STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Liability, insurance and settlements

Introduction

1. This paper is part of our assessment of barriers to entry or expansion in the market for statutory audits to the FTSE 350 companies as outlined in the Barriers to entry framework working paper.[1]

2. It first considers the different types of liability facing auditors, the extent to which statute enables such liability to be limited, and the insurance arrangements of KPMG, Deloitte, Ernst & Young (EY) and PricewaterhouseCoopers (PwC) (the Big 4) and Baker Tilly, BDO, Grant Thornton,[2] Mazars and PKF (the Mid Tier).

3. The paper then sets out data on the extent of litigation from statutory audit clients and settlements paid as a result; and the amount of insurance cover and costs of that cover for each of the Big 4 and the Mid-Tier firms.

4. Finally it sets out some initial views on whether liability, insurance and settlement costs may act to restrict entry.

The potential liability of auditors

5. This section sets out the heads of legal liability that auditors may face, how incorporation as limited liability partnerships (LLPs) may limit the quantum that might have to be paid should such liability be established, and describes the possible use of liability agreements as a further way to limit firms liability for mistakes in performing an audit.

[1] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers_to_entry_framework_wp.pdf in particular paragraph 53*(d) Auditor liability*, which identified the cost of liability, whether direct or arising from insurance premiums, as a potential barrier to entry.
[2] Insurance data from Grant Thornton is insufficient to enable this firm to be included in the tables

Heads of liability

Negligence

6. The Legal and regulatory framework working paper sets out an auditor's liability in negligence.[3] In particular in a claim in negligence against an auditor the claimant must prove: (i) that the relationship between the auditor and the claimant was capable of giving rise to a duty of care; (ii) that the loss flowing from the auditor's breach of that duty was caused by the auditor's negligent report, and was foreseeable; (iii) that, at the time he undertook those services, the auditor had in contemplation that they would be relied on by the claimant for the purpose of a particular transaction or class of transaction; and (iv) that the claimant, in fact, relied on the auditor's report when embarking on such transaction which resulted in the loss for which compensation is claimed.

Professional

7. Part 5 of the Legal and regulatory framework working paper describes the various regulatory bodies and boards under the aegis of the FRC and concerned with registration, standards and ethics. The sanctions that these bodies can impose for a defectively performed audit include financial penalties and the ultimate sanction of withdrawal of registration and hence of eligibility to perform audits. This risk and the risk of reputational damage arising from regulatory investigations and criticism is unlikely to be commercially insurable.

Criminal

8. Finally, Section 507 of the Companies Act 2006 (CA 2006) creates a criminal offence in relation to inaccurate auditors' reports. The offence consists of knowingly or recklessly causing a report to include anything that is misleading, false or deceptive,

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[3] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf, paragraphs 3.47–3.49.

or omitting a required statement of a problem with the accounts or audit. The individuals potentially caught by the offence are the auditor, if a sole practitioner, and their employees and agents; and the directors, members, employees and agents of an audit firm. However, the offence only applies to such an individual if they are an accountant who would be qualified to act as auditor of the company in their own right. This offence is therefore applicable to audit firm partners. The maximum penalty is an unlimited fine.

Limited liability partnerships

9. Prior to the Limited Liability Partnerships Act 2000 (LLPA 2000), a partnership did not have its own legal identity: each individual partner was jointly and severally liable for claims against the partnership. Since the LLPA 2000, an LLP is available as a form of corporate entity with a separate legal personality thus reducing the individual exposure of the partners. In the event of a claim against the firm, the partners' liability is generally limited to the amount of their capital contribution to the firm.[4]

10. Each of the Big 4 and Mid Tier are now established as LLPs. EY stated that if a negligence claim against the firm were successful, it would usually be paid by the firm's insurance cover (subject to a deductible or excess). In the:

> unlikely event that insurance cover was exhausted, the other assets of the Firm would be used to pay the claim. If those assets were exhausted and the Firm were wound up, as the Firm is a limited liability partnership, its members' (ie the Partners') liability would be limited to the amount of capital they contributed to the Firm. Unlike in a general partnership, the partners' personal assets are in principle protected.

[4] 'Financial Liabilities for LLP Members: How Limited?' Miguel Pereira, *Accounting Age*, April 2012, http://www.accountancyage.com/aa/feature/2167450/financial-liabilities-llp-limited.

