Auditor Liability Reforms in the UK and the US:
A Comparative Review

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Abstract

The past decade has seen many changes in audit liability regimes of the US and the UK, and more may be on the way. These include LLP status for audit firms, proportional liability, and the introduction of various forms of liability caps through contract in engagement letters. These changes may affect audit quality, price and profitability, the organization of the market for audit services, as well as domestic and cross-national mechanisms for regulation of this market. What have been, or will be the consequences of these changes? Will the auditors, who advocate many of these reforms, benefit from them? Will the investors, who advocate other reforms, benefit from them? Answers to these questions are relevant to policy decisions at hand. We analyze the recent changes and the proposals for future changes on the basis of available research on the market for audit services, including some studies commissioned by regulators. We find it difficult to establish a correspondence between the self-interest of the advocates of various changes and the observed and anticipated effects of such changes. More evidence is needed to inform the debate in the corridors of power. Such evidence could be obtained by requiring audit firms to publish information about their true litigation costs. Moreover, the regulatory process might benefit from somewhat greater reliance on market forces.

Keywords: Auditor liability, U.K. and U.S. comparison, International accounting

JEL Codes: F19, K22, M41
Auditor Liability Reforms in the UK and the US: Who Benefits?

1. Introduction

The UK Companies Act 2006 contains provisions for limiting auditors’ liability, a global goal of large audit firms, which has already been partially achieved in the US and some other countries. The Act provides for liability limitation by contract to ‘such amount as is fair and reasonable in all the circumstances’. The European Commission has commissioned research (London Economics 2006) on the existing liability regimes within the European Union (EU) and consulted on possible ways forward (Europa 2007a). It is possible that the EU may follow the UK’s lead in limiting auditor liability, though the issue remains undecided.

Recent years have brought changes in the legal regimes that govern UK and US audit firms. Since the 1989 UK Companies Act, UK firms have been able to incorporate. In both jurisdictions, firms can become limited liability partnerships, protecting the individual partners from the risk of personal bankruptcy unless they were personally responsible for a defective audit opinion. Nevertheless, UK firms continued to press for abandoning the joint-and-several responsibility in favor of a proportionate liability regime. This had been achieved in class action cases in the US via the Private Securities Litigation Reform Act (PSLRA) of 1995. Since the collapse of Arthur Andersen LLP, audit firms in the UK have sought to reinforce their case for reform of joint-and-several liability with two new arguments: (1) liability risk is a barrier to smaller firms entering the concentrated market for listed company auditing, and (2) if another major firm collapses under the pressure of joint-and-several liability, the market for audit services for large listed companies may become unacceptably concentrated.
In the context of these attempts to limit auditor liability, recognition that there are two distinct types of liability in law appears to be missing—the liability to third parties in the laws of tort (the so-called “decision usefulness” model) and the contractual loss suffered by the entity itself being audited (the “stewardship” model).

The International Standards of Auditing (ISA) model, largely based on US decision usefulness methodology, has been adopted in the UK with some adjustments to meet essential UK legal requirements. The 8th Directive proposes to adopt ISA throughout the EU. The wisdom of this broad official blessing for the ISA has been questioned by some members of the UK investment industry, particularly by certain long-term fund managers who are concerned about the possible limitations on audit scope inherent in a model that is becoming globally accepted (Morley Fund Management 2005).

In this paper we argue that the introduction of global standards, which ignore local laws and practices, combined with limitation of auditor liability, will reduce the value of the audit. Initially, the reduced value might appear to be of concern only to the investors. Ultimately, however, companies and their investors will only pay what such audits are worth to them, reducing the price of audit services (Gode 1994) and the esteem they attach to the limited-liability audits. Should the price and perceived value of audit services drop as a consequence of the reforms auditors are pressing for, the large firms\(^1\) may end up hurting their own interests.

We also discuss whether auditing standards and International Financial Reporting Standards (IFRS), combined with the growth of regulatory power and intervention (occupying the position of the principal) since the collapse of Enron and

\(^1\) There is not a major liability problem with small firms who do not audit listed companies in the UK since they can get insurance to cover their risks. However, in the US there are many relatively small firms auditing small and non-listed companies who cannot get insurance coverage.
the increasing responsibilities of audit committees, lead us to a framework rooted in
auditor risk mitigation, instead of best serving the needs of business and society.

We review and contrast the UK and US legal systems which shape their respective audit regimes. The differences between the two legal systems render it unlikely that the same audit, financial reporting, and corporate governance systems will suit them both. The vision of harmonizing accounting and auditing standards and governance regimes, even if it were preferred, may not be achievable across a world of diverse legal frameworks.

This paper is divided into six sections. After this introduction, Section two traces the development of the liability reform regimes in the UK and the US up to the grant of Limited Liability Partnership (LLP) status to firms in both countries. We also include the provisions in the Companies Act 2006 and other recent developments in the UK and the EU. In Section three we consider the switch to the joint-and-several liability regimes. In Section four we discuss the economics of reform and the evidence supporting the case in both countries. Section five considers the expectations gap—auditing standards and the implication of global standards for the future of accounting—followed by concluding remarks in Section six.

2. Auditor Liability in the UK and the US

2.1 Historical background

Audit has three main functions: monitoring, reducing information risk, and insurance. The insurance role has been perceived by banks, investment bankers, and exchange members as a private alternative to regulation by public agencies (Wallace 1980). In the UK, the law requires audit to ‘provide the shareholders with information about the state of affairs of the entity and its performance and to assist them in assessing the stewardship exercised by the directors (Auditing Practices Board,
Ethical Standard One 2004). Table 1 shows the relevant differences between the US and UK legal and regulatory regimes. In the UK, the primacy of the stewardship function, combined with the high proportion of securities in the hands of institutional investors, allows shareholders a powerful role in removing directors from office. This model assumes that the auditor will do sufficient basic controls checks to reach an informed opinion, not only on the presentation of the financial status of the firm at one moment in time, but also about the underlying substance and integrity of business for more enduring benefit.

(The Insert Table 1 about here)

The US Securities Act of 1933 made audit mandatory for public companies and introduced a tough liability regime which placed the burden of proof on the defendant (Carey 1979). A high proportion of companies listed on the New York Stock Exchange voluntarily chose to have themselves audited prior to 1933 (Zeff 2003a). The profession not only welcomed the compulsory audit, it had successfully lobbied for Congress to grant the members of the American Institute of Accountants the exclusive franchise to conduct these audits (Zeff 1972). Audit was viewed primarily as a means of detecting and preventing fraud or error in financial statements as distinct from smaller problems incubating inside the business which might cause greater or repeated harm later, i.e., the decision usefulness model (Public Company Accounting Oversight Board (PCAOB) 2004). Audit reports originally certified accounts to be ‘correct,’ although this changed over time to an ‘opinion’ on fair presentation (Cochran 1979). This was partly as a defense in litigation and partly because of the high cost of verifying all transactions and accounts of large and increasingly complex businesses.
In the UK, auditors’ duties are defined by company and case law and are not subject to securities legislation as in the US. Since there is no federal corporation law in the US, auditors’ duties and responsibilities, and therefore their liabilities under contract, have developed at the state level. Their duties to investors who may buy or sell shares have developed through federal securities legislation (Bush 2005).

In the UK, following the City Equitable Fire Insurance case where auditors escaped liability because of an exclusion clause in the company’s articles of association, the 1929 Companies Act prohibited auditors from limiting their liability (Grainger 1931). In the early days, UK audits also focused on verifying correctness of accounts and detecting fraud and error. Over time, the emphasis shifted to verifying the credibility of financial statements (Lee 1979; Chandler, Edwards, and Andersen 1993). Table 2 shows the similarities and differences between the current liability regimes in the US and the UK. Class actions in the US arise from financial misstatements, i.e., information risk, not from fraud or defalcation within the company itself.

(Insert Table 2 about here)

2.2 The Development of Limited Liability Partnerships (LLPs)

In both countries, audit firms are now able to incorporate as LLPs to protect the personal assets of the partners not directly involved in a defective audit against claims. Traditionally, audit firms operated as unlimited liability partnerships in which all assets of the firm, as well as personal assets of the partners, were at risk if the firm were found to be liable in a court of law. This liability took the joint-and-several form, typically exposing them to the burden of fulfilling the liability obligations of their bankrupt co-defendants in cases of fraud. As the firms grew in size, the assets at risk increased and potentially made them more attractive to litigants.
US securities legislation is set at federal level but corporation law operates at state level and legislation varies from state to state. In US in 1991 the audit firms started to lobby various states to pass enabling legislation to for the establishment of LLPs. They were successful and large audit firms all now have LLP status. The route to LLP status in the UK was more complex. Company law is set at national level only so the firms had to persuade government to allow them to set up limited liability trading vehicles. Provisions were introduced in the 1989 Companies Act to allow audit firms to incorporate as companies. This, however, meant additional tax liability, compliance with the provisions of company law, and publication of financial statements (Freedman and Finch 1997; Cousins, Mitchell, and Sikka 1999). By 1995, only KPMG had incorporated a part of its listed company audit practice. Other firms were prepared to continue without liability reform. The 1989 Act also allowed companies to buy indemnity insurance for their auditors and directors, but companies were unwilling to buy insurance for their auditors (Gwilliam 1997). In public discourse, one reason given for firms not incorporating as companies was the potential damage to the partnership ethos of the profession (Accountancy 1996a).

