



# International Journal Of Engineering Sciences & Management Research

## THE EFFECTS OF STANDARD OF CARE ON AUDITOR'S LIABILITY

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**Keywords:** Audit quality, Auditor liability, Consequence severity, Standard of care

### ABSTRACT

This study contributes to the debate by examining the legal liability implications of professional malpractices including negligence and non compliance with standards. That's why, we are interested in the auditor's work process to show the impact of the standards of care on his legal liability. Specifically, this study attempts to determine the minimum level of audit quality required to avoid legal responsibility for the audit failure, which is defined by the standards of care that the auditor must meet during the execution of his audit mission. These issues are investigated in the context of a auditor decision-making task, who evaluated whether an auditor should be held liable for non-compliance with standards of diligence and whether these standards are dependent on the consequences of the audit failure

### INTRODUCTION

The questioning of audit quality as a guarantor of financial information can be linked to the work of auditors, which can be inexhaustive. Indeed, it is widely accepted that the external auditors will assess procedures throughout their mission, internal control rules, and the degree of compliance of their work with standards which are generally accepted in this field.

Thus, during the realization of an independent audit for a client, an auditor must provide audit with due diligence, good faith and without fraud or collusion.

The minimum audit quality level required to avoid liability for audit failure, is defined by standards of care which auditor has to meet during the process of auditing. Therefore, the standard of care holds auditor responsible for performing an audit of a minimum quality level, and the performance of such an audit should relieve the auditor of the responsibility of subsequent audit failure (Causey and Causey, 1991). However, Kadous (2000) supports that diligence standards depend on the *ex post* observed consequences of audit failure. More exactly, she supports that the observation of serious consequences of audit failure (such as client's company bankruptcy, employees job loss, and investor and creditor losses) causes assessments of higher due diligence standards than observing less serious consequences. In this paper, we present in the light of attribution theory how the auditor's liability may be influenced by auditor's professional negligence behavior and /or contextual factors.

This study contributes to the accounting literature by fostering an understanding of how evaluators assess legal liability of auditors. The general finding in prior research (e.g., Kadous, 2001) is that evaluators (often appropriately) heavily weigh adverse outcome information when judging auditor negligence (Peecher and Piercey, 2008). However, our results demonstrate that legal liability assessment depends on audit quality that exceeds the minimum effort required from auditors to be judged non-negligent (standard of care).

### Background And Development of Hypotheses

#### Standards of care and auditor's liability

Attribution theory helps to explain the implication of the auditor can be attributed to internal factors related to the auditor and specifically to his quality of care. Internal attributions are controlled and dependent on the actor, so the auditor is responsible for his behavior (Heider, 1958). In this sense, the auditor's responsibility can be attributed to negligence resulting in his lack of diligence. In other words, when the auditor is accused of negligent conduct, judges must decide whether the auditor has exercised professional due care.

Judges and jurors are required to provide assessments based on the behavior and / or the decision-making process of the defendants auditors prior to the occurrence of the negative result (Devitt *et al.*, 1987; Sand *et al.*, 1997). Consequently, Causey and Causey (1991) indicate that jurors should evaluate the auditor's responsibility based on quality, rather than on the consequences of their work. However, a persistent finding in the audit

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literature shows that knowledge of the jurors of the adverse outcome associated with an audit failure affects evaluations of auditors (Lowe and Reckers, 1994; Kadous, 2000, 2001; Clarkson et al., 2002; Peecher and Piercey, 2008; Becker et al., 2009).

Auditors have the duty to exercise the usual judgment, care, skill and diligence employed by other auditors (Causey and Causey, 1991). Thus, the standards of care enjoy a sort of consensus in terms of certain behaviors of an auditor cautiously and reasonably diligent. Deviance from these standards or providing an effort less than that required by these standards is widely sanctioned. Indeed, standards of care hold the auditors responsible for performing an audit of a minimum quality level and performance of such an audit should relieve the auditor of liability for subsequent audit failure (Causey and Causey, 1991). Theoretically, auditors are liable for audit failure when their work does not meet the required standard of care of the average prudent auditor (Shaub and Thornton, 2014).

