Effect of Audit Regulations and Litigation on Auditors' Liabilities: A Subjective Approach

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Abstract
In this review, we take a theoretical look at how audit regulation and litigation have changed the liability landscape for auditors. In order to increase transparency and trust in financial reporting, auditing is a crucial public service. The auditing industry has received a lot of attention, some of it unfavourable, as a result of scandals like Enron and WorldCom in the United States or Parmalat in Europe or Cadbury Nigeria PLC. People all throughout the world have spoken out to demand better audit quality. Due to this, adjustments have been taken to increase audit openness and auditor accountability. However, there is still a need for enhancements to be made. This leads to inquiries into the different requests and concerns, and the extent to which they may be fulfilled (auditors' responsibility). Auditors are put in a difficult position since they are expected to please both shareholders and other interested parties. When it comes to the auditor's responsibilities, each stakeholder group has different priorities and requirements. Several ideas have been developed since the field's inception that attempt to pin down audit's precise purposes. Findings of the study has revealed that regulations and litigations have significant positive and adverse effect on auditors' liability and the expectations of the stakeholders as a result of audit expectation gap. The conclusion here is that, audit regulations and litigation have a significant relationship with auditors' liability. Irrespective of the outcome of audit litigations as a result of auditors' negligence to duty, there is an impact on the affected organizations. Therefore, auditors should carefully practice in accordance with national and international auditing standards in order to sustain the good reputation of the organizations.

1. Introduction

Concerns regarding auditors' possible criminal liability grow by the day in the public's mind. To boost trust in a company's financial accounts is the primary role of an external auditor. When doing their jobs, they have the same potential for civil and criminal culpability as any other professional. Without independent and trained auditors, many cases of fraud throughout the world would have gone unnoticed, and that doesn't even take into consideration the ones that have yet to be discovered. Auditors are expected to use reasonable care in performing their duties, as outlined in one code of professional conduct (Minlei & Dan, 2022). The "prudent

person" idea refers to the necessity of exercising due care. An audit of financial statements requires the auditor to have the necessary skills and knowledge, to apply those skills and knowledge with due care and diligence, to act in good faith and with integrity, and to be subject to liability only for acts of negligence, bad faith, or dishonesty (Jeff, 2023) and not for simple mistakes in judgment.

There are several scenarios in which a business owner may find themselves embroiled in litigation. Maybe you're being sued by a rival business or a consumer who claims they had their rights infringed. The effects of a lawsuit are negative regardless of the cause for it. Litigation has the potential to have far-reaching effects on businesses throughout the world. To begin, company litigation has the potential to eat up a lot of money and take up a lot of time. Both small and large firms can be harmed by the time and money spent defending themselves in court. Furthermore, your company's reputation may be at stake if legal action is taken against it. If you lose in court, your company's reputation could suffer, possibly resulting in lower sales or other problems down the road. Therefore, litigation has the potential to harm vital commercial connections. Business partners, firms, workers, and other important connections might be irreparably damaged by a conflict (Wiley, 2017; Al Qadasi & Abidin, 2018).

Avoiding legal trouble is usually preferable if you can. However, in many situations, this is just not possible. With so much at risk and so many strong feelings involved, business litigation may be extremely stressful. Confidence in how you manage the litigation, though, may help alleviate some of your worries (Wiley, 2017).

Losses incurred by audit companies as a result of litigation, whether through out-of-court settlements or the payment of damages to the affected parties, can be substantial both monetarily and in terms of reputational capital. Theoretical research suggests that auditors will increase their oversight of their clients' financial reporting processes and the ensuing financial statements if they perceive a higher danger of litigation (Mahfuz, Gus, & Barbara, 2020; Yu, 2011). Several empirical studies show that an increase in the likelihood of litigation against auditors improves the quality of audits and financial reporting in a variety of contexts. DeFond and Zhang (2014) point out that the question of whether the net benefit of increased auditor lawsuit risk is favourable or negative complicates the ability to draw firm conclusions from these empirical investigations. In this study, we test the hypothesis that increased auditor lawsuit risk leads to better financial outcomes for client organisations. If the answer is yes, then, all else being equal, these customers get a significant economic benefit from the increased risk of litigation against the auditors.

