APPENDIX 1

# FINANCIAL REPORTING COUNCIL

# GUIDANCE ON AUDITOR LIABILITY LIMITATION AGREEMENTS

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# GUIDANCE ON
# AUDITOR LIABILITY LIMITATION AGREEMENTS

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## INTRODUCTION

The Financial Reporting Council ('FRC') aims to promote confidence in corporate reporting and governance in the United Kingdom.

The FRC has identified that the significant uncertainty and cost that would occur in the event of one or more major accounting firms leaving the market is a major threat to confidence in corporate reporting in the UK[1]. Such a situation could arise, for example, if the future of a major accounting firm were to be jeopardised as a result of its inability to meet any potential liability that it incurred as a result of audits that it has undertaken.

For this reason, the FRC welcomed the Government's decision to repeal the prohibition on auditors limiting their liability for negligence. In the Companies Act 2006, the Government decided not to mandate a particular approach - preferring a permissive regime that would allow companies and their shareholders to decide whether, and, subject to certain provisions, on what terms, to approve an agreement.

In response to requests from interested parties, and recognising that the permissive nature of the new legislative provisions might result in uncertainty whether and if so how they should be utilised, the FRC asked a group chaired by Sir Anthony Colman to develop guidance on the new legislation and how it might be implemented. The FRC welcomes the Guidance that Sir Anthony's group has developed and believes that it will provide valuable assistance to companies considering entering into Auditor Liability Limitation Agreements.

Each company must make its own decision as to whether to enter into a Liability Limitation Agreement with its auditors. However, the FRC believes that it would be desirable for companies to discuss with their leading shareholders and with their advisers the merits of entering into an auditor liability limitation agreement in their particular circumstances.

Concerns that shareholder interests may be prejudiced by such arrangements should, in the FRC's view, be assessed in the light of the efforts being made by the audit profession to improve audit quality, by the requirement that such agreements must be approved by a company's shareholders, and by the fact that, if an auditor seeks to rely on such an arrangement, a court must be satisfied that its terms are fair and reasonable.

The impact and content of this Guidance will be reviewed by the FRC in the second half of 2010 to ensure that it incorporates developments in generally accepted practice and any other relevant developments.

Financial Reporting Council
June 2008

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[1] Plan And Budget 2008/09; Financial Reporting Council; April 2008

# SECTION 1

# BACKGROUND TO THE GUIDANCE

1.1. Under sections 532 to 538 of the Companies Act 2006, which came into force on 6 April 2008, companies are permitted to limit the liability of their auditors by contract provided that shareholder approval is obtained. The resulting arrangements are effective only to the extent that they are "fair and reasonable" in the particular circumstances.

1.2. Previously auditors were 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. In particular, auditors were prohibited from entering into arrangements to limit their liability to the proportion of the losses suffered by a company for which they were directly responsible.

1.3. 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.

1.4. 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.

1.5. The Government's decision to include the provisions in the Companies Act 2006 to permit auditors to limit their liability by contract followed extensive consultation.

1.6. A proposal involving the removal of the prohibition on auditors limiting their liability was developed in the course of the Company Law Reform project ('CLR')[2]. The CLR proposal was aimed at alleviating concern that:

- a leading firm might exit from the market for the provision of audit services, which would seriously threaten the effective functioning of the UK capital markets, and adversely affect many listed and other companies through disruption of the market for audit services;

- without a means of limiting auditor liability, audit fees might increase to cover the risks arising from increasing exposure to claims or firms would not be willing to accept appointments as auditors of higher risk entities; and

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[2] The Company Law Reform project was sponsored by the Department for Trade and Industry, but it was undertaken by interested parties drawn from all sections of the community. The output of and proposals made by the CLR project did not represent Government policy until expressly adopted as Government policy and, where necessary, appropriate legislation introduced.

- the pre-existing arrangements for liability and the increase in litigation against auditors had contributed to an environment which encouraged auditors to adopt a defensive, risk-averse approach to auditing.

1.7. Following the CLR project, there were discussions involving the Government and representatives of the key constituencies – institutional investors, companies and the audit profession. In the course of those discussions, institutional investors and companies indicated that they would support the proposal provided:

- it was linked with a programme to improve audit quality. The audit profession agreed to progress particular initiatives identified in the course of those discussions and it continues to seek ways to improve audit quality; and

- it allowed for the concept of proportionality. Institutional investors indicated that they would not support an agreement that limited an auditor's liability to a fixed amount.

1.8. In the event, the Companies Act 2006 allows companies to enter into auditor liability limitation agreements, subject to the agreement of shareholders, and to the provision that such agreements will not be effective to limit auditors' liability to less than would be 'fair and reasonable'. The effect of the legislation is that auditors remain liable for the consequences of their own negligence. The legislation also contains a number of other measures designed to promote audit quality, including the introduction of criminal sanctions for certain offences by auditors[3].

## The European Commission's position

1.9. In January 2007 the European Commission undertook a consultation on the desirability of permitting auditors to enter into liability limitation agreements with the companies they audit.

1.10. In June 2008 the European Commission issued a Recommendation[4] concerning the limitation of the civil liability of statutory auditors and audit firms. The Recommendation states that EU Member States should take national measures to enable auditors to limit their liability except in cases of intentional breach of their duties.

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[3] Section 507 of the Companies Act 2006 provides that auditors commit a criminal offence if they knowingly or recklessly give an incorrect audit opinion.

[4] 'Commission Recommendation of 5 June 2008 concerning the limitation of the civil liability of statutory auditors and audit firms'. The Recommendation is available at: http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

1.11. The Recommendation states that these measures are justified because:

- "increasing volatility in market capitalisation of companies has led to much higher liability risks, whilst access to insurance coverage against the risks associated with such audits has become increasingly limited" and
- "since unlimited joint and several liability may deter audit firms and networks from entering the international audit market for listed companies in the Community, there is little prospect of new audit networks emerging which are in a position to conduct statutory audits of such companies".

1.12. The Recommendation suggests the types of such agreement that should be permissible, which include those contemplated by the Companies Act 2006. The Recommendation states that agreements should be conditional on receiving shareholder approval and that a description should be included in any financial statements published by the company concerned, as required by the Companies Act 2006 and the accompanying regulations.

## The purpose and status of this guidance

1.13. This guidance aims to provide practical assistance to companies and their directors 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);
- set out some of the factors that will be relevant when assessing the case for an agreement (Section 3);
- explain what matters should be covered in an agreement, and provide specimen clauses for inclusion in agreements (Section 4 and Appendices B to E); 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 F).

1.14. 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 - for example, whether the company is a public or private company and whether its shares are listed or traded - it is unlikely that any one approach will be considered suitable in all cases. The guidance therefore sets out the available options.

1.15. The guidance does not attempt to determine whether particular arrangements will be considered "fair and reasonable". That is because every arrangement will need to be assessed in the context of the particular circumstances. That would ultimately be for the Courts to decide in the event of a dispute.

1.16. The guidance includes specimen clauses for inclusion in agreements governed by English law and specimen resolutions to put to the General Meeting (or, for private companies, for agreement by written resolution). These are not intended to be binding and are provided as examples only. Companies and auditors that are considering entering into an agreement should satisfy themselves that the agreements, the resolutions to approve them and any related documentation are adequate and satisfactory for their purposes.

1.17. Companies and directors should consider other relevant sources of guidance when considering whether to enter into a limitation of liability agreement and, if so, on what terms. Details of some sources of guidance can be found on the FRC website[5].

[5] http://www.frc.org.uk/about/auditorliability.cfm.

## SECTION 2

## WHAT DOES THE LAW ALLOW?

2.1. The provisions relating to auditors' liability are set out in sections 532 to 538 of the Companies Act 2006 ("the Act"), and are described in more detail in Appendix A to this guidance.

### What does the Companies Act allow?

2.2. A liability limitation agreement is defined in the Act as an agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of the audit of accounts, for which the auditor may be responsible in relation to the company.

2.3. The Act states that for a liability limitation agreement to be valid it cannot cover more than one financial year and it must be approved by a resolution of the company's shareholders. For public companies this must be done at a General Meeting, while private companies have the option of using a written resolution, and for group companies this means each UK company in the group and not just the holding company.

2.4. The Act also states that any arrangements to limit liability will not be effective except to the extent that they are "fair and reasonable" in the particular circumstances. This is the key principle in the legislation, and it means that the Court can override any contractual limits agreed between the company and the auditors if it considers that they are less than "fair and reasonable". The Court may reach this conclusion notwithstanding the fact that the agreement had been approved by the company's shareholders. In these circumstances the agreement does not become null and void; instead the liability is amended to a level set by the Court.

