PROPOSALS FOR A NEW AUDIT LIABILITY REGIME IN EUROPE

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ABSTRACT

The past few years have seen a growing trend towards the focus on audit liability. In the UK, the Company Law Reform Bill which became the Companies Act 2006, has removed the previously existing limits on auditor liability and compelled an agreement between the company and the auditor. As well as the UK, audit liability caps also currently exist in Austria, Belgium, Germany, Greece and Slovenia. This paper addresses the four options presented by the European Commission in the reform of the audit liability regime in Europe. It also responds to the proposals put forward by Doralt and others[1] in their response to the European Commission's four options. The paper commences with a background to how increased audit concentration has contributed to increased audit liability measures. It then discusses the significance of the Companies Act 2006, following the leading case of Caparo Industries plc v Dickman and Others. The four options presented by the European Commission for reforming auditors' liability regime are then introduced. In arriving at a preferred choice, the need for a consideration of harmonisation and facilitating greater cooperation between national financial regulators, were contributory factors.

[1] See W Doralt , A Hellgardt, K J Hopt, P C Leyens, M Roth and R Zimmermann 'Auditors' Liability and Its Impact On The European Financial Markets' (2008)

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Up until 1989, there existed "the Big Eight"[3] accountancy firms. At present, there remain only four. Four of the Big Eight accounting firms merged to create two firms in 1989. The four firms consisted of Arthur Young (AY) and Ernst & Whinney (EW), which merged to form Ernst & Young (EY), and Deloitte Haskins & Sells (DHS) and Touche Ross (TR), which merged to form Deloitte & Touche (DT). This resulted to the "Big Six". The merger between Pricewaterhouse and Coopers & Lybrand which resulted in Pricewaterhouse Coopers and the Enron debacle which lead to Arthur Andersen being made dyfunct have resulted in the "the Big Four".Whilst the existence of "the present Big Four"[4] occurred mainly as a result of mergers between these accountancy firms, the demise of Arthur Andersen, its role in the collapse of Enron, and the devastating effects on so many lives, cannot be ignored. Before proceeding with a discussion on Enron, the earlier collapses of BCCI[5] and Barings[6], which also involved major audit firms, will be analysed briefly.

The auditors involved in the BCCI collapse were Ernst & Whinney (EW) and Price Waterhouse (PW).[7] A consolidated action was brought by BCCI (Overseas) Ltd, BCCI Holdings (Luxembourg) SA and BCCI S.A against these auditors. BCCI went into liquidation in 1991 partly as a result of wrongdoing in the operation of the banking activities of its companies. These activities involved fraudulent transactions which occurred on a massive scale, with the result of huge losses. However, these losses had not been disclosed in the relevant accounts of BCCI. The major claim against both EW and Pricewaterhouse was attributable to the fact that audits carried out by these two firms had been undertaken negligently.[8] They also argued that due to this, errors had not been detected or brought to the attention of the relevant board of directors.[9]

BCCI's depositors and creditors had been afforded inadequate protection through the regulatory procedures of the Bank of England. Moreover, the Bank had withheld information from the public for fifteen years before closing BCCI. The Bank of England's decision in April 1990 to allow BCCI transfer not only its headquarters, officers but also records, out of British jurisdiction to Abu Dhabi

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[3] The Big Eight accountancy firms consisted of the eight major international accountancy firms namely, Arthur Young (AY), Ernst & Whinney (EW), Deloitte Haskins & Sells (DHS) ,Touche Ross (TR), Pricewaterhouse, Coopers and Lybrand, Arthur Andersen and KPMG. Also see MW Sullivan, 'The Effect of the Big Eight Accounting Firm Mergers on the Market for Audit Services' (2002) 45 The Journal of Law and Economics 375-399; D Duxbury and others, 'Effects of the PricewaterhouseCoopers Merger on the UK Audit Services Market' (2007) 22 Managerial Auditing Journal 121-138; ER Feldman, 'A Basic Quantification of the Competitive Implications of the Demise of Arthur Andersen' (2006) 29 Review of Industrial Organization 193-212

[4] Namely, PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte & Touche.