This article will explain why the danger of lawsuit against auditors has a negative impact on company performance. If the literature is correct and increased auditor litigation risk enhances financial reporting quality, then higher quality financial statements would be of more use to creditors in vetting potential customers and determining whether or not borrowers could produce sufficient cash flows to service debt. Customers have less uncertainty about the liquidation value and collateral value of their assets when audit quality is better, as discovered by Amiram and Owens (2018). Debt payment expenses for government organizations can be reduced as a result of improved financial reporting quality (Christensen, Nikolaev, & Wittenberg-Moerman, 2016). Creditors can also file lawsuits against auditors for damages incurred due to subpar auditing

services. Creditors who suffer damages as a result of an audit failure now have more legal avenues open to them. For these reasons, financing to auditors' clients who pose a higher lawsuit risk is more appealing.

Numerous elements that affect or are outcomes of auditor lawsuits are identified and supported by evidence in the auditing literature (DeFond & Zhang, 2014). Because these elements are typically both sources of and causes of auditor lawsuit risk, it can be challenging to disentangle the impacts among them and draw judgements. The tests might not be reliably detected to the degree that these connections cannot be fully modelled or accounted for. Auditor liability to a third party under theories of privity, restatement, or foreseeability is determined by common law. Only the parties to a contract have standing to sue an auditor for ordinary negligence. Auditors' liability to identifiable third parties (such as creditors) is triggered by a restatement. All potentially affected parties have the right to sue auditors for negligence in foreseeability. In a nutshell, the auditor's legal obligation to third parties is narrowest under the privity standard, making it the lowest, while it is broadest under the foreseeability standard, making it the largest. Between these two tenets lies restatement. We will employ realistic exogenous shocks in auditor litigation risk (from Privity-to-Restatement-to-Foreseeability) across industries as identifiers to analyze the effects of a change in auditor lawsuit risk on client businesses' access to debt finance. Concerns about correlated omitted variables are lessened because these auditor legal liability shocks strike sectors exposed to heterogeneous local conditions in an unpredictable order (Jeff, 2023; Mahfuz, Gus, & Barbara, 2020).

2. Review of Relevant Literature

2.1 Conceptual Review

2.1.1 Sources of Legal Liability for an Auditor

Possible entities that may sue an auditor and the possible reasons for a lawsuit (Al Qadasi & Abidin, 2018).

Client: Breach of Contract. A corporation can take legal action against an auditor for any violation of the terms outlined in the engagement letter.

Financial Statement Users: Negligence. A major misrepresentation was not found because the auditor did not use reasonable diligence. Users of financial statements are injured if they cannot depend on the published financials free of unreasonable doubt when making an investment choice because a major mistake has not been identified.

Government Fraud: The government's gross negligence amounts to fraud. The auditor intentionally released a flawed audit. Financial statements for publicly traded companies are required by law to provide an accurate reflection of the company's financial performance. The government has a responsibility to safeguard investors, but if an inaccurate audit report is released, it cannot do so.

2.1.2 The Legal Liability of Auditors to Third Parties

To whom, exactly, do auditors answer? An auditor may be sued by anybody or just specific types of third parties? It is common knowledge that auditors must answer to two distinct sets of outside

parties: Both 1) those who are already familiar with the financial accounts and 2) those who may reasonably be expected to depend on the audited financial statements. Financial statements are only used by the company's actual shareholders and creditors. The names of all such individuals are typically recorded and kept by the company. Discretion is warranted while dealing with the second group of potential consumers. If the company is looking to obtain cash through the issuing of new shares or a loan from the bank, then investors and the potential creditor (i.e. a bank) would be foreseeable consumers. Even if the auditor doesn't know the specific user, they know the type: the client will use the financial statements to get bank funding or issue further shares (Jeff, 2023; Mahfuz, Gus, & Barbara, 2020).

2.1.3 Unjustified Lawsuits (Litigations)

Many lawsuits filed by third parties against auditors are baseless, despite the numerous opportunities for such claims. A third party's claim that the auditor should have known that its client (the firm being audited) was no longer a viable business would be without merit, because the auditor has no duty to ensure the client's financial health. The only duty of the auditor is to ensure that the financial statements are presented honestly in light of the established standards of evaluation. However, audit risk may also be associated with baseless legal action (Jeff, 2023; Mahfuz, Gus, & Barbara, 2020; Amiram & Owens, 2018) that fails to adequately account for the facts at hand.

