The Impact of Legal Responsibility of External Auditors on Auditing Quality and Investment Level

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Abstract

This research aims to study the effects of legal liability rules on auditing quality in order to devise and implement a guideline for the optimal liability rules that can be applied to the auditing profession within society, and thus encourage investment.

In an emerging market like Kuwait state, there is a weakness in the legal system, which may cause users to place less reliance on financial reports and auditing services. This environment does not encourage investment. The position in Kuwait state will be studied as an example of how emerging economies can add to the understanding of the role of the auditor, for the purposes of improving audit quality and encouraging a greater amount of investment. Where this position can be understood, this study gives a strong impression of how the legal liability of external auditors can impact on the auditing quality and, importantly, the chances of obtaining investment. For this reason the study is applied in Kuwait state.

This research differs from the other literature in several important ways. First, the study has been performed in an environment of weak governance. Second, it studies the effects of the civil legal liability system from two views at the same time, so the research is carried out in relation to two different sides: first, the demand side of the auditing services represented by the users of financial information; and second, the supply side of the auditing services represented by the auditors. This has been done through two questionnaires, one distributed for each side.

The results of **users' questionnaire** revealed that the existence of civil legal liability will increase the demand for auditing service. Also, consideration is directed towards the main determinant of auditing quality, which is the legal liability system, more so than other factors. As well as, through increasing auditor liability, trust in financial information will be enhanced, subsequently prompting investment within society. Moreover, the users, besides their needs for auditing services, require auditors to provide collateral for their investment process in order to increase their investment level. On other side, the results of **auditors' questionnaire** detected that the auditors hold the view that the demand for auditing services by companies will not be affected by the existence or non-existence of the liability rules. However, auditors believe that the existence of legal liability rules will make financial statement users more trustful in financial information, thereby increasing the number of users of audited financial reports. Also, the auditors do not agree that their liability should be increased since this will make auditing services more costly through the need to collect more evidence, increase the time of auditing, increase the sample size, etc. The increase in liability will also limit their acceptance of risky clients, make them increase their efforts, and due care. Furthermore, the introduction of legal liability may cause them to reduce their supply of audit services.

Finally, a statistical test is carried out to compare the answers of the two groups. It is found that there are differences in views concerning the effects of the existence of legal liability on the demand for auditing. As well as, there are differences regarding their preferences about the alternative civil legal rules. The results of this study will help legislators by comparing the effects of available legal rules on audit quality and investment level. Accordingly, legislators can select the appropriate legal structure for auditors' liability that achieves benefits to the business environment.

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Chapter One: Introduction

1.1 Preface

The legal responsibility of external auditors is considered integral to the underpinning of auditing profession within any society. Legal responsibility affects auditing quality (Palmrose, 1988; Melumad & Thoman, 1990; Dye, 1995; Kinney & Nelson,1996; Schwartz, 1997; Schwartz, 1998; Radhakrishnan,1999; Zhang & Thoman, 1999; King & Schwartz, 2000; Defond *et al*., 2002). Increasing audit quality means less uncertainty concerning financial information, which improves the overall decision-making process when allocating resources in performing auditing tasks. In this regard, reporting results honestly reflects the financial status of the customer's firm subjected to auditing. As a result, the entire process reflects on decisions made by financial statements users.

The legal accountability of external auditors rests on a number of rules governing the dimensions forming responsibility, e.g. the incident constituting the auditors' responsibility, parties claiming the auditors' fault and the subsequent measurement of the damage incurred and necessitating compensation, and the party held accountable for paying the damage estimated by the court having jurisdiction in interest of the plaintiff.

It should be noted that there are various rules available, each of which affects auditing quality in different manner. Such alternative rules vary in terms of the level of responsibility imposed upon the auditor. Therefore, such rules produce different levels of quality provided, thus compelling the auditor to exercise due care during the auditing process and also affecting decisions made by financial statement users regarding their investments.

There is a great deal of controversy concerning the rules of legal responsibility that should achieve ideal levels for the society in terms of auditing quality and the investment volume in business firms. With this in mind, previous studies (Palmrose, 1988; Melumad & Thoman, 1990; Elitzur & Falk, 1996) indicate that there is, in general, a positive correlation between the levels of compensation expected by the plaintiff as a result of auditors' liability towards them and auditing quality; this

subsequently affects users' decision and the level of investment and trade. Some studies (Ball *et al.*, 2003; Christensen *et al.*, 2008; Li, 2010; Daske *et al.*, 2009) argue that the benefits of IFRS mandatory adoption are appear to be stronger in countries where legal systems effectively protect outside investors' claims. A common finding is that IFRS has an effect only in countries with strong enforcement regimes. However, other studies (Narayanan, 1994; Patterson & Wright, 2003) indicate another trend, which emphasises that heightening the legal responsibility of external auditors may not strengthen auditing profession. This is owing to the fact that certain legal rules may reduce or even completely demise the auditing process, as a whole; however, there might be other alternative rules which could be far harsher.

From another perspective, i.e. that indicated by Schwartz (1997) and King & Schwartz (2000), the possibility of the legal system to attain auditing quality is not necessarily the most efficient for society, as legal responsibility enforces more accurate auditing in addition to protecting users of financial statements against potential losses. As a result, greater levels of legal accountability for auditors may prompt investors (amongst users of financial statements) to exaggerate investment compared with ideal levels for society.

Moreover, unjustified legal suits may be filed in regard to external auditors, once the auditor's responsibility is unfairly heightened. Some (Schibano, 2000, in Yu, 2000) argue that greater levels of legal responsibility may force the auditor to show discretion when issuing reports—a development that would result in the potential rejection of financial statements issued by the auditor, thereby causing business firms to experience difficulties in obtaining the funds necessary for conducting investment activities, although they may be beneficial to society.

Accordingly, there is a call for exercising care by legislators by comparing available legal rules to select the legal structure appropriate to the business environment, when considering the benefits achieved by society. Such a process would ultimately ensure the overall effective allocation of resources under the assumption that every legal rule has a different effect on decisions relating to auditing quality and those made by users of financial statements.

In a weak legal environment, such as the state of Kuwait, there is a trend to expand the proprietary base along with other measures aiming at economic reform, resulting in the development of the Kuwaiti securities market. Moreover, there is the dire need to improve the business climate and enhance both local and foreign investors' trust in the financial information disclosed to reveal the financial status of firms operating in Kuwait. With this in mind, it has become imperative that financial reporting and the overall credibility of financial statements be enhanced. The outcome should be the restoration of public trust in the financial statements issued, with information attached to them, upon making investment decisions.

To this end, the legal liability of external auditors operating in a weak legal environment, such as that of Kuwait state, should be scrutinised so as to ensure the high quality of the auditing profession potentially achieved by well-defined standards for auditing liability. Notably, this can facilitate investment decisions in the financial markets in Kuwait.

Such scrutiny would markedly determine the extent to which statutory amendments are needed for existing provisions and the issuance of new laws, thus implementing controls on enforced legislature and bringing benefits to society.

1.2 Study Problem

The problem can be summarised, as follows:

1. What are the liability rules improving overall auditing quality within society?
2. What are the factors affecting auditor activity and auditing quality?
3. Is there a relationship between investment level and the liability rules applied and audit quality?

In light of the aforementioned, many have questioned the overall credibility of the auditor's job role, the quality of auditing outcomes and the legal responsibility of auditors, the latter of which urges a professional review to improving performance quality and eventually rationalising the decisions made by financial statement users.

The aim of auditors' legal liability is the guarantee of achieving a reasonable quality for the auditing profession and the overall creditability of financial reports; hence the support of investment process within society. The investment level should be at an optimal level and not at the utmost level. Thus considered a full guarantee for investment through the imposition of legal rules to compensate investors for any loss potentially exacerbating investment levels, without any study of the risk and cause of collapse in the investment process. Therefore, our problem is concerned with achieving a framework for the relation between auditors' legal liabilities, auditing quality, and investment level. It is considered that this will help to structure emerging economies.

When striving to achieve auditor liability, there is the call for a well-defined liability rule and damage measure. Moreover, there are a number of legal rules adopted to govern auditor liability; these vary from compensation to deterrence, and which can ultimately enhance auditing quality. In this regard, a compensation rule offers a greater guarantee for investors regarding investments, although this may ultimately cause auditors additional apprehensions regarding financial reports and thus a lesser desire to accept customers with risky business. Moreover, a deterrence rule, through professional sanction, may offer higher auditing quality, but a lesser guarantee for investors.

