

LEGAL ISSUES CONCERNING AUDITOR - CLIENT RELATIONSHIP

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ABSTRACT: *Based on the contractual clauses and not only, the legal perspective of the relation is also very much of interest when liability occurs. The aim of this paper was to analyze the different types of legal issues concerning the auditor client relationship. As beneficiaries of the audit services, clients tend to resort to the means that aim to attract auditor's liability in case unprofessionalism or misconduct is of reasonable presumption from client's perspective. Moreover, the auditor can be the subject of different type of liability, enforced by the state, the criminal liability, as opposed to the civil liability that could be enforced by the client. On the other hand, the natural reaction of the auditor is to make use of legal provisions and clauses meant to protect himself by limiting liability. Therefore, almost every aspect of the auditor-client relationship also has a legal perspective as the very first interactions during the audit mission are predetermined by the contract signed by the two parties.*

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1. INTRODUCTION

Taking interest into this matter is directly generated by the increase in the appearance and recurrence of legal issues and lawsuits regarding auditors and the practice of the auditing profession. For example, a consistent change has been noticed in the United States of America where the auditing market has suffered major changes starting with the late 1980's. According to Dye (1993), the most significant change has been regarding the number of litigations having auditors as a subject which has increased significantly. One observer concluded regarding the accounting market that in 1987 "more suits have been filed against accountants in the past 15 years than in the entire history of the profession" (Mednick, 1987). Only five years later, in the United States, the total value of the lawsuits targeting auditors summed up to approximately \$30 billion (Dye, 1993). This period is relevant of taking to notice as it marks the beginning of a litigation phenomenon or practice at a much larger scale than isolated cases as it has been before that moment. Therefore, there is need for more focus on the subject as this consists in a professional risk for the auditors.

There are various situations and factors that could lead to the apparel of legal issues unfolding in the context of the ACR. One of the most important factors of influence of the ACR, independence, is directly related to auditor's legal liability (Dye, 1993). Auditors are legally responsible not only to the management, but also to shareholders and stakeholders as well. "In the absence of legal liability, one would not expect auditors to be good watch-dogs for the owners of firms" (Lee&Gu, 1998). No liability tends to translate over time, in case of many, in no responsibility.

It is of the essence of auditing profession that the auditor is responsible for providing reasonable assurance regarding the veridicity of the audited financial statements. Having no liability could affect severely the potential outcome from quality point of view. Moreover, the mixture of low balling and auditor legal liability is an effective method for avoiding the

marketplace collapse. This method involves the auditor to set up a bail bond with the owner, to be forfeited if she is found (not necessarily convicted) to have colluded with the manager (Lee&Gu, 1998).

2. JURIDICAL PERSPECTIVES AND DYNAMICS OF LEGAL LIABILITY SYSTEM

The economic ecosystem depends on the confidence that the investors can get when analyzing the opportunity of placing their funds in various entities in some economic sector. An issue on this area is linked to the fact that “the legal liability climate in some countries is causing an increasing number of large firms to avoid high-risk audit clients and even entire industries ... Without audited financial statements ... start-up businesses may not be able to generate shareholder confidence. As a result, economic growth can be stymied.” according to the statements of International Federation of Accountants (1995). The issue identified by the International Federation of Accountants is permanent over time as legal climate in some countries are continuously behind the needs of real market situation. The fact that the auditor is legally responsible for a potential audit failure translates into a indirect assurance towards outside sources, providing greater chances for the entrepreneur to finance the company from external investors at lower costs (Laux&Newman,2010). Naturally, this leads to moral dilemma for the auditor whether to put more emphasis on properly evaluating the task. The auditor’s motivation to appreciate the client varies not only on the legal obligation setting, but also on the audit fee obtainable by the businessperson: the higher the fee, the superior is the value of fetching informed around customer-type (likened to remaining uninformed and refusing the customer) and the higher is the auditor’s effort devoted to the estimation of the procedure (Laux&Newman,2010). Basically, the auditor is in need for contextual incentives, in this case of a financial nature, in order not to reject the client based on lack of information, but to make a better research regarding client's specific and needs.