An auditor may risk providing an unsuitable audit opinion on financial statements even if they do their duties to the letter. The core issue here is that an auditor may still find accounting problems after adhering to all of the relevant auditing standards. An auditor may select a random sample when conducting an audit. It turns out that the sample does not accurately reflect the complete data set. These lapses are not indicative of any willful deception on the part of the auditor. A valid basis for a lawsuit (an audit failure) exists, however, if an auditor fails to follow the general auditing standards established by the relevant regulating accounting organisation (Jeff, 2023; Amiram & Owens, 2018).

2.1.4 Successful Regulations and Litigations Against Auditors

It takes more than just putting together evidence and filing a lawsuit for a third party or client to successfully sue an auditor for negligence. The plaintiff is responsible for establishing the four factors below (Mahfuz, Gus & Barbara, 2020; Amiram & Owens, 2018):

1. There was a responsibility for the auditor to use caution (they needed to be a typical or reasonably anticipated end-user).
2. Second, the auditor failed to use reasonable care (an audit failure).
3. The plaintiff incurred a loss, and it is a genuine loss (not just a missed opportunity).
4. The plaintiff's loss was directly attributable to the auditor's carelessness.

If any of the above criteria is not met, then the lawsuit against the auditor will likely fail.

2.2 Theoretical Framework

The concepts of materiality, evidence, professional judgement, and auditor skepticism are all further refined by audit theory. Conceptual enquiry, understood as a specific type of philosophic research, is employed to this end. This paper therefore, is anchored on agency theory in conjunction with other theories as briefly highlighted here.

Agency Theory and Audit Quality

The origins of the audit may be traced back to agency theory, a valuable economic theory of accountability. An audit's primary goal is to increase public trust in the reliability of financial data. Understanding the evolution of the audit requires an appreciation of the principal-agent relationship typical of agency theory. Principals designate agents and give them discretionary power over certain matters. A financial audit, often known as a "Agency Audit," is a detailed examination of a company's books and reports to guarantee their correctness and credibility. The theory of agency is grounded in the law of agency, which is defined as a relationship established by contract or statute in which one party (the principal) gives another party (the agent) authority to act on behalf of and under the control of the principal in dealing with a third party (Wallace, 1980 in Volosin, 2017).

According to the agency hypothesis, businesses use auditors to protect their own interests while also looking out for those of their clients. When management makes decisions on behalf of principals like shareholders, employees, banks, etc., it is acting as an agent. For instance, both shareholders and management may want to maximize share value and company development, and both may be motivated by maximizing utility, but it doesn't mean the agent will always act in the best interests of the principal. As a result, agency theory weighs the benefits and drawbacks of using agents and principles. Delegation of decision-making authority to agents in modern organizations leads in a separation of ownership and control, which results in agency costs, which include the principal's monitoring expenditure, the agent's bonding charge, and any residual loss. In the absence of any friction between investors and management, agency fees are a net gain for shareholders. By assessing agency costs, the principal may evaluate how effectively the agent is fulfilling his commitments to the principal and can put measures in place to avoid any potential conflicts of interest. Because there are so many contracts and so many different parties (suppliers, workers, etc.) that supply value to the company for a certain price, for their own personal interests, it is the agent's job to optimize the contracts in order to maximize the value of the organization (Ogoun & Atagboro, 2020).

The foundations of agency theory are the following two assumptions: People are egocentric and typically prioritize their own interests over those of others. To sum up, the sole thing driving either the principal or the agent is money. Agents may act autonomously and have greater access to relevant data. Wallace (1980) suggested three theories to explain the widespread use of audits: the stewardship hypothesis, the information hypothesis, and the insurance hypothesis. The agency theory provides the most compelling justification for the stewardship concept. The idea explains how a company's leadership (the agent) should interact with the company's stockholders (the principles). Because he knows more about the company's worth, the agent is thought to have a significant edge over the principle. This situation is fraught with potential for shareholder and management conflicts of interest due to information-asymmetry. Managers and external

investors alike have an interest in hiring competent auditors (Hayes et al., 2005 in Volosin, 2017) so that principals may trust the information provided by management. With the audit function in place, users may have faith that the data they're using to make choices is accurate. Information-asymmetry can have a negative impact on a company's value, however external audits can help mitigate this impact (Soltani, 2007 as cited in Volosin, 2017).

