IRISH PRACTITIONERS' PERCEPTIONS ON LIMITING AUDITORS' LIABILITY AND THE EXPECTATIONS GAP

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ABSTRACT

The objective of this study is to investigate whether Irish practitioners' views on the limitation of auditors' liability and the exectations gap are motivated purely by self-interest. The empirical evidence presented is based upon 104 responses to a questionnaire survey. The results of the survey support the contention that Irish practitioners consider the needs of audit users. It is not possible, however, to determine whether the consideration of users' needs is a contraint on pursuing self-interest or whether it derives from an underlying ethical aspect of professionalism, that is, the tradition of a professional having a fundamental and unavoidable responsibility for his or her actions.

INTRODUCTION

The auditing profession is currently trying to resolve a number of interwoven problems. These include the issues of auditors liability and the expectations gap.

Auditors' Liability

In a paper to promote public debate, *The Future Development ofAuditing,* the Auditing Practices Board (APB) has identified the cost and potential damages arising from litigation, as a major constraint on the development of a more responsive and effective audit service:

> '... the litigious environment militates against the wider role and scope of audit... In particular, if auditors are to take on

> responsibilities to a wider group than shareholders alone, a solution to the difficulties arising from litigation will be needed' (November 1992, p. 13).

Concern about the liability of the auditor may be considered under two sub-headings. First, the extent of third party liability and second, the extent of damages payable. With regard to the first, the decision in Caparo Industries Plc v Dickman (1989) and the subsequent ruling in the British House of Lords at least indicated that the courts may restrict the right of third parties to institute proceedings against auditors. The second issue, however, is potentially more important, especially given that this embraces both liability to third parties and the liability to the client.

In Australia the Companies and Securities Law Review Committee in a discusion paper entitled *Civil Liability of Company Auditors* has canvassed for the placing of a limit, regardless of fault or culpability, upon the liability of the auditor. This resulted from concerted lobbying by the Australian accounting profession. In a survey of Australian practitioners' views, Adams and Kimber (1992) report that 85% of the 340 respondents to the survey considered that auditors' liability should be limited. The decision in AWA v Deloitte (New South Wales, 1992), where the level of damages payable was apportioned 72% against the auditors, 20% against AWA and 8% against specific individuals, at least provides some indication that the issue is being addressed in the courts in Australia.

Whilst the call for limiting auditors' liability in the UK was originally rejected in the 'Likierman Report' (1989), the auditing profession has forwarded convincing arguments in favour of limiting the extent of damages payable arising from litigation. Such arguments include: it is not the auditor who causes the collapse or failure of a company; the professional indemnity insurance market is coming under heavy strain; the disparity between audit fees and extent of damages payable; the additional costs and loss of reliability deriving from dysfunctional auditor behaviour, such as 'over auditing' and the proliferation of qualified audit reports; and the loss of talented personnel who, when faced with unlimited liability, are reluctant to accept the exposure of a partnership.

Balanced against these arguments is the impact of limiting liability upon both professional standards of work and auditor independence, and the public perception of a profession placing its own interests above the interests of the people they are appointed to protect. The latter argument is perhaps the most important for the auditing profession to address, especially bearing in mind the contention of Tom Peters that everything is perception and there is no such thing as reality!

Austin Mitchell (1993), Labour Member of Parliament for Great Grimsby, states:

> 'Led by its major firms, the auditing industry is naturally concerned about short-changing the public, poor quality of work, lack of accountability, poor professional education, lowballing, lack of effective sanctions, undue influence over the regulator, collusive relationships with directors, the peddling of creative accounting and all the other problems that afflict consumers of audits. *But not very much.* All that has a far lower priority than the producers' interest in protecting themselves by preventing consumers of audit opinions from resorting to law to seek redress for poor work. To suit their economic interests and their profits, the firms suggest all sorts of dodges: a "cap" on auditor liability; fixing the maxima judges can award as compensation; and proportional liability arrangements with directors.'