Cousins et al. (1999) describe how Price Waterhouse and Ernst & Young supported the development of a bill in the Channel Islands State of Jersey (an offshore tax haven) containing provision for limited liability partnerships under proportionate liability regime without the requirement to publish financial statements. It induced the UK government to introduce the Limited Liability Partnership Act in 2000. Both Freedman and Finch (1997) and Cousins et al. (1999) doubt that it would actually have been possible for the audit firms to move their UK head offices to Jersey legally. Nevertheless, the threat implicit in the Jersey bill worked.

3. Reform of Joint-and-Several Liability

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
Lobbying for and successfully achieving LLP status has been one stage in the accounting profession’s campaign for liability reform. Nevertheless, lobbying continues for change from a joint-and-several regime, which the firms claim exposes them to the burden of fulfilling the liability obligations of their co-defendants who have less wealth and limited, if any, indemnity insurance\(^2\). Auditors understandably have regarded a joint-and-several regime to be financially unfair (Institute of Chartered Accountants in England and Wales (ICAEW) 1996a (UK); Cooke, Freedman, Groves, Madonna, O’Malley, and Weinbach 1992 (US)). They argue that it adversely affects how they conduct audits by making them defensive, and it potentially limits their ability to recruit and retain good quality staff (ICAEW 1996b). They prefer a proportional liability regime where they pay only for their contribution to the loss or a predetermined cap on their liability.

The efforts of audit firms for reform of joint-and-several liability have been rewarded with a considerable degree of success in both the US and the UK.

### 3.1 Developments in the US

The attempts to reform auditor liability in the US focused on the argument that the tort system was out of control, partly as a consequence of the 1933 Securities Act, which placed auditors under a joint-and-several liability regime and made them, not the plaintiffs, carry the burden of proof (Carey 1979). The senior partners in the large firms (Cooke et al. 1992) argued that Securities and Exchange Commission (SEC) Rule 10-b permits class action claims against companies and auditors where share prices have fallen. Because there is no provision in US law for recovery of costs by successful defendants, auditors felt compelled to settle even merit-less legal claims in

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\(^2\) Under a joint and several regime, the injured party can claim against one defendant even though there may be several and it is up the defendant to claim against the other parties who have also have caused the injury. Because auditors have liability insurance, they claim they are sued in preference to others who are equally guilty. This is often referred to as the ‘deep pocket’ problem.
order to avoid high costs of litigation. The average claim in 1991 was $85m; the average settlement was $2.6m with legal costs of $3.5m. The audit firms claimed that legal costs represented 9% of their revenues in 1991.

Congress overrode a presidential veto and passed the Private Securities Litigation Reform Act (PSLRA) in 1995. This was followed in 1998 by the Securities Litigation Uniform Standard Act (SLUSA). These Acts restricted the ability of plaintiffs to bring class action lawsuits against auditors at the federal as well as the state level. Claims were restricted to a proportionate liability model, except if the auditors commit a criminal offence joint-and-several liability remains. In return, and to get past the presidential veto (Briloff 1999), auditors are now required to (1) give reasonable assurance of having detected illegal acts in the financial statements, (2) identify related party transactions, and (3) notify the SEC of securities law violations if the company fails to do so within a prescribed time.

PSLRA and SLUSA reformed tort law i.e. duty of care to investors and other third parties, but not contract law i.e. the contract between the auditor and the company which is made under the US model at state level. Claims at the state level against the auditor by the company continue under contract law and are subject to jury trial, where the level of damages cannot be predicted and punitive damages may be awarded.

Audit firms are attempting, variously, to reduce their exposure at state level by including restrictive clauses in their engagement letters to limit the cost of litigation and avoid punitive damages (Council of Institutional Investors 2005). These clauses vary but may include provisions requiring the client companies to agree to

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3 Meritless claims are those where there is no case for misrepresentation or fraud associated with the fall in the share price.
4 Some cases under tort law, but not class actions, may still be brought at state level if privity can be established by a plaintiff.
alternative dispute resolution, jury trial waivers, limitation of liability to the company, and indemnification of auditors against management fraud. These steps represent direct or indirect contractual limitation of liability.

The US reforms took place before the merger of Price Waterhouse with Coopers & Lybrand in 1997 and before the collapse of Arthur Andersen LLP. After the Enron scandal in 2002, Arthur Andersen LLP was found guilty of charges of obstruction of justice (United States v. Arthur Andersen LLP, No. H-02-121, 2002 U.S. Dist. LEXIS 26871 (S.D.Tex. Sep. 11, 2002)) and was disbarred by the SEC (Accounting and Auditing Enforcement, Exchange Act Release No. 44444 (June 19, 2001)) from auditing listed companies. On appeal, the Supreme Court reversed the guilty finding of the trial court, but it came too late to revive the firm whose reputation had been damaged beyond recovery. (Arthur Andersen LLP v. United States, 544 U.S.__, 125 S. Ct. 2129 (2005)).

3.2 Developments in the UK and the EU

There is no provision in UK law for class actions to be brought by shareholders against auditors or companies based on drops in share price; UK shareholders can sue for losses incurred by the company. The Caparo case (Caparo Industries v. Dickman and others (1990) BCLC 273) restricts the ability of individual shareholders to sue the auditor. Caparo states that as the auditors’ duty of care is to the shareholders as a group not to individual shareholders\(^5\). Under the stewardship model of director and auditor accountability (see Table 2) the auditor has no duty of care to third parties who rely on the audited financial statements for investment decisions. Following the Caparo case, there is no duty of care to existing individual shareholders.

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\(^5\) This case arose because Caparo plc, an existing shareholder in another company – Fidelity, then purchased all the fidelity shares and found that the accounts were misstated. They sued the auditors as an existing shareholder but the Lords refused the appeals because the auditors duty was to the shareholders as a group not to individuals who choose to increase their holding.

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
shareholders, unless the auditor knows or would be expected to know that a third party or existing shareholder would rely on the accounts for investment purposes. In such a case the auditor could choose whether to accept the responsibility and charge accordingly. Thus the main justification for the US liability reform—meritless class actions—has no relevance to the UK regime.

Nevertheless, UK firms estimated their litigation costs to be eight percent of their revenues (Accountancy 1996b). In the early 1990s, as a result of large claims resulting from some major financial scandals, auditors’ litigation costs were increasing, and the campaign for liability reform intensified. In 1996, despite lobbying from the profession, the UK Law Commission’s Feasibility Investigation of Joint and Several Liability (Department of Trade and Industry (DTI) 1996) rejected wholesale reform of joint-and-several liability on the grounds that it was generally unfair to plaintiffs who had suffered losses and may have to pursue a number of defendants for restitution.

The ICAEW (1996b) continued to press its case for liability reform in response to the government consultation on the grounds that (1) the joint-and-several liability regime is unfair to auditors, as the directors are responsible for the accounts; (2) that the firms cannot get insurance to cover their risks; (3) there is a profound imbalance in the risk reward relationship of auditing; (4) auditors are sued for amounts out of proportion to their involvement in wrongdoing; (5) high risk companies would not be able to get an auditor; (6) the cost of audit would increase; and (7) the profession would not be able to attract the best quality recruits (ICAEW 1996b). The profession offered no concessions in return, such as extending the auditors’ duties. A further argument (Freedman and Finch 1997) was the claim that a drop in the number of major audit firms from six would increase concentration and
disrupt the market for audit services. The UK government rejected the case for joint-and-several liability, but left open the possibility of companies and auditors contracting to limit their liability subject to shareholder approval.

With the collapse of Arthur Andersen LLP in 2002 arose the possibility that the failure of yet another firm would create an unacceptably uncompetitive environment with only three large firms left in the game. Two events further intensified this pressure on the UK government. In a case of alleged criminal behavior of KPMG in the US with respect to fraudulent tax advice, the US Justice department chose to settle for a $456 million fine on the firm and action against the individuals involved, instead of disbarring the firm from performing audits of publicly held firms (U.S. Department of Justice, 05-433, August 29, 2005). The case is still proceeding. The possibility of the collapse of KPMG caused grave concern in the UK. Secondly, a claim of £2.6 billion was made against Ernst & Young in the UK in the Equitable Life case. Although the claim was dropped, had it succeeded at considerably lower damages, the firm could have been seriously weakened in the UK.