Therefore, judges in cases of audit negligence should check which level of audit quality, they evaluate standards of care in order to determine whether the audit effort was sufficient to avoid liability (Kadous, 2000).

Researchers usually design the standard of care as a multidimensional concept, develop standards according to the type and extent of work that an auditor should perform before judging the financial statement presentation fairness, and set the degree of professional skepticism that auditors must maintain during an audit (Anderson et al., 1993 ; Kadous, 2000 ; Shaub and Thornton, 2014).

However, their investigation is still very inadequate compared to their explanatory power that looks very promising. This invites us, therefore, to integrate them more in research on auditors' liability.

To do this, we focused on the constructs of the standard of care for which we have made the following assumptions:

H1: Compliance with the standard of care, apprehended in terms of type and extent of work of the auditor, and his professional skepticism tends to decrease the auditor's liability.

*H1.a The type of work influences the auditor's liability negatively.*

*H1.b The extent of work influences the auditor's liability negatively.*

*H1.c Professional skepticism influences the auditor's liability negatively.*

### Severity consequences and standards of care

Kaplan and Reckers (1985) have tried to understand the auditors' assessment criteria. Their experiment has evaluated the auditor's responsibility in case of an audit failure. Their results have shown that managers rely on external attributions to explain the audit failure in which the auditor's past experience never included bad evaluation.

Kadous (2000) notes that an increase in the severity of the client's loss increases the attribution of responsibility to the auditor. In fact, Kadous (2000) argues that the standard of care depends on the ex post observed consequences of audit failure. More specifically, it showed that observing significant adverse consequences of audit failure (such as client's company bankruptcy, employee job loss, and losses suffered by third parties external to the litigation) causes the evaluations of higher standard of care than observing less severe consequences.

Nevertheless, the results of the study of Sennetti et al. (2011) has found no evidence that the severity of the negative outcome increases the assignment of responsibility to the auditor.

When standards of care are defined *ex ante*, auditors can improve their chances of avoiding responsibility for audit failure by achieving higher quality audits. However, if standards of care depend on consequences, thus achieving higher quality audits can not protect auditors against any legal liability when the consequences of audit failure are severe (Kadous, 2000).

On the other hand, Shaub and Thornton (2014) has found that the assessment of the standard of care does not depend on *ex post* consequences of audit failure. These results are consistent with the model of Schwartz (1997), who argues that the increase in audit quality may reduce the legal responsibility of the auditor. Unlike Shaub and Thornton (2014), Kadous (2000) has found that when consequences of an audit failure are severe, jurors hold auditors to a higher standard of care than when consequences are moderate.

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Moreover, Dye (1993) provides that standards of care are independent of audit failure consequences. Under these conditions, auditors can improve the probability of avoiding responsibility by applying an additional audit effort (Schwartz, 1997; Radhakrishnan, 1999).

***H2 Standards of care assessments will be rather higher when audit failure consequences are severe than when they are moderate.***

### PARTICIPANTS

To assess auditor's legal liability, a number of studies use jurors members (Shaub and Thornton, 2014; Brandon and Mueller, 2006; Kadous, 2000, 2001; Lowe et al., 2002) or judges (Jenning et al., 2006). However, previous research has found that jurors tend to exhibit an outcome bias against auditors, which occurs because of the awareness of the outcome impairs jurors' ability to objectively judge auditors' performance on a past audit (Lowe and Reckers, 1994; Latham and Linville, 1998). Bias against auditors in a trial setting has also been attributed to the 'expectation gap', which refers to the difference between jurors' expectations of auditors and auditors' perception of their responsibilities (Lowe and Reckers, 2002; Arel, et al., 2012). To overcome these biases against auditors, we used in our study auditors as participants because the auditor is considered an expert observer of the audit process and able to understand sufficient evidence elements to differentiate audit quality levels and accountability that results.

