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Risk and the construction of a European audit policy agenda: The case of auditor liability

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ABSTRACT

In 2008, following a sustained policy campaign by the large international accounting firms, the European Commission issued a Recommendation that European Union (EU) Member States should limit civil liability for statutory auditors. The Recommendation, however, was far from the firms' desired outcome because, as a non-binding policy document, it left it to individual Member States to decide whether (or not) and how to limit auditors' liability exposure. This paper analyzes the European transnational audit policy-making processes by which such a decision was reached and what prevented the firms from securing a more definitive EU-wide policy solution with respect to auditor liability limitation. Drawing on Hilgartner's concept of a 'risk object', the paper reveals how a search for a policy consensus on auditor liability was invariably frustrated by the competing conceptualizations of, and exposure to, risk attributed to particular proposed liability arrangements. As such, auditor liability emerges as a constantly shifting regulatory construct rather than a dilemma waiting to be resolved. The study also emphasizes the residing significance of the authority of the nation state in the European audit policy context, with policy preferences of individual EU Member States having a substantial influence on the outputs of European audit policy making.

Introduction

The past decade has witnessed a substantial growth in accounting research concerned with issues of transnational regulation and the existence of an international financial architecture (Arnold, 2009; Humphrey, Loft, & Woods, 2009). There has been an active level of engagement, for example, with the work of various multinational agencies, including the World Trade Organization and the World Bank (Arnold, 2005; Neu, Ocampo Gomez, & Graham, 2006) as well the growing global significance of accounting and audit regulatory and standard setting initiatives (Bengtsson, 2011; Botzem, 2012; Richardson, 2009; Thornburg & Roberts, 2008). This literature has highlighted the influence of professional (accounting) actors on the transnational regulatory landscape (Arnold & Sikka, 2001; Barrett, Cooper, & Jamal, 2005; Cooper & Robson, 2006; Suddaby, Cooper, & Greenwood, 2007), supporting claims in other professional domains (Faulconbridge & Muzio, 2011) that elite professional services firms increasingly utilize relations with supranational institutions to resolve policy issues that had failed to gain sufficient support at the national level and, thereby, superimpose an additional layer of soft regulatory authority on the "traditional (i.e. coercive) power relations that exist between nation states and professional associations" (p. 356). Such regulatory tendencies have been identified, for example, in studies of the large international accounting firms' representation on international standard setting and regulatory governance boards (Loft, Humphrey, & Turley, 2006) and their

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interactions with, and even mutual dependency on, different national audit oversight institutions (Malsch & Gendron, 2011; Shapiro & Matson, 2008). Attention has also been given to the mobilizing capacity of the profession internationally to form a united policy front in the wake of the recent global financial crisis (Humphrey et al., 2009). One of the key implications of such literature is the substantial ability of the audit profession and its largest firms to shape global regulatory agendas and actions, with some authors emphasizing the success that the profession has had in securing desired outcomes or at least diverting attention away from a critical questioning of contemporary audit practice (Arnold, 2009; Sikka, 2009).

Audit liability limitation has been flagged for many years by large accounting firms as one of their key concerns and pressing reform priorities (Gwilliam, 2004; Power, 1998). After a sustained policy campaign by the firms to prompt EU-wide policy action, the European Commission, in June 2008, issued a Recommendation (European Commission, 2008a) suggesting that "every Member State would be invited to introduce a liability limitation, taking into account their own systems and circumstances" (European Commission, 2008b, p. 32–33). The Recommendation, however, was a non-binding policy instrument and not the outcome that the firms had strived for. They had wanted an EU-wide binding limitation but the Commission chose to leave any decision on auditor liability limitation to the individual national governments of Member States (Ojo, 2009). Analytically, such developments provide a fascinating opportunity to study how and why the agendas of accounting firms, with their readily acknowledged capacity to engage with transnational policy processes, were frustrated in terms of the firms' ability to secure a desired policy outcome.

In examining the processes of policy development leading to the issuance of the Commission's aforementioned Recommendation, the paper utilizes Hilgartner's (1992) portrayal of a 'risk object' to show the highly polemical nature of the European auditor liability debate – with actors' policy positions varying depending on their differing conceptualizations of, and exposure to, risk associated with particular auditor liability arrangements (Hilgartner, 1992). The resulting array of (often, conflicting) definitions of risk served to frustrate attempts at reaching a shared policy position on the subject of auditor liability and precipitated instead a policy outcome that was substantially less definitive and exacting than the large accounting firms had desired. Such analysis serves to highlight the residing significance of the authority of the nation state in the determination of EU policy. In the case of auditor liability limitation, the overall policy outcome was clearly influenced by national policy-making experiences and the respective standpoints of certain individual EU Member States, illustrating in the process the connectivity between national and transnational policy realms and the importance of viewing such realms as mutually dependent, rather than distinctive, fields of influence.

The paper is structured as follows. The next section outlines the complexities associated with auditor liability as a regulatory object. The third section provides an overview of EU governance systems and the European audit policy-making arena. The fourth section presents the methodological approach applied to studying auditor liability reform in the European context. The fifth section analyzes the policy processes that led to the issuance of the Commission's aforementioned Recommendation. The final two sections explain the significance of the paper's findings in terms of enhancing understanding of the dynamics of European audit policy making.

Risk and the complexities of auditor liability

The term 'auditor liability' is not easy to define in a concise, all-encompassing manner. Beyond the basic premise that auditors need to be held liable for providing sub-standard services, the legal arrangements to support its functionality comprise multiple dimensions that can vary significantly. In this section, we draw on the work of Hilgartner (1992) and others, to show how this variability is linked to the differences in the manner in which various actors conceptualize liability as a source of risk. Hilgartner characterized risks not as static facts, independent of interpretation, but as contextually embedded entities whose meanings vary and are inherently unstable. According to Hilgartner (1992), differences in how we conceptualize risk stem from the way we define the object that poses risk and identify it as risky by constructing causal linkages between such an object and putative harm. In the case of auditor liability, key dimensions of variation in understandings of risks associated with auditor liability revolve around questions, such as: who, and under what conditions, should bear the consequences of a liability claim?; who are the harmed (endangered) parties that have the right to demand compensation for related damages?; and finally, what should be the size of any such compensation, including possible ways of limiting the amount claimed? The way in which the above dimensions have been incorporated within a particular auditor liability regime has been subject to change over time and across contexts as, borrowing from Lupton (1999), "[w]hat is deemed a 'danger' or 'hazard' in one historical or cultural context may not be so identified in another" (p. 31–32).

A typical starting point in the audit literature for discussions on auditor liability involves reference to auditors' assumed liability in relation to contractual parties, with the principle of privity of contract limiting liability to the corporate body being audited (Porter, Simon, & Hatherly, 2008). The 1970s and 1980s saw a substantial extension of liability to the point where it was asserted that virtually any party who could reasonably be considered to have relied on an audit opinion could claim damages against auditors arising from negligent misstatements (Porter et al., 2008). This was deemed an appropriate mode for disciplining auditors and also responding to public calls for fairer treatment of 'innocent' third parties such as potential investors, creditors, employees and other stakeholders (Chung, Farrar, Puri, & Thorne, 2010; Gwilliam, 2004; Siliciano, 1997). In subsequent years, however, these arrangements were reconsidered. In Britain, for example, the landmark decision by the House of Lords in the *Caparo* case (1990) signified a move back to a more narrow