Re-thinking auditor liability: The case of the European Union's regulatory reform

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Abstract

Recent years have witnessed increasing academic and professional debate over the equitable nature of auditor liability and the potential risk that a successful lawsuit against the auditors could serve to bring down one of the major audit firms. This paper looks at the recent change in the European Commission's policy stance vis-à-vis auditor liability, moving from one of relative non-interference to the issuance in 2008 of a recommendation that Member States should take action to limit the civil liability of auditors. By examining how this change of opinion came about and the factors/standpoints that proved most influential in inducing it, the study provides valuable insights into the evolving nature of European audit policymaking. Specifically, our findings point to the increasingly transnational and expertise-driven nature of interest representation in European policy-making. In turn, this is leading to the growing influence of market players and a supplanting of conventional national governmental polity. Such observed shifts in the ways in which policy issues gain or lose regulatory momentum emphasise the value of capturing historic accounts of policy processes and of understanding the significance of institutional environments in shaping the way in which policy debates and dilemmas occur, reoccur and, ultimately, get resolved.

> “(R)epresentatives of the worldwide auditing profession must take initiatives to educate both the public and the media about the financial reporting process and auditor responsibilities. Misunderstandings about the nature, purpose and limitations of financial statements cause the public to have unrealistic expectations of auditors, contribute to misperceptions that audit failures have occurred, and exacerbate auditors’ legal liability. Consistent communications to the public and ongoing dialogue with all those involved in or affected by the financial reporting process can help to clarify misperceptions and increase awareness of the need for liability reform.”
> (*Auditors’ Legal Liability in the Global Marketplace: A Case for Limitation* – IFAC, 1995, p. 14)

1. Introduction

The current global financial crisis has intensified enduring discussion in the professional accounting and related financial press over the equitable nature of auditor liability and the potential risk that a successful lawsuit against the auditors of a collapsed bank or financial services institution could serve to bring down one of the four largest audit firms (Talley, 2006; Zubli, 2007; Spence, 2009). Powerful illustrations of these concerns are some recent instances of legal action against the Big Four audit firms, including the $1bn lawsuit against KPMG for their audit of the failed US subprime lender, New Century (Essen, 2009), and the currently unfolding case against Ernst & Young following the largest in the U.S. history bankruptcy of Lehman Brothers (Inman, 2010).

Characteristically, the times of financial turmoil, such as this, intensify the longstanding polemic about the public’s discontent with the actual nature and scope of audit work (the infamous notion of an audit–expectations gap), countered, in turn, by the profession’s claims about an inequitable reliance on the deep pockets of auditors. History shows, however, that much of this strong rhetoric conventionally dampens down as the memories of major corporate collapses fade, only to be awakened when a new crisis breaks (Humphrey, 1997). Nonetheless, it is often through reference to the past historical accounts that one can better understand how present-day policy dilemmas gain momentum, spiralling into a new development cycle. This paper documents the European Union’s (EU) evolving regulatory approach towards the civil liability of auditors over the past decades. Through the analysis of relevant developments in this area, the study provides an insight into the evolving nature of the EU’s audit policymaking, and implications of this for the outcomes of regulatory endeavours.

Recently, the creation of an equal level playing field in financial services as part of a Single Market initiative has been one of the areas of the EU’s ’legislative boom’ (Dewing & Russell, 2002 & 2008). In relation to auditor liability, the last few years have proved to be particularly distinctive in that, following the continuing debate about the appropriateness of liability limitation, there was an actual change in the legislative provisions governing the issue. Specifically, in June 2008, the European Commission recommended that Member States should take action to limit the civil liability of auditors, presenting each country with a full *carte blanche* to independently choose a method of limitation. In the words of EU Commissioner for Internal Markets, this was necessary because the combination of "unlimited liability combined with insufficient insurance cover is no longer tenable" (European Commission, 2008c). The recommendation has been portrayed as a significant development, amounting to a complete turnaround from the Commission's prior (and long held) stance that auditor liability was too difficult and complex an issue for it to advocate any formal limitation.

The objective of this paper is to examine how such a transformation in the European Commission's opinion came about and the factors and standpoints that proved most influential in inducing it. We argue that the Commission's actions in advocating the limiting of auditor liability signifies a growing transnationalisation (Risse-Kappen, 1995; Andersen & Eliassen, 1996; Nolke, 2003; Djelic & Sahlin-Andersson, 2006a) of European policymaking, with an evidently increased representational influence on the part of private actors as compared to the more traditional, national affiliations that have been seen in the past to be the primary influence. Specifically, the paper shows that, with regards to the auditor liability reform, the EU's formalised policy process is increasingly confronted with a more informal polity built around what is rationalised as "professionalized or scientific knowledge" (Drori & Meyer, 2006, p. 34) and representative of the so-called market governance as opposed to governance by the nation states (Djelic & Sahlin-Andersson, 2006a). This new expanded expertise-driven authority underpins the empowerment of transnational interest groups, such as audit networks, as organised European policy actors. Beyond the specifics of the auditor liability case, the paper argues that appreciation of this complex and evolving European polity is essential for understanding how and why policy debates and dilemmas occur, reoccur and, ultimately, get resolved.

The presented historical account of the evolving regulatory debate and the Commission's policy formulation is constructed through an analysis of relevant EU policy documents and statements by EU officials as well as a comprehensive range of reports, public pronouncements and commentaries on the topic by various organisations, members of audit community, and other policy stakeholders involved in the debate. Such archival material was supplemented by interviews with senior members of the auditing profession and EU officials who, at the time of the issuance of the 2008 recommendation by the EC, were active players in the EU policy arena and took direct part in the shaping of the auditor liability debate.

The first two sections of the paper outline the increasingly transnational nature of the European policymaking process and contextualise the issue of auditor liability, the paper reviews the way in which the European Commission's stance changed over the last two decades. To illuminate the story, we focus in some depth on a limited number of key incidents/stages, including the Commission's 1996 conference on the role of the audit and the well-publicised report by the London Economics consultancy (London Economics, 2006) that is said to have been especially critical in convincing the European Commission as to the merits of liability limitation. We also focus on some lesser known and less publicised incidents, notably including a prior report on the issue of auditor liability limitation prepared by London Economics in 1998. In showing the considerable similarity between these two reports and their differential impact in terms of inducing regulatory action, the paper provides an empirical reinforcement of Power's (1998) conclusion that auditor liability has to be understood "not just as an abstract problem of designing efficient incentive structures but also as the product of social and institutional forces" (p. 79).

2. Transnationalisation of interest representation in the European policymaking

Recent years of academic debate have seen transnationalism termed a forcefully growing feature of the present-day governance and a third type of politics stretching beyond the conventional focus on the regulatory pre-eminence of governmental institutions (Risse-Kappen, 1995; Knill & Lehmkuhl, 2002; Nolke, 2003; Djelic & Sahlin-Andersson, 2006a). At the core of this new and evolving rationalisation are transnational relations, or in other words, "interactions across national boundaries when at least one actor is a non-state agent or does not operate on behalf of the national government or an intergovernmental organisation" (Risse-Kappen, 1995, p. 3). This new mode of governance has been deemed a manifestation of the departure from the common view of the world order as mainly centred around the nation-state and growing appreciation of other actors that converge across fluid national boundaries and "structure themselves, connect with others and pursue their interests" (Djelic & Sahlin-Andersson, 2006b, p. 4). This diversity of actors, although retain some form of national identity, constitute a transnational body of interest representations, both individual and collective, stemming from cross-border public, business, and professional affiliations.

