THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

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European Commission
DG Internal Market and Services
Unit-F4 – Auditing/Liability
B-1049 Brussels
Belgium

Submitted by email to:
Markt-f4@ec.europa.ec

Dear Sir

EUROPEAN AUDITOR LIABILITY REFORM

The Institute of Chartered Accountants in England and Wales ('the Institute') is writing in response to the European Commission's Staff Working Paper: '*Consultation on Auditors' liability and its impact on the European capital markets'*.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

We set out below our comments on the overall case for reform and then a number of observations on the four potential ways forward suggested in the European Commission Staff. Working Paper.

If you require further information, please do not hesitate to contact Martin Manuzi, Director of the ICAEW European Office, Tony Bromell, Head of Accountancy Markets and Ethics, or myself.

Yours faithfully

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Overall case for reform

The Institute welcomes the consultation and indeed the work that has been carried out leading up to it, as it has consistently argued that auditor liability reform will enhance audit choice and audit quality. Reform across the European Union is important because of the globalising of capital markets, the increasing litigation culture, increased international perspective to audit work and it is also in the interests of the Single Market. Consequently, the Institute strongly encourages the European Commission to publish, as referred to in the Statutory Audit Directive (2006/43), a Recommendation to Members States on the need for auditor liability reform in all EU jurisdictions.

At present the joint and several liability regime in operation in many Member States means that auditors not only have to bear the consequences of their own actions but those of others who are also responsible but do not have funds. It cannot be economically efficient or equitable, for a market to operate on the expectation that all financial deficiencies will be compensated by the auditors.

We note that the London Economics study published by the Commission in Autumn 2006 was also supportive of liability reform as, inter alia, it reduced the risk of the failure of a major audit firm with potential consequences for the wider international audit network. We note particularly the following key points made in the study:

- The international market for statutory audits of large and very large companies is highly concentrated, largely as a result of market forces, and there is a limited likelihood of new entrants into this market in the coming years.
- The level of auditor liability insurance available for higher limits has fallen sharply in recent years and there are limited other funds available to meet claims. Accordingly, large claims put at risk firms and potentially an entire network.
- The failure of a network could lead to difficult consequences for the wider economy like a significant reduction in large company statutory audit capacity pos sibly creating serious problems for companies whose financial statements need to be audited.

Our own analysis of the position in the United Kingdom is that the level of concentration does present issues of lack of choice, particularly for large specialised businesses. A further concentration as a result of a failure of one of the large networks would significantly exacerbate this. The remaining largest networks would be constrained both by conflict-of-interest issues and their appetite for audit risk in the aftermath of the loss of one of the Big Four. The possibility in this situation that some companies would not be able to find an auditor is as real as it is serious for the markets.

Another key point in favour of liability reform is the impact on audit quality. Contrary to a common perception, there is no evidence that liability reform has a negative impact on quality. On the contrary, maintaining unlimited liability in an increasingly litigious environment would encourage defensive auditing. There are also longer-term quality issues which need to be considered in relation to human resources. With liability reform the audit profession will be better positioned to continue to attract many of our brightest and most talented young people to join, train and remain in a profession that is not at a comparative disadvantage to other sectors in terms of economic stability and security and personal risk . The quality of audit is dependent in large part on the ability of audit firms to maintain the quality of new professional recruits and, having trained them, keeping these skilled and highly employable professionals within the audit sector. Demand for talented young people from the other professions, commerce and the public sector is and will continue to be very strong. While today the profession remains attractive to graduates, there is some evidence that a long term career as an auditor is becoming less attractive. We must act now before a serious problem develops, by which time significant long term damage will have been done.

Introductory comment on specific options being consulted on:

As noted above, we believe that liability reform in all European Union jurisdictions is vital in view of the increased international perspective to audit work and is advantageous in terms of the potential benefits of the single European market. It is also important in relation to the operation of audit networks which, as noted in the European Commission's Staff Working Paper, is a subject requiring further clarification. However, in agreement with the conclusions in the London Economics study, we recognise that the differing legal regimes across Europe mean that different solutions are likely to be most appropriate in each country, at least for the time being. We therefore do not comment specifically on what might or might not be appropriate in different countries but set out below some issues for consideration in respect of the four proposals set out in the consultation document.

Single monetary cap at European Union level
Question 1: Do you agree with the analysis of the option of fixing a single monetary cap at EU level?

We do not believe that a single monetary cap at European Union level, which we interpret to mean a fixed monetary cap to be applied across all EU jurisdictions, is a practicable proposition at least for the time being given the variable size and composition of European capital markets ..

We have not favoured a fixed monetary cap that is unrelated to the size of the entity being audited in the UK, as the level of such a cap is difficult to set: if set too low, they would allow auditors unreasonably to escape the consequences of their own actions and, if set too high, they will benefit only those carrying out large audits and have no beneficial effect on competition just below that level (where firms that could ultimately compete at the highest level might be expected to operate). We note that such limits exist at a national level in a number of other member states, which have clearly found them to be an appropriate means of limitation.

Cap based on market capitalisation of audited company
Question 2: Would a cap based on the size of the listed company, as measured by its market capitalisation be appropriate?

The concept of a market cap linked in some manner to the size of the entity being audited does remove the difficulties noted above and, if given a basis in statute and set at appropriate levels, addresses the problem of a 'catastrophe claim'. It also has the advantages that it does not distinguish between sizes of audit firm and applies equally across all sizes of audit market,

However, we believe that there are practical problems with seeking to link the cap to market capitalisation:
- such a formulation could not be applied to the audits of unlisted companies or of public interest entities that are other types of organisation, as there is no clear indicator of market capitalisation;
- even where there is a readily available market capitalisation, this can vary over short spaces of time as a result of a whole set of market and external economic factors, resulting in any cap varying similarly.

There are other measures of size, though, which could be applied if this option is to be taken forward, which overcome the above difficulties. An example is the option considered in the next section.

Cap based on a multiple of audit fees
Question 3: Would a cap based on the audit fees charged to the company be appropriate?

A cap based on a multiple of audit fees would be a reasonable proxy for the size and risk profile of the entity being audited. It also does not suffer from the practical problems referred to above in relation to market capitalisation as there will always be an audit fee to base it on and more closely relates to the risk profile of the company than a limit set by reference to the size of the audited entity. We are aware that in some member states there is no disclosure of audit fees but we strongly believe that there would need to be transparency in any form of liability limitation and there would therefore need to be disclosure of the limitation in some form (possibly in the audited financial report).

Proportionate liability
Question 4: Do you agree with the analysis of the option of introduction of the principle of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?

The Institute supported proportionate liability reform in the UK as we believe it to give the most equitable result: auditors continue to be responsible for the consequences of their own actions, but not those of others.

However, the effectiveness of proportionality does depend on relatively robust legal protection against liability to third parties, particularly if implemented by the relatively straightforward means of contractual agreement. This is available in the UK but not available in all countries in the EU. In addition, though a clear and helpful move in the right direction, the effectiveness of proportionality is confined in that it does not directly address the issue of a ‘catastrophe claim’., While we would therefore like to see proportionate liability form part of the reform package where possible at EU Member State level, proportionality on its own is not a complete solution to the risk of a catastrophic claim.