### Variables and measures

#### ✓ Auditor's responsibility

Regarding the measure of the auditor's liability, two scales were developed that of Lowe (2002) and that of Jennings et al., (2008). Both scales present a one-dimensional structure. The instrument of Lowe (2002), unlike that of Jennings et al., (2008), has the advantage of being used and empirically validated by researchers other than those having originally developed (Shaub and Thornton, 2014).

To estimate the questioning of the responsibility of the auditor, the version of the scale of multi-item measure developed by Lowe (2002) was selected in this research.

Participants responded to the above questions on a 1-10 Likert scale, with lower values (higher) suggesting that the auditor was more (less) responsible for audit failure.

#### ✓ Standards of Care

Kadous (2000) used the paradigm of Churchill (1979) to measure the multidimensional variable of the standard of care. Participants were required to develop standards for the type and extent of the work that an auditor must perform before making a decision about the sincerity of presentation of the financial statements, and for the degree of professional skepticism that auditors should maintain during an audit.

Accordingly, Kadous (2000) has developed a set of items to measure the three standards of care (type, extent and skepticism). Most items have been newly built, but five were adapted from Anderson et al. (1993). Like Shaub and Thornton (2014), we adapt seventeen standards of care measures from Kadous's (2000) instrument that she considers important in measuring standards of care, and solicit comments from auditors to identify what standards of care that an auditor should perform during an audit. Participants respond using 11 points Likert scales (0 - completely disagree 10 - Strongly Agree) for each measure within the three dimensions (type, extent, skepticism).

#### ✓ Consequence Severity

We retain the measure developed by Kadous (2000) who has described the financial difficulties as moderate and severe. In this sense, Kadous (2000) described severe consequences of audit failure to design the bankruptcy of the audited company, the loss of employees of their jobs, and investor and creditor losses, and moderate to design significant losses for creditors, but the audited company was acquired by another company and continued to operate. In our study, responses will be coded dichotomous (0-severe, 1-moderate).

### Sample

We divided our sample into two sub-samples: a subsample for the exploratory phase, and a second subsample for the confirmatory phase. For the first exploratory phase, 120 usable questionnaires were sent to Tunisian auditors who were selected to be the object of principal component analysis. The 360 remaining questionnaires



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were voluntarily kept to the confirmatory phase, mobilizing structural equation models, requires a larger sample size. Thus, to achieve the confirmatory analysis we gathered 360 questionnaires constituting our final sample.

## EMPIRICAL RESULTS

### Empirical validation of the measures

Under the paradigm of Churchill (1979), two general steps can be broadly identified in the process of analyzing the quality of the instrument: an exploratory first step, followed by a confirmatory step.

Exploratory factor analysis aims to examine the reliability of a measurement scale via Cronbach’s alpha. According to Churchill (1979) Coefficient alpha is an indicator used to measure the reliability of the various items supposed to contribute to measure a phenomenon. Table I shows the results of the Principal Component Analysis (PCA). Reliability is satisfactory and certifies, therefore, good internal consistency of each scale. To clarify and validate the factor structure that emerges following the ACP, confirmatory factor analysis is required. The Confirmatory Factor Analysis (CFA) is a method of analysis of second generation data that applies a structural equation model to the measurement model. The advantage of this type of analysis consists particularly in the choice and validation of adequate factor structure of the constructs (Igalens and Roussel, 1998; Roussel et al., 2002). We examined the validity of the measurement model for each variable using AMOS 18.0. Table II shows the result of confirmatory factor analysis (CFA).