Liability limitation agreements

11. Section 534 CA 2006 allows an auditor to enter into a ‘liability limitation agreement’, a contractual limitation of an auditor’s liability to a client company. The agreement can cover liability for negligence, default, breach of duty or breach of trust occurring in the course of an audit of accounts. The agreement must be authorized by the shareholders of the client company.[5] Without this, the agreement will not be effective. The agreement must relate to the audit of one specified financial year and the limitation may be expressed in any terms specified in the agreement, not necessarily as a fixed financial amount or formula.

12. However, section 537 provides that the agreement will not be effective to limit an auditor’s liability if the limitation would result in the company recovering an amount that is less than what is ‘fair and reasonable’ in all the circumstances of the case and having regard to the auditor’s responsibilities (under Part 16 of the CA 2006), contractual obligations and the professional standards expected of the auditor. An agreement that purports to limit the auditor’s liability to less than this amount has effect as if it limited the auditor’s liability to that amount. In assessing what is fair and reasonable, the courts do not take into account circumstances arising after the loss or damage in question has been incurred nor the chances of the company successfully claiming compensation from any others responsible for the loss or damage.

13. We asked the Big 4 and Mid Tier whether they had entered into agreements with audit clients to limit liability for negligence.

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[5] CCA 2006 section 536(2) relates to authorization by shareholders of a private company.
Section 536(2) relates to authorization by shareholders of a public company: *(a)* by resolution in general meeting before the company enters the agreement or *(b)* by resolution in general meeting approving the agreement after it has been entered.

Big 4

14. Each of the Big 4 told us that they had not entered into such agreements in relation to statutory audits of FTSE 350 companies. Although theoretically possible, such provision for liability limitation agreements in the CA 2006 had not proved acceptable to companies in practice.

15. EY said that there were two reasons for this. First, company management and shareholders had been historically disinclined to seek or grant shareholder approval. Second, the United States Securities and Exchange Commission (SEC) had decided not to permit such agreements on the basis that an auditor's independence might be affected.

16. Deloitte supported this stating that whilst such agreements are 'in theory, possible, the need for companies to obtain shareholder approval has made the legislation to allow such agreements ineffective in practical terms and certainly within the listed company market'.

17. One firm stated that it did not anticipate that the position is likely to change in the foreseeable future.

> The firm, therefore, anticipates facing unlimited liability for its FTSE 350 audit work for the foreseeable future, meaning the entire assets of the firm are at risk. This is because of the potentially catastrophic impact on the firm in the event of an audit failure, both in terms of the impact on reputation and on financial resources. Whilst we have appropriate insurance arrangements in place, there is no affordable insurance to underwrite the largest potential losses (which are those that would arise from auditing FTSE 350 companies, given their scale). Even taking insurance into account, an audit failure in the context of a FTSE 350

company could put the firm out of business. A damaged reputation can put an audit firm out of business in a very short space of time [✂]. The most effective way to mitigate the risks we face is by providing a high quality audit service.

18. KPMG explained that as part of its statutory audit, KPMG LLP or KPMG Audit Plc may 'agree with the client to extend its work beyond the minimum necessary'. Such 'extended audit' work is required by the FRC's Ethical Standard 5 (non-audit services provided to audited entities) to be undertaken on the same principal terms and conditions as the audit (and therefore, in practice, on an unlimited liability basis). KPMG's standard audit engagement letter for a statutory audit provides for a limitation on liability in respect of any other ancillary services such as work in relation to a preliminary announcement or corporate governance statements. The amount of the limitation is negotiated with the client 'but for a major client would typically be in the order of £[✂]'.

19. PwC told us that it had not been able to agree a cap on liability with any of its FTSE 350 clients and that it now discontinued attempts to secure such caps.

Mid Tier

20. The Mid Tier also had not generally entered into such agreements. Baker Tilly stated that the regime introduced by the CA 2006 was 'extremely limited in its capability' and 'no real compulsitor can be brought to bear by an audit firm'. Second, it would not seek to limit liability given that other firms will offer unlimited liability as part of their overall offering. [✂].

21. GT did not have such agreements with public company clients ‘in line with the market and restrictions placed upon us by other jurisdictions’. They have, however, limited liability for negligence with some private company audit clients.

22. PKF said that unlimited liability of auditors was a potential barrier to taking on some of the larger audits, but noted that this should not be overstated.[6]

23. BDO said that auditor liability did not affect its decision to compete for larger audit clients, because the market currently did not accept limitation of liability for larger audits (other than in exceptional cases). However, BDO had limited its liability for negligence in respect of [✂] FTSE 350 clients: [✂]

Legal structure of international networks

24. As discussed in our working paper on International Networks, firms are members of international networks. The nature and legal structure of a network means that each firm is legally independent, owned by its partners, rather than any other entity within the network, and as a result is financially liable only for its own actions.

