DIRECTORATE GENERAL FOR INTERNAL MARKET AND SERVICES

COMMISSION STAFF WORKING PAPER: CONSULTATION ON AUDITORS' LIABILITY AND ITS IMPACT ON THE EUROPEAN CAPITAL MARKETS

Interested parties are invited to respond by **15 March 2007**.

Comments, preferably in the form of general remarks followed by answers to the questions listed in appendix, should be submitted by e-mail to the following address: markt-f4@ec.europa.eu. Respondents may alternatively send comments by post to the European Commission, DG Internal Market and Services, Unit F4 – Auditing / Liability, SPA 2 (JII), 02/085 , B-1049 Brussels, Belgium.

The European Commission will make comments publicly available on the Commission's web-site unless respondents specifically request otherwise. In case of e-mail response which includes an automatically generated notice stating that the content is to be treated as confidential, respondents should make it clear in the body of the message whether or not they wish their comments to be treated as confidential.

January 2007

Commission Staff Working Paper

Consultation Report on auditors' liability and its impact on the European capital markets

TABLE OF CONTENTS

Commission Staff Working Paper

Auditors' liability and its impact on the European capital markets

1. INTRODUCTION

The efficient functioning of capital markets in Europe depends on investors having confidence in financial reporting in those markets. Statutory auditors, who review financial statements, play an important role in ensuring that accounts are trustworthy and reliable. Companies need access to high quality audits at a reasonable cost. The EU Statutory Audit Directive[1] introduces provisions whose aim is to give stronger guarantees as regards statutory audit, thereby enhancing integration in European capital markets.

The increased market capitalisation of companies during the last decade has produced a corresponding increase in the risks of auditing such companies. At the same time, access to insurance for auditors has fallen sharply, especially for firms auditing international and listed companies, thus leaving partners in audit firms with the unattractive prospect of entirely supporting the liability risks themselves.

The EU audit market is composed of broadly two segments: the audit of local unlisted companies and the international audit of listed companies.

As regards the second segment, the international audit market is at present comprised of a very limited number of players[2]. This number could be reduced even further in case of a major damages suit ("catastrophic claim") resulting in the collapse of a major audit network. In consequence, capital markets might then no longer benefit from the necessary statutory audit capacity which listed companies need at an affordable cost. Unlimited liability is perceived as a barrier to access the international audit market. Moreover, since liability regimes vary considerably between the Member States, there is an impact on the Internal Market.

The increase in the risk of auditing listed companies merits a wide public debate. Article 31 of the Statutory Audit Directive expressly requires the Commission to present a report on the impact of the current national liability rules for carrying out statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations on financial liability. In the light of that report, the Commission is invited to issue, if appropriate, a recommendation to Member States.

---

1 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

2 Arthur Andersen collapsed in 2002 and the then "Big 5" became the "Big 4".

The Directorate General for Internal Market and Services therefore seeks views on the questions set out in this report and the possible reform of auditors' liability regimes in the Member States. As a preparatory step an independent study was carried out by London Economics[3]. The study was published in October 2006. The study considers in detail the current situation in Member States and in the EU audit market and the economic impact of the different options for limiting auditor liability. The study was prepared with the assistance of the Auditors' Liability Forum, set up in November 2005[4]. The Forum is composed of all those who have a stake in the market, namely auditors, investors, bankers, insurers, companies and academics. This report refers to the results of the study.

The scope of this consultation is limited to the liability that auditors are exposed to due to their possible acts of negligence associated with a corporate fraud or corporate failure. Cases related to fraud or intentional misconduct perpetrated by individual auditors or audit firms are excluded.

2. STATE OF PLAY FOR AUDITORS OF LISTED COMPANIES

2.1. Legal situation in the Member States[5]

Liability of the auditor and the audited company towards others (shareholders, creditors) is joint and several in the legislation of nearly all Member States. These joint and several liability regimes are designed in such a way that the statutory auditors and the audit firms may also bear a portion of charges resulting from the misconduct of the audited company, in particular if that company goes bankrupt. In consequence, plaintiffs can claim damages from the auditor, regardless of the degree of involvement of the auditor.

In several Member States, there are concerns about these liability risks which could deter auditors and indirectly affect the capital markets. In order to address these concerns, auditor’s liability is currently capped in five Member States (Austria, Belgium, Germany, Greece and Slovenia). In these countries, the auditor is jointly and severally liable with the company only up to the cap provided. In November 2006, the UK allowed contractual limitations between a company (subject to shareholders approval) and its individual auditor.

