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## Is there a case for limiting auditors'

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# liability **in** MALTA?

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### Introduction

On 5 June 2008, the European Commission issued a recommendation concerning the limitation of the civil liability of statutory auditors and audit firms. This followed a number of studies and consultations mandated by the European Commission in reaction to strong representations received from auditors concerned with the increasing trend of litigation and lack of insurance cover. The Recommendation aims to protect the supply of statutory audits within European Capital markets by shielding audit firms from disproportionate liability claims. Although the Recommendation proposes three possible methods, each member state, including Malta, will be free to choose a method which best suits its legal environment. The Commission must be informed of the actions taken by member states in the light of this Recommendation by 5 June 2010.

The objective of this paper is to evaluate the applicability of this Recommendation within the Maltese audit market. The paper will first discuss the notion of liability limitation itself, the impact of such limitation on audit quality, the relevance of insurability and market concentration as well as the impact on investors and companies. The rest of the paper will then evaluate the applicability of the three proposals suggested by the Recommendation.

The findings of the paper are based on the results of e-mailed questionnaires filed by 36 participants comprising audit firms, listed companies, banks and insurances as well as twelve interviews carried out with a selection of the respondents.

### The Notion of Liability Limitation

The study first investigated whether respondents agreed with the notion of placing a limitation on the civil liability of statutory auditors and audit firms in Malta. Results showed that while auditors were in favour of such a limitation, other respondents were generally as yet undecided. Most on both sides argued that the risks faced by Maltese audit firms have increased significantly in recent years in view of the changing business scenario and that therefore liability risks faced by auditors cannot be measured by reference to past civil claims. Such augmented risks have mostly emanated from the substantial increase of Malta-registered international trade companies, the expansion of Maltese listed companies and the additional companies registered in Malta but quoted on a foreign stock exchange. However, whether such increased risks necessarily led to the need to limit liability was a moot point.

On the one hand, most auditors pointed out that liability exposure was increasingly becoming disproportionate to the audit fees being charged, this strengthening the argument in favour of limitation of liability. This increasing exposure/fee gap was claimed to be particularly taking place in the case of larger audit firms whose client portfolio includes a number of high-profile foreign-owned companies and companies listed on other European capital markets. The stakeholders of such companies tend to view their auditors as having “*deep pockets*,” this leading to a higher possibility of malpractice claims arising against them than was the case in the past. Of course, this is not so applicable to many small and mid-tier audit firms whose client portfolio is mainly made up of family-owned SMEs.

On the other hand, most other respondents argued that the case for limitation is not yet proved; despite the increased risks, Maltese auditors have never as yet been held liable for audit negligence. Against the concept of limitation, they also argued that Maltese civil law is based on the concept of proportionality and thus, in cases of audit negligence, auditors do not face the risk of being held jointly and severally liable for the wrongdoing of others. It was also notable that both audit and non-audit respondents in their majority did not believe that auditors currently face any significant risk in Malta of catastrophic claims.

## Audit Quality

In its public consultation on auditors’ liability, the European Commission found that a major concern of those opposing limitation of liability was that this would have a negative impact on audit quality. Yet, such concern was not expressed in Malta: on average, respondents believed that audit quality would remain unchanged, with only a few indicating that it would deteriorate. Furthermore, respondents, mostly auditors, emphasised that the regulatory framework in Malta was such that in any case the introduction of such limitation could hardly bear any noticeable influence on quality: in this connection, they made particular reference to the various compliance obligations of audit firms: the international auditing standards, EU legislation regulating statutory audits, as well as the firms’ own internal policies and procedures. They argued that, limitation or not, non-compliance gave rise to various sanctions occasioned by regular inspections of the Maltese Quality Assurance Unit, if not of the firms’ own international networks. Even worse, non-compliance impacted negatively

on the firms’ reputation, and therefore also their financial interests.

On the other hand, some respondents, particularly non-auditors, saw a possible danger of limitation: that of rendering an increasing sense of complacency within the Profession. Over the long term, this could easily impair professional attitudes and work ethics, as well as reduce the incentives to go beyond what is strictly required.

## The Question of Insurability

One of the major motives behind the proposed liability reform is the inability of auditors in most EU member states to obtain sufficient insurance cover for major audit engagements. It was therefore necessary to investigate whether such insurability issues also concern Maltese audit firms.

Response indicated that while the absolute majority of respondents consider indemnity insurance as offered by Malta-based insurance companies as adequate for small and mid-tier audit firms, the situation is different for the “Big 4” firms. The client portfolios of the latter expose them to greater liability risks which often necessitate a level of insurance beyond the risk capacity of Malta-based insurances. Yet, most agreed that numerous local brokers and agencies can still fill the gap by providing alternative indemnity insurance as offered by non Malta-based insurances. In addition, a number of larger audit firms have the availability of captive insurances provided by their international networks.

the sustainability and competitiveness of the current supply of statutory audits. In Malta, the market for statutory audits of listed companies is predominantly controlled by the “Big 4” as evidenced in Figure 1. This clearly indicates market concentration.