The auditing profession is accutely aware of such accusations of self-interest. Stella Fearnley (1993), a Council member of the Institute of Chartered Accountants in England and Wales, argues:

> 'It will do our profession's public image no good if we press forward with a case that appears to serve no-one but ourselves'.

The recognition that auditors are not autonomous is important. Sikka et al (1992, p. 2) note:

> 'In order to preserve their (limited) powers of self-regulation and public confidence in their craft, auditors are obliged to be responsive to other voices – most notably those of the government, industrialists, press and politicians – who are in a strong position to exert pressure upon the auditing profession to revise the meaning of auditing practice.'

In essence, Sikka et al. argue that the utility maximising behaviour of the auditing profession is constrained by negotiation with significant others.

Arguments of self-interest are also found with regard to the issue of the expectations gap.

The Expectations Gap

There is a substantial body of evidence which supports the contention that there is a divergence between what the public expects from an audit and what the auditing profession understands the objectives of an audit to be (see, for example Purewal and Sikka, 1987, and Steen, 1990). The expression used to describe this difference in understanding is the 'Expectations Gap'.

Much of the literature has attempted to attribute the expectations gap to widespread user misunderstanding (for example, Ellis and Shelley, 1988) and/or a lack of user education (for example, Amhowitz, 1987). In October 1991, the APB issued a consultative paper *Proposals For An Expanded Auditors' Report*. The rationale for introducing an expanded audit report was identified as reducing possible misunderstandings. Whilst the APB recognised that not all expectations gap issues could be dealt with in the audit report, it suggested that the auditing profession could improve communications with users via the proposed expanded report.

In addition to the proposed changes in the actual content and format of the audit report, it was also suggested that a booklet explaining at length the meaning of the auditors' report and the scope of work required to express an audit opinion should be published.

It is important to note that the APB perceived the expanded audit report as the first step towards bridging the expectations gap. Essentially the APB identified the expectations gap as falling into three areas: the gap relating to accounting practice; the gap between what the public/users think auditors' responsibilities are and what they really involve; and the situation where the auditor fails to meet those responsibilities. The introduction of an expanded audit report was intended to address the second of these areas. Subsequent reports by the Cadbury Committee (1992) and specifically in the Republic of Ireland by the Ryan Commission (1992) have similarly addressed the issue of auditors' responsibilities.

As noted previously, the auditing profession has been accused of pursuing self-interest in its attempt to reduce the expectations gap. Sikka et al (1992, p. 7) argue that the auditing profession by defining the expectations gap as a lack of user education or misunderstanding, '... strives to silence, or at least draw private boundaries around, discussions of issues that could unsettle its authority'. Further, Sikka et al (1992, pp. 1-2) suggest that where the user education approach has been found to be ineffective against criticism, the auditing profession has offered additional reassurances by appealing to notions of public interest and claims to independence and objectivity, whilst simultaneously attempting to re-define the role of the auditor in such a way that responsibilities are reduced:

'For example, whilst providing paper evidence of redoubled

> efforts to ensure the highest standards (for example, through the issuance and revision of auditing standards), the auditing profession has sought to redefine and narrow the range of its responsibilities (and potential liabilities).'

Clearly, both with regard to the issue of limiting the liability of auditors and the issue of the expectations gap, it is perceived by some that bodies such as the Auditing Practices Board are pursuing policies on the basis of self-interest, with little or no consideration being given to the users of audit reports. These views are held despite the fact that only 50% of the members of the APB are practitioners (the remaining 50% are representatives of audit users) and the fact that the APB considers user education as only one contributory factor to the existence of the expectations gap.

The primary objective of this study is to investigate whether Irish practitioners' views on the limitation of auditors' liability and the expectations gap are motivated purely by self-interest.

The remainder of this paper is organised as follows: first, an outline of the sample and methodology employed in the study is given; second, a review of the results is provided; and finally a brief summary of the study is provided.