The key argument in this new body of literature is that policy-making increasingly takes place in "patchwork political structures" (Djelic & Sahlin-Andersson, 2006b, p. 4) – *regulatory networks* - where constellations of actors acquire means for influencing the ways in which policy endeavours are shaped. Within these policy networks occur complex socialisation processes, epistemic exchanges, knowledge sharing, promotion of ideas, and interest-driven debates around the policy issues in question (Nolke, 2003).

Contemporary scholarship into the European governance regime has only started to appreciate fully the roles of transnational governance actors as in increasingly important sources of European co-ordination. In this respect, Eberlein and Grande (2005) point to the existing conceptual gap created by scholars' excessive focus on the regulatory activities at the national level or formal organisation of policy processes within EU bodies, such as the Council of Ministers, the European Parliament, and the European Commission. Notwithstanding the importance of the EU's formalised structures where legislative activities take place, recent decades have witnessed the European agenda-setting and policy-making processes being increasingly shaped by the strategic agency of diverse interest groups organised within transnational regulatory networks as new soft forms of informal institutions. In this respect, the authors note,

> Transnational regulatory networks are composed of experts and representatives of national regulatory bodies, who come to agreement among themselves, guided or supported by European bodies. If necessary, they are joined by economic actors or the regulatory addressees concerned. On an informal basis, these networks develop common 'best practice' rules and procedures for regulation in their sector. […] The most important demand for this informal harmonisation

> undoubtedly comes from the European Commission. (Eberlein & Grande, 2005, p. 100)

Since the 1957 Treaty of Rome laying grounds for united Europe, establishment of an economic equal level playing field and eventually a single European market have been at the core of the European Union's legislative agendas, also implying harmonised policies for the provision of accountancy services (Maijoor et al., 1998; Combarros, 2000; Haller, 2002). Albeit the formal role of the EU's principal legislator is played by the Council of Ministers that may instigate an official examination of a particular policy issue it is the European Commission that, *de facto*, carries the primary responsibility for initiating and developing new legislation. This monopoly of legislative initiative translates into the Commission's key part in framing regulatory agendas, which gives priority to some policy dilemmas over others. Constituting the Commission's political apparatus is the college of twenty-seven individual Commissioners, one appointed per each Member State government. Within their respective policy portfolios, Commissioners play a key part in administering the lengthy legislative process involving formulation of policy proposals, negotiation, consultation, drafting legislative pieces, and supporting their implementation (Nugent, 2001; Schmidt, 2004).

An "explosive growth of direct interest representation" has been one of the most striking developments in the European regulatory scene (Andersen & Eliassen, 1996, p. 45). This started to occur in the late 1980s following the issuance of the Single European Act of 1986 that laid grounds for the re-launch of the European integration initiative. The document created the system of delegated powers to legislate where the Council entrusted the European Commission with a central role, subject to institutional constraints. Particularly, one of the Council's requirements was to rely on *comitology*[1], i.e. a procedure where the Commission is assisted by a committee comprising civil servants and external experts representing the Member States to supervise the legislative process (Curtin, 2004; Schusterschitz & Kotz, 2007). This set a stage for the European Commission as a major lobbying site attracting transnational stakeholder groups to the very heart of policy-making (Mazey & Richardson, 1993; Coen, 2007; Broscheid & Coen, 2007). The trend was further reinforced by the Maastricht Treaty (the Treaty on European Union) signed in 1992 which introduced the principle of subsidiarity leading to the establishment of regional representative offices within the EU governance structure to promote direct representation of national and regional interests.

Despite the high level of institutionalisation of its decision-making procedures, the Commission nonetheless has remained "more a political system in itself than a single-minded institution" (Peterson, 1999, p. 60) where political actors carry multiple identities defined by their national, sectoral, and institutional roots. Increasingly however, this politicization appears to be counterbalanced by the growing power of expert knowledge as EU policy-making "accentuates the thorny issue of integrating expertise and democracy" (Radaelli, 1999, p. 770). Expertise plays a key part in the European regulatory decision-making in that it "disciplines the political bargaining in the specialised networks" and "provides a language and means of framing problems and their

[1] Jacque (2004, p. 385) defined comitology as "the methods according to which committees composed of representatives of the Members States form a framework within which the Commission exercise the executive powers which are delegated to it".

solutions, that is, to *structure the discourse of policy-making*" (Andersen & Burns, 1996, p. 235) . Besides, inviting the inputs from external interest constituents has been the European Commission's conscious intention aimed at establishing an accountability link between civil society and European policy makers. In this respect, mobilising expert networks has been a way for the Commission to legitimise its legislative outputs but also to address the general "democratic deficit" concerns characteristic of many EU institutions deriving from EU politicians' posts being designated rather than elected through open democratic process (Greenwood, 2007).

The increasing reliance on expertise in the European policy-making has recently been typified by the new approach to the regulation of the securities and investment sector. The development pertained to the issuance in 2000 of the report by the Committee of Wise Men on the Regulation of European Securities Markets chaired by Baron Alexandre Lamfalussy[2]. The Report criticised the Commission's lawmaking procedures as "too slow, too rigid, complex and ill-adapted to the pace of global financial market change" (p. 7) and lacking transparency. The proposal was to introduce a four-level regulatory model (Lamfalussy approach) covering all stages of policy-making from issuing framework documents (e.g. Directives and regulations) to detailing technical measures adequate to the current market development, their implementation and enforcement. Specifically, the Report proposed that, within the comitology process, the Commission be monitored and assisted by two new institutional committees. First political, or comitology, committee was to play a supervisory role and the second non-political committee - to provide an expert advice and technical assistance. As a result, the Commission's European Securities Committee was established in 2001 together with the Committee of European Securities Regulators to undertake an advisory role. Crucially, the latter committee, composed of high-level representatives from the national securities regulators, is required to invite experts and interested external stakeholders and facilitate extensive consultation already at an early stage of a policy development. The significance of the Lamfallusy approach is that its successful implementation in the securities sector has a potential to lead to a more wide-spread institutionalisation of the external interest representation in the Commission's legislative routines and outputs in other financial services sectors. The recently introduced extension of the Lamfalussy model to banking and insurance sectors (Council of Economics and Finance Ministers, 2004) seems to increase such likelihood.

The Lamfalussy reform is one of many examples of the conventional channels of influence through national representation of the Council of Ministers having been extended to incorporate a wider, transnational, range of networks of private and semi-private interests converged along the notion of expertise. Here, the European Commission's committees facilitate the functioning of such regulatory networks by constituting a formalised basis for generation and rationalisation of policy ideas through which policy actors acquire the political means of influence over the Commission's decision-making. A growing dependence of the EU legislative process on expertise of external policy constituents is a striking feature of what Andersen and Burns (1996) refer to as European *post-parliamentary governance* where the competence of national

[2] See *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, 15 February 2001: Brussels

governments is challenged by the increasingly complex transnational nature of policy dilemmas, and hence, "expert sovereignty tends to prevail over popular sovereignty or parliamentary sovereignty" (p. 229). Therefore, at the core of the European system of governance is a complex net of specialised discourses that, apart from *national representation*, are also characterised by the principles of *interest representation* and *representation of expertise*. A remarkable growth in self-representation of interests of corporate groups, industry actors, professional unions and various other policy stakeholders has made the EU system "more lobbying-oriented than any national European system" (Andersen & Burns, 1996, p. 234). Meanwhile, the rise of expertise is, *inter alia*, evident from the European Commission's increasing reliance on the work of external consultancies. The growing value of consultancy outputs has been attributed to the shift in European interest representation towards professionalisation, competitiveness and market dynamics, with commercial consultancies being at the core of these institutional developments (Lahusen, 2002). Crucially, while these developments accentuate the growing spatial dispersal of European interest representation, they also elevate the need for considering the wider context in which various interest groups operate and circumstances that give rise to their strategic agendas in order to understand why some policy issues gain momentum in the European regulatory arena while others are left ignored.