2.5. Although the question of what is a "fair and reasonable" limit on the auditor's liability will ultimately be for the Court to decide in each individual case, the Act sets out a number of factors that should be taken into consideration:

- the auditor's responsibilities under Part 16 of the Act (which include provisions relating to the statutory audit and the duties and rights of auditors);
- the nature and purpose of the auditor's contractual obligations to the company; and
- the professional standards expected of the auditor.

2.6. However the Act also states that no account is to be taken of:

- matters arising after the loss or damage in question has been incurred; or
- matters (whenever they arise) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.

**What is the effect of these changes?**

2.7. At present, under English law, if an auditor negligently audits a company's accounts, the auditor is liable to the company for all the loss it suffers as a result. There may be others, such as company employees and other advisers, who are also liable to the company for all or part of the same loss - for example, if a company employee has been fraudulent or another adviser has negligently advised the company in connection with the accounts. The company can recover all its loss from the auditor, even though others are also liable to it. This is known as "joint and several liability".

2.8. Under the Civil Liability (Contribution) Act 1978, the auditor may be able to claim a contribution from the others who are liable. A court can order such a person to pay such amount as is "just and equitable having regard to the extent of the person's responsibility for the damage in question." For example, a court could find that the employee was 70% to blame, the other adviser was 10% to blame and the auditor was 20% to blame. However, if the other parties were insolvent or had fled the country, the auditor will not be able to recover any money from them and must therefore pay the full amount of the loss. This will continue to be the position in those cases where the company and its auditors have not agreed a liability limitation agreement.

2.9. Where an agreement is in place, the Act does not restrict the manner in which liability can be limited (except as set out in paragraph 2.4). This means that, in principle, the contractual limits could be set in a number of different ways, for example:

- a limit based on the auditor's proportionate share of the responsibility for any loss. Under this approach, the company would agree that if there is someone other than the auditor who is also liable to the company for, or who has caused or contributed to, all or part of the same loss, the auditor's liability would be limited to the extent to which the auditor was responsible for that loss. The company would not be able to look to the auditor for any loss attributable to the acts of any other party (which could include a director, officer or employee of the company, irrespective of whether they had acted negligently, in breach of trust or dishonestly);
- purely by reference to the "fair and reasonable" test;
- a cap on liability, expressed either as a monetary amount or calculated on the basis of an agreed formula; or

- a combination of some or all of the above.

2..10 Specimen principal terms and provisions for each type of agreement are contained in Appendices B, C and D to this guidance[6]. It is important that companies and their advisers appreciate that it is neither appropriate nor practical for this guidance to provide definitive direction on every issue that companies may encounter when developing an auditor liability limitation agreement. The specimen principal terms and provisions contained in the Appendices to this guidance identify certain choices to be made and the accompanying notes explain the main considerations.

2.11 It is important to appreciate that any agreement will only be effective if it receives shareholder approval. The factors relevant to obtaining shareholder approval are discussed in Section 3 of this guidance.

2.12 It is not possible at this stage to predict how the "fair and reasonable" test will be applied by the Court and the extent to which the Court will look beyond matters relating purely to the auditor's proportional share of the blame.

2.13 The Act does not specify the test to be applied to determine what is fair and reasonable, and in particular does not specify that what is fair and reasonable will depend solely on the auditor's share of the responsibility. The Court can take into account all the surrounding circumstances subject only to the provisions described in paragraph 2.6. Whilst it seems likely that a court may decide that it is fair and reasonable to limit the auditor's liability to an amount which reflects his percentage responsibility for the loss, this may not always be the case.

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[6] The specimen wording and the accompanying explanatory notes are for guidance only and assume that the agreement will be governed by English law. It is the responsibility of companies, auditors and their own legal advisers to ensure that the principal terms, liability limitation agreements, the resolutions to approve them and any related documentation which they issue is adequate and satisfactory for their purposes. Neither the Financial Reporting Council, nor any member of the working group that has prepared this guidance, takes any responsibility for or in respect of the specimen wording or the explanatory notes.

## SECTION 3

## WHAT ISSUES SHOULD THE DIRECTORS CONSIDER?

3.1. This section considers some of the factors that may be relevant to a decision by directors as to whether a company should enter into a liability limitation agreement.

3.2. There are three factors that directors should have in mind when considering whether a company should enter into a liability limitation agreement:

- Parliament has replaced legislation prohibiting an agreement that has the effect of limiting an auditor's liability to the company it audits with legislation prescribing the procedures to be followed if such an agreement is to be enforceable. Therefore there is no legal or regulatory prohibition on companies entering into liability limitation agreements provided the provisions of sections 532 to 538 of the Companies Act 2006 are complied with.

- Auditors are subject to professional standards they are required to follow and to a duty to act with reasonable care and diligence in performing their functions and these requirements will not be affected by an agreement that limits their liability.

- Shareholder approval is required before any agreement can take effect.

3.3. Directors will wish to ensure that they have a full understanding of the legal and regulatory environment in which they will make their decision. This will include being familiar with:

- their general duties as directors as set out in sections 171 to 177 of the Companies Act 2006;

- their responsibilities for the production of financial statements for the company that comply with the legislative and regulatory requirements applicable to the company; and

- the responsibilities of the auditors under the Companies Act 2006 including their duty to report whether the accounts give a true and fair view, whether they have been properly prepared in accordance with the relevant financial reporting framework, and whether they have been prepared in accordance with the requirements of the Act.

3.4. Directors of a company which enters into an agreement with its auditors to limit their liability owe the same duties as they would when entering into any other contract on behalf of the company. Provided they obtain valid shareholder consent under the Companies Act 2006, directors will not incur personal liability in relation to the decision to enter into such an agreement if they act independently with reasonable competence in what they honestly believe to be most likely to promote the company's success for the benefit of the shareholders.

3.5. When deciding whether the company ought to enter into a liability limitation agreement, directors will need to obtain a clear understanding of the nature of the proposed agreement and its practical implications[7]. By limiting the auditors' liability, the company will necessarily accept that there will be an increased risk that the company may be unable to recover part of the loss suffered.

3.6. Reasons why companies and their directors might conclude that it is appropriate for the company to enter into a liability limitation agreement include the following:

- The proposed agreement is an essential element of the arrangements under which the company is able to secure the appointment of auditors who, for example, the company believes are particularly well suited to audit its affairs by virtue of their specialist industry expertise or geographic coverage.
- It enables the company to obtain audit services from an audit firm of the company's and shareholders' choice at an acceptable price.
- A proposed agreement which uses the proportionality approach would ensure that the auditors' potential liability in the event of a financial reporting failure is appropriately matched to their degree of responsibility for that financial reporting failure and their available resources.
- The fact that companies regularly enter into agreements with suppliers of goods and services which contain limitations (or exclusions) of liability.

Additional considerations that may be relevant to directors of private and/or owner managed companies (but not to companies with institutional shareholders) are considered in Section 6.

3.7. Other matters that the directors may need to consider include:

- Whether the company is subject only to the laws and regulations of the United Kingdom or whether it is subject to the laws and regulations of other countries that affect a company's ability to enter into a liability limitation agreement. In the case of the US, the FRC is in discussion with the SEC about the impact of its Rules on UK SEC registrants, and will publish advice on this issue as soon as possible.
- Whether the company is subject to other sector-specific laws and regulations that may be relevant to the decision of whether to enter into an agreement.
- Whether any of the company's shareholders have particular policies in relation to proposals involving auditor liability limitation agreements and, if so, whether those policies are likely to result in opposition to any particular proposal.

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[7] The forms of auditor liability limitation agreement and their effects are discussed in paragraph 2.10 and in the introductions to Appendices B, C and D.

- Whether the method by or extent to which the auditor's liability is to be limited would be appropriate to achieve the stated rationale for the proposed agreement.

- Whether there is any potential interaction between the proposed liability limitation agreement and the future plans for the company. For example, if the company is currently privately owned and there are plans to take the company public in the foreseeable future, the directors may be advised that difficulties might be encountered if they entered into a liability limitation agreement in a form that is not approved by particular prospective shareholders.

3.8. Having decided that a liability limitation agreement is appropriate in the particular circumstances, the directors will need to consider the manner in which they communicate that decision and any reasons for it to the shareholders of the company and seek their approval of the proposed agreement. Their approach may differ depending upon whether the company is public or private and on the identity of its shareholders.

3.9. They will also need to consider the form of any resolution to be put before the shareholders and any disclosure to be made in the financial statements of the company (see Section 5 of this guidance).

3.10. Examples of matters that directors should consider addressing when approaching the company's shareholders for approval include

- whether the company's governance arrangements relating to its financial reporting obligations (including the composition and operation of its audit committee) observe the Combined Code.

- if the company's subsidiaries and associated companies (including any joint ventures) are also entering into agreements to limit the liability of their respective auditors, an explanation of those agreements and how they will operate.