SAMPLE AND METHODOLOGY

Questionnaires were mailed to the partners of all certified accounting practices throughout Ireland, both North and South (270). In addition, questionnaires were mailed to the partners of all chartered accounting practices in Belfast (120). A total of 104 responses were received. An overall response rate of 27%.

Certified accounting practices were selected as it was possible to survey the total population of partners in Ireland. Due to the relatively larger number of chartered accountants in Ireland, a sample is surveyed. For geographical convenience and in the absence of any *a priori* reasons to suspect bias, the partners of practices in Belfast are surveyed. Both professional bodies are surveyed to determine whether significant differences exist in the viewpoints held by the members of the two bodies. Statistical tests on the mean responses of both bodies failed to detect any significant differences[1]. Subsequent analysis was thus based upon the combined responses of both samples.

An analysis of respondents revealed that 96% were male; 38% were graduates; 62% were members of the Chartered Association of Certified Accountants and 38% were members of the Institute of Chartered Accountants in Ireland. The length of work experience in auditing was on average 15 years, ranging from one year to 41 years.

Partners were asked to indicate the extent of agreement or disagreement with a number of statements using a seven point scale: strongly agree, agree, slightly agree, neither agree or disagree, slightly disagree, disagree and strongly disagree. A seven point scale is employed to gauge the relative strength of the opinions expressed.

The responses are initially reviewed via frequency analysis. Factor analysis is then applied to determine which perceptions are in some way related. In general, the factor analysis provided little insight over and above the fact that respondents gave very similar answers to the statements made. For this reason and for the purpose of brevity, the results of the factor analysis are not reported[1].

RESULTS

Table 1 provides a summary of the responses received on statements concerning the limitation of auditors' liability.

The results clearly indicate that respondents considered the issue of liability as one of the most important issues facing the profession. The beliefs that the extent of damages payable should be limited and that this reform would not lead to a decline in the reputation of the profession are strongly upheld, with an overall total of 93.3% of respondents indicating that the extent of damages should be limited and 70.3% indicating that this would not result in a decline of the reputation of the profession. Further, respondents agreed that loss of reputation from judicial or disciplinary action is a stronger incentive for optimal audit quality control than unlimited liability.

Table 2 provides a summary of the responses obtained to statements on the general impact of limiting auditors' liability.

The majority of respondents considered that auditors carry excessively high monetary risk in comparison with other professionals, but recognised that limiting the extent of damages payable by auditors may set a precedent for other professions to seek similar protection. In addition, it was

Table 1

Statement	Strongly agree (%)	Agree (%)	Slightly agree (%)	Neither agree nor disagree (%)	Slightly disagree (%)	Disagree (%)	Strongly disagree (%)
The area of liability of the auditor is one of the most important issues confronting the audit profession today	39.6	39.6	10.9	4.0	4.0	2.0	0.0
The auditors' liability as regards the extent of damages payable should be limited	51.0	40.4	1.9	1.0	0. 0	4.8	1.0
The reputation of the audit profession will decline if the extent of damages payable is limited	3.0	7.9	7.9	10.0	8.9	50.5	10.9
The possibility of loss of reputation arising from judicial action is a stronger incentive for optimal audit quality than the amount of damages payable	15.5	45.6	18.4	7.8	6.8	4.9	1.0
The possibility of loss of reputation arising from disciplinary action is a stronger incentive for optimal audit quality than the amount of damages payable	13.7	48.0	21.6	7.8	2.9	5.9	0.0

Table 2

Statement	Strongly agree (%)	Agree (%)	Slightly agree (%)	Neither agree nor disagree (%)	Slightly disagree (%)	Disagree (%)	Strongly disagree (%)
Auditors carry excessively high monetary risk when compared with other professionals	19.6	35.3	11.8	17.6	6.9	8.8	0.0
Limiting the extent of damages payable by auditors may act as a precedent for other professionals to seek similar protection	3.9	52.9	14.7	15.7	2.0	10.8	0.0
The risk of personal loss is causing potential partners to have second thoughts about accepting partnerships	5.8	35.9	16.5	18.4	5.8	16.5	1.0
The extent of damages payable by auditors is turning graduates away from the audit profession	1.0	6.8	8.7	29.1	7.8	36.9	9.7

perceived that the risk of personal loss is causing potential partners to have second thoughts about accepting a partnership, although this had no impact upon graduate entry to the profession. This finding is not surprising given that it is the partners and not graduate trainees who are liable for any losses arising from litigation.