3. The issue of auditor liability and the case for its limitation

For many years, the principle of privity of contract dominated the legal arena – such that auditors were generally seen liable to contractual parties, such as the client company or other primary beneficiaries stipulated in the audit contract. In the course of 1970-1980s, the range of users to whom auditors could owe a duty of care was gradually extended and subsequently reached the level when a liability claim could be made by virtually any stakeholder reasonably considered to rely on an audit opinion (Huss, 1991). This extension of the scope of liability was rationalised as an appropriate way to encourage auditors' professional conduct and a response to the increasing public calls to fairer treatment of 'innocent' third parties (Siliciano, 1988). The renowned decision by the British House of Lords in the Caparo case (1990) signified a return to the position established in the Ultramares case in 1931 which refused individual shareholders a possibility to make claims against auditors and set criteria to specify conditions under which a duty of care was owed (Napier, 1998). Also, this was the time when the profession, after much hesitation, started to embrace a wider responsibility for fraud detection as a way of not merely tackling the "expectation gap" dilemma evident from increased litigation, but also, arguably, encouraging demand for their services and justifying higher fees (Fogarty et al., 1991). By the later 1990s, annual reported claims against auditors were estimated to be well in excess of £1 billion just in Britain alone, leading some to assert that third party litigation presented the biggest threat to the profession because stakeholders increasingly relied on auditors' "deep pocket" regardless of the scope of an auditor's failure relative to that of the management (Ward, 1999). Furthermore, the gap between the potential liability exposure and obtainable insurance was flagged up as plausibly increasing the risk of such a threat (Lochner, 1993; Palmrose, 1997; Moizer & Hansford-Smith, 1998), and also, leaving smaller auditors on the verge of bankruptcy (Jones & Raghunandan, 1998; Lemar, 1999). It was also asserted that excessive litigation might induce experienced auditors to abandon the profession or make new qualified personnel reluctant to enter, potentially leading to diminished quality of audits (Hill, Metzger & Wermert, 1994). Unsurprisingly, further intensification of these debates took place in the wake of large corporate fraud scandals in the beginning of the twenty-first century in Europe (e.g. Ahold in Holland, Nordisk Fjer in Denmark, and Parmalat in Italy) and the U.S. (most famously, Enron) (Dewing & Russell, 2004).

Over the years, more prominent were becoming the voices within the audit profession itself, indicating a growing anxiety over the scope of auditor liability and pointing, at various times, to ‘an epidemic of litigation’ (Arthur Andersen & Co. et al., 1992, p. 1), an ‘outrageous level of current claims’ (ICAA, 1995, p.11), and even a possibility that ‘many audit firms face the risk of Armageddon’ (Ward, 1999, p. 388). It has been commonly accepted within the profession that damages claimed against auditors were disproportionate to both their actual wealth and fees received from the client. These concerns led auditors to seek for alternative ways of sheltering themselves from liability exposure, for example, through managing the audit firm’s legal status. An apt illustration is the Jersey LLP (Limited Liability Partnership) case in Britain (Sikka, 1996 & 2008; Cousins et al., 1999; Turley, 2008). Since the mid-1990s, Price Waterhouse and Ernst & Young, influenced by the success of LLPs in the US, started to lobby the UK government for the introduction of laws that would allow British audit firms to adopt the LLP organisational structure. The firms’ strategy was to promote the enactment of similar legislation in Jersey and then threaten to move their main business there. The goal was accomplished when the British government legislated for the LLP option in the Limited Liability Partnership Act 2000. In 2001, Ernst & Young was the first Big audit firm to register as an LLP with the intent that it would offer a greater protection to its individual partners and their personal assets.

Echoing the industry’s concerns were pronouncements of influential professional bodies. In 1995, the International Federation of Accountants (IFAC, 1995), for example, issued a report which presented results of a comprehensive survey involving member organisations in 36 nations. The report provided a summary of the members’ views on the legal liability regimes adopted in their countries and used these to make a case for international regulatory action to establish clear and consistent limits on auditor liability. The key argument posed was that unwarranted liability exposure was having an adverse effect on business activities, including the operation of capital markets, as well as on the accountancy profession itself. It was argued that in those countries with unlimited liability regimes (such as US or Australia) the public conceptions of the roles of an auditor were distorted and often unrealistic, fuelling excessive litigation activity against auditors. In contrast, limited liability environments maintained in other countries were seen to facilitate greater efficiency in auditors’ work, while serving the public interest through rigid enforcement and compliance practices.

The European Union’s initial attitudes to the issue of audit liability

First attempts at regulating auditing at a European level date back to the issuance of the European Council Fourth (78/660/EEC) and Seventh (83/349/EEC) accounting

Directives which required an audit to be carried out on annual financial statements of limited liability companies. The Eighth Company Law Directive on Statutory Audit (84/253/EEC) came out in 1984 and was designed to promote the Single Market principle by providing a uniform framework for the delivery of audit services. The Directive, however, did not specifically refer to auditors' responsibilities, nor did it define the circumstances under which auditors could be held liable. It merely stated that it remained upon the Member States to warrant that auditors were, to an adequate degree, liable for a failure to act in an honest and independent manner. Effectively, this meant that individual countries within the EU had considerable flexibility in determining the nature and scope of auditors' liability exposure.

Individual EU countries' positions vis-à-vis auditor liability have been diverse. Much of this diversity relates to the range of parties that may claim damages caused by audit failure as well as to the nature and scope of liability exposure. In the majority of countries, particularly those placing an emphasis on auditors as public servants and the social meaning of audit practice (such as France), statute law does not confine audit liability merely to the company's officers but extends it to a wide range of parties. In some countries, however (e.g. Germany, Britain, Spain), auditors owe a duty of care to the client business only, including its shareholders as a collective body. Moreover, in the common law regimes of Britain and Ireland, auditor liability is also defined through court decisions, and hence, is also a judicial matter. Most countries follow the *joint and several liability* principle which implies that any of individual defendants can be required to pay for the whole amount of damages, regardless of the degree of other parties' contribution. Where liability is limited, the common method used is through the setting of a cap[3], either by tort or contract. In Germany, one of the countries where a liability cap is stipulated in tort law, cap relates only to claims by the client; whereas legislation in Belgium, Austria and Greece also covers liability to third parties. Also, Germany, over the years, saw an increase in audit liability capping levels, advocated by German auditors apparently in the hope of warding off any possible government measures seeking to increase the rights of third parties (Gietzmann and Quick, 1998; Kohler, Marten, Quick & Ruhnke, 2008).

Concerns about the EU Member States' divergent liability regimes started to be clearly voiced as far back as the mid 1990s. In 1996 alone, for example, two notable documents came out. The first was the EC-commissioned study entitled "The role, position and liability of the statutory auditor within the European Union" (Buijink et al., 1996) which concluded that the diversity was likely to have an adverse effect on the development of auditing, making hopes for a united European audit market rather premature. Analogous arguments were posed in the second document - a position paper by the FEE (Fédération des Experts Comptables Européens) (FEE, 1996), an international organisation representing national professional accountancy associations in Europe. The document called for a more active involvement of the European Commission in matters of audit regulation, including audit liability.