However, despite the concentration, the study found that in Malta, the choice of audit firms for statutory audits is still considered sufficient in view of the relatively small number of listed and large unlisted companies. Therefore, there seems to be little need for specific measures such as a liability reform in the hope of encouraging mid-tier audit firms to enter the market of statutory audits for such companies. While such a possibility of encouragement is known to be a major argument held abroad in favour of the introduction of the limitation of liability, such argumentation seems therefore scarcely justified within the Maltese scenario. Increasing further the market choice in Malta is in any case beset with further natural barriers: the considerable entry investment required, the common deficiencies in skills and resource capabilities as well as the reputation gap as against the larger companies.

## Impact on Companies and Investors

The European Commission Recommendation also suggests evaluating the impact which a liability reform would have on companies and investors. In Malta, company respondents argued that, while they acknowledged their responsibilities with respect to the preparation of financial statements, it was important that any liability reform would not in practice

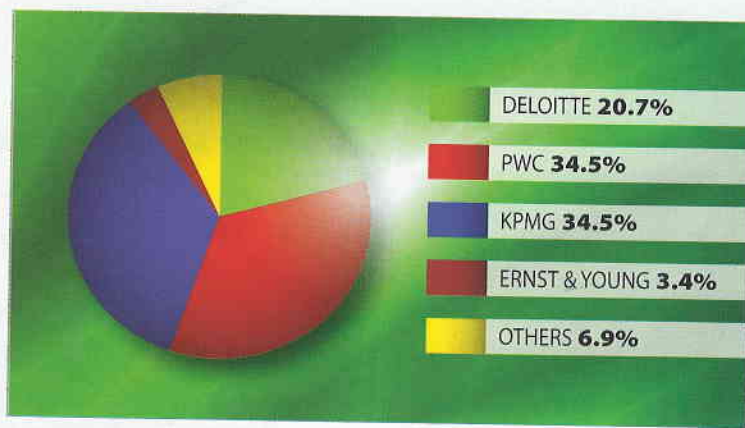


Figure 1: Chart showing how the market for statutory audits of companies whose equities and bonds are listed on the Malta Stock Exchange is segmented (data compiled from the Registry of Companies in February 2009).

## Market Concentration

The concentration within the audit market of listed and large unlisted companies is a major concern at EU level as this could threaten

shift on company directors and officers that portion of liability which would at present be fairly imputed on the auditor as a result of his



When questioned on how limiting auditor liability would impact investor confidence in Malta, respondents were split between a negative impact and no impact. Although the matter is very controversial, most interviewees argue that it is unlikely that Maltese investors will take into consideration auditor's liability when making investment decisions. A further comment was that investors are more likely to lose confidence if an audit opinion is proved to be incorrect, rather than if a liability reform is undertaken.

## Methods for limiting auditors' liability as proposed by the European Commission

Respondents were asked to evaluate the three methods proposed by the EC Recommendation to limit the civil liability of auditors. These alternative methods are the following:

- 1) the establishment of a maximum financial amount or a formula allowing for the calculation of such an amount (*hereinafter referred to as "capping"*);
- 2) the establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant (*hereinafter referred to as "proportionate liability"*);
- 3) a provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement (*hereinafter referred to as "liability agreed by contract"*).

The study clearly demonstrates that Method 2 is the preferred option. This probably emanates from the belief amongst a number of respondents that proportionate liability as proposed by the European Commission is already incorporated in the provisions of the Maltese Civil Code. Furthermore, proportionate liability seems to represent the fairest method wherein each would be held liable for the damage s/he has caused. This goes in contrast with the establishment of a cap which is regarded by most non-audit respondents as being inappropriate given that a cap implies that auditors would not necessarily be held completely liable for damages resulting from their negligence. As regards the third option of limiting auditor liability through a contract agreement, this was the least favoured option. Nonetheless, this could still be a viable alternative given that it is already used in other professions even in Malta.

## The current legal position in Malta

In evaluating the methods proposed by the European Commission to limit the civil liability of auditors, it may be argued that this is already limited under Maltese Law. In fact, the method proposing the concept of proportionate liability, which as has been seen is the preferred method, is similar to the liability provisions of the Maltese Civil Code.

Under Section 1049(1) of the Civil Code, a person will be held jointly and severally liable towards others if he has acted maliciously. As can be seen in Table 1, this is very near to what the EC Recommendation proposes, where a limitation should not apply in cases of intentional breach of duties by the statutory auditor or the audit firm.