It would therefore appear that the contention of the APB that the cost and potential damages arising from litigation is a major concern to practitioners is valid.

The partners were also questioned about whom they perceived auditors should be financially responsible to. **Table 3** provides a summary of the responses obtained.

An analysis of responses indicates that whilst 58.8% of respondents recognised that there should be *full* financial responsibility to shareholders, only 35.3% recognised a similar responsibility to creditors, and 23.5% to third parties. Further, 71.5% of respondents perceived that liability to those other than shareholders and creditors creates a disincentive for accountants to undertake auditing work, due to the high personal risks involved. Clearly, the APB is also correct in its assertion that the 'litigious environment militates against the wider role and scope of audit'.

Table 4 provides a summary of the responses to statements on the impact of limiting liability as regards the manner in which auditors perform their work, the protection afforded to investors/creditors and the maintenance of good accounting standards.

Although it would appear that practitioners wish to limit liability and perceive the loss of reputation arising from judicial or disciplinary action as a stronger incentive for optimal audit control than unlimited liability, the responses shown in **Table 4** indicate that it is perceived that the extent of damages payable acts as a primary incentive for auditors to undertake their work with due skill and care. Further, the majority of respondents perceive that the policy of limiting damages payable does not provide the best protection to investors nor, albeit at the margin, to creditors. The distribution of responses with regard to the impact of limited liability upon accounting standards is relatively evenly spread. It is important to note, however, that 41.2% of the respondents agreed that limiting the extent of damages payable may not be the best spur for the maintenance of good accounting standards.

Although the overall results of the survey do confirm the primary

Table 3

Statement	Strongly agree (%)	Agree (%)	Slightly agree (%)	Neither agree nor disagree (%)	Slightly disagree (%)	Disagree (%)	Strongly disagree (%)
Members of the auditing profession must accept full financial responsibility for their work and be required to compensate shareholders who, in reliance thereon, suffer loss	5.9	39.2	13.7	5.9	4.9	13.7	16.7
Members of the auditing profession must accept full financial responsibility for their work and be required to compensate creditors who, in reliance thereon, suffer loss	2.0	17.6	15.7	7.8	10.8	26.5	19.6
Members of the auditing profession must accept full financial responsibility for their work and be required to compensate third parties who, in reliance thereon, suffer loss	2.0	13.7	7.8	8.8	9.8	29.4	28.4
The extent of damages payable creates disincentives for accountants to undertake auditing work due to the high personal risks involved	17.6	34.3	19.6	5.9	9.8	11.8	1.0

Table 4

Statement	Strongly agree (%)	Agree (%)	Slightly agree (%)	Neither agree nor disagree (%)	Slightly disagree (%)	Disagree (%)	Strongly disagree (%)
The extent of damages payable acts as a primary incentive for auditors to undertake their work with due skill and care	5.9	48.0	26.5	2.9	5.9	9.8	1.0
The policy of limiting damages payable does not provide the best protection to investors	2.0	35.3	14.7	13.7	12.7	19.6	2.0
The policy of limiting damages payable does not provide the best protection to creditors	2.9	32.4	11.8	17.6	9.8	23.5	2.0
Limiting the extent of damages payable may not be the best spur for the maintenance of good accounting standards	2.0	23.5	15.7	13.7	12.7	28.4	3.9

contentions of the APB, additional areas of concern were identified, specifically the recognition that unlimited liability is perceived by practitioners as an incentive for auditors to undertake their work with due skill and care, and that limited liability may not provide the best protection to investors. Further, a large proportion of practitioners believe that limiting liability may not result in the maintenance of good accounting standards. It would therefore appear that Irish practitioners do not purely consider self-interest in evaluating the call for limiting the extent of damages payable by auditors. However, it should be emphasised that whilst practitioners recognise the needs of users, and in particular investors, they still desire a limitation of their liability.

