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Statement of the Shadow Financial Regulatory Committee on

**Limitations on Auditors' Liability**

May 7, 2007

Only four large audit firms (commonly known as the Big Four) are currently capable of auditing the world's globally active companies. According to both the Interim Report of the Committee on Capital Markets Regulation and the report of the U.S. Chamber of Commerce's Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century, the Big Four are subject to class-action litigation involving claims of many billions of dollars, far exceeding their partners' capital. Because of the size of past litigation and litigation settlements, these firms are now unable to obtain insurance coverage. Accordingly, each of them operates under the threat of a catastrophic judgment that might drive the firm out of business.

The loss of even one of the Big Four audit firms would be very costly to corporate shareholders and the economy. As shown by the history of accounting and the failure to reconstitute or replace Arthur Andersen, the organization and market acceptance of firms capable of auditing major enterprises proceeds slowly. Furthermore, large judgments and settlements incurred by audit firms might cause the unraveling of other audit firms, if members lose faith in the business model of the profession. This would undermine the institutional integrity of the world's financial markets, from which there might be no recovery for many years. At the least, the cost of audits would increase substantially, to the detriment of stockholders and the economy.

The prospect of institution-destroying damage awards and settlements is a characteristic of private class actions, both under state and federal law.

These awards are meted out by juries, which are not allowed to consider the financial health of the defendant auditor—let alone the well-being of the world financial system—when they make their judgment as to compensation. The private class action system, then, insofar as it is applied to auditors, presents a continuing risk of a catastrophic event, outside the control and independent of the policy of any governmental entity. This risk would be greater if, as the Shadow Financial Regulatory Committee proposed in Statement 242 (February 12, 2007), private class-action lawsuits were eliminated for securities law violations other than insider trading, since the external auditors would be almost the sole large remaining targets of the plaintiffs' bar. Apart from a decision to bail out an audit firm with taxpayer funds in the event of a catastrophic judgment, the U.S. government would be powerless to prevent the destruction of one of the Big Four firms through the class-action process.

Consequently, the Committee urges the Congress to adopt legislation that would limit audit firms' legal liability for damages (direct and punitive). Damages might be limited to a specified dollar amount, which would allow audit firms to return to the insurance markets. This dollar amount could be a multiple of audit fees from a particular client. Such a penalty would serve effectively as a deterrent both to negligent audits and to essentially baseless lawsuits that are intended to extract settlements from audit firms that fear the imposition of very large damages. The limitation of damages would benefit investors, who must pay the audit fees and other costs that audit firms must charge in the face of possible large damage awards and the larger cost if even one of the Big Four audit firms were destroyed.

In addition, individual auditors should be penalized for negligent work or acceding to the demands of clients. Consequently, we urge the SEC and the Public Company Accounting Oversight Board to discipline the senior auditors who are responsible for audits that reflect gross negligence. We also suggest adoption of the procedure used in Europe, which requires the audit partner-in-charge and the confirming auditor sign their own names as well as the names of their firms to their attestation reports.