The UK government, in the process of drafting a bill bringing widespread reform to company law, conducted a further consultation (DTI 2003) citing the large firms’ concerns about the possibility of further reduction in their number, but also reporting the European Commission’s (EC) view that liability is a driver of audit quality.

Liability limitation for auditors is included in the 2006 Companies Act, which was laid before the House of Lords in 2005 and finalized in 2006. The provisions

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6 The last argument notwithstanding, Price Waterhouse and Coopers & Lybrand announced their merger in 1997, and KPMG and Ernst & Young attempted to do the same at about the same time.


8 The 2006 Companies Act included major changes to UK company law, particularly easing the regime for smaller companies. The Department of Trade and Industry started a major consultation in 1998 which took several years to complete.
allow the auditors to limit their liability by contract with their company clients, subject to shareholder approval (to address the tort liability) and subject to the liability being ‘such amount as is fair and reasonable in all the circumstances of the case.’

These reforms are counterbalanced by the following provisions: (1) a new criminal offence is introduced for an auditor who ‘knowingly or recklessly’ includes any matter which is misleading, false, or deceptive in the audit report or who omits information which results in the audit report being misleading, false, or deceptive; (2) auditors may be required to disclose their terms of appointment, i.e., the engagement letter; (3) the audit report must be signed by a named partner – the senior statutory auditor; and (4) in the case where the auditor ceases to act for a listed company, he or she must file a statement on the circumstances connected with that departure with the appropriate audit authority.

Audit firms lobbied to change the original provisions of the bill, which they claimed did not give them proportionate liability and allowed the courts to override a negotiated amount. The group A, i.e., the second tier below the Big Four firms, were concerned that public disclosure of negotiated caps would be anti-competitive, as the Big Four might be able to offer a higher negotiated cap. The bill was changed to avoid including a negotiated fixed amount. There was also an attempt to modify provisions of the bill which require auditors to report where the company has not kept proper accounting records. Although this requirement has been in UK company law since 1948, audit firms argued for its relaxation on the grounds that the bill raised the penalty for failing to comply with this requirement (Accountancy Age 2006). The profession was concerned about the criminal sanctions and the effect they might have

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9 Although these provisions are now in the Act, they have not yet been implemented and the practicalities of interpretation are still to be agreed upon.

10 The last two points partially derive from the revised 8th Directive of the EU. Lobbying within the EU led to the inclusion of a requirement for a study of the auditor liability regimes in the EU in the revised EU 8th Directive (London Economics 2006).
on auditor behavior, particularly in making the auditors more defensive. There are also concerns about the difficulties of establishing guilt under a criminal standard of proof\(^\text{11}\) (Fearnley and Sunder 2006). These concerns did not justify an attempt to remove an essential component of the UK’s stewardship regime.

Shareholders have to approve the arrangement between the auditor and the company, and already one group is proposing that shareholders should vote against the reforms. This has been countered by a suggestion that, without an agreement, firms would be ‘very concerned’ about taking on a client (Grant 2006). In response to investor concerns expressed in 2004 (e.g., Morley Fund Management 2004) at the behest of the Department of Trade and Industry, the ICAEW facilitated an Audit Quality Forum where stakeholders with an interest in audit continue to debate a range of proposals to enhance confidence in audit. Since the forum was set up in 2005, many issues have been debated with stakeholders in the audit process, including competition and choice; making global auditing standards local; principles based auditing standards; audit purpose; asking questions of auditors; disclosure of audit engagement letters; auditor resignation statements; and identifying the audit partner in the audit report (Outputs may be found on ICAEW website (ICAEW 2007)). Some of the issues debated have been included in the provisions of the 2006 Companies Act.

One result of the establishment of the Audit Quality Forum was the commissioning of research by DTI and the Financial Reporting Council (FRC) into the issues of market concentration as a first stage to finding a market solution to the problem and to mitigate the risk of the collapse of another audit firm. Following publication of the research findings (Oxera 2006), the FRC set up a group to consider

\(^{11}\) A major concern for an auditor found ‘knowingly or recklessly’ issuing a misleading audit report is the risk of loss of license. In the UK there are only two standards of proof, whereas for securities law in US there are three (Fearnley and Sunder 2006), and therefore it can be easier to prove a case in US.
what action might be taken to address the problem of concentration, competition, and choice (FRC 2006).

The research commissioned by the EC into liability in the EU was published in 2006 (London Economics 2006). It highlights the variety of legal regimes throughout the EU, but similar to the Oxera research, the report does not offer solutions. The EC issued a consultation paper (Europa 2007a) on liability reform in the EU, which offers four different proposals, while at the same time recognizing the differing regimes in EU countries. The alternatives offered are a fixed monetary cap, a cap based on the market capitalization of the audited company, a cap based on a multiple of the audit fee, or on proportionate liability.

The results of the consultation (Europa 2007b) show mixed views moving forward. There was no agreement among respondents that liability reform would prevent catastrophic losses, increase auditor choice, reduce the deep pocket problem, or improve insurability and quality.

4. The Economics of Reform and Evidence

The consequences of introducing or lowering caps on auditors’ liability take several forms. In this section, we consider the views of the strength case for reform as presented by the firms and their critics and explore these possibilities, initially focusing on absolute caps. We return later in this section to the analysis of proportionate liability which shares some of the consequences of absolute caps.\(^ {12}\)

4.1 The Case for Reform

\(^ {12}\)In the US, under the PSLRA, auditor liability arises only in cases of fraud, and the PSLRA restricts this liability to a proportionate basis. In the UK, liability can arise through negligence; even under a proportionate regime. If the loss were large enough, some claim that it could bankrupt the audit firm. There are concerns in the US about cases being brought to court in states where the regime is more punitive.
The reform campaigns in both countries have come under criticism. According to Briloff (1999), the profession’s submission to the US Senate in support of liability reform overstated the case. Auditors cited their estimate of 1992 litigation costs at $783 million or 14 percent of their revenues. However, this figure included a highly unusual $400 million one-off settlement of savings and loan cases by Ernst & Young. There were also a number of other large settlements. US case law had already established that an auditor could only be found guilty if the conduct was reckless, i.e., something more than negligence (Hochfelder v. Ernst & Ernst 425 US. 185 1976). According to Slavin (1977), acts of negligence can no longer impose statutory liability to third parties under SEC Rule 10.5b. Furthermore, the case of Central Bank of Denver v. First Interstate Bank US. 16, 1994 determined that ‘aiding and abetting a fraud could not subject the auditor to legal liability.’ Briloff argues that the firms were quite well-protected under the existing regime. Palmrose (2000) finds that during 1960-1995, there were over 1071 lawsuits against accounting firms, or 28 per year on average, which is a small proportion of the overall market. The success rate for the lawsuits was 50 percent.

Post-PSLRA research does not indicate an improvement in audit quality. Lee and Mande (2003) find evidence of more earnings management in companies audited by the large firms after the PSLRA was passed, suggesting that the protection from claims may have led to less stringent audits. Francis and Krishnan (2002) find fewer going-concern qualifications after the reform, suggesting that the Act may have changed behavior; they are uncertain whether it is for better or for worse. Levitt (1998) also expresses concern about increasing earnings management. Chan and Pae (1998) develop an economic model which shows that, in the absence of joint-and-

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13 This differs significantly from the UK situation where although the opportunities to sue are more limited, the plaintiff only has to prove negligence to gain compensation.
several liability, auditors reduce their effort. Zeff (2003b) suggests that after the PSLRA, audit firms did less work, adding to the moral hazard problem. This could have contributed to the scandals that followed, but no clear causal link has been established.

Gwilliam (2004) concludes that the UK case for reform of joint-and-several liability is also overstated. He finds no evidence of provisions to meet major claims in the 2001-2002 financial statements of three of the large audit firms.\(^\text{14}\) He also points out that the liability reform case has been pursued in the UK for 20 years, and there have been no major calamities during this period. The one problematic case for a UK tier A firm, the *ADT Ltd v. BDO Binder Hamlyn* (1996 BCC 808) succeeded because the auditor unnecessarily (and foolishly) extended the firm’s liability to a third party. Cousins et al. (1999) also conclude that there is no case for liability reform and point to evidence of firms’ competitive strategies potentially undermining audit quality.

Table 3 shows the disclosures available in the financial statements of the large firms for 2005 and 2006 year ends, including average partner remuneration and disclosures about claims.\(^\text{15}\) Average profit per partner increased well above the rate of inflation between 2005 and 2006. The greatest increases of 22% were made in Ernst & Young and KPMG. The lowest increase of 9% was in Deloitte, but Deloitte partners have the highest average earnings.