**Table I : Principal Component Analysis for the constructs**

TABLE I. ITEMS	DEPENDENT VARIABLE	TABLE VII.	CRONBACH'S ALPHA
TABLE II. FAILURE	AUDITOR’S RESPONSIBILITY FOR	TABLE VIII.	0,926
TABLE III.	INDEPENDENT VARIABLE	TABLE IX.	
TABLE IV. 5	TYPE OF WORK	TABLE X.	0,797
TABLE V. 8	EXTENT OF WORK	TABLE XI.	
TABLE VI. 4	PROFESSIONAL SKEPTICISM	TABLE XII.	0,918
		TABLE XIII.	
		TABLE XIV.	0,913

**Table II : Confirmatory Factor Analysis for the variables**

TABLE XV. VARIABLES	TABLE XVI. TEMS	TABLE XVII. 2	TABLE XVIII. 2/DDL	TABLE XIX. FI	TABLE XX. MSEA	TABLE XXI. FI
TABLE XXII. AUDITOR’S RESPONSIBILITY	TABLE XXIII.	TABLE XXIV. ,267	TABLE XXV. ,756	TABLE XXVI. ,962	TABLE XXVII. ,082	TABLE XXVIII. ,921
TABLE XXIX. TANDARD OF CARE	TABLE XXX. 2	TABLE XXXI. 45,864	TABLE XXXII. ,647	TABLE XXXIII. ,944	TABLE XXXIV. ,086	TABLE XXXV. ,967

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From the results of the adjustment indices scales, it can be found that model fits adjusts correctly to the data. Thus, the RMSEA is satisfactory; GFI, and CFI are satisfying since they have exceeded the threshold of 0.9; The report  $\chi^2 / df$  is very acceptable according to established standards. An examination of the standardized loadings shows that they are all significant which provides an evidence of convergent validity.

### Structural model and testing the hypotheses

Figure 1 shows the structural model developed based on the hypotheses in Section 4. As it is shown in Table III most of the GFI statistics are within (or very close to) the recommended value. The RMSEA, being 0.082, demonstrates a good model (Brown and Cudeck 1993). The report  $\chi^2 / df (= 3.389)$  is quite satisfactory and is below the threshold of 3 and 5 to that provided for complex models. Moreover, the other indices meet the standards commonly. Overall, with the result from Tables II and III we can conclude that the validity of the measurement model and the structural model has been established.