Laux and Newman (2010) show that there is a direct influence between the levels of potential damage payments regarding any of the litigation components and the quality delivered in that certain audit resulting in an increase of the last along with the equilibrium audit fee. The previous relation between the three component is also empirically sustained by Seetharaman et al. (2002), Venkataraman et al. (2008) and Choi et al. (2008). Theoretically, if the context could lead to a greater anticipated damage cost on behalf of the auditor, the entrepreneur has to compensate this with an increased audit fee thus maintaining a higher interest on the auditor side and preventing an increase in the rejection rate. If shareholders anticipate a greater loss award from the auditor in case of an audit failure, then investors are willing to give the entrepreneur better financing conditions. “The entrepreneur, in turn, can use these savings to compensate the auditor for the increased liability exposure. We call this the *triangle effect*” (Laux&Newman,2010). We can conclude the fact that this relation of cascade influence tends to benefit all the parties: the auditors even if they are exposed to potentially higher damage payments also received higher audit fees, the investors perceive a higher assurance and in exchange are willing to ease the financing process and the entrepreneur also benefits from improved financing process transposing this to the need to overcompensate the auditor's fee without generating an increased cost for the company.

Legal systems across countries are not always stable and are always in constant change in the mission to adapt, and therefore, this may result in a shift in the system's strength. The previous mentioned shift could have a dual effect, increasing the potential litigation frictions on one hand and influencing the expected damage payments on the other hand. The two opposing effects, could lead, depending on which tends to manifest more, to either a decrease or an increase of the probability of rejecting a client. Laux&Newman (2010) describe the

relationship among the strength that lies in the legal liability system and rate of client rejection as being U-shaped. There is evidence in literature (Dye, 1993) that a significant part of the formal models of auditor-client interactions analyze to what extent legal liability system alterations could influence the motivation of an auditor to provide high quality audits. Laux&Newman (2010), base their relation for analysis starting from the influence that changes in legal liability system influences the efficiency of investment decisions.

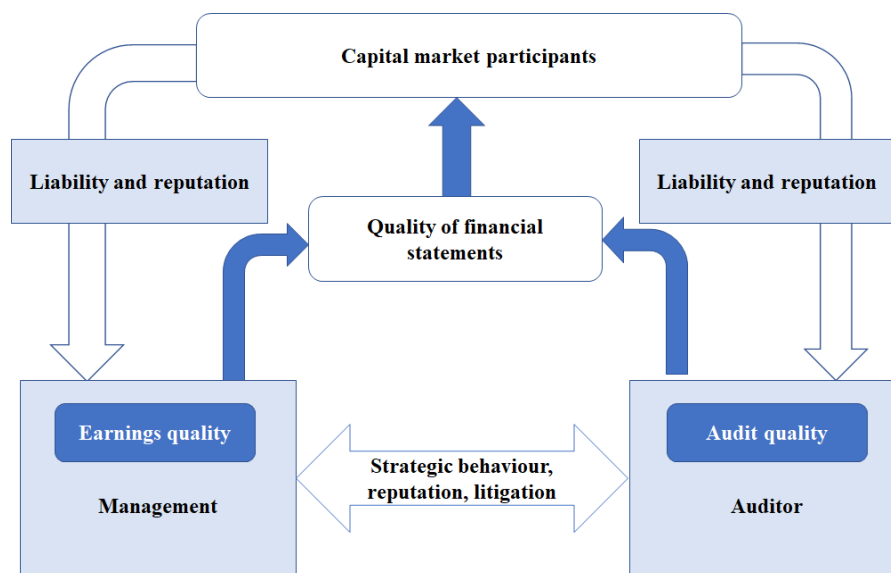
The legal liability system, as mentioned before, is a complex mechanism that is all the time in a constant change in order to adapt to market evolutions, being variously stronger or weaker over different period in time. The liability environment can be described from a three component perspective:

- the severity of the legal rule, described as the probability that the auditor is sued and found liable in case of an audit failure,
- possible damage payments from the auditor to investors,
- other legal action costs experienced by the auditor, regarded as legal action frictions, such as antagonisms costs or damage of reputation (Laux&Newman, 2010).

From a different perspective the liability system is a direct influencer of the quality of an audit. There are two indicators for the added value of an audit:

- the *informational* indicator showing the extent to what an audit provides supplementary information in order to help the entity take better decision on how to allocate resources;
- the *liability* indicator which represents the potential value of the claim that could be received by the customers of the financial reports and audit report in case of a proven audit failure (Dye, 1993).

Figure 1 Auditor Liability Dynamics



Source: Beckman&Nass, 2007

The dynamics of liability mechanism is represented by Figure 1. The ideas that can be drawn from this representation of auditor's liability is that audit quality is directly linked to the existence and extent of liability. Moreover, the input of the participants in the capital markets does influence liability. "These participants are more willing to sue when quality of financial statements is poor, whereas an auditor's reputation falls or stands with the number of claims

inflicted upon him” (Beckman&Nass, 2007). Further analyzing the Figure 1 it can be observed that audit quality is also determined by the interaction among the auditor and the client. The auditor is to some extent dependent on the management as it is one of the information provider, either it is of financial nature or linked to that.