Lending credibility theory is another popular idea that takes into account how the public views lenders. Important concerns in this theory also include the improvement of financial statement reliability and the reduction of information asymmetry. The firm's economic worth must be accurately reflected for the benefit of all stakeholders. The credibility hypothesis states that an auditor's principal responsibility is to boost investors' confidence in the reliability of financial accounts. Trust in an organization's financial records and leadership increases the likelihood that users will make educated choices, such as making investments or signing contracts. The financial statements must inspire confidence among stakeholders. The credibility of financial statements helps shareholders have trust in management and lessens the "information asymmetry" between shareholders and the company's leadership, both of which can have an impact on the activities of stakeholders (such as credit constraints granted by suppliers).

An auditor's principal function, according to the information hypothesis, is to guarantee the accuracy of financial reports. When dealing with uncertainty, auditing may be necessary for a variety of reasons. The first is that most people think an audit improves the trustworthiness of financial statement data and gives them peace of mind when making decisions based on such data. The fact that investors rely on audits to provide useful information for risk estimation is another possible reason (Soltani, 2007 in Volosin), even if the audit just confirms the investor's preexisting assumptions and opinions. According to the insurance hypothesis, clients seek out auditors because they provide an added layer of protection against potential financial loss.

According to the policeman hypothesis, it is the auditor's job to actively look for, report on, and stop any instances of fraud. However, auditors are responsible with delivering a reasonable level of assurance while being objective, honest, and fair in their assessment of the financial records. Auditing firms now under more pressure to detect evidence of fraud as a result of high-profile accounting catastrophes like Enron's. Since contemporary societies often rely on audit reports for analysis and decision making, users of statements may want auditors to be held liable for detecting fraud. While auditors are not required to find every case of fraud, improving their detection rate would go a long way toward earning the public's trust. Management and governance bear the major burden of preventing and detecting fraud inside an organisation; more attention should be paid to preventing fraud. However, while determining audit risk, the auditor should take into account the possibility of major misstatements as a result of fraudulent activity (Al Qadasi & Abidin, 2018).

2.3 Empirical Review

In 2020, Gus Mahfuz and Barbara Mahfuz analyzed data from a quasi-experiment to determine how auditor litigation risk affects a customer's ability to get bank financing. The study uses staggered state-level shocks to third-party auditor legal liability in the United States to examine

how auditor litigation risk affects client companies' access to private financing markets. We show that an exogenous increase in auditor litigation risk enhances both the likelihood and quantity of bank loans obtained by customers. We find that similar shocks lead to improvements in the quality of audits and financial reports for clients by reducing the number of accruals made, increasing the number of going-concern opinions made, decreasing the number of restatements made, and increasing the ability of accruals to predict future cash flows. We also find that the cost of borrowing decreases and the contractibility of customers' accounting numbers increases (as assessed by the application of loan covenants) when the danger of lawsuits against auditors rises.

Anthony Marteen and David Marteen (2012) developed a theoretical model of audit standards and auditor obligations. Auditing as a profession is highly governed. Licencing, professional standards, and legal responsibility all contribute to regulating the auditing industry. Losses suffered by those who rely on audited financial statements are subject to a standard of carelessness on the part of the auditor. However, there is sometimes a lack of clarity on what constitutes "due audit care." Legal studies show that auditors who comply with professional audit standards are not always fully protected against allegations of negligence. According to the auditor's point of view, the current situation is characterized by uncertainty (ex ante) around the 'legal' norm of good audit quality (as regarded by courts in the case of litigation). The implications of the ambiguity of legal norms on audit behavior are far-reaching and sometimes undervalued. Using concepts from the economics and legal literature (such as Kolstad et al., 1990; Shavell, 1984a, 1984b, & 1987; Calfee & Craswell, 1984 & 1986), this research examines the effects of ambiguity concerning auditor negligence on the generated level of audit quality and on audit fees. If an auditor is held to a negligence norm, the result will be an audit quality that is either too low or too high relative to what would be considered socially optimum. It is demonstrated that knowing the audit quality provided requires first comprehending the legal norm of "due audit quality." An insurance premium is included into auditing fees to account for this kind of ambiguity. Surprisingly, it has been shown that when there is a lot of ambiguity about the legal standard of care, it can actually degrade the quality of audit work given and increase the insurance component. When compared to alternative forms of risk management, insurance premiums may be the most economical option. The results of applying ex ante audit quality standards to a negligence rule with unknown outcomes are analyzed. Since ex ante standards have an indirect influence on ex post responsibility, they must be considered alongside 'legal' standards when analyzing auditing practices. If the appropriate legal standard of care were clear, auditing would be unnecessary. Audit standards will have an impact on auditor behavior and help explain the legal standard of care if it is unclear. A combination of ex-post care standards and ex-ante criteria that provide a lower constraint on allowable work is beneficial. Audit criteria would be worthless for operational decisions if they were based on the lowest common denominator and lowered to the level of minimum legal standards. When quality expectations are raised, the cost to the lowest-quality providers rises.