3.11. Directors of companies with institutional shareholders should consider the policies of bodies such as such as the Association of British Insurers (ABI), the National Association of Pension Funds (NAPF), and others. The ABI and NAPF have indicated that their members are likely only to support limitation agreements that provide for proportionate liability unless there are compelling reasons why that is not appropriate. In addition, the Institutional Shareholders' Committee (ISC) has indicated that it intends to issue a statement, which will set out the expectations of institutional shareholders.

3.12. As a practical matter, institutional shareholders have indicated that

- They are likely to welcome early discussion with companies that are considering auditor liability limitation agreements, and, save in exceptional circumstances, may be reluctant to approve such agreements after they have been entered into.

- They are unlikely to be able to review individually the detailed terms of every limitation agreement. As a result, the acceptability of a proposed limitation agreement may be influenced by whether it is in a form that has been previously considered and supported by, for example, institutional shareholders or bodies such as those referred to in paragraph 3.11 above.

- If a company decides to propose an agreement which is different from those previously considered and supported by institutional shareholders and those bodies referred to in paragraph 3.11, the directors should be able to explain any changes that may impact on the legal effect of the agreement and the reasons for making those changes.

## SECTION 4

## WHAT SHOULD BE COVERED IN ANY AGREEMENT?

4.1. Under the Companies Act 2006 a company has the option of seeking shareholder approval either before or after entering into an agreement with its auditors. If the company is seeking approval having already entered into an agreement, the shareholders must approve the whole agreement; if seeking approval first, the shareholders must approve what the Act calls the "principal terms". These are the terms which specify:

- the kind of acts or omissions covered by the agreement;
- the year the agreement relates to; and
- the limit of the auditor's liability, however expressed.

4.2. Appendices B, C and D to this guidance contain specimen "principal terms", being the operative terms for a liability limitation agreement. These have been drafted so that they can be referred to in the resolution and sent to shareholders with the notice of the meeting (see Appendix F), and then incorporated into the agreement without the need for further drafting. They are provided as examples only. The effect of each clause is explained in the appropriate Appendix.

4.3. Appendix E contains specimen clauses that can be added to the principal terms to form a liability limitation agreement. The exact form and content of an agreement will be a matter for discussion between the company and the auditors.

### Other issues for consideration

4.4. Companies and auditors will need to consider how any agreement inter-relates to the audit engagement letter. One option is for the principal terms to be part of the audit engagement letter. This might particularly be appropriate if that letter includes an "all agreement" clause (that is, a clause confirming that the letter alone records the agreement to audit). Another option is to have a separate agreement which just deals with the limitation of the auditor's liability, and which cross refers to the audit engagement letter.

4.5. Timing will also need careful consideration in deciding whether to incorporate a liability limitation agreement into the audit engagement letter (see paragraph 5.6 onwards).

4.6. Companies and auditors will also need to consider whether there are any provisions in the audit engagement letter that would have the effect of limiting the auditor's liability in other ways.

# SECTION 5

# WHAT PROCESS MUST BE FOLLOWED TO IMPLEMENT THE AGREEMENT?

5.1. The process that must be followed to obtain shareholder approval for a liability limitation agreement varies, depending on whether the company is a private company or a public company (whether or not its shares are listed or traded). In both cases, approval must be given by ordinary resolution.

5.2. Private companies can ask for shareholder approval by written resolution or at a shareholders meeting. If a private company has not yet entered into the agreement, it can seek a resolution waiving the need for approval or approving the principal terms of the agreement. If the agreement has been entered into, the resolution must approve the agreement (not just the principal terms).

5.3. Public companies must hold a General Meeting of shareholders to pass a resolution. If a public company has not yet entered into the agreement, the resolution must approve the principal terms of the agreement. If it has already entered into the agreement, the resolution must approve the full agreement (not just the principal terms). In addition listed companies will need to consider the relevant Listing Rule requirements for circulars sent to shareholders, and companies with institutional shareholders should consider any guidance issued by those shareholders.

5.4. Where a company is part of a group, every UK company in the group which enters into a liability limitation agreement must obtain authorisation from its shareholders. Although the Act does not require such a subsidiary to obtain the approval of the shareholders of any holding company, the directors may wish to consider whether the agreement should be conditional on obtaining the authorisation of the company's ultimate parent as well as authorisation from its own shareholders (see paragraph 5.15 onwards for further points to consider where a company is part of a group).

5.5. Appendix F contains specimen resolutions and notices. These are provided as examples only.

## Timing of authorisation

5.6. The Act does not require authorisation to be given before the beginning of the financial year to which the liability limitation agreement relates. The agreement can be entered into before, during or after the financial year to which it relates.

5.7. Companies and auditors will need to consider the timing for shareholder approval of a liability limitation agreement. In particular they will need to consider how it fits in with the timing of the financial year to which the agreement relates, the timing for signing the auditor's engagement letter for that financial year, the timing for holding the Annual General Meeting, and the expectations of shareholders. Some institutional investors have indicated that they will be unlikely to support agreements after the audit work for the relevant year has been carried out.

5.8. The Act contains requirements relating to the appointment of auditors and their remuneration. Companies may therefore wish to seek authorisation for a liability limitation agreement at the same time as proposing a resolution to appoint the auditors and a resolution to fix their remuneration. This may not be possible in all cases in the first year in which companies can enter into liability limitation agreements.

5.9. In the case of a public company with only a small number of shareholders, it should be relatively straightforward to arrange for the liability limitation agreement (or principal terms) to be approved by the shareholders at the same time as the company settles the auditor's engagement letter for the financial year to which the agreement relates. This is because it should be possible for the company to arrange for a General Meeting to be held at the appropriate time. However directors and auditors will need to consider whether this will require them to make any changes to the existing arrangements for agreeing the engagement letter.

5.10. In the case of companies whose shares are publicly traded – including listed companies and those whose shares are traded on the AIM and PLUS markets - and any other companies that have a large shareholder base, the timing issues may be more complicated.

5.11. These companies will in normal circumstances wish to propose the resolution to approve the liability limitation agreement (or principal terms) at their Annual General Meeting (AGM) each year, rather than call an Extraordinary General Meeting solely to deal with this issue.

5.12. The AGM is normally held towards the end of the first half of each financial year, and will include resolutions to approve the audited accounts from the previous financial year and to reappoint the auditors for the current financial year. This is a different timetable to that involving the audit engagement letter. The practice to date has been for the letter to be signed in the final quarter of the financial year to which it relates. To be effective it must in any event be signed before the audit report for the financial year in question has been signed off.

5.13. This may give rise to difficulties as to the timing of shareholder approval for a liability limitation agreement. Given that the terms of an agreement are likely to be closely linked to the terms of the engagement letter, the company and auditor will want to look at both aspects together.

5.14. Normally, it seems likely that shareholders will be asked to approve the liability limitation agreement (or the principal terms of the agreement if it has not yet been entered into) at the AGM held during the financial year to which it relates. So, for example, a liability limitation agreement for the financial year ending 31 December 2009 would be approved at the AGM earlier in 2009. If this approach is adopted companies and auditors may wish to consider a process whereby the negotiation of the audit engagement terms is brought forward to a point in time early in the relevant financial year so that agreement on those issues is reached before the liability limitation agreement is put to shareholders. The timing of this may be different in the first year of agreeing a liability limitation agreement.

## Groups of companies

5.15. For companies that are subsidiaries, the timing for approval of a liability limitation agreement will be influenced by the timing for approval of the holding company agreement. Obtaining shareholder approval via a written resolution or shareholder meeting should be a straightforward process to put in place across the group at the appropriate time. Companies will need to consider whether to arrange for the subsidiary company approval to be put in place before or after the holding company approval; and if it is before, whether it should be conditional on the approval by the holding company's shareholders of the agreement relating to the holding company.

5.16. The contractual arrangements between auditors and companies in a group will vary depending on whether or not the same auditors are appointed to audit the accounts of all group members. Where group members include entities that are not registered in the UK, there may be multiple auditors for the group and separately agreed engagement terms for entities with overseas auditors. Where the company is a member of a group of companies and all group members are UK companies and have the same auditors, the auditors will typically have a single audit engagement letter that is addressed to the parent but structured to capture all group members for the purposes of consolidation as well as the audit of the accounts of each company separately. Where the group includes entities not registered in the UK, for consolidation purposes the auditors will obtain information from overseas auditors who will have their own separately agreed local audit engagement letters.

5.17. Under the Act a separate agreement is also needed for each UK company within a group. Consideration should be given to whether this can be achieved by having one letter (a typical structure as outlined in paragraph 5.16) setting out the terms of the agreement and a schedule of companies who are to be bound, constituting a separate agreement between each company and the auditor. This model will work only where the same audit practice audits all UK members of the group. If not, separate arrangements will be needed with the other auditor. The timetable will need to make provision for discussions with that auditor too.