The highest provision is PricewaterhouseCoopers’ (PwC) at £33m (down £10m from the previous year), and the lowest is Grant Thornton at £4.8m (up £1m from the previous year). It is not clear, however, what these figures actually represent and whether claims and costs recovered from insurers are included. If these figures

\(^{14}\) GAAP compliant financial reports are required to be made public under the LLP legislation; Deloitte had not produced its accounts at the time Gwilliam wrote.

\(^{15}\) Information about partners’ income is not publicly available in US.
exclude any insured costs and recoveries, then the liability problem cannot be as severe as has been claimed. If the figures are net of insurance costs and recoveries, then the firms’ claim that they cannot get sufficient insurance is weakened, since the excesses are small relative to the size of the firms. These data suggest that the only possible reason for liability reform in UK would be to protect firms against a catastrophic claim.

One result of the US PSLRA has been the drop in the number of cases against auditors under SEC Rule 10-b (class actions). Cornerstone Research (2006) finds that auditors were named as defendants in only three in 2004 and five cases in 2005. Auditors are now focusing on limiting contractual liability at the state level through engagement letters. Since these terms are not required to be disclosed, investors are concerned about their impact on auditor independence. It has been suggested that these arrangements may help lower the audit fees (Council of Institutional Investors 2005), though it is not clear if audit fee minimization is a desirable goal in this context. The issue is also a matter of concern to the Public Company Accounting Oversight Board (PCAOB 2006). Enron Watchdog (2005), a US consumers lobby group, demands a repeal of the PSLRA of 1995, which it believes is not in the consumers’ best interests. Because of its safe harbor protection for forward-looking statements, the PSLRA has led to an increase in the frequency of accounting restatements.

Enron Watchdog (2005) cites large increases in campaign contributions from Big Five firms and the members of the AICPA to members of Congress as the path of legislation was greased along. Coffee and Bearle (2000) refers to a gate-keeping problem and are convinced that the PSLRA and the SLUSA have rendered the gatekeeper less incorruptible.
Given the special features of auditing, Moizer and Hansford-Smith (1998) identify key problems surrounding the contracts between auditors and their insurance companies. It is difficult for the insurer to assess the size and frequency of risks it accepts in underwriting an auditor, and full coverage insurance creates a moral hazard for the auditor. The audit firm itself may not know the extent of the risk being taken on, even though risk management techniques in the profession have improved. Table 3, however, does not indicate a major problem. Ronen (2002), and Ronen and Cherny (2003) propose an alternative model for auditing whereby companies choose the amount of insurance coverage they wish to buy for their financial statements and pay a negotiated premium for the cover. The policy is issued when a clean opinion is obtained. Ronen believes that this system would overcome the problem of auditors being dependent on management. It would put a cap on what shareholders can recover, and would encourage them to actively engage in monitoring the company.

Bhattacharjee, Moreno and Yardley (2005) offer a different model. They express concern that the regulatory objective (in the US) of audit is to eliminate investment risk, whereas the courts concentrate on the audit process and GAAS compliance. They propose that the company should buy insurance for its financial statements; the auditor should not give an opinion, but instead act as an underwriter for the integrity of the financial statements. Jamal and Sunder (2007) ask if the essentially pass-fail nature of audit certificates could be improved through provision of, or permission to use, finer gradations. Gietzman, Ncube and Shelby (1997) apply a contingent claims analysis to derive valuation equations for expected litigation costs and consider how rules could be set to avoid both a low degree of care and collusion with management. They suggest that proportionate liability will not provide sufficient incentives for auditors to commit to independence and a high degree of care. Mitchell (1993)
believes that the UK firms can resolve the liability crisis by doing better audits and that reform is not in investors’ interests.

**4.2 The Economics of Auditor Liability Caps**

All other things being equal, caps on auditor liability are desirable from the auditors’ point of view. Lower liability exposure amounts to lowering the cost to the auditor of a given audit engagement. If this lowered cost were the only consequence of liability caps, such caps would clearly be to auditors’ advantage. This is, however, unlikely.

Lower exposure of an auditor to liability lowers the cost to an auditor of a given engagement, but there are other consequences of limiting liability. The liability of auditors (and other sellers of goods and services) is intended to induce them to be diligent in providing such services to their clients. Any tendency in a service provider towards saving money or effort by cutting corners on quality of service is counterbalanced by the possibility of increased exposure to liability. Since the quality of services in general, and audit service in particular, is notoriously difficult for clients and others to observe, this internal balancing act by the service provider plays an important role in proper functioning of the market for this service.

By reducing the liability exposure, the introduction of a liability cap would also induce the auditor to lower the quality of service provided. Each unit of additional diligence costs effort or money on one hand, and reduces liability on the other. In the absence of a cap, the auditor will choose a level of effort so that the additional cost of the marginal unit balances the additional reduction in expected liability. Since a cap eliminates liability above the specified level, the expected liability for any given level of effort is lowered, meaning that the equality condition between the marginal cost and expected marginal liability is met at a lower level of effort. Simply put, we should
expect liability caps to put a downward pressure on the quality of audit services rendered.

Such a reduction in quality, taken by itself, should not be a matter of concern to auditors, that is, until we consider the point of view of those who buy their services. From the perspective of companies and their investors who pay the auditor, a reduction in quality is not a desirable event. Under these circumstances, investors and companies would be inclined to pay less for auditors’ services for two reasons. First, the limitation of liability induces auditors to lower the quality of their services, thus exposing the investors to a higher probability of error or fraud in financial reports and, under the stewardship model, fraud in the company as well. Second, caps also reduce the amount investors can expect to recover from auditors if the latter are found to be guilty of negligence in their work or, under the PSLRA, guilty of fraud. Hit by this double whammy, companies will be willing to pay less for the service of an auditor in an open market. In other words, other things being the same, the open market price paid by clients for audit services for a given engagement under a regime of liability limitation will be lower.

While it is clear that the price and the quality of audit service will come under a downward price pressure in a regime of liability limitation, the consequences for the profitability of the firm are not clear. Liability limitation may cut auditors’ legal costs, but in a competitive but highly concentrated market for audit services, it is not clear that auditors will get to carry any of these cost savings to their bottom line instead of transferring them to clients in the form of lower prices. We are not aware of any arguments to suggest that the net profit to auditors will necessarily increase or

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16 If a fraud in a company involves theft of assets and the financial statements show the true position of the company after the theft, then an audit of the financial statements alone may not uncover the defalcation.

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
decrease as a result of liability limitation, nor is it clear whether it will make the investors necessarily better or worse off.

4.3 Regulatory Requirement of Audit Certification

In the preceding argument we have assumed that each (public) company is required by law or regulations to obtain an audit certificate or report from “qualified” parties. These parties are expected to provide audit services of a given quality, although there is no reliable way for clients to verify if services of the specified quality have been delivered. The PCAOB in the US and the Audit Inspection Unit in the UK inspect audit firms for quality control.

Suppose there were no such requirement for public companies to obtain an audit certificate (as was the situation in the US before the 1933 Securities Act). This would leave the market open to the possibility that some firms may choose not to “buy” audit certificates, while others do. The market forces in such open competition will push the price of audit towards its value to the company and its investors. To the extent liability limitations reduce the insurance value of audit, their introduction inhibits evolution of a wide range of audit services.

4.4 Liability Caps and Industry Consolidation

In the US, the UK and many other countries, a large portion of the audit services for large publicly held companies are now provided by four international firms: Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers. This is an unacceptable level of concentration in the industry. Some have argued that concentration is more than the number four would suggest, because these four firms are not quite substitutes for one another. Firms which supply advisory services to a company are excluded as candidates for audit, and in certain industries and locations in the world, companies often have less than four as real options. For example, since
an auditor cannot audit its own bank, the number of audit firms a large bank may choose from is already down to three.

There is widespread concern among regulators, as well as client firms, about the possibility of further consolidation in the industry. If another firm fails, it could leave the market for audit services to the remaining three, considerably increasing concentration and reducing competition among them. What would be the effect of introducing auditor liability limitation on industry concentration?

In a world without liability caps, if two or more audit firms are consolidated or the largest firms expand their client base at the expense of the smaller firms, they would have to consider, among other things, the possibility that if the consolidated or larger firm is found to have been negligent or fraudulent in an audit (depending on the country regime), the assets of the increased-size firm would be at risk, as compared to the risk of the pre-consolidation component firms. This consideration of increased risk exposure would discourage consolidation or increased concentration of the industry, other things being the same. The introduction of liability limitation takes away this additional risk associated with consolidation and expansion, and is therefore likely to encourage further consolidation or concentration in the industry in the event of a collapse of another firm. It has also been suggested that allowing audit firms to be owned by third parties would enable smaller firms to expand their capital base and compete more effectively with the Big Four, but this ignores the likelihood that the Big Four themselves would take the opportunity to expand further (Accountancy Age 2005).