Following the publication of the aforementioned study (Buijink et al., 1996), the EC issued a Green Paper (European Commission, 1996a) in the same year in order to foster

[3] Caps may be monetary or a function of the audit fee. In Greece, for example, the liability cap is linked to the salary of the President of the Supreme Court.

further debate and consultation. The Paper reinforced the claim that liability had become a principal issue for the auditing profession, pointing to fundamental differences in the statutory auditors' liability regimes across the EU. It argued that a 'harsh' liability regime might deter audit firms from conducting audits for high-risk clients and increase audit fees. These conditions, in turn, might lead to a greater audit market concentration. Vitally, the Paper acknowledged that 'the liability of the auditor should be limited to amounts which reflect his degree of negligence' (European Commission, 1996a, para.5.6). However, in its appraisal of the liability issue as one of the key dilemmas facing the European audit arena, the Paper suggested that the capacity for such action should rest with Member States, *de-facto*, rejecting the need for any interference at an EU level. In this respect, the document stated,

> Action at EU level in this field is likely to be difficult. The audit profession is not the only profession which is struggling with problems of liability. Furthermore, the legal traditions in Member States in the area of civil liability are quite different. It is for consideration whether the negative effects of a continuation of differences in the regulation of audit liability are significant enough to justify EU action, considering the difficulties which such action is likely to face and the possible discrimination which action specific to the audit profession might entail as regards other professions. (European Commission, 1996a, para.5.7)

In December 1996, as part of the consultation process launched by the Green Paper, the European Commission coordinated a conference that, for the first time, brought together European audit regulatory community, academics, preparers and auditors themselves (European Commission, 1996b). The opening note to the section of the conference on the issue of auditor liability stated the following,

> We have saved probably the most difficult issue to the end of this Conference. Litigation against auditors is increasing. It is difficult to get an accurate picture of the extent of the problem because most cases are settled out of court. The situation is not the same in all Member States. Rules on professional liability are not harmonised at EU level. The professional liability of auditors is dealt with differently at national level. There are systems of proportional liability, joint and several liability and indeed of limited liability. Is there a reason to limit the professional liability of the statutory auditor by law? Should this not be left to the parties concerned? To whom should the statutory auditor be held liable? Is there a reason for action at EU level? Is there a reason why the EU should take the initiative, as opposed to Member States? Is it realistic to believe that one can deal with professional liability of auditors at EU level without at the same time tackling the liability regime of other professions? There is no doubt that we cannot give a final answer to this various questions today. (European Commission, 1996b, p. 193)

Conference discussions indicated a general consensus that a legislative framework for auditing in Europe needs improvement and should derive from the IFAC's International Standards on Auditing (ISAs). Nonetheless, participants' views on the possibility of the EU's action on auditor liability were somewhat less uniform. While the audit industry and FEE supported liability limitation, some expressed concerns that such limitation would cause inferior audit quality and shift liability to other parties. Additionally, it was argued that the relative scarcity of actual court cases against auditors indicated that existing liability regimes were not as harsh as claimed (Darbyshire, 1996). In his overview of the comments received on the Green Paper, Karel Van Hulle (at that time, Head of the EC's Financial Information Unit) stated the following:

> The commentators from the accounting profession regret the absence of a clear message in the Green Paper that a limitation of liability should be organised at EU level. Most other respondents think that there is no justification for reducing the professional liability of auditors as opposed to other professionals. These commentators believe in particular that a liability cap is not in a public interest. (European Commission, 1996b, p. 30)

Significantly, he concluded by noting that a 'study is necessary to conclude on recommendations on how to limit the auditors' liability to amounts which reflect his degree of negligence' (European Commission, 1996b, p. 30).

Various EU policy institutions welcomed the Green Paper initiative, including the European Economic and Social Committee, and also, the European Parliament which, in January 1998, endorsed the Paper emphasising the importance of eliminating national obstacles that impede audit development and the pursuit of the European Single Market (paras.2.8 & 2.9, European Commission, 1998). Following the Green Paper consultation, the EC, in May 1998, published a Communication (European Commission, 1998) which outlined future plans for regulatory action at EU level. The, then, Single Market Commissioner, Mario Monti stated, 'this Communication will make an important contribution to improving the quality and consistency of statutory audits throughout the EU' (European Commission, 1998a, p. 1). As part of achieving this objective, the Commission instituted a Committee on Auditing consisting of experts designated by Member States and representatives of the European auditing profession.

Another notable development that year was the issuance of an IFAC-commissioned report on the issue of auditor liability prepared by a UK-based consultancy London Economics (London Economics, 1998). The report rationalised current liability regime as an excessive *'blunt instrument'* for giving auditors the right incentives to deliver quality. In this respect, the report argued that auditors were already incentivised by the possibility of reputation loss and hence severe liability was a needless restraint tactic that was neither adequate nor effective in terms of delivering a high-quality audit product. Hence, the findings of the report served to support the IFAC's long-standing claims warning of the dangers of unlimited liability which "should be of concern not just for accountants, but for those concerned about the economy at large" (p. *v*).

It is worth noting that, at this point, the ratification of new or revision of the existing regulations was not considered necessary by EU politicians. However, a key emphasis was placed on the areas where national regulatory practices were seen as barriers to the functioning of the Single Market. With respect to audit liability, the EC argued that it was important to ensure that differences in national auditor liability regimes did not create barriers between Member States. It also expressed commitment to investigate national auditor liability practices in more detail with a view of identifying whether harmonisation of national laws was necessary (European Commission, 1998, paras.3.14-3.15).

Towards this aim, the EC, in January 2001, published a comparative study within fifteen Member States to determine the extent to which national differences in the EU countries' liability regimes could constitute an obstacle to a European audit market (Thieffry & Associates, 2001). Although acknowledging the presence of differences, the study nonetheless did not consider their effects on the development of a European Single Market significant (Thieffry & Associates, 2001). This may well be seen as yet another illustration of how the Commission's early views were dominated by the idea of the insuperability of the divergence in national liability regimes across Europe, and resultant scepticism about any type of harmonization in this area.

4. Changing EU policy: The developing significance of the auditor liability problem

Recognising liability as a problem area

The demise of Enron in 2001, the subsequent fall of Arthur Andersen, and a reported general loss of confidence in the auditing profession led many to believe in the imminence of regulatory action by the European Commission. Following an informal meeting of EU finance ministers in Oviedo (Spain), the Commission, in April 2002, issued a paper entitled 'A first response to Enron related policy issues' (European Commission, 2002) presenting steps that should be taken so as to prevent the occurrence of similar corporate disasters in Europe. The document indicated a number of targets for urgent regulatory policy action. Although the reform of statutory auditing was considered one of such priority issues, this did not involve any mention of the need to reform auditor liability. Frits Bolkestein, at that time a European Commissioner for the Internal Market and Taxation, asserted the following at a London conference in 2003,

> I should like to say at the outset that, in the current economic climate, I think there would be little support for a regulatory intervention which would generally limit auditor liability. After so many major financial reporting scandals and potential audit failures, regulators need to act to restore investor confidence. An intervention limiting liability, to my mind, would not serve to revive the trust of investors (Bolkestein, 2003).

Furthermore, the Bolkestein's address revealed the apparent shift in the Commission's focus towards clarifying auditors' roles and responsibilities as a way to achieve higher audit quality and restore public's trust in the profession. In this respect, Bolkestein (2003) noted:

> In addition, the Commission's forthcoming Action Plan on Company Law and Corporate Governance will set out a series of actions for the short and medium term. Many of the actions are aimed at clarifying the role and responsibility of those involved in managing and governing a company. There can be no doubt that the clarification of the role and the position of the statutory auditor would

have a positive effect on the assessment of his liability in the case of an audit failure.