5.18. If the holding company does not own all the shares in a subsidiary, or if the company is a joint venture, the timetable will need to make allowance for any extra time needed to obtain shareholder approval in respect of liability limitation agreements for such entities.

5.19. Consideration should be given to the location of subsidiaries and joint ventures. Where there are non-UK entities in the group, the provisions of the Companies Act 2006 will not apply to those non-UK entities and the liability limitation agreements will not apply to them. However, there may be liability limitation regimes overseas which apply, for example under the local law where these entities are incorporated. The auditors of these entities may have limitations on their liability and this may influence the position of the UK group members and their directors and shareholders when considering the liability of the auditors of UK companies and of

group members generally. In the case of the US, the FRC is in discussion with the SEC about the impact of its Rules on UK SEC registrants, and will publish advice on this issue as soon as possible.

5.20. Where liability limitation agreements are to be entered into by different members of a group, the companies and the auditor will want to consider any inter-relationship between the limit of the auditor's liability to any one company and the total amount payable by the auditor to the group as a whole. This should not be an issue if all the agreements use the proportionate liability or the "fair and reasonable only" approach. Where a holding company is seeking shareholder approval for a limitation liability agreement, although the Act only requires it to seek approval for the limitation of liability which applies to that particular company, shareholders are likely to wish to understand how that limitation of liability fits with any limitation of liability agreed by other group members (including any joint ventures). It is recommended that holding companies should explain this in seeking shareholder approval.

### Withdrawal of authorisation

5.21. Authorisation may be withdrawn at any time before the company enters into the agreement. If the company has already entered into the agreement, it can be withdrawn before the beginning of the financial year to which the agreement relates (even if the agreement provides otherwise). Authorisation is withdrawn by the company passing an ordinary resolution to that effect.

### Change of auditor

5.22. Where there is a change of auditor it will be important to recognise that, as any agreement is personal to its parties, any prior limitation agreement with the previous auditor will not apply to the new auditor. Therefore if the incoming auditor wishes the company to agree to limit its liability, the company will need to enter into a new agreement with that auditor. Shareholder approval for any new agreement will be required and it is likely for the reasons set out in paragraph 5.7 that the new auditor will wish that to be obtained, if necessary at a specially convened General Meeting, before undertaking the next audit. Similarly, shareholders are likely to wish to have the opportunity to consider the appropriateness of the proposed limitation agreement in the light of the reasons for the change of auditor.

### Disclosure of the agreement by the company

5.23. A company which has entered into a liability limitation agreement must disclose the principal terms of the agreement in a note to the company's annual accounts for the financial year to which the agreement relates, unless the agreement was entered into too late for it to be reasonably practicable for the disclosure to be made in those accounts in which case it must be disclosed in the next annual accounts. It must also disclose the date of the resolution approving the agreement or the agreement's principal terms or, if the company is a private company, the date of the resolution waiving the need for such approval[8].

5.24. Although there is no legal or regulatory obligation to do so, the company may also want to consider whether any explanation or further disclosure would be appropriate either in any report by the audit committee or elsewhere in the directors' report.

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[8] These requirements are set out in the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008, which can be found at: http://www.opsi.gov.uk/si/si2008/uksi_20080489_en_1

# SECTION 6

# PRIVATE COMPANIES

6.1. The provisions of the Companies Act 2006 relating to auditor liability limitation agreements apply in the same way to private companies as they do to public companies. There are, however, a limited number of differences in practice that are described in this Section.

## Types of auditor liability limitation agreements

6.2. The types of agreement that private companies may enter into are those set out in paragraph 2.9 of this guidance. Specimen principal terms and provisions for such agreements are set out in Appendices B to E.

## Matters for consideration by directors

6.3. In the case of a private company, the main areas for consideration are likely to arise from the nature of the relationship between the directors and management of the company and those shareholders who are not involved in management.

6.4. Private companies may more easily be able to engage in an interactive discussion with shareholders which will allow the advantages and disadvantages of agreeing to the limitation of liability to be explored in more detail, particularly if the limit may involve a cap or other financial limitation.

6.5. Entry into such an agreement may be possible because shareholders in an owner-managed company may be closely involved in the business and consequently less dependent on the audit as part of the corporate governance structure, in which case a lower financial limit to the auditor's potential liability may be appropriate. While the scope of the audit is prescribed by Auditing Standards, the auditor may be able to make a different assessment of the risks in some circumstances in relation to his fee.

6.6. However, shareholders who are not closely involved in a company's business or do not have direct access to management information may attach particular importance to the independence of the auditor and the auditor's role in reporting upon the financial statements of the company. Such shareholders may be concerned that an auditor's ability to discharge its responsibilities may be adversely affected where there is a controlling shareholder or group of shareholders and where an auditor liability limitation agreement has been entered into.

6.7. Some institutional investors have indicated that their strong preference for proportionate liability, as set out in paragraphs 3.11 and 3.12, applies to private companies in which they invest as well as to public companies.

**The process for obtaining shareholder approval**

6.8. The approach taken by directors of private companies when seeking shareholder approval for a proposed auditor liability limitation agreement will differ depending upon the number of shareholders who have no involvement in the management of the company, and the nature of the directors' relationship with those shareholders

6.9. The process that must be followed to obtain shareholder approval for a liability limitation agreement varies, depending on whether the company is a private company or a public company (whether or not its shares are listed or traded). In both cases, approval must be given by ordinary resolution.

6.10. Private companies can ask for shareholder approval by written resolution or at a shareholders meeting. If a private company has not yet entered into the agreement, it can seek a resolution waiving the need for approval or approving the principal terms of the agreement. If the agreement has been entered into, the resolution must approve the agreement (not just the principal terms). Specimen resolutions are set out in Appendix F.

6.11. In the case of a private company with only a small number of shareholders, it should be relatively straightforward to arrange for the liability limitation agreement (or principal terms) to be approved by the shareholders at the same time as the company settles the auditor's engagement letter for the financial year to which the agreement relates. This is because it should be possible for the company to arrange for a written resolution to be circulated to shareholders, or a General Meeting to be held, at the appropriate time. However directors and auditors will need to consider whether this will require them to make any changes to the existing arrangements for agreeing the engagement letter.

## APPENDIX A

# SUMMARY OF THE COMPANIES ACT 2006 PROVISIONS

This Appendix sets out a summary of the provisions in the Companies Act 2006 ("the Act") relating to auditors' liability incurred in the course of auditing financial statements. The relevant provisions are sections 532 to 538 (Chapter 6 of Part 16) of the Act.

### Starting point - provisions limiting liability or providing indemnities are void

The starting point in section 532 of the Act is that provisions limiting auditor liability and provisions giving indemnities to auditors are void under the Act. These are defined as any provision for exempting an auditor or indemnifying an auditor from any liability for "any negligence, default, breach of duty or breach of trust in relation to the company" which occurs "in the course of the audit of accounts".

Section 532 also makes it clear that, for this purpose, it does not matter where the provision is set out, for example it may be in a company's Articles or any contract with the company or otherwise, it is still covered by the restrictions.

The Act then allows certain liability limitation agreements and indemnities, as an exception from this absolute restriction, provided they meet the requirements set out in the Act.

### Permitted indemnities for costs of defending proceedings

Section 533 of the Act provides an exception for indemnities for costs of defending proceedings. It restates section 310 of the Companies Act 1985 which allowed a company to indemnify an auditor against any liability in defending both civil and criminal proceedings in which judgement is given in his favour or he is acquitted. Section 533 is more restrictive than section 310 in one respect, which is that it no longer permits a company to purchase insurance for an auditor.

### Permitted liability limitation agreements

Sections 534 to 536 set out the details of the liability limitation agreements that are permitted as an exception to the general prohibition in section 532. It is these provisions that are new – section 310 of the 1985 Act just contained an absolute bar on exempting an auditor from liability.

There are three requirements for a valid liability limitation agreement:

- an agreement cannot limit an auditor's liability to less than such an amount as is fair and reasonable (and if it does so it instead takes effect as if it limited the auditor's liability to such an amount);
- the agreement must be approved by a resolution of the company's shareholders; and
- the agreement cannot cover more than one financial year.

### Permitted terms

Section 535(4) expressly states that it is immaterial how the actual limitation is framed and that in particular it need not be a sum of money, or a formula, specified in the agreement.

### Fair and reasonable test

Section 537 limits the effect of liability limitation agreements. Section 537(1) provides that a liability limitation agreement is not effective to limit the auditor's liability to "less than such amount as is fair and reasonable in all the circumstances of the case having regard (in particular) to

(a) the auditor's responsibilities under this Part;

(b) the nature and purpose of the auditor's contractual obligations to the company, and

(c) the professional standards expected of him".

