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EXECUTIVE SUMMARY

1. INTRODUCTION

European legislation requires a company's financial statements to be audited ("statutory audits"). Auditors should provide an independent opinion about a company's financial position, as reflected in the financial statements. Auditors, therefore, play an important role. By promoting confidence of investors, they contribute to the stability of financial markets.

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. This Impact Assessment considers whether such liability risks threaten the sustainability and competitiveness of the current statutory audit market structure.

The Impact Assessment finds that within the EU, liability risks for audit firms are significant. However, the insurance capacity to cope with such risk exposure is not available today.

The Impact Assessment concludes that in the light of the current audit market structure, these liability risks combined with insufficient insurance cover may deter auditors from providing audit services for listed companies. The Commission services conclude that if structural obstacles (liability risks/lack of insurance) are not addressed, mid-tier audit firms are unlikely to become a major alternative to the Big 4 audit networks on European capital markets.

The Impact Assessment presents certain options for addressing the situation at EU level. The chosen option of the Commission encourages Member States to introduce a limitation on liability into their national liability regimes. Action, implemented by way of a recommendation, would only fix the objective of having a limitation. The objective could be achieved by introducing high-level principles to ensure that the limitation is fair for auditors, the audited companies and other stakeholders. Member States would have the choice between measures that currently exist such as a cap or proportionate liability, a mixture of both or other methods as they see fit including contractual arrangements. However, limitation of liability would not apply in the case of wilful misconduct on the part of the auditor.

2. PROCEDURAL ISSUES AND PUBLIC CONSULTATION

Article 31 of the 2006 Directive on Statutory Audit invites the Commission to examine the impact of the current national liability rules for the carrying out statutory audits on European capital markets and the insurance conditions for statutory auditors and audit firms including an objective analysis of the limitations of financial liability. Where appropriate, the Commission may present recommendations to the Member States.

In January 2007, the Commission Services launched a public consultation on the need to reform auditors' liability in Member States and presented four options for a possible initiative. The consultation was based on the results of a study[1] and the debates of an expert group (Liability Forum). A slight majority of respondents supported a Commission initiative but none of the options found a clear-cut preference.

3. PROBLEM DEFINITION

The supply of audit services is based on two premises: 1) companies should be able to choose their auditors according to their needs and at reasonable cost and 2) investors should be able to rely on an independent audit opinion based on a high quality audit before investing in a company. It is in the public interest to ensure a sustainable audit function and accordingly a competitive market for audit firms.

A market failure on the supply side

Companies listed on European capital markets demand audit services on an international scale as they have subsidiaries in many jurisdictions. Companies are often restricted to choosing from four networks (the Big 4[2]) capable of meeting the demand for international audit services for listed companies. In some industries (e.g. financial services), and given the independence rules preventing from selecting the same network for audit and non audit services, the choice is even more limited.

The Big 4 hold together a market share of more than 80% for listed companies across Member States. Compared to the situation five years ago, there is an increasing risk that for various reasons (such as loss of reputation, catastrophic claim, indictment or removal from a register in a major country harming the brand of the global network) one of these networks could disappear[3].

The prospect that a new major player on the supply side might step in are very low. It takes time and resources to build the necessary large international network. Such networks are not multinational companies but rather fragmented structures of independent local audit firms. This is because local audit firms refuse to share unpredictable liability risks of other audit firms in other jurisdictions. New players would have to develop such integrated network structures able to compete with the Big 4. However, significant investments cannot reasonably be expected given the current liability risks.

Risk exposure of the audit profession

As an auditor is jointly and severally liable with the audited company, plaintiffs are tempted to claim against the auditor in the event of any corporate malpractice. In the case of bankruptcy of a company, the auditor is seen as the actor having financial resources to compensate the damage. Thus, audit firms risk being treated as having

[1] London Economics: "Study on the Economic Impact of Auditors' Liability Regimes", September 2006.
[2] PWC, KPMG, Deloitte, Ernst & Young.
[3] This risk has not decreased after the demise of Arthur Andersen, the fifth major network in 2002.

"deep pockets" even if the damage arose due to corporate wrongdoing which an auditor did not commit but failed to detect.