Auditing quality—a multi-faceted concept—is concerned with all participants in the auditing process and beneficiaries. However, both parties view the auditing process from different perspectives: shareholders, on the one hand, evaluate quality in a different way from creditors, who consider quality differently from investors.

Importantly, auditing quality needs to be at a level where the probability of audit failure is at its lowest rate in society. Importantly, auditing quality could not be at its highest level owing to the high costs of the auditing process or at its lowest level owing to legal liabilities. Essentially, auditing quality depends on auditor activity, which is a function of auditing costs and expected liabilities in the case of auditing failure. With additional costs meaning a lesser supply of auditing process, which subsequently increases uncertainty for financial statements users. Accordingly, imposing a strict liability regime means a high cost for the auditing profession.

Uncertainty affects the level of investment: a higher risk will lead to reduced investment levels, whilst reducing risk depends on auditors' liabilities, which may lead to poor investments decisions and the transfer of risk from investors to auditors.

Trust in regard to the financial statements released by companies is one of the fundamentals helping to support and assist the financial markets. In this context, it is true to state that the role played by external auditors from the aspect of validating and authenticating the issued financial statements is of great importance as the basis for decision making.

Various studies have examined this issue; however, thus far, there has not been any development in terms of establishing a definite and comprehensive framework addressing the different dimensions constituting the relationship of legal liability to the auditing process, thus helping users to measure the overall quality level of auditing. Therefore, there is a dire need for researchers and practitioners to develop existing approaches to quality control, thus suggesting new approaches that would protect equity and enhance performance quality, so that decisions made by investors are rationalised.

1.3 Study Importance

The importance of this study can be seen from two different perspectives.

1.3.1 A Theoretical Perspective

A number of emerging economies seek to expand the proprietary base, thus leading to the expansion of the role adopted by the capital market and an increase in the listed joint stock in the securities market. As a result, there is a critical need to incorporate greater trust into the quality of information circulated through improving the quality of the auditor's report. For this reason, the position in Kuwait will be focussed on as a generic suggestion for how the emerging economies can add to the understanding of the role of the auditor, when it comes to improving audit quality and encouraging a greater amount of investment. Where the position in Kuwait can be understood, this will then

give the researcher a strong impression of how the civil legal liability of external auditor can impact on the quality of the audit and, importantly, the chances of obtaining investment.

In regard to the financial violations experienced by major corporations in developed economies, the collapse of some of these entities is attributed, in some cases, to faulty accounting practices, which points the finger of accusation at auditing service quality. Harsh criticism has been directed towards the auditing profession, in Kuwait, for failing to keep up with developments in light of recent changes, thus causing deficient professional performance and poor levels of quality.

With this in mind, few studies have thus far sought to tackle the issue of legal responsibility for external auditors, from the various dimensions relevant to auditing quality, as viewed by the different parties making up the auditing environment and the users of financial statements.

With the discussion thus far taken into account, the present study will seek to incorporate legal and accounting knowledge in order to gain an understanding of the way in which legal rules impact the liability of external auditors and decisions by auditors, as well as the users of financial statements. Importantly, there have been no studies carried out, previously, in a weak legal environment, such as the Kuwaiti business environment, and which have tested the relationship between the administrative alternatives of the legal responsibility, and decisions relating to auditing quality.

The present study aims to consider and discuss the impacts of alternative rules, and further directs attention to the third party, who has the right to sue the auditor in respect of auditing quality, as well as the users of financial statements—an issue rarely examined by previous studies.

1.3.2 A Practical Perspective

The present study will provide empirical evidence to develop understanding of the major factors obstructing legal liability of the auditor in emerged economies, such as

that of Kuwait, as a guarantor of auditing quality. The study will also determine various ramifications associated with alternative legal rules, thus enabling the legislator, in any countries, to control such ramifications, while formulating the rules governing legal liability of the auditor.

Satisfying the needs of the business environment in emerged economies can be achieved through the provision of guidelines on the appropriate system, with such concerned with regulating the legal liability of external auditors. It is recognised that this would enable a balance to be struck between the utilities of the main parties affected by the auditing process, while also dealing with the rapidly changing economic factors on the local and international levels, e.g. free market economics, integration into globalism, and movement toward trade liberation, within the framework of international trade agreement. This will certainly impact on the accounting and auditing profession, and the investment climate in Kuwait, as a whole. Therefore, the investment atmosphere within Kuwait is required in order to adapt to such changes, since the existing rules governing the legal liability of external auditors in Kuwait may not help enhance trust amongst the users of financial statements.

In relation to the above-mentioned, this study is performed in the State of Kuwait for many reasons:

- The weaknesses in its legal system make the users less concerned with the financial reports and the auditing services.
- Kuwait is an emerging economy, where its government seeks to encourage investment.
- There is a critical need for a legal system to support audit quality and investment level in such an emerging economy.
- The field of the study is adequate to study the conflict between financial information users and auditors, concerning the auditors' responsibility.
- There are no previous studies concerning this field performed in Kuwait.
- This study can help in understanding the audit quality and investment level in a weak legal environment, and the users' expectations from the auditors.

1.4 Study Objectives

The present study will seek to attain the following objectives:

1. To identify the factors preventing the implementation of auditors' liability within the current business environment.
2. To study the ways in which different levels of auditor liability affect decisions relating to overall auditing quality and subsequent investment.
3. To identify the major factors defining the auditing process, through analytical examination of a literature review, so as to delineate a relationship between these factors and the overall legal liability of external auditors.
4. To establish a conceptual framework able to facilitate the interpretation of a relationship between the legal liability of external auditors and professional performance quality.
5. To measure and thereby analyse the main variables influencing professional performance quality, illustrating the impacts on decisions taken by the users of financial statements concerning their investments.

1.5 Study Hypotheses

In order to meet the study objectives, this research will seek to test four hypotheses, considering the users of financial statements (the demand side of the auditing services) at the first stage of the study. In the second stage of the study, the first and third hypotheses are tested considering the auditors (the supply side of the auditing services). The four hypotheses are formulated as follows:

H1: The degree of the civil legal liability system within society has no effect on the auditing profession.

H2: The civil legal liability rule is not the main factor affecting auditing quality.

H3: Increasing the civil legal liability of auditors will not increase audit quality.

H4: Investment level within society is not dependent on the civil legal rules applied.

1.6 Study Methodology

In order to test the hypotheses of the research and achieve the objectives, a comprehensive framework (theoretical and practical) will be relied upon. With this in mind, the research includes two styles:

First, a theoretic study: this aspect seeks to build a scientific framework for the study problems and the objectives through depending on text books, essays, researches, conferences and periodicals, in order to:

- study and cite the relationship between the legal responsibility of external auditors, and the professional performance quality in auditing; and
- describe the relationship between auditing professional performance quality and the decisions made by investors.

Second, field study: this aspect includes the design of two questionnaires and its distribution through interviews and via mail to a sample of both users and external auditors working in the private offices in the state of Kuwait. This aspect has the objective to realise opinions and experiences in solving the research problem through analysing the results of the questionnaire by using the relevant statistics methods and depending on ready statistics programmes; this helps to ensure the overall correctness or inaccuracy of the research hypotheses.

The questionnaires help the researcher to establish the exact information from the people concerned, which helps in terms of reaching suitable and precise results for the research.

1.7 Study Plan

This study will be organised into seven chapters, as follows.

- Chapter One provides an introduction to the study.
- Chapter Two is dedicated to performing a literature review concerning the development of the most important legal liability rule for auditors.
- The Literature Review of auditing quality and auditor responsibility will be discussed in Chapter Three.

- The testing of the hypotheses will be performed in Chapter Four for users.
- Chapter Five will test the hypotheses for auditors.
- Chapter Six will include a comparison between the results of users' and auditors' tests.
- Finally, Chapter Seven will provide the conclusion, recommendations, limitations and future research suggestions associated with this study.

1.8 Conclusion

The field of this study is considered new owing to the fact that there have been no previous studies carried out in the context of the weak business environment examining the legal responsibility for external auditors from various dimensions relevant to auditing quality, as viewed by the different parties making up the auditing environment, as well as users of financial statements.

This research enriches the literature by working to incorporate legal and accounting knowledge, in order to understand the way in which the legal rules impact the overall liability of external auditors, and the decisions by auditors as well as users of financial statements.

