks, have experienced

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56 In October 2004 it was reported that KPMG US and its Belgium affiliate had agreed to pay US$ 115m to settle a shareholder lawsuit related to the audit of Lernout & Hauspie Speech Products (L&H), a once high-flying global speech recognition software firm which was based in Belgium but traded on the Nasdaq. When the settlement was announced, it was reported that two other suits remained pending. KPMG's US and Belgian firms have reportedly been sued in the US Bankruptcy Court in Delaware for US$ 340m by the trustee charged with helping L&H's creditors pursue legal claims. Also still pending was a separate claim by L&H's Belgian liquidator for US$ 427m against KPMG's Belgian affiliate.

57 Parmalat, an Italian dairy group, filed for insolvency in December 2003, with about US$ 17.3 billion of debt, after realizing there was a massive US$ 4.9 billion discrepancy in its books. Its auditor, Deloitte, was facing four claims in connection with allegations that they helped to prolong fraud at Parmalat prior to its collapse. In January 2007, Deloitte reached an accord with Parmalat, agreeing to pay US$149m (€115m) to settle those allegations. see: http://search.ft.com/ftArticle?queryText=parmalat&page=2&id=070113005661&ct=0

58 Settlements are often higher than they might be because it is safer for audit firms to agree a large amount than run the risk of losing in court and being fined a much larger amount or, even more importantly, a firm may settle to avoid further reputational damage.

59 Morley Fund Management: "Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)", February 2004.

60 According to a MORI survey, recruitment and trust are seen as the top two challenges facing the profession. When asked to rate a number of issues on a one to ten scale, 90% gave a rating of seven or above to the recruitment/retention of high quality staff. This was closely followed by 85% who placed similar emphasis on restoring trust/confidence in the audit profession. Of particular concern to partners was the question of unlimited liability. Almost half (45%) gave this a rating of ten.

Two-thirds (67%) of auditors saw a career as an auditor as less attractive than it was two years ago, a particular concern among more senior staff, with 78% of partners and directors stating this was the case. Just 6% of partners said it was more attractive. The survey results cast some light on the reasons for this concern. Two-thirds (68%) – and 83% of partners – believed potential liability in cases of corporate wrong-doing was making the profession less attractive, while half (49%) disagreed that changes to the regulation of the profession would not affect the ability to recruit quality auditors. See results of MORI, Auditor career and working life survey, January 2005.

difficulties in retaining talented professional staff, who can then go on to become partners[61].

*Companies*

For companies listed on European capital markets, the principal influence in the selection of the statutory auditor is the Board's Audit Committee[62]. However, in practice, the company's Finance Director (CFO) also plays an important role[63]. Therefore, it is these two parties that are most directly affected by the limited choice of statutory auditors[64]. In certain sectors (primarily in the banking and insurance sector) companies have little/no effective choice of statutory auditors. Companies feel that this increased concentration reduces competitive pressure in the statutory audit market for large listed companies[65]. As a result, the limited choice may impair the ability of audit committees/boards to change statutory auditors and their ability to effectively negotiate audit fees with statutory auditors[66].

Currently statutory auditors and management can be (in most European legal regimes) jointly and severally liable for a company's failure. Whereas management can limit their risks by obtaining Directors and Officers Liability Insurance (D&O insurance), statutory auditors face a lack of insurance cover for audits of large companies. In contrast to the situation facing major audit firms, the liability risk of directors and officers can be spread amongst many D&O policy holders in several thousand listed companies in the EU[67].

*Investors*

Investors (shareholders, bondholders) rely on the independent audit opinion on a company's financial statement[68]. Therefore, investors are affected by the lack of

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61 According to the U.S. Bureau of Labour Statistics, the demand for accounting graduates is predicted to grow 18-26% through 2014, see: US Advisory Committee on the Auditing Profession, Working Discussion Outline, October 2007

62 According to Art 41 of the 8th Directive, the decision to appoint an auditor will be based on the recommendation of the Audit Committee. Based on this recommendation, the auditor will be appointed by the company's board or shareholders.

63 London Economics study, P. 54

64 For instance, over one-third of the FTSE 350 audit committee chairs in the UK do not feel that their company has sufficient choice of auditor. See Oxera: "Competition and choice in the UK audit market. Report prepared for Department of Trade and Industry and Financial Reporting Council", April 2006

65 Oxera Competition study, P. V

66 For instance in the US, audit fees have increased 271% between 2001 and 2006; However, this increase was also driven by the implementation of the requirements under the Sarbanes-Oxley Act. The figures stand in stark contrast to the UK, where audit fees for major companies (ranked in the FTSE 100) increased by just under 1% between 2003 and 2006. See:
http://www.accountingweb.co.uk/cgibin/item.cgi?id=171453&d=1025&h=1024&f=1026&dateformat=%25o%20%25B%20%25Y
In France, audit fees for companies listed in the CAC 40 increased in the period 2005-2006 by 11%. However, a major part of this increase was related to US-listed French companies, which were obliged to apply Sarbanes Oxley requirements the first time in 2006. See:
http://www.amf-france.org/documents/general/7874_1.pdf

67 London Economics study, P. 102

68 85% of investors perceive the annual statutory audit adds value; 73% of investors believe that the added value is due to the independent process and opinion thereby reducing investor risks; see: ICGN/GPPC survey

choice between statutory auditors in the international audit market[69]. Lack of choice could affect investor confidence in the effective operation of the audit market, due to a perception that the major players have too much market power[70]. On the other hand, institutional investors consider the "Big 4" audit networks as a guarantee and even as an insurance of last resort against corporate malpractice.

An even more significant impact on investor confidence may come from concerns that the current level of concentration is undesirable. The experience following the dissolution of Arthur Andersen has led to a perception that the audit market is close to the point where the loss of another large audit firm is possible. Such a loss would compound existing market dynamics and could lead to a crisis of confidence in the financial status of a large number of 'high-risk' companies[71]. As a consequence, the potential damage to investor confidence, in particular to institutional investor confidence, could result in an increase in the cost of capital[72].

*Insurers*

Insurers are unwilling to offer insurance cover in the international audit market due to the potentially high risks associated with statutory audits for large listed companies, and the fact that this risk cannot be adequately diversified (i.e. a portfolio comprising of only four audit networks).

*Public Oversight*

The new Directive on Statutory Audit requires Member States to establish and organise independent public oversight of the audit profession. These new European audit regulators have to monitor statutory audits for compliance with the professional duties[73] thereby ensuring adequate audit quality. In the past, audit quality was controlled by the audit profession through processes such as peer review, or was not controlled at all. Therefore, the risk of liability law suits and investigations were two of the principal mechanisms for ensuring audit quality.

*Other stakeholders*

In general, an increase in the cost of capital, due to a loss of investor confidence in capital markets, could lead to less efficient listed companies, which in theory at least, would have a negative effect on employment. Obviously, should one Big 4 audit firm disappear for whatever reason, the impact on the firms' employees would be direct and substantial[74].

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69 80% of investors assess the level of choice to be insufficient; 65% of investors perceive the level of competition to be insufficient; see: ICGN/GPPC survey

70 Oxera Competition study, P. V, 86

71 Oxera: "Competition and choice in the UK audit market. Report prepared for Department of Trade and Industry and Financial Reporting Council", April 2006, P. V, 86

72 In contrast, it is rather unlikely that cost of capital is affected by even a sharp increase in audit fees, as the share of audit fees in company's total operating costs is relatively small.

73 In particular the 4th and 7th Company Law Directives as well as the banks and insurance companies Directives.

74 The Big 4 member firms employ in total more than 500.000 professionals around the world.

### 3.6. Does the EU have the right to act?

The market for the provision of audit services and the related liability risks has global significance, given the importance of the audit function to the smooth functioning of capital markets.

The major audit networks not only lack adequate international insurance cover for their activities, but there is also a question of "lack of choice" which cannot be solved solely by individual Member States. There is a need to assess what action - if any - should be taken at the EU level. In Europe, only a few Member States have some form of limitation on auditors' liability and only seven Member States offer mechanisms mitigating the current excessive unlimited litigation risks, and the consequential difficulties that major audit firm networks face in obtaining insurance. The European Parliament requested the Commission to address the liability aspect under the 2006 Directive on Statutory Audit. Article 31 of the Directive accordingly invited the Commission to prepare a further analysis and, if appropriate, take action. Any action on auditors' liability should be limited to the cases of a statutory audit of the consolidated or the annual accounts of a company which is registered in a Member State and the securities of which are admitted to trading on a regulated market in a Member State.

## 4. OBJECTIVES

Trust in capital markets is a necessary condition to enable those markets to allocate capital efficiently. It is necessary to ensure the efficient functioning of financial markets and to preserve investor confidence in financial statements. The general objectives for this impact assessment are:Reduce the risk to capital markets that statutory auditors might no longer be available to audit listed companies; and

- Facilitate access to the international statutory audit market (in order to encourage more auditors to audit large and listed companies)

To achieve these general objectives, the following specific objectives are defined:

- Achieve fairer liability risk exposure for statutory auditors
- Facilitate access to professional indemnity insurance for statutory auditors
- Encourage investments into the expansion of audit firms
- Reduce differences in liability regimes across the EU.

## 5. POLICY OPTIONS

### 5.1. No EU action (Option 1)

This option would leave it to market forces and Member States to take autonomous action thereby addressing also any cross-border problems within the EU.

Keeping the status quo means that Commission would be of the view that liability risks are considered to be a purely domestic problem. However, the insufficient level of professional insurance available for international audits is not expected to improve considerably in view of the existing litigation risk exposure. Thus, statutory audit firms would continuously face risks of large claims that would have to be covered by themselves, either through their network captives or, once such limited cover has been exhausted, by the partners within the audit network. Without any EU action towards limiting liability, mid-tier audit firms would continue to be reluctant to enter the international audit market. Other players would also continue to refuse to consider investing in audit firms. Major claims could even threaten the survival of an audit firm thus reducing the number of few players on the supply side.

Accordingly, the structure in the international audit market would continue to solidify.

## 5.2. Possible options in substance

A reform in this area is primarily aimed at facilitating access by (new) entrants to the international audit market. Policy action will not deal with competition regulation issues, since the Commission has already examined the impact of previous mergers between audit firms on European markets, for example the merger of Price Waterhouse and Coopers & Lybrand in 1998[75] and the mergers between Arthur Andersen and Ernst & Young / Deloitte Touche in 2002[76]. The following options are put forward as possible steps which could be taken to achieve the objectives:

### *5.2.1. Compulsory insurance for all auditor liability risks (***Option 2***)*

As outlined above, commercial insurers currently do not provide sufficient insurance cover for statutory auditors in the international audit market. This is due to the lack of mutualisation (diversification) of audit liability risks (since there are only a limited number of participants in this market), the lack of predictability of such liability risks (in terms of both probability and magnitude) and the differences between liability rules. Given these characteristics, insurers have difficulty in pricing the risks at international level and as a result in providing adequate insurance cover[77].

Since the insurance market is not able to close this "insurance gap", one policy option could be to make insurance of all liability risks compulsory using new legislation at EU level. As the risk exposure for statutory auditors would remain unchanged, the audit profession would not be able to pay the necessary premiums.

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75 On 1st July 1998, the merger between Price Waterhouse and Coopers & Lybrand received formal regulatory clearance from the Commission. See COMMISSION DECISION of 20 May 1998 declaring a concentration to be compatible with the common market and the functioning of the EEA Agreement (Case No IV/M.1016 - Price Waterhouse/Coopers & Lybrand).

76 Following the demise of the Arthur Andersen audit network, most of its country practices around the world were sold to members of other Big 4 audit networks, notably Ernst & Young globally and Deloitte & Touche in the UK. In 2002, the Commission examined the impact of such mergers in several important Member States, in particular in UK, Germany and France. After examining these cases, the Commission concluded that the mergers did not raise serious doubts as to their compatibility with the common market and the EEA Agreement. See: Commission Decisions on Deloitte & Touche / Andersen (UK) of 1 July 2002, Ernst & Young / Andersen Germany of 27 August 2002, Ernst & Young France / Andersen France of 5 September 2002.

77 London Economics study, P. 102

The economy at large would be called upon to finance such a compulsory insurance system. As a consequence, the insurance risks would be transferred to and diversified over a much broader base. The following possibilities are conceivable:

- investors might be required to pay a levy on every security transaction[78], or
- companies could be forced to buy insurance cover for the auditor[79].

The premiums could be allocated to a compensation fund or an insurance pool at international level. An alternative route could be to securitise audit failure risk; securities could hence be packaged in a way to reflect underlying cash flows – e.g. premiums and the related risks of audit failure.

As a last resort, one might even consider the possibility that governments (and effectively tax payers) take over liabilities for the part of any claim exceeding a pre-agreed threshold[80].

A governmental scheme would reinforce even further the moral hazard argument for the audit profession, whilst taxpayers, companies and the investor community would not appear to derive any benefit.