After a series of consultations with members of the EU Committee on Auditing, the Commission issued, in May 2003, a Communication to the Council and the European Parliament entitled ‘Reinforcing the statutory audit in the EU’ (European Commission, 2003) outlining a new regulatory framework for statutory audit. This was a re-evaluation of the European policy priorities in order to restore the auditing profession’s credibility - with the Commission seeking to provide ‘a robust, effective but also comprehensive, balanced, and proportionate response - after a wide consultation process’ (European Commission, 2003, p. 3). The document reinforced the importance of high-quality auditing as a prerequisite for achieving the European Single Market. Towards this goal, the Communication proposed the enactment of new EU laws. Specifically, among the key proposals were the revision of the Eighth Directive (84/253/EEC) and the formation of an Audit Regulatory Committee to assist in revising existing and implementing new regulatory measures. Furthermore, the Communication also recommended the reinforcement of the auditing profession’s public oversight and the application of International Standards on Auditing (ISAs) to statutory audits of public interest entities from 2005 onwards.

These new proposals may be seen as an indication of the start of the EC’s departure from reliance on a relatively ‘non-invasive’ strategy of coordination and collaborative encouragement of uniformity among Member States to a more direct ‘hands-on’ approach to harmonisation through legislative activity at the EU level. However, with respect to the issue of audit liability, the Commission continued to insist liability limitation was unnecessary and considered auditor liability as a primary “driver for audit quality” (European Commission, 2003, para.3.10).

In 2004, the European Economic and Social Committee issued a statement (European Economic and Social Committee, 2004) welcoming the Commission’s communication document, in a similar fashion as it did with respect to the 1997 Green Paper. The 2004 statement by the Committee, however, contained a key distinction in that, while maintaining that auditor liability was a key underpinning for audit quality, it believed that such liability should be proportionate (para.4.7).

Corporate failures, such as that of Enron, also provoked a strong reaction from auditors themselves. The profession’s forceful rhetoric followed the collapse of Arthur Andersen, one of then Big Five audit firms, resurrecting earlier claims of ‘cataclysmic’ litigation and portrayals of auditors as ultimate victims of an unfair litigation battle that could potentially lead to another ‘Big’ firm failure with disastrous consequences for the longevity of the profession as a whole (Talley, 2006). Moreover, these claims were contextualised by an evidence of increased litigation in the post-Enron era, fuelling discussions around the importance of preventive regulatory policies (Talley, 2006).

Advocating audit liability reform became a key priority for the European Contact Group (ECG), i.e. a lobbying body set up in 1993 by the Big Four and medium-sized auditors BDO and Grant Thornton to generate a united front for the larger firms in Europe. Specifically, in 2004, the Group then led by Jeremy Jennings, a partner at Ernst & Young, called for a “multiple of the fees” cap on auditor liability to be included in the proposal regarding amendments to the Eighth Company Law Directive being prepared by the EC's officials. The ECG, *inter alia*, claimed that such a cap was necessary to prevent a collapse of another large auditor by helping counterbalance a substantial increase in auditors' responsibilities proposed in the new draft of the Directive, and ideally, by making liability proportionate to the extent of auditor's fault. In pursuit of this objective, the Group, in the second half of 2004, instigated negotiations with a number of MEPs (Members of the European Parliament), and also, pressed diplomats to raise the issue in the Council of Ministers (Chapman, 2004a). Despite individual Member States' governments were unsuccessful in reaching a uniform view on liability in their discussions of the new Directive, senior MEPs responded more favorably to the profession's lobby. The German MEP Wolf Klinz, for example, advocated a cap of a maximum of €25 million, warning of "a situation where a liability case could ruin whole firms" (Chapman, 2004b). Another strong advocate of the liability limitation was a Dutch MEP Bert Doorn, incidentally the subsequent rapporteur for the Eighth Directive, steering the issue in the Legal Affairs Committee. Doorn found some welcome ears in the EC, specifically in the Commissioner Charlie McCreevy (who succeeded Frits Bolkestein as a European Commissioner for Internal Market and Services in November 2004). Both politicians actively advocated the need to examine the nature and effectiveness of existing auditor liability regimes within the EU, and contributed significantly to lobbying for the subject being addressed in the revised draft of the new Directive that was submitted to the European Parliament.

Furthermore, influenced by these developments, the European Commission launched, in November 2005, a European Forum on Auditors' Liability composed of experts representing various professional backgrounds (auditors, businesses, insurers, bankers, investors, and others) with a broad task of assessing potential solutions that would moderate auditors' litigation risk. In his appraisal of the role and expected contribution of the Forum, Charlie McCreevy observed that:

> No-one wants another corporate scandal that could reduce the Big Four to the Big Three - especially audit firms themselves, who we know want to limit their liability for acts under their direct responsibility. Now that some EU countries already have limitations or are moving in that direction, we think the time is ripe for EU-wide action. The forum's market experts will help us to analyse all the issues. (European Commission, 2005a, p. 1 of 1)

The above statement by McCreevy suggests that claims by the audit industry about 'cataclysmic' consequences of unlimited liability exposure had finally been successful in terms of evoking EU officials' interest and, as the following section will demonstrate, ultimately led to EU policy action.

In May 2006, in line with proposals outlined in the Commission's aforementioned Communication 'Reinforcing the statutory audit in the EU' issued in 2003 and subsequently endorsed by both the European Council and Parliament, the new Eighth Company Law Directive (2006/43/EC) on Statutory Audits of Annual Accounts and Consolidated Accounts replaced the previous version (84/253/EEC). A primary goal of the amended Directive was to strengthen and standardise statutory audit practice among the Member States by providing definition of auditors' responsibilities, their independence and ethical imperatives of their work. In addition, the Directive set out provisions for public oversight and commented on the potential application of international standards on auditing. Crucially, within the scope of the Eighth Directive, the Commission indicated that it would release a comprehensive appraisal of the effects of national liability regimes on European capital markets and the availability of professional indemnity insurance in Member States (European Commission, 2006). The Commission duly appointed the consultancy firm London Economics to undertake this study. It has been widely argued that it was the outcomes of this research project that became a major catalyst for the subsequent change in European policy on audit liability.

The 2006 London Economics Study

The London Economics report came out in October 2006 making a number of key propositions inferred from its analysis of the European audit market (London Economics, 2006). The study drew on a wide spectrum of sources ranging from relevant documents to interviews with the members of the auditing profession in twenty-seven Member States. The aforementioned Forum on Auditors' Liability set up in 2005 had a task of feeding into the research process by providing a formal ground for debate and discussion among the regulatory, professional and investment communities. Analysis of the forum meetings indicates the high degree of involvement of the ECG in the process, most importantly through facilitating invaluable access to the commercially sensitive litigation, insurance and other data from ECG member firms (i.e. the Big Four as well as BDO and Grant Thornton) (European Commission, 2005b), including the scope and nature of litigation and details of how individual cases were resolved.