Moreover, the research will provide empirical evidence to support understanding of the major factors obstructing the legal liability of the auditor in emerged economies, such as Kuwait state as a guarantor of auditing quality. The study will also determine various ramifications associated with alternative legal rules, thus enabling the legislator in any countries to control such ramifications whilst formulating the rules governing legal liability of auditor. Moreover, this study aims to satisfy the needs of the business environment both across the world generally and in Kuwait, in particular; this will be achieved through the provision of guidelines on the appropriate systems to regulate the legal liability of external auditors. So the contributions of this research are:

- This research will enrich the literature by working to incorporate legal and accounting knowledge, in order to understand how the legal rules impact liability of external auditors and decisions of users of financial statements related to their investments level.

- The study also will determine various effects of alternative legal rules, thus enabling the legislator to control any of these effects, while formulating the rules governing legal liability of the auditor; it is then possible to suggest an appropriate system for auditor legal responsibility (ALR).

Chapter Two: Literature Review of the Development of Legal Liability Rules for Auditors

2.1 Introduction

According to the legal rules organising the civil responsibility of external auditors, we can conclude that, if the civil court working in any country states that, if there is anything misleading in audited financial statements resulting in damage incurred by one or more parties, this means that the firm management (the client) has responsibility. On the other hand, the auditors' responsibility is based on auditing efforts and liability rules (strict liability rules, negligence rules, etc.) to which external auditor is subjected in these countries towards the party, who has the right to litigate civilly. If auditor responsibility is proven, this responsibility would then be divided between the auditor and the firm's management (the client) by the Court in light of its estimation for the share of every party from fault. Importantly, damage caused necessitates compensation, which is decided by the Court by referring to measures used in estimating the compensation (out of pocket measures [OOP] and independent of investment measure [IOI]). As auditing failures are commonly associated with client bankruptcy, the matter requires determining responsibility, in terms of paying compensation, which is determined for the plaintiff in the case of insolvency of one or more defendants, according to applied legislative base (pure proportional rule, hybrid proportional liability rule, and joint and several liability rules).

Figure (1): Rules of legal organisation of civil liability for the external auditors:

Damage apportionment rule	Damage measures	Liability rules	Liability scope rules

Alternatives rules organisation civil liability for auditor

Dividing liability for paying compensation	damage measure	occurrence of liability	Determination of the scope of parties who can litigate auditor
1. Joint and several liability rule 2. Pure proportional rule. 3. Hybrid proportional liability rule	1. Out of Pocket (OOP). 2. Independent of Investment (IOI).	1. Strict liability rule 2. Negligent liability rule	1. Contract rule. 2. Primary beneficiary rule 3. The foreseen user rule. 4. Reasonable foresee ability rule.

Many studies in the field of auditor legal responsibility provide evidence regarding the ability of the responsibility system, in terms of encouraging the desirable behaviours of the auditor by increasing auditing quality and thereby introducing the appropriate apportionment of resources so as to achieve the highest economic efficiency within society.

The problem of legal responsibility worsens concerning the third parties' benefit from auditing services. Generally, we can define the third party who has the right to litigate the auditor legally (Boynton & Kell 1999) as a category of users, their names not given in advance to the auditor, but which depends on his professional opinion when making their decisions relating to audited firms. Examples of this category include stockholders, prospective investors, creditors, and others who use financial statements.

However, it is clear that the third party—who has the right to litigate auditors owing to injuries incurred resulting from dependence on misleading financial statements accredited by the auditor—belongs to different categories with branched and conflicting interests. No one calls an auditor to reconcile between the interests of these categories or to care for their interests to the same degree. Also, by opening the door to legal responsibility for the third party to litigate the auditor exposes the auditor to arbitrary requirements, thus causing the greatest injury to the auditing profession.

In this context, we review the most important rules governing the responsibility of the auditor toward the third party, which have been drawn from the judicial practices and legislative systems in the USA, the UK, and the specific situation of Kuwait. Finally, the nature of the decisions made by users is discussed.

2.2 The Situation in the USA

Pacini & Sinason (1998) declare that, to make the auditor responsible about damages caused to non-clients (the third party) due to negligence, the following conditions must be met:

a. The existence of auditor negligence towards the third party who is obliged before him to give due care, thus resulting in misleading and untrue financial statements used by this other party.
b. The auditor has the belief that the other party depends on these financial statements in making certain decisions.
c. The auditor must be informed that the other party may depend on these financial statements in making this decision; consequently, the auditor knows that, if a mistake were to be made, this could cause damages for the party.
d. The dependence of the third party on audited financial statements is logical and justified.
e. The occurrence of real damages for the third party (plaintiff).
f. The existence of a causal relationship between the auditor's behaviour and the causing of damages for the plaintiff.

The American jurisdiction pursued several legal suit cases dealing with the auditors' responsibility towards the third party in different situations, and was involved in

establishing rules and principles regulating such responsibility and determining the third party who has the right of civil litigation on the auditor under common law. American legislators had a pioneering role in the codification of legislative texts, in this regard.

2.2.1 The Responsibility towards the Third Party under Common Law

American courts developed four main legal rules or criteria in regard to determining the third party who debits the auditor with a care task, whereby the other has the right to litigate the auditor owing to the inaccuracy of financial statements resulting from the auditor's negligence. These rules were developed by supreme courts in both New York and New Jersey states in addition to the American Bar Association.

The rules must not be considered as representing an independent and separated point *per se*, as these rules do, in fact, fall within a continuum. These rules are:

a. The privacy rule.
b. The primary beneficiaries rule (near privacy rule).
c. The foreseen user rule.
d. The reasonably foresee ability rule.

The case of Landell vs. Lybrand, 107 A. 783 (Pa. 1919) considered the first case litigated against auditors in the USA with regard to the auditor’s overall responsibility towards the third party, whereas the supreme court in Pennsylvania state judged that the auditor had no responsibility toward a buyer of some normal stocks of the employer’s indemnifying company, who bought these stocks in direct consideration to the report issued by the auditor concerning the financial situation of the company; this report was later demonstrated as not accurate and/or honest. In its rejection, the court depended on the non-existence of a contractual relation between the plaintiff and defendant (auditor). In addition, the plaintiff could not provide evidence that the auditor had issued this report and had the intention to cause damages for the plaintiff (Pacini & Sinason, 1998).

Upon this judgment, the only party with the right to litigate an auditor owing to negligence was the client according to the rule established by the court of

Pennsylvania—that of privacy of contract. This rule requires the existence of a contractual relation or direct connection between the auditor and any other party, and so this party litigates the auditor owing to his negligence and his overall responsibility of damages incurred by this party. The privacy of the contract rule is considered to be the strictest rule regulating auditors' responsibility from the point of view of the third party. This rule is referred to only in the Virginia and Pennsylvania states in the USA (Gormley, 1988; Pacini & Sinason, 1998).

In 1931, the Supreme Court in New York judged the case of Ultramares vs. Touche, 174 N.E. 441 (N.Y. 1931) which is currently considered one of the most important judgments. The case is believed to represent an essential development in the field of establishing the other party and the pioneering application of primary beneficiaries, leading to the expanding zone of the auditor's responsibility of negligence to include parties other than the client. Occurrences of this case were summed up with the statement that the plaintiff (the Ultramares company) provided financial loans to the Fred Stern company as a direct result of the auditor's report (Touche and Niven Com), who presented an unqualified opinion on the financial statements of the company. Subsequently, the plaintiff incurred large financial damages when it was found that the financial statements of the company were misleading, failing to reveal its actual financial situation. When the financial statements revealed that the net assets of the company were US$1070000, the liabilities of the company were more than its assets of US$200000. Moreover, it was demonstrated that the assets, as mentioned in the balance sheet, implied fallacious debts, the value of which were US$950000. Furthermore, this balance sheet did not reveal some of its obligations, itemising its value as US$30000. The auditor presented 32 copies of this report to the client, the implied balance sheet of the company on which he approved, knowing that such reports would be reviewed by various different creditors and stock holders. When the company declared its bankruptcy, the plaintiff litigated the auditor owing to his negligence, thus resulting in approving the misleading balance sheet statement and causing damages to the plaintiff, who depended on the balance sheet statement when providing loans for the company (Pacini & Sinason, 1998).

The court judged that, in spite of the auditor's negligence, he was not responsible for compensating the damages incurred by the plaintiff, as he did not know that the

financial statement of the company would be presented exactly to the plaintiff; thus, it was necessary for the Ultramares Company to litigate auditors for his normal negligence. At this stage, the client was required to inform the auditor, upon appointment, that they identified another party particularly as a user of the financial statements; thus, he was considered a primary beneficiary of the audit (Pacini & Sinason, 1998). Importantly, in this regard, the court established the identity of the primary beneficiary as any person considered to be the main receiver of the auditor report, with auditors needing to know the name of this beneficiary prior to auditing (Tucker & Zurich, 1993).