Therefore, there is need for equilibrium as it only in the right proportion of value that liability brings the most benefits, without determining client rejection or a too bigger risk for the auditor. Neither in one of the edge situations does auditor liability reaches it's goal, but it is when the potential value is correlated with the audit company size, the audited entity and the contextual environment itself. Finally, there have to be considered the most advantageous report between liability and standards combinations, all together with measuring the auditor's potential to increase or reduce his own wealth through either merging or breaking up outside capital (Dye, 1993). Basically, there is need for evaluating also the personal interest of the auditor in the equation, resulting the fact that the most efficient rules have proven to be the ones that bring the auditor closer to respecting the standards that are applicable in the matter. Many liability regulations are proved to be comparable to regulations that correct very severe penalties on auditors who are detected to have violated the standards. When auditors can adjust their capital by increasing outside capital, they do so only if they would violate the standards out of the profit of the investment and with the capital they have an incentive to comply with the standards. When auditors can change their wealth by breaking up, it is shown that they prefer either not to break up at all or else to break up into as many firms as their wealth permits (Dye,1993). An auditor would decide to alter his wealth as a natural response of harsh liability rules that could potentially impose on him in case of standards violation. The target is to protect his wealth, the only matter that can vary is the manner in which he chooses to do so, either with the help of external capital or by devising into an optimal number of companies so that he reaches his goal.

Consequently, differences in legal systems set different requirements for the auditor and audit report, thus, developing different potential liabilities, from type and extent perspective. Regulations such as auditing, or accountings standards have dissimilar functions in financial reporting (Simunic et. al., 2017). According to previous research (Schilder&Knechel 2010) the scope of performing audits is to increase users' reliability regarding the information provided by a certain company in accordance with a set of accounting standards, whereas auditing standards aim to serve as a point of reference considering the objectives that have to be reached in an audit and the quality level in which this happens. Of course that regulating bodies have continuously tried to make the applicable regulations more uniform from country to country by developing unitary standards, so that potential exposure and liability for auditors is more predictable. Unfortunately, there are unseen and natural barriers in this process. For example, only the countries that have a comparable legal system will tend to adopt and apply ISA, even though they will bring or not slight changes to the standards (Simunic et. al., 2017). Moreover, this is of key importance because in the end the level of audit quality is a joint resultant between the characteristics of legal systems and auditing standards (Simunic et. al., 2017). There is proof in existing research that legal institutions do generate a certain influence with the downside that guidance linking a particular legal system to highest audit quality lacks (Francis&Krishnan 2002; Lee&Mande 2003; Choi et al 2008, 2009).

As mentioned before, with the unseen increase in the early 90's in litigation against auditor, leaders in domain exposed the need for supplementary research (Palmrose, 1991; Arthur Andersen et al. 1992) and the researchers did not fail to respond with various studies even until recent (Donelson et al. 2014). The scope of these studies was to reveal the causes of litigation and the needs, risks and worries of both actors. It has been stated that “most businesspeople, when questioned regarding which risk doubts them really, will frequently talk about reputation (Power, 2004). This is also applicable for auditors as in the auditing profession

reputation is of most important. Therefore, auditors have a primary need in finding and applying mechanism for limiting liability to protect not only their assets, but also their professional reputation. In case of audit-related claims, clients usually tend to appeal to lawyers in case auditor's conduct is not only of professional body competence but could consist in a lawsuit. Maksymov et. al. (2020) shows that when initiating an audit-related claim, in case attorneys step in, they take into consideration a dual perspective, both from their client's and their own professional reputation and financial potential risk, even from the early stage of litigation until a resolution is pronounced in the case.

Therefore, for a better understanding of an auditor's liability, an overall perspective upon the types of liabilities to which auditor might be exposed is needed.

➤ Types of auditor liability

During the practice of their profession, the auditor are the subject of general regulations and specific ones as well, such as accounting and auditing standards. When obliged to apply and work after the general and specific regulations, any breach of the previsions, among with the ethics code auditor must follow, could lead to liability on their behalf. Such as any other professional categories, for example architects, physicians and others, auditors are also liable (Palmrose,1991). Their liability comes at different levels and stages depending on the type of regulations and provisions that disrespected or breached. In case of professional bodies' provisions and ethics code breach, the auditor could face professional sanctions (Abdulsalam, 2020). Furthermore, in case the auditors breach regulations or contractual clauses between individual and/or organizations they could be subject of civil offences (Callen & Fang, 2017). On the other hand, the harshest case, when the sanctions could be on several levels including professional, financial and rights, is when auditors breach regulations that are directly enforced by government, thus arising disputes among entities or individuals and state that could lead to criminal offences (Palmrose,1991; Măgdaş & Fülöp, 2019). There is need for detailing each type of liability so that a proper further analysis of the protection mechanisms and liability limitation methods.