In October 2005, EU audit firms from the six biggest audit networks[4] indicated that they were dealing with 28 outstanding matters that could give rise to individual claims each in excess of € 75 m; of these claims, 16 are each above € 160 m and in five cases, the individual amounts being demanded exceed € 750 m. Six of the 28 outstanding matters fall under US jurisdiction. The remaining matters originate from cases within the EU.

The most important liability risks are typically international, where the audit involves a listed company with subsidiaries in many jurisdictions and investors investing in many jurisdictions at the same time. Managing different liability regimes at international level is costly. Therefore, such differences also represent a barrier to the cross-border integration of networks of audit firms.

Lack of insurance capacity

The current level of commercial insurance often covers less than 5% of the larger claims. For the remaining, the Big 4 operate with their own "captive" insurance companies, which pool premiums of audit firms in the same network and may, to a limited extent, cover a few major compensation claims. Access to outside insurance for firms auditing listed companies has fallen sharply over the years. From 1981 to 1992, there were only two years during which underwriting professional indemnity insurance for auditors in the world (excluding the U.S.), was profitable. The commercial insurance market, having sustained losses in excess of € 2 billion up until 1992, decided to no longer offer full professional indemnity insurance cover in the international audit market.

The situation did not change in the meantime. The lack of predictability of future claims – in terms of both probability and magnitude – makes it difficult to effectively assess the risk that would be assumed by insurance companies. Over the period 1981 to 2003, the average individual cost of a claim against an EU firm was € 3.9 million. However, total costs for liability claims have fluctuated widely in this period, reaching a peak of almost € 400 million in 1991. Furthermore, the small number of major auditing networks (Big 4) severely limits the possibility for diversifying risks across a wider range of policyholders.

4. OBJECTIVES

The general objectives for any policy action are:

- Reduce the risk to capital markets that statutory auditors might no longer be available to audit listed companies; and
- Encourage more auditors to audit listed companies.

To achieve these general objectives, the following specific objectives should be met:

[4] The Big 4, Grant Thornton and BDO

- Achieve fairer liability risk exposure for statutory auditors;
- Facilitate access to professional indemnity insurance for statutory auditors;
- Encourage investments enabling smaller audit firms to build integrated networks; and
- Reduce differences in liability regimes across the EU.

5. POLICY OPTIONS

Limitation of liability would not apply in the case of wilful misconduct on the part of the auditor.

Against this background, the following options are examined:

- **Option 1**: no EU action.
- **Option 2:** require investors or companies to pay for insuring auditors' liability risks. However, the volatility of liability risks would render it difficult to implement such option. Investors or companies would need to pay very high insurance costs. This option would also cause moral hazards within the audit profession as auditors will not have to pay for liability risks.
- **Option 3:** limit the risk exposure for auditors by "carving-out" certain risky tasks from the audit activity under international standards (“safe harbour”). Compared to option 2, this option causes similar difficulties as auditors would strive to work within the boundaries of any such "safe harbour".
- **Option 4a:** harmonise liability regimes on the basis of a cap at Member States level. Such harmonisation would be most efficiently achieved by a directive.
- **Option 4b:** harmonise liability regimes on the basis of proportionate liability. Under proportionate liability, audit firms would be only liable to the extent of their contribution to the damage caused. Such harmonisation would be also most efficiently achieved by a directive.
- **Option 4c:** fixes the objective of a limitation of liability but not the precise method of achieving any such limitation. Instead, it would be left to Member States to define implementation thus allowing for convergence over time. Both a directive and a recommendation might be appropriate for this option.

Options 4a, 4b and 4c appear to address the objectives and are therefore compared to Option 1 "No action".

6. ASSESSMENT OF IMPACTS

No EU action at the EU level (Option 1)

Responding to the demands of the companies needs time and resources. New market players would have to undertake significant investments in this regard. If structural obstacles (liability risks/lack of insurance) are not addressed at international level, mid-tier audit firms are unlikely to become a major alternative to the Big 4 audit networks on European capital markets.

It is also unlikely that, in the absence of a signal from the EU, the majority of Member States would move towards limiting liability. So far, only 7 out of 27 Member States have addressed this issue at their domestic level. There is a lack of recognition in the EU that liability risks are a problem in the international audit market. The US introduced proportionate liability in 1995 at federal level; in the last two years, several reports by stakeholders discussed the need for capping liability in the US.