From the evidence presented to the court in regard to the aforementioned case, it was demonstrated that performing auditing was originally for the sake of the client; the plaintiff was not identified as the user of the auditor's report, and the auditor was not informed of any name of a third party considered to be the beneficiary of the auditing process. Consequently, the plaintiff must prove serious negligence by the auditor when auditing; the plaintiff did not do this and so his case was rejected (Pany & Whittington, 1997).

The previous judgment established the rule of the primary beneficiary of the auditor's work. This rule implies that the auditor is responsible for normal negligence towards the third party other than the client if he knows, in advance, that these parties depend on his work in terms of making certain decisions. Consequently, such parties would benefit directly from the auditor's work, and so they must benefit equally to the clients in spite of the non-existence of a direct contractual relation linking them with the auditor. This rule has been used till now in several American courts when identifying the third party with the right to litigate the auditor for negligence.

During consideration of the case, it was evidenced that, if the auditing procedures were tarnished with serious negligence to a degree, calling the court to believe that the auditor himself was not persuaded by the sufficiency of these procedures, or if he was otherwise considered to be careless or intended to turn a blind eye to the essential occurrences, or did not investigate the situations that must raise his doubts, negligence in these cases is considered to be serious negligence raised from the perspective of the court to fraud. This makes the auditor responsible to the other party in this case—even if the other party was not identified. The judge indicates, in the same case, that the

auditor's responsibility towards his client was represented by the law in terms of compiling his report without fraud, and so he was therefore obliged in virtue of the auditing contract to prepare the report with a degree of care required from a person in such a situation, but also with regard to the creditors and investors to whom the client presented the auditing report. In this regard, the auditor's obligation toward them was to compile the report without any fraud as the auditor knew from the surrounding conditions that the client did not have the intention to keep the report for himself. From this, it was demonstrated that the court tends to restrict the auditor's responsibility in regard to the other party concerning fraud or serious professional negligence committed by him (Pacini & Sinason, 1998).

Approximately 50 years following the Ultramares case, the Court of New York emphasised the primary beneficiary rule through considering the case of Credit Alliance vs. Arthur Anderson and Co., 483 N.E.2d 110 (N.Y. 1985). This case implied that, for several years, the financial services company Credit Alliance provided financing for a company called Smith. In 1978, the creditor company asked the Smith company to provide its financial statements, after subjecting it to auditing by an external auditor as a condition to accept the obtaining of any additional financial credit in the future. In actual fact, the Smith company provided its financial statements to the creditor company accompanied with the auditor's report, which implied an unqualified opinion with regard to these financial statements for the years 1976–1979. In 1980, the Smith company declared its bankruptcy, and the creditor company litigated the auditor owing to negligence.

In this case, the court emphasised the privacy concept as a base for the auditor's responsibility for normal negligence towards the third party, and accordingly identified the three criteria or conditions that must be made available so that the third party has the right to litigate the auditor as a primary beneficiary according to this rule (Pacini *et al*., 2000):

a. The auditor must be acquainted with the fact that financial statements subjected to auditing would be used for the purpose identified.
b. There must be one party or more identified and known to the auditor; this party will essentially depend directly on such financial statements when making decisions.

c. It must be proven that the auditor was informed of the intention of this party to depend on the financial statements in his work, and must accordingly take actions from the auditor to connect with this party, thus indicating the awareness of the party's dependence on the auditing process.

The New York court emphasised that it must check the availability of all previous conditions to prove the auditor's knowledge of dependence of the other party on his work, as this third party is considered a primary beneficiary of the auditing. Many American courts agree with this statement, whereas other courts in the same states are content with adopting the first two components.

However, the court did not identify what actions are sufficient in terms of proving the auditor's awareness and understanding of the dependence of the other party on his work. Accordingly, in the case of European American Bank vs. Strauhs and Kay, 65 NY2d 536(1984), the court was obliged to determine three forms of acts, all demonstrating the existence of a connection between the third party and auditor, thereby proving that the auditor knew the intention of the third party to depend on the auditor's work. Such acts are represented in Pacini & Sinason (1998):

a. The existence of direct oral communication between the auditor and the third party (plaintiff).
b. The existence of direct correspondence between the auditor and the third party.
c. Conducting a series of personal meetings between the auditor and the third party.

In 1968, the rule of foreseen or known user, known as the restatement rule, was applied for the first time in the case of Rusch Factors Inc. vs. Levin, 284 F. Supp. 85, (D.R.I. 1968). The occurrence of this case represented that the defendant (auditor) audited financial statements of a company to support its obtaining finance from the other. In actual fact, this company obtained a loan from the Rusch Factors Company, which was dependent on the audited financial statements, and which demonstrated the ability of this company to repay; however, the debtor could not pay back the funds, and so the creditor company litigated the auditor owing to negligence. The auditor, in his defence, stated that there is no object for responsibility towards the plaintiff company depending on the lack of availability of conditions required for applying the privacy rule in this case—or what is referred to as a lack of privacy—as the Rusch Factors company was

not identified with the name during the agreement on auditing. In spite of this, however, the court of Rhode Island state considered the auditor responsible to the third party, as the court considered it the foreseen beneficiary of the auditor's work (Tucker & Zurich, 1993).

In 1977, the American Bar Association supported and encouraged the use of the foreseen or intended beneficiaries rule by American courts, with the association indicating the rule in restatement 2nd of Torts, used by judges as a guide when establishing rules forming the common law. This law stated in Section 552 that a person charged with a public task to make available certain information is considered responsible for a damage incurred by any person that belongs to the exact category of persons for the beneficiary and guiding them. This task is stated as a general principle; every person making available misleading information with the purpose of using it to affect the other's financial processes, which is considered responsible for financial damages incurred by those receiving this information and depending on it logically.

In the application of this text, the auditor responsible for auditing a client's financial information is considered to be obliged to show care not only towards the client but also towards any other person belonging to any exact group of persons; the auditor aims to use this information and is guided by it for their benefit. It is enough to consider the auditor responsible in the sense that the person depends logically on this information in one process or a similar process for which the auditor or the client acknowledges the financial information affects making a decision. As such, the auditor may be responsible towards one of the client’s creditors if the client informs the auditor that the auditing process will be used for obtaining a certain loan—even if the client does not exact the name of the creditor and even if the name of the creditor is extracted with funds subsequently borrowed from another one (Tucker & Zurich, 1993).

A court decision built upon this rule does not require that the third party that incurred the damages be known by name, although it is conditioned that this third party belongs to a class of persons known to the auditor before beginning the auditing process (Allegeart & Tinkelman, 2000). Furthermore, it is also conditioned that the dependence of this third party on the auditor's work is logical and intentional by the auditor, and thus there must exist a direct relation between errors implied in the financial statements on the one hand and financial damage incurred by the plaintiff on the other hand. The

court evaluates this relation in the light of the plaintiff's culture and experience. Consequently, if the plaintiff himself is considered negligent, his dependence on the auditor's work is then considered illogical, and the auditor is considered as not responsible for the damage incurred by the plaintiff in this case (Pacini & Sinason, 1998).

In regard to the above-mentioned, under this rule, the auditor is not responsible towards other parties when the auditor do not have sufficient reason to believe that they will use audited financial statements. Accordingly, this rule will not be applied if it is proven that there was no communication between the auditor and the client, with such communications considered valid evidence of the auditor's knowledge and his intention to influence the third party's behaviour through the use of financial information prepared by the auditor (Pacini *et al*., 2000). In addition, the auditor is appointed to the task of performing annual auditing only and, according to this rule, therefore has no responsibility in regard to normal negligence towards the third party. Thus, the responsibility of negligence is restricted compared with the responsibility of fraud (Tucker & Zurich, 1993).

Although the application of the foreseen user rule was accepted on a wide scale, as it was applied in many negligence cases against auditors from non-clients and is still used nowadays in many courts in American states, the direction towards increasing the zone of the auditor's legal responsibility was not ceased to this extent but rather increased to a remarkable degree under the following factors:

a. Development of the legal responsibility concept in general to include the protection of consumers from producers and professionals' errors.
b. Increase the size of the publicly held corporations, accounting and auditing firms, which enable these firms to afford the consequences of their legal responsibility.
c. Increase the number of individuals and groups depending on financial statements audited by auditors to verdict its validity.