Further details on the legal situation in Member States are provided in Annex I.

3 "Study on the Economic Impact of Auditors' Liability Regimes", London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany, September 2006. http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

4 For further information on the composition and role of the Forum, see press release on DG MARKT website: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/05/1420&format=HTML&aged=0&language=EN&guiLanguage=en

5 In 2001, the Commission published a study by Thieffry into the systems of civil liability. The Commission services, with the contribution of the European Federation of Accountants (FEE) and of the Members of the Audit Regulatory Committee, updated this study in 2006 (see report in Annex I).

2.2. Evaluation of the potential risks for audit firms

Audit firms in the EU reported that they face a considerable number of high-value actual or potential claims arising from statutory audits. As of 31st October 2005, EU audit firms from the six biggest networks (the so-called Big Four[6] as well as Grant Thornton and BDO) indicated that their risk managers are dealing with 28 outstanding matters that could give rise to claims[7] in excess of EUR 75 million, of which 16 are in excess of EUR 160 million and 5 are in excess of EUR 750 million. According to the audit firms, 6 of these 28 outstanding matters fall under US jurisdiction. The remaining matters originate from within the EU.

The London Economics Study demonstrates that the current claims may entail serious financial consequences for audit firms. Of 59 cases[8] concluded between 1998 and 2005 for which claim and settlement or information on the amounts awarded is publicly available, the average settlement was slightly less than 12% of the damages sought by a plaintiff. In almost one fifth of the cases, the award or settlement ratio ranged from about 25% to almost 40% of the initial claim.

The actual annual costs of settling liability claims[9] have fluctuated widely over the last 20 years, reaching a peak of almost EUR 470 million (in 2005 prices) in 1991. Over the period 1981 to 2003, the average annual cost of the claims against EU firms amounted to EUR 4.7 million (in 2005 prices), but the average yearly standard deviation amounts to EUR 12.9 million.

Between 1999 and 2004, the gross costs of awards and settlements incurred by Big 4 firms in the U.S. rose from 7.6% to about 11% of total audit revenues. Net costs in the US, including insurance premiums and recoveries from insurance companies, rose even more sharply, almost doubling from 7.7% of total audit fee revenues in 1999 to 14.2% in 2004 in the US. However, audit firms suggest that, while showing a rising trend, the total comparable cost as a percentage of revenues is still lower in the EU.

It is not only the final settlement costs which are significant; the costs involved in dealing with claims are also considerable. Liability claims take a very long time to be resolved. A period of 5 to 10 years, or more for some big claims, is not uncommon.

2.3. Lack of international insurance cover for audit networks

The professional indemnity insurance market for auditors can be broadly split into three categories:

---

[6] This group includes the largest audit firm networks, i.e. Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.

[7] Arising from audit services.

[8] AON Risk Professional, *Awards / Settlements Analysis of a selection of publicly known matters involving auditors,* March 2006. 18 cases were non-U.S. cases.

[9] i.e., the annual costs to the firms and insurance companies of the awards, settlements or reserves against unresolved claims.

(1) Category 1: Mandatory insurance required by law or professional associations of auditors coupled with additional voluntary insurance, still largely available but only for local audit mandates.

(2) Category 2: Self-insurance for international audit mandates. This includes insurance provided by captive insurance companies set up not by individual audit firms, but by the international networks within which audit firms operate.

(3) Category 3: Audit partners' income in an international network.

Auditors do not appear to have major difficulties in finding insurance cover for the first category. However, this category offers limited protection and is of no major practical relevance for the auditors of listed companies as their liability risks are well above the insurance amount.

The crisis started in the mid eighties when the reinsurer, which provided most of the reinsurance capacity for the auditors' professional indemnity insurance market (especially the Big 6), withdrew from the market following big losses. In the years that followed, the insurance industry sustained large losses in underwriting auditor professional indemnity insurance. For example, over the period 1981 to 1992, the loss ratio[10] for the audit insurance market averaged 266% in the world excluding the U.S. and 305% in the U.S. Moreover, the lack of risk diversification opportunities, the unpredictability of claims and the related volatility in awards and settlements make it impossible to develop proper insurance programmes for auditor liability.

In the 1990s, the then Big 5 (including Arthur Andersen), facing such an insurance crisis, had to establish "captive" insurance companies to cover the second category (international audit mandates). "Captives" are mutual insurance entities owned by the member firms of an international network who share risk by pooling premiums to meet their individual claims over a long period of time. Each individual firm insured by the captive covers the lower levels of risks itself, through its own contribution in the captive. At higher levels all the participating firms share the liabilities for claims from other firms. Thus, significant claims adversely impact all the firms regardless of their individual claims record. However, those captives can no longer provide the levels of insurance cover needed in today's international audit market.