The study's findings suggested that the market for international audits was highly concentrated and effectively controlled by the 'Big Four' networks, which significantly reduced the likelihood of any middle-tier auditor becoming an alternative to the Big Four firms. In addition, the study stated that the issue of a concentrated audit market structure was further exacerbated by the growing gap between the amounts of damages claimed against auditors and available insurance cover, noting that "the commercial re-insurance cover available is less than 5% of some of the mega-claims currently outstanding against some of the Big Four firms" (p. 99) forcing auditors to cover the remaining amount of damages from their personal wealth. It was, therefore, suggested that unlimited auditor liability combined with only limited availability of liability insurance left auditors unprotected against the 'catastrophic' consequences of growing litigation, increasing the likelihood of another large auditor's failure, and even endangering the effective functioning of a broader economy. In this respect, the report stated:

> A failure of one of the Big-4 networks may result in a significant reduction in large company statutory audit capacity if partners and other senior staff at the failed firm, the remaining Big-3 firms, and possibly even some middle-tier firms, were to decide that auditing is a too risky activity and therefore shift to other business lines. This would obviously create very serious problems for companies whose financial statements need to be audited. In such circumstances, a major increase in the price of statutory audits would be required to restore the equilibrium between demand for and supply of statutory audit services. (London Economics, 2006; p. 134)

The report further argued that limiting auditor liability would tackle the adverse effects of auditors' extensive litigation exposure by, inter alia, reducing concentration in the market for statutory audits, helping ease staffing pressure on audit firms, and ultimately, preventing another major audit firm failure (London Economics, 2006, p. 177). That said, a "one-size-fit-all" approach was deemed unhelpful in terms of adequately catering for the variety of liability regimes and audit firm characteristics in different Member States (p. 188).

The publication of the London Economics' report was soon followed by a public consultation on auditor liability launched by the European Commission in January 2007. This sought to collect opinions on the need for regulatory reform of auditor liability in the EU and develop recommendations. The Commission's position was largely in line with the findings of the London Economics' report in that limitation of auditor liability was deemed to be a necessary step towards increased efficiency of the European audit market and required appropriate regulatory action (Directorate General for Internal Market and Services, 2007a). The Consultation was concerned with auditor liability caused by negligence excluding cases of fraud or intentional misconduct on the part of an auditor. The limitation alternatives considered during the consultation processes included:

1. A single monetary cap at EU level;
2. A cap based on the company's size as a function of its market capitalisation;
3. A cap based on a multiple of the audit fees charged by the company; or
4. Limiting the contribution of the audit firm to the damages suffered by the plaintiff (proportionate liability), either by statute or contract (Directorate General for Internal Market and Services, 2007a).

EU Commissioner McCreevy forcefully acknowledged the timeliness and importance of liability limitation being factored into the European law, arguing that rapidly growing volumes of claims against auditors could pose serious risk to the survival of the auditing profession and economic stability in Europe (European Commission, 2007a).

The public consultation was concluded in March 2007; and in June, the Commission published a summary of responses received (85 in total) (Directorate General for Internal Market and Services, 2007b). This summary indicated that the audit industry was strongly in favour of the Commission's proposal, backed by non-auditor participants from countries where limited liability had already been introduced. However, the majority of respondents, particularly those from countries with unlimited liability regimes, opposed the liability reform and argued that the possibility of 'catastrophic' losses had no connection with factual levels of risk. Rather, it was claimed that the risk of auditor failure was intently associated with a loss of reputation and not with liability exposure. On the issue of audit quality, reform campaigners rejected propositions that limited liability could lead to auditors' inferior proficiency, whereas opponents of reforms argued that liability limitation would impair auditors' incentive to achieve quality, and hence, undermine public trust in the auditing profession in general (Directorate General for Internal Market and Services, 2007b). Some categories of stakeholders, including investors and bankers, appeared in particularly strong opposition to the change. For example, Peter Montagnon, Director of Investment Affaires at the Association of British Insurers, asserted in a Financial Times article (6 June 2008) that, while liability limitation would clearly offer auditors greater protection against litigation, the benefits of this to investors were somewhat less evident. Furthermore, some argued that the low level of provisioning against legal claims by large and mid-tier firms offered no real reason to suggest that auditors were being treated unfairly, and hence, the profession's claims of 'catastrophic' liability exposure were argued to be overstated (Gwilliam, 2004; 2006). With respect to the methods of limitation, the auditing profession generally supported introducing a liability cap, whilst other respondents recommended a proportionate liability approach as way to best address the 'deep pocket' syndrome (Directorate General for Internal Market and Services, 2007b).

The Recommendation Concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms (2008/473/EC) was duly published in June 2008 (European Commission, 2008a). It saw unlimited liability as a serious impediment to a healthy competition within the audit industry and effective functioning of the European capital market. Specifically, the Recommendation stated,

> 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.

The Commission recommended,

> 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. (European Commission, 2008a).

The Recommendation also suggested that Member States' national laws supporting unlimited joint and several liability should be replaced with provisions introducing, either by statute or contract, a liability cap or proportionate liability, except in cases of intentional breach of duties by an auditor. Essentially, this provided considerable flexibility in terms of enforcement strategies by leaving it to the Member States' discretion to determine which one or several methods of liability limitation would be most appropriate and correspondent to the existing legal environment. The recommended methods included,

(1) establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount (*liability cap*);
(2) establishment of a set of principles under which statutory auditors and audit firms are liable only to the extent of their contribution to the damage caused, (*proportionate liability*);
(3) provision allowing the client and an auditor to determine a limitation of liability in an agreement (*limitation by contract*) (European Commission, 2008a, para.5).

The Recommendation was also accompanied by an impact assessment carried out as part of the policy-making process in order to identify policy alternatives and appraise their respective effects (European Commission, 2008b). This claimed the liability limitation was an optimal solution for improving the operation of the audit market as a result of increased fairness and predictability of auditors' risk exposure.

5. Understanding the reasons for change in the EU's policy position

The presented historical account of the European Commission's position vis-à-vis auditor liability signifies a significant turnaround in the European Union's audit policy-making. Accounts of the Commission's early views suggest its initial conception that EU action on this matter was both problematic and unnecessary. This unwillingness to accept the 'uniqueness' and 'vast nature' of auditors' responsibilities heralded by the audit industry seemed to be further reinforced by disastrous corporate scandals, such as Enron, which led many to believe that liability restriction would impair audit quality and increase public concerns about trustworthiness of business. However, more recent statements and regulatory activity by European officials are seen as a change in the EU's position. The new line of arguments in favour of liability limitation rationalises liability reform as a necessary precondition for a Single European market and viability of the Europe's audit profession. In this concluding part of the paper, we reflect further on the driving forces and key factors behind the EU's recently issued recommendation for the Member States to limit auditor liability.

The 2006 London Economics report for the European Commission is often seen as a key trigger of change in the EU's stance vis-à-vis auditor liability. However, we have demonstrated earlier in the paper that, almost a decade before it, London Economics prepared a report for the IFAC (London Economics, 1998) which presented a very similar set of conclusions. Indeed, both reports referred to audit liability as an issue of concern, calling for its limitation. The two documents contained a number of differences, however. Specifically, the 1998 report presented a somewhat softer take on the liability problem, focusing more on the dysfunctional aspects of a punitive liability regime and refraining from the fundamental questioning of the state of the audit market or its viability. Also, the analysis presented was rather limited due to the insufficiency of empirical data to substantiate the arguments developed, and as a result, reliance primarily on the normative rhetoric. This led to the report being criticised by the professional community as producing "a stream of theoretical arguments that are not underpinned by hard empirical evidence" (Accountancy, July 1998, p. 7)[4].

In contrast, the 2006 report was prepared on the premise that legal arguments alone would be insufficient to persuasively rationalise the need for change, and presented instead an economics-driven rationalisation of the liability dilemma. By using a forceful language, the report provided a detailed consideration of the potential collapse of another Big auditor, appraising the likelihood and economic consequences of such a possibility. What perhaps greatly increased the credibility of the report's findings was the fact that they were substantiated by the aforementioned access to the highly sensitive and therefore rare data on litigious activity provided by the large auditors themselves.

[4] An excerpt from the statement by Roger Adams, Head of Technical Services, ACCA.