[5] Bank of Credit and Commerce International; see also Bank of Credit and Commerce International SA (In Liquidation) v Ali (No.3) [1999] 4 All E.R. 83; [2000] I.C.R. 1354; [1999] I.R.L.R. 508; (1999) 96(30) L.S.G. 28; Times, June 30, 1999

[6] See Barings Plc v Coopers and Lybrand [1997] 1 BCLC 427

[7] Ernst and Whinney and Price Waterhouse had carried out audits during periods of 1985 and 1986. Thereafter, Ernst and Whiney had resigned and carried out no further audits within the BCCI group. Other proceedings were commenced against Pricewaterhouse alone in relation to audits which took place in subsequent years. The plaintiffs had continued trading whilst further frauds and losses continued to occur. It was alleged that had the audits been carried out properly, further losses would have been avoided.

[8] To this day, no evidence exists to demonstrate whether Pricewaterhouse (UK) alerted Pricewaterhouse (US) to the extent of the problems discovered at BCCI. For more information on this, see 'BCCI and its Accountants' <http://www.fas.org/irp/congress/1992_rpt/bcci/10accounta.htm> (last visited 3 June 2008)

[9] For more information on this, see ibid

resulted in grave consequences for world wide investigations relating to BCCI. Furthermore, even though the Bank had been aware of BCCI's fraudulent reputation and that consolidation into a single entity was essential for regulating a bank, in late 1990 and early 1991, the Bank of England agreed with BCCI and its Abu Dhabi owners to a restructure as three separate institutions which were based in London, Abu Dhabi and HongKong. Flawed decisions by US regulators, which enabled BCCI's secret acquisition of US banks resulted in part, from gaps in the regulatory process and also, partly as a result of BCCI's use of well-connected lawyers.

The auditors involved in the Barings case were Deloitte &Touche and Coopers and Lybrand. Barings group had collapsed as a result of losses incurred from fraudulent trading by Nick Leeson. Barings' figures in Singapore had been audited by Deloitte & Touche and Coopers and Lybrand Singapore. For two years those figures had revealed a profit when in actual fact, Nick Leeson had already run up huge losses.

Whilst the collapse of Enron resulted in the demise of Arthur Andersen, the earlier collapses of BCCI, followed by Barings Bank Plc, also involved the present "Big Four" accountancy firms. These collapses also produced devastating effects and one can only arrive at the conclusion that whilst Arthur Andersen paid the price for failing to live up to its role, the other "Big Four" accountancy firms escaped such draconian punishment as a result of the consequences of having two or more of such accountancy firms being made dyfunct, among which include concentration in the audit market. Following the collapse of Arthur Andersen, only the "Big Four" and few medium sized auditing firms are capable of auditing major stock corporations.[10] Regulators are also concerned about having a situation whereby only 3 of the present "Big Four" accounting firms exist, thereby giving rise to increased audit concentration within the industry which could also generate a "too big to fail" moral hazard[11] problem amongst audit firms. The issue of further concentration in the auditing industry has also provided an interesting forum for debates relating to government intervention to bail out any of the Big Four audit firms given the potential consequences of having a Big Three.

The consequences of increased audit concentration within the industry stem from the possibilities of a moral hazard situation whereby auditors not only exercise undue risk, but also where low standard financial reporting is encouraged. Moreover, the neglect of smaller institutions as a result of rescuing large organisations is another consequence of moral hazard.[12] The use of Financial Statement Insurance (FSI), has been proposed as a means of improving the effectiveness of auditing and helping to neutralise moral hazard.

