Competition Commission Audit Services Market Inquiry

5 October 2012

Deloitte response to the Competition Commission’s working paper “Liability, insurance and settlements”
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1. Introduction

1.1 Deloitte is grateful for the opportunity to comment on the working paper published by the Competition Commission (the CC) on “Liability, insurance and settlements” (the Working Paper). We set out our views on the matters considered by the CC in the Working Paper below.

1.2 The Working Paper sets out the factual position relating to the types of liability to which auditors may be exposed, the extent to which statute may enable such liability to be limited, and the insurance arrangements of the top tier and mid tier audit firms. Insofar as we can interpret the content with the commercially sensitive information redacted, we agree with the majority of the factual content in the Working Paper.

1.3 However, we note the comment that “the risks faced by audit firms in relation to professional negligence may be regarded as low”, a view which appears to have been formed on the basis that the frequency and value of claims against auditors is low, and that effective insurance arrangements are available to audit firms. We consider the Working Paper has reached an incorrect conclusion which is not supported by the evidence available to it. In our response below we clarify that it is incorrect to conclude that adequate insurance is available to cover potential losses. We also clarify that the low incidence of claims does not mean that the existence of a high risk environment has been removed, rather that firms have risk management and quality procedures which enable them to operate in the high risk environment. The high risk environment remains and the CC should not conclude that “the risks faced by audit firms in relation to professional negligence may be regarded as low”.

2. Liability Limitation Agreements

2.1 As noted in the Working Paper, attempts were made in the UK to introduce a regime permitting auditors and companies to negotiate auditor Liability Limitation Agreements (LLAs).

2.2 In June 2008 the European Commission issued a recommendation advising EU Member States to take measures to enable auditors to limit their liability.

2.3 The concept of LLAs received wide support from the Financial Reporting Council and business at the time; with the CBI commenting: “No other organisation is faced with the threat of unlimited liability if a claim by a client should ever be made, and we feel that it is appropriate that audit firms are not unduly discriminated against”.

2.4 However, in practical terms, as noted in the Working Paper, LLAs have proved an ineffective solution to address the concerns recognised above, since companies have declined to accept LLAs, despite encouragement from regulators, key stakeholders and audit firms. As such, the risks faced by audit firms in relation to professional negligence may be regarded as high.

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1 Paragraph 53
2 http://ec.europa.eu/internal_market/auditing/liability/index_en.htm
3. Auditor liability

3.1 As noted in the Working Paper, commercial insurance cover is scarce in the market. A European Commission publication identified that the current level of commercial insurance often covers less than 5% of the larger claims faced by auditors. This is not surprising given:

(a) the scale of operations and potential losses of shareholder capital in the reference market;

(b) the effect of the common law doctrine of joint and several liability (which means that auditors can be held liable for an audit client’s entire losses, even if their role in causing those losses was at the margin); and,

(c) the fact that auditors in this market cannot effectively cap their liability.

3.2 The majority of top tier and mid tier audit firms operate with captive (self) insurance arrangements (with limited reinsurance cover available in the commercial market). The insurance which is available is expensive and subject to sizeable deductibles (insurance excesses) and per claim and aggregate limits. The limits are invariably well below the potential losses of a failed company in the reference market. The fact that extensive commercial insurance is largely unavailable to large audit firms confirms the view of specialist risk assessors that the inherent risks in this market cannot be said to be “low”. Indeed, we believe that commercial insurers would view the insurance of FTSE 350 auditors as high risk.

3.3 The protections of LLP status and insurance mitigate the risks for the partners personally, in that their personal assets are protected, but the assets of the firm, and the partners’ and employees’ future income, remain at risk.

3.4 The Working Paper suggests that the instance and value of claims against larger audit firms is low. The following are high profile examples of significant litigation being commenced against audit firms, which may provide a more complete picture:

(a) in the case of Andersen, the global collapse of the network was caused by the alleged conduct of the US firm; conduct which was beyond the control of the UK partners;

(b) in the mid 1990s, Binder Hamlyn, then a mid tier firm, faced a claim in relation to the audit of a listed company. The firm lost and damages, believed to be in excess of the firm’s capital and insurance, were awarded and the firm subsequently collapsed;

(c) Equitable Life brought a very significant claim against Ernst & Young for negligently auditing its accounts in the late 1990s. Whilst the claim was withdrawn in 2005, the legal costs alone reportedly ran into tens of millions of pounds;

(d) in 1998, the Bank of Credit and Commerce International’s (BCCI) two auditors (firms now subsumed within PwC and Ernst & Young) reportedly paid £75m in settlement of a claim;

(e) in the United States, the case of Banco Espirito Santo SA against BDO Seidman LLP, a member of the BDO global network, illustrates the potential for litigation at an international network level. The initial judgement was for damages of over $520m. This was subsequently reversed and the case settled on a confidential basis.

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5 http://ec.europa.eu/internal_market/auditing/docs/liability/summary_en.pdf
6 ADT v BDO Binder Hamlyn (1996) BCC 808
7 The Guardian Equitable Life drops £700m claim for damages from Ernst & Young 23 September 2005 http://www.guardian.co.uk/money/2005/sep/23/equitablelife.business
8 BBC News BCCI auditors pay up to stop legal dispute 22 September 1998 http://news.bbc.co.uk/1/hi/business/177833.stm
(f) the 2005 case of MAN v Freightliner involved a claim in the region of £350m; Freightliner sought to bring the auditors in to the claim, but was ultimately unsuccessful \(^{10}\).

3.5 Unlike other providers of professional services, given the significant repercussions of a negligence claim, auditors operate under a professional, regulatory and legal regime which has zero tolerance for failure.

3.6 Our procedures to mitigate the risks of significant litigation involve constant investment in our people and in the steps we take to ensure audit quality, as described in more detail in our response to the Issues Statement and our Initial Submission. In our view, the best mechanism to avoid or defend any potentially catastrophic claim or reputational issue is the quality of our work and the integrity and behaviour of our people.

4. Conclusion

4.1 We welcome the Working Paper’s observation that the top tier and mid tier audit firms have a very good claims record. Deloitte takes the threat of litigation seriously and has worked hard to achieve and protect our excellent claims record. Given the importance we attach to quality and the inherent risks involved in auditing, we do not find it surprising that the current larger audit firms have strong claims and quality records. If they did not, there is a genuine risk they would no longer be in business, as the examples we provide illustrate.

4.2 Whilst not explicitly stated, the implication of the Working Paper is that liability, insurance and settlement costs do not act to restrict entry into the statutory audit market for large companies in the United Kingdom \(^{11}\). We agree with this view. A professionally run audit firm with appropriate quality control and risk management procedures can operate in this high risk environment.

4.3 However, for the reasons stated above, we do not agree with the statement that the risks faced by audit firms in relation to professional negligence may be regarded as low. Rather, it is a relatively high inherent risk, which we then mitigate to a level that we and our stakeholders (including our regulators) consider to be acceptable. These steps reduce the likelihood of claims arising, rather than reducing the existence of a high risk environment.

\(^{10}\) MAN Nutzfahrzeuge AG and Anor v Freightliner Ltd and Ernst & Young [2007] EWCA Civ 910

\(^{11}\) Working Paper paragraphs 4 and 53