International
Capital
Market
Association Ltd

15 March 2007

European Commission
DG Internal Market and Services
Unit 4 – Auditing / Liability

Attn.: Mr Jurgen Tiedje
Head of Unit

Dear Mr Tiedje

Commission Staff Working Paper: Consultation on Auditors` Liability and its Impact on the European Capital Markets

The International Capital Market Association (**ICMA**) is pleased to respond to the Commission Staff Working Paper: Consultation on Auditors` Liability and its Impact on the European Capital Markets (the **Working Paper**).

ICMA is the self-regulatory organisation and trade association representing investment banks and securities firms issuing and trading in the international capital markets worldwide. ICMA's members are located in some 50 countries across the globe, including all the world's main financial centres, and currently number over 400 firms.

Our response is based on extensive consultations with our member firms and their legal counsel.

We attach our response as **Annex** to this letter and would be pleased to discuss it with you at your convenience.

Yours faithfully,

Ondrej Petr

Ondrej Petr
Regulatory Policy – Primary Markets
+44 (0)207 538 5656
ondrej.petr@icmagroup.org

ANNEX

Summary

In our view, the analysis by the Commission needs to take into account more fully a number of other factors, in particular the impact of the limitation on various third parties. If the case is eventually made for the limitation, the harmonisation should take the form of a high-level recommendation with its scope limited to liability of audit firms for statutory audits as normally used. Of the options proposed, we find proportionate liability the least problematic solution, provided that the same treatment is extended to other professional advisers involved in the preparation of the audited financial statements.

General comments

The proposed limitation of audit firms` liability for statutory audits is a complex issue and a number of aspects need to be considered in order to come to an informed decision about whether and how to proceed. These should be included in the upcoming impact assessment and, if the case is ultimately made for the limitation, reflected in any harmonisation instrument. This section of our response summarises our general observations on the most important of such aspects.

Comments on the case for limitation

From various discussions with the Big Four, we understand that they have restructured their international networks and now operate as separate entities (partnerships or limited liability companies) in different countries without an overall global parent/holding entity. If that is indeed the case, it should in our view limit the impact of any claim against the audit firm to the country it relates to without affecting the entire global network. In such a scenario, the likelihood of a “catastrophic negligence claim” which could result in the collapse of one of the Big Four – and the resulting need for the audit firms to limit their liability to address such a risk - would appear to be substantially lower than claimed.

Impact of limitation on third parties

We are concerned that the debate does not take into account the likely impact of the limitation on third parties, in particular the investors in the audited company and other persons involved in the preparation of the financial statements (namely directors of the audited company but potentially also professional advisors other than the audit firm such as asset valuers or actuaries).

Irrespective of any other policy aims of the limitation of audit firms` liability, the basic purpose of the audit needs to be borne in mind. Auditors are the accounting experts who are expected to give an independent view on the company’s financial statements to enable the shareholders and other investors (existing or potential) of the company to inform their investment decisions and, more generally, to promote market confidence in the company. This aim can be achieved only if the investors (and any investment advisors who will in practice often make recommendations to investors on the basis of the financial statements) believe they are able to rely on the audit firm to conduct the audit with professional care. This, in turn, presupposes that the audit firms accept responsibility for their actions together with liability for any negligence. Any shift of this responsibility to third parties, in particular to “non-experts”, may have an impact on investor protection and market confidence and should therefore be carefully analysed for such an impact.

If an audit firm is held liable for deficiencies in the statutory audit, but its liability is limited, the shortfall of the loss is borne by the investors in the company (assuming that, as will often be the case, the company is insolvent or otherwise unable to meet the claim for the shortfall). It has so far not been clearly articulated why shifting the risk to the investors, non-experts who should be entitled to rely on the audit work, is a better solution from a policy perspective than the current situation.

In reality, other persons will have been involved in preparation of the audited financial statements. Their liability is generally not limited. It is possible they will be held jointly and severally liable for any deficiencies together with the company and the audit firm. In principle, any limitation of the liability of the audit firm increases the liability of such persons. This is particularly the case of any cap-based limitations of liability: In such cases, even if the audit firm were hypothetically the principal cause of the loss, the other persons could be required to pay the majority of any damages claims irrespective of their fault. This may be justifiable in case of directors of the company but it is not obvious why this is a correct policy with respect to its other professional advisors. Consequently, any limitation of liability available to audit firms should also be available to such other professional advisors involved in preparation of the audited financial statements.

Impact of limitation on perception of audit quality

Any limitation of the audit firms` liability could be perceived as having an impact on the quality of the audit work or the reliability of the financial statements. Such a perception would be based on the assumption that if audit firms know that their exposure for any failure in their work will be materially limited (for example to a low multiple of their fees), they may not carry out that work with the same level of care and vigilance as if such a limitation or cap did not exist. Even if there is no proof to suggest this is actually the case, the adverse impact on market confidence of such a perception is obvious. The lower any cap or limitation, the more acute this issue would be.

If the case is ultimately made for the limitation, it should therefore be set at a level which on one hand protects the audit firms and the audit market as suggested in the Working Paper, but on the other hand is sufficiently high to enhance the confidence of the users of the audited financial statements by incentivising the audit firm to conduct the audit with professional care.