Once an audit firm belonging to one of the Big 4 networks has exhausted the cover provided by the networks' captive and commercial insurers, the remaining source of funds is essentially the partners' income. This is the third and final category. In this regard, the income of a partner is not only affected if there is a claim against a partner in the same firm, but even if there is a claim against a partner in the same international network.

The London Economics Study concludes that the current level of commercial insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States. In consequence, audit partners' income will be increasingly affected – and not only within audit firms, but also across networks. The middle-tier networks, which are much looser and less co-ordinated, do not have captives. Their only

[10] The loss ratio is the ratio of claims incurred to the premiums received.

insurance comes from the market place, and for this reason, they face a huge obstacle if they want to audit listed companies.

2.4. The "deep pocket" syndrome?

Auditors assert that joint and several liability systems are unjust and that they are considered by plaintiffs as an insurance against any deficiencies on the part of companies in their financial statements. Auditors can only give a reasonable assurance that financial statements provide a true and fair view of the company’s financial position. The opinion of an auditor cannot provide an absolute assurance and is not required to do so under law.

A liability regime under which an auditor is liable for any damage caused by the failure of the audit client might create the expectation amongst potential plaintiffs that auditors are gatekeepers against corporate fraud or other corporate malpractice. Joint and several liability reinforces this “expectation gap” on the side of investors. But it is neither efficient nor equitable for the market to operate on the expectation that the financial deficiencies of a company will be compensated for by the company’s audit firm. Moreover, it is arguable that the existing regime decreases the incentive for companies to prevent corporate malpractice.

Joint and several liability is particularly relevant where the audited company becomes bankrupt since creditors and liquidators are seeking further avenues for compensation. Major audit firms risk being treated as offering “deep pockets” although this is very questionable since in recent years the amount of claims has increased significantly and the available insurance has sharply decreased.

It has been argued that any limitation of auditors' liability could shift some of the liability risk to directors and officers of companies. However, directors and officers in companies are already liable for wrongdoings related to preparing and presenting financial statements. This principle will not be changed by reforming the liability for auditors. As for the impact on D&O insurance, the London Economics Study stated that a key difference is that the liability risk can be diversified across a wide range of policy-holders (being directors of companies) while it cannot in the case of a few audit firms operating in this audit market segment.

2.5. The situation in the US

The US undertook liability reform in 1995. Under the PSRLA[11], Section 27 of the Securities Act of 1933 and Section 21 D (e) of the Securities Exchange Act of 1934 were amended as follows: damages should be allocated amongst wrongdoers only by the judge in proportion to their fair share of the harm done. Accordingly, the principle of joint and several liability was eliminated and replaced by a form of proportionate liability. In addition, damage awards to plaintiffs were limited[12] taking into account the particularities of US litigation law. However, the US system offers less protection for

---

[11] The Private Securities Litigation Reform Act of 1995

[12] Damage awards to plaintiffs are accordingly limited to the difference between purchase or sale price and the mean trading price during the 90-day period starting on the date the market was made aware that a misstatement of information has occurred. However, this situation concerns investors at large who sell or purchase securities. Under the law of Member States, only securities holders can at most take legal action against an auditor (see also annex I).

auditors than they currently enjoy in the EU, as it includes the possibility to award punitive damages (i.e. damages compensating more than the loss). In Europe, auditors are not faced with this possibility. The US litigation system seems to compound the problems faced by auditors in the US and therefore highly relevant to the debate there.

A debate about possible reform of auditor liability is again underway in the US. In January 2006, the US Chamber of Commerce[13] called for a better definition of the limits of auditors' responsibility and to permit companies and auditors to agree reasonable limits on litigation. On 30 November 2006, the Committee on Capital Markets Regulation set up by the US Treasury considered in its interim report whether the US congress should be invited to explore further protecting audit firms from catastrophic loss[14].

2.6. The situation on the audit market

The London Economics study distinguishes between two audit markets: (i) a local market for the provision of audit services to medium and small-sized companies, in which the Big 4 firms are active together with the mid-tier audit firms[15], and (ii) an international market for providing audit services to listed and large unlisted companies and multinationals in terms of operations and branches, which are predominantly carried out by the Big 4. In 2004, in all but 2 Member States, the market share of the four largest audit firms, for the market including only the companies of the main stock exchange index, ranged from 83% to 100%. In 14 of these countries, this figure ranged from 90% to 100%.