Furthermore, in section 537(3) the Act specifically states that no account is to be taken of:

(a) "matters arising after the loss or damage in question has been incurred; or

(b) matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect the same loss or damage".

The Act also provides in section 534(3) that a liability limitation agreement is not subject to section 2(2) or 3(2)(a) of the Unfair Contract Terms Act 1977 (UCTA) (or in Scotland, sections 16(1)(b) or 17(1)(a) of that Act). These are the provisions in UCTA which prevent a contract from excluding liability for negligence except to the extent it is reasonable to do so and which prevent a consumer contract from excluding or restricting liability from breach of contract. This means that the provisions in the Act regarding the requirement for the limitation to be fair and reasonable take effect in place of these UCTA provisions.

### Effect of agreement limiting liability to more than is fair and reasonable

If a limitation liability agreement purports to limit the auditor's liability to less than an amount which is fair and reasonable, then the agreement is treated as if it limited the auditor's liability to an amount that is fair and reasonable (section 537(2)). This acts to preserve any agreement which goes beyond what is permitted, by reducing the limitation by reference to the fair and reasonable test, rather than making the agreement completely void.

## Duration

Liability limitation agreements cannot apply in respect of acts or omissions occurring in the course of the audit of the accounts for more than one financial year (section 535). An agreement therefore needs to be limited in duration to one financial year and must also state the financial year for which it applies.

## Approval of shareholders

Each new liability limitation agreement must be approved by an ordinary resolution of the members of the company that has agreed to it (section 536). For group companies this means each UK company in the group, and not just the holding company.

Shareholder approval can be given before or after the agreement is entered into. If it is before the agreement is entered into, then the resolution must approve the agreement's principal terms (see Section 4 of this guidance).

This approval can be withdrawn by a subsequent shareholder resolution but if the agreement has already been entered into by the company the withdrawal of approval can only be effective if it is done before the beginning of the financial year to which the agreement relates (section 536(5)).

## Disclosure

Section 538 requires disclosure of the liability limitation agreement by the company in a note to the accounts or in the directors' report. The details to be disclosed are set out in the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008[9].

The Regulations state that a company which has entered into a liability limitation agreement must disclose the principal terms of the agreement in a note to the company's annual accounts for the financial year to which the agreement relates, unless the agreement was entered into too late for it to be reasonably practicable for the disclosure to be made in those accounts in which case it must be disclosed in the next annual accounts. It must also disclose the date of the resolution approving the agreement or the agreement's principal terms or, in the case of a private company, the date of the resolution waiving the need for such approval

## Power to make regulations

Section 535(2) gives the Secretary of State power to make Regulations, both to require liability limitation agreements to contain specified provisions and to prohibit them from containing specified provisions. Specifically there is a power to do so if the Government believes that there has been an adverse effect on competition. The Government has indicated that this power will only be used if problems emerge in practice from the use or misuse of the liability limitation provisions.

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[9] The regulations can be found at: http://www.opsi.gov.uk/si/si2008/uksi_20080489_en_1.

## APPENDIX B

# SPECIMEN PRINCIPAL TERMS:
# AUDITOR'S LIABILITY TO BE LIMITED TO ITS PROPORTIONATE SHARE OF THE RESPONSIBILITY FOR ANY LOSS

*An agreement using these specimen principal terms would set a limit on the auditor's liability in circumstances where the company itself and/or persons other than the auditor also caused or contributed to the loss and damage suffered by the company. Under this approach, the company would agree that if there is someone other than the auditor who is also liable to the company for all or part of the same loss or has caused or contributed to that loss, the auditor's liability would be limited to such amount as is just and equitable having regard to the extent to which the auditor was liable for that loss as opposed to others (that is to say, the auditor would be responsible for its proportionate share of the loss). The company would not be able to look to the auditor for any loss attributable to the acts of any other party. This approach does not limit the assessment to an arithmetical calculation only of the actual loss caused by the auditor but allows the Court discretion, which is more consistent with the requirement that the limit should be fair and reasonable*

*If directors intend that a company should enter into a liability limitation agreement, institutional investors have indicated that this approach, based on the auditor's proportionate share, is the one they expect companies they invest in to take, except in exceptional circumstances. The wording and notes set out some possible options within this approach. If a company wishes to propose an approach which differs from this specimen, institutional investors may ask the company to explain the reasons for the difference in approach.*

*The specimen wording and the accompanying explanatory notes provided are for guidance only. It is the responsibility of companies, auditors and their own legal advisers to ensure that the principal terms, liability limitation agreements, the resolutions to approve them and any related documentation which they issue is adequate and satisfactory for their purposes. Neither the Financial Reporting Council, nor any member of the working group that has prepared this guidance, takes any responsibility for or in respect of the specimen wording or the explanatory notes.*

*The specimen clauses cover the principal terms for which companies are required, as a minimum, to get shareholder agreement under Section 536 of the Companies Act. An explanation of the principal effect of each clause is included in the notes following the specimen wording.*

*Clauses A and B describe the scope of, and period covered by, the limitation. They (or something similar) will need to be included in all agreements.*

*The Liability Limitation Agreement will either form part of the Engagement Letter, probably as a Schedule or Appendix, or be a separate agreement. If it is part of the Engagement Letter, the main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.*

Specimen principal terms

**Clause A [see Note 1]:**

This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, [or] breach of duty [, or breach of trust,] occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("the Auditor's Liability").

**Clause B [see Note 2]:**

This Agreement shall not limit the amount of any liability of the Auditor for its fraud or dishonesty or any other liability of the Auditor that cannot be excluded or restricted by applicable laws or regulations.

**Clause C [see Note 3]:**

Subject to Clause [B], where any Person (as defined below), whether or not that Person is or could be made a party to or a witness in any relevant proceedings, is also liable to the Company for, or has otherwise caused or contributed to, all or part of the same loss or damage as the Auditor (a "Responsible Person"), and/or where the Company itself has contributed to such loss or damage, the Auditor's Liability shall be limited to such amount as is just and equitable having regard to the extent to which each of the Auditor, any such Responsible Person and the Company is liable for, or has otherwise caused or contributed to, such loss or damage. Any limitation exclusion or restriction (however arising) on the liability of any Responsible Person and any other matter (whenever arising), including inability to pay or insolvency, affecting the possibility of recovering compensation from any Responsible Person shall be ignored in determining:-

(1) whether and to what extent that Responsible Person is liable to the Company for, or has caused or contributed to, such loss or damage;

and

(2) the amount to which the Auditor's Liability should be limited.

Neither the Auditor nor the Company shall unreasonably resist the joinder to the proceedings or the calling as a witness in the proceedings of any Responsible Person.

"Person" means any corporate body, individual or other person, including

(i) any director or employee of the Company,

(ii) persons associated with the Company,

(iii) persons providing or who have provided finance or services to the Company including other professionals, and

(iv) any governmental or regulatory authority or body where such governmental or regulatory authority or body is in breach of duty, whether statutory or otherwise, and irrespective of whether such authority or body has, in respect of the relevant loss or damage, any statutory immunity from liability for damages,

but excluding the Company itself and the Auditor.

**Clause D [see Note 4]:**

In accordance with section 537 of the Companies Act 2006, if the effect of Clause [C] of this Liability Limitation Agreement would be to limit the Auditor's Liability to less than such amount as is fair and reasonable, as determined in accordance with that section, this Liability Limitation Agreement shall have effect as if it limited the Auditor's Liability to such amount as is fair and reasonable, as so determined.

**Clause E [ see Note 5]:**

In Clauses [A, B, C and D] of this Agreement, the "Auditor" means *[insert the name of the audit firm]* and includes any of its [members,] partners, employees, consultants [and agents] and any other person for whom [*insert the name of the audit firm*] is vicariously liable.