It may be argued that the demise of Andersen was caused both by the conduct of the firm in failing to discharge its public interest responsibilities and by the overzealous behavior of the US Department of Justice in taking action against the
firm instead of the individuals responsible. However, the mergers of the audit firms to reduce their number to five were entirely of their own doing, driven by a desire for competitive advantage. The Big Four firms have used industry concentration as their primary argument for liability reform, as they are aware of regulators’ concerns about disruption to the capital markets should another firm collapse, even though Andersen did not collapse through inability to settle claims.

4.5 Global Regulation and Global Liability

The listed-company segment of the audit industry is essentially concentrated in the hands of the Big Four firms. The firms claim to be global networks, and there is without doubt global branding. However, there remains considerable doubt as to whether there is global liability, although the Parmalat case\textsuperscript{17} (Parmalat, 2005 US Dist.Lexis 12553) may open the possibility of global liability and bring about a change in the way firms structure and market themselves. Green (1999) is concerned that those outside the audit firms cannot tell how serious the litigation crisis really is because the firms do not publish sufficient information about themselves or their litigation costs to enable evaluation of the true position. Information about claims is given as part of the lobbying for liability caps, but no information about costs and settlements is made available.

It is understandable that these audit firms believe that their work would be easier, perhaps more efficient and less risky, if it were to be governed by common, written, international standards. They argue that the process of auditing clients, especially larger, often multinational, companies, in a global patchwork quilt of audit standards and legal liability regimes is confusing at best; this situation makes it harder

\textsuperscript{17}The judge for the US District Court for the Southern District of New York allowed the case against Deloitte and Grant Thornton in the US to proceed because the case was effectively against the networks. The case has now been dropped.
to train their staff with clear guidelines and creates uncertainty about how the quality of their work might be judged by others after the fact.

That uniform auditing standards would make auditing easier is an extension of the argument from financial reporting, i.e., international standards will produce more uniform and comparable financial reports worldwide. The validity of this argument is subject to question. In financial reporting, uniformity and comparability depends not only on accounting standards, but also on the economic and business environment in which various firms operate. Application of the “same” accounting standards to firms operating in different countries with diverse legal and tax regimes, or to industries and to firms of varying sizes, does not yield comparable results. In auditing, the comparability problem across legal and tax regimes and across diverse observability of transactions is even more acute.

The responsibility and authority of auditors depends not only on the economic but also the legal environment of business and corporate governance. The US and the UK are often cited to have very similar environments. Yet, a comparison (see Tables 1 and 2) reveals major difference between these presumably similar countries that affect the authority and responsibility of auditors. The same auditing standards, applied to the supposedly similar environments of the US and the UK could yield quite different results. The consequences of applying a “one-size-fits-all” international set of auditing standards to countries with diverse legal and economic environments can hardly be expected to yield comparable results. Consider the following:

- The effect of limitation of liability in both countries is different. US firms have a clear position that they are not liable under the Securities Acts. The SEC can only take action against them if they are criminal or collusive.
• Because auditors report to shareholders in the UK, UK companies need to get their shareholders’ approval of liability limitation, and some shareholders are already threatening to vote against it. Firms may be sued for negligence, although regulators do not take action if only negligence is involved. In the future, under the Companies Act of 2006, auditors may be criminally liable for knowingly or recklessly issuing a misleading opinion.

• The events which turned six firms into four originated in the US. Limiting liability in other countries may not make much difference to the global audit market, other than making the Big Four even more powerful and less accountable for poor auditing to investors and/or companies (and other stakeholders in some regimes) than they already are.

• The stewardship model of auditing in the UK creates a different liability regime than the decision usefulness model in the US. The Caparo case makes it difficult for shareholders to sue auditors. Under the stewardship model, the loss in the company can be claimed, but not the loss to the shareholders from drop in share price.

‘Global’ standards, which the Big Four may influence through funding the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC), will give them a potential advantage. This advantage may serve as a barrier to entry by domestic or smaller firms. Since all regulation is at the national level in the absence of a global unitary regulation, international firms or their networks are difficult to control. In other words, globalization of markets without corresponding change in regulatory framework has empowered global audit firms.

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18 The merger between Coopers Lybrand and Price Waterhouse was US driven and the Andersen collapse happened in the US.
Over time, this additional power, if unfairly exploited, may lead to a loss of trust by regulators and other stakeholders, diminishing the value of the service they offer.

5. The Expectations Gap, Auditing Standards, Increased Regulation, and Globalization

As a result of accounting and audit failures in both the US and the UK, an expectations gap is said to exist in both jurisdictions. Chapin (1992), the US Assistant Comptroller General for Accounting and Financial Management, refers to the profession’s campaign to limit liability and believes that the US regulators have unbelievably low perceptions of the profession. Trying to close the gap by lowering the responsibility of auditors would be the wrong solution. He refers to the Report of the National Commission on Fraudulent Financial Reporting (1987), also known as the Treadway Commission, which recommended early warning of business failures, reporting on related party transactions, and detection of fraud, among other changes. He suggests that the gap between the Treadway Commission’s ideas and the US profession’s implementation guidance would ‘fill the Grand Canyon’. Interestingly, to overcome the Presidential veto of the PSLRA, the provisions proposed a decade earlier by the Treadway Commission were finally introduced.

Humphrey (1997) reviews the expectations gap in both the US and the UK and attributes its origins to the US. According to him, the purposes of audit in the UK are stewardship, information, and insurance. He cites Moizer (1992) who argues that the unobservability of audit would lead the auditor to ensure that audits did not fall below the minimum standards required, and they would benefit economically by improving their image with management. He also refers to how auditing standards have moved away from reporting on fraud.
Audit methods have changed. Until the 1980s, audits in both countries focused on tests of company’s internal controls (Cooper 1973) and the degree of reliance on controls dictated the scope of the remaining parts of the audit. These methods began to change to a risk based approach, which in turn developed into a business risk approach, focusing on whether the company itself was at risk of not meeting its own objectives. Eliffsen, Knechel and Wallage (2001) believe this improves assurance to the client and increases opportunities for value added services. Others doubt this. Jeppesen (1998) believes that identifying with the objectives of management undermines auditors’ independence. Levitt (1998) refers to ‘re-engineered approaches that are efficient but less effective’. Section 404 of the Sarbanes-Oxley Act requires the auditors to report on the company’s internal financial controls.

Disenchantment with the quality of auditing standards, as set by the US profession, led to the transfer of the responsibility for standards setting to the PCAOB under the Sarbanes-Oxley Act. Whether this transfer leads to an improvement in auditing quality remains to be seen. The International Audit and Assurance Standards Board (IAASB) sets International Standards of Auditing (ISAs), which have now been adopted for use in the UK, with appropriate additions to meet UK legal requirements, beginning with the year ending December 2005. Concern about the adoption of ISAs has been expressed by Morley (2005) as some believe that the ISAs are based on the US model of auditing, i.e., financial statement audit, rather than stewardship. The Institute of Chartered Accountants of Australia (ICAA) also expresses concern about the ISA model (ICAA 2003).

IAASB is part of IFAC, which is entirely funded by accountancy professional bodies worldwide and the large audit firms. IFAC is based in New York and appears to be heavily influenced by the US profession (Giles, Venuti, and Jones 2004).
has already been resistance in the UK to the potential loss of the true and fair override due to changes from the adoption of International Financial Reporting Standards (IFRS) (Jopson 2005). After pressure from institutional investors, this has now been partially restored in the 2006 Companies Act. 19 Concerns remain in the UK that the adoption of global standards, with a decision usefulness focus in both accounting and auditing, but without a comparable liability regime for information risk, may lead to compromises in quality of financial reporting and auditing which are not in the UK public interest.

The Sarbanes-Oxley Act has also transferred some of the responsibility for audit quality to the company audit committees and the PCAOB inspection unit. There has been a similar transfer of responsibility in the UK to audit committees and the Audit Inspection Unit. Thus, audit risk (the risk of giving the wrong opinion), which was previously borne by the auditors and the professional bodies who managed quality control and set standards, is now shared with audit committee directors and regulators.

6. Concluding Remarks

Auditors feel the pressure of liability when an investor suit for negligence or fraud is filed against them. Settlements or judgments against the auditors generate a natural and understandable wish on their part for their liability to be lower. Liability could be lowered either by law (statute or tort), or through greater diligence in auditing practices. Neither is without potential consequences undesirable for auditors. The legal route, e.g., LLPs, proportional liability, liability caps in engagement letters, safe-haven headquarters, reduces the insurance value of auditing to the clients and regulators.

19 The Act requires accounts to show a true and fair view, but it will not be clear, until the clauses are interpreted into audit report wording, whether the override has been fully restored. The matter is further complicated by the parallel use of IFRS and UK GAAP in financial statement preparation.