*5.2.2. Establishing "safe harbours" (***Option 3***)*

Another option could focus on reducing the risks of auditing activities by excluding certain activities with a higher risk profile from the auditors' liability. A mechanism to achieve this outcome would be to introduce so-called safe harbour provisions. A safe harbour is a provision that reduces or eliminates a party's liability under the law, provided that the party has acted in good faith. Legislators include safe harbour provisions to protect legitimate or excusable violations. For instance, in the US safe harbour provisions were introduced in 1995 for certain forward-looking information provided by companies in the management's discussion and analysis ("MD&A") that is included with filings with the US Security Exchange Commission (SEC) containing a financial statement[81].

Another example in the EU of a safe harbour type provision is the limited responsibility of the statutory auditor for information contained in the annual report ("Management Report") under the 4th Directive[82]. The statutory auditor has to verify only whether the management report is consistent with the financial statements for the same financial year. The auditor is not obliged to conduct a full scope audit on

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78 London Economics study, p. 113/4

79 London Economics study, p. 114; Lawrence A. Cunningham, Securitizing Audit Failure Risk: an alternative to caps on damages, 49 William&Mary Law Review 3 (2007), http://ssrn.com/abstract=1012919

80 Terrorism insurance and nuclear insurance are or were provided under schemes in similar form.

81 The US Private Securities Litigation Reform Act of 1995 adopted a statutory "safe harbour". In order to minimize an auditors' exposure to legal liability, the safe harbour protects "any reports issued by an outside reviewer retained by an issuer who address a forward-looking statement by the issuer". See: Paul Munter: "Safe Harbor" under the private securities litigation reform act of 1995; in: The CPA Journal, August 2000

82 According to the Fourth Council Directive 78/660/EEC of 25 July 1978, the annual report must include a fair review of the development of the company's business and of its position. It must also provide information on any important events that have occurred since the end of the financial year, the company's likely future development and activities in the field of research and development.

the management report. Consequently, the auditor can only be held liable in cases where the management report contains inconsistent or contradictory information compared to the financial statements.

Minimising audit risks associated with management reports can be justified by the fact that they include predominantly forward-looking information, which can be verified only to a very limited extent by external auditors. Safe harbour provisions encourage companies to disclose more useful information to investors which would otherwise (i.e. under full liability risk exposure) not be disclosed.

By way of contrast, financial statement assertions are determined fundamentally on the basis of objective and verifiable facts (i.e. historical information). Introducing safe harbour provisions for the application of the auditor's professional judgement with regard to certain, "risky" financial statement assertions[83] (e.g. fair value based assertions) would create a situation of moral hazard. The auditor would no longer feel fully responsible for the correctness of financial statement assertions. This "responsibility gap" could not be adequately closed by other parties (e.g. regulators), leaving investors with the concern that particular assertions in financial statements might not be reliable.

An important downside would be that international standard setting in accounting and auditing could no longer be based on principles which companies and auditors should apply on the basis of sound professional judgment. Instead, standards would become a target for liability driven "safe harbour" provisions containing a great degree of detail and working as arbitrary shields for preparers and auditors of financial statements. Furthermore, such a result would defeat the overall policy of the European Union to follow international standards in accounting (introduced by the IAS-Regulation in 2002) and to perhaps introduce international standards on auditing (an option foreseen under Article 26 of the Directive on Statutory Audit).

*5.2.3. Limiting auditors' liability (***Option 4***)*

Two main methods for limiting liability are currently in force in the Member States - a cap and proportionate liability (liability proportionate to the extent of the contribution of the auditor to the damage caused). The main difference between these methods is that a cap (the maximum settlement amount) is known in advance whereas under proportionate liability there is no maximum and the actual amount remains unknown until a final decision is taken by courts. However proportionate liability is linked directly to the degree of fault associated with each "guilty" party, whereas a cap can be seen as a more arbitrary figure allowing predicting the maximum to be paid by an audit firm.

An initiative for limiting liability could be therefore approached in three main different ways:

[83] E.g. financial projections, future management plans and objectives, or statements of the future economic performance

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

This option focuses on introducing liability caps throughout the EU. The most radical solution would be to introduce a uniform fixed monetary cap at EU level (for example a cap up to €10m or €100m). Nevertheless, it would be difficult to set an amount of cap or a method to calculate a cap which would suit all the Member States. Due to different economic conditions and legal traditions in Member States, the "fairness" of a uniform liability cap on EU level might be perceived by Member States and market players unequally. Whilst countries with a cap for many decades might prefer keeping "their cap" at a more modest level of €4m or €12m[84], other Member States might want to have a much higher fixed cap of perhaps €100m or even more.

Alternatively, one could accordingly fix a range of methods for limiting liability amongst which the Member States should choose (e.g. determining a liability cap by a formula, depending on the company's size or on the audit fees charged to the company).

If liability were to be capped by an EU instrument, the results of the public consultation show a preference within the audit profession to determine a cap that would be based on a multiple of audit fees. Nevertheless, there are arguments against this option. The main fears of mid-tier audit firms and investors would be that a cap based on audit fees could lead to "fee dumping" as it would be an incentive for audit firms to negotiate fees down in order to minimise liability. Auditors could charge lower audit fees and recover their costs from fees for non-audit services. Imposing such a method might therefore be unacceptable for many Member States. It would also oblige Member States who already have a cap to change their system.

Therefore this option would consist of introducing a cap but would not set a fixed amount of cap at EU level nor a single method for calculating one.

Liability caps might be either implemented by law (as in Germany, Austria or Belgium) or possibly by contractual arrangements (like in the UK[85]). However, an EU-wide harmonisation by contractually arranged caps would not be feasible, as in many Member States the liability of auditors is based on tort law and not on contract. Moreover, such contractual solutions would not be effective everywhere, as unlike in the UK case law, shareholders which are not bound by the contract, can introduce claims against statutory auditors in the majority of Member States[86]. Consequently, a harmonisation of liability regimes could effectively be implemented only by law and not by contracts allowed under national law. Harmonisation on the basis of statutory caps would address all the objectives described in section 4. A cap would reduce the magnitude of potential settlements for auditors and thereby achieve reduced liability risk exposure for auditors. Furthermore, capping the magnitude of potential claims would enable insurers to better ascertain liability risks and thus improve insurance

84 For example Germany or Austria (see Annex 3)

85 See FRC consultation paper of December 2007. However, the consultation paper notes that a cap might probably not obtain the required shareholder consent as UK investors oppose a cap.

86 The contractual solution is workable in the UK where, in the case of statutory audit of annual accounts, claims against auditors can be introduced only by the company and not by the individual shareholders or other third parties.

coverage. Finally, the introduction of a cap at the EU level would reduce differences of the liability regimes across the EU. However, it depends on the individual cap whether the risk exposure would be sufficiently reduced and partners of mid-tier audit firms or new players would feel encouraged to invest into the expansion of audit firms.

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

This option focuses on introducing a uniform liability "principle" i.e. proportionate liability throughout the EU. If proportionate liability were to be applied audit firms would be only liable to the extent of their contribution to the damage caused, without being financially liable "in solidum" with other parties.

In theory, proportionality might be implemented either by law (like in Hungary) or possibly by contractual arrangements (like in UK). However, as described under Option 4a, an EU-wide harmonisation by contractual limitations would not be feasible in many Member States.

Harmonisation on the basis of proportionality would address all the objectives described under section 4. Some stakeholders (in particular investors) might even perceive proportionality to be a "fairer" method to limit liability, compared to a fixed liability cap, because the liability risk of auditors would not be limited to a certain amount, but to the proportion of their contribution to the damage. Whilst harmonisation based on proportionate liability could not fully address the concerns of insurers in terms of the magnitude and predictability of potential claims, it would reduce differences in the liability regimes across the EU.

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

To date, cap and proportionate liability are the methods used in Member States. Other methods for limiting liability could also be appropriate under some circumstances. For example, the UK has allowed under its company law for a limitation of liability of auditors by contract in 2006 and is currently considering giving guidance to the markets how to apply the new law in practice. Contractual arrangements limiting liability will be possible as from June 2008 onwards. One possibility considered is a general test of fairness that would be performed by a court. A mix of different methods of limitation of liability (for example cap plus proportionality) is also conceivable.

(1) Therefore as an alternative to harmonisation (options 4a and 4b), Member States could be first encouraged to introduce a limitation into their liability regimes. The EU measure would only fix the objective of having a limitation but not the precise method of achieving the limitation. This objective could be implemented by introducing high-level principles to ensure that the limitation is fair both for the auditors and for the other stakeholders.

(2) Member States would have the choice between measures such as a cap or proportionate liability or other methods as they see fit. This could include the possibility for auditors to negotiate the limitation of their liability by contract or by a mixture of different methods. In this way, every Member State would be invited to introduce a liability limitation, taking into account their own

systems and circumstances. Limitations should again not apply in cases of intentional misconduct by the auditor.

This solution, which should encourage the convergence of national liability regimes, would address the first three specific objectives for the same reasons as described under options 4a and 4b. However, since Member States might opt for different solutions, the impacts on the objectives might vary. This option would give Member States the opportunity to converge over time and learn from each other (evolutionary approach). It would reduce differences of the liability regimes across the EU to some degree, as all Member States would have some limitation, but this could be calculated by different methods.

### 5.3. Screening of the options

Under section 5.2, a number of policy options have been presented. However, some of the options will not satisfactorily achieve the objectives as set out in section 4.

- **Option 2:** focuses on insuring liability risks by parties other than auditors. This would certainly increase the number of interested audit firms to enter the market. Option 2 would however not meet the objectives set in section 4. As it is already impossible to price liability risks in audit fees, it would equally not be workable for insurers to price their risks under option 2. Accordingly, this option would not facilitate the access to professional indemnity insurance. Even if that objective were achieved, option 2 would impose significant additional costs on companies, investors or – what is the likely outcome – taxpayers via governmental action. As a result, liability risks would be shifted from auditors to the public at large. The current model of a private audit firm on the supply side would be broken. Market failure on the supply side would be repaired by the demand side or even the public (i.e. taxpayers) at large. On the other hand, this policy option would be a major concession to the audit profession currently in this business. They would receive considerable relief from the need to seek insurance coverage. Furthermore, the proposal would have the potential to expose the audit firms to a significant risk of moral hazard[87] as there would be far fewer consequences of audit failure. Such an insurance regime would insulate the auditor from any risks related to his or her professional behaviour. The auditor would be much less concerned about the negative consequences of the risks, when compared to today. As a result, this might have negative effects on audit quality.

- **Option 3**: might limit the risk exposure for auditors, since it focuses on "carving-out" certain liability risks from the audit activity ("safe harbour"). However, negative trade-offs, particularly with regard to quality in financial reporting and auditing, would be significant. In addition, "safe harbours" would need to be anchored in international standards thereby defeating the generally acknowledged aim that such standards should remain principles-based. Minimising audit risks by safe harbour provisions would certainly reduce the risk exposure for statutory auditors, particularly when carving out certain audit activities from liability. However, insurers might find it difficult to assess in which case a specific safe

[87] Moral hazard refers to the prospect that a party insulated from risk (such as through insurance) will be less concerned about the negative consequences of the risk than they might otherwise be.

harbour provision limits the magnitude of potential liability claims. Therefore, such an option could be expected to have only a limited impact on improving the insurability of the audit profession. Due to the likely limited impact of safe harbour provisions on the auditor's risk exposure, such an option would not be particularly effective in assisting new entrants into the international audit market.

In contrast, options 4a, 4b and 4c appear to address all the objectives, although the impacts of the individual options would differ. Therefore, these three options will be further compared to Option 1 "No action at the EU level".

## 5.4. Legal instruments

- It is difficult to imagine how liability risks could be addressed by self or co-regulation. Firstly, self-regulation works best where there are a limited number of stakeholders with similar interests - auditors' liability typically involves a large number of stakeholders, often with divergent interests (e.g. auditors and their regulators, companies, insurers, investors). Secondly, the assessment of the current situation demonstrates a degree of market failure where market forces have not been able to address the issue on their own. Relying upon self or co-regulation would therefore be an ineffective mechanism to achieve the best outcome. Also, given the many national legal differences, self and co-regulation are unlikely to succeed and in such cases developing recommendations is perhaps a more reasonable alternative[88]. Finally, liability is determined by law, for example tort law; and such self or co-regulation seems to be an inappropriate tool in this context.

- For **Option 4a and 4b**: These options could possibly be achieved by a non-binding instrument (e.g. a recommendation). However, a binding legal instrument (e.g. a directive) would bring about measurable effects within a specific timeframe and would be the best, if not the only way to achieve harmonisation at EU level. In contrast, Member States could at any moment decide not to follow a recommendation. Therefore a directive appears to be the most suitable instrument to implement options 4a and 4b.

- For Option 4c: A recommendation would be an appropriate instrument, as it is non-binding on Member States, but should act to stimulate action in this area. Many respondents to the public consultation emphasise that any Commission action should give maximum flexibility to Member States. It could also be envisaged that the content of the option 4c could be implemented by a directive. This would ensure that all Member States would have to limit liability in some way, but they would each decide for themselves the method of limitation. Therefore two ways of implementing the option 4c, by a recommendation or by a directive, appear to be feasible and will be considered further.