## Explanatory Notes

*Note 1:*

*This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*

*Note 2:*

*In general, liability based on fraud or dishonesty of the Auditor (including anyone for whom it is vicariously liable) cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply e.g. deliberate breach of trust or deliberate breach of fiduciary duty. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*

*Note 3:*

*1. The wording in Clause C provides that the Auditor's Liability (as defined in Clause A) is to be limited. Because of the definition of "the Auditor's Liability", it will cover the position both where the Liability Limitation Agreement is part of the Engagement Letter and where it is entered into separately. Clause D refers to the fact that section 537 of the Companies Act 2006 means that any limit on liability will always be subject to the "fair and reasonable" test.*

*2. The wording in Clause C deals with the situation where someone other than the Auditor is also liable or responsible to the Company for loss caused by the Auditor's fault or has caused or contributed to that loss. It provides that the Auditor's Liability is limited by reference to the Auditor's proportionate responsibility for the loss and damage suffered by the Company in the light of the extent of the responsibility of the various other parties involved. For example, if the Auditor is 30% responsible and an employee of the Company or another professional is 70% responsible or, say, an employee is 20% responsible and another professional 50% responsible, under an arithmetical approach the Auditor's Liability would be limited to 30% of the loss.*

*3 The wording in Clause C also takes account of others who have also caused or contributed to the loss, in circumstances where they do not have any legal liability to the Company. They have been included because they may have caused or contributed to the loss but may not be liable for example because they do not owe a duty of care to the Company. It should be noted that section 537 of the Companies Act 2006 will always apply, so the Auditor's liability cannot be limited to less than is fair and reasonable - see Note 4 below. In some cases it may be argued that a regulatory authority or body has caused or contributed to the loss by acting in accordance with its statutory duties and it would be inappropriate for this to be taken into account in determining the amount of the Auditor's liability. If the parties agree that a regulator's actions should only be taken into account where it has acted in breach of duty and has no statutory immunity, the parties could agree to replace the words "and irrespective of whether such authority or body has, in respect of the relevant loss or damage, any statutory immunity from liability for damages" in the definition of 'Person' with the words*

*"and has no statutory exemption from liability in damages in respect of the relevant loss or damage".*

*4. The wording in Clause C also takes account of situations in which the Company is at fault because of systemic failures or weaknesses in procedure, resourcing or other matters which are not the responsibility of any individual who has a liability to the Company for them, but rather are failures for which the Company as an entity or its shareholders, directors or staff collectively, are responsible. The wording provides that where there is any such contributory negligence of this nature, it also is taken into account.*

*5.The wording in Clause C does not limit the assessment to a strict arithmetical calculation but instead uses wording and concepts taken from the Law Reform (Contributory Negligence) Act 1945 and the Civil Liability (Contribution) Act 1978, with its reference to what is "just and equitable". This allows the Court (in the event of disagreement) a discretion as under the 1945 and 1978 Acts, which is more consistent with a requirement that the limitation should be fair and reasonable as required by section 537 of the Companies Act 2006. In practice, the Court is likely to apply a broadly arithmetical approach as its starting point, but has a discretion to depart from this if that is necessary to reach a just and equitable result.*

*6. The use of the words "just and equitable" and "having regard to" provide a discretion as to how the various factors are to be taken into account, as opposed to a strictly arithmetical approach. It would be possible to make the approach much stricter and more arithmetical by deleting the words "as is just and equitable having regard to the extent to which the Auditor, as opposed to any Responsible Person" and instead including the words "as represents the extent to which the Auditor, as opposed to any Responsible Person" but this would make it more likely that an application might be made to the Court to apply the overriding test of what is fair and reasonable.*

*7. Where there is a fraudulent employee of the Company or someone outside the Company who has been fraudulent and for whom no-one (including the Company) is vicariously liable, the Company may have little prospect of recovering the loss caused by such fraudulent persons. The impecuniosity of the fraudster and the difficulty of recovering compensation from him are matters which are to be ignored. However, the "just and equitable" wording would allow the Court to depart from a strictly arithmetical approach when determining the amount of the Auditor's liability where that approach would not give a fair result. For example, it might be thought unfair for the Auditor to be required to pay only a very small fraction of the loss where it had failed to detect fraud on the part of a Company's book keeper, in circumstances where the Auditor had failed to detect something which would have been obvious on a proper audit. In such circumstances, the just and equitable test would permit the Court to take account of such matters as:-*

*(a) the opportunities reasonably available to the Auditor to discover the fraud or dishonesty of the employee;*

*(b) the opportunities reasonably available to the Company to discover such fraud or dishonesty, as well as any fault on the part of the Company and its other employees or directors.*

*So, for example, if as between themselves a fraudulent employee is held 70% responsible and the Auditor is 30% responsible, applying the "just and equitable" wording, the Court could decide that the Auditor should be liable for more than a 30% share of the loss suffered by the Company. This is consistent with the alternative approach suggested by the Court in Henderson & Others v. Merrett Syndicates Ltd & Others [1996] 1 PNLR 32 at 43g to 44a.*

*8. The wording in Clause C provides that other facts which affect the Company's ability to recover money from another responsible person are to be ignored. These could include the fact that that person has no money or that the Company has agreed to limit their liability. The wording also provides that the fact that another person is not a party to any court proceedings or a witness in those proceedings does not matter in deciding what the Auditor's Liability is to be. Both the Auditor and the Company agree not to resist a Responsible Person being called as a witness or joined in any court proceedings, unless it is reasonable to do so.*

*Note 4:*

*Section 537 of the Companies Act 2006, which substitutes a fair and reasonable amount if a lower amount is agreed, applies whether or not a clause like this is included. However, it is recommended that such provision is included as a reminder of the position under the Act. The limitation is therefore stated to be subject to the statutory fair and reasonable overriding test. This means that, whatever the result after applying the various limitations in clause C, a court can step back and decide whether that result overall is fair and reasonable in all the circumstances.*

*Note 5:*

*The definition of Auditor for the purposes of clauses A, B,C and D includes not just the firm or LLP which is acting as the auditor but also its members ( if it is an LLP), partners, employees, agents and others for which it is vicariously liable. This will give them the benefit of the limited liability provision. It also ensures ( because the definition of "Person" expressly excludes the "Auditor") that, in determining the amount to which the Auditor's liability should be limited, the liability of such persons and the extent to which they have caused or contributed to the loss will be taken into account in determining the extent to which the Auditor is liable or has caused or contributed to the loss, but will not be taken into account in determining the extent to which any other Person is liable or has caused or contributed to the loss. The definition of the "Company" should be the name of the company which is the audit client. In other clauses of the Agreement, it may not be appropriate to give the definition of "Auditor" this extended meaning.*

## APPENDIX C

## SPECIMEN PRINCIPAL TERMS: AUDITOR'S LIABILITY TO BE LIMITED TO THE FAIR AND REASONABLE TEST.

***An agreement using these specimen principal terms would set a limit on the auditor's liability purely by reference to the 'fair and reasonable' test.***

*Institutional investors have indicated that, except in exceptional circumstances, they expect companies in which they invest to adopt the approach set out in Appendix B.*

*The specimen wording and the accompanying explanatory notes are for guidance only. It is the responsibility of companies, auditors and their own legal advisers to ensure that the principal terms, liability limitation agreements, the resolutions to approve them and any related documentation which they issue is adequate and satisfactory for their purposes. Neither the Financial Reporting Council, nor any member of the working group that has prepared this guidance, takes any responsibility for or in respect of the specimen wording or the explanatory notes.*

*The specimen clauses cover the principal terms to which companies are required, as a minimum, to get shareholder agreement under Section 536 of the Companies Act. An explanation of the principal effect of each clause is included in the notes following the specimen wording.*

*Clauses A and B describe the scope of, and period covered by, the limitation. They (or something similar) will need to be included in all agreements.*

*The Liability Limitation Agreement will either form part of the Engagement Letter, probably as a Schedule or Appendix, or be a separate agreement. If it is part of the Engagement Letter, the main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.*

## Specimen Principal Terms

**Clause A [ see Note 1]:**

This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, [or] breach of duty [, or breach of trust,], occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("the Auditor's Liability").

**Clause B [see Note 2]:**

This Agreement shall not limit the amount of any liability of the Auditor for its fraud or dishonesty or any other liability that cannot be excluded or restricted by applicable laws or regulations.

**Clause C [ see Note 3]:**

(i) The Auditor's Liability shall (so far as is permitted by law) be limited to such amount as is fair and reasonable in all the circumstances of the case having regard (in particular) to :

(a) the Auditor's responsibilities under Part 16 of the Companies Act 2006;

(b) the nature and purpose of the Auditor's contractual obligations to the Company; and

(c) the professional standards expected of the Auditor.

(ii) In determining what is fair and reasonable in all the circumstances of the case no account is to be taken of:

(a) matters arising after the loss or damage in question has been incurred; or

(b) matters (whenever arising) affecting the possibility of recovering compensation from other persons liable in respect of the same loss or damage.

**Clause D [see Note 4]:**

In Clauses [A, B, C and D] of this Agreement, the "Auditor" means [*insert the name of the audit firm*] and includes any of its [members,] partners, employees, consultants [and agents] and any other person for whom [*insert the name of the audit firm*] is vicariously liable.