In conformity with the direction towards expanding the zone of the third party who indebts the auditor with care, the Supreme Court of New Jersey, in 1983, established a new concept considered as the most wide explanation for users' rights than the third parties. This is the foreseen ability concept revealed by the court after investigating the

case Rosenblum Inc. vs. Adler, 461 A.2d 138 (N.J. 1983). According to this concept, the auditor is responsible for normal professional negligence and not toward primary beneficiaries and foreseen users only, but towards all persons the auditor predicts, to a reasonable degree, will use and depend on financial statements. Importantly, the auditor's report should consider unforeseen user concepts, including all creditors and stock holders, which makes the auditor exposed to legal responsibility towards an unlimited class of persons (Tucker & Zurich, 1993).

The occurrences of this case are represented in issuing the auditor an unqualified report on financial statements of the Giant stores company, which revealed the profitability of the company. Depending on these statements, Rosenblum sold its' project to the Giant Company in exchange for obtaining a share of its stocks. After a short time, the Giant Company declared its bankruptcy, at which point the stocks became valueless. Rosenblum litigated the auditor, claiming his normal negligence, whereas it was demonstrated that the client's management manipulated the records to reveal that the assets were not possessed by it or otherwise omitted the creditor's accounts from these records (Pacini & Sinason, 1998).

The court of the first instance refused to condemn the auditor, depending on the auditor having no responsibility for normal negligence towards the non-identified third party; however, the Supreme Court of New Jersey rescinded the judgment and refused to apply the rules of primary beneficiaries and foreseen user, judging that the auditor was responsible for normal negligence towards any third party as the auditor can reasonably foresee its receiving and dependence on financial statements audited by him (Pany & Whittington, 1997). Nevertheless, the court identifies the zone of applying this rule to include only the users of the financial statements who have received such statements from the auditing firm directly so as to achieve a specific goal related with its works. Consequently, the auditor has no responsibility towards persons receiving these financial statements from annual reports existing in libraries and specialised governmental bodies (Pacini *et al*., 2000).

Many courts have adopted the application of the reasonably foreseen ability rule; of these courts, the Supreme Court of Wisconsin has expanded the zone of the auditor's legal responsibility to include all parties who predicted that they would depend on the auditor's work, and who add that there were reasons for applying such rules as

compensation for the injured party, risk-spreading and deterrence, which are essential goals for any civil legal responsibility system.

In 1987, the Court of Mississippi applied the rule of reasonably foreseen ability in the case of Touch Ross vs. Commercial Union Insurance Co, 514 So. 2d 315 (Miss. 1987). After the judgment of the Mississippi court, this rule was not applied again; however, some courts indicated that applying this rule would harm the auditing profession, and so the courts refused its application.

From the beginning of the 1980s, there appeared to be a strong direction in the USA calling for restricting the zone of the auditor's legal responsibility owing to negative effects exposed by the auditing profession and business environment as a result of an increased number of parties having the right to litigate auditors, and so exposure to litigation risk increased as costs incurred by large auditing firms in the USA—called the Big Six (now only four)—in 1993 were approximately US$1.1 billion for litigation and defence costs. This matter called for restricting auditors' legal responsibility towards the third party. In response to this call, American courts reviewed the rule of identifying the third party where the auditor is responsible toward them, and identifies any one of them representing the zone of legal responsibility appropriate for both the auditors and users of financial statements. Moreover, the court put forward a different explanation for these rules to identify that the third party has the right to litigate an auditor for normal negligence.

In this regard, this period witnessed the refusal of many courts in terms of expanding the zone of the third party. More specifically, the rule of reasonably foreseen ability was applied in most of the American states, whereas these three other rules were depended on with different explanations; however, the primary beneficiaries rule was applied in many states, with the Court of Arkansas judging that the auditor has no responsibility for compensating the third party—who notably has no contractual relation—unless the client informs the auditor that the identity of the person will depend on the auditing services, and include a written note. The court also conditioned that the auditor must send a copy of any correspondences to the identified persons to prove the knowledge of the auditor and client of the dependence of those persons on the auditing process. This explanation of the primary beneficiaries rule is considered as the most restricted in the USA, although the Court of Illinois presents a less restrictive

explanation than the previous one for the primary beneficiaries rule: it contends that, if there is no correspondence from the auditor to the third party proving the intention of the client of the dependence of this party on the auditing process and knowledge of the auditor with this intention, the third party can prove this intention with all methods (Pacini *et al*., 2000).

Courts of Nebraska and Idaho embraced the primary beneficiaries rule through adopting criteria identified by the Court of New York in the case of Credit Alliance, in which the same court emphasised and explained, in the case of Security Pacific vs. Peat Marwick Main, 597 N.E.2d 1080 (N.Y. 1992). Other states, such as Montana and Utah, adopted the same rule but with different explanations (Pacini & Sinason, 1998; Pacini *et al*., 2000).

In 1995, the Court of New Jersey retreated from the rule established in 1983. This rule considers reasonably foreseen ability since it adopts a similar explanation for the concept applied in the case of Credit Alliance, which outlines three conditions but which does not require the necessity of informing the auditor through written note of the intention of the third party to depend on the auditor's work—except if the third party (plaintiff) is a bank. In 1999, the Court of Louisiana almost agreed with this explanation, except for in one case where the auditor had no need for written knowledge of the intention of the third parties' dependence on his work—even if it is a bank (Pacini *et al*., 2000).

Moreover, the Court of Kansas ratifies a legal principle that judges that the auditor has no responsibility towards non-clients if the following occurrences are not realised (Pacini *et al*., 2000):

a. The auditor must know when contracting the intention of the client towards using his work for the sake of the third party planning to make a certain decision.
b. The auditor must be informed by the client that the auditor's work will be available for the third party.
c. The auditor must be informed of the identity of the third party by a written note.
d. The dependence of the third party on the auditor's work must be connected with specific transactions specified in correspondences sent to the auditor.

Similarly, in 1996, the Court of Michigan put forward limits for applying the auditor's responsibility towards the third party as it considers the auditor as not responsible for normal negligence towards non-clients if not informed by the client, with a written note, of the main intention of the client from auditing to realize the interest of the third party or to otherwise influence it. The Court also allowed for the client to identity, in writing, not only the identified persons, but also a class of persons for which the client intends to use the auditors' work, to pursue interest or to influence them (Pacini *et al*., 2000).

From the above-mentioned, it was demonstrated that the rule of foreseen user has gained great acceptance before many courts in the USA after studying and analysing different rules establishing the identity of the third party for which the auditor is indebted with the required care (Pacini *et al*., 2000).

In 1992, in the case of Bily vs. Arthur Young & Co., 834 P.2d 745 (Cal. 1992) which was raised owing to the failure of the Osborne firm (for computers), the Court of California turned from applying the reasonably foreseen ability to adopting the foreseen user rule. This judgment is considered as more important as it is viewed as an essential turn from protecting the rights and expectations of investors, creditors and the public for the sake of auditors to alienating them from exposure to the legal responsibility towards the unlimited class of non-clients (Pacini *et al*., 2000). The Court further mentioned reasons for its refusal for the continuity in terms of applying the reasonably foreseen ability rule. These reasons were represented in the generality of the class, which can litigate an auditor owing to negligence and the responsibility for its damages under this rule.

At the beginning of 1997, an appellate court of Arizona stated that the rule of the foreseen user was the appropriate rule to determine whether or not the third party had the right to litigate the auditor for negligence in the case of Standard Chartered Bank vs. Price Waterhouse, LEXIS 243 (Ariz. Ct. App. 1997). Occurrences of this case are represented in the claim of a plaintiff—a British bank—of possessing another bank—Arizona Bank—through its branch in the USA. The Arizona Bank presented all financial statements audited by an auditor. Upon the financial statements being acquired by the plaintiff, in 1988, the bank was exposed to great damage, which induced the plaintiff to litigate the auditor for negligence. The auditor stated that was

no contractual relation linking him with the plaintiff, but the Court adopted the foreseen user and emphasised the responsibility of the auditor for damages incurred by the plaintiff. Moreover, the Court considered him a member in a limited class of foreseen users of the auditor's work. In spite of this, however, the Court refused to expand the auditor's responsibility to include all damaged parties that could be predicted (Pacini & Sinason, 1998).

