

## **Institutional Shareholders' Committee Statement on Auditor Liability Limitation Agreements**

The Companies Act 2006 permits, subject to the approval of shareholders, agreements to limit the liability of statutory auditors. The FRC has issued guidance for directors on entering into such agreements. In light of this, the Institutional Shareholders' Committee (ISC) has set out what institutional investors are likely to expect from private or public companies proposing such agreements. Companies which fulfil these expectations are most likely to gain the support of their shareholders.

### **Preference for proportionality**

Institutional investors are generally willing to support agreements providing for proportional liability or those providing for liability to be at the level that is fair and reasonable. They consider that agreements which include an element of a fixed cap – however calculated – are not appropriate.

Shareholders take comfort from the fact that the law ensures that whatever liability agreement is reached by companies with their auditors, the liability will never be reduced below what a court deems as fair and reasonable.

### **Permissive, not compulsory**

The ISC notes that the legislation in this respect is permissive rather than compulsory: companies are allowed to enter into these agreements, but are not obliged to do so. Directors should remain conscious that they are not compelled to agree such deals, and neither are shareholders – whose support is necessary before agreements will be enforceable. Directors will wish to satisfy themselves that proposing a resolution for the approval of such an agreement accords with their fiduciary duties to the company and its shareholders.

Institutional investors were willing to support the introduction of this new power as part of a wider debate which focused on ways to improve audit quality. Investors will be keen to see audit quality maintained and improved when companies seek their approval for an auditor liability limitation agreement.

### **Consultation**

Institutional investors will welcome the opportunity to discuss proposed agreements with investee companies early, to understand the reasons why such an agreement is being entered into and the terms which are being proposed.

### **Timing of seeking shareholder approval**

Shareholders will be unlikely to support agreements after the audit work for the relevant year has been completed. For institutional investors, it would be contrary to their fiduciary duties to agree to something which reduced their

rights unless there was a clear benefit from it; where the audit itself has been completed, this benefit will not be available.

This means that authority will in practice need to be sought during the year of the relevant audit assignment.

## **What should be disclosed when seeking shareholder approval?**

### **1. Quality**

The key concern for institutional investors in relation to the audit is that audit quality be maintained and enhanced over time. Given concerns that limitations of liability may decrease the drive for quality, this is an issue of particular concern.

In agreeing to limit liability, companies are reducing their opportunity to recover losses from their auditors. They will need to reassure their shareholders that they have obtained something in return for this. Investors will welcome disclosure from audit committees as to the ways in which they have used their discussions with auditors on liability limitation to assure themselves that audit quality will be preserved and enhanced, and to secure other benefits for the company. In this regard, shareholders attach great importance to 'true and fair'. The ISC is keen that this is reinforced by audit committees with auditors when entering into liability limitation agreements in order to, inter alia, mitigate any tendency to unduly defensive auditing.

### **2. Groups**

Investors will only have the opportunity to approve the limitation of auditors' liability in respect of a group's holding company. They will not wish to see their preference for proportional liability blocked by other forms of liability further down the group structure. Companies will therefore need to indicate in their disclosures how auditors' liability will apply not just at the holding company but throughout the group. Institutional investors acknowledge that some jurisdictions do place fixed caps on auditor liability but investors will not support proposals to limit auditor liability unless the substantive effect is that proportionality applies across the group.

### **3. Compliance with the FRC's guidance**

Institutional investors will expect companies to employ the specimen principal terms for agreements laid out in the FRC's guidance. Where companies do not believe that an element of those principal terms would be right for them, they should disclose the reasons why and the details of the divergence. Where companies choose not to follow the FRC guidance, early consultation with shareholders will be particularly important.

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