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
potentially increases the moral hazard for the auditor. The diligence route reduces the residual of the audit fee the auditor can take home as compensation (Sunder 1997).

As long as audit fees remain a matter of negotiation between auditors and their customers, economics suggests that we should expect that reducing the value of the audit service through legal means will be accompanied by a reduction in the price the customers are willing to pay for the service. Once this linkage between their liability and the investor willingness to pay for their services is recognized, the wisdom of the auditors’ campaigns to restrict their liability becomes less obvious. Indeed, it could be argued that such campaigns help speed up the economic demise of a profession that at present more than sustains itself by earning decent profits.

Auditors could conceivably push to have the price of their services fixed by regulation. Since the quality of audit service is difficult for their customers to monitor, such a step is likely to result in the ultimate transformation of auditing from a service provided by privately owned businesses to a function of the civil service.

The diligence route is not without problems of its own. Doing more work leaves less net compensation for the auditor after the cost of their efforts is subtracted from the fee paid by the client. This net compensation determines the quality of talent the audit profession can attract and retain. If this compensation falls much below what their class fellows who choose to go into corporate management, investment banking, or law earn, the quality of talent in audit profession will suffer. This will not serve the investors well. However, there is some anecdotal evidence emerging in the UK that excessive regulation may be a greater deterrent to retention of high quality staff.

The increasing complexity of businesses—their diversification across products, industries, geography, and legal and financial structure—increases the amount of effort the auditor must exert to gain the same level of assurance for themselves and
their clients. The additional cost of auditing associated with additional complexity should discourage such complex structures. At present, there is a mismatch between the integrated globalized companies and the largest audit firms on the one hand, driving the global standards for accounting and auditing, and the fragmented national regulation of corporations, securities markets, audit firms, and national audit quality on the other. This mismatch adds to the difficulty of developing a single stable audit regime, where standard setting is global, multi-layered, and difficult for any one regime to influence. What is developing, in a fragmented way, is a transfer of audit risk from audit firms to regulators and company audit committees. This is combined with a push from the profession for limitation of liability and with an auditing standards model that focuses on decision usefulness, despite being applied in some regimes where audit is required by the law to be stewardship based. There seems to be little consideration of the potential for increased moral hazard for auditors and reduced insurance value to investors of the audit service. In the absence of rational, evidence-based policy-making in this area, there is a real risk that all parties could eventually be made worse off.

The Big Four audit firms continue to press regulators for liability limitation and are achieving a considerable degree of success. Liability reform has already been achieved in the US and in the UK and may be introduced in the EU. Regulators’ concern that the failure of a major firm could cause market disruption, and their desire to find ways of reducing market concentration seem to have primacy over consideration of the risks which liability reform may bring. It is surprising that regulators are considering such major concessions to audit firms without requiring them to be far more transparent to clients regarding claims against them, the true costs of litigation, and their financial reports.
References


Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007


Table 1: Key Features of the US and UK Legal and Regulatory Regimes for Listed Companies and Their Auditors

<table>
<thead>
<tr>
<th>Topic</th>
<th>US Regime</th>
<th>UK Regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation law</td>
<td>Corporation law is set at the state level and varies by state.</td>
<td>Company law is set by the UK Parliament and applies to all UK companies regardless of their size or listing status.</td>
</tr>
<tr>
<td></td>
<td>Corporations may choose the state in which they wish to incorporate.</td>
<td>As a member of the EU, the UK government is required to adopt EU Directives into UK law. This is normally done by revisions to existing law or by subsidiary regulation.</td>
</tr>
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<td></td>
<td>Most corporations, especially the larger ones, choose to incorporate in the State of Delaware.</td>
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</tr>
<tr>
<td>Regime for listed companies</td>
<td>Governed by the Securities Act 1933, the Securities Exchange Act 1934, and the Sarbanes Oxley Act of 2002. Stock exchanges issue listing standards subject to the SEC’s approval.</td>
<td>Governed by the requirements of Companies Acts and by the additional requirements of the Listing Rules set by the UK Financial Services Authority (FSA). The Listing Rules are subject to amendment for compliance with EU Directives.</td>
</tr>
<tr>
<td>Market structure</td>
<td>Approximately 40 percent of outstanding shares are held by individuals and 60 percent by financial institutions.</td>
<td>Approximately 20 percent shares are held by individuals and 80 percent by institutions.</td>
</tr>
<tr>
<td></td>
<td>Approximately 13,000 domestic listed companies and 1,350 foreign companies.</td>
<td>Approximately 1350 UK domestic companies and 350 foreign companies with a full listing. Also 1400 on AIM (less regulated) market.</td>
</tr>
<tr>
<td>Accountability and governance</td>
<td>US listed company boards are normally composed of a majority of non-executive directors (outside directors). The CEO may be the only board member who is an executive of the company. The board has an oversight role over the managers.</td>
<td>UK boards are normally composed of executive directors, i.e., managers, and non-executive directors. Managers and non-executive directors function together as a unitary board.</td>
</tr>
<tr>
<td></td>
<td>It is difficult for investors to have a real voice in directors’ appointment to, or removal from, office except as a rubber stamp for the nominated slate.</td>
<td>Under UK company law investors can (and do) appoint and remove directors from office by vote. This enables institutions to exercise control over directors.</td>
</tr>
<tr>
<td></td>
<td>Governance derives mainly from state law and requirements of stock exchanges which are approved by the SEC. Federal law, e.g., the Sarbanes-Oxley Act of 2002, imposes some requirements on directors, including maintaining an effective system of internal control and reporting on its effectiveness.</td>
<td>Governance derives partly from company law and partly from the Combined Code which is issued by the Financial Reporting Council. The Code offers a “comply or explain” model which is incorporated into the FSA Listing Rules.</td>
</tr>
<tr>
<td></td>
<td>In most states (including Delaware), auditors report to directors. In others, they report to shareholders.</td>
<td>Company law requires the directors to maintain proper accounting records, and the Combined Code requires directors to report on adequacy of internal control systems.</td>
</tr>
<tr>
<td></td>
<td>The audit committee is responsible for appointing, compensating, retaining, and overseeing the work of the external auditor.</td>
<td>Under company law auditors always report to shareholders.</td>
</tr>
</tbody>
</table>

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007 38
### Table 1 (Continued): Key Features of the US and UK Legal and Regulatory Regimes for Listed Companies and Their Auditors

<table>
<thead>
<tr>
<th>Filing of reports and information dissemination</th>
<th>All US listed companies are required to file financial information annually with the SEC on form 10-K and on quarterly form 10Q, which is available online to investors. Companies release results quarterly with other price sensitive information released as it arises. They have to provide an annual report including financial statements to shareholders.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Key regulators</td>
<td>The US Securities and Exchange Commission (SEC) is responsible for the regulation of the US stock exchanges and enforcement of its rules. It is responsible for investigation and punishment of offenders (auditors and company directors/managers) for violations of its rules. Financial reporting standard setting for listed companies is the responsibility of the US Financial Accounting Standards Board (FASB), which is subject to oversight by the SEC. There are no other financial reporting standards. The Public Company Accounting Oversight Board (PCAOB) regulates the auditors of US listed companies and also foreign auditors of US listed companies, who are also subject to their own domestic regulation. Audit firms must register with the PCAOB and are subject to inspections of their work. Reports are made public and firm specific. PCAOB sets auditing standards for listed company auditors only. Auditor independence rules remain with the SEC. SEC sets PCAOB’s budget. The US auditing profession is responsible for setting auditing standards for non-listed entities.</td>
</tr>
<tr>
<td>Key regulators</td>
<td>All UK listed companies are required to send an annual report to the FSA and file on public record at Companies House. Accounts or summary accounts are sent to all shareholders unless the shares are held in a managed fund. The annual report is the same document for both purposes. Results are announced semi-annually with other price sensitive information being disseminated as it arises. The Financial Services Authority regulates the UK Stock Exchanges (mainly London) and investigates and disciplines violations of the Listing Rules in relation to trading activities and company announcements. Accounting standards for listed companies are set by the International Accounting Standards Board (IASB). UK GAAP currently remains in effect for non-listed entities. The Financial Reporting Council (FRC) is responsible for the following: setting auditing standards and standards for auditor independence, which apply to all audits carried out in the UK (not just those of listed companies); enforcement of compliance with accounting standards for public interest entities; investigation and disciplining of qualified accountants involved in public interest scandals; setting accounting standards for non-listed companies; oversight of all the activities of the UK accountancy professional bodies (of which there are six); and inspection of public interest audits. Inspection reports are made public but are not firm-specific. Four accountancy professional bodies issue audit licenses to firms and individuals, including public interest auditors, subject to FRC oversight. The Institute of Chartered Accountants in England and Wales issues the licenses to the Big Four firms.</td>
</tr>
<tr>
<td>Objectives of financial reporting</td>
<td>Financial reporting under the Securities Acts and the FASB framework is driven by the decision usefulness model of accounting, i.e., providing information to support investors’ buy, sell or hold decisions. The stewardship function of accounting is not considered by the FASB. Financial reporting under UK company law is based on the stewardship model, i.e., accountability of the directors to their existing shareholders in running the company, keeping proper records, and safeguarding its assets. This links to the rights of shareholders to remove directors. The decision usefulness approach is found in accounting standards but not in company law.</td>
</tr>
</tbody>
</table>
Table 2: Differences between US and UK Regimes with respect to the Duties of Auditors and their Liability