Finally, at the beginning of 1998, the Court of Massachusetts adopted the rule of foreseen user in the case of Nycal Corp. vs. KPMG Peat Marwick, 688 N.E.2d 1368 (Mass. 1998). The occurrences of this case are summed up as the plaintiff (Nycal Corporation) entering into an agreement in 1991 to buy stocks from a Gulf resources and chemical corporation. The auditor audited the financial statements of the company for 1990, and accordingly presented an unqualified opinion. Subsequently, the company declared its bankruptcy in 1993, with the Nycal establishment prosecuting the auditor for negligence as he did not take into consideration the costs of environmental protection that must be incurred by a Gulf company, as well as failure to consider credit obligations related to workers' pensions. It was proven that the auditor had ceased auditing in February 1991, despite purchasing deliberations having begun in March 1991. Nevertheless, the auditor was not aware of this matter until the beginning of July 1991. As such, in this case, the Court adopted the foreseen user rule and emphasised that the auditor was responsible for non-clients who met the condition that the auditor had actual knowledge that the client belonged to a limited class of users who would depend on the auditor's report in making decisions specific to a certain process, and that the auditor intended to influence them through his work. For this reason, the Court judged that the auditor had no responsibility (Pacini *et al*., 2000; Pacini & Sinason, 1998).

On the other hand, the case of Boykin vs. Arthur Andersen & Co., 46 ALA. L. REV. 703 (1995) was the only case since 1988 in the USA; in this case, a rule nearer to the concept of reasonably foreseen ability was applied where the number of financial statement users with the right to litigate the auditor civilly than was reported was increased under the concept of the foreseen user, as the Alabama Court stated that the auditor's responsibility, when recognising that his opinion would be depended on by a limited class of persons, could be predicted to a reasonable degree. This conflicted with

the foreseen user rule, which frankly refuses the principle of the foresee ability (Pacini *et al*., 2000).

To conclude from the above-mentioned, the direction prevailing in the USA at the end of the 1960s till the end of the 1980s increased the zone of the auditor's legal responsibility to a great degree to include parties other than the client, beginning with the third party (thus representing the primary beneficiary of the auditor's work) and then the foreseen user of the auditor's work. Ultimately, the third party is considered as every person for whom the auditor can predict the possibility of depending on the auditor's services (the reasonably foreseen ability rule).

Owing to several passive effects relating to the auditing profession resulting from expanding the zone of the auditor's legal responsibility, the final decade of the last century witnessed a change in direction towards restricting the zone of non-clients who have the right to litigate the auditor for normal negligence. This was demonstrated in judgments and explanations, as presented by American courts in the different states, with regard to cases prosecuted against auditors. Emphasising this direction, most of the American states at the current time applied the primary beneficiary rule and the foreseen user as a base for the identification of the third party's identity, who credits the auditor with required care with its reasonable and absolute refusal of the reasonably foreseen ability rule. Markedly, only two states emphasised the rule of participation in a contract as only the base for stating the auditor's responsibility for normal negligence.

The reason for this direction adopted by civil American courts towards restricting the zone of the third party who has the right to litigate auditor civilly lies in the wide range of consideration concerning the potential of misleading financial information to affect the user through audited financial statements. Accordingly, it is impossible for the auditor to control the scope of the use of such financial statements by maintaining client control on the financial report as well as the control in terms of distributing the auditor's report, whereas the auditor has no knowledge. In consideration of this, the various parties of different classes may be exposed to tremendous damage owing to their dependence on such information. Accordingly, an auditor may find himself responsible to an unlimited number of persons, and therefore required to pay compensation that they may not be able to afford, thus causing great injury to the auditing profession.

2.2.2 The Responsibility towards the Third Party under Legislative Laws

Legislative bodies in the USA have issued several laws addressing the legal responsibility of the auditor towards the third party (non-clients); these laws consider the auditor as responsible civilly towards a wide section of parties other than non-clients, as American legislators come from this narrow cycle drawn by the jurisprudence for the zone of the auditor's responsibility. The most important of these laws is the Securities Act 1933 and Securities Exchange Act 1934. The purpose of the codification of such acts was to protect investors from exposure to similar conditions prevailing after the collapse of the stock market in 1929 in the USA.

2.2.2.1 Auditors' Responsibility under the Securities Act of 1933:

The Securities Act of 1933 aims to provide investors with appropriate information to evaluate the extent of the quality of new securities. Consequently, this law did not control trading securities after selling them for the first time. Accordingly, through this law, companies will issue new securities for the public and are obliged to register these securities in the American Securities Exchange Committee (SEC) before putting them forward to the public. The registration statement must include financial statements accredited by an external auditor, as well as all essential facts related with the securities that will be put forward for selling for the first time (Thomas *et al.*, 1991).

By the Act of 1933, the auditor and company issuing these securities are responsible for any falsification of or alterations to the contents of a registration statement, or of a copy of a registration publication that will be distributed to foreseen investors containing the same information included in the registration statement. Consequently, the auditor is responsible, before any buyer of these issued securities, if the registration publication contains any altered data or has disregarded any essential information in virtue of the first clause of Section n.11 of this Act, which indicates that, if a registration publication contains an incorrect statement related with an essential fact or has otherwise disregarded an important fact that must be mentioned in order to make the financial statements not misleading, any person who obtained these securities can litigate the

auditor associated with preparing or reporting any party of the registration statement if it was not proven that the owner of these securities knew about the incorrectness of the data contained in the registration statement (Pany & Whittington, 1997).

The Act of 1933 provides these guarantees for a limited class of investors represented by buyers of securities put forward for selling for the first time in the light of the registration publication. This Act did not require this class to prove the auditor's negligence to be responsible civilly before them, but it is enough to hold the auditor responsible to put forward evidence for the following:

- There are damages incurred by the plaintiff.
- The registration publication contained an essential alteration or disregard for important facts, where the information contained in this publication is misleading and it is not necessary that the plaintiff put forward evidence for his dependence on this information when making purchase decisions on these securities to litigate the auditor.

In spite of the new jurisprudence, there is no consideration to the auditor as being responsible for incorrect information, generally, except for work characterised by fraud and deception, or a lack of considering the facts known to him. Upon this, the auditor must put forward the proof for his non-negligence in exerting the professional care required for doing his job. In this regard, he is accredited with the information contained within the registration statement and publication in the light of his reasonable investigation of such data, with the need to prove the exertion of the required care to put forward evidence that damages incurred by the plaintiff were due to other factors and had no relation with the financial statement enclosed with the registration statement and publication (Thomas *et al.*, 1991).

From the above-mentioned, if the auditor did not want to carry the liability for damages incurred by plaintiff; the buyer of the new securities, auditor should put forward the evidence for the following:

- he was committed by exercising due care when writing his report that enclosed with the registration publication; or
- there is no relation between damages incurred by the plaintiff and the altered financial statement; or

- the plaintiff knew that the financial statements were misleading, when he bought these securities.

The case of Escott vs. Barchris Construction Corporation, 283 F. Supp. 643 (S.D.N.Y. 1968) is considered one of the most important cases related with the auditor's responsibility, which relied on Article n: 11 of the Act of 1933. This case was prosecuted by the buyers for securities issued by the Barchris company against both the managers of the company and the auditor, where the company declared its bankruptcy after issuing these securities. Subsequently, the buyers claimed that the registration publication specific to the securities implied an altered financial statement, and disregarded the disclosure of essential facts. It was proven by the court that untrue data were included in the registration publication, thus concluding that the financial statements were considered misleading for whoever depended on the statements in making purchasing decisions for issued securities. As a result, the Court judged with the responsibility of the auditor and managers of the company, although the Court criticised the auditor as his non-obligation with acknowledged auditing standards and his negligence in examining and investigating various subsequent occurrences to the auditing process but prior to the effective date of registration publication that registered in (SEC). However, the Court indicated that the auditor must investigate any evidence that can be concluded from the occurrences following the date of auditing, which may subsequently refute the data implied in the registration publication registered in SEC, preparing for acquainting with it by the public (Pany & Whittington, 1997).

2.2.2.2 Auditors' Responsibility under the Securities Exchange Act of 1934

The Securities Exchange Act of 1934 regulates the public markets in terms of circulating securities in the USA. This act requires, from every company, that its securities be circulated in these markets and subjected to the authority of SEC in terms of presenting an annual report, including financial statements subjected to auditing, thus representing the main source of the auditor's responsibility.

According to the Act of 1934, everyone who bought or sold securities issued by the company can litigate the company issuing such securities, as well as its auditors, if it is

demonstrated that the annual report presented to SEC contained altered and misleading financial statements greatly.

The auditor's responsibility towards non-clients is under the Act of 1934 sections n. 10 and n. 18, where clause (b) of Section n.10 indicates that it is not legally permitted for any person to use—directly or indirectly—any one of various communication methods with the intent to:

- Employ it as a tool to fraud the other.
- Mention untrue statements related with an important fact or disregard an important fact to make these financial statements not misleading.
- Participate in any work considered as fraud for any person with regard to buying and selling securities.

