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Economic aspects of audit regulation and auditor liability

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practice is specially significant in the case of option premiums, valuation criteria and the accounting treatment of hedging strategies.

NOTES

The thesis supervisor was Professor Dr Vicente Condor. The thesis was accepted in May 1995 and is written in Spanish. Address for correspondence or more information: Departamento de Contabilidad y Finanzas, Gran Vía 2, 50.005 Zaragoza, Spain.

Economic aspects of audit regulation and auditor liability

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The dissertation provides a micro-economic analysis of audit regulation and auditor liability. The analysis draws on insights from the economics and law literature that liability and regulation are alternative policy instruments available to governments to monitor behaviour of individuals and organizations. In the auditing context, both instruments are used and they affect demand for and production of audit services. Liability is established by common law and/or by statute since (in most countries at that time) financial statement issuers and auditors are jointly and severally liable for economic losses to users due to negligently prepared and/or audited financial statements. Auditing related regulations are the mandatory audit requirement for some classes of firms which affects audit demand, and professional audit standards which put a constraint (lower bound) on the required quality of the audit service produced.

Over the past years the outstanding claims against public accounting firms have risen exponentially, especially in the USA, but also in Australia, the UK and other countries. As a result audit firms claim to be used as deep pockets (insurers) for business failures. Lobbies to change the legal framework in which the auditor operates and to restrict auditor liability have emerged. At the same time, the quality of auditing has been under much public scrutiny, with allegations at the address of the profession of producing audit services below acceptable quality. A popular suggestion has been to increase the audit quality standards. However, in the auditing context little formal economic analysis exists of the impact of liability rules and regulations. Without an

understanding of the effects, it is difficult to address the auditing crisis, and to assess whether legal and regulatory changes are indeed necessary and if so, what they should look like. The dissertation attempts to address this caveat.

The dissertation is organized in two parts. Part I of the dissertation includes critical reviews of the literature in areas that are relevant to the subject: auditor risk, economics of auditing, audit regulation and auditor liability. Part II incorporates analytical chapters which are associated with the formal economic analysis of the impact of liability and regulation on audit demand and production, and are the proposed contribution of the author to the auditing literature. Throughout the analytical part of the dissertation the focus is on the vagueness (*ex ante* uncertainty) of what constitutes 'due care' for company directors when preparing the financial statements, and for external auditors when certifying these statements, and the impact thereof on audit demand and production. In the 'unrealistic' case where due care would be known with certainty (which would be the case should due care standards be clearly specified in the law) both directors and auditors would always comply with their respective due care standards, unless these standards would be extremely high. The analysis shows that the level of vagueness (uncertainty) about due care crucially affects financial statement and audit quality, and sometimes in unexpected ways.

A first contribution of the thesis is the analysis of the joint impact of auditor liability and professional audit standards on audit quality production in a framework of vagueness about auditor negligence standards. The analysis of audit quality production is general, in the sense that a number of alternative legal scenarios are considered, and therefore hopes to be of relevance to various legal environments. A number of propositions about audit quality production for alternative legal scenarios (with and without restrictions on liability) are derived, and a set of corollaries about the social efficiency of these scenarios are drawn. Some major conclusions from the analysis are that a decrease in vagueness in auditor negligence standards may have a positive effect on audit quality, but could also have a negative effect, depending on how vague the original negligence standard was. Professional audit standards always have a positive effect on audit quality, given that they are written such that they change auditor beliefs, whereas mechanisms to restrict auditor liability have a negative effect on audit quality. The latter may however promote socially efficient auditing behaviour in situations where there is overproduction of audit quality. Finally, the joint use of liability restriction mechanisms and the introduction of additional professional audit standards may lead to a status quo in terms of audit quality produced and may therefore not be welfare improving.

A second contribution to the economics of auditing literature is a formal analysis of the 'liability avoidance' (insurance) hypothesis for audit demand. The problem is modelled in a leader-follower framework, where company

directors are the central actor or the leader who conjecture the external auditor's (who is the follower) quality production behaviour before making a decision on demand. From the analysis, propositions about the director's demand for financial statement quality and related external auditing services are derived, given the liability rules applying to them and to the auditors. Propositions about the effectiveness of mandatory audit requirements in safeguarding an acceptable level of financial statement quality are also derived. Some major conclusions from the analysis are that vagueness about the due care standard for auditors (and hence audit quality production behaviour) does not affect the director's demand decision (and hence that 'liability avoidance' rationales for audit demand are irrelevant) if the due care level for directors is not too vague. Further, mandatory audit requirements are only effective in safeguarding an acceptable level of financial statement quality under limited circumstances (for example, when due care levels are certain).

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The dissertation supervisor was Professor Anthony Steele. The dissertation was defended on 27 January 1995. The address for correspondence is: Catholic University Leuven, Naamsestraat 69, 3000 Leuven, Belgium.