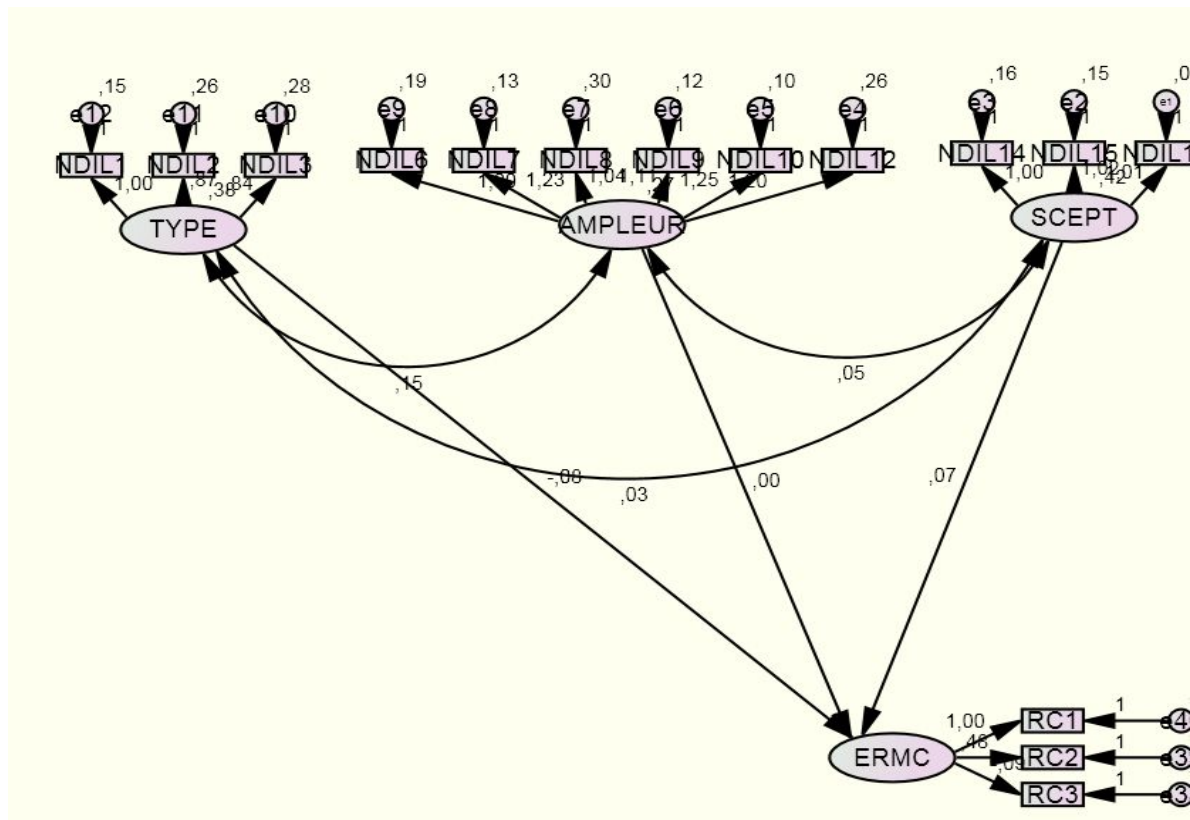


Figure1. Structural model

Table 3. Goodness-of-fit statistics of the structural model

Goodness-of-fit statistics	Structural model	Recommended value
$\chi^2/df$	3,389	< 3
GFI	0,920	> 0,9
AGFI	0,867	> 0,9
RMSEA	0,082	< 0,1
NFI	0,942	> 0,9

NNFI	0,915	> 0,9
CFI	0,958	> 0,9

### Tests of H1: Influence of standards of care on the auditor's responsibility

In this work, the methods of structural equations allow to reconsider the assumptions related to the influence of standards of care on the auditor's responsibility (from H1.a to H1.c).

**Table 4. Impact of standards of care on the auditor's liability**

	Auditor's liability		
	Cor	Vt	Sig
Type of work	-0,77	-3,849	0,046
Extent of work	-0,02	-0,022	0,982
Professional Skepticism	-0,72	-3,992	0,041

A link statistically significant and negative (Sig= 0.046; CR = -0.77) is reached between the type of work and the auditor's responsibility. This demonstrates that the more the auditor realizes different tests of audit control, the less his liability is claimed. Our H1.a is thus confirmed.

Regarding H1.b. is not confirmed. Indeed, the extent of work does not influence the auditor's responsibility as demonstrated by the results obtained for this purpose (Sig = 0.982; Cr = -0.02).

In the same way, a statistically significant and negative relationship (Sig= 0.041; CR = - 0.72) is reached between the professional skepticism of the auditor and its responsibility. Demonstrating that an attitude of professional skepticism by the Tunisian auditor influence negatively on his liability. Our H1.c is thus confirmed.

### Test of H2 : Consequence severity and standards of care

Pour voir si les évaluations des normes de diligence dépendent des difficultés financières, nous procédons au test ANOVA pour chaque dimension des normes de diligence et chaque item.

To show whether the assessments of standards of care depend on severity consequences, we are conducting the ANOVA test for each dimension of the standard of care and each item.

Table 5 provides insufficient evidence to support consequence severity effect predicted in H2, the claim that auditors' assessment of standards of care will be higher when consequences of audit failure are severe than when consequences of audit failure are moderate. To test for an ex post increase in standards of care associated with higher consequence severity, ANOVA results indicate that consequence severity does not significantly influence these standard of care factors (type of work,  $p=0,810$  ; extent of work,  $p=0,754$  ; professional skepticism,  $p=0,754$ ).

In unpaired t-tests of consequence severity on individual standard of care measures, no item of standard of care was marginally significant. Table 6 compares our effects of consequence severity on standards of care findings to those of Kadous (2000) and Thornton and Shaub (2014).