Furthermore, the document introduced an interesting allegiance with public oversight as a method of motivating auditors' proper conduct, effectively reinforcing the 1998 report's quest for alternative (to the 'blunt instrument' of liability laws) sources of auditor incentives. Hence, the 2006 report may be seen as an illustration of the refinment of the the profession's lobbying tactics over the recent years. This new tone of campaigning puts a greater emphasis on the (more effective) quality assurance capacities of public oversight in addition to the conventional claims about mounting risk of catastrophic failure facing audit firms under severe liability regimes.

By virtue of their global reach and dominant standing in the audit market, the Big auditors have acquired the political means of influence through association with regulatory circles and influential professional bodies, such as the IFAC and FEE (Green, 1999; Roberts, Dwyer, & Sweeney, 2003; Gwilliam, 2006). Through their persistent calls for regulatory reform and carefully orchestrated political lobbying in the European context, the Big auditors have effectively managed to overcome the initial bias towards them well worded in the Accountancy Age journal (28 April 1994, p. 9) asserting that 'audit liability was a crisis for just six of the 9,330 English ICA- registered audit practices'. Initially, these efforts appear to have targeted individual Member States through rationalising the catastrophic consequences of 'non-action' for the countries' professional communities and the observance of public interest (with reference to the UK, see Accountancy, 1992; Accountancy Age, 1993, 1994a&b; The Accountant, 2003; The Sunday Times, 2004). Subsequently, the focus has been extended on a broader, European and even global, scale. Illustrative in this respect appear the position papers by the IFAC (1995) and FEE (1996) and, more recently, vision statements issued by the Big firms' executives within the Global Public Policy Symposium initiative in support of liability limitation (e.g. Global Public Policy Symposium, 2006). The intensity of polemic is evident from public statements by individuals associated with the Big Four community, such as the one below by Peter Wyman (at that time, Head of the Institute of Chartered Accountants in England and Wales):

> The auditors are left to pick the entire tab. If this perverse situation is allowed to continue, the inevitable consequence will be that the larger accountancy firms will progressively remove themselves from the audit market, or at least from auditing any company they perceive top be a significant risk, with potentially serious and damaging consequences for audit quality. (*The Times*, March 6, 2003, p. 28)

Over the past years, the audit networks' global attempts to resolve the liability issue at a national level have often remained inconclusive, including in the worlds' major markets. Among the recent examples is the little impact of the largest firms' pitch (Center For Audit Quality, 2008a; Ernst & Young, 2008; Grant Thornton, 2008; Center for Audit Quality, 2008b) on the draft reports by US Treasury's Advisory Committee on the Auditing Profession looking into the state of the profession. Among the central arguments put forward was that the existing claims against the six largest auditors totaled "an astounding 140 billion dollars [*authors* – incidentally, 37 times the combined wealth of these firms], including 27 lawsuits with potential damages in excess of one billion dollars each and seven lawsuits with potential damages in excess of 10 billion dollars each" (Oberly, 2008, p. 6). The Committee, however, remained unconvinced as is evident from the final version of its report where liability was not mentioned among the areas recommended for reform. The profession's frustration with the US Treasury for ignoring the liability reforms wasn't helped by the "hands-off" approach by the UK's Financial Reporting Council (FRC) which left liability limitation to the remit of the auditor-client contractual arrangements as opposed to providing a universal legislative response.

The aforementioned 2007 public consultation on auditors' liability and the audit liability forum launched by the European Commission also provide an ample and well documented evidence of the major auditors' forceful attempts to silence the sceptics of liability reform. In response to those essential criticisms implying an association between limited liability and inferior audit quality, auditors dismissed such a link by pointing, with reference to the findings of the London Economic report, to the importance of proficient personnel, intra-firm quality control structures and public oversight as key drivers of quality. Commentaries by some of the firms read in this respect,

> Concern has been attributed to some commentators that removal of unlimited liability will impact negatively on audit quality. However, the independent study commissioned by the EC from London Economics/Professor Ewert on the Economic Impact of Auditors' Liability Regimes, which forms a sound basis for political decisions, reported that there was no evidence that unlimited liability promotes audit quality. (Grant Thornton, 2007)

> The current experience with liability caps in Germany as well as academic research demonstrates that limitations on audit liability do not adversely affect audit quality; on the contrary, we believe a limitation can have a positive effect. (KPMG, 2007).

Another commentary below demonstrates how, in additional to the conventional claims about the inadequacy of professional insurance cover and the deep-pocket dilemma, major firms increasingly question the audit market viability and rationalise catastrophic consequences of another Big firm failure (Talley, 2006) as motivations for an EU-level regulatory reform:

> BDO International therefore sees the consultation as an opportunity for the Commission to bring forward solutions which address contemporaneously the "catastrophic claims" possibility, the "deep pocket syndrome" and the [market - *authors*] concentration/[auditor - *authors*]choice issue. Any recommendation to Member States must address *all of the issues* and be *equitable to all stakeholders* including audit firms. (BDO, 2007)

An interesting feature of the profession's response to the EU's public consultation has been the growing emphasis placed on the significance of public oversight. Internationally, systems of public oversight of the auditing profession have become considerably more prominent in recent years - with notable developments including the establishment of the PCAOB in the US, the formation of a Public Interest Oversight Board (PIOB) to overlook the public interest (standard setting) activities of the IFAC (Loft et al., 2006) and the emergence of co-ordinating auditor oversight bodies at both regional level (i.e., the European Group of Auditor Oversight Bodies – EGAOB) and internationally (i.e., the International Forum of Independent Audit Regulators - IFIAR). Focal here is the larger international firms' categorisation of independent public oversight of the auditing function as a more reliable system for enhancing audit quality than punitive liability regimes, as illustrated below by the reply of Grant Thornton:

> We believe that in contrast to unfettered litigation, other recent moves to increase the consistency of high quality auditing, many of which have been driven by the Directive on Statutory Audit, such as independent public oversight incorporating inspection, investigation and discipline, are more reliable drivers of audit quality. (Grant Thornton, 2007)

What is fascinating about such a form of response is that one does not have to look too hard to find more critical noises emanating from the profession with regard to the impact of public oversight systems. For example, it is evident from the response letters that firms are able to include at the end of public inspection reports by the PCAOB on individual audit firms that inspection findings with respect to audit quality are not uniformly accepted. It is also a matter of regular debate in the professional press as to the cost of oversight regimes and the extent to which they are stimulating or hindering innovation in audit practice and whether they are serving to impose a more compliance, evidential and rules-based mindset among auditors which ultimately could prove detrimental to levels of audit quality (see Khalifa et al, 2008). Finally, it is also clear that auditor oversight bodies have a fairly substantial future agenda. For instance, the PCAOB's (Public Company Accounting Oversight Board, 2008) recent review of its annual inspections highlighted the potential for improvement in auditing quality across virtually all elements of the audit process.

At first sight, there may appear quite a distinction between independent oversight and mutually collaborative partnerships but when the professional and commercial institutions subject to oversight are both supportive and critical of such regulatory functions, the relationship starts to look a rather more complex one. In terms of the auditor liability limitation debate there are considerable grounds for suggesting that the above noted claims by the larger firms as to the impact of public oversight in improving audit quality (and its comparative strength over liability provisions) are rather more aspirational and strategic than independently proven empirical facts.