<b>EUROPEAN COMMISSION Recommendation</b> (Methods for limiting liability)	<b>SECTION 1049 (2) Civil Code</b> (Liability in tort)	<b>SECTION 1137 Civil Code</b> (Liability in Contract)
Method (2) - Establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant and is accordingly not jointly and severally liable with other wrongdoers.	Where some of them have acted with malice, and others without malice, the former shall be jointly and severally liable, and each of the latter shall only be liable for such part of the damage as he may have caused.	Even where the non-performance of the obligation is due to fraud on the part of the debtor, the compensation in respect of the loss sustained by the creditor, and of the profit of which he was deprived, shall only include such damages as are the immediate and direct consequence of the non-performance.

Table 2: Compatibility of provisions as to where limitation of liability is applicable

Furthermore, under liability in tort, where a person has caused damage but has not acted maliciously, his/her liability is limited to the amount of damage which s/he has caused. Additionally, liability arising under contract is limited to the immediate and direct consequences of the non-performance. Again, as shown in Table 2, these provisions within the Civil Code are very near to the concept of proportionate liability as proposed in Method 2 and apply both against the company being audited and any third party.

<b>Section 1050 (1) Civil Code</b> (Liability in tort)
Where the part of the damage which each has caused cannot be ascertained, the injured party may claim that the whole damage be made good by any one of the persons concerned, even though all or some of them have acted without malice, saving the right of the defendant to seek relief from the other or the others.

Table 3: An exception to limitation of liability in tort in Malta

An exception to the above liability in tort provision of the Civil Code with respect to Method 2 is that where the damage which each person has caused cannot be ascertained, they may be held jointly and severally liable even though some might have acted without malice. However, the latter would have the right to seek relief from the others. The actual provision is reproduced in Table 3.

If one were to adopt Method 3, that is limitation of liability as agreed by contract, one would need to amend both Section 13 of the Accountancy Profession Act and Section 148 (1) of the Companies' Act. These state that any agreement or arrangement exempting an auditor from any liability, responsibility or duty relative to the statutory audit would be null and void. The provisions are reproduced in Table 4.

<b>EUROPEAN COMMISSION Recommendation</b> (Limitation of liability)	<b>SECTION 1049 (1) Civil Code</b> (Liability in tort)
The civil liability of statutory auditors and of audit firms arising from a breach of their professional duties should be limited except in cases of intentional breach of duties by the statutory auditor or the audit firm.	Where two or more persons have maliciously caused any damage, their liability to make good the damage shall be a joint and several liability.

Table 1: Compatibility of provisions as to where no limitation of liability is applicable

<b>EUROPEAN COMMISSION Recommendation</b> <i>(Methods for limiting liability)</i>	<b>SECTION 148 (1) Companies' Act</b>
<p>Method 3 - provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement.</p>	<p>Any provision, whether contained in the memorandum or articles of a company or in any contract with a company or otherwise for exempting any officer of the company or any person engaged by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would in the absence thereof have been attached to him in respect of negligence, default or breach of duty or otherwise of which he may be guilty in relation to the company shall be void: provided that a company may, in pursuance of any such provision as aforesaid, indemnify any such officer or auditor against any liability incurred by him in defending any proceedings in which judgment is given in his favour or in which he is acquitted.</p>
<b>SECTION 13 Accountancy Profession Act</b>	
<p>Any agreement or other arrangement, as may be prescribed by the Minister, purporting to exempt a warrant holder or a holder of a practising certificate, from any liability, responsibility or duty relative to the statutory audit, except under a policy of insurance made out under article 11, to indemnify him against any such liability or responsibility, shall be null and void.</p>	

Table 4: Contrasting positions regarding limitation of liability agreed by contract

Therefore, it may be stated, in favour of Method 2, that unlike the position as it stands with the other methods, the concept of proportionality is already included in the liability provisions of the Maltese Civil Code. However, one still needs to await a decision of the Maltese Courts to see how this concept would be interpreted with respect to the liability of auditors towards damaged parties.

## Conclusion

Although the increasing volatility in capital markets has led to much higher liability risks faced by audit firms, it is inappropriate to generalise the situation as it applies to all EU member states. This results from the fact that each national market has its own characteristics in terms of investment culture and perceived risks, legal regimes, type of investors, companies and ways of doing business. A clear example may be seen in the recent international credit crunch; the stability within the Maltese banking scenario was in sharp contrast to the turbulent banking situation in most international economies, including other countries within the EU.

The study therefore concludes that most of the concerns upon which the EC Recommendation was issued are not necessarily relevant to the Maltese scenario where the current provisions seem to suffice. Furthermore, the Recommendation specifically refers to statutory auditing of listed companies and therefore the potential beneficiaries of its application in Malta are probably mostly limited to the larger audit firms. Therefore, the case for changing the law may as yet not be fully justified.

## About the authors:

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Mr. Baldacchino is Head of Department of Accountancy at the University of Malta. He specialises in auditing and financial strategy and has written a number of accredited research papers in these areas. He is a chartered certified accountant, holds a Master of Philosophy and Directorships in a number of companies.