In Section n.18, Clause (a), on the other hand, it is stipulated that holding the legal responsibility towards any person—ignoring financial statements that are altered and misleading—who depends on these statements by buying or selling securities at a price affected by these misleading statements and incurs damages due to his dependence on these statements, unless the defendant can prove that his behaviour was bona fide and the individual had no knowledge that the statement was misleading and altered (Pany & Whittington, 1997).

Markedly, it is clear that the Act of 1933 limited the auditor's responsibility to a limited class of investors who possessed these new securities put forward to the public for the first time; however, under the law of 1934, the zone of the auditor's responsibility increased, where everyone who bought or sold—at any time—some circulated securities in the stock market was able to litigate the auditor depending on the existence of fraudulent financial statements or otherwise omitted important and essential facts, thus making such statements misleading.

According to Article No. 10 and No. 18 of the Act of 1934, holding the responsibility towards a buyer or seller of securities, it is required that the plaintiff put forward evidence for:

- Financial damages incurred by the plaintiff.
- Financial statements those were misleading.

- The dependence of the plaintiff on these misleading financial statements when making buying or selling decisions for these securities.

Article n. 10 of the Act emphasises putting forward evidence that the auditor has the intention to commit fraud against the plaintiff, whereas Article n. 18 holds the auditor responsible towards the other, if he has failed to prove that his professional acts were in the frame of being bona fide.

With regard to the auditor's defence aspects represented in terms of refuting accusations that he had the intention to commit fraud against the plaintiff through auditing, which he carried out according to Article No. 18 of the law—mainly according to Article No. 10 of that law—the auditor can avoid the responsibility, if he proves he was bona fide in performing the auditing and he did not know that there was an important financial statement that had been altered and that the financial statement was misleading if the auditor is not accused of serious negligence or fraud. Finally, the auditor can refute such accusations by putting forward evidence that the damages incurred by the plaintiff resulted from other reasons.

As the zone of the auditor's responsibility in virtue of the Securities Exchange Act of 1934 is, to a great extent, that the plaintiff (buyer or seller) can litigate the auditor depending on any altered or fraud statement, under this law, the auditor is then not responsible for ordinary negligence but rather responsible only for gross negligence or fraud.

The case of Hochfelder vs. Ernst 425 U.S. 185 (1976) is one of the most important guiding cases in the field of determining the auditor’s overall responsibility according to the Securities Exchange Act of 1934. This case is related with an accountability and auditing firm, which audited the accounts of a company working in the field of securities brokerage in the period from 1964–1967. In 1968, the Board Director—who possessed 92% of the stocks of the company—stated in a note after he had committed suicide. that the company bankrupted owing to his manipulation of the accounts of various investors, as the director had persuaded those investors to send him their money directly through cheques deposited in a special bank account in his name or sent by post using his personal name, where he latter invested this money in escrow accounts, producing high revenues for the investors. The director gave instructions that the letters

with his name on them were not to be opened, but were to be delivered to him personally. In fact, there were no escrow accounts amongst the company accounts, and the director used the investors' money for his personal interests, as soon as he received the cheques.

Upon this, the company accounting records did not disclose these escrow accounts, and so they did not appear in the financial statements deposited in SEC. Accordingly, the investor, whose money was embezzled by the director, litigated the auditor civilly in virtue of Article No. 10 of the Securities Exchange Act of 1934, accusing him of ordinary negligence, claiming his responsibility for the damages they incurred. However, the plaintiff did not accuse the auditor of fraud or intentional mis-performance (Pany & Whittington, 1997).

In this case, the plaintiff depended on the auditor's negligence, due to his failure in detecting the shortcoming aspects in the inner control structure of the company, thus enabling the director to embezzle; if the auditor had performed his duty, he would have detected the fact that rule put by the director related, i.e. not opening post received with his name on it, as being an unsound measure as it was acknowledged, in financial establishments, that letters received to a company are opened in the mail room so as to secure the company against fraud that may be committed by its employers, thus making use of their position in the company.

The American Supreme Court refused the case and indicated non-recognition to litigate the auditor for compensation in virtue of Article No. 10 of the Securities Exchange Act of 1934 and related the rule issued by SEC, in the case of the auditor having no intention to commit fraud or deceive. Accordingly, the Court judged that the auditor had no responsibility as he did not have the intention to commit fraud or disclose untrue data. Also, the court judged that he had no responsibility for ordinary negligence under the acts of the Securities Exchange in 1934 with regard to regulating securities circulation (Pany & Whittington, 1997).

Generally, the pronouncement of this judgment reduced the zone of the auditor's responsibility towards non-clients as, under the Act of 1934, this responsibility became nearer to his responsibility under common law in the USA, as mentioned previously in this chapter.

2.3 The Situation in the UK

It may be stated that the auditor's civil legal responsibility was limited to the privacy doctrine. Napier (1998) indicates that, until the beginning of the 20th Century, the third party had no right to litigate the auditor for negligence—even if the financial statements on which they depended were the direct reason for the damages incurred.

Upon this, there was a difficulty in litigating the auditor outside the frame of contractual relations where the contract lagged and the contracted relation was non-existent. Essentially, the auditor had no responsibility, unless he committed fraud on the basis of the judgment whereby the auditor would not be responsible toward the other party for the damages it incurred, owing to its dependence on the auditing—even if the auditor was negligent. This was confirmed by the judgment pronounced in the case of Candler vs. Crane Christmas & Co., 2 KB 164 (1951) where such judgment emphasised the necessity to prove the existence of a contractual relation between the auditor and plaintiff to prove the responsibility of the auditor for negligence toward the plaintiff. Moreover, the third party had no right to litigate the auditor for negligence where a responsibility case is not recognised for a mere mistake statement (Pacini *et al*., 2000).

In 1964, there began an interest in the nature of the auditor's responsibility toward the other resulted from mentioning untrue data after pronouncing the judgment in the case of Hedley Byrne & Co Ltd. vs. Heller & Partners Ltd, 465 AC (1964). In this case, it was judged that responsibility may arise from damages occurring as a result of mentioning untrue data. Occurrences of this case are summarised in that the defendant's firm (Heller & Partners Ltd), a commercial bank, presented financial data concerned with the credit ability of Easipower Ltd. in response to the demand of another bank (National Provincial Bank) charged with this task for the sake of one of its clients. Markedly, the defendant knew that these financial data would be transferred to another unknown party (Hedley Byrne), which depended on these data so as to expand granting credit for Easipower. However, Easipower bankrupted shortly after that, and it was subsequently demonstrated that the data on which it was dependent for granting credit were untrue and misleading (Pacini *et al*., 2000).

The House of Lords, as is the supreme juridical authority in the UK, ratified a new legal principle stating that a person who has special skills, gives advice and information and knows that the information will be depended on must exert due diligence towards the person who will depend on such, and so he would be responsible for any negligence or breach for this task but would be responsible for compensating the damage incurred by this person due to his negligence. From this, the importance of this case arises, as it advocates the responsibility for negligence owing to failing to mention facts by a specialised advisor in any field. This means that the auditor will be held responsible for negligence towards any person other than the client (Hedley Byrne & Co. Ltd. vs. Heller & Partners Ltd.) (Wikipedia website).

Depending on the case of Hedley Byrne, the Institute of Chartered Accountants in England and Wales issued its bulletin concerning the auditor's responsibility towards the other (third party), demonstrating that the third party—who notably has the right to litigate for compensation—is limited to who incurred the damage due to the auditor's negligence in preparing his report (Wikipedia website).

The bulletin of the Institute of Chartered Accountants included various practical applications in the light of the previous judgment, where it indicated to Hedley Byrne & Co. Ltd. vs. Heller & Partners Ltd. (Wikipedia website).

2.3.1 For the Creditors of the Auditors' Clients

Clients generally present a financial statement ratified by an auditor for creditors in support of requests that are presented to get loans. Those creditors are considered from the other for the auditor. It was conditioned that, if they incurred financial injury by virtue of their dependence on the financial statements that checked by the auditor, evidence must be put forward to prove that the auditor committed negligence, and that he was aware when performing the audit that such financial statements were required by the client to be presented to the bank or other to facilitate obtaining credit or to continue obtaining credit facilities presented to the client.