The international audit market is the more relevant for capital markets. This second segment has, for a number of years, been dominated by the Big 4 networks. It is unlikely that mid-tier networks could become significant players in this market because they face a number of barriers to entry into the market. Such barriers were identified in the London Economics study as being: reputation, capacity and breadth of their networks, and the exposure to unlimited liability in most Member States combined with very limited professional insurance availability.

Financial services companies have an even more limited choice. In the EU today, the Big 4 hold 90% of the audit mandates of financial institutions (banks and insurance companies) listed on the regulated markets of the stock exchanges. In a number of countries, the Big 4 hold all audit mandates of financial institutions.

The difficulties for mid-tier firms trying to compete with the Big Four are set out very clearly in the London Economics study. These problems were also set out in a study

---

13 Auditing : A profession at risk, US Chamber of Commerce, January 2006

14 Two approaches have been favoured: either creating a safe harbour for certain defined auditing practices or setting a cap on auditor liability in specified circumstances. In addition, any protection from catastrophic loss should be premised on a firm's satisfying minimum capital levels as a condition for receiving protection (see Executive Summary on page 14)

15 This group includes all the audit firms other than Big-4 firms that belong to smaller networks and generally undertake statutory audits of medium-size companies as well as occasionally of larger companies.

carried out by the United States General Accounting Office[16] in 2003. They have also been at the centre of a recent wider debate about competition and choice in the audit market, launched in the United Kingdom[17].

In this context, the concentration of the audit market and the limited choice facing listed companies could be addressed in two ways:

- in the short-term, measures might be taken to mitigate any catastrophic claims on auditors in order to avoid the failure of another large audit firm, which would further reduce choice and increase concentration;

- in the medium term, other measures might facilitate the access of mid-tier audit firms to the audit market of large listed companies.

2.7. Short term measures: How to reduce the risk of further concentration in the audit market due to catastrophic claims

The London Economics study concludes that the risk of a large settlement that Big 4 firms would have to assume themselves (i.e. without any insurance cover) has increased substantially in recent years. A catastrophic negligence claim against them would mean a real possibility that one of them would fail and disappear. The disappearance of a major international player would perhaps not be a matter of public concern since it might be expected that market forces would help to remedy any problems on the supply side.

However, according to the London Economic Study, the situation would seem to be different for audit firms of listed companies:

- The current concentration and lack of choice would be exacerbated further if one of the Big 4 were to collapse. This could result in a major increase in the audit fees for listed companies.

- The huge liability risks might make the audit profession less attractive. [18]

- The adjustment to a Big 3 market structure would be very challenging. The completion of statutory audits might be delayed, especially if the failure occurred close to the company's year end.

- Financial institutions could face more serious transition problems as the special skills their audits require might severely restrict their range of choice for a new auditor.

---

[16] GAO, Public Accounting Firms, Mandated study on consolidation and competition, Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services July 2003.

[17] The Financial Reporting Council (FRC) and the Department of Trade and Industry (DTI) published in April 2006 a study jointly commissioned by them, “Competition and choice in the UK audit market”. The Financial Reporting Council is consulting over the public interest issues that may arise from the existing competitive environment for audit services to large companies in the UK and how they might be addressed.

[18] See also MORI, Auditor career and working life survey, January 2005.

- The overall cost of capital is unlikely to be directly affected even if audit fees increase sharply as the share of audit fees in total operating costs is small. But the cost of capital could be affected indirectly if the loss of one of the Big 4 were to make investors lose confidence more generally in capital markets.

- Given the limited availability of insurance and the large claims faced by all Big 4 firms, a second major audit network could also fail at the same time. A scenario where the international audit market would be dominated by only the Big 2 is as realistic as the Big 3 scenario. Investor confidence would fall significantly and capital markets would probably react much more negatively than in the case of the disappearance of one major network.

- There is currently no possibility for mid-tier firms to enter this international audit market in a meaningful way. There are also no prospects that this will change in the near future

2.8. Medium term measures: How to improve choice in the audit market

It would clearly be desirable to have a larger number of players offering the same capacities as the Big 4. However, the London Economics study confirms that this will take time.