<table>
<thead>
<tr>
<th>Topic</th>
<th>US regime</th>
<th>UK regime</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Auditors’ report</strong></td>
<td>Under SEC regulations, auditors are required to report that financial statements are being fairly presented in accordance with US GAAP.</td>
<td>Under the 1985 Companies Act auditors are required to report whether the financial statements show a true and fair view and comply with the Act. Auditors are required to state in their report if: proper accounting records have not been kept; if they have not received all the explanations and information they require; if returns adequate for their audit have not been received from branches not visited; and if the financial statements are not in agreement with the accounting records returned. These provisions have been substantially carried forward into the 2006 Companies Act.</td>
</tr>
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<td></td>
<td>Under Section 404 of Sarbanes-Oxley Act auditors are required to report on management’s assessment of the internal controls.</td>
<td>Auditors may qualify their report with an adverse opinion for disagreement, a disclaimer for limitation of scope, or an ‘except for’ opinion under both the above Companies Acts, where the non-compliance is material but not pervasive to the financial statements.</td>
</tr>
<tr>
<td></td>
<td>Audit report qualifications are not accepted on filings under SEC regulations, although modified reports may be issued in respect of going concern problems.</td>
<td>Modified reports may be filed in cases where there are going concern problems.</td>
</tr>
<tr>
<td><strong>Auditors’ duties</strong></td>
<td>Auditors owe a duty of care to the company under the law of contract at the state level. They may also be sued under tort, but the plaintiff must be able to show a causal link to reliance on the auditors’ negligent misrepresentation.</td>
<td>Auditors owe a duty of care to the company under contract law and a duty of care to the shareholders in tort. Privity and proximity generally apply but in certain circumstances the duty of care may extend to third parties (ADT v BDO Binder Hamlyn (1996) BCC 808) if the auditor is aware that the third party will rely on the audit report. Causality remains a condition.</td>
</tr>
<tr>
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<td>The auditor may be sued under statute, i.e., the Securities Acts, for violations of duties imposed by statute. Ernst &amp; Ernst v. Hochfelder 1976 established that the defendant had to act intentionally or recklessly to be found guilty. Most claims relate to drops in share price.</td>
<td>The Caparo case (1990) defines responsibility of auditors to the shareholders as a group, but not to current or potential individual investors. However, auditors also have a duty to protect the company from itself.</td>
</tr>
<tr>
<td></td>
<td>In some states, foreseeability may apply to third parties whose reliance on audit report was foreseeable by the auditor.</td>
<td>Auditors are liable to the company or the shareholders for losses incurred within the company as a result of their negligence and for subsequent losses. Investors cannot sue for a fall in share price, and there are no class actions.</td>
</tr>
<tr>
<td></td>
<td>The PSLRA (1995) and SLUSA (1998) effectively limited the potential for class actions against auditors to those in which criminality is involved, but other claims are possible.</td>
<td>The majority of claims against UK auditors are made by liquidators. A recent major exception was the Equitable Life case where the claim was made by the directors of the company.</td>
</tr>
</tbody>
</table>
Table 2 (Continued): Differences between US and UK Regimes with respect to the Duties of Auditors and their Liability

| Legislative position on joint-and-several liability | The Securities Act of 1933 mandated that all listed companies should have an audit, but joint-and-several liability would apply to external claims. At this stage, all firms were partnerships with unlimited liability themselves. Following relaxing of rules in 1992 by the Association of Certified Public Accountants (AICPA) to allow accounting firms to adopt different corporate forms, legislation in various US states allowed audit firms to incorporate as Limited Liability Partnerships (LLPs), protecting the partners’ personal assets. All the large firms in the US are now LLPs. In 1995, the Private Securities Litigation Reform Act (PSLRA) restricted the claims that could be made against auditors and other professionals. It removed the incentives for claimants to participate in class actions, created new rules for settlements and sanctions on attorneys for meritless cases. Joint-and-several liability only applies where there is criminality on the part of the auditor, not just aiding and abetting. In 1998, the Securities Litigation Uniform Standard Act limited the opportunities of litigants to use the state courts to pursue actions which PSLRA restricted. |
| In 1900, the Companies Act required all companies to have an audit. In 1929, Companies Act prohibited auditors from limiting their liability, but included provisions for reasonableness. These provisions were carried forward into the 1985 Companies Act: Section 310 prohibits an auditor from limiting liability, and Section 727 provides for the courts to relieve an auditor of all or part of his liability if he has acted honestly and reasonably. Until 1989, all audit firms were partnerships with unlimited liability applying to the personal assets of all the partners. In 1989, the Companies Act allowed audit firms to incorporate, but, of the large firms, only KPMG incorporated its listed company audit practice in 1995 with a capitalization of £50m. In 2000, the Limited Liability Partnerships Act allowed audit firms (and other entities) to create LLPs, thus protecting the assets of the partners against claims, but not the assets of the firms. All the large firms are now LLPs. This protects the personal assets of partners in the firms, except for the partners who were responsible for the failed audit where section 310 of 1985 Companies Act still applies. The Companies Act 2006 allows limitation of auditor liability in the UK by contract with the company, subject to shareholder approval and subject to the amount being fair and reasonable in all the circumstances of the case. There are provisions in the EU 8th Directive (article 30a) for review of auditor liability in the EU. |

| Legislative position on joint-and-several liability | The Securities Act of 1933 mandated that all listed companies should have an audit, but joint-and-several liability would apply to external claims. At this stage, all firms were partnerships with unlimited liability themselves. Following relaxing of rules in 1992 by the Association of Certified Public Accountants (AICPA) to allow accounting firms to adopt different corporate forms, legislation in various US states allowed audit firms to incorporate as Limited Liability Partnerships (LLPs), protecting the partners’ personal assets. All the large firms in the US are now LLPs. In 1995, the Private Securities Litigation Reform Act (PSLRA) restricted the claims that could be made against auditors and other professionals. It removed the incentives for claimants to participate in class actions, created new rules for settlements and sanctions on attorneys for meritless cases. Joint-and-several liability only applies where there is criminality on the part of the auditor, not just aiding and abetting. In 1998, the Securities Litigation Uniform Standard Act limited the opportunities of litigants to use the state courts to pursue actions which PSLRA restricted. |
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Table 3: Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest UK Audit Firms

<table>
<thead>
<tr>
<th>Firm: Year end Auditors</th>
<th>Accounting policy for claims</th>
<th>Disclosures under provisions for liabilities and charges</th>
<th>Contingent liability note disclosures re: claims</th>
<th>Average profit per partner</th>
</tr>
</thead>
</table>
| Deloitte 31 May 2005 Grant Thornton Audit fee: £200,000 | **Note 1: Provisions** Provision is made on a case by case basis in respect of the cost of defending claims and, where appropriate, the estimated cost of settling claims net of insurance recoveries. | **Note 12 (extract)** £m  
At 1 June 2004  19.0  
P/L charge  7.4  
Unused  (8.0)  
Utilised  (5.3)  
At 31 May 2005  13.1 | **Note 20** No disclosure specifically identifiable to liability claims | Note 7 £702,000 |
| 31 May 2006 Grant Thornton Audit fee: £300,000 | **Note 2: Provisions (extract)** Provisions are recognized when the group has a present obligation as a result of a past event, and it is probable that the group will be required to settle that obligation. Provisions are measured at the partners’ best estimate of the expenditure required to settle the obligation at the balance sheet date and are discounted to present value when the effect is material… | **Note 15: Provisions (extract)** Professional liability claims  
At 1 June 2005  13.1  
P/L charge  4.4  
Unused  (1.1)  
Utilised  (5.6)  
At 31 May 2005  10.8 | **Note 22** No disclosure specifically identifiable to liability claims | Note 8 £765,000 |
Table 3 (cont’d) Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest
UK Audit Firms

