1. Economic Reasons for Setting Caps on Auditors’ Liability

The Commission argues that a cap on auditors’ liability may be necessary in order first to mitigate the risk that another big audit firm collapses and second to make it easier for mid-tier audit firms to insure liability risk and to enter the market of bigger clients.

Our research suggests that a liability cap may be economically sensible also for other reasons neither mentioned by the Commissions’ report nor by London Economics. With unlimited liability auditors may perform excessive care, that is, work more than would be efficient from the outside investor’s point of view. Two reasons cause this undesired effect, overcompensation of victims in secondary markets and possible reputation losses.

Overcompensation in secondary markets.¹ To which extent should an auditor be held liable for damages caused to outside investors? From a law and economics point of view damage compensation should be equal to the social loss. If there are some investors who lose whereas others benefit from false audits – even though they are not insiders! – the individual loss of the losing investors exceeds the social loss. This usually is the case for a false audit on a financial report of a firm already listed in the stock market (secondary market case). Some investors might benefit from the wrong audit because they are able to sell a stock at a higher price – a correct audit would have revealed the “true” value which is lower. However, auditors should only pay for social loss else they have incentives to audit too carefully which is not efficient. It is also not desirable from the investors’ point of view. Actually, there would be no problem if the investors who gain from the wrong audit compensate the losing investors or would disgorge their profits to the auditor. Still, no tort law in Europe requires this. In order to mitigate the problem of overcompensation we suggest to introduce a cap on auditors’ liability for statutory audits in the secondary market. Full liability would therefore result in overcompensation and overdeterrence. A liability cap can correct for this result. We wish to

¹ Schäfer (2005) and Bigus / Schäfer (2007).
emphasize however that this rationale of liability caps is confined to audits for the secondary market. It does not extend for audits made for an initial public offering where a group of informed owners sell to uninformed buyers and the audit is instrumental for removing this information asymmetry. For initial public offerings liability should be stricter than for the secondary market.

Reputation loss. If auditors are involved into an accounting scandal they usually suffer a reputation loss and may lose clients in the future. Hence, the auditor not only takes into account that he might have to pay damage compensation but also suffers the reputation loss. From the clients’ investors’ point of view, this reputation loss is not relevant and they do not want to pay for that either. However, auditors may have stronger incentives to work hard and if there is unlimited liability they again may perform excessive care. A liability cap may mitigate this problem of excessive care.\(^2\)

2. Options of liability caps

From a law and economics point of view liability caps can be justified, if they correct for the problem of excessive care or if a risk-averse auditor may be deterred from offering his services because damage awards are not insurable or because additional insurance coverage causes excessive marginal costs. Thus, the natural limit for any liability cap is the maximum insurance amount possible. For fixing liability caps we propose a two step procedure. In the first step one should investigate to which amount insuring companies are willing to take over the liability risk. This would lead to a general cap. In a second step one should limit the damage award to the individual contract between the firm and the auditor. This would lead to an individual cap within the confines of the general cap. Considering the claims outstanding and mentioned in the Commissions’ report on page 5, we assume in the following that a liability risk of 100 Mio. € is still insurable and that a general cap of 100 Mio Euro is advisable. This general cap takes into account the problem of insurability.

The second step takes into account the problem of overcompensation and overdeterrence, even if insurability is given. As a default rule, the monetary cap may be reduced in the audit contract. As a minimum, we suggest 20 times the audit fees which were agreed upon. Since audit fees have to be disclosed courts can observe them. One has to make sure, though, that audit fees disclosed are the actual audit fees paid and are not reported as other fees like consulting fees. Usually, there is a strongly positive correlation between company size and audit fees, thus, the discretion of shaping the audit fee may be limited. This second cap in the confines of the first cap would alleviate the overdeterrence effect described above.

\(^2\) See Bigus (2006).
From our reasoning it should be clear, that the second cap has no rationale for initial public offerings. For wrong IPO audits we propose only the first cap. The rationale for the second cap arises only for false audits in the secondary markets.

The factor 20 suggests that auditors should perform a significantly false audit with probability of less than 5%, else they will not make profit from an ex-ante point of view (this, of course, also depends on the issue how easy and risky it is for investors to bring law suits). The 5%-limit is a figure which is also considered to be a landmark in the so called risk-oriented audit approach which also the Big4 do follow.

We suggest to associate the cap to the audit fees paid and not to proxies of company size for two reasons. Audit fees do not only depend on company size but also on the client’s industry, on the complexity of the group and the nature of the assets in place. For instance, the financial services industry faces relatively strict regulation from supervisory agencies but also with regard to accounting standards and thus, fees usually are higher. Financial statements of groups with complex pyramid structures including more than 100 subsidiaries are much more difficult to audit than groups with only, let’s say, three subsidiaries. Finally, most proxies for company size are based on accounting figures and thus, auditors may then have an incentive to put size down. Therefore the auditing price provides a much better proxy for the social damage caused to the community of investors than any indicator for the size of the firm.

3. Proportionate liability

The switch from joint and several liability to proportionate liability certainly has the benefit that auditor’s liability payments are first smaller and second, more predictable and thus, better insurable. However, there is one cost to it which the Commission’s paper does not mention. If London Economics is right that liability of the firm’s directors and officers (D&O insurance) is better insurable than auditors’ liability risk because directors’ risk is better diversifiable (see page 7 of the Commission’s report) the legislator should assign the risk to the party which is better able to insure against it. In the auditing case, D&O insurance companies may be better able to diversify and thus, be better able to bear high liability risk.

Proportionate liability, however, limits the management’s liability risk vis-à-vis the shareholder to her proportion of guilt. Joint and several liability does not do so and therefore exposes the management to a higher risk than the auditor as compared to proportionate liability. We think that this is justified and prefer joint and several liability over proportionate liability due to two reasons. First the risk of the management is more diversified and better insurable than the risk of auditors. Management should be required to insure a liability risk of, let’s say 200 Mio.€. Because diversification works better with D&O insurances, a higher
liability amount should be insurable than in the case of auditor’s liability. The deep pockets are now with the director’s insurance.

Second: from an incentive point of view, it might be also desirable to put the management at a higher liability risk than the auditor because he knows the business better and may detect errors in the financial accounting system at lower cost. Again, an important rule of the economics of tort law applies: liability should be generally assigned to the party who can avoid damages at lower cost. It is therefore justified to expose the management to a higher liability risk than the auditor.

References