According to London Economics, the unlimited liability regime is perceived by mid-tier audit firms as having a potentially significant impact on the capacity of firms to supply the audit market. The current insurance situation described in the study gives strong new evidence that only the Big 4 are able to put in place a risk management system adapted to dealing with high claims. Only the Big 4 operate a system of self-insurance in the form of captives necessary to cope with certain liability risks arising from the audit of listed international companies. Mid-tier audit firms are not in the same situation and face a real deterrent to enter this market. Neither reinsurers nor insurers are currently willing from an economic point of view to take initiatives to help change this unsatisfactory situation.

Liability is certainly not the only barrier to entry. Mid-tier audit firms face other obstacles, such as reputation, capacity and breadth of their networks.

In the medium term, there are at least two further aspects to be addressed: (1) access to capital and (2) the liability of a network of audit firms as such. Both might be relevant in particular for mid-tier audit firms:

- London Economics mentioned the absence of access to capital for investors outside the audit firms as a possible barrier for entering the international audit market[19]. Increased access to capital by non-auditors could be an additional driver to increase competition on the international audit market. In this respect, the shared liability between auditors and those other investors could be a deterrent for potential investors. A well balanced limited liability regime might therefore be a condition to attract investors outside the audit profession to invest more in mid-tier audit firms.

[19] Article 3(4) of the Statutory Audit Directive already allows that 49% of the voting rights in an audit firm might be held by investors outside the audit firms.

- Mid-tier audit firms operate either in isolation or in much looser structures. Globally operating listed companies need globally operating audit firms and audit networks. This situation calls for a common understanding of the obligations applicable to the entire network[20]. However, Member States' laws do not expressly deal with liability in respect of such networks. It is not clear whether liability rules will apply to an entire network or only to individual firm members of the network. These structures have already attracted plaintiffs to take action against an entire network (such as in the Parmalat case in the US).

In November 2006, the Commission commissioned a study with the consultancy firm OXERA on ownership rules applying to audit firms (including the possibility to provide better access to capital) and their consequences for audit market concentration. The Commission expects the final results in August 2007. They should give also answers to the two questions mentioned above. The Auditor Liability Forum which already assisted the Commission during the London Economics study could also further analyse these questions.

2.9. How to maintain audit quality

Unlimited auditor liability has been considered as a driver of audit quality. However, audit quality is difficult to quantify and measure. The opinion an auditor gives is subjective and based on professional judgment. The London Economics study proposed to measure audit quality based on accrual based accounting[21], using accruals quality as a proxy for audit quality. According to this method, audit quality measured by accruals management does not appear to be affected by the existence of a limitation on auditor liability.

Independent public oversight has been introduced in the US and – under the new Directive on Statutory Audit – in the European Union. Independent public oversight bodies have also been set up in a number of other jurisdictions, such as in Japan, Canada and Australia. Other jurisdictions in the world will no doubt follow. Independent public oversight bodies have an important role to play in maintaining and enhancing audit quality. The dialogue between a public oversight body and audit firms is a powerful tool to improve audit quality over time.

The Commission considers that it is important to encourage co-operation amongst Member States' oversight bodies, in particular with regard to audit firms dealing with listed companies. It intends to do this in the first instance through the recently formed European Group of Auditor Oversight Bodies (EGAOB). If necessary, the Commission may take action to facilitate uniform application of the principles on external quality assurance set out in Article 29 of the new Directive on Statutory Audit.

---

[20] Article 2 (7) of the Statutory Audit Directive introduces a definition of a network for defining the scope of the independence rules for auditors. This definition clarifies that the independence of one audit firm towards its client might be compromised by the relationship between other audit firms belonging to the same network and the audit client.

[21] Accruals are temporary adjustments that resolve timing problems in the underlying cash flows at the cost of making assumptions and estimates. Precise estimates imply a good match between current accruals and past, present, and future cash flow realizations, while imprecise or erroneous estimates reduce the beneficial role of accruals. Accordingly, accrual quality is defined as the extent to which accruals map into cash flow realizations.

3. POSSIBLE OPTIONS FOR LIABILITY REFORM IN THE EU

The London Economics Study assessed the various possible approaches to liability reform on the basis of 4 criteria: (1) impact on the risk that one or several of the big-4 will disappear in case of catastrophic claims; (2) impact on insurability of statutory audit liability risk; (3) impact on competition and entry into the market of mid-tier firms; (4) impact on audit quality. It concluded that the key issue in terms of reduced risk for audit firms and increased competition by the audit firm is not so much the precise form of the limitation as the level of liability that firms face in a regime in which auditors' liability is limited. The study considered the pros and cons of 4 options.

