Relative Liability Exposure for Negligence and Financial Reporting Quality: Evidence from the Audit Interference Rule

How does shifting legal responsibility between auditors and clients under the Audit Interference Rule affect financial reporting quality, and what does this reveal about each party's motivations?

Hyun Jong Park and colleagues explore how moving legal responsibility between auditors and their clients changes financial reporting quality. The authors focus on a legal doctrine known as the Audit Interference Rule (AIR), which varies across U.S. states. The AIR limits when auditors can blame client negligence in third-party lawsuits. When a state adopts the AIR, auditors face greater liability. When a state rejects it, clients bear more legal responsibility.

Using a difference-in-differences research design and data from 2000 to 2015, the authors examine whether changes in the AIR affect the likelihood of financial statement restatements, a common sign of poor reporting quality. They find that rejections of the AIR, which increase client liability, are linked to fewer restatements. This suggests that when clients face more legal risk, they take greater care to ensure accurate financial reporting. Interestingly, adopting the AIR, which increases auditor liability, does not show a significant change in restatement rates.

The study also finds that clients are inclined to respond to increased liability by paying higher audit fees, indicating they demand more systematic audit services. These effects are strongest among large companies and those with higher exposure to litigation risk.

The study suggests that clients' incentives to avoid legal risk have a stronger impact on financial reporting quality than auditors' incentives. This challenges the view that higher auditor liability is always required to ensure accurate reporting and highlights the importance of how liability is divided between parties. By focusing on relative rather than total liability, the article offers new insights for accounting, legal research, and policy decisions.

MAJOR TAKEAWAYS:

- Shifting liability to clients leads to fewer financial restatements, suggesting improved financial reporting quality.
- Clients respond to increased legal risk by demanding more audit assurance, reflected in higher audit fees.
- Clients' incentives to avoid litigation have a stronger impact on reporting quality than auditors' liability concerns.

WHO NEEDS TO KNOW:

- Policymakers
- Auditors
- Legal Professionals

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