[88] See the recommendations, page 6 of EIM study in 2006 for DG ENTR on self and co-regulatory practices in the European Union

## 6. ANALYSIS OF IMPACTS

### 6.1. No EU action at the EU level (Option 1)

This option would continue the approach of leaving the resolution of the issues outlined in section 3 to market forces. However, the structure of the international audit market would appear unlikely to improve in the coming years should this option be adopted[89].

#### *6.1.1. Impact of market forces in the future*

Responding to the demands of the companies (reputation, capacity and geographical spread of audit firms) needs time and resources. Mid-tier networks would have to undertake significant investments in this regard. Due to their superior financial capacities, Big 4 firms could continuously strengthen their market position over this period by significant investments into their brand, human capital and geographical spread[90].

Barriers (liability risks/lack of insurance) are still likely to constrain the scope and breadth of the presence of mid-tier firms in the market for larger audits over the coming years. If such failures are not addressed, it is unlikely that mid-tier audit firms, even if merged or consolidated, could ever become a major alternative to the Big 4 audit networks in the foreseeable future.

Due to the volatility of the market capitalisation of the audited companies, audit firms would continue to face increasing litigation risks when auditing such companies. Since the current insurance market does not already provide sufficient professional indemnity insurance coverage for these risks, successful liability claims would need to be covered by the firms themselves, either through network captives or, once the limits of such cover had been exhausted, by the partners within the audit network.

As there is little likelihood of insurers being better able to mutualise and diversify liability risks across more audit firms, the inadequate level of professional insurance available to statutory auditors is not expected to improve materially.

One might argue that there would perhaps be no need for liability reform if the insurance capacity to cover the risks related to major international audits could be restored by market forces. However, for example, in Belgium, the lack of domestic insurance capacity drove liability reform in 2005 (see section 6.1.3 below). This strongly indicates that limiting auditors' liability would be a necessary first step to also solve the problem of the lack of suitable insurance.

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89 London Economics study, P. 209

90 In 2007, all Big 4 audit firms have reported again a significant growth in revenue, particularly to the strong growth in emerging markets like China. KPMG reported global revenues of $19.8bn, up 12.7 per cent in local currency terms. This compared with a 12.6 per cent increase to $23.1bn at Deloitte, 11 per cent to $21.1bn at Ernst & Young while PwC grew 10.5 per cent to $25.2bn.

*6.1.2. The Big 3 scenario and its consequences for the capital markets*

Constantly high liability risks might be one of the reasons for a future collapse of one of the Big 4 networks (see also section 3.2.3 above).

Self insurance of audit firms has only limited capacities. As mentioned above, London Economics estimated that the maximum absorption capacity of a Big 4 firm ranges from € 170m to € 365m depending on the firm. A firm would not be able to sustain a subsequent large claim (or series of smaller significant claims) in the immediate period following settlement of the first claim before its resources had been rebuilt, which would take several years. Such a scenario is possible - in 2005, EU audit firms from the six biggest audit networks were faced with 16 claims exceeding € 160 million and five cases exceeding € 750 million.

One might question whether the risk of such a successful claim only reflects a theoretical "doomsday" scenario. If no action is taken, the fact that this risk is a real one would be ignored.

Based on the information available, (see predictability of litigation costs section 3.3.3), the average settlement amount for one of these five cases should be around €90m (= 12% of a claim exceeding €750m). However, in one fifth of the cases, the settlement amount could be higher - between 25-40% of the claim. So for one of these five cases it is probable that the settlement will range between €188m (= 25% of €750m) and €300m (=40% of €750m). Looking at the table summarising the London Economics threshold simulations (section 3.4.4), it is clear that settlements of this order would be far outside the reach of mid-tier firms (in 3.4.4 table: firms with an annual turnover of around €200m). Depending on the threshold assumptions, even one or two of the Big 4 firms might also be unable to pay the higher (25-40% of claim) settlements and would have to call on the support of partners in its network but located in other countries. There is no reason to suppose that firms in many other Member States would be better placed. Given the figures available on the (not always final) settlements being proposed for certain large claims e.g. Parmalat, L&H, such high payments can clearly not be ruled out.

The loss of another major audit network would have **serious consequences** for the European and global capital markets both in terms of auditor choice and the actual availability of audit. The completion of statutory audits could be delayed, especially if the failure occurred close to the year-end, as the Transparency Directive will require audited financial statements to be published no later than four months after the end of a company's financial year. More importantly, it is possible that some companies would no longer be able to find a firm with the degree of specialisation required to undertake their audit. Financial institutions in particular could face serious transition problems as the special skills their audits require could severely restrict their range of choice for a new auditor.

Many leading mid-tier accountancy firms have already confirmed that in these circumstances they would not be prepared to move into the Big 4's current audit market due the liability risks. The remaining largest firms would be constrained both by independence rules (see section 3.2.3) and their ability to bear audit risk in the aftermath of the loss of one of the Big 4. The Big 3 scenario could lead to calls to

open up the independence rules, although the regulatory world decided to strengthen them after the Enron debacle in 2002.

Audit fees have not increased significantly over the recent years in the EU[91]. According to London Economics' survey, the audit risk is not fully priced into the fees as this is difficult and some clients would be forced to pay for risks which should be carried by other clients. In the case that one of the Big 4 audit firms would leave the market in future, audit fees would, according to the London Economics Study, also increase due to an even more limited number of market players. In such a case, the remaining Big 3 would have an even more dominant position. Whilst liability risks might still not be priced into audit fees, the usual competition would be severely constrained. For instance, insurers currently use mainly only 2 out of the Big 4 audit networks[92]. If one of these two disappeared, the remaining audit network would be almost the only available auditor for all insurers in Europe. A competitor would not be immediately available to respond to the demand for an auditor with the specialisation but also a presence in many jurisdictions in the world.

If more players were in a position to compete, this Big 3 scenario would not occur.

*6.1.3. Current situation in the Member States*

If no action is taken at the EU level, the current situation in Member States will remain. Auditors' liability will be limited in some countries whereas it will remain unlimited in the majority of the Member States.

- Auditor's liability is currently capped in five Member States (Austria, Belgium, Germany, Greece and Slovenia: see **Annex 6**). Hungary has introduced proportionate liability by law as from 1st January 2008. In 2006, the UK allowed for negotiation of contractual limitations of liability as from June 2008.

- Some examples are presented below: Belgium, UK, Austria and Germany (these latter two introduced limitations in 1931). The local liability reforms have however one major problem in common: they address local liability risks and fail to address the international dimension. If an investor sues an auditor in a different jurisdiction, the local liability limitation will not apply.

**Belgium**

Since 2006 (law of 23 December 2005), Belgium has had caps on liability: €3m[93] for statutory audits of non-listed companies and €12m for statutory audits of listed companies. The main reason for their introduction was to solve the problem of domestic insurance capacity.

91 In UK, audit fees for major companies (ranked in the FTSE 100) increased by just under 1% between 2003 and 2006. See: http://www.accountingweb.co.uk/cgibin/item.cgi?id=171453&d=1025&h=1024&f=1026&dateformat=%25o%20%25B%20%25Y

92 KPMG and PwC

93 Per damages per year (can be extended to more damages per year)

The increasingly litigious environment had forced insurers to terminate the collective insurance policy which was concluded between the insurers and the Professional Institute of Auditors (IBR/IRE) on behalf of its members. This liability reform enabled insurers to renew their collective policy at no higher cost, under conditions that were more flexible to the auditors and for insured amounts substantially higher than before (insurance coverage before the reform was € 1,9m[94] whereas now the coverage is €3m and €12m[95] respectively for the audit of unlisted and listed companies). According to the information received from Belgian Big 4 firms, the premiums paid have not been influenced by this reform. In other terms, a domestic liability reform has had no significant effect for the insurability for the international audits as other countries did not follow the example of Belgium.

The other reasons for introducing the cap were:

- Unlimited civil liability was not seen as strengthening the quality of the audit. A certain level of liability is recommended but it is not reasonable to expect that the auditor should bear the full cost of a fraud committed by the directors or by the management or resulting from an internal accounting error;
- There were concerns about the concentration of the audit market for listed companies with international audit firms and the risk of an audit firm disappearing;
- In addition, an underlying preoccupation was to keep the audit profession sufficiently attractive for trainees and practitioners.

**UK**

In 2006, the UK introduced the possibility for auditors to negotiate with their clients a limitation of liability by contract. This new law will apply from June 2008. The UK opted for this policy for two main reasons:

- The limitation should allow maintenance of a strong audit market characterised by at least the existing levels of competition. The UK authorities recognised auditors have faced an increasing number of claims, including many that, if they were successful, would be beyond their financial capacities.

- The second reason was the expectation that liability limitation agreed by contract could lead to the reduction of audit fees [96]. In 2007, a working group was established by the FRC in order to produce guidance on the use of agreements to limit liability of auditors of public companies. In December 2007, the working group published a consultation paper. The draft guidance provides for four possible methods to limit the liability by contract: i) proportionate liability; ii) a pure reference to a "fair and reasonable test" that would be later on assessed by the courts; iii) a cap on liability, expressed either as a monetary amount or calculated on the basis of an agreed formula or; iv) a combination of some or all of those methods. The consultation paper also proposes guidance on other aspects of the limitation agreements and offers examples of such agreements to the markets. The paper makes clear that the major investors in UK are however not ready to accept a contractual cap. Final guidance is expected for May 2008.

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94 Per loss per year (possibility to extend, but rare in practise)

95 Per damages per year (can be extended to more damages per year)

96 See for example: Company Law Reform Bill REGULATORY IMPACT ASSESSMENT: November 2005, p 15 http://www.berr.gov.uk/files/file29023.pdf

**Germany**

Since 1931, there has been a statutory limit (cap) on auditor's liability which has been continuously up-dated over the years. The cap today is €1 million for statutory audits of unlisted companies and €4 million for statutory audits of listed companies. Although the market segment for the largest listed companies (top 20) is highly concentrated, Germany in general shows relatively low concentration rates in the market segments for smaller listed companies (see **Annex 3**, Table 3). Particularly, in the market segments for the "top 200" or "top 300" listed companies, the market concentration in Germany is significantly lower than e.g. in UK or Italy. In 2004, 198 German audit firms conducted statutory audits of 971 companies listed on the regulated German stock market[97]. Amongst the world's G8 economies, Germany shows one of the lowest concentration rates in the market for public company audits[98]. Once again, the German cap is not recognised in other countries. Major international audits are facing considerable uncertainty in terms of liability risks.

**Austria**

Since 1931, there has been a statutory limit (cap) on auditor's liability which has been continuously adapted over the years. At present, this cap ranges between to €2m and €12m, depending on the size of the audited company (see **Annex 6**). The concentration rate of Big 4 audit firms in the market for companies listed on a regulated stock market is lower than in many other countries[99].

*6.1.4. Current situation in the United States*

The problem of liability of auditors is also under discussion in the US. In 1995, the US already introduced some liability reform. Under the PSRLA[100], the principle of joint and several liability was eliminated and replaced by a form of proportionate liability. In addition, damage awards to plaintiffs were limited[101] taking into account the particularities of US litigation law. However, the US system offers less protection for auditors than they currently enjoy in the EU because; i) it includes the possibility to award punitive damages (i.e. damages compensating more than the loss) and ii) it allows not only shareholders but a much wider range of investors to sue companies and auditors. In the US, litigation risks in general are much higher compared to EU, in particular in the area of securities markets. The US Supreme Court recently endeavoured to reduce liability risks for listed companies and accordingly the

97 See WPK-Magazin 1/2006

98 Auditor concentration across the G8: Canada 96%, France 61%, Germany 83%, Italy 99%, Japan 84%, Russia 90%, UK 98%, US 97%; see: http://www.grant-thornton.co.uk/press/press/PressRoom-g8_economies_creates_systemic_risk.aspx

99 According to information received from the Austrian audit profession, the concentration rate of Big 4 audit firms in the market for companies listed on a regulated stock market amounts to 78%.

100 The Private Securities Litigation Reform Act of 1995

101 Damage awards to plaintiffs are accordingly limited to the difference between purchase or sale price and the mean trading price during the 90-day period starting on the date the market was made aware that a misstatement of information has occurred. However, this situation concerns investors at large who sell or purchase securities. Under the law of Member States, only securities holders can take legal action against an auditor (see also annex I).

auditors of such companies[102]. One of the arguments of the US Supreme Court has been that litigation seriously harms the attractiveness of US capital markets.

There is a wide public debate in the US about whether there is a need to even cap auditors' liability. In January 2006, the US Chamber of Commerce[103] called for a better definition of the limits of an auditor's responsibility and ways to permit companies and auditors to agree reasonable limits on an auditor's liability.