Financial scandals such as that of Enron have resulted in more stringent audit liability measures in the form of higher corporate governance[13] and auditing standards.[14] Whilst audit liability should not be imposed to such extent that it results to defensive auditing[15], external auditors should still be held

[10] See W Doralt and others, 'Auditors' Liability and Its Impact On The European Financial Markets' (2008) 67 Cambridge Law Journal 62

[11] Moral hazard occurs where risks are taken because of the absence of incentives to deter from taking such risks. There are lack of incentives because protection exists to guard against such risks. For example, with deposit insurance protection, depositors do not demand an appropriate risk premium in their interest rates and, the existence of deposit insurance may force banks to hold lower levels of capital. In this case, auditors being well aware of the fact that regulators are keen to avoid further concentration (reduced number of major audit firms)within the audit industry, would tend to be more lax with their responsibilities.

[12] See L Cunningham, 'Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels' (2006) Boston College Law School Faculty Papers 36-38

[13] Corporate governance is defined as "the system by which companies are directed and controlled" (Cadbury Committee)

[14] See W Doralt and others, 'Auditors' Liability and Its Impact On The European Financial Markets' (2008) 67 Cambridge Law Journal 62

[15] Defensive auditing refers to the practice whereby auditors, rather than exercising their professional judgment, resort to excessive application of rules or audit standards as a means of justifying the results of the audit report.

accountable for consequences resulting from negligence on their part. In BCCI, it was held that even though the existence of a duty of care was arguable, the Caparo question had to be addressed. In Caparo, the question concerned to whom a duty of care was owed.

Generally producers of consumables owe a "duty of care" to third parties. However, it was held in *Caparo Industries plc v Dickman and Others*[16] that generally, auditors only owe a duty of care" to the company as a legal person and that they do not owe a "duty of care" to any individual shareholder, creditor, pension scheme members or any other stakeholder.[17] The Company Law Reform Bill which became the Companies Act 2006, has removed the previously existing limits on auditor liability and compelled an agreement between the company and the auditor.[18] Subject to sections 533[19] and 534-536[20], the auditor will not be exempt from liability where he has been negligent, been in a breach or default of duty and other situations which would void his exemption from liability as provided under section 532. In this sense, the Companies Act 2006 has altered the situation which existed under Section 310 of the Companies Act 1985 whereby the liability of auditors was limited to the companies which they audited.[21] A limit to liability which is agreed upon by the auditor is still subject to such as is "fair and reasonable in all circumstances of the case."[22] The reasonableness test to be applied differs from that under the Unfair Contract Terms Act 1977.[23] It remains to be seen how the Companies Act 2006 will develop.

Even though reform has taken place in the UK with the introduction of the Companies Act 2006, and the consequence that auditor liability caps are now a reality in the UK, the question of audit liability protection is still being debated in the US and the EU.[24]

The European Commission has been involved in consultations relating to whether there is a need for a reform of the auditor liability regime.[25] Not only has it presented four options, it also invited stakeholders to submit their opinions by 15 March 2007.[26] The four options presented for reforming auditors' liability are as follows:[27]

- The introduction of a fixed monetary cap at European level, which in the Commission's opinion, might be difficult to achieve.
- The introduction of a cap based on the size of the audited company, as measured by its market capitalisation.
- The introduction of a cap based on a multiple of the audit fees charged by the auditor to its client.
- The introduction by Member States of the principle of proportionate liability, which means that each party (auditor and audited company) is liable only for the portion of loss that corresponds to the party's degree of responsibility.

16 (1990) 1 All ER HL 568

17 See House of Commons Select Treasury Committee 'Further Memorandum Submitted by Professor Prem Sikka 'The Institutionalisation of Audit Failures : Some Observations' p 21

18 Sections 534 – 536 Companies Act 2006

19 Which relates to indemnity for costs of successfully defending proceedings

20 Which relate to liability limitation agreements

21 See < http://www.thelawyer.com/cgi-bin/item.cgi?id=120697&d=122&h=24&f=46> (last visited May 2 2008)

22 ibid

23 ibid ; Another difference is that in considering what is fair and reasonable, the court will take into account circumstances arising after the liability limitation agreement was made. ibid