Each of the five identified categories of liability is based on the different set of regulations which, in case of knowingly or involuntary breaking, could lead to specific sanctions on behalf of the auditor (Callen & Fang, 2017). The types of liability, for better overview, are exposed in the figure below (Figure 2).

Figure 2 Categories of Auditor Liabilities



✓ *Liability for Professional Misconduct - Professional Sanctions*

Provided the conduct of a certain auditor is not according with the professional requirements there is case for professional liability, usually enforced by the professional bodies in which they are members. This type of liability is the least severe one in most of the cases, but it can be linked with any of the other types of liability in the situation where regulations that could lead to that have been breached. There are several sanctions that can be applied to an auditor when professional misconduct is proven (Callen & Fang, 2017; Abdulsalam, 2020). For auditors, a result of professional wrongful conduct across disciplinary procedures can result in interruption or exclusion from the profession (Mohan&Raj, 2021). Depending on the severity of the misconduct and on a relapse case or not, the professional body could also issue a written warning before moving on to the next measures as severity. The suspension consists in the prohibition to temporary practice for a specific period of time, which is automatically lifted when the term expires in case no other misconducts have occurred meanwhile. The most severe measure that a professional body could apply is the expulsion from the profession which forbids the auditor to ever practice again. This type of measure could also be a resultant of a criminal conviction of the auditor.

✓ *Civil Liability*

When breaching regulations or contractual provisions that are enforced between individual and/or organizations, auditors are civilly liable (Abdulsalam, 2020). The previous mentioned liability could apply also under the common law on one hand or a statutory law liability on the other hand. "Common law liability arises from negligence, breach of contract, and fraud. Statutory law liability is the obligation that comes from a certain statute or a law which is applied to society. The scope of both common law liability and statutory liability has been expanded to include certain third parties, mainly the foreseen or foreseeable users of audited financial statements" (Lessambo, 2014).

From another perspective, civil liability can be treated from another perspective and make the object of contract law provisions or law of tort regulations. Basically, the two different categories of law regulations split the auditor's liability based on the category to whom they are accountable: either to the client or to third parties (Shu, 2000; Callen & Fang, 2017). In the first case, liability towards the client based on contractual law regulations might emerge from breaching the contractual obligations (Callen & Fang, 2017; Măgdaş & Fülöp, 2019; Abdulsalam, 2020). This translates into the case where an auditor could fail to meet all that he has signed to in his engagement letter, thus providing to the shareholders occasion for litigation in order to seek remedy. The contract is one form of agreement which together with the audit engagement letter contain and define the agreed terms of the specific audit and include at least the following:

- the aim and scope of the audit of the financial report;
- the responsibilities of the auditor;
- the responsibilities of organization;
- recognition of the appropriate financial reporting framework for the realization of the financial report;
- note to the anticipated structure and content of any reports to be realized by the auditor and a statement that circumstances may arise in which a report may differ from its expected form and content (Lessambo, 2014).

Secondly, when law of tort is in place auditors might face a law suit in case they do not respect obligations that concern duty of care regarding a third party (Abdulsalam,2020). Basically, they could be subject of litigation for negligence provided one extra conditions is

meet: the auditor, through is faulty conduct, has generated a certain form of loss on behalf of the third party.

✓ *Liability under Tax Law*

This minor category of liability on behalf of the auditor derives, indirectly, from certifying financial reports that are eluding the taxes owed to the state. Basically, the auditor is not the author of the fiscal crime, but auditor's client could be the potential author (Măgdaş & Fülöp, 2019). Therefore, the auditor, by certifying the financial reports, statements or account certifications that he either knows to be false or due to negligence does not properly verify the statements and financial reports, is also liable and might be charged. Even in the case where the auditor had no knowledge of the client's eluding intentions, client's carelessness would be an positive defense only in cases when a client has contributed to the auditor's failure to achieve his agreement and to report the fact (Lessambo, 2016) so the auditor is still potentially liable. He, indirectly, participates in sustaining, knowingly or not, the fiscal crime conducted by the client.

