

# Study on the Economic Impact of Auditors' Liability Regimes

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# Presentation



- Purpose of the study
- Key elements of the study
- Method
- Key findings
- Models of liability limitation

# Purpose of the study

- European Commission to present before the end of 2006 a report to the European Parliament on on:
  - *“the impact of current liability rules for carrying out statutory audits on the European capital markets and on the insurance conditions for statutory audits and audit firms, including an objective analysis of the limitations of financial liability”*

# Purpose of the study

## □ Terms of reference:

- *“Undertake a detailed examination of the economic impact of the various auditors’ liability regimes which exist in the EU25, from the perspective of the auditors, the capital market, the insurance market and the directors (impact on their liability)*
- *Identify the various solutions to ensure a high quality audit on the one hand and to maintain the audit function as an economically viable activity on the other hand”*

# Key elements of the study



## □ 5 Parts

- The state of the international market for audit firms in the EU
- The insurance market for statutory audit
- Likely short and long-run effects of the possible disappearance of one or more of the Big-4 firms
- Economic Impact of alternative auditor liability regimes
- How to limit auditors' liability

# Key elements of the study

- **Part I: The state of the international market for audit firms in the EU**
  - Patterns of concentration of the audit market
  - Specialisation of the Big-4 firms
  - What factors have led to the current patterns of concentration?
  - Barriers to entry into the audit market segment served by the Big-4 firms
  - What factor determine a company's choice of a provider of auditor services and related services?

# Key elements of the study

- **Part I: The state of the international market for audit firms in the EU (continued)**
  - Influence of various stakeholders on a company's choice of auditor
  - What factors influence a company's decisions to change its auditor?
  - Mergers and acquisitions and collaborative arrangements among small and medium-sized audit firms

# Part I: The state of the international market for audit firms in the EU



## □ Part II: The insurance market for statutory audit

- Statutory audits risks faced by audit firms
- Audit liability risk and insurance
- Availability of liability insurance for audit firms
- The threshold at which a mega-claim results in a wipe-out of a major audit network
- Impact of potential external quality oversight bodies on audit quality and liability risk
- Alternative risk protection solutions



# Key elements of the study



- Part III: Likely short and long-run effects of the possible disappearance of one or more of the Big-4 firms
  - Results of survey
  - Migration patterns of Arthur Andersen clients
  - Auditor switching in the Japanese audit market
  - Potential consequences of the disappearance of one or several Big-4 networks

# Key elements of the study

- **Part IV: Economic Impact of alternative auditor liability regimes**
  - Economic impact of different auditor liability regimes on incentives – what theory tell us?
  - Consequences of regulatory actions on audit quality
  - Impact of different auditor liability regimes on:
    - audit quality
    - legal claims
    - structure of the audit market
    - capital markets
    - staffing of audit firms

# Key elements of the study



## □ Part V: How to limit auditors' liability

- Main issues to take into account in assessing options of limiting liabilities
- Options
  - Assessment criteria
  - Models

# Methods

- Surveys of audit firms (Big-4 networks, medium size networks)
- Survey of companies
- Survey of institutional investors
- Interviews/telephone conversations: insurance and re-insurance sectors, audit firms, institutional investors
- Auditor Liability Forum (7 meetings)

# Key results

- ❑ Market for statutory audits of large companies is highly concentrated
- ❑ Structure of market unlikely to change significantly in near future – barriers to entry for middle-tier firms
- ❑ Current level of commercial insurance would cover less than 5% of the larger claims
- ❑ Substantial increase in the risk of large claim against Big-4 to be assumed directly or indirectly

# Key results

- Very real risk that one or more of the Big-4 networks may fail
- Potentially significant impact, especially if more than 1 network fail
- A limitation of auditor liability would reduce risk
- A number of models for limiting liability exist
- Variety of circumstances within the EU25 makes it unlikely that one size-fits-all is the best approach

# Models of liability limitation



- Absolute cap
- Variable cap
  - Based on size of audited company
  - Based on size of audit firm
- Proportionate liability
- Not mutually exclusive. For example,
  - Variable + cap
  - Cap + proportionate liability

# Where to find the study?



[http://ec.europa.eu/internal\\_market/auditing/docs/liability/auditors-final-report\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/liability/auditors-final-report_en.pdf)