## Explanatory notes

*Note 1:*

*This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed.*

*Note 2:*

*In general, liability based on fraud or dishonesty of the Auditor (including anyone for whom it is vicariously liable) cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply e.g. deliberate breach of trust or deliberate breach of fiduciary duty.*

*Note 3:*

*This wording tracks the wording of section 537 of the Companies Act 2006.*

*Note 4:*

*The definition of Auditor for the purposes of clauses A, B and C includes not just the firm or LLP which is acting as the auditor but also its members ( if it is an LLP), partners, employees, agents and others for which it is vicariously liable. This will give them the benefit of the limited liability provision. It also ensures ( because the definition of "Person" expressly excludes the "Auditor") that, in determining the amount to which the Auditor's liability should be limited, the liability of such persons and the extent to which they have caused or contributed to the loss will be taken into account in determining the extent to which the Auditor is liable or has caused or contributed to the loss, but will not be taken into account in determining the extent to which any other Person is liable or has caused or contributed to the loss. The definition of the "Company" should be the name of the company which is the audit client. In other clauses of the Agreement, it may not be appropriate to give the definition of "Auditor" this extended meaning.*

**APPENDIX D**

## SPECIMEN PRINCIPAL TERMS: AUDITOR'S LIABILITY LIMITED TO A CAP ON LIABILITY EXPRESSED AS A MONETARY AMOUNT OR CALCULATED ON THE BASIS OF AN AGREED FORMULA

***An agreement using these specimen principal terms would set a limit on the auditor's liability expressed either as a monetary amount or calculated on the basis of an agreed formula.***

*Institutional investors have indicated that, except in exceptional circumstances, they expect companies in which they invest to adopt the approach set out in Appendix B.*

*The specimen wording and the accompanying explanatory notes are for guidance only. It is the responsibility of companies, auditors and their own legal advisers to ensure that the principal terms, liability limitation agreements, the resolutions to approve them and any related documentation which they issue is adequate and satisfactory for their purposes. Neither the Financial Reporting Council, nor any member of the working group that has prepared this guidance, takes any responsibility for or in respect of the specimen wording or the explanatory notes.*

*The specimen clauses cover the principal terms to which companies are required, as a minimum, to get shareholder agreement under Section 536 of the Companies Act. An explanation of the principal effect of each clause is included in the notes following the specimen wording.*

*Clauses A and B describe the scope of, and period covered by, the limitation. They (or something similar) will need to be included in all agreements.*

*The Liability Limitation Agreement will either form part of the Engagement Letter, probably as a Schedule or Appendix, or be a separate agreement. If it is part of the Engagement Letter, the main body of the letter should refer to the Liability Limitation Agreement. If the Liability Limitation Agreement is to be separate from the Engagement Letter, it will be necessary to consider how the two interrelate and, if the Liability Limitation Agreement is entered into after the Engagement Letter, it will be necessary to ensure that it is either entered into as a Deed or is for valuable consideration, in order to be enforceable.*

Specimen Principal Terms

**Clause A [see Note 1]:**

This Agreement limits the amount of any liability owed to the Company by the Auditor in respect of any negligence, default, [or] breach of duty [, or breach of trust,], occurring in the course of the audit of the accounts for the financial year [beginning/ending] [*insert date*] pursuant to [this Letter of Engagement *or* the Letter of Engagement entered into on [date]] of which the Auditor may be guilty in relation to the Company ("the Auditor's Liability").

**Clause B [see Note 2]:**

This Agreement shall not limit the amount of any liability of the Auditor for its fraud or dishonesty] or any other liability that cannot be excluded or restricted by applicable laws or regulations.

**Clause C [see Note 3]:**

The maximum aggregate amount of the Auditor's Liability to the Company shall not exceed (1) the sum of £[ ] times the fees payable (excluding expenses and Value Added Tax) under the Engagement Letter referable to the financial year in question, or (2) £[ ], whichever is the lesser amount.

*[For groups of companies (see Note 4)]* This limit shall apply to the Company and collectively to any and all other companies to which the Engagement Letter applies so that the Auditor's aggregate liability to all such companies including the Company shall not exceed the amount stated above. The apportionment of the total amount payable by the Auditor between the Company and such other companies shall be made by agreement between the Company and all other such companies without reference to the Auditor.

**Clause D [see Note 5]:**

In accordance with section 537 of the Companies Act 2006, if the effect of Clause C of this Liability Limitation Agreement would be to limit the Auditor's Liability to less than such amount as is fair and reasonable, as determined in accordance with that section this Liability Limitation Agreement shall have effect as if it limited the Auditor's Liability to such amount as is fair and reasonable, as so determined.

**Clause E [see Note 6]:**

In Clauses [A, B, C and D] of this Agreement, the "Auditor" means *[insert the name of the audit firm]* and includes any of its [members,] partners, employees, consultants [and agents] and any other person for whom [*insert the name of the audit firm*] is vicariously liable.

## Explanatory notes

*Note 1:*

*This wording sets out the scope of the Auditor's liability which is to be limited. It follows section 534(1) of the Act. Companies and Auditors will want to consider if this scope is appropriate. Companies and Auditors may prefer to identify the relevant financial year by reference to the date on which it begins, rather than when it will end, if the period the financial year relates to may be changed*

*Note 2:*

*In general, liability based on fraud or dishonesty of the Auditor (including anyone for whom it is vicariously liable) cannot be excluded. Companies and Auditors may wish to specify any other circumstances in which the limitation of liability should not apply e.g. deliberate breach of trust or deliberate breach of fiduciary duty. Their views on this may be affected by the way in which liability is limited, for example proportionately or by a fixed amount.*

*Note 3:*

*This example assumes the Company and Auditor will agree to limit the Auditor's Liability to whichever is the lower of two amounts. However, Companies and Auditors may wish only to agree a fixed stated amount or an amount calculated by way of formula.*

*The Company and Auditor may agree to limit liability to a multiple of the audit fees payable. If this is the approach adopted, it will be important to identify these precisely.*

*Note 4:*

*Where the Company is a member of a group of companies, the Company and Auditor may wish to agree a limit for the group as a whole which can be shared between different companies in the group. For this reason the limit is expressed as a maximum aggregate so that it captures multiple acts of negligence and applies to all companies in a group. If the limit is a fixed sum it will need to be apportioned between the group companies, so that the total of all amounts paid to any group company do not in aggregate exceed the agreed amount. This is consistent with the common practice for audits of groups to have an audit engagement letter addressed to the parent, to which all other group companies agree separately, in line with ISA (UK&I) 210, Terms of Audit Engagements.*

*Parties who want the limit to be apportioned between different companies in the group should consider how to achieve this and whether there should be a fall back mechanism to be applied if the relevant companies cannot agree on apportionment.*

*Reference to the fees payable under the Engagement Letter will, assuming a "group" letter as described, capture all fees payable by all companies, although it will be important to make sure the drafting fits appropriately with the drafting of the Engagement Letter.*

*Note 5:*

*Section 537 of the Companies Act 2006, which substitutes a fair and reasonable amount if a lower amount is agreed, applies whether or not a clause like this is included. However, it is recommended that such provision is included as a reminder of the position under the Act. The limitation is therefore stated to be subject to the statutory fair and reasonable overriding test. This means that, whatever the result after applying the various limitations in clause C, a Court can step back and decide whether that result overall is fair and reasonable in all the circumstances.*

*Note 6:*

*The definition of Auditor for the purposes of clauses A, B,C and D includes not just the firm or LLP which is acting as the auditor but also its members ( if it is an LLP), partners, employees, agents and others for which it is vicariously liable. This will give them the benefit of the limited liability provision. It also ensures ( because the definition of "Person" expressly excludes the "Auditor") that, in determining the amount to which the Auditor's liability should be limited, the liability of such persons and the extent to which they have caused or contributed to the loss will be taken into account in determining the extent to which the Auditor is liable or has caused or contributed to the loss, but will not be taken into account in determining the extent to which any other Person is liable or has caused or contributed to the loss. The definition of the "Company" should be the name of the company which is the audit client. In other clauses of the Agreement, it may not be appropriate to give the definition of "Auditor" this extended meaning.*

## APPENDIX E

## SPECIMEN PROVISIONS FOR AGREEMENTS

*Note: This Appendix contains specimen clauses that can be added to the principal terms to form a liability limitation agreement. They are provided as examples only. The exact form and content of an agreement will be a matter for discussion between the company and the auditors.*

This Agreement is made between [*name and address of the audit client*] (the ***Company***) and [*name and address of the audit firm*] (the ***Auditor***) on [*date*] 200[ ].

This Agreement accompanies an engagement letter [issued/to be issued] by the Auditor relating to the delivery of audit services to the Company under the Companies Act 2006.[10]

In consideration of [ ][11], the Company agrees to limit the Auditor's[12] liability to the Company on the terms and conditions set out in this Agreement.