**TYPE OF WORK**

NDL1AUDITORS SHOULD ALWAYS CREATE AND PERFORM SPECIAL TESTSDESIGNED TO DISCOVER FRAUD, EVEN IF THE COMPANY’S OWNERS AND MANAGERS SEEM TO BE HONEST.	N.S	**	*
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*Table 5. Standard of Care Assessments by Consequence Severity*

	CONSEQUENCE SEVERITY		
	SIG	DDL	F
TYPE OF WORK	0,810	3	0,321
EXTENT OF WORK	0,754	6	0,571
PROFESSIONAL SKEPTICISM	0,754	3	0,192

**SUMMARY AND CONCLUSIONS**

This study investigates whether the standards of care affect the auditor’s responsibility and, whether these standards depend on the severity of the consequences of audit failure.

Our findings have established a relationship between the standards of care and the auditor's responsibility for audit failure to assert that an audit which complies with reasonable standards of care should protect the auditor from legal liability. Indeed, the type of audit test performed and professional skepticism influence auditor’s liability. However, it proved the absence of any relationship between the extent of work and auditor chances of being held liable.

This result is consistent with the study of Philipsen (2014) which provides that auditors who do not follow the auditing standards are required more responsible in terms of violation of standards of care. Besides, Thornton and Shaub (2014) also find that the judgments against the auditor depend on their assessments of standards of care. Specifically, as jurors’ assessment of standards of care increases, auditors are more likely to be held liable.

<b>NDL2</b> IN THE PERFORMANCE OF AN AUDIT, IT IS THE AUDITOR'S RESPONSIBILITY TO ACTIVELY SEARCH FOR INSTANCES OF FRAUD IN FINANCIAL REPORTING, NO MATTER HOW SMALL.	N.S	**	N.S
<b>NDL3</b> AUDITORS SHOULD ALWAYS PERFORM A COMPLETE REVIEW OF THE CLIENT'S ACCOUNTING SYSTEM AND OF THE CONTROLS OVER THE SYSTEM, EVEN IF THEY CAN VERIFY THE NUMBERS ON THE FINANCIAL STATEMENTS WITHOUT DOING SO.	N.S	***	N.S
<b>EXTENT OF WORK</b>			
<b>NDL6</b> AUDITORS CAN TELL A LOT ABOUT A COMPANY'S FINANCIAL RECORDS BY INSPECTING ONLY A FEW DOCUMENTS IF THOSE FEW DOCUMENTS ARE SELECTED CAREFULLY.	N.S	N.S	N.S
<b>NDL7</b> AUDITORS CANNOT EXAMINE EVERY CLIENT TRANSACTION. THEY MUST RELY ON SAMPLES AND TESTS OF RELATIONSHIPS IN CONDUCTING AN AUDIT.	N.S	N.S	N.S
<b>NDL8</b> WHEN A CLIENT STORES INVENTORY IN SEVERAL DIFFERENT PLACES, AUDITORS CANNOT AND DO NOT NEED TO OBSERVE INVENTORY AT EVERY SITE.	N.S	N.S	N.S
<b>NDL9</b> AUDITORS MUST MAKE THEIR DECISIONS AFTER INSPECTING ONLY A SMALL SAMPLE OF THE DOCUMENTS THAT ARE AVAILABLE BECAUSE THIS IS MORE EFFICIENT THAN LOOKING AT EVERY DOCUMENT	N.S	N.S	N.S
<b>NDL10</b> BY PLANNING CAREFULLY AND USING SOPHISTICATED TECHNIQUES FOR CHOOSING WHICH DOCUMENTS TO EXAMINE, AUDITORS ARE ABLE TO REDUCE THE NUMBER OF TESTS THAT THEY DO WITHOUT SACRIFICING QUALITY OF THEIR WORK.	N.S	N.S	N.S
<b>NDL12</b> AUDITORS CANNOT ALWAYS USE THE STRONGEST TESTS; THEY NEED TO BALANCE THE STRENGTH OF THE TESTS WITH THE COST AND CONVENIENCE OF THE TESTS.	N.S	N.S	N.S
<b>PROFESSIONAL SKEPTICISM</b>			
<b>NDL 14</b> AUDITORS SHOULD BE COMPLETELY INDEPENDENT OF THEIR CLIENTS, SO THEY SHOULD NOT ACCOMMODATE THEIR CLIENTS' WISHES IN DESIGNING THEIR TESTS.	N.S	N.S	N.S
<b>NDL15</b> AUDITORS SHOULD BE COMPLETELY OBJECTIVE AND UNAFFECTED BY THEIR CLIENTS' WISHES.	N.S	N.S	N.S
<b>NDL16</b> AUDITORS WORK FOR THE COMPANIES WHOSE FINANCIAL STATEMENTS THEY AUDIT, SO THEY HAVE TO ALLOW THEIR CLIENTS SOME LATITUDE IN WHAT THEY REPORT.	N.S	N.S	N.S