The major audit firms appear to have achieved a bigger success with their liability campaign within the European regulatory arena than at the level of individual Member States. In the wake of a series of corporate collapses and the demise of Arthur Anderson, the European approach to audit regulation, as in many other locales worldwide, has become subject to fundamental revisiting, most notably through amendments to the European Commission's Eighth Directive on statutory auditing. The profession's increasingly prominent 'catastrophic claims' have plausibly been amplified by the general sense of concern about the fading stature of the auditing profession. It is conceivable that this sentiment might have translated into a characteristic change in rhetoric around the issue of auditor liability evident from the public statements by members of Europe's regulatory establishment. In his commentary of the 2007 consultation process, Commissioner McCreevy emphasised the importance of competition within the audit industry and noted that another audit firm failure could undermine these aspirations and lead to further audit market concentration and therefore limiting auditor liability was key in addressing these concerns (European Commission, 2007b).

Moreover, illustrative have been considered the regulatory practices in those Member States, such as Germany, Austria, and Greece, where limited liability regimes had already been enacted; and who appeared supporters of a European harmonised approach towards liability limitation. It is evident from the comments some of these countries' representatives supplied within the 2007 consultation process. According to the consultation summary report, more than 70% of respondents from Member States with limited liability were supportive of European liability reform (Directorate General for Internal Market and Services, 2007b).

Looking at the dramatic turnaround of opinions by European officials with respect to auditor liability, some may argue that the audit profession has secured a victory. However, with a view of the intended nature of the liability reform as a way to achieve a uniform treatment of the liability issues by all Member States, this seems as an overstatement. Indeed, as opposed to a blanket law approach, the Commission opted for a softer country-to-country option solution giving discretion to individual nations in terms of selecting a suitable limitation method. This is effectively an indication that the EU has refrained from fully addressing the very complexity of the liability debate evident in the national differences of liability regimes across Europe. Hence, these recent developments at an EU level are an important but by now means final step to be taken by the proponents of limited liability. The events in the United States indicate that liability reform is a battle that is yet to be won. There, recent years have seen the audit industry embarking on a lobbying campaign to reduce their liability and a growing support of this initiatives by some members of the country's regulatory community, such as the Committee on Capital Markets Regulation (Committee on Capital Markets Regulation, 2006), the United States Chamber of Commerce, and crucially, the SEC. So far, however, these initiatives "have not garnered significant support, largely because of the political fears that the effort would be seen as an abandonment of some of the investor protections that were adopted after the collapse of Enron in 2001 and the huge accounting fraud scandal at WorldCom a year later" (Labaton, 2007).

6. Concluding remarks

This paper has documented the evolution of the EU's regulatory approach to auditor liability over the past two decades leading to the recently announced recommendation for liability limitation. The study shows that, despite the longstanding calls by the audit industry, liability reform, until recently, received limited attention from the EU officials. The recent developments, however, indicate a significant turnaround, leading to liability limitation being incorporated in EU statutes.

The presented account serves to demonstrate the growing role in European polity of organized interest representation and lobbying, much of which is transnational in nature (Nolke, 2003; Djelic & Sahlin-Andersson, 2006a). The study has demonstrated that, most notably, this has been evident from continous elaboration as key policy actors of international audit firm networks (Cooper et al., 1998; Covaleski et al., 2003; Cooper and Robson, 2006; Suddaby et al., 2007), incidentally the strongest proponents of liability limitation..

Furthermore, it is plausible that the profession's focus on the EU has been motivated by the perceived shift in the potential for regulatory action from a national to the supranational level. Specifically, the EU's regulatory setting allowed the audit firms to distance themselves from the sturdiness of national rules and restrictions often undermining individual country lobbying and move to a more lobby-prone European policy scene. The wide range of limitation methods discussed in the EC's 2008 recommendation to limit auditor liability provided flexibility to reach an acceptable, for various stakeholders, solution for the audit liability dilemma. On the other hand, however, it is this flexibility coupled with the recommendatory nature of what appears to be a "blanket-law" document by the EU that makes claims about EU liability reform as the Big firms' success story rather premature.

This essay may be seen as an illustration of the increasingly prominent view that European polity is post-parliamentary, in the sense that conventional state-centric forms of governance are complemented by more informal interest representation organized around the notion of expertise (Andersen & Burns, 1996; Burns, 2000; Drori & Meyer, 2006). Specifically, in light of a growing complexity and cultural differentiation of policy issues the EU appears to increasingly rely on expert knowledge as a way to justify, rationalize and defend the policy choices (Radaelli, 1999). Furthermore, the meaning of expertise has evolved to emphasize more the significance of market-oriented actors. Just one example of this in the European Commission's increasing use and acceptance of market consultancies' outputs (Lahusen, 2002), which plasibly motivated a greater emphasis on the findings of the 2006 report by London Economics.

Furthermore, the study has demonstrated that the making of policy endeavors is intimately linked to the institutional features of a milieu in which they take place. Regulators' agendas are as much driven by the perceived demands of the every-day life presenting policy dilemmas as they are triggered by the subjective and often incidental contiguity of individual interests of governance actors, interplays between contextual variables and related events. The large international firms' well-orchestrated regulatory lobbying is by no means unique to the European context, but, in Europe, its impact has been amplified by a series of events which with time put the issue of auditor liability back on regulatory radar. Specifically, the related debate surrounding the issuance of the 2006 London Economics study was reinstated by personal sentiment of some influential EU policy actors plausibly rooted in their past professional experiences and fuelled by the far-reaching global echo of recent corporate disasters, about the fragility of the profession's survival and public image should another such scandal occur in the European context. Characteristic in this sense have been the views of Commissioner McCreevy, a trained Chartered Accountant and Ireland's former Finance Minister, who once stated, "Personally I make no secret I have been in favour of having some cap on auditor liability for as long as I've been a Chartered Accountant" (McGinley, 2005).

The significance of the European story is also evident from the fact that it resonates with the stance of US regulatory establishment on the audit liability issue. The recent comment by an audit partner at a US firm helps put things into perspective, "If the Fortune 500 screams at Congress, then they might react. Or if someone thinks they can make points in an election by proposing something, then it [audit liability issue – *authors' note*] gets attention. Right now it isn't on anybody's list of important issues, so it isn't getting a lot of attention” (Doherty, 2007). What might have distinguished the European case were the already existent experiences of some individual Member States where limitation of auditor liability, in one form or another, had already been introduced. It is plausible that availability of these country-related experiences served as a reference point, and also, as additional reassurance needed to trigger relevant reform.

In this respect, the study echoes Power’s rationalization of liability regimes as institutions “designed with a certain set of issues in view” that are “often quick to forget their own histories and slow to adapt to changed conditions in the web of corporate governance” (Power, 1998, p. 78). Capturing historic accounts of policy processes, as the study has shown, helps better understand the nature of related practice dilemmas which occur and re-occur in a given institutional locale. Changing rationalizations of these policy issues by governance actors, triggered by the evolving outlook of institutional environments themselves, narrate the new wisdom about how new institutions of governance emerge and develop.

In conclusion, our analysis suggests that the EU’s current position is not a steady state equilibrium. The EC's decision to allow the individual countries to choose from a range of alternative solutions has in many respects transferred debates over liability limitation from the regional, EU level to the national, Member State level. So rather than solving the liability problems that it once said prevented it from taking action, the EU has rather side-stepped them and left their resolution to individual member states. The most visible consequence of this can be seen in terms of ongoing discussions by senior industry representatives seeking to secure movement in the US liability position, indicating that the battle for liability reform is still an ongoing matter. Likewise, the profession's support of public oversight in the context of debates on liability limitation sits uncomfortably with criticisms elsewhere of such oversight processes in terms of the effectiveness of individual firm inspections. Hence, the unfolding of the liability reform will remain an arena on which to maintain a watching brief as a researcher. There is a clear need to see how liability developments play out at the national and cross-national levels (both within and outside the EU) and how the profession's stance on oversight changes as its influence increases on audit practice development.

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