25. If international networks adopted a traditional business structure based on a parent company and a number of subsidiaries, there would be a potential risk of the assets of firms being at risk from an act of negligence in an overseas territory.

Litigation and settlements

26. Where a company considers that its auditors have not acted with due care and attention, it may seek redress either through litigation or negotiation on complaining to the firm.[7]

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[6] PKF hearing summary, paragraph 7.

27. Deloitte told us that in the last ten years it had had [✂] claims arising out of its statutory audit work across its entire audit business. [✂]. In addition, Deloitte had [✂] complaints arising out of its statutory audit work across its entire audit business, [✂]

28. EY told us that it had had [✂] audit-related claims in this period, of which [✂]failed, [✂] settled, [✂]abandoned and [✂]ongoing.

29. KPMG also had [✂] claims in this period, of which [✂]dismissed [✂] settled, [✂] discontinued and [✂] pending.

30. In the same period, PwC had [✂] claims, [✂] struck out. The other claims were either settled by mediation or negotiation [✂] or were not pursued. [✂] still pending. PwC told us that it had had [✂] other complaints during this period, all of which were settled.

31. In the ten years in question, Deloitte settled [✂] at £1 million or more ([✂]); PwC had [✂] occasions when total claims paid out in a particular year were £1 million or more ([✂]); KPMG had [✂] such occasions ([✂]); and EY had[✂]).

32. BDO had [✂] occasions when the total claims paid out in a year were £1 million or more ([✂]). We have no comparable data for the other Mid-Tier firms.

Professional Indemnity Insurance

33. Professional Indemnity Insurance (PII) is a form of liability insurance that protects professional individuals and firms from claims by dissatisfied clients. It usually covers claims in negligence.

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[7] Additional liabilities might arise from financial penalties levied by regulators.

34. The Big 4 and Mid Tier were asked to provide an overview of how they insure the risks faced by the firm and individual partners, including the PII arrangements in place for the statutory audit business in the UK, any excess and any maximum sums insured and the annual cost of the insurance over the last ten years.

35. Historically, audit firms would seek PII cover in the commercial insurance market. According to Deloitte, until the mid-1980s, the large firms were able to secure cover in this way. This became increasingly costly and the insurance market had a ‘decreasing appetite’ to provide cover on a basis that made ‘economic sense’. KPMG also noted, ‘[i]n recent decades it has been progressively more difficult for the largest firms to obtain the insurance cover required on a consistent and cost effective basis from the commercial market’. PwC added that ‘PII cover provided by third party insurance companies was not available on a commercially affordable basis to large accountancy firms’.

36. This led to the larger firms developing captive insurance arrangements either used by the individual firms or acting akin to a mutual across a firm’s international network. These arrangements would seek to provide PII cover and to reinsure part or all of that cover in the commercial reinsurance market.

37. Captive insurance is insurance provided by a company that is formed primarily to cover the assets and risks of its parent company or companies. A captive insurer is essentially an ‘in-house’ insurance company with a limited purpose and is not available to the general public. Captive insurance is an alternative form of risk management through which companies can protect themselves financially while having more control over how they are insured.

38. Reinsurance is the practice of mitigating insurance risks by sharing those risks with another insurance carrier in exchange for paying that other carrier a part of the premium. The practice makes it possible for larger policies to be written, but still have the protected party only deal with the main insurance provider. This simplifies things for the customer and generally does not affect rates.

39. Each of the Big 4 have captive insurance arrangements, usually establishing a different entity for each level of potential liability (e.g. company A for claims up to £45 million; company B for claims between £45 million and £100 million; company C for claims above £100 million). By syndicating the liability in this manner firms appear to be more readily able to obtain reinsurance in the commercial market.[8] They also may have arrangements for a mutual insurer to cover their international networks.

40. Of the other large audit firms in the UK, BDO, GT and PKF used captive insurance arrangements. BDO used a mixture of captive and commercial arrangements. Mazars and Baker Tilly used the commercial market.

41. We requested details of the premiums paid, the sum insured and the claims paid out by the large audit firms over a ten-year period. We note that these premiums typically cover all professional business carried out by the firm, including but not limited to, statutory audit.

42. Direct comparison of the costs of insurance is problematic because of the factors that may be taken into account in pricing insurance. These factors include the total sum insured per claim and the number of claims permitted; the likely frequency and size of payouts; and whether there is any uninsured excess. In addition there may be

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[8] We assume that by reinsuring each element of risk separately that the captive is able to obtain the most beneficial rates.

difficulties in comparing premiums paid to a captive insurer with those paid to a third party; for example, due to differences in profit-sharing arrangements.