On 30 November 2006, the Committee on Capital Markets Regulation set up by the US Treasury considered in its report whether the US Congress should be invited to explore whether there is still a sustainable and competitive audit market. The Committee suggested a cap based on a multiple of audit fees as a possible reform to be considered by the US Congress.

The US is not fully comparable as their legal system permits the use of punitive damages, but the EU has no common view whereas the US already introduced proportionate liability.

On the other hand, a report in March 2007 from the US Chamber of Commerce on the regulation of US capital markets recommended that national audit firms should be allowed to raise capital from private shareholders other than audit partners. No liability reform was suggested.

The most recent input into the US debate about choice and limitation of auditors' liability is a study concerning market concentration prepared by the US Government Accountability Office (GAO) published in January 2008. According to GAO's survey, 82% of US large public companies - the Fortune 1000 - saw their choice of auditor as limited to three or fewer firms, and about 60 percent viewed competition in their audit market as insufficient. Although current concentration does not appear to be having a significant adverse effect, the loss of another large firm would further reduce large companies' auditor choice and could affect audit fee competitiveness. The GAO study does not recommend capping of liability in the US as there would be no consensus amongst business community.

In October 2007, US Treasury Secretary Paulson set up an advisory committee which will examine auditing industry concentration, audit quality, recruitment and retention of auditors in audit firms as well as the impacts of insurability and liability risks. This committee should present recommendations in summer 2008.

### 6.2. Impact of option 4a on the objectives (Capping liability by a Directive)

It might be difficult for all Member States to fix a uniform amount of cap or a uniform method to calculate a cap taking into account the necessity to ensure fair protection of damaged parties, audit quality and the necessity to avoid anti competitive effects for audit firms auditing mainly smaller listed companies.

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102 US Supreme Court, ruling on 15 January 2008 in the case StoneRidge Investment Partners v Scientific Atlanta/Motorola with regard to the causal link between an accounting misstatement and the decision of investors for investing

103 Auditing : A profession at risk, US Chamber of Commerce, January 2006

Nevertheless, once this first difficulty is overcome, all the objectives would be efficiently addressed.

- Achieve fairer liability risk exposure for auditors:

In Member States with regimes of joint and several liability, liability caps would effectively protect auditors from excessive claims by plaintiffs and, thereby, address the deep pocket syndrome[104]. In addition, depending on the level of cap, the risk of the disappearance of a major audit firm would be reduced. However, a cap might not necessarily reflect the degree of negligence or loss the auditor has caused, so might still not be "fair".

- Facilitate access to insurance for auditors:

A cap at the EU level would improve the predictability of claims for insurers as those claims would be capped by a fixed amount or a method to calculate an amount. The insurance coverage should therefore be restored. For example in Belgium the introduction of a cap has improved the insurance coverage for auditors (see section 6.1.3). However, some insurers believe that a cap would not overcome the lack of mutualisation of risks amongst a large number of players. These insurers might slowly act once more audit networks entered the market.

- Encourage investment into the expansion of audit firms:

If the cap were set too high by the Member State, the cap could favour the Big 4 and mid-tier audit firms auditing smaller listed companies would not benefit from such a high cap. Nevertheless, we can assume that if the cap is not too high, it would be beneficial for mid audit firms wishing to enter the market of large public companies. Germany for example, where a cap has existed since 1931, shows one of the lowest concentration rates in the market for large public company audit (see section 3.2.2). All EU Member States where caps do exist seem to have opted for rather low caps in order to let mid-tier audit firms benefit.

- Reduce differences in liability regimes across the EU:

This option would reduce differences of the liability regimes across the EU as all Member States would have a cap. However, differences would not be eliminated, as Member States would not necessarily apply the same cap amount. The impact in terms of the effort required to change the liability regimes could be quite high, as each Member State could introduce a cap tailored to its own situation – for example, the chance of using some standard text would be low; the effort required in determining the cap could also be large.

### 6.3. Impact of option 4b on the objectives (Introducing proportionate liability by a Directive)

Currently only Hungary has introduced proportionate liability as a principle applicable to statutory audits by law. All other Member States would need to change their law in order to implement this option.

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104 London Economics study, P. xxiii

- Achieve fairer liability risk exposure for auditors:

This option would contribute significantly to achieving a fairer liability risk exposure for auditors, as auditors' liability would be defined in proportion to their level of responsibility. Proportionality by law would reduce the risk of audit firms being used as insurance of last resort against any corporate malpractice. However, proportionality might not be enough to protect auditors against excessive claims, since it does not limit absolutely the magnitude of such claims.

- Facilitate access to insurance for auditors:

As proportionate liability would not limit absolutely the magnitude of liability risks, the insurability situation of audit firms would not improve as effectively as in the case of liability caps. There could still be some expectation of an improvement in the availability of insurance, as insurers would know that auditors would not face full liability for any claim but some lesser amount.

- Encourage investment into the expansion of audit firms:

Respondents to our public consultation coming from the mid-tier audit firms tended to consider that proportionate liability is a more appropriate solution compared to a cap (option 4a) to reform auditors' liability. Mid-tier audit firms are more concerned about a cap as they fear that caps might be set at such high level having no practical effects for mid-tier audit firms currently focussing at small listed companies. In the UK, a reduction in the level of market concentration was one of the objectives for introducing the possibility to agree on proportionate liability through contractual arrangements.

- Reduce differences in liability regimes across the EU:

This option would effectively eliminate differences in the liability regimes across the EU as all Member States would have the same rules i.e. proportionate liability. The effort required to introduce such a change into the different legal regimes would depend on the existing legal basis – in some countries it would be quite low, in others it would be quite high. However, as all Member States would be introducing the same rules (the principle of proportionate liability), a similar approach could be found in all countries.

### 6.4. Impact of option 4c on the objectives (convergence of liability limitations)

This option should address the first three objectives to a large extent, whilst also permitting Member States to choose the most suitable solution according to their legal, economic and insurance systems. The fourth objective, i.e. reducing differences in liability regimes across the EU, would be addressed to a lesser degree. The changes needed in national law would obviously depend on the individual solutions being adopted. The impacts of this option are also affected by the different legal instruments proposed. The following sections consider the impacts according to the legal instrument.

#### *6.4.1. Reaching convergence by a Recommendation*

A possible downside of a Recommendation could be that not all Member States would take action. Therefore, the following analysis considers two scenarios:

implementation by all Member States (the "full implementation scenario") and implementation only by some Member States (the "partial implementation scenario").

a) Full implementation scenario

Under this scenario, all Member States would follow an EU recommendation by introducing a certain method or system of auditors' liability limitation in their national legal regimes. Compared to the current situation, any movement from the current position which ranges between known limits and infinity, to a more bounded situation, could be viewed as a considerable improvement for the audit market and as a consequence for capital markets.

Introducing a recommendation containing high-level principles for limiting auditors' liability in the EU would address all objectives described under section 4.

Since Member States might realistically be expected to opt mainly for a cap or proportionality, the impacts of this option should by and large be similar on the first three objectives as those of the options 4a (cap) and 4b (proportionality). Nevertheless, the magnitude of the impacts will depend on the ratio of Member States adopting a cap, proportionate liability or a mix of the two. The option 4c would allow individual Member States the possibility to assess which method they consider as the most appropriate under their given legal regimes. Each Member State would implement the recommendation in a way which best suits its environment, its legal tradition and the expectation of shareholders. This is the case today - some Member States, e.g. Germany or Belgium, have introduced modest caps since they are concerned about the negative impact of higher caps on competition on the audit market but are convinced that there is no negative impact on audit quality. By way of contrast, other Member States, e.g. Hungary, might favour proportionate liability rather than a cap as they consider that confidence into audits, where liability is capped against the will of shareholders, might be negatively affected[105].

Hence, the main difference is that like 4a (caps), this option would not fully remove the differences in liability regimes across the EU, as could occur under 4b (proportionality). Hence audit firms would still need to deal with different rules across the EU. But it should at least improve (i.e. make more level) the playing-field for audit firms across all Member States as all Member States would have some known way of limiting liability. Currently, in the Member States where a limitation exist, as analysed above in section 6.1.3, the impact on the objectives is positive, regardless of the method of limiting liability retained in these Member States. One of the main reasons is that these methods are well adapted to the national legal environment. The impacts are expected to be much more positive if a limitation exists in all the Member States, even if there is no uniform method for limiting liability across the EU.

b) Partial implementation scenario

105 See the study of the UK Office of Fair Trading of 2005

The magnitude of the impacts obviously depends on how many Member States decide to introduce limits to liability, on the forms that such limits take and on the timing, as a recommendation does not have a given implementation date. Under the worst case scenario, it could not be excluded that none of the Member States which currently have unlimited liability introduce changes. For instance, some Member States do not see any need for action at this stage.

**Finland**

The Finish Ministry of Trade and Industry informed the Commission Services during the public consultation early 2007 that they had commissioned research on the necessity to limit auditors' liability in Finland. This research, published in December 2006, found no reasons to introduce further limits to liability in Finland, since an important safeguard limiting liability already exists: compensation for damages may, according to Finnish legislation, be adjusted if the liability is deemed unreasonably onerous in view of the financial status of the person causing the damage and the person suffering the same and other circumstances.

**France/Denmark: joint audits**

France shows comparable or even slightly lower audit market concentration rates than Germany, which are due to the implementation of "joint audit"-regulations which were imposed in 1966. These regulations commit listed companies to mandate two statutory auditors. As a consequence, mid-tier audit firms often participate in the statutory audits of listed companies. According to a recent study of the French audit market[106], the Big 4 market share in the audit market for companies listed in the main stock exchange index, based on number of audit engagements, amounts to 83%. However, the concentration rate based on audit fees is significantly higher (94%). In addition, the study found a continued concentration trend in France towards joint-audits carried out by two Big 4 audit firms. Amongst listed companies, the Big 4 are by far at least one of the two joint auditors. It is extremely rare that only two mid-tier audit firms carry out the joint audit. Effectively, smaller audit firms participate more under a kind of "piggy-back" method in the audit of listed companies. Such mid-tier audit firms do not necessarily see a need to increase their investments, but are content with the current "piggy-back" situation. As no other Member States follows suit, the lack of international acceptance would neither allow the growth of a new international player on the audit market nor overcome the fragmentation into local firms averse to liability risks from other jurisdictions.

Denmark, which also has low concentration rate (see Annex 3), dropped this requirement in 2001 as it felt that it was no longer justified against the background of audit quality. In the past, Denmark felt that joint audits would overcome previous companies' difficulties of finding audit firms with a presence in all necessary jurisdictions in the world. Due to the mergers in the 1980s and 1990s, the Big 5 (today Big 4) emerged and these networks have been able to meet the companies' demands for international audits.

106 See Autorité des Marchés Financiers (AMF): Study of fees paid by French companies listed in the CAC 40 index to statutory auditors and their networks in respect of the 2006-2005 period", July 2007.

It is therefore not excluded at this stage that a recommendation would not be followed by Finland and France. Such a situation would nevertheless not prevent a recommendation having positive effects.

It is probable that such a recommendation would at least prompt Member States to discuss and debate the issue with market participants and to take appropriate action. A clear signal would be given that problems linked to liability risks and high concentration are not only local problems, but deserve international recognition for the European capital markets. It should incite Member States and the different stakeholders to discuss possible solutions. Presented below are some examples of current debate, from which it could reasonably be expected that some Member States would follow the Commission recommendation.

**Sweden**

The Swedish Ministry of Justice informed the Commission Services during the public consultation that the Swedish government has appointed a commission to analyse different models for limiting auditors' liability and to, if appropriate, propose new legislation. The work should be concluded by September 2008. The Swedish Ministry of Justice underlined that any recommendation from the European Commission should only establish the objective for developing national liability solutions without imposing any restrictions for Member States on how to reach this objective.

**Ireland**

In 2007 the Irish government asked the Company Law Review Group (CLRG) to examine the matter of auditors' liability. In the event that CLRG would propose that reform to the present system is warranted, they were also asked to identify the areas in which reform would be required, and the means by which this could be best achieved. This could include potential methods, including but not limited to, changes in the law:

- for the introduction of statutory liability caps;

- to permit limitation of liability by contract;

- to introduce a regime of proportionate liability;

- to permit auditors to incorporate (i.e. establish limited liability companies).

The CLRG Report on its activities is scheduled for publication in 2008.

*6.4.2. Reaching convergence by a Directive (option 4 c implemented via a Directive)*

On that basis, the impact versus the objectives should be the same as the impact of full implementation of the option 4c via a Recommendation.

However, there are differences between the two variants of option 4c, due to the nature of the instruments proposed. The Directive is a legally binding instrument requiring a much higher degree of detail. The Commission has the possibility to use formal infringements procedures against Member States for not having complied

with an adopted Directive. The costs of introducing implementing legislation for Member States are potentially higher for a Directive as all the Member States have to implement the Directive whereas for a Recommendation they are free to choose to which extent the Recommendation will be implemented taking into account the current measures they have in place. Moreover, the procedure for adopting a Directive is longer compared to a Recommendation.