NOTES: A HIGHER STANDARD OF CARE FOR THE SEVERE- VS MODERATE CONSEQUENCE CONDITION (ONE-TAILED TEST) AT: \*0.10, \*\*0.05, AND \*\*\*0.01 LEVELS; ASOURCE OF KADOUS SIGNIFICANCE RATINGS (KADOUS, 2000, P. 334); N.S. – NON-SIGNIFICANCE; SUBJECTS RESPONDED FROM 0 (COMPLETELY DISAGREE) TO 10 (COMPLETELY AGREE); SOURCE: ADAPTED FROM KADOUS (2000)

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Furthermore, our research is consistent with Sennetti et al. (2011) who affirm that the auditor protecting themselves against negligence, can demonstrate the due diligence according to the audit standards. Otherwise, our results join the conclusion of Willekens and Simunic (2007) reporting that an auditor who complies with audit standards will be considered as exercising "due diligence". Conversely, non-compliance constitutes professional negligence that makes the auditor potentially liable of the losses suffered by investors and creditors who rely on the false financial statements.

However, our search does not reach the conclusion of Kadous (2000), which suggests that the auditor's use of the proper application of auditing standards do not always lead to a favorable assessment of the responsibility of the auditor. Thus, according to Kadous (2000), this compliance with auditing standards does not necessarily relieve the auditor of the responsibility. That is because the care standards are dependent of realizations such as the severity of consequences of audit failure (Kadous, 2000).

Thus, to deepen our research, we examined the impact of the severity consequences of audit failure on care standards. In fact, when an auditor is accused of negligent conduct, we need to demonstrate whether the provided assessments are based on professional diligence behavior before or after the occurrence of the negative result. The results of our research show that assessments of standards of care are independent of financial difficulties. Indeed, the influence of financial difficulties on the items of the standard of care is not significant. This proves that financial difficulties have no influence on the standard of care.

Our results are consistent with those of Thornton and Schaub (2014) which showed that assessments of standards of care does not depend on ex post consequences of audit failure. Indeed, ANOVA results of Thornton and Schaub (2014) indicate that the severity of consequence has no significant influence on standards of care factors. In unpaired t-tests of consequence severity on individual standard of care measures, only one measure (type of work item 1) was marginally significant.

These results are consistent with Schwartz's (1997) model that states that an increase in audit quality may reduce the auditor's legal liability, but differ from Kadous's (2000) finding that the standards of care depend on ex post consequences of audit failure. In other words, when the consequences of audit failure are severe, the judges evaluate the highest standards of care for the two important aspects of the auditor's work: the type of tests performed and the professional skepticism that an auditor maintained during the performance of the audit. However, the extent of work standard of care does not differ between the two terms of consequences.

The determinants' standards of care may be another fruitful area for future research. At present, we know very little about the training standards of care. Future work could provide a more detailed study of the factors that are important in determining each standard of care. Future research could also extend this study by incorporating other factors associated with audit quality that influence auditor's liability.

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