*[Insert principal terms]*

R This Agreement shall not be affected by any amendment to or expiry or termination of the Engagement Letter.

S Any amendment to this Agreement must be in writing.

T If and to the extent that any provision of this Agreement is held to be illegal, void or unenforceable, such provision shall be given no effect and shall be deemed not to be included in this Agreement but without invalidating any of the remaining provisions of this Agreement. [The parties shall meet to negotiate in good faith to agree a valid, binding and enforceable substitute provision or provisions (if necessary with reconsideration of the other terms of this Agreement not so affected) so as to re-establish an appropriate balance of the commercial interests of the parties.]

U This Agreement is governed by and shall be interpreted in accordance with English law.

V A person who is not a party to this Agreement shall have no right under the Contracts (Rights of Third Party) Act 1999 to enforce of any of its terms.[13]

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10 Where the liability limitation agreement is a separate agreement from the audit engagement letter, it will usually be helpful to cross refer to the audit engagement letter.

11 For a liability limitation agreement to be a valid agreement, there must either be consideration provided by the Auditor (which can be nominal) or the agreement could instead be executed by the Company as a deed (in which case, the attestation provisions should be those for a deed).

12 Where an extended definition of Auditor is being used to include persons for whom the audit firm is vicariously liable, the extended definition should apply here as well.

W This Agreement sets out the entire agreement between the Company and the Auditor in respect of the limitation of the Auditor's liability [14]to the Company in connection with the audit of the accounts for the financial year [beginning/ending] [*date*].

X Neither party has relied on any representation, warranty or undertaking not set out in this Agreement and neither party has a claim or remedy for any misrepresentation or untrue statement made by or on behalf of the other. This does not exclude any liability for, or remedy in respect of, fraudulent misrepresentation.[15]

Signed by ......

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[13] If an extended definition of the Auditor is being used to include persons for whom the audit firm is vicariously liable, and the parties wish to give such persons a right to enforce the provisions of this Agreement, this clause will need to be amended.

[14] See footnote 11.

[15] The Company and the Auditor will usually want to include a provision like this (known as an "entire agreement clause") to make sure neither party has relied on something said or done by the other which is not reflected in the agreement. Liability for fraudulent misrepresentations cannot be excluded. Both parties should consider carefully how this agreement fits with the audit engagement letter and any entire agreement clause in that letter.

## APPENDIX F

## SPECIMEN RESOLUTIONS

*Note: these resolutions are provided as examples only.*

### Resolution approving the principal terms of a liability limitation agreement before the company enters into the agreement

It is resolved that the principal terms (as defined in section 536(4) Companies Act 2006) produced to the meeting and initialled by the chairman of the meeting for the purpose of identification[16] of a liability limitation agreement (as defined in section 534 Companies Act 2006) for the financial year [beginning/ending] [*date*] proposed to be entered into by the Company and [*name of auditor*] be and are hereby approved.

### Resolution approving a liability limitation agreement after the company has entered into it

It is resolved that the liability limitation agreement produced to the meeting and initialled by the chairman of the meeting for the purpose of identification[17] [for the financial year [beginning/ending] [*date*] between the Company and [*name of auditor*]] be and is hereby approved.

### Resolution withdrawing authorisation

It is resolved that the authorisation given under section 536 Companies Act 2006 by ordinary resolution passed on [*date*] approving [the principal terms of a liability limitation agreement/the liability limitation agreement] between the Company and [*name of auditor*] dated [ ] be and is hereby withdrawn.

### Resolutions waiving the need for approval before entering into the agreement [*for private companies only*]

It is resolved that the requirements of the Companies Act 2006 as to approval of any liability limitation agreement (as defined in section 534 Companies Act 2006) for the financial year [beginning/ending] [*date*] be and are hereby waived.

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16 The principal terms should either be sent with the notice of the meeting or reproduced in a letter or circular being sent to shareholders with the notice of the meeting. It is also recommended that they are available for inspection at the company's registered office and at the meeting.

17 A copy of the liability limitation agreement could be sent with the notice of the meeting or be reproduced in a letter or circular being sent to shareholders with the notice of the meeting. If this is not done, at least the principal terms of the agreement and any other terms of the agreement which the directors think the shareholders should be told in order to make an informed decision on how to vote on the resolution should be described in the letter or circular sent with the notice of meeting. It is also recommended that the liability limitation agreement be available for inspection at the company's registered office during the notice period and at the meeting.

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APPENDIX 2



# COMMISSION RECOMMENDATION

## of 5 June 2008

## concerning the limitation of the civil liability of statutory auditors and audit firms

*(notified under document number C(2008) 2274)*

(Text with EEA relevance)

(2008/473/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 211, second indent, thereof,

Whereas:

(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 ([1]) establishes a minimum harmonisation of statutory audit requirements. Pursuant to Article 31 of that Directive, the Commission is to report on the impact of the national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms and to make recommendations if it considers it appropriate.

(2) Smooth functioning of capital markets requires sustainable audit capacity and a competitive market for audit services in which there is a sufficient choice of audit firms capable of conducting and willing to conduct statutory audits of companies the securities of which are admitted to trading on a regulated market of a Member State. However, increasing volatility in market capitalisation of companies has led to much higher liability risks, whilst access to insurance coverage against the risks associated with such audits has become increasingly limited.

(3) Since unlimited joint and several liability may deter audit firms and networks from entering the international audit market for listed companies in the Community, there is little prospect of new audit networks emerging which are in a position to conduct statutory audits of such companies.

(4) As a consequence, the liability of auditors and audit firms, including group auditors, carrying out statutory audits of listed companies should be limited. However, any limitation on liability is not justified in cases of intentional breach of professional duties on the part of an auditor and should not apply in such cases. Nor should such a limitation prejudice the right of any injured party to be fairly compensated.

(5) In view of the considerable variations between civil liability systems in the Member States, it is appropriate at this stage that each Member State be able to choose the method of limitation which it considers to be the most suitable for its civil liability system.

(6) Member States should accordingly be able to determine under national law a cap in respect of auditors' liability. Alternatively Member States should be able to establish under national law a system of proportionate liability according to which statutory auditors and audit firms are liable only to the extent of their contribution to the damage caused, without being jointly and severally liable with other parties. In the Member States where any claims against statutory auditors might be brought only by the audited company and not by individual shareholders or any other third parties, Member State should also be able to allow the company, its shareholders and the auditor to determine the limitation of the auditor's liability, subject to appropriate safeguards for investors in the company audited,

HEREBY RECOMMENDS:

### Subject matter

1. This Recommendation concerns the civil liability of auditors and audit firms carrying out a statutory audit of the consolidated or annual accounts of a company which is registered in a Member State and the securities of which are admitted to trading on a regulated market in a Member State.

### Limitation of liability

2. 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.

([1]) OJ L 157, 9.6.2006, p. 87. Directive as amended by Directive 2008/30/EC (OJ L 81, 20.3.2008, p. 53).

3. The limitation of liability should apply against the company audited and any third party entitled under national law to bring a claim for compensation.

4. Any limitation of civil liability should not prevent injured parties from being fairly compensated.

### Methods for limiting liability

5. Member States should take measures to limit liability. For that purpose, it is recommended that any one or more of the following methods in particular be used:

(a) establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount;

(b) 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;

(c) provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement.

6. Where liability is limited by agreement as referred to in point 5(c), Member States should ensure that all the following conditions are met:

(a) the agreement is subject to judicial review;

(b) with regard to the company to be audited, the limitation is decided collectively by the members of the administrative, management and supervisory bodies referred to in Article 50b of Council Directive 78/660/EEC (1), or, in the case of a group audit, in Article 36a of Council Directive 83/349/EEC (2), and such a decision is approved by the shareholders of the company to be audited;

(c) the limitation and any modification thereof are published in the notes to the accounts of the audited company.

7. Before adopting measures implementing any of the methods referred to in point 5(a), (b) or (c), or any other method limiting liability which complies with points 2, 3 and 4, a Member State should take into account the impact on financial markets and investors and on conditions for access to the market of statutory audit for listed companies, as well as the impact on audit quality, insurability of risks and the companies to be audited.

### Follow-up

8. Member States are invited to inform the Commission of actions taken in light of this Recommendation by 5 June 2010.

### Addressees

9. This Recommendation is addressed to the Member States

Done at Brussels, 5 June 2008.

*For the Commission*
Charlie McCREEVY
*Member of the Commission*

(1) OJ L 222, 14.8.1978, p. 11. Directive as last amended by Directive 2006/46/EC of the European Parliament and of the Council (OJ L 224, 16.8.2006, p. 1).
(2) OJ L 193, 18.7.1983, p. 1. Directive as last amended by Directive 2006/99/EC (OJ L 363, 20.12.2006, p. 137).