Impact of limitation on competitiveness of EEA companies abroad

The potential liability of an audit firm which “stands behind” the financial statements of a company is one of the considerations taken into account by investors deciding whether or not to invest in the company. If this liability is markedly different in relation to foreign companies than in relation to domestic ones (in particular if it is, in relation to foreign companies, more limited or subject to stricter conditions), the investor could be disincentivised from investing into foreign companies. More seriously, the regulatory authorities in the country of the investor might take the view that the more limited liability of audit firms in a country of the company results in an unacceptably low standard of the overall audit framework and prevent companies from such a country from accessing its markets.

Adoption of a more limited liability of audit firms in the EEA might therefore create a competitive disadvantage for EEA companies when competing for investor interest in foreign markets and possibly prevent them from accessing foreign markets altogether. Any pan-EEA harmonisation effort should therefore protect the competitiveness of EEA companies as issuers abroad, in particular in the US and other key foreign markets. To this end, any harmonised liability regime should not be more limited or subject to stricter conditions than the regimes of those markets. In particular, more work should be done in comparing the proposals to the regime in the US.

Scope and method of harmonisation

Any eventual harmonisation instrument should be very clear as to its scope, the (negligence-based) liability of audit firms for statutory audits as normally used, i.e., submitted to the company for publication as a part of a statutory report which includes the audited annual or consolidated financial statements. Audit firms conduct a number of other reviews, some of which include a certification of financial statements which have been subject to a statutory audit. It would not be correct to extend the analysis of the statutory audit market to the market for such other reviews without careful consideration and further consultations. This is because such other reviews will often involve, be addressed to or otherwise concern additional parties and additional policy considerations will arise which are unlikely to be fully taken into account in the current discussion. Inclusion of any other reviews is, of course, also not anticipated by Article 31 of the Statutory Audit Directive.

Any harmonisation efforts would need to tackle the different legal frameworks, practices and other relevant considerations across the EEA. Workable detailed harmonisation would therefore be very difficult to achieve. The harmonisation should focus on the permissibility of the principle and the method of any agreed solution, rather than its precise level and other legal or technical detail. If adopted, it should go no further than requiring the Member States to take measures to the extent necessary to protect the audit firms from the risk of a "catastrophic negligence claim." This would enable the Member States to work out the details of the agreed solution in accordance with their domestic considerations. A recommendation to the Member States, as envisaged by Article 31 of the Directive, would seem to be the preferred solution.

Answers to questions posed in the Working Paper

This section of our response summarises our answers to the specific questions raised by the Commission. It assumes that the Commission, having addressed the concerns expressed above, proposes a high-level harmonisation recommendation.

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

We agree with the analysis of this option in the Working Paper. The level of the cap would inevitably be arbitrary and would not reflect in any way the extent of any losses suffered or the relative fault of the various parties. In the countries where such a cap has been introduced, it is usually considered too low to achieve these aims. Since it is highly unlikely that a workable cap could be identified and agreed, we do not believe this option should be considered further.

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

Caps based on the size of the audited company could in principle link the liability of the audit firms to their potential exposure. They might not, however, fully reflect the complexity of the audit or the risks involved and will not reflect the relative fault of the audit firm.

Market capitalisation would appear to be the best indicator of a company size for companies admitted to regulated markets, although other indicators (such as total assets) would have to be found for other companies.

A number of details would have to be considered to make this option at least theoretically workable. They include, for example, how and at which point of time to fix the level of market capitalisation for the purposes of the limitation, relationship between audit firms auditing the group and the subsidiaries or relationship between several auditors auditing the same company. Most importantly, the multiple would have to be set at a level which would satisfy the various considerations discussed above.

In light of the above considerations, this option would, in our view, be not only difficult to implement but also unlikely to work in practice. It should therefore not be considered further. We note, however, that of the options involving a fixed cap (Questions 1 to 3) it is the "least bad" option.

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

Caps based on the audit fees could in principle link the liability of the auditors to the complexity of the audit or the risks involved but will not reflect the relative fault of the audit firm or the portion of the loss caused by it. Similarly to the previous option, a number of details would need to be considered to make this option at least theoretically workable. There would in our view still have to be some sort of a link to the size of the company.

The difficulty with this option is that by negotiating the fees the parties would effectively be negotiating the liability of the audit firm. This could lead to a divergence of interests between the company, the audit firms and other affected parties. By way of a hypothetical example, an audit firm might try to reduce the audit fees and therefore the liability cap and then compensate for the loss of income by increasing other advisory fees charged to the company. The level of liability could also be affected by market trends in audit pricing unrelated to the risks or complexity of the audit work.

For the above reasons, we do not believe this option should be explored further.

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?

In principle, we consider that proportionate liability might be a helpful tool to reduce the audit firms` risk, in particular the "deep pocket" risk, in relation to statutory audits. As a matter of principle, it should be considered fair if a party is liable only for the portion of the loss for which it was responsible. It is, in principle, preferable to any cap-based limitation.

The companies should be free to apply or disapply proportionate liability in their relationship with audit firms by contract. Whether the legal substance of the proportionate liability will be contained in a statute or left to contractual arrangements is of secondary importance.

Such a regime would also be broadly similar to the US regime and should therefore not impact on the perception in the US of the quality of audits of EEA companies listed in the US.

Out of the four options proposed in the Working Paper, proportionate liability is in our view the most balanced and least problematic course for the Commission to take if it ultimately decides to recommend the limitation of audit firms` liability for statutory audits. This is, however, subject to our general comments made above. In particular, it would be necessary to extend the same treatment to other professional advisers involved in the preparation of the audited financial statements.