Introducing a liability cap by a Directive (Option 4a)

A liability cap would make liability risk exposure more predictable. A cap would also improve the insurance coverage for auditors, as the magnitude of potential claims would be limited, facilitating better pricing of risks by insurers. Depending on the level of the cap, lowering liability risks could encourage investment into audit firms wishing to enter the international audit market. The differences in liability regimes across the EU would also be reduced.

Introducing proportionate liability by a Directive (Option 4b)

This option would contribute to achieving a fairer liability risk exposure for auditors, as auditors' liability would be defined in proportion to their actual level of responsibility. Auditors would no longer be jointly and severally liable with companies. However, proportionate liability might not be enough to protect auditors against excessive claims, since it does not limit absolutely the magnitude of such claims. Therefore, the insurability of audit firms would not improve as much as in the case of a liability caps. This option would eliminate differences between liability regimes across the EU.

Promoting convergence of liability limitations in Member States (option 4c)

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 national circumstances. It would not fully remove the differences of liability regimes in the EU. But it would at least achieve a more level playing-field for audit firms. The impacts of this option would be obviously stronger if a recommendation were to be implemented by all Member States or if this option were introduced via a directive.

Impacts on Audit Quality of options 4a, 4b and 4c

Any Commission initiative would not apply in the case of an auditor's wilful misconduct, for example, collusion with management in corporate fraud. Opponents to any reform also argue that auditors would act in a more negligent manner and audit quality would be affected more if auditors' liability were limited, particularly by the introduction of a liability cap. However, experience in countries where a cap exists (e.g. Germany, Austria and Belgium) shows no such adverse effects on audit quality. Moreover, the independent public oversight bodies (to be established in all Member States under the 2006 Directive on Statutory Audit), will in future play a pivotal role in maintaining audit quality. These bodies should carry out regular independent inspections in audit firms.

Other possible up- and down-sides for stakeholders outside audit firms

Introducing a liability limitation in the EU would have several positive impacts; particularly companies should have a wider choice beyond the current Big 4. Widening the choice has become more urgent as there are risks that one of the current major networks disappears.

However, different stakeholders are also concerned about possible downsides:

Companies are concerned about the impact on the liability of directors and company officers. However, any liability risk of directors and officers (D&O) can, in contrast to the risks faced by statutory auditors, be more widely diversified amongst many D&O policy holders and can therefore be insured.

Another concern is that third parties (in particular investors) might not be compensated for their full loss. Nevertheless, this is already the case as compensation claims 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 plaintiffs would not expect unlimited compensation. Moreover, the limitation chosen by the Member States should ensure that the damaged parties are fairly compensated.

Positive impacts mainly for the Big 4 ?

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

Other impacts

An EU-wide liability limitation would only address parts of the risk exposure to which auditors are also exposed in other parts of the world (particularly with regard to the US). However, it would at least address the risks coming from European capital markets. A liability limitation should have limited administrative costs.

7. COMPARING THE OPTIONS

Limiting liability would facilitate both the access to professional indemnity insurance for auditors and investments enabling audit firms to forge more integrated networks. Risk exposure would become fairer compared to the status quo. However, this would require a choice between options 4a and 4b. A cap could give rise to the concern that an auditor would not have to compensate beyond a fixed amount though the degree of fault would suggest that he should in principle do so. Investors might therefore fear that a cap might negatively affect the quality of the audits. On the other hand, as a way of facilitating access to insurance and limiting risks for auditors, proportionate liability might, however, be viewed as less efficient than a cap.

There is no common view on which option to favour. At present, only 7 out of 27 Member States have limited liability. Of these, some Member States choose a cap whilst others proportionate liability. The public consultation of the Commission confirmed this divergence in approach. Option 4c acknowledges this and offers considerable advantages compared to a scenario where the Commission takes no action. A directive for implementing option 4c would not be acceptable to Member States at this stage. In this new area, a recommendation is therefore preferable to start with. Not all Member States might implement it immediately. However, the more Member States follow, the more benefits will accrue. Some might be a pacesetter for others, convergence across the EU might happen as well.

8. CONCLUSION

In conclusion, a principles-based short recommendation (option 4c) appears to be the appropriate solution to address the general and the specific objectives. The Commission would monitor and evaluate the impacts of the recommendation.