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<tr>
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<th>Average profit per member</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ernst &amp; Young 30 June 2005 BDO Stoy Hayward</td>
<td>Note 1: Claims Provision is made on a case by case basis in respect of the cost of defending claims and, where appropriate, the estimated cost to the firm of settling claims. Separate disclosure is not made of any expected insurance recoveries in respect of claims on the grounds that disclosure might seriously prejudice the position of the firm.</td>
<td>Note 18 (extract) At 1 July 2004 17 P/L charge 9 Release (4) Paid (3) At 30 June 2005 19</td>
<td>Note 21 In the normal course of business Ernst and Young LLP may receive claims for alleged negligence. Substantial insurance cover is carried in respect of professional negligence. Cover is principally written through captive insurance companies involving other Ernst &amp; Young firms and a significant proportion of the total cover is reinsured through the commercial market. Where appropriate, provision is made for the costs arising from such claims.</td>
<td>Consolidated P/L account £561,000</td>
</tr>
<tr>
<td>30 June 2006 BDO Stoy Hayward Audit fee: £300,000</td>
<td>Note 2: Provisions and contingencies (extract) Provisions are recognized when the firm has a present obligation (legal or constructive) as a result of a past event. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. The amount of the provision represents the best estimate of the expenditure required to settle the obligation at the balance sheet date. … Separate disclosure is not made of any expected insurance recoveries in respect of claims on the grounds that disclosure might seriously prejudice the position of the firm.</td>
<td>Note 16 (extract) At 1 July 2005 19 P/L charge 19 Release (4) Paid (3) At 30 June 2005 31</td>
<td>Note 21 In the normal course of business the firm may receive claims for alleged negligence. Substantial insurance cover is carried in respect of professional negligence. Cover is principally written through captive insurance companies involving other Ernst &amp; Young firms and a significant proportion of the total cover is reinsured through the commercial market. Where appropriate, provision is made for the costs arising from such claims.</td>
<td>Note 7 £686,000</td>
</tr>
</tbody>
</table>

Consolidated P/L account £561,000

£686,000

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
Table 3 (cont’d) Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest UK Audit Firms

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</tr>
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</table>
| KPMG 30 September 2005  | Note 1: Insurance arrangements  
Insurance cover in respect of professional negligence claims is principally written through a number of mutual insurance companies, but also through the commercial market. Where appropriate, provision is made against the eventual settlement of claims with any related insurance recoveries included in debtors as ‘Other debtors’.  
Note 1: Provisions  
Provision is recognized in the balance sheet when the group has a present or legal constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation… | Note 18: Provisions  
No disclosure of provisions for claims. | Note 23: Contingencies  
The businesses consolidated in the financial statements of the group may, in the normal course of conducting their businesses, receive claims for alleged negligence. They contest such claims vigorously and maintain appropriate professional indemnity cover. | Note 3: £556,000 |
| Grant Thornton  
Audit fee: £200,000 | | | | |
| 30 September 2006  | Note 1: Insurance arrangements  
A substantial level of insurance cover is maintained in respect of professional negligence claims. This cover is principally written through captive or mutual insurance companies. Premiums are expensed as they fall due. Where appropriate, provision is made for the uninsured cost to the group of settling negligence claims. Separate disclosure is not made of insured costs and related recoveries on the grounds that such disclosure would be seriously prejudicial to the position of the group.  
Note 1: Provisions  
Provision is recognized in the balance sheet when the group has a present or legal constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation… | Note 13: Provisions  
No disclosure of provisions for claims | Note 19: Contingencies  
The businesses consolidated in the financial statements of the group may, in the normal course of conducting their businesses, receive claims for alleged negligence. They contest such claims vigorously and maintain appropriate professional indemnity cover. | Note 3 £680,000 |
| Grant Thornton  
Audit fee: £230,000 | | | | |
| Note 18: Provisions  
No disclosure of provisions for claims. | |
No disclosure of provisions for claims | | | |

Bush, Fearnley, Sunder, Auditor Liability, August 27, 2007
Table 3 (cont’d) Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest UK Audit Firms

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<tbody>
<tr>
<td>Pricewaterhouse Coopers 30 June 2005 Horwarth Clark Whitehill Audit fee: £300,000</td>
<td>Note 1 Provisions In common with comparable professional practices, the Group is involved in a number of disputes in the ordinary course of business which may give rise to claims. Provision is made in the financial statements for all such circumstances where costs are likely to be incurred and represents the cost of defending and concluding claims. The Group carries professional indemnity insurance, and no separate disclosure is made of the cost of claims covered by insurance as to do so could seriously prejudice the position of the Group.</td>
<td>Note 14: Provisions (extract) At 1 July 2004 47 P/L charge 7 Released unused (5) Cash payments (6) At 30 June 2005 43 The claims provision is the estimated cost of defending and concluding claims. No separate disclosure is made of the cost of claims covered by insurance, as to do so could seriously prejudice the position of the Group.</td>
<td>Note 22 The Group’s policy with regard to claims which may arise in connection with disputes in the ordinary course of business is described in note 1 on provisions.</td>
<td>Note 7 £620,000</td>
</tr>
<tr>
<td>30 June 2006 Horwarth Clark Whitehill Audit fee: £300,000</td>
<td>Note 1 Provisions In common with comparable professional practices, the Group is involved in a number of disputes in the ordinary course of business which may give rise to claims. Provision is made in the financial statements for all such circumstances where costs are likely to be incurred and represents the cost of defending and concluding claims. The Group carries professional indemnity insurance, and no separate disclosure is made of the cost of claims covered by insurance as to do so could seriously prejudice the position of the Group.</td>
<td>Note 14: Provisions (extract) At 1 July 2005 43 P/L charge 5 Released unused (2) Cash payments (13) At 30 June 2006 33 The claims provision is the estimated cost of defending and concluding claims. No separate disclosure is made of the cost of claims covered by insurance, as to do so could seriously prejudice the position of the Group.</td>
<td>Note 21 The Group’s policy with regard to claims which may arise in connection with disputes in the ordinary course of business is described in note 1 on provisions.</td>
<td>Note 7 £716,000</td>
</tr>
</tbody>
</table>
Table 3 (cont’d) Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest UK Audit Firms

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<tr>
<th>Firm: Year end Auditors</th>
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<th>Disclosures shown under provisions for liabilities and charges £m</th>
<th>Contingent liability note disclosures re: claims</th>
<th>Average profit per member</th>
</tr>
</thead>
</table>
| Grant Thornton          | No disclosure under accounting policies | Note 13 Extract: Insurance claim provisions  
At 1 July 2004 5.2  
Settlements (.8)  
Released to P/L (2.0)  
Provided during year 1.4  
At 30 June 2005 3.8  
The provision for claims is in respect of the estimated amounts for commercial settlements and professional indemnity claims. | Note 22  
No contingent liabilities re claims | Note 5  
£354,426 |
| 30 June 2006  
PKF: £152,000 | No disclosure under accounting policies | Note 16 extract  
At 1 July 2005 3.8  
Settlements (.5)  
Released to P/L (.9)  
Provided during year 2.4  
At 30 June 2006 4.8  
The provision for claims is in respect of the estimated amounts for commercial settlements and professional indemnity claims. | Note 22  
No contingent liabilities re claims | Note 5  
£384,840 |
Table 3 (cont’d) Disclosures of Liability Provisions and Partner Remuneration in the Published Financial Statements of the Six Largest UK Audit Firms

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<tr>
<td>BDO Stoy Hayward 30 June 2005 Pricewaterhouse Coopers Audit fee: £200,000</td>
<td>Note 1 Professional Insurance Provision is made on a case by case basis in respect of the cost of defending claims and, where appropriate, the estimated cost of settling claims where such costs are not covered by insurance. Outstanding claims are reviewed each year and adjustments to provisions are made as appropriate in the current year. In common with comparable businesses, the Group is involved in a number of disputes in the ordinary course of business, which may give rise to claims. The group carries professional indemnity insurance and no separate disclosure is made of the cost of claims covered by insurance as to do so could seriously prejudice the position of the Group.</td>
<td>Note 16 Extract At 1 July 2004 2.9 Utilised during year (0.5) Charged to P/L 3.3 At 30 June 2005 5.7</td>
<td>No contingent liability note</td>
<td>Note 7 £291,000</td>
</tr>
<tr>
<td>30 June 2006 Pricewaterhouse Coopers Audit fee £200,000</td>
<td>Note 1 Professional Insurance Provision is made on a case by case basis in respect of the cost of defending claims and, where appropriate, the estimated cost of settling claims where such costs are not covered by insurance. Outstanding claims are reviewed each year and adjustments to provisions are made as appropriate in the current year. In common with comparable businesses, the Group is involved in a number of disputes in the ordinary course of business, which may give rise to claims. The group carries professional indemnity insurance and no separate disclosure is made of the cost of claims covered by insurance as to do so could seriously prejudice the position of the Group.</td>
<td>Note 15 Extract At 1 July 2004 5.7 Utilised during year (0.4) Charged to P/L 1.5 At 30 June 2005 6.8</td>
<td>No contingent liability note</td>
<td>Note 7 £327,000</td>
</tr>
</tbody>
</table>