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European Commission
DG Internal Market and Services
Unit F4 - Auditing/Liability
SPA 2 (JII), 02/085
B-1049 Brussels, Belgium

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Dear Sirs

CONSULTATION ON AUDITORS' LIABILITY AND ITS IMPACT ON THE EUROPEAN CAPITAL MARKETS

Grant Thornton International welcomes the opportunity to respond on the commission staff working paper "Consultation on Auditors' Liability and its impact on the European Capital Markets" (the working paper) published by the European Commission (EC). We support the approach taken by the EC in seeking views from stakeholders. We support attempts to bring an element of uniformity throughout the EU on auditor liability, which we believe would benefit EU business and capital markets.

Grant Thornton International (Grant Thornton) is one of the world's leading international organisations of independently owned and managed accounting and consulting firms. Firms operate in 113 countries and employ over 25,000 people worldwide. Grant Thornton has member firms in 21 EU countries and a further two member firms in European Economic Area countries.

Below we outline our views on the issues raised, and in the attached appendix we answer the specific questions posed in section three of the working paper.

The need for liability reform

High quality financial reporting is critical to the efficient operation of capital markets and the wider economy. Audit plays an important role in assuring users of financial reports about the quality and reliability of the information contained in those reports. Assurance is a necessary check and balance alongside entrepreneurial activity and it is for this reason that a sustainable audit profession is important for Europe, its economic growth and confidence in its markets.

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Grant Thornton supports the principle that auditors be held appropriately accountable for auditors' negligence. In our view, no audit firm is too big to fail where it is identified that there is systemic failure within that firm. However, the current system in some Member States of unlimited liability is clearly inequitable, allowing as it does the possibility that an audit firm could fail as a result of disproportionate litigious activity responding to unauthorised actions of a small number of employees.

Concern has been attributed to some commentators that removal of unlimited liability will impact negatively on audit quality. However, the independent study commissioned by the EC from London Economics/ Professor Ewert on the Economic Impact of Auditors' Liability Regimes, which forms a sound basis for political decisions, reported that there was no evidence that unlimited liability promotes audit quality. We believe that in contrast to unfettered litigation, other recent moves to increase the consistency of high quality auditing, many of which have been driven by the Directive on Statutory Audit, such as independent public oversight incorporating inspection, investigations and discipline, are more reliable drivers of audit quality.

Investors and regulators agree that EU and global capital markets need a sustainable audit profession. The London Economics/ Professor Ewert Study reported that the current imbalance between audit fees (low) and settlement of claims against auditors (high) is not sustainable. The study reported that the major European accounting firms faced 28 claims in excess of US$100m, of which 16 claims were in excess of US$200m, of which five were in excess of US$1bn. Based on an analysis of the audit market and the insurance market for audit services, the Study identifies consequences of the current regime which could raise serious problems for capital markets, and the availability of capital generally, if not carefully addressed. The Study found that there were problems in jurisdictions which have not taken appropriate measures to limit auditor liability.

For the audit profession to be sustainable audit firms must also be able to attract and retain the best people. The best people will not join or stay in a profession where the risks of failure are high or where the profession is not itself profitable.

We observe that the interim report of the US Committee on Capital Markets Regulation expressed concern that excessive litigation and unlimited auditor liability are likely to inhibit market stability and a sustainable audit profession. The interim report found that if not changed the combination of these factors could lead to a loss of confidence in financial reporting in the US.

Auditor liability should be equitable across all markets

The introduction to the working paper states "the risk of auditing listed companies merits a wide public debate". Auditor liability is not just an issue in the listed company market. There should be equity in all audit markets. If there is to be liability reform in the EU it should apply to all audits, not just audits of listed companies, otherwise unlisted companies and their auditors would be disadvantaged in comparison with the listed sector.

Proportionate liability

Any system for auditor liability should result in a system that is, and is seen to be, in the public interest and a system that has at least a neutral impact on competition in the audit market.

It is difficult to see how a single monetary cap at EU level could meet these principles, given the wide diversity of the capital markets and companies in different Member States. A cap that is set too low might be considered to be unfair on shareholders of large companies. A cap that is set too high might be seen to benefit only the very largest audit firms and networks, resulting in the exclusion of other smaller firms and networks thereby limiting market choice.

Grant Thornton supports proportionate liability. Proportionate liability ensures that the audit firm is responsible for the results of its own actions (or inactions), but not for the results of the actions or inactions of other parties. Proportionate liability is clearly the most equitable and logical means of enforcing auditor liability.

Further, proportionate liability is in the public interest because it would have at least a neutral impact on competition in the audit market, and over time proportionate liability might encourage firms outside the Big 4 to increase their presence in the listed company market. In order to function properly, capital markets need a sustainable audit profession with a satisfactory level of choice.

To ensure consistent and fair implementation across firms and across jurisdictions, proportionate liability would best be introduced through statute.

We acknowledge that proportionate liability may not be wholly sufficient in itself, not only because it may be impossible to implement via the existing legal frameworks in certain jurisdictions, but also because proportionate liability would not on its own prevent a catastrophic claim from leading to the collapse of an audit firm. Based on the London Economics/Professor Ewert Study the ability of even the largest firm to meet a claim falls well below the market capitalisation of the EU's largest companies.

A liability cap based on audit fee

A necessary alternative or supplement to proportionate liability would be a system of limiting liability based on the size of the audited entity. Companies in different sectors have varied indicators of size and risk, so we believe the most practicable liability cap based on company size would have reference to the audit fee. This is likely to be a reasonable indicator of the entity's size, complexity and risk.