✓ *Liabilities towards Third Parties*

The entity, which is auditor's client, is not the only beneficiary of the audited financial report as many other rely on them. Based on the audited financial report and it's apparent reliability, there are several parties that might engage is various forms of collaboration with the entity. Therefore, the actions that are triggered by the interested third parties could be headed against the auditor only based on the law of torts (Lessambo, 2016). Among those tort parties there can be creditors, tax authorities, prospective shareholders, and many others. Out of the two fundaments for auditor's liability, negligence and fraud, only one of them applies regarding tort parties (Măgdaş & Fülöp, 2019). As the auditor has no binding contract with tort parties and, therefore, no obligations towards them, negligence could hardly make the case for liability towards tort parties. So, basically, the most often met case in which the auditor could be held liable towards tort parties is in case of fraud, even though the auditor has no legal binding contract with the tort parties. In any case, tort parties must prove a certain form of loss generate by the auditor's conduct. There have been established over the years, in practice several elements that a third party must make proof of in order to file a law suit against an auditor:

- the existence of a duty of care;
- the failure to provide the duty;
- the causation;
- the damage.” (Lessambo, 2016).

Only when all the above elements are all together proven by the third party the law suits is admissible against an independent auditor.

✓ *Criminal Liability*

Besides any professional specific regulations that auditors are obliged to comply with, they also have to apply and respect all laws from the country in which they operate. Throughout the program of audit, an auditor may execute several offences and be held criminally liable. “That might be the case if: (i) the auditor knowingly makes, permits, or directs another to make materially incorrect entries in a client's financial statements, (ii) fails to correct statements that are materially false or misleading when the member has such authority, and (iii) signs, permits or directs another to sign a document containing materially false or misleading information” (Lessambo,2016). Breaching the laws that are issued by the state while they conduct their activity could draw upon them criminal persecution for acts like fraud or trading based on

inside information. There are several examples of situations that could lead to criminal liability for the auditor, without excluding others such as: “the false statement, mail fraud, aiding and abetting, conspiracy statutes” (Lessambo, 2016). Moreover, criminal prosecution could be made against auditors in case they either with full knowledge of their acts or from irresponsibility regarding their acts have issued an audit report that is unsuitable for the specific case. The result of criminal conviction could be either a criminal fine, a penalty involving deprivation of liberty or a combination of the two. Moreover, in case the criminal offences brought to the auditor are proven and they result in a conviction, the judge could decide to apply complementary penalties. These complementary penalties could consist in forfeiture of rights, prohibiting the auditor of practicing the specific professional activity in which he committed the crime for which he is convicted for (Măgdaş & Fülöp, 2019). The forfeiture of rights could, depending on the severity of the crime, be set for a shorter or longer period of time and could impact partially or totally the practice of auditing profession.

3. WAYS FOR LIMITING AUDITOR'S LIABILITY - ASSET AND PROFESSIONAL STATUS PROTECTION

As any action is followed by reaction, the auditor also, has the natural incentive of reacting to potential liability that could influence his assets and professional status. As soon as litigation started to multiply and the value of the damages in the lawsuits reached a more consistent amount as describes in the previous sub-chapter, the methods of protecting asset and professional status for the auditors started to emerge. Thoman (1996) concluded that the increase in the value of the damages leads to a reduction of the competition for clients amongst all auditors; furthermore, one of the direct choices of the auditor would be to start approaching a more conservative reporting method instead of increasing his work load, aiming for reducing his legal exposure.

There are multiple implications that start from auditor's liability and which diverge in several branches of ACR and dynamics. Previous research has shown over the years that liability impacts, for example, audit quality (Schwartz, 1997; Smith&Tidrick, 1998; Abdulsalam, 2020). Moreover, given a certain legal system literature provides proof that audit quality is also influence by auditing standards (Dye, 1993; Abdulsalam, 2020). Auditing standards enforce rules for auditor's which can serve as basis, in case of breaching the rules, for auditor liability. It is widely proven that starting from the variation of legal systems and, consequently, litigation risk to which the auditor is exposed the outcome is consistently differently from one country to another (Mednick, 1987; Arthur Andersen & Co. et al., 1992; Seetharaman et al., 2002; Francis& Wang, 2008; Choi et al., 2008, 2009; Abdulsalam,2020). This is one of the main reasons for the difficulty in providing a unitary solution for liability regulations and enforcement on one hand and, mechanisms for limiting the potential liability. Nonetheless, there are two sides to the coin: on one hand the potential litigation risk that hovers upon the auditors could be constructive motivation in providing audits of high quality, but on the other hand a too highly disproportioned cost exposure in litigation could lead even to bankruptcy for the audit companies (Honigsberg et. al., 2020).