Table 5 provides a summary of the responses received to statements on the expectations gap and the expanded audit report.

Clearly, it is perceived that investors misunderstand the audit process. Further, it is perceived that the current audit report format contributes to such misunderstandings, although overall 60.8% of the respondents agreed that the current format of the audit report acted as a primary incentive for auditors to undertake their work with due skill and care. The majority of the respondents agreed that the proposed expanded audit report would not provide the best protection to investors, nor would it provide the best spur for the maintenance of good accounting standards.

As with the responses received to statements on limiting auditors' liability, responses to statements on the expectations gap indicate that Irish practitioners do not purely consider self-interest. It is not possible, however, to determine whether the consideration of users' needs is a contraint on pursuing self-interest or whether it derives from an underlying ethical aspect of professionalism, that is, the tradition of a professional having a fundamental and unavoidable responsibility for his or her actions.

SUMMARY

The objective of this study is to investigate whether Irish practitioners' views on the limitation of auditors' liabilities and the exectations gap are motivated purely by self-interest. The empirical evidence presented is based upon frequency analysis of 104 responses to a questionnaire survey.

The results of the study indicate that the expectations gap is perceived as resulting from user misunderstanding, a contributory factor to which is the current audit report. The proposed expanded audit report is not,

Table 5

Statement	Strongly agree (%)	Agree (%)	Slightly agree (%)	Neither agree nor disagree (%)	Slightly disagree (%)	Disagree (%)	Strongly disagree (%)
Investors misunderstand the nature of audited financial statements	21.2	48.1	15.4	8.7	2.9	3.8	0.0
Investors misunderstand the type of work undertaken by auditors	24.3	57.3	10.7	2.9	3.9	1.0	0.0
Investors misunderstand the extent of work undertaken by auditors	27.2	58.3	6.8	6.8	1.0	0.0	0.0
Investors misunderstand the level of assurance provided by auditors	24.3	56.3	9.7	5.8	1.0	2.9	0.0
The current audit report format contributes to the possible misunderstandings of the auditors' role	6.9	45.5	18.8	16.8	5.0	6.9	0.0
The current format of the audit report acts as a primary incentive for auditors to undertake their work with due skill and care	2.0	33.3	25.5	15.7	6.9	16.7	0.0
The proposed new expanded audit report does not provide the best protection to investors	2.0	19.6	18.6	36.3	9.8	13.7	0.0
The proposed new expanded audit report may not be the best spur for the maintenance of good accounting standards	1.0	23.8	13.9	25.7	10.9	22.8	2.0

however, perceived as providing the best protection to investors. A dominant belief is that the extent of damages payable arising from litigation should be limited and that this step would not lead to a decline in the reputation of the profession. It is recognised, however, that limited liability may not afford the best protection to investors and that auditors should be responsible for losses incurred by shareholders who in reliance on their work suffer loss.

Such positions/attitudes may be attributed to Irish practitioners not purely pursuing self-interest, indicating that an underlying ethical aspect of professionalism (the tradition of a professional having a fundamental and unavoidable responsibility for his or her actions) exists. Equally it may be argued that to protect powers of self-regulation and public confidence, auditors are obliged to consider the interests of users. Hence, recognition of the needs of the users of audit reports is a contraint upon auditors' utility maximising behaviour. Future research may be directed towards specifically testing which of these two explanations more accurately portrays the rationale for the views expressed by Irish practitioners.

[1] *The full results of the study are available from the authors on request.*

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