## 6.5. Impact on Audit Quality

### *6.5.1. General impact of a liability limitation on audit quality*

The first safeguard should be that the proposed action would not extend to limiting liability in case of an auditors' wilful misconduct, for example in the case of cooperation with management in corporate fraud. It would concern only cases of negligence.

Opponents to liability reform often argue that audit quality would nevertheless be affected if auditors' liability were limited. However, there exists a second safeguard: audit regulators - not judges or courts – will in future play a pivotal role in maintaining the top audit quality which companies and investors deserve.

The 2006 Directive on Statutory Audit provides important safeguards aimed at increasing audit quality. It requires Member States to implement an external independent quality assurance system (inspection system) for all statutory auditors (Art. 29) under independent public oversight (Art. 32). Such oversight should prevent potential risks to audit quality compared to the past, when the audit profession was self-regulated and self-controlled. The public oversight system should organise independent inspections[107] and take sanctions against auditors who do not follow the professional standards. Such independent inspections linked to appropriate sanctions would be a much stronger and more appropriate driver for audit quality than civil liability rules.

In addition, the quality of the audit staff, their training and the internal quality systems of the audit firms could be more important drivers for audit quality than the fear of liability claims. It is questionable to what extent imposing potential liability claims on auditors would be effective in affecting their behaviour[108].

Moreover, auditors would still be liable for their actions after Member States have implemented the proposed recommendation. Audit firms are also unlikely to disregard audit quality as their reputation and their business might otherwise be damaged.

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107 Regular controls at least every 6 years, for auditors of public interest companies every 3 years

108 Accounting and auditing standards leave the auditor with significant latitude of judgement, thus, auditors are not able to exactly assess ex-ante whether they have fulfilled the requirements of a certain standard. The actual level of auditors' care of duty does not only affect the probability of damage, but also – in a second step – the probability that a court ex-post adjudges negligent behaviour of the auditor. However, according to Ellsberg-Paradoxon, individuals are averse to such a two-tiered probability distribution. Consequently, this aversion may under certain conditions also result in a reduced level of the auditors' care of duty. See: Prof. Ewert: "Wirtschaftsprüferhaftung bei unpräzisen Sorgfaltsstandards and Ambiguitätsaversion", 2007: http://www.rewi.hu-berlin.de/jura/ls/knr/WorkshopLawandEco/Bigus.pdf

Finally, it is important to underline that the quality of an audit service depends on the perception of companies and investors and is therefore difficult to assess[109]. Despite evidence suggesting that actual audit quality is high, users may have different views of the degree of audit quality. Therefore, even if the quality of the audits was not affected in reality by a reform of liability, one might fear that the investors' and companies' confidence would be affected. Nevertheless, the new 2006 Directive on Statutory Audit should prevent such a negative impact on the perception of audit quality. As described above, it would allow public authorities to control better the audit quality and therefore the perception of audit quality would be linked more to more objective elements such as the outcome of independent inspections. Moreover, Article 40 of the new Directive requires audit firms to provide transparency reports, for example about their internal quality systems, which should be an element improving the perception of the audit quality. In addition, Article 29 allows more transparency on the results of the quality assurance reviews in audit firms.

*6.5.2. Impact of each of the options on audit quality*

Many respondents to the public consultation coming from outside the audit profession expressed their opposition to an initiative if it led to capping liability at the EU level. They claimed that this would lead to moral hazard amongst auditors (option 4a).[110] However, the experience of countries where a cap has existed for a long time (e.g. Germany or Austria) shows that investors and companies do not believe that even a low cap has adverse effects on audit quality. Belgium which introduced a cap in 2005 did not experience a deterioration or general negative impact on audit quality. This option would in no way prevent Member States setting a very high cap, for example, at more than €100 m or even €200 m, far beyond the caps in use in Germany or Belgium. It would also allow the application of a more flexible solution, such as a cap calculated on the amount of audit fees charged by the auditor or a cap calculated as a percentage of the balance sheet figures in the company's accounts.

According to the public consultation, stakeholders would be less concerned about the possible effects of proportionate liability on audit quality (option 4b), because auditors' liability would be linked to the level of contribution to the damage.

Probably the best solution would be that the appreciation of the impacts on audit quality is left to Member States discretion, given the results of their quality control systems (option 4c). Investors could also better express their local preference. Member States which find reasons to fear negative consequences of a cap could chose proportionate liability or even develop a further method. If shareholders are too critical, some Member States could also introduce the possibility of allowing

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109 This is because the only observable outcome of the audit is the audit report which is a generic template and the overwhelming majority of reports are standard clean opinions. While it is possible to assess audit quality ex post in the case of outright audit failures, these are relatively infrequent occurrences. See Jere R. Francis: "What do we know about audit quality?", The British Accounting Review 2004

110 Audit quality can be defined as the market-assessed probability that the financial statements contain material errors and that the auditor will be able to discover and to report such errors to investors. This probability is affected by the competence and independence of the auditor. This general understanding has been developed in DeAngelo, L. E. (1981b): Auditor size and audit quality: Journal of Accounting and Economics 1981, P. 183-199

contractual limitation of liability. Such limitations would need to be subject to the approval of shareholders at shareholders meetings.

### 6.6. Positive impact mainly for the Big 4?

Some respondents to the public consultation were concerned that a limitation of auditors' liability would mainly benefit the Big 4 audit firms.

Firstly, a liability limitation should significantly benefit potential new entrants and especially the mid-tier audit firms. The limited availability of insurance creates high costs for any mid-tier audit firms interested to enter the market for large audits as these firms may not have the same ability to establish captive insurance, which the Big 4 established more than a decade ago. Moreover, mid-tier audit firms may not be able to diversify liability risks effectively due to the size and selection of their mandates[111]. In Belgium, the introduction of a cap favours the access to insurance for smaller audit firms[112].

Secondly, liability risks also affect the willingness of partners in an audit firm to provide more extensive funding allowing further expansion of the audit firm's activities. The partners of the audit firms would have no incentive to invest in such an expansion if, given the high liability risks, expected returns are likely to be low. Therefore lower liability risks would provide a stronger incentive for mid-tier audit firms to invest more and to compete more with the major audit networks, in particular with regard to the smaller listed companies.

Finally, the Big 4 will remain subject to the general market mechanism. Like in the case of Arthur Andersen, a significant audit failure might erode the reputation and brand of a network. Accordingly, such network might implode as leading partners would no longer see any benefit in sustaining such eroded brand. In the same vein, audit failure within such a network can lead to public investigations and removal of licences in major capital markets leading to the collapse of the network as a whole. However, some stakeholders defend that there is a risk that the Big 4 are "too big to fail" and that liability reform would consolidate, even strengthen this risk. However, liability reform as proposed under option 4c will not have this result. The examples above demonstrate that a major audit network might fail for other reasons. Member States which might have strong concerns could opt for proportionate liability which does not offer such an immediate protection like a cap. Finally, the current audit market always remains subject to general competition rules, in particular Articles 81 and 82 of the EC Treaty.

### 6.7. Possible up- and down-sides for stakeholders outside audit firms

The following section describes the possible up- and down-sides of liability limitations for stakeholders outside the audit profession.

Possible concerns of the different stakeholders are addressed below*:*

*Companies*

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111 See London Economics study, P. 92 and the Oxera ownership study p 156 and p.174

112 See section 6.1.3.

Companies fear that the limitation of auditors' liability would restrict their right for compensation in the case of auditors' malpractices. However, as has been made clear, any limitation would not apply in the case of a wilful misconduct of the auditor. Moreover, a reform of auditors' liability would not change the general principle: a company has always been culpable of its own malpractice. The negligence of auditors could only be related to the detection of such malpractice. Accordingly, the statutory auditor may always raise the audited company's own fault as a defence in a claim brought by this company.

Some companies are concerned about the possible negative impacts of a limitation of auditors' liability with respect to the liability of directors and company officers. However, any liability risk of directors and officers can, in contrast to the risks faced by statutory auditors, be more widely diversified amongst many D&O policy holders[113] whereas this a major problem for a few international audit firms.

*Investment banks*

Investment banks raised the issue that they could be co-defendants together with audit firms in any claim.

Investment banks act as underwriters in the context of an initial public offering (IPO), when such banks arrange the possible sale of securities by an issuer to the public. The initiative proposed on limiting auditors' liability is not focussing on IPO's and the role of auditors in an IPO but on the statutory audit of annual accounts to be regularly published after a company has been listed. Therefore, a limitation of auditors' liability would not increase liability risks for investment banks in the context of an IPO.

Banks can also act as advisers of a company in other cases (i.e. not just for IPOs). Nevertheless investment banks currently benefit from insurance coverage[114] and there is a high degree of competition in the market for investment banking services.

*Third parties seeking compensation (in particular investors)*

One of the concerns expressed during the consultation is that the third parties and in particular investors, might not be compensated for their full loss. Yet this is already the case in practice. Their expectations of obtaining compensation face practical limits, corresponding to the financial capacities of the audit firms. In this respect, the advantage of limiting auditor's 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.

Again, it is to be stressed, any limitation of liability should only apply to cases where an auditor acted in a negligent manner. Limitations would not apply to wilful misconduct of an auditor, such as collusive behaviour with management in committing corporate fraud. This solution would be consistent with legislation in Member States who already limit liability.

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113 London Economics study, P. 103

114 See also Final Report from the European Commission on the continued appropriateness of the requirements for professional indemnity insurance imposed on intermediaries under Community Law of 11 April 2007 (COM (2007) 178 final), P. 10

## 6.8. Other impacts (for options 4a, 4b and 4c)

*Impacts at the international level*

Some respondents to the public consultation asserted that a limitation of auditors' liability at EU level would not be able to address potential plaintiffs' claims in conjunction with statutory audits also relevant for other jurisdictions, such as the US. The European Union clearly has no powers addressing liability in other jurisdictions. However, a limitation would at least address the risks in the EU, for instance in conjunction with group audits of multinational companies carried out in Europe. The audit firms presented evidence that litigation risks exist in the EU (see section 3.3 above).

If complimentary solutions along the same lines were adopted by major countries outside the EU, the progress at global level would be even more effective

*Social impact on the profession*

Audit firms, which are exposed to high audit risks, have difficulties in retaining experienced professional staff, who might otherwise continue as partners[115]. A less attractive audit profession might result in fewer talented professionals interested in pursuing their career path all the way to partnership level. A limitation of auditors' liability should improve the attractiveness of audit firms to hire and keep highly qualified professional staff.

*Administrative cost*

According to the 4th and 7th Company Law Directives, financial reporting is already mandatory for companies in European Member States. Under particular circumstances, a specific information requirement might be important: a company should disclose any contract based limitation of the auditor's liability in the financial statements. The related costs cannot be exactly determined but they should be very limited as listed companies should, in any event, prepare financial statements. The benefit for investors, who might be considering buying shares, is to make them aware of such limitation before taking an investment decision. This benefit should clearly outweigh minor costs involved in adapting financial statements. This disclosure solution has also been introduced in the UK when allowing contract based limitations.

The administrative cost could be higher for the options 4a and 4b as those options would require some Member States which already have a limitation to change it in order to adapt it to the provisions of the directive.

## 7. COMPARING THE OPTIONS

The baseline for the comparison is option 1: "No EU action " whilst at the same time an increase in audit quality is expected through the implementation of the 2006 Directive on Statutory Audit, in particular through more rigorous inspections by independent public oversight systems.

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115 See also MORI, Auditor career and working life survey, January 2005

### 7.1. Criterion 1: Effectiveness regarding the objectives

Objective 1: Achieve fairer liability risk exposure for auditors

Compared to the current situation of "No EU action", implementation of any of the options would achieve fairer risk exposure for auditors. Harmonizing liability regimes at an EU level on the basis of proportionate liability (option 4b) is the most effective option to achieve a fairer risk exposure for statutory auditors. Under this option, auditors would be financially liable only for the consequences of their own negligent behaviour and not for the consequences of other parties' fault. Limitation by a cap (option 4a) would not be linked to the extent of auditors' fault. Nevertheless, proportionate liability (option 4b) might not protect auditors sufficiently against catastrophic claims,[116] compared to a cap (option 4a).

Option 4c allows Member States to choose the most appropriate method or even to combine various methods (cap and proportionate liability) to achieve a fair liability risk exposure. In some Member States with legal regimes allowing contractual arrangements, the liability could also be limited by a contract between the auditor and the company (i.e. on a case by case basis) provided adequate safeguards, such as the consent of shareholders, are in place. Consequently, option 4c implemented by a Directive or a Recommendation fully followed by the Member States, might achieve this objective at least as effectively as an EU wide harmonisation based on proportionate liability (4b). This option would be less effective if option 4c was not fully implemented.

Objective 2: Facilitate access to insurance for auditors

Compared to the current situation of No EU action, implementation of any of the options would bring a great improvement at international level. As described in section 6, harmonisation using a cap (option 4a) would be the most efficient option to achieve this objective. Proportionate liability (option 4b) could not limit absolutely the magnitude of liability risks and could not improve the predictability. As a consequence the insurability situation of audit firms would not improve as well as in the case of using liability caps. Nevertheless, the implementation of either of these two options at the EU level could allow better development of insurance coverage for the audits conducted in the EU.