That is why having the right proportion of liability is important. The goal is to obtain the maximum of benefits from auditor's liability without sliding to the point where the benefits start to decline to leave place for the downsides. Even though there are proven downsides of to high liability on behalf of the auditors, there is still resistance from the regulators towards the attempts meant to limit auditors' liability based on the assumption that there is direct correlation between limiting liability and lower quality in financial reporting (Louis et. al., 2019). In order to maintain a proper equilibrium of liability, as there are rules that enforce liability, there is need for mechanisms that, from the other perspective, the auditor's, limit the potential liability.

✓ *Liability for Professional Misconduct - Professional Sanctions*

The liability enforced by the professional bodies in cases of professional misconduct cannot be limited by any kind of clauses by the auditor. From the moment the auditor gains his statue of a active member of the professional body, all the rules and regulations that regard auditor's activity are applicable. Therefore, as long as the auditor is a member of the professional body and actively practices there is no other option to avoid liability for professional misconduct, but to comply with the applicable regulations and ethics code.

✓ *Civil Liability*

This type of liability is probably the most encountered in case of an auditor as it aims the compensation of the damage that was created or determined by the auditor through his actions or faulty conduct. There are several mechanisms for an auditor to attempt to protect themselves by limiting the extent of civil liability. It is natural and beneficial to maintain a balance in the situation of liability so that the equilibrium between protecting the client in case of damage or loss generate as a result of auditor's misconduct and not exceeding the proper amount of liability so that a to high risk for the auditor does not interfere with the audit quality and level of engagement, is maintained. Koch&Schunk (2009) state that in the analytic models in auditing there is proof regarding the direct influence that liability poses on the decision making process of the auditor. This decision making process includes audit efforts and decision on fees (Dye, 1993), auditor's reporting strategies (Thoman, 1996) and client-auditor acceptance (Laux& Newman, 2010). Therefore, the need for balance in the domain of auditor's civil liability is to high to be debated.

The primary method that could serve the auditors' purpose of limiting civil liability consists in contractual clauses that might be involved in the contract and commitment letter. Of course, this clauses are often subject of negotiation among the auditor and the client as they are on opposite points of view. Even though, such clauses are valid only to the extent in which they are reasonable, clauses that totally exclude liability on auditors' behalf or entirely protect the auditor against liability for guilt or fraud. Basically, this type of clauses is useful only in case their content aims to establishing a financial threshold to which liability could be enforced or exclude liability for auditor only in agreed and specific determined cases (Vera-Munoz, 2005).

Another method for limiting liability is through a professional assurance policy, which is already compulsory according to many countries' regulations. This policy implies a financial limitation of liability as in case of auditor generated damage, it will be the insurance company who will pay for the damage claim in case proven, provided the policy covers that specific type of misconduct. There is still some repercussion for the auditor as he will have to pay an increased value of the policy after the event. Moreover, in case the auditor acted in bad faith and there is proof of that, the insurance company might also try to litigate in order to avoid the obligation of covering for the damage generated by auditor's faulty conduct.

Of course that, due to the interest that this manner poses, among time there were different proposals regarding new mechanisms for limiting liability. Out of them, one of high interest and debate was to limit liability in accordance with either the size of the company or stock market capitalization (Doralt et. al., 2008). In the end, this mechanism was not considered to be suitable as it could lead to discrepancies between listed and not listed companies. To add to that, stock market capitalization is quite volatile and cannot serve as a predictable base for a liability limitation mechanism. Another highly debated approach is the one of limiting liability based on the audit fees, but this was not considered to be suitable as well considering that in order to satisfy the compensatory function of liability the bar should be set quite high (Doralt

et. al., 2008). Although this method could bring some correlation between the income and the risks to which the auditor is exposed, current practice excludes this approach as a method for limiting auditors' liability.

Mainly, the preferred method for limiting auditor's civil liability is the contractual one as this allows both the auditor and the client to meet their expectations regarding the extent of the potential liability. In principle, the risk of civil liability for auditors should be reasonably predictable in advance (Doralt et. al., 2008). This is high importance so that the auditors could fairly choose a the most efficient professional liability policy to both protect themselves and maintain a lower costs generated by civil liability risk (Doralt et. al., 2008). The main condition for liability limiting clauses is to be reasonable as the court could rule, if asked, also on the validity of such a clause, dismissing it provided it's content is far from what would be fair from both parties perspective.