3.1. Option 1: One single monetary cap at EU level

Examples of absolute caps can be found in Germany, Austria and Belgium (see Annex I). The monetary caps in Austria, Belgium and Germany were developed purely for domestic cases, mainly to improve domestic insurance cover and they differ from each other considerably. Extending such a model to the entire European Union would have the following implications:

- A European-wide cap would imply a maximum harmonisation of liability regimes for the European Union.
- Finding the appropriate level would be very challenging. If such a cap were set too high, mid-tier audit firms would be further disadvantaged. If, on the other hand, the cap were set too low, this might have a negative impact on the quality for the audit of major listed companies.
- The differences in companies' sizes (and the associated audit risks) and in the economies of Member States are significant. A single European-wide cap might amount to a "one size fits all" solution for 27 Member States, which would fail to take account of the diversity of circumstances in different Member States in terms of audits and company size.
- Insurers clearly signalled to the Commission that an EU-wide cap would not necessarily improve the insurance situation for audit firms at international level.

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

3.2. Option 2: Cap depending on the company's size

Another option could be a variable cap on auditors' liability depending on the company size. A variable cap would be more transparent and easier to apply as compared with proportionate liability. This option, based on an audit risk approach, recognises that the magnitude of risk of statutory audit liability may vary with the size of the listed company whose accounts are audited (e.g. measured by its market capitalisation). Statutory audit liability risk also appears to be higher in certain industries and differs for small listed companies compared to "blue chip" companies. The determination of the applicable amount thus remains relatively transparent for investors and public at large as information about the size of the company is publicly available.

To be efficient, the variable ceiling should be fixed at a level that reduces risk of collapse due to catastrophic claims. On the other hand, it should not lead to the creation of barriers to entry to the market for smaller audit firms.

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

3.3. Option 3: Cap depending on the audit fees charged to the company

A cap might be based on a multiple of the audit fees charged by the auditor to its client. This option might steer the conduct of auditors towards audit quality adapted to audit risks and deliver a balance between audit efforts and liability risks. It would also give protection against catastrophic claims that would be more effective compared to the other options. A variable cap based on auditor's fees should be transparent in the future since disclosure of audit fees is required under Article 50 of the Statutory Audit Directive.

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

3.4. Option 4: Proportionate liability

The principle of proportionate liability means that each party is liable only for the portion of loss that corresponds to the party's degree of responsibility.

As described in section 2.4 above, investors may perceive "joint and several liability" regimes as a kind of loss insurance. Under proportionate liability investors could only expect to recover from the auditor the portion of loss that can be attributed to the auditor's actions (or inaction). The fundamental guiding principle would be that the auditor should be liable for damages in accordance with his degree of responsibility for the damage suffered.

Proportionate liability might help preventing catastrophic claims against audit firms in the European Union.

Proportionate liability could be implemented in two manners:

- Member States could change their laws to allow Courts to award damages only for the portion of loss corresponding to auditor's degree of fault, or
- Member States could allow proportionate solutions between the company and its auditors to be negotiated and enshrined in contractual arrangements. Shareholders of the audited listed company would have to approve such arrangements when appointing the auditor or when approving audited financial statements in a general meeting. Such an approved limitation could however be overridden by a national court if it were to find that what has been agreed is not in accordance with what should be considered as fair and reasonable.

Question 4:	Do you agree with the analysis of the option of introduction of the principle of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?

4. CONCLUSIONS

This report outlines the current situation in the audit market in the EU and sets out the issues involved in possible reform of auditors' liability regimes. Whilst the issues raised are certainly difficult and controversial, they deserve to be addressed. It is appropriate to have an informed debate on these issues now, rather than in a situation of crisis.

Any changes to the existing situation would need to be regularly monitored to measure their effectiveness and impact on the market.

The Commission services would invite comments and views on the issues set out, the possible options identified for reform of auditor liability and related issues.

Interested parties are invited to respond by 15 March 2007. Comments, preferably in the form of general remarks followed by answers to the questions listed in Annex 1, can be submitted by e-mail to the following address: markt-f4@ec.europa.eu.

The Commission will publish all responses received on its website unless confidentiality is specifically requested.

LIST OF QUESTIONS:

Question 1:	Do you agree with the analysis of the option of fixing a single monetary cap at EU level?
Question 2:	Would a cap based on the size of the listed company, as measured by its market capitalisation be appropriate?
Question 3:	Would a cap based on the audit fees charged to the company be appropriate?
Question 4:	Do agree with the analysis of the option of introduction of the principle of proportionate liability? What are your views on the two ways in which proportionate liability might be introduced?