24 See 'Auditor Liability Caps: Now Available in the UK' http://www.thecorporatecounsel.net/blog/archive/001780.html (last visited 31 May 2008)

25 See < http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/60&format=HTML&aged=0&language=EN&guiLanguage=en>

26 ibid

27 ibid; also see < http://ec.europa.eu/internal_market/auditing/liability/index_en.htm > (last visited 2 May 2008)

This move to provide accountants with some form of liability protection has been instigated by the European Commissioner for Internal Market and Services, Charlie McCreevy. Protection would be extended to the EU's Member States even though the Member States would not be required to enact them.[28] It is yet too early to predict the outcome of such reform proposals. As well as the UK, audit liability caps also currently exist in Austria, Belgium, Germany, Greece and Slovenia.

In relation to the European Commission's options, I would propose a model based on a combination which are variants of the first and third options, namely a combination of a single monetary cap at a European level and a cap based on audit fees[29]. Whilst a cap based on market capitalisation would be rather subjective, adopting a principle of proportionate liability, also involves subjective elements. According to the European Commission, the option relating to proportionate liability would not only consist in courts awarding damages which are in proportion to the auditor's fault, but also in contractual arrangements being negotiated between the company and its auditors and approved by shareholders.[30] In relation to the subjective nature of disproportionate liability, where does one draw a distinction between negligent acts and those acts committed intentionally? Whilst some negligent acts may result in greater losses, is this to imply that such unintentional acts should attract more severe punitive sanctions than intentional ones whose acts incurred less losses? Furthermore, how is one to distinguish between grossly negligent and mere negligent (simple negligent) acts, and how is one to apportion liability for those acts which are merely negligent but which have resulted to greater losses than grossly negligent acts? Do we apportion according to the losses incurred by the company or on the basis of the nature of the act? It seems that a response to these questions would necessitate a consideration and balance of those factors surrounding both the nature of the act, the extent and consequences of the losses incurred. For example, the impact of the loss on third parties and other affected stakeholders. These are issues which would have to be considered in the contractual arrangements being negotiated between the company and its auditors and approved by shareholders.

These variants are introduced as follows:
In relation to the first option, I support a monetary cap at a European level. However, such cap would have to be defined since a fixed figure does not take into consideration the differences which exist in the audit environments of various EU member states. For example, whilst 5 million Euros may be deterrent for audit companies in Italy and Germany (as the market for audit services are not as great as in the UK and the US)[31], it might not produce such a deterrent effect in the US or the UK. In defining what the cap should be, an appropriate determinant would be the revenue[32] generated by the audit firm.

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[28] See K LaCroix, 'Looking at Auditor Liability Caps'< http://www.dandodiary.com/2007/01/articles/regulatory-reform/looking-at-auditor-liability-caps/> (last visited 31 May 2008)
[29] In considering a variant based on audit fees, the audit revenue generated by the audit firm is considered.
[30] See 'The European Federation of Accountants_ Federation des Experts Comptables Europeens' Paper <http://www.iwp.or.at/veranstaltungen/documents/unterlagen_2007-05-07.pdf>
[31] Audit markets with relatively few large clients are referred to as thin markets. Germany has been classed as having a relatively thin market as relatively few companies are public limited companies (AGs). See MB Gietzmann and PK Sen, 'Improving Auditor Independence Through Selective Mandatory Rotation' (2002) 6 International Journal of Auditing 201
[32] The revenue generated by the audit firm constitutes the variant of the audit fees (third option as proposed by the European Commission). Reasons for a preference of revenue, instead of operating profit include the fact that operating profit is more subjective as costs are deducted (administration and distribution costs) in order to arrive at a profit figure. These deductions can provide a leeway for creative accounting, that is, the manipulation of accounts to achieve a desired figure (for taxation or penalty purposes). Ranges of audit revenues chosen by national regulators or the European Commission, to which different fines are imposed, in the event of audit liability, should also take into account the fact that some audit firms may generate the same revenue but not the same profit. The selected ranges could also determine the extent to which some firms would be tempted to manipulate their accounts in order to be classified or designated within a certain range. This is so, particularly if such range would attract lower fines. Whilst the difference between different ranges should not be so narrow as to make it easier for audit firm to "manipulate" its way into a more desirable range, it should also not be so wide as to compel certain firms to take greater risks. A means of achieving this balance would be to apportion fines in