✓ *Liability under Tax Law*

In case the auditor, indirectly, participates in sustaining, knowingly or not, the fiscal crime conducted by the client he is also liable. As this crime is enforced by regulations issued by the state which holds the main interest in investigating it, there is no clause or mechanism on behalf of the auditor in order to limit liability. The reason for this is that a contractual clause or any other private mechanism for limiting liability is secondary in rank when opposed to public tax law. The only manner in which the auditor could limit partially or totally liability under tax law is either to prove that it was client's conduct that determined the non-fulfilment of contractual clauses and obligation to report (Lessambo, 2016) or to manage to report the tax crime committed by the client.

✓ *Liabilities towards Third Parties*

Third-party liability occurs when interested parties trigger a lawsuit against the auditor based on the law of tort (Lessambo, 2016). The most common legal base for third-party liability is committing fraud by the auditor, but the interested party still must prove the existence of damage and the causal link between auditor's actions and the claimed damage. Obviously, the auditor has no binding contract with the third parties that could try to claim liability against the auditor for the mentioned cases. Although there is no direct contract between the auditor and the third parties, there is also no specific provision in the contract the auditor has with the client stating otherwise. So, basically, the most common and handy mechanism for the auditor in limiting liability towards third parties is to include a clause in the audit report the auditor has signed and released. The best manner to do so is to add an extra clause, after the paragraph containing the opinion, under the form of a liability disclaimer paragraph aimed against third parties in order to protect themselves from this type of liability. Also, the disclaimer paragraph mechanism could be combined, for more efficiency, with the professional assurance policy presented previously.

✓ *Criminal Liability*

Criminal liability has the same regime, as a basis, like the liability under tax law. It is the most severe form of liability for an auditor. Criminal liability for the auditor finds it's material basis in the criminal code which reunites all the norms that together represent the common law in matter of criminal law. The criminal code defines the crimes and the according sanctions. This is a normative act and it is situated from the enforcement power point of view at a higher level than any of the clauses and mechanisms that the auditor has at choice in order

to limit liability. Lessambo (2016) defines three ways of conduct on behalf of the auditor that could lead to criminal liability: directly creates false data in financial situations, knowingly fails to detect and correct them, signs, allows or directs to signing a document that has knowledge to contain false information. All of the previous mentioned conducts, as they are defined as crimes by the criminal code, a normative act at its basis, could not be limited in enforcement by private law clauses or mechanisms. Basically, the auditor has no option for limiting criminal liability other than the full compliance of the law.

There has been interest for the limitation of civil auditor's liability even at institutional level resulting in the Commission Recommendation 2008/473/EC stating the following proposals:

- “the establishment of maximum financial amounts of compensation (liability caps);
- the adoption of proportionate liability (instead of joint and several liability);
- an agreement between the auditor and his client to set a monetary cap or establish proportionate liability.” (Flores, 2011).

Even though public and governmental interest in the matter has been manifested auditors need to stay one step ahead and, in case the divergence with a client is heading towards litigation, use another protective mechanism to limit their financial damages, settling.

In the history of auditor-client litigation there have been high amounts of payments representing damages and claims based on negligence or acting in bad faith in order to gain at personal level. There are several examples of lawsuits with multi-million claims that have led to another phenomenon which is common in legal system, but in this case could be similar to liability limitation measure. This approach is called settling which implies an agreement among the two parties of a lawsuit. Two of the most well known settling cases in auditing are the 250 million dollars' settlement in 2005 made by Deloitte in the case of auditing the Fortress Re insurance company and the 229 million dollars' settlement in 2007 made by PwC in the case built against the auditors by the shareholders of Tyco. Another significant case from the amount of the damage was in 2011 when Deloitte and Touche were the target of a lawsuit arguing that due to ignorance, problems in the audited company, Taylor Bean, were not observed sooner. There are several arguments in favor of settling both in models of litigation (Lederman 1999) and audit litigation (Cushing&Gilbertson 2002), the most important advantage being related to the ability to manage risk so that the financial losses that are generated by preparing for the lawsuit are avoided, thus creating a short-term economy. Of course there are other setbacks which can be observed from the theoretical perspective in which “as individual audit litigation attorneys seek to settle cases to manage their risks, particularly the risk of reputational loss, the audit litigation profession as a whole maintains its public image and thereby its jurisdictional claim” (Maksymov et. al., 2020). The area of audit litigation exceeds in complexity the average lawsuit (Cushing&Gilbertson 2002; McCracken 2003; Guthrie 2004; Donelson et al. 2014) having a multitude of precedents in common law for example (Maksymov&Nelson 2017). There are several other aspects that differentiate the area of audit litigation from other litigation areas such as:

- the high number of legal claims that could exceed the professional insurance policy limit (Donelson et al. 2014; Peterson 2017);
- the potential high impact of such litigation that has prior led to demise of two of the largest auditing companies (Laventhol& Horwath and Arthur Andersen) having as a direct effect the increase in market share and control of the other major auditing companies;
- the existence and applicability of auditing professional standards and specific documentation to support it (Maksymov et. al., 2020).

