

The Companies Act 2006

Auditor liability

Introduction

The Companies Act 2006 (the Act) received Royal Assent on the 8th November 2006. It contains roughly 1,300 sections and is said to be the largest ever UK statute. The Act, which will not come into effect in its entirety until October 2009 replaces virtually all of the Companies Acts 1985 and 1989.

This briefing focuses on the main changes affecting the exposure of auditors to their clients and third parties, in particular, the introduction of liability limitation agreements (LLAs) for auditors.

The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 require companies to disclose fees receivable by their auditors and their auditors' associates and also to disclose liability limitation agreements that they make with their auditors as a note to the company's annual accounts.

Background

The introduction of LLAs for audit work has been seen as a victory for auditing firms who have lobbied for the ability to control their exposure as the number and value of claims against them increased. The Government has responded by permitting LLAs, subject to conditions and in return, by requiring auditors to be exposed to potential criminal claims in relation to their work.

Increase in Exposure

The Act introduces a new criminal offence of knowingly or recklessly including any material misleading, false or deceptive

matters in an auditor's report. The punishment if found guilty is a fine.

The offence can be committed by an individual and applies to audit reports for financial years beginning on or after 6 April 2008.

Decrease in exposure

One area of uncertainty for auditors has been their potential exposure to third parties. It is accepted that auditors owe a duty of care to their client company. In the 1990 case of *Caparo Industries plc v Dickman* the House of Lords expressed the principle that the responsibility of auditors for misstatements in a company's financial statements is owed to the company's shareholders as a body but not to individual shareholders or the public at large who may have relied on the statements when deciding whether to invest in the company.

The Act provides that, in relation to the directors' report, business review, directors' remuneration report and any summary financial statements, the liability of the auditor is to the company alone.

Liability limitation agreements

1 Position prior to 6 April 2008

Until April 2008, auditors were not permitted to limit their liability to their clients in relation to audit work.

2 Current position

The general prohibition against a company indemnifying its auditor continues to exist. As before, a company may indemnify its auditor for the costs of successfully

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defending a claim but can no longer purchase insurance for an auditor.

Auditors are, however, now permitted to limit their liability for negligence, default or breach of duty or trust in relation to the audit of the accounts, provided that the liability limitation agreement meets certain criteria:

- 1 the agreement must be approved by the shareholders of a public company, in a general meeting
- 2 in relation to a private company, the shareholders of the company can waive the requirement that the agreement be approved by the shareholders. In the absence of a waiver, the shareholders of a private company can approve the agreement by ordinary resolution
- 3 the agreement can only take effect for one financial year
- 4 the agreement must limit liability to an amount which is "fair and reasonable" in all the circumstances
- 5 the company must disclose the "principal terms" which are:
 - a a description of the kind of work covered by the agreement
 - b the financial year to which the agreement relates
 - c the limit to which the auditor's liability is subject
 - d the date of the resolution approving the agreement or the date of the resolution waiving the need for approval, in the case of a private company

The existence of the agreement must be disclosed in the company's accounts as a

note and private companies can approve the terms of the agreement either before or after it is entered into. In fact, it is possible for private companies to waive their right to approve the agreement altogether.

The agreement can be brought to an end by the shareholders but only in respect of future acts or omissions.

The significant unknown is how the Courts will interpret "fair and reasonable". The familiar reasonableness test in the Unfair Contract Terms Act (UCTA) test, relating to limitation of liability for negligence, is excluded by the Act, but no new test replaces it. Instead, the Act sets out certain guidance. In determining what is fair and reasonable, certain factors will be relevant:

- the auditors' responsibilities
- the nature and purpose of the auditors' contractual obligations
- the professional standards for auditors.

The Act provides that limitations can take various forms other than a simple financial cap. It may take the form of a percentage or a proportion of liability.

Comment

Although auditors will be pleased with the possibility of controlling their exposure to their audit clients, their clients may not be so accommodating. It is the auditors client who has the power to agree or refuse to enter into a limitation of liability agreement and it will be interesting to see how many firms are able to negotiate successfully with their audit clients.

It is also worth bearing in mind that, as with corporate law generally, the EU is currently

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considering the question of auditor liability which could prompt further changes in this area in the not too distant future.

Please refer to your usual contact at Thomson Snell & Passmore for further information.

This information sheet summarises and comments on certain provisions in the Companies Act 2006. It is not intended to be comprehensive or to provide legal advice, which should be sought on particular matters.

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