Revenue should not relate only to the audit fees generated by these firms, but also to fees generated from non audit services. However, a benchmark needs to be set in relation to the cap. This is so because if a cap were solely determined by the audit firm's revenue, those firms generating low revenues would be inclined to take greater risks. If a minimum figure were set depending on whether the firm was a medium sized or large audit firm (small sized audit firms should be exempted from liability in the same way as small companies are not mandated by law to carry out audits)[33], say x million Euros minimum for medium sized audit firms and y million Euros minimum for large audit firms (y million Euros naturally being greater than x million Euros), then cases whereby caps are higher, would have to be justified according to the revenue generated by the medium or large sized audit firm. For example whilst the benchmark liability would apply to firms earning relatively low audit income within their class[34], higher penalty fees would apply to those earning higher revenues (within different specified ranges).

The minimal caps of x million Euros (medium sized audit firms) and y million Euros (large sized audit firms) should be deterrent enough to discourage such audit firms from taking undue risks.

Whilst I support the Commission's Working Paper proposal for a single monetary cap at European level, the designation as a medium or large sized audit firm would have to be determined by the revenues generated by these firms. The use of revenue generated by these firms should provide an objective basis even though the audit markets in various jurisdictions differ.[35] Thus, whilst numerous large sized audit firms may exist in the UK, this would not be the case in Germany[36] or Italy. Even

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such a way, between the different ranges of audit revenues, that there are less incentives to resort to creative accounting practices.

33 See Explanatory Memorandum to the Companies Act 1985 (Small Companies' Accounts and Audit) Regulations 2006.

Section 4.1 reads as follows: All companies are required by the 1985 Act to prepare annual accounts and to have those accounts audited. These requirements originate from EU directives.

However, small companies can take advantage of less onerous accounting and reporting requirements. Under section 246 of the 1985 Act they can prepare and file at Companies House less detailed accounts and reports. Small companies do not have to have their accounts audited (sections 249A and 249AA).

Section 4.2 states:

To qualify as small, a company must meet two of the following criteria (set out in section 247 of the 1985 Act):

- its turnover in a financial year is not more than £5.6m,
- its balance sheet total for that year is not more than £2.8m, and
- it has not more than 50 employees.

Whilst section 4.3 states : Section 249 of the 1985 Act sets out similar criteria for qualifying as a small group. Under section 248 the parent company of a small group does not have to prepare group accounts.

Also see Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 of 14 August 1978. Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts, OJ L193/1 of 18 July 1983.

34 Classification as medium sized or large audit firm

35 ibid

36 supra note 679; Audit markets with relatively few large clients are referred to as thin markets. Germany has been classed as having a relatively thin market as relatively few companies are public limited companies (AGs).

though it has been argued that a single monetary cap is not appropriate,[37] I would only agree with the criticism that certain issues need to be clarified. Such issues as whether the liability cap applies separately to claims or once to the sum of claims, differences in laws of member states as regards direct claims by the company or third parties, need to be addressed[38]. However these issues do not imply that the implementation of a single monetary cap at EU level is unworkable. Moreover in my opinion, it is preferable to the desired choice of Doralt and others[39] for the purpose of promoting harmonisation and facilitating greater cooperation between financial regulators on an international basis.

[37] See W Doralt and others, 'Auditors' Liability and Its Impact On The European Financial Markets' (2008) 67 Cambridge Law Journal 64

[38] ibid at 63

[39] ibid