Audit litigation attorneys have sufficient incentives to argue in favor of settling provided the fact that prolonged litigation could also affect audit company's professional

reputation. There are several reasons that motivate attorneys in making settling their first option as compared to litigation. Some of the reasons are specific to audit litigation area and consist in:

- attorneys generally perceive trial outcomes to have an element of surprise dreaded by both attorneys and their clients;
- audit litigation tends to involve particularly high claim amounts and litigation expenses on each side, which may jeopardize audit firms' solvency (Peterson, 2017) and make the litigants truly dread the potential for the unpleasant surprises discussed above;
- the outcomes of trials are publicly available and widely covered by the press, whereas details of settlements usually are not (Peterson, 2017; Maksymov et. al., 2020).

Based on the above reasons it can be concluded that both auditors and attorneys have to gain by leaving the trial as a last resort and primary opting for settlements. On one hand, attorneys provide to auditors a middle resolution, the settlement, which from auditors' and external perspective could be considered as a form of win, thus contributing to the public image of the attorneys. On the other hand, for the auditors and the auditing company, going to trial has a variable amount of unpredictability that could lead to prolonged trial expenses and higher damages which in the end might put at risk the very future existence of the audit company. Basically, as long as it is based on solid arguments and fair and reasonable positions, settling appears to be the best choice for both of the two parties that are headed for a lawsuit, the auditor and the client.

4. CONCLUSIONS

In the history of auditor-client litigation there have been high amounts of payments representing damages and claims based on negligence or acting in bad faith in order to gain at personal level. There are several examples of lawsuits with multi-million claims that have led to another phenomenon which is common in legal system, but in this case could be similar to liability limitation measure. This approach is called settling which implies an agreement among the two parties of a lawsuits. Two of the most well know settling cases in auditing are the 250 million dollars' settlement in 2005 made by Deloitte in the case of auditing the Fortress Re insurance company and the 229 million dollars settlement in 2007 made by PwC in the case built against the auditors by the shareholders of Tyco. Of course there are other setbacks which can be observed from the theoretical perspective in which "as individual audit litigation attorneys seek to settle cases to manage their risks, particularly the risk of reputational loss, the audit litigation profession as a whole maintains its public image and thereby its jurisdictional claim" (Maksymov et. al., 2020).

Based on the above reasons it can be concluded that both auditors and attorneys have to gain by leaving the trial as a last resort and primary opting for settlements. On one hand, attorneys provide to auditors a middle resolution, the settlement, which from auditors' and external perspective could be considered as a form of win, thus contributing to the public image of the attorneys. On the other hand, for the auditors and the auditing company, going to trial has a variable amount of unpredictability that could lead to prolonged trial expenses and higher damages which in the end might put at risk the very future existence of the audit company. Basically, as long as it is based on solid arguments and fair and reasonable positions, settling appears to be the best choice for both of the two parties that are headed for a lawsuit, the auditor and the client.

In all of the five analyzed types of liability on auditor's behalf (liability for professional misconduct, civil liability, liability under tax law, liability towards third parties and criminal

liability) there is need for equity and proportion so that the advantages previously mentioned, brought by adequate liability could bring, do not generate bigger disadvantages by disrupting the balance between auditor and client. Having regulations for the liability part it is only natural that there is a need for mechanisms allowing auditors to limit liability. Criminal liability and liability under tax law to a certain extent, are the only ones that, due to the enforcing power of authorities is involved, can not be the subject of liability limiting mechanisms. The type of liability where the client is opposite to the auditor is the civil liability, while stakeholders could be reimbursed in case of audit failure through the means of liability towards third parties. Even if auditors chose to make use of contractual clauses, professional assurance policies or disclaimer paragraph as liability limiting mechanisms it is important for the balance of auditor-client relationship that such case of unbalanced liability are properly identified and adjusted. In case the conflict between auditor and client turns into a lawsuit, settling has proven to be most effective for both parties, from professional and financial perspective.

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