The effects of the option 4c should also be effective at the national level as Member States should be able to find the best solution possible taking into account the national insurance conditions. Insurers which are also major investors at the same time might find this flexibility more attractive.

The option 4c introduced via a Recommendation would be less effective if this option was not fully implemented by the Member States.

Objective 3: Encourage investment into the expansion of audit firms

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116 Under proportionality, in the event of a major claim amounting to €300m and an assigned responsibility to the statutory auditor of 50%, the auditors' liability would be limited to €150m. In contrast, the liability caps existing in Member States are significantly lower (see Annex 3).

Again, compared to the current situation of No EU action, implementation of any of the options would be a positive step in order to encourage new investments into expansion of audit firms. If the cap were set too high by the Member States, recommendation on auditors' liability could favour the Big 4. Mid-tier audit firms auditing smaller listed companies would in practice never benefit from such a high cap. Respondents to our public consultation coming from the mid-tier audit firms tend to consider that proportionate liability (4b) is a more appropriate solution to reform auditors' liability.

Nevertheless, we can assume that if the cap is not too high, it would be beneficial for mid audit firms wishing to enter the market of large public companies.

The option 4b could be more effective to attract more players into the market of the audits of the smaller listed companies but could be less effective for the market of big listed companies, as it would not reduce absolutely the magnitude of claims. Proportionality would have the same impacts for both small and big audit firms whereas a cap, especially fixed at a high level might privilege major audit firms auditing big listed companies.

The option 4c would allow the Member States to choose the solution which is the most adapted to the needs of the mid-tier audit firms in their country and could therefore provide a strong incentive for other audit firms to invest more and to compete more with the major audit networks. Option 4c introduced via a Recommendation would be less effective if this option was not fully implemented.

Objective 4: Reduce differences in liability regimes across the EU

Option 4b introducing harmonisation of liability regimes on the basis of proportionality would be more effective than the options 4a and 4c as the same liability regime would apply in the whole EU. Option 4a would strongly reduce but not eliminate the differences. There would be a cap on liability in all the Member States but it could vary considerably across the EU. Nevertheless, the amounts of caps would be known in advance and they could be easily managed by the networks of the audit firms. That said, the final cap would determine whether mid-tier audit firms can make more inroads into the market. The higher the cap, the less the chances will be for mid-tier audit firms. The option 4c would be the least effective of the three options but it should at least improve (i.e. make more level) the playing-field for audit firms across all Member States. It would be therefore more effective than the current situation of "No EU action".

### 7.2. Criterion 2: Efficiency

Efficiency should mainly be assessed in respect to the fragmentation issue described in the section 3. If the regime of liability is the same in the whole EU, it would involve less costs for the audit networks to deal with the question of liability and therefore audit networks could become more integrated. Options 4a and 4b (harmonisation) would be more efficient than option 4c. The downsides of option 4c would be even stronger if it would be implemented only partially by Member States. Nevertheless, the option 4c would still be a considerable progress compared to a "No EU action" (option 1).

### 7.3. Criterion 3: Audit quality

If a cap were set too low by the Member States under option 4a, this might have a negative impact on the quality for the audit of major listed companies. In particular, investors might see a great risk and loose confidence into the audits.

Option 4b would steer the conduct of auditors towards audit quality adapted to audit risks and might deliver a better balance between audit efforts and liability risks.

The option 4c should not have negative effects on audit quality as Member States should choose the best possible method and level of limitation. Local investors' perception of audit quality and confidence into the audit could be much better taken into account. For example, in Germany a cap has existed since 1931 and German investors have no concerns about this. Some Member States would also be able to allow the possibility to limit liability by contract to be concluded between the auditor and the company. Such agreements should not have any negative effects as they would be submitted to the agreement by the shareholders and to the judicial review.

### 7.4. Criterion 4: Acceptability

*a) Acceptability for Member States/ subsidiarity*

Both harmonisation options (4a and 4b) would today constitute a disproportionate intervention into the national civil laws. Countries where one solution is already in place would oppose a change to any other method. Germany and Austria have been operating with relatively low caps for over 75 years; Belgium introduced such a system in 2005 – all three countries find this solution effective to their problems. Hungary, having just introduced the system would prefer proportionality rather than a cap. Others, such as the UK market place, have a strong preference for limitation of liability via contractual arrangements and are highly likely not ready to accept a cap imposed by a directive leaving shareholders of a particular company without any say. Option 4b, a harmonisation by introducing proportionate liability would also represent a significant intervention into many existing legal regimes, because most Member States have joint and several liability systems and would have to change to proportionate liability. Therefore the harmonisation at the EU level leading to proportionate liability would require many Member States to change core aspects of their law, at least for auditors.

The outcome of the public consultation proved that legal and economic differences between Member States are so significant that harmonisation would not be accepted by Member States. Moreover given that civil liability rules for listed companies with regard to their financial statements and accounting failures are not harmonised[117], a complete harmonisation of liability rules for auditors would not be accepted. Therefore options 4a and 4b are probably not realistic at this stage despite being highly effective and efficient regarding their impact on the objectives.

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117 See e.g. Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC

Many respondents to the public consultation also emphasised that any Commission measure should give maximum flexibility to Member States.

Introducing high-level principles for limiting liability in the EU via a Recommendation according to the option 4c would allow individual Member States the possibility to assess which method they consider as the most appropriate under their given legal regimes. Such an action seems more proportionate at this moment as legal regimes and economic conditions are very different in the Member States. This option is also more acceptable than a Directive as it would leave the possibility to Member States not to take action.

Introducing a choice of method of limitation via a Directive would also be difficult for Member States to accept because of the timing of the action. The Directive on Statutory Audit was adopted in 2006 and the implementation deadline is June 2009. It is therefore difficult to impose a new Directive when Member States are still transposing the first one. Moreover Article 31 of the Directive on Statutory Audit suggests that the issue of auditors' liability should be dealt with via a recommendation and not via a legally binding instrument. Finally, a directive under option 4c introduced at this stage would exacerbate the current divergences between cap and proportionate liability in the long run and not really promote convergence of liability regimes. Instead, Member States would all insist on their national option and would not be ready to reconsider their position in the future.

*b) Acceptability for the markets*

The results of the public consultation show that the stakeholders from outside the audit profession would today prefer proportionate liability (option 4b) rather than a cap (option 4a). For the majority of these respondents, the proportionality should be negotiated by contract rather than imposed by law. Respondents from outside the audit profession coming from the UK wish to keep the system allowing them to agree on limitation by contract but important academic voices (e.g. Max Planck Institute) also consider such an approach to be the best. Such flexibility would not be possible under options 4a and 4b and therefore those options would be unacceptable to them.

Many of the respondents consider therefore that the choice should be left to the Member States (option 4c). According to the results of the public consultation, half of the respondents coming from outside the audit profession would support a Commission initiative on auditors' liability. The views from respondents outside the audit profession depend to a large extent on whether or not they come from countries where limitation already exists. 74.1% of respondents from countries where limitation exists would support an initiative at EU level, whereas 76.5% of the respondents from countries without limitation reject a Commission initiative. This opposition is mainly related to a scenario where the Commission might recommend a harmonisation of liability regimes in Member States based on capping liability.

In brief, if sufficient flexibility is left to the Member States, they could be able to find a system of limitation which is acceptable to stakeholders coming from outside the audit profession. Moreover, a recommendation could be adopted quickly and give a strong signal to Member States. Therefore a recommendation seems the most adapted way to find solutions acceptable for all the stakeholders.

A directive introducing choice of a limitation between different measures would be less acceptable as such a directive would take time before it is adopted. No clear signal could be given quickly to the markets.

*c) Acceptability for other professions*

Some respondents to the public consultation also argued that the Commission should avoid singling out auditors in contrast to other professional services or other economic players who might ask for a limitation in the same way. However, there are important reasons justifying a distinction:

- Doctors: might also be exposed to high risk activities, but only to claims from patients or their relatives. More importantly, liability risks for the activities of doctors do not have cross border effects[118].

- Tax advisors: act in the purely private interest of their clients. The statutory audit function is mandatory and thus policy makers have a genuine public interest responsibility for ensuring a sustainable audit market.

- Lawyers: the market for their advisory services is not as vulnerable (i.e. not as concentrated) as the international audit market. If a significant law firm were forced to leave the market, the gap could be closed by other market players.

- Finally, compared to auditors, these professions lack an important safeguard to control the quality of the services they provide: their activities are not controlled by an independent public oversight, as required under the Directive on Statutory Audit.

Option 4c would be preferable to options 4a and 4b as it would be more acceptable for the others stakeholders and could be discussed with them.

### 7.5. Overall comparison

The following table summarises the arguments for and against all options:

[118] Any international aspects are relevant for insurance sector dealing with medical malpractice. See also Report of OECD of 16 June 2006: Coverage of medical malpractice in OECD countries.

## 7.6. Conclusion

The Services of the Commission would propose a short principle based recommendation (**Option 4c**), as the preferred solution, compared to other possible options, to address the general and the specific objectives. Although other options could achieve the objectives more efficiently, they are not politically acceptable at this time.

| | **Effectiveness** (impact[119] over time) as regards to | | | | **Efficiency** (cost effectiveness) | **Acceptability** | **Audit Quality** |
|---|---|---|---|---|---|---|---|
| | Objective 1: Achieve fairer liability risk exposure for auditors | Objective 2: Facilitate access to insurance for auditors | Objective 3: Encourage investments into the expansion of audit firms | Objective 4: Reduce differences in the liability regimes across the EU | | | |
| Option 1: No EU action | ○ | ○ | ○ | ○ | ○ | ○ | ○ |
| Option 2: Compulsory insurance | ○ | +++ | ++ | ○ | -- | -- | -- |
| Option 3: "Safe harbours" | ○/+ | + | + | ○ | ○ | -- | -- |
| Option 4a: Liability cap | +/++ | +/++ | +/++ | ++ | ++ | --- | ○/- |
| Option 4b: Proportionate liability | +++ | ○/+ | +/++ | +++ | +++ | --- | ○ |
| Option 4c: Convergence of liability limitations in the EU via a Recommendation | | | | | | | |
| *Full implementation of the Recommendation* | ++ | + | +/++ | ++ | + | ++ | ○ |
| *Partial implementation of the Recommendation* | + | + | + | + | + | ++ | ○ |
| Option 4c Convergence of liability limitations in the EU via a Directive | ++ | + | +/++ | ++ | + | - | ○ |

119 **+ = Positive Impact; ○ = Benchmark (current situation); - = Negative Impact**

## 8. MONITORING AND EVALUATION

The Commission would closely monitor and evaluate the impacts of the proposed Recommendation on the audit market. As the Recommendation would contain only high level principles, Member States would be able to choose very different solutions. The Commission would therefore need to carefully monitor the way the Recommendation was implemented by Member States as well as the effects of the implementation.

To this aim, the Commission would propose the collection of information related to possible advantages and disadvantages of each of the solutions. For example, information to be collected every four years could include:

- General information about the international audit market e.g., concentration rates of audit firms in international market in the EU, liability regimes in Member States, number of new audit firms entering the international market;

- Information about insurability of liability risks e.g. insurance availability and source (e.g. from market, via audit firms); cost of insurance premiums;

- Information about audit quality e.g. in light of the Directive on Statutory Audit, outcome of inspections carried out under the responsibility of the public oversight bodies;

- Information about claims and settlement of such claims, e.g. compensation actually paid versus claimed versus cap in Member States with a cap and in Member States with proportionate liability.

The Commission will review this information and discuss it with Member States. Further debate with private stakeholders (audit firms, investors, companies, insurers) will take place on the basis of this information.

The monitoring phase provides with the possibility of identifying further actions if necessary. It can also lead to the use of another instrument. The general policy of the European Commission is to start addressing a problem first by the use of soft law, when possible. But if the expected results were not achieved because of an unsatisfactory implementation of the Recommendation, a binding instrument such as a Directive might be considered in the future.

