THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND AND WALES

14 March 2008

Our ref: ICAEW Rep 26/08

Chris Hodge
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By email: auditorliability@frc.org.uk

Dear Mr Hodge

DRAFT GUIDANCE ON AUDITOR LIABILITY LIMITATION AGREEMENTS

The Institute of Chartered Accountants in England & Wales is pleased to respond to your request for comments on the *Draft FRC Guidance on Auditor Liability Limitation Agreements* published in December 2007.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 26/08

DRAFT GUIDANCE ON AUDITOR LIABILITY LIMITATION AGREEMENTS

Memorandum of comment submitted in March 2008 by the Institute of Chartered Accountants in England and Wales, in response to the Financial Reporting Council consultation paper: Draft FRC Guidance on Auditor Liability Limitation Agreements

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'Institute' or the 'ICAEW') welcomes the opportunity to comment on the Financial Reporting Council (FRC) consultation paper: *Draft FRC Guidance on Auditor Liability Limitation Agreements* published in December 2007.

WHO WE ARE

2. 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 130,000 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.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

OVERALL COMMENTS

Background

4. As noted in its Company Law Reform White Paper 2005, the Government enacted liability reform on the back of a strong consensus built across the profession, business and investor groups that liability limitation (specifically proportional liability limitation) by contract is in the public interest.

5. This recognises that reform will help to maintain a strong audit market which in turn is one of the necessary ingredients for the maintenance of investor confidence in capital markets.

6. Similar views have been taken internationally: for example Australia has implemented liability reform, the European Commission has expressed itself to be in favour of liability limitation and is considering further action, and the issue is increasingly on the agenda in the U.S.

Need for guidance

7. The Companies Act 2006 permits a limited liability agreement (LLA) to include any form of limitation, subject to an overriding principle that it be fair and reasonable. The wide variety of agreements permissible in law has led to an urgent need for guidance to avoid:

    - uncertainty by directors as to what they should recommend to their shareholders; and

    - uncertainty by shareholders as to what it is reasonable to approve and why.

8. We are grateful that the FRC has taken on the preparation of this guidance and the draft issued for consultation is a very useful document in terms of explaining the law and the procedures to be followed. However, it does not address the key issues raised in paragraph 7 above. It needs to:

    - explain why liability limitation has been stated to be in the interests of the public and shareholders and therefore why recommending LLAs is consistent with the scope of director's duties to shareholders; and

    - highlight the widespread support by investor groups for proportional liability limitation.

RESPONSES TO CONSULTATION PAPER QUESTIONS

Question 1: Does the draft guidance meet the objectives summarised in paragraph 8?

9. By and large the draft guidance meets the objectives that have been set out in the consultation paper. However these objectives are too narrow and do not address the fundamental concerns regarding why LLAs should be recommended to shareholders and what terms they should be able to approve.

10. As noted above, the guidance needs to explain why liability limitation has been stated to be in the interests of the public and shareholders and therefore why recommending LLAs is consistent with the scope of director's duties to shareholders. The government has made public statements as to the rationale for liability limitation so we suggest guidance refer to this: see for example section 3.5 of the Company Law White Paper 2005, attached as an appendix.

11. See also comments on question 2.

Question 2: Should the final guidance identify which methods of setting the auditor's liability are most likely to be acceptable in particular circumstances as proposed in paragraph 10, or simply set out the options as in the draft guidance?

12. We do not believe that setting out the options without further comment is particularly helpful to users as it does not address the fundamental question as to what terms it would be reasonable to approve.

13. While it is probably not appropriate for the FRC to advocate a particular method of limiting liability the guidance should, as suggested in paragraph 10 of the consultation document, record the preferences of key investor representative groups, in particular highlighting the widespread support by those groups for proportional liability limitation.

Question 3: Does Section 3 of the draft guidance identify all of the main factors to be considered when assessing the case for an agreement? If not, what other factors should be considered?

14. See comments above re government rationale for liability agreements and addition of views of investor representative groups.

15. Otherwise we are not aware of any additional matters that should be referred to.

Question 4: The guidance is intended to be equally applicable to public and private companies. Are there different considerations for private companies, and does the guidance address them adequately?

16. We do not think additional points need to be considered.

Question 5: Are there any other procedural issues that should be covered in Sections 4 and 5 of the guidance?

17. No.

Question 6: Do you have any comments on the specimen principal terms, clauses and resolutions and notices in Appendices B to D?

18. The purpose of the guidance is to assist decision-making. Specimen terms are very useful in this respect but it is highly desirable to have only one proportionality draft clause, to avoid confusion. We believe the shorter version 2 is preferable as it is simpler, easier to read, and in our view is unlikely to result in different behaviour by the courts compared to that specified in the longer version 1.

19. Some of the items in the draft LLA clauses seem unnecessary given that these are already principal terms set out by law (e.g. proportionality version 1 items D and E). In addition, item B in proportionality versions 1 and 2 is misleading: this is intended to remove liability limitation where there has been fraud by the auditor, not by the client.

Question 7: Are you aware of any sources of information and advice that should be cross-referenced in the guidance?

20. Statements by investor representative groups could usefully be cross-referenced here.

Extract from Government Company Law Reform Bill White Paper 2005

"3.5 Auditor liability and audit quality

The Government is keen to encourage confidence in the statutory audit and to ensure a strong, competitive and high quality audit market. To help in this, over the course of the past two years the Government has promoted debate to identify further ways by which these goals can be achieved.

In the aftermath of a company failure, those who have suffered losses may look to the auditors as having the "deepest pockets" of all of those they can pursue for compensation. Consequently, the auditor may bear 100% of the compensation even though the auditors' "share" of the blame (when compared to other culpable parties) may be less. Theoretically, this makes audit firms vulnerable to very large claims where they are held to have been negligent in their conduct of an audit. In practice, however, most claims are settled out of court.

In December 2003, the Government launched a public consultation on director and auditor liability. This showed clear support for changes to the law on directors' liability, and appropriate provisions were included in the Companies (Audit Investigations and Community Enterprise) Act 2004. These come into force next month. The responses on auditor liability were more mixed and the Government concluded that it would be inappropriate to permit the capping of auditors' liability to a predetermined amount. However, it invited auditors, their clients and investors to work together to consider other approaches by which liability might be limited, and in parallel to identify ways to improve audit quality and enhance competition. The Government is grateful for the helpful and constructive approach adopted by all contributors.

In the light of that work, the Government is now persuaded of the benefits of change. The reforms will have three key parts – firstly, legislating to allow shareholders to agree limitations to the liability of auditors; secondly, some specific improvements to the quality of the audit process; and, thirdly, the establishment of an on-going process by which further enhancements to quality and competition can be identified and then implemented. The Government sees these three parts making up a balanced package of measures to improve the audit market, and believes it is important that all of these go forward together…"

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