Minlei and Dan (2022) looked at how PCAOB-like laws affected auditors in different legal systems. This article looks at how the Public Company Accounting Oversight Board's (PCAOB) style of regulatory monitoring and legal duty affects audit quality and social surplus. We show when the influence of regulatory monitoring is more beneficial to audit quality and social surplus than the impact of legal systems. We also demonstrate that regulatory oversight is not a viable

substitute for the rule of law. To the best of our knowledge, our study is the first cross-legal-system examination of the relationship between regulatory oversight, the law, and societal surplus.

The ideas of audit expectations and the expectations gap were studied by Volosin (2017). This paper discusses the increasing need for audit services and the ensuing high standards for auditor performance. For regulatory organisations looking to safeguard the public interest, the legitimacy of required disclosure of financial accounts is of paramount importance. Because of this necessity, there will be increased interest in auditing services. Theories were developed at the outset of the auditing field to define and define the auditing tasks. When shareholders and management of a corporation have competing goals, the 'agency-theory' suggests that shareholders, as the less-informed side, would want access to information that keeps tabs on how management is carrying out those goals. One such kind of information would be audits of financial reports, which would provide shareholders third-party confidence regarding the state of affairs. Like the agency theory, the 'loan credibility hypothesis' posits that stakeholders' trust in management may be bolstered by the presentation of audited financial accounts. The 'principle of inspired confidence' proposes that stakeholders should expect management to be answerable for their investment in return. The 'policeman hypothesis' is the final one addressed; it limits the role of the auditor to the identification and prevention of fraud. Auditors are relied upon by a wide range of parties, and the ideas discussed here detail the range of services that auditors should give, such as safeguarding against fraud, identifying probable insolvency, reassuring financial well-being, protecting auditor independence, and making audit reports understandable. The audit expectations gap exists despite the seeming common sense of these expectations because of different viewpoints on the audit process. What the public expects the auditor to accomplish is not always in line with what the auditor may legally do. Several proposals were made to bridge the gap between what is expected and what is actually done, including the creation of legislation that outline audit functions, in particular the duty to identify and report mistakes and fraud.

Riyadh and Mawih (2021) analyzed how audit litigation and ownership structure affected the audit quality of Big 4 and non-Big 5 audit companies in Oman. The modified audit opinion is employed as a surrogate for audit quality, and the percentage of shares held by big shareholders and the percentage of shares held by minority shareholders (mainly of Arab [non-GCC] stockholders) are the principal metrics of ownership structure in the research. Firm age, size, risk profile, and activity type serve as independent factors in this analysis. Analysis and interpretation of the data is performed using descriptive statistics, correlation, regression, and the T-test. Based on data from 107 companies listed on the Muscat Securities Market (MSM) between 2013 and 2017, we find that audit litigation has a significant impact on audit quality for Big 4 audit firms but not for non-Big 4 audit firms. In addition, the results demonstrate that the risk of legal action is the same for both Big 4 and non-Big 4 audit firms.

3. Findings, Conclusion and Recommendation

The study, following the subjectivist approach, reviewed extant literature about the effect of regulations and litigation on auditors' liabilities. Findings have clearly shown that audit regulations and litigations have both positive and adverse effect on auditors' liabilities and the expectations of the stakeholders of various organizations globally. The study was anchored on

several audit theories such as agency theory, stewardship hypothesis, credibility theory, policeman theory. The conclusion here is that, audit regulations and litigation have a significant relationship with auditors' liability. Irrespective of the outcome of audit litigations as a result of auditors negligence to duty, there is an impact on the affected organizations. Therefore, auditors should carefully practice in accordance with national and international auditing standards in order to maintain the good reputation of the organizations.

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