The paper makes no mention of how a cap would be set. The working paper identifies that a cap could be set either in law or by contract negotiated between the entity and the auditor. The "multiple" of the audit fee should be set in EC law, for the reasons we set out in the appendix.

Other jurisdictions are starting to look at the area of capping auditor liability. It is important that the EC takes the lead in implementing appropriate liability reform in a way that is both fair and at least neutral in its impact on audit competition.

If you have any questions on this response, please contact April Mackenzie (phone: +1 212 542 9789; email April.Mackenzie@gt.com) or Nick Jeffrey (phone: +44 870 991 2787; email Nick.Jeffrey@gtuk.com).

Yours faithfully

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APPENDIX - GRANT THORNTON INTERNATIONAL'S RESPONSE TO SPECIFIC QUESTIONS RAISED IN THE WORKING PAPER

General comments: There should be a common (EU-wide) statutory capping mechanism with a common methodology for setting the level of the cap. This is because professionals in all Member States need consistent rules across the EU to avoid the risk that disgruntled shareholders would choose the most favourable jurisdiction in which to bring an action against an auditor of a multinational group. A statutory cap gives certainty to all parties in the way it is calculated and in the way that actions would be resolved.

The ability to enter into a contracted cap may encourage the undesirable practice of competition between firms based on capping level. A contracted cap is only a partial solution to the issue of liability reform because the cap would probably only be binding on parties to the contract, which would leave the auditor with unlimited liability exposure to claims from those who are not party to the capping contract.

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

Grant Thornton view: We do not support a single monetary cap fixed at EU level.

A single monetary cap at EU level may well imply a maximum harmonisation of liability regimes, but that appears to us to be the only benefit, and it is a benefit that is insufficient to recommend it. It is difficult to see how a fixed cap at EU level can satisfy the two key tests, ie that it is, and seen to be, in the public interest and it is at least neutral on competition.

We disagree that a cap that is set too low would have a negative impact on audit quality because there are other more important drivers of audit quality such as personal and corporate reputational risk. However we agree that a cap that is set too low would be unfair to shareholders of the largest companies because there would be insufficient recourse for the loss suffered.

A cap that is set too high would be anti-competitive and have a negative impact on auditor choice because a high cap would benefit only the major audit firms.

A fixed cap at EU level would also have a limited useful life because the EC would have to have regular debates to ensure that the fixed cap remained at what stakeholders considered to be an appropriate level.

A problem with a fixed cap is that it is not equitable for all parties. Where a number of actions are brought against the auditor, a fixed cap might be utilised by the first actions to be resolved, to the detriment of later (but perhaps nonetheless worthy) claims.

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

Grant Thornton view: A cap based on market capitalisation would be acceptable for listed companies, but not our preferred size-based cap. A cap based on market capitalisation would be impractical for unlisted entities.

A cap based on market capitalisation would be difficult to implement and potentially lead to lack of transparency to investors of capping arrangements. Market capitalisation changes constantly for a variety of reasons unconnected with the underlying size and risk profile of the company and so the law would have to define the date on which the relevant market capitalisation is determined.

Possible options for the market capitalisation determination date include:

- the date the assignment is accepted by the audit firm
- the date on which the audit report is signed
- the balance sheet date
- the date of commencement of the accounting period.

All four events are wholly unrelated to the audit and its quality, and are potentially open to distortion by market events.

However, if there is to be a cap based on market capitalisation, to ensure consistent application across the EU, the multiple should be a statutory multiple set in EC law.

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

Grant Thornton view: We would recommend a statutory cap based on a multiple of audit fees as a necessary alternative or supplement to proportionate liability.

A statutory cap based on a multiple of audit fees would have at least a neutral impact on competition in the audit market because it favours no one jurisdiction or group of audit firms and on its own it would not act as a disincentive to an audit firm from taking on certain types of work. A cap based on a multiple of the audit fee neither favours nor penalises any one group of investors. A cap based on audit fee is also workable for unlisted entities, and it changes with financial years.

A cap based on a multiple of the audit fee is a system of liability capping that is seen by many to be a reasonable proxy for proportionate liability because the audit fee is negotiated by reference to the size, complexity and risk of the audit assignment. We accept that the multiple itself would be arbitrary but there is at least a direct link between the reward to the auditor and their maximum potential liability. There is a link between the audit fee paid by the company and the protection afforded to the owners of the company.

A low audit fee might lead to the audit team cutting corners, which in turn might increase the need for protection, but the protection actually provided to the shareowner is lower because

the cap is lower. So it might be argued that a cap based on audit fee would encourage shareowners to support appointment of the best auditor for that company's circumstances, as opposed to appointing the cheapest auditor.

A cap based on a multiple of the audit fee would be easy to implement and there would be clarity for all parties as to the extent of the auditor's liability. To ensure consistent application across the EU the multiple should be a statutory multiple set in EC law to ensure transparency to investors, and the fee and multiple (or aggregate cap) should be disclosed in the financial statements (possibly in the audit report).

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?

Grant Thornton view: Although proportionate liability is the fairest and most equitable system of liability capping, on its own it might not achieve its aim of limiting the impact of the highest claims, or it may prove impossible to implement in certain jurisdictions. Consequently it should also be used in conjunction with a statutory cap based on a multiple of audit fees.

Capping liability using a size based cap, such as a cap based on a multiple of the audit fee, is sometimes seen as a specific form of proportionate liability. The use of proportionate liability in conjunction with a cap based on a multiple of the audit fee might assist implementation of auditor liability capping in those jurisdictions that are unfamiliar with the concept of proportionate liability.

Liability reform should be established via statute rather than via contract. The benefits of statutory liability reform include maximising the likelihood that liability clauses are effective in practice, are in the public interest and anti-competitive behaviour is prevented.

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