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**List of annexes**

Annex 1: Results of the Public Consultation on Auditors' Liability

Annex 2: Market capitalisation / turnover of large companies listed on European capital markets Market capitalisation / turnover of large companies listed on European capital markets

Annex 3: Audit market concentration in European Member States

Annex 4: Legal base (contractual or tort law) for auditors' liability situation in EU-15 Member States

Annex 5: Insurance obligations in EU-25 Member States

Annex 6: Liability caps in European Member States

## Annex 1

### Results of the Public Consultation on Auditors' Liability

85 replies were received[120] from 15 Member States. Responses came mainly from international based respondents (20 responses) and from respondents based in UK, Germany and France, with respectively 18, 12 and 10 responses. In addition, replies from 12 other EU-27 Member States have been received. The breakdown by category of respondents is follows:

| Category | Number | % |
|---|---|---|
| Auditors | 30 | 35% |
| Insurance | 10 | 12% |
| Companies | 9 | 11% |
| Investors | 8 | 9% |
| Academics | 6 | 7% |
| Banks | 6 | 7% |
| Miscellaneous | 6 | 7% |
| Regulators | 5 | 6% |
| Member States | 3 | 4% |
| Other financial market participants | 2 | 2% |
| TOTAL | 85 | 100% |

The overall reaction of the respondents towards a possible reform of auditors' liability regime was as follows:

120 For further information on the composition and role of the Forum, see summary report on DG MARKT website: http://ec.europa.eu/internal_market/auditing/docs/liability/summary_report_en.pdf

| 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% |

Most of the respondents clearly expressed their views in favour or against a possible limitation on auditors' liability. 66% of all respondents (35% from audit profession, representing all replies from audit profession, plus 31% from outside the audit profession) support a limitation on auditors' liability, whereas 29% rejected the possibility. The categories of stakeholders who raise more concerns about a possible reform are investors and companies. One argument often mentioned in their responses is the complexity of establishing an EU-wide approach to auditors' liability, given the variety of legal systems in the Member States.

Moreover, it is important to distinguish between those Member States which have already liability limitations in place and those which have no limit. A majority (74.1%) of respondents from outside the audit profession and from countries where limitations exist (e.g. UK, Germany and Austria) support a reform on European basis as long as their national regimes are not seriously affected. In contrast, 76.5% of the respondents from outside the audit profession and from countries without any limitation reject a Commission initiative.

All respondents from the category “auditors” agreed unanimously that a limitation on auditors’ liability should be introduced. Most of them ask the European Commission for a recommendation favouring a cap.

Respondents from the insurance sector can be divided between those from Member States having already a liability limitation in place, who support the reform, and those from Member States without a limitation, which support the *status quo*, i.e. no action to be taken at Community level. A third category of respondents are the insurance brokers, who support a limitation. It is also worthwhile noting that some insurers provided different replies reflecting their multiple roles - as underwriting insurers, institutional investors and users of audit services. These different view points were often conflicting.

In terms of the specific options that were examined in the public consultation, 59% of all respondents - regardless whether they were in favour for a reform or rejected it

- considered that the principle of proportionate liability would be the best option to limit auditors´ liability. Approximately, 38% of respondents would prefer a combination of proportionality plus cap. The introduction of any sort of capping is supported by 62% of those respondents. In relation to the possible caps suggested in the consultation paper, option 3 (a cap based on a multiple of the audit fees charged by the auditor to its client) is the most supported option (43% of respondents).

## Annex 2

**Market capitalisation of companies in main index of national stock exchange in EU-25 – largest company, median company and smallest company by capitalisation in index, million of €**

| Country | Size of company | Market capitalisation | Size of a 5% decrease in market capitalisation | Size of a 10% decrease in market capitalisation |
|---|---|---|---|---|
| **Austria** | Largest | 15,151 | 758 | 1,515 |
| | Median | 3,107 | 155 | 311 |
| | Smallest | 452 | 23 | 45 |
| **Belgium** | Largest | 40,679 | 2,034 | 4,068 |
| | Median | 5,617 | 281 | 562 |
| | Smallest | 853 | 43 | 85 |
| **Cyprus** | Largest | 3,990 | 200 | 399 |
| | Median | 79 | 3.9 | 7.9 |
| | Smallest | 6.6 | 0.3 | 0.7 |
| **Czech Republic** | Largest | 17,188 | 859 | 1,719 |
| | Median | 56 | 2.8 | 5.6 |
| | Smallest | 25 | 1.2 | 2.5 |
| **Germany** | Largest | 68,169 | 3,408 | 6,817 |
| | Median | 17,294 | 865 | 1,729 |
| | Smallest | 3,738 | 187 | 374 |
| **Denmark** | Largest | 26,661 | 1,333 | 2,666 |
| | Median | 3,568 | 178 | 357 |
| | Smallest | 548 | 27 | 55 |
| **Estonia** | Largest | 1,054 | 53 | 105 |
| | Median | 111 | 5.5 | 11.1 |
| | Smallest | 43 | 2.2 | 4.3 |
| **Greece** | Largest | 15,617 | 781 | 1,562 |
| | Median | 4,376 | 219 | 438 |
| | Smallest | 666 | 33 | 67 |
| **Spain** | Largest | 75,740 | 3,787 | 7,574 |
| | Median | 8,721 | 436 | 872 |
| | Smallest | 1,829 | 91 | 183 |

**Market capitalisation of companies in main index of national stock exchange in EU-25 – largest company, median company and smallest company by capitalisation in index, million of €**

| Country | Size of company | Market capitalisation | Size of a 5% decrease in market capitalisation | Size of a 10% decrease in market capitalisation |
|---|---|---|---|---|
| **France** | Largest | 128,519 | 6,426 | 12,852 |
| | Median | 19,722 | 986 | 1,972 |
| | Smallest | 3,407 | 170 | 341 |
| **Finland** | Largest | 68,617 | 3,431 | 6,862 |
| | Median | 3,096 | 155 | 310 |
| | Smallest | 919 | 46 | 92 |
| **Hungary** | Largest | 9,096 | 455 | 910 |
| | Median | 788 | 39 | 79 |
| | Smallest | 30 | 1.5 | 3.0 |
| **Ireland** | Largest | 17,668 | 883 | 1,767 |
| | Median | 2,434 | 122 | 243 |
| | Smallest | 777 | 39 | 78 |
| **Italy** | Largest | 96,289 | 4,814 | 9,629 |
| | Median | 7,769 | 388 | 777 |
| | Smallest | 1,229 | 61 | 123 |
| **Lithuania** | Largest | 1,598 | 80 | 160 |
| | Median | 124 | 6.2 | 12 |
| | Smallest | 59 | 3.0 | 5.9 |
| **Luxembourg** | Largest | 11,300 | 565 | 1130 |
| | Median | 418 | 21 | 42 |
| | Smallest | 171 | 9 | 17 |
| **Latvia** | Largest | 791 | 39.5 | 79.1 |
| | Median | 300 | 15 | 30 |
| | Smallest | 84 | 4.2 | 8.4 |
| **Malta** | Largest | 462 | 23.1 | 46.2 |
| | Median | 75 | 3.7 | 7.5 |
| | Smallest | 6.8 | 0.3 | 0.7 |
| **The Netherlands** | Largest | 180,871 | 9,044 | 18,087 |
| | Median | 11,259 | 563 | 1,126 |
| | Smallest | 682 | 34 | 68 |

**Market capitalisation of companies in main index of national stock exchange in EU-25 – largest company, median company and smallest company by capitalisation in index, million of €**

| Country | Size of company | Market capitalisation | Size of a 5% decrease in market capitalisation | Size of a 10% decrease in market capitalisation |
|---|---|---|---|---|
| **Poland** | Largest | 1,607 | 80 | 161 |
| | Median | 367 | 18 | 37 |
| | Smallest | 335 | 17 | 33 |
| **Portugal** | Largest | 11,628 | 581 | 1,163 |
| | Median | 1,695 | 85 | 170 |
| | Smallest | 22 | 1.1 | 2.2 |
| **Sweden** | Largest | 80,721 | 4,036 | 8,072 |
| | Median | 10,438 | 522 | 1,044 |
| | Smallest | 1,667 | 83 | 167 |
| **Slovenia** | Largest | 2,274 | 114 | 227 |
| | Median | 214 | 11 | 21 |
| | Smallest | 68 | 3.4 | 6.8 |
| **Slovakia** | Largest | 1,957 | 98 | 196 |
| | Median | 189 | 9 | 19 |
| | Smallest | 6.1 | 0.3 | 0.6 |
| **UK** | Largest | 183,935 | 9,197 | 18,394 |
| | Median | 9,044 | 452 | 904 |
| | Smallest | 4,138 | 207 | 414 |

**Note: Data as of 17 September 2006.**

**Source: Bloomberg Professional Services and websites of national stock exchanges**

| Fifty largest listed firms by turnover, 2004 (€million) | | | | |
|---|---|---|---|---|
| **Country** | **Size of Company** | **Total Turnover** | **5% of Total Turnover** | **10% of Total Turnover** |
| **Austria*** | Largest | 9,880 | 494 | 988 |
| | Median | 404 | 20 | 40 |
| | Smallest | 4.6 | 0.2 | 0.5 |
| **Belgium** | Largest | 40,739 | 2,037 | 4,074 |
| | Median | 854 | 43 | 85 |
| | Smallest | 208 | 10 | 21 |
| **Cyprus** | Largest | 1,203 | 60 | 120 |
| | Median | 412 | 20 | 41 |
| | Smallest | 19 | 0.9 | 1.9 |
| **Czech Republic*** | Largest | 4,088 | 204 | 409 |
| | Median | 189 | 9.5 | 18 |
| | Smallest | 0.9 | 0 | 0 |
| **Germany** | Largest | 142,954 | 7,148 | 14,295 |
| | Median | 7,699 | 385 | 770 |
| | Smallest | 2,443 | 122 | 244 |
| **Denmark** | Largest | 43,570 | 2,179 | 4,357 |
| | Median | 3,379 | 169 | 338 |
| | Smallest | 814 | 41 | 81 |
| **Estonia*** | Largest | 163 | 8 | 16 |
| | Median | 34 | 1.7 | 3.4 |
| | Smallest | 0 | 0 | 0 |
| **Greece** | Largest | 4,538 | 227 | 454 |
| | Median | 447 | 22 | 45 |
| | Smallest | 161 | 8.1 | 16 |
| **Spain** | Largest | 41,689 | 2,084 | 4,169 |
| | Median | 1,734 | 87 | 173 |
| | Smallest | 537 | 27 | 54 |
| **France** | Largest | 122,700 | 6,135 | 12,270 |
| | Median | 15,669 | 783 | 1,567 |
| | Smallest | 6,172 | 309 | 617 |
| **Finland** | Largest | 29,610 | 1,481 | 2,961 |
| | Median | 1,727 | 86 | 173 |
| | Smallest | 386 | 19 | 39 |
| **Hungary** | Largest | 7,784 | 389 | 778 |
| | Median | 11 | 1 | 1 |
| | Smallest | 1.1 | 0.1 | 0.1 |
| **Ireland** | Largest | 30,814 | 1,541 | 3,081 |

| Fifty largest listed firms by turnover, 2004 (€million) | | | | |
|---|---|---|---|---|
| **Country** | **Size of Company** | **Total Turnover** | **5% of Total Turnover** | **10% of Total Turnover** |
| | Median | 472 | 24 | 47 |
| | Smallest | 10 | 0 | 1 |
| **Italy** | Largest | 54,316 | 2,716 | 5,432 |
| | Median | 4,306 | 215 | 431 |
| | Smallest | 1,686 | 84 | 169 |
| **Lithuania*** | Largest | 2,202 | 110 | 220 |
| | Median | 33 | 1.7 | 3 |
| | Smallest | 2 | 0.1 | 0.2 |
| **Luxembourg*** | Largest | 60,717 | 3,036 | 6,072 |
| | Median | 1 | 0 | 0.1 |
| | Smallest | 4 | 0.2 | 0 |
| **Latvia*** | Largest | 178 | 8.9 | 17.8 |
| | Median | 9 | 0 | 1 |
| | Smallest | 0 | 0 | 0 |
| **Malta*** | Largest | 126 | 6.3 | 12 |
| | Median | 91 | 4.5 | 9.1 |
| | Smallest | 3 | 0.1 | 0.3 |
| **The Netherlands** | | 67,814 | 3,391 | 6,781 |
| | Median | 3,475 | 174 | 348 |
| | Smallest | 1,005 | 50 | 100 |
| **Poland** | Largest | 10,091 | 505 | 1,009 |
| | Median | 320 | 16 | 32 |
| | Smallest | 144 | 7 | 14 |
| **Portugal** | Largest | 23,881 | 1,194 | 2,388 |
| | Median | 515 | 26 | 51 |
| | Smallest | 8 | 0.4 | 0.8 |
| **Sweden** | Largest | 42,281 | 2,114 | 4,228 |
| | Median | 3,708 | 185 | 371 |
| | Smallest | 895 | 45 | 89 |
| **Slovenia*** | Largest | 1,602 | 80 | 160 |
| | Median | 172 | 9 | 17 |
| | Smallest | 4 | 0.2 | 0.4 |
| **Slovakia*** | Largest | 7,784 | 389 | 778 |
| | Median | 248 | 12 | 25 |
| | Smallest | 0.4 | 0 | 0 |
| **UK** | Largest | 216,304 | 10,815 | 21,630 |
| | Median | 15,268 | 763 | 1,527 |
| | Smallest | 7,487 | 374 | 749 |

**Note: * = Countries in which there are less than 50 companies listed on the main market of the stock exchange.**

**Source: Amadeus, annual reports of individual companies and LE calculations**

## Annex 3

The following tables are based on a range of concentration measures:

First, the market share of:

- the largest audit firm (C1);
- the two largest audit firms (C2);
- the four largest audit firms (C4); and,
- where relevant, the eight largest audit firms (C8).