Value of claims and the cost of insurance

43. As noted above the data obtained from the firms is not directly comparable and given the infrequency of claims (below) it is hard to draw conclusions about trends in claims data. However, it is possible to make a number of observations which are discussed in the following sections.

Frequency of claims against insurance in relation to statutory audit clients

44. As noted in paragraphs 31and 32 above, in the last ten years there have been relatively few successful claims of a significant size (£1 million or above). The five largest firms have settled [✂] such claims in this period, with a total value of [✂].

45. We set out in Table 1 the total value of claims from statutory audit clients against insurance[9] for each firm in each year from 2002 to 2011. The value of claims fluctuates widely from year to year and between firms. For instance, in 2003 KPMG claimed £[✂] from its insurance arrangements in relation to statutory audit clients, compared with £[✂] the previous year and £[✂] the following.

TABLE 1 **Value of claims against insurance**

£'000

	KPMG	*DEL*	*EY*	*PwC*	*BDO*	*BT*	*Mazars*	*PKF*
2002	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2003	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2004	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2005	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2006	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2007	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2008	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2009	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2010	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2011	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

[9] Firms may choose not to recoup the costs of settling a claim from insurance arrangements and may have an excess or deductible to pay. We also note the claims may not reflect all costs including legal costs.

Total value	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC Analysis.

Note: PKF data relates only to the period 2006 to 2011.

Premiums paid and level of cover

46. Table 2 shows the total value of premiums paid by the firms in relation to PII arrangements with captive or commercial insurers. These relate to all professional business carried out by the firm, including statutory audit. With the exception of [✂], the value of annual payments of premiums by firms has decreased for all firms. In the period 2002 to 2011 there were significant year-on-year fluctuations in the premiums paid by some firms ([✂]) including some increases in premiums paid ([✂]).

TABLE 2 **Total value of premiums paid**

£'000

	KPMG	*DEL*	*EY*	*PwC*	*BDO*	*BT*	*Mazars*	*PKF*
2002	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2003	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2004	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2005	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2006	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2007	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2008	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2009	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2010	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
2011	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CC Analysis.

47. Table 3 sets out the level of insurance cover carried by the largest firms on a per-claim basis. The number of claims that can be made varies by firm. This appears to indicate that Mid-Tier firms are able to obtain insurance cover at comparable levels to those of Big 4 firms, on a per-claim basis.

TABLE 3 **Level of insurance cover per claim carried by firms, 2011**

Firm	*Level of cover £'000*
KPMG	[✂]
Deloitte	[✂]
EY	[✂]

PwC	[✂]
BDO	[✂]
Mazars	[✂]

Source: CC Analysis.

48. We considered whether it was possible to compare the premiums paid by Mid Tier and larger firms for comparable levels of cover; for example, by calculating the cost per £ of cover. However, for the reasons discussed in paragraph 42 we did not consider this comparison to be meaningful, in particular due to differences in the number of claims permitted under each policy, differences in the periods covered by each policy, and differences in the excess. In addition because the Mid-Tier firms have smaller clients the probability of a large negligence claim could be lower and hence the premiums may be lower for this reason.

Initial views

49. We found that audit firms may face civil claims for negligence or breach of contract at common law, and criminal charges under section 507 of the CA 2006 for knowingly or recklessly causing a report to include anything that is misleading, false or deceptive, in a material particular, or by knowingly or recklessly omitting a required statement (concerning the accounts or the audit). The theoretical maximum limit for such claims is large. However, in the last ten years the number of successful claims of a significant size has been small, with [✂] occasions when total claims in any year was at £1 million or abovefor the larger audit firms.

50. Insurance cover (PII) is available for claims based on negligence, however the submissions made by the parties indicates that they consider that it is no longer cost-effective for the largest firms to obtain such cover from the commercial insurance market, and as a result the largest firms have set up ‘captive’ (ie in-house) insurers, but with the risk reinsured, in whole or in part, in the commercial market.

51. We note that the use of captive insurance arrangements is not limited to the Big 4 and that a number of Mid-Tier firms participate in these types of arrangements.

52. We have not been able to make direct comparisons of the costs of insurance. However, we have seen no evidence to suggest that Mid-Tier firms cannot obtain adequate levels of insurance cover or pay disproportionately more for cover than do larger firms.

53. It appears that the low level of claims settled by firms in the last ten years and the low value of these claims (relative to the size of the firms), combined with the ability of the firms to enter into effective insurance arrangements, suggests that the risks faced by audit firms in relation to professional negligence may be regarded as low.