



FINANCIAL REPORTING COUNCIL

**FRC WORKING GROUP ON
AUDITOR LIABILITY LIMITATION AGREEMENTS**

CONSULTATION PAPER

DECEMBER 2007

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AUDITOR LIABILITY LIMITATION AGREEMENTS
CONSULTATION ON DRAFT GUIDANCE**

Introduction

1. When Sections 532 to 538 of the Companies Act 2006 come into force on 6 April 2008, auditors will be permitted to limit their liability to the companies they audit provided they obtain the agreement of the company and its shareholders.
2. The purpose of this consultation is to obtain views on draft guidance on the use of limitation of liability agreements that has been prepared by a working group established by the Financial Reporting Council. The working group was established following an approach by the accountancy profession and after consultation with other interested parties. It includes representatives of companies and investors as well as the accountancy profession.
3. Provided that the draft guidance enjoys broad support from all market participants, the FRC intends to publish final guidance (taking account of views expressed in response to this consultation) in May 2008. The impact and content of the guidance will be reviewed in 2010.

Background

4. Currently auditors are prohibited from entering into contractual arrangements that would have the effect of reducing or excluding their liability in relation to the statutory audit work performed for a company.
5. As companies have become larger and their activities global, and as society has become more litigious, auditors have faced an increasing number of claims, including many that, if they were successful, would be beyond their financial resources.
6. That position is exacerbated if other parties (such as directors or other advisers) who are held responsible for the losses suffered by the company are unable to meet any award made against them. In those circumstances, under the principle of 'joint and several' liability, the auditors could be required to meet the full amount of the damages awarded in favour of the company, not just the amount for which they were held to be directly responsible.

7. As a result of the changes introduced in the Companies Act 2006, from 6 April 2008 auditors will be able to limit their liability by contract provided that the resulting arrangements are “fair and reasonable” in the particular circumstances, and subject to the approval of the company’s shareholders. The legislation applies to both public and private companies.

Status and purpose of guidance

8. The working group has prepared draft guidance that is intended to provide practical assistance to directors, auditors and shareholders on how to apply the new legislation. In particular it aims to:
 - explain what is and is not allowed under the 2006 Act (Section 2 and Appendix A of the draft guidance);
 - set out some of the factors that will be relevant when assessing the case for an agreement (Section 3 of the draft guidance);
 - explain what matters should be covered in an agreement, and provide specimen clauses for inclusion in agreements (Section 4 and Appendices B and C of the draft guidance); and
 - explain the process to be followed for obtaining shareholder approval, and provide specimen wording for inclusion in resolutions and the notice of the general meeting (Section 5 and Appendix D of the draft guidance).
9. The law allows a degree of flexibility as to the manner in which liability can be limited and the form that agreements can take. Given the wide variety of circumstances to which the law applies it is unlikely that any one approach will be considered suitable in all cases. The draft guidance therefore does not currently identify a preferred approach, but simply sets out the available options.
10. However, the working group recognises that identifying acceptable approaches could reduce the need for extensive negotiation between auditors, companies and shareholders, and the time and costs associated with implementing an agreement. Subject to the outcome of consultation, it is proposed that the final guidance would indicate which approach or approaches are most likely to be acceptable in certain circumstances; for example, the ABI and NAPF have indicated that, in the case of listed and publicly trading companies, their members should only support limitation agreements that provide for proportionate liability unless there are compelling reasons why that is not appropriate.

11. Even if the final guidance does indicate which options are most likely to be acceptable, it will not and cannot give firm assurances as to whether particular arrangements will ultimately be considered “fair and reasonable”. That is because every agreement will need to be assessed in the context of the specific circumstances. That judgement would be made by the Courts in the event of a dispute, and cannot be defined in advance.

Questions for consultation

The working group would welcome views on the following questions. In order to ensure that the final guidance properly reflects views received, please indicate which constituency you represent and to which category of companies your comments apply.

Question 1: Does the draft guidance meet the objectives summarised in paragraph 8?

Question 2: Should the final guidance identify which methods of setting the auditor’s liability are most likely to be acceptable in particular circumstances as proposed in paragraph 10, or simply set out the options as in the draft guidance?

Question 3: Does Section 3 of the draft guidance identify all of the main factors to be considered when assessing the case for an agreement? If not, what other factors should be considered?

It would be particularly helpful to hear from shareholders and their representative bodies whether there are factors which will make it unlikely or significantly more likely that liability agreements will be approved by shareholders, and the category of companies to which those considerations apply.

Question 4: The guidance is intended to be equally applicable to public and private companies. Are there different considerations for private companies, and does the guidance address them adequately?

Question 5: Are there any other procedural issues that should be covered in Sections 4 and 5 of the guidance?

Question 6: Do you have any comments on the specimen principal terms, clauses and resolutions and notices in Appendices B to D?

If in response to Question 2 you consider that the final guidance should indicate a preferred form of agreement, please identify which form you prefer by reference to the examples in Appendix B.

Appendix B(i) of the draft guidance contains two different sets of principal terms for an agreement based on proportionate liability; the difference between the two versions is explained in the Appendix. Views are invited on whether it would be helpful to include both sets of principal terms in the final guidance. If you feel it would be better only to include one version, please indicate which one you prefer.

Question 7: Are you aware of any sources of information and advice that should be cross-referenced in the guidance?

We would encourage representative bodies to make their views clear during the consultation period on this document, so that they can be referenced in the guidance. Such information will be of significant assistance to directors in developing any agreements and the resolutions which seek shareholder approval for them.

How to comment

Comments on the questions set out in this consultation document, and any other aspect of the draft guidance, are requested by 14 March 2008.

Responses should be sent by e-mail to auditorliability@frc.org.uk, or in writing to:

Chris Hodge
Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

Unless otherwise stated, responses will be regarded as being on the public record. Respondents should indicate specifically whether their responses should be treated as confidential (standard disclaimers in responses received by e-mail will be disregarded for this purpose).



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