Second, the estimated Herfindahl-Hirschman index (HHI) which is equal to the sum of the square of the market shares of all audit service providers. As this concentration measure takes account of the market shares of all the suppliers in a given market, it is

a more comprehensive indicator of concentration than the concentration ratios described above and is widely used by competition authorities to assess the structure of a given market. In the U.S. a HHI value of more than 1,800 is viewed as problematic while in the EU, in the context of merger assessment, a HHI between 1,000 and 2,000 is not viewed as problematic if a merger increases the HHI by less than 250 and a HHI of more than 2,000 is viewed as not problematic only if the merger increases the HHI by less than 150 (see Official Journal of the European Union, *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentration between undertakings*, 2004/C 31/03, 2nd May 2004).

**Table 1 Concentration in EU statutory audit markets – companies in main index of main national stock exchange**

| Country | Number of companies | Concentration indices by number of mandates (% except HHI) | | | | |
|---|---|---|---|---|---|---|
| | | C1 | C2 | C4 | C8 | HHI |
| **BE** | 19 | 25 | 50 | 88 | - | 2031 |
| **CZ** | 9 | 40 | 60 | 100 | | 3000 |
| **DK** | 19 | 26 | 48 | 78 | - | 1833 |
| **DE** | 30 | 53 | 87 | 97 | - | 4022 |
| **EE** | 10 | 30 | 50 | 90 | - | 2200 |
| **EL** | 20 | 40 | 60 | 90 | - | 2550 |
| **ES** | 35 | 50 | 80 | 97 | 100 | 4100 |
| **FR** | 40 | 30 | 46 | 73 | 96 | 1818 |
| **IE** | 20 | 45 | 70 | 95 | 100 | 3000 |
| **IT** | 40 | 35 | 60 | 100 | - | 2662 |
| **CY** | 20 | 50 | 85 | 95 | - | 3800 |
| **LV** | 5 | 40 | 80 | - | - | 3600 |
| **LT** | 21 | 29 | 52 | 95 | - | 2340 |
| **LU** | 11 | 31 | 54 | 92 | - | 2307 |
| **HU** | 12 | 64 | 91 | - | - | 4876 |
| **MT** | 14 | 43 | 71 | 100 | - | 3163 |
| **NL** | 23 | 32 | 60 | 100 | - | 2608 |
| **AT** | 22 | 42 | 71 | 83 | - | 2743 |
| **PL** | 20 | 44 | 70 | - | - | 3150 |
| **PT** | 20 | 50 | 65 | 85 | | 3000 |
| **SI** | 15 | 40 | 53 | 73 | - | 2000 |
| **SK** | 5 | 40 | 80 | - | - | 3600 |
| **FI** | 25 | 56 | 80 | - | - | 3984 |
| **SE** | 30 | 34 | 66 | 100 | - | 2792 |
| **UK** | 100 | 43 | 65 | 99 | - | 2912 |

**Source: London Economics calculations using data from Amadeus and annual reports of financial institutions and companies included in the main stock market indices. Oxera (2006) for the UK.**

**Table 2 Concentration in EU statutory audit - all companies listed on regulated national stock exchange.**

| Country | Number of companies** | Concentration indexes by number of mandates (% except for HHI) | | | | | Concentration indexes by revenues audited[1] or fees received | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | C1 | C2 | C4 | C8 | HHI | C1 | C2 | C4 | C8 | HHI |
| **BE** | 135 | 27 | 43 | 70 | 84 | 1431 | 48 | 69 | 96 | 97 | 3119 |
| **CZ** | 36 | 29 | 50 | 65 | 82 | 1540 | 56 | 76 | 94 | 99 | 3754 |
| **DK** | 175 | 21 | 40 | 68 | 86 | 1314 | 30 | 45 | 77 | 98 | 1824 |
| **DE*** | 541 | 19 | 36 | 55 | 66 | 918 | 57 | 82 | 92 | 96 | 3976 |
| **EE** | 16 | 33 | 60 | 93 | - | 2444 | 34 | 61 | 94 | - | 2499 |
| **EL** | 292 | 34 | 48 | 66 | 84 | 1600 | 31 | 51 | 73 | 97 | 1784 |
| **ES** | 115 | 44 | 70 | 91 | 97 | 2854 | 78 | 92 | 99 | 100 | 6334 |
| **FR** | 489 | 15 | 24 | 42 | 58 | 551 | 28 | 45 | 71 | 90 | 1577 |
| **IE** | 65 | 25 | 51 | 80 | 89 | 1756 | 41 | 81 | 99 | 100 | 3488 |
| **IT** | 276 | 27 | 53 | 88 | 93 | 2053 | 34 | 62 | 100 | - | 2651 |
| **CY** | 141 | 30 | 57 | 76 | 87 | 1867 | 30 | 59 | 90 | 95 | 2465 |
| **LV** | 40 | 13 | 20 | 30 | 50 | 500 | 30 | 53 | 81 | 93 | 1894 |
| **LT** | 43 | 23 | 44 | 79 | 93 | 1644 | 68 | 77 | 93 | 100 | 4802 |
| **LU** | 27 | 30 | 48 | 74 | - | 1604 | 46 | 79 | 96 | - | 3389 |
| **HU** | 36 | 25 | 44 | 64 | 75 | 1280 | 60 | 80 | 99 | 99 | 4247 |
| **MT** | 14 | 43 | 71 | 100 | - | 3163 | 63 | 99 | 100 | - | 5328 |
| **NL** | 140 | 25 | 50 | 89 | 96 | 2147 | 29 | 57 | 100 | - | 2551 |
| **AT** | 44 | 40 | 58 | 78 | 91 | 2212 | 43 | 78 | 93 | 96 | 3198 |
| **PL** | 236 | 15 | 23 | 41 | 61 | 597 | 56 | 69 | 83 | 94 | 3417 |
| **PT** | 52 | 42 | 62 | 73 | 83 | 2300 | 64 | 81 | 93 | 99 | 4553 |
| **SI** | 15 | 40 | 53 | 73 | - | 2000 | 49 | 89 | 100 | 100 | 4073 |
| **SK** | 7 | 29 | 57 | 100 | - | 2040 | 95 | 98 | 100 | - | 8998 |
| **FI** | 148 | 43 | 70 | 94 | 97 | 3038 | 74 | 94 | 100 | - | 5893 |
| **SE** | 272 | 30 | 56 | 93 | 99 | 2370 | 37 | 67 | 99 | 100 | 2766 |
| **UK** | 316 | 37 | 61 | 98 | 100 | 2654 | 36 | 59 | 100 | - | 2660 |

**Notes: (1) Revenues audited are the gross revenues of companies being audited as reported in the companies' annual reports. *= figures based on fees received by the auditing company in 2005 as reported in the annual reports of the companies. ** = number of companies for which information could be found. UK FTSE 350 only, Germany Frankfurt All Share list only.**

**Source: London Economics calculations using data from Amadeus and annual reports of companies and financial institutions listed on the respective national stock exchange. Oxera (2006) for the UK.**

| Table 3: HHI in EU statutory audit market by size turnover of companies - all companies listed on regulated national stock exchanges- 2004 – countries with and without a cap on auditor liability. | | | | | | |
|---|---|---|---|---|---|---|
| | **Top 20** | **Top 50** | **Top 100** | **Top 150** | **Top 200** | **Top 300** |
| **BE**[2] | 2650 | 2288 | 1843 | - | - | - |
| **CZ** | 2325 | - | - | - | - | - |
| **DK** | 2218 | 1817 | 1492 | - | - | - |
| **DE** | 3325 | 1600 | 1249 | 1046 | 919 | 838 |
| **EE**[3] | 2200 | - | - | - | - | - |
| **EL** | 1750 | 1528 | 1452 | 1587 | 1823 | - |
| **ES** | 5150 | 3568 | 3003 | - | - | - |
| **FR** | 1951 | 1480 | 1252 | 1082 | 844 | 669 |
| **IE** | 3400 | 2288 | - | - | - | - |
| **IT** | 2650 | 2640 | 2614 | 2535 | 2462 | - |
| **CY** | 2250 | 2016 | 1625 | - | - | - |
| **LV** | 1000 | - | - | - | - | - |
| **LT** | 1950 | - | - | - | - | - |
| **LU** | 2100 | - | - | - | - | - |
| **HU** | 2575 | - | - | - | - | - |
| **MT**[4] | 3163 | - | - | - | - | |
| **NL** | 2925 | 2971 | 2488 | - | - | - |
| **AT** | 3100 | - | - | - | - | - |
| **PL** | 2400 | 1576 | 1084 | 848 | - | - |
| **PT** | 3225 | 2080 | - | - | - | - |
| **SI**[5] | 2977 | - | - | - | - | - |
| **SK** | - | - | - | - | - | - |
| **FI** | 5550 | 4104 | 3328 | - | - | - |
| **SE** | 3150 | 2556 | 2647 | 2628 | 2202 | - |
| **UK** | 2850 | 2776 | 2854 | 2882 | 2798 | 2659 |

**Notes: (1) HHI based on number of mandates. (2) Since December 2005, Belgium has a cap on auditor liability. But, as the data refer to market concentration in 2004 , Belgium is not shown as having a cap in the table; (3) Estonia = 10 companies, (4) Malta = 14 companies, (5) Slovenia = only 15 companies are listed on the stock exchange.**

**Source: London Economics calculations using data from Amadeus and annual reports of companies.**

## Annex 4

## 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 |

121 Under contractual law, a statutory auditor is liable for a breach of his duties under a contract (e.g. of the audit contract concluded between the statutory auditor and the audited company).

122 Under tort law, a statutory auditor is liable for a breach of his duties under statutory law of a certain jurisdiction (e.g. of the professional standards set under Community or national law).

## Annex 5

## Insurance obligations for auditors in EU-25 Member States

These tables show whether the legal entity or the individual auditor is obliged to maintain the legal obligation of insurance in case the statutory auditor is the audit firm.

| COUNTRY | LEGAL OBLIGATION OF INSURANCE | | |
|---|---|---|---|
| | LEGAL ENTITY | INDIVIDUAL AUDITOR | BOTH |
| AUSTRIA | x | -- | -- |
| BELGIUM | -- | -- | x |
| CYPRUS | -- | -- | x |
| CZECH REPUBLIC | -- | -- | x |
| DENMARK | -- | x | -- |
| ESTONIA | -- | x | -- |
| FINLAND | -- | -- | -- |
| FRANCE | -- | -- | x |
| GERMANY | x<br><br>(for auditors practising in a public limited liability company or a limited liability company) | x<br><br>(for auditors practicing in a civil law association) | -- |
| GREECE | -- | -- | x |
| HUNGARY | -- | x<br><br>(the insurance of the firm can also be accepted under certain circumstances) | -- |
| IRELAND | x | -- | -- |
| ITALY | x | -- | -- |
| LATVIA | x | -- | -- |
| LITHUANIA | x | -- | -- |
| LUXEMBOURG | -- | -- | -- |
| MALTA | -- | -- | x |
| NETHERLANDS | x | -- | -- |

| COUNTRY | LEGAL OBLIGATION OF INSURANCE | | |
|---|---|---|---|
| | LEGAL ENTITY | INDIVIDUAL AUDITOR | BOTH |
| POLAND | -- | -- | x<br><br>(but the obligation of insurance does not rest with an auditor who delivers audit services on behalf of an audit firm, not acting in his own name and on his account) |
| PORTUGAL | -- | x | -- |
| SLOVAK REPUBLIC | -- | -- | x<br><br>(but there is no obligation for the individual auditor if he delivers audit services on behalf of an audit company) |
| SLOVENIA | x | -- | -- |
| SPAIN | x | -- | -- |
| SWEDEN | -- | -- | x |
| UNITED KINGDOM | x | -- | -- |

**See: Thieffry & Associates: "A study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union", Report to the European Commission. Update by DG Internal Market and Services in January 2007**

## Annex 6

## Liability caps

Auditor's liability is currently capped in five Member States. Liability caps do not apply in case of intentional conduct of the auditor (see table below).

| COUNTRY | CALCULATION | AMOUNT OF THE CAP | CONDITIONS |
|---|---|---|---|
| AUSTRIA | Per audit (audits of group accounts and individual accounts being counted separately) | €2 million : statutory audit of a small or medium sized company (§ 221 (2) HGB)<br><br>€4 million : statutory audit of a large company (§ 221 (3) HGB)<br><br>€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<br><br>€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<br><br>Special amounts apply to banks and insurance companies | Scale not applicable to intentional conduct; applicable to claims by the audited company and claims of third parties |
| BELGIUM | Per mandate | €3 million (unlisted company)<br><br>€12 million (listed company) | No cap in case of fraud or intentional conduct |
| GERMANY | Per audit or per group audit | €1 million (unlisted company)<br><br>€4 million (listed company) | 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 the cap |