2.3.2 Stockholders

The purpose of presenting these annual financial statements accredited by the auditor is to help stockholders to control the affairs of the company and to judge the efficiency of its management. The stockholders, as a whole, can litigate the auditor civilly if he has committed negligence or defaulted in his work, causing financial damage to the company owing to their dependence on the auditor's work. However, an individual stockholder has no right to litigate an auditor, if a related investment decision has been made, depending on the misleading accounts of the company supported by the auditor's report. Accordingly, it is demonstrated that the report was prepared negligently by the auditor or otherwise included misleading data as the purpose of preparing final accounts is as a service for all stockholders in total—not to enable one of the stockholders to make investment decisions.

However, the matter is different in the context of the auditor's report concerning the data recorded in the subscription bulletin. Markedly, if it appears that the auditor knows or must know that such data will be used for this purpose, in this case, he would be responsible toward the other for financial damages incurred owing to dependence on the report prepared by the auditor in spite of the non-existence of a contractual relation that may be used as a foundation for accountability.

Furthermore, the bulletin issued by the Institute of Chartered Accountants included an example of occasions wherein the auditor would be responsible for damages incurred by the third party according to a legal principle stated in the case of Hedley Byrne. The most important of these occasions (Abo Zeid, 2000):

- preparing reports or financial statements, when the auditor knows or is expected to know that the client intended to make the third party depend on financial statements (even if the exact identity of the third party was not disclosed to the auditor at the appropriate time);
- giving an auditor data related to the creditability of the client or giving guarantees related to its ability to carry out the conditions of contracts or giving any other kind of confirmations on behalf of the client.

The institute indicates that, when an auditor restricts the field of his report specifically or otherwise expresses appropriate reservations in his report or in a note enclosed with the financial statements, this may represent a repudiation of the responsibility to be effective in any negligence case prosecuted against him by any other third party. However, it must be kept in mind that reservation must be disclosed by the auditor only, if the situation requires this, as using this reservations randomly may deteriorate public confidence in the work done by the auditing profession.

In the next Hedley Byrne case, there appeared a direction towards expanding the zone of parties having the right to litigate the auditor for negligence; this was ascertained by the judgment pronounced in the case of JEB Fasteners Ltd. vs. Marks, Bloom & Co., 3 All ER 289 QBD (1981). In this case, the concept of the foresee ability was applied. Occurrences of this case are summarised as the plaintiff buying all stocks of a company depending on the auditor's report, which implies an unqualified opinion concerning the validity of the financial statements. Subsequently, it was demonstrated that such financial statements contained a huge amount of errors resulting from stocks possessed by the plaintiff where they were evaluated as being worth more than their real value. Although the auditor did not know when contracting with the client about auditing that there was a third party who wanted to possess stocks of the company, the auditor later became aware of such a purchasing process, and there were communications between the buyer (plaintiff) and the auditor throughout the purchasing process (Pacini *et al*., 2000).

The buyer litigated the auditor, claiming his negligence and his responsibility for the damages he incurred owing to his dependence on the audit when purchasing these stocks. This was supported by the court, which pronounced the responsibility of the auditor, emphasising his awareness of the fact that a third party may depend on these financial statements ratified by the auditor, when making certain decisions.

Moreover, the previous principle was applied in the case of Twomax Ltd. vs. Dickson, McFarlane and Robinson, SLT 98, 103(1983), wherein the Court investigated three separate cases prosecuted by some investors who purchased stocks of a company. After a short period, the company declared its bankruptcy. The Court judged that the auditor was indebted with due diligence towards the investors, and so the court pronounced the responsibility of the auditor for damages they had incurred on the foundation that the

auditor had knowledge with the dependence of foreseen investors on the financial statements subjected to auditing. Importantly, this was found to be enough to apply the proximity condition, on which the Court depended in terms of ratifying the auditor's responsibility towards the third party (Pacini *et al*., 2000).

Accordingly, it appeared that there was the need for controlling the zone of the auditor's responsibility towards the third party in the UK during the 1980s, when the judgment was pronounced in the case of Caparo Industries PLC vs. Dickman, 2 AC 605(1990). Occurrences of this case are summarised as the entering of the plaintiff into negotiations to obtain the majority of the stocks in a company in which he had previously possessed some stocks. In 1984, the plaintiff received a copy of financial statements subjected to auditing; these statements showed a profit of about GBP1.3 million, and depended on these statements when purchasing stocks. Later, the plaintiff discovered that the company that possessed the majority of its stocks had incurred losses of approximately GBP 460,000, and that the financial statements on which he depended when making decisions to control the company were misleading, and so he litigated against the auditor, claiming the auditor's negligence and responsibility for the damages he incurred.

The House of Lords made its decision unanimously for refusing the case prosecuted against the auditor. The House of Lords acknowledged the absence of identified conditions, stating that the auditors in public shareholding companies were not responsible for negligence towards foreseen investors or current investors buying new stocks of the company depending on the obligatory auditing process (Pacini *et al*., 2000).

In the same case, the court established conditions for applying the auditor's responsibility towards the third party. Such conditions are represented by the auditor, predicting the dependence of this party on the auditor's work, and a proximity state must exist in the relationship between the auditor and plaintiff. The court identified the following conditions that must be proven to apply this state, and accordingly highlight its realisation conditions:

- The auditor must know and understand that the results of the auditing process would be conducted to a third party known to him or belonging to a limited and identified class of persons.

- The third party must experience financial damages due to its dependence on the auditor's work.
- The dependence of the third party on the auditor's work must be the identified purpose of the auditing process.

The Appellate English Court adopted the same principle in its judgment in the case of James vs. Hicks Anderson & Co., 2 QB 113 (1991); in this judgment, the court ratified the necessity of not expanding the zone of the auditor's responsibility towards the third party, when it mentioned that courts in England must adopt a restricted concept towards identifying the third party, and the zone of the auditor's responsibility must be limited to a person or a class to which he belongs, and the auditor is intended to make him depend on the results of the auditing, and in the purpose for which the auditing was carried out. (Pacini *et al*., 2000).

From the above-mentioned, we can conclude that the legal principle issued in the next Caparo case resulted in restricting the zone of the auditor's responsibility towards the third party, as the auditor was not—under the absence of certain conditions—obliged to exert due diligence towards foreseen external investors or any one of the current stockholders who bought stocks of the company depending on financial statements certified by the auditor. To hold the auditor responsible for negligence towards the third party, they must put forward evidence that the auditor knew that the results of his work would be communicated to this party separately or otherwise to a member of a limited class of persons, and that this party would be dependent on the auditor's work with regard to a limited process or transaction.

2.4 The Situation in the State of Kuwait

The researcher reviews in this section the regulations in Kuwait state; from the reality of legislative texts contained in various Kuwaiti laws, that exposed to professional liability in general and the responsibility of the external auditor in particular. The aim of the review is to help understand the narrower issue of auditor liability in Kuwait state in order to determine the need for new legislation. Alternatively, an amendment to the existing legal texts to be more specific and appropriate to contemporary economic changes in the business environment of Kuwait.

The Kuwaiti legal environment depends on the code law; thus, Kuwaiti courts did not discuss much litigation regarding a dispute between users and auditors. Kuwaiti laws that dealt with financial regulation and came under the responsibility of external auditors in particular and professionals in general are as follows:

- Kuwaiti business Companies Law No. 15 of 1960.
- Kuwaiti Civil law.
- The regulation of securities and the establishment of investment funds No. 31 of 1990.
- Practicing the profession comptrollers Law No. 5 of 1981.

These laws are considered the foundation for the plaintiffs when they litigate the external auditor, who causes them damage as a result of their reliance on his report. Also, Kuwaiti Civil courts rely on them to issue the judgments when considering the raised cases against the external auditor.

According to these laws, auditor's responsibility is divided to civil liability and disciplinary responsibility:

Here the researcher reviews briefly what stated in this regard:

2.4.1 The civil liability for the external auditor:

Companies Law No. 15 issued in 1960, Article No. 165, is the only law concerning the auditing profession. It states that the auditor is responsible for the accuracy of the data in his report, as he represents all shareholders of the company (Fatwa and Legislation Dep., 2005). This article has been written, ambiguously.

Article no. 148 in the same law states that the chairman and members of the board of directors are responsible towards the company, shareholders, and third parties for all acts of fraud, abuse of power, and every violation of the law or the company's system and error in the administration.

On the other hand, the Kuwaiti civil law continues some articles (Fatwa and Legislation Dep., 2004) which are not concerned directly with the relationship between the auditors and the users, such as:

- Article No.705 for the relation between the agent and the client states that the agent should exert the due care of the ordinary person.

- Article No. 227 for the damage caused by another party, directly or indirectly, states that the party caused the damage should compensate the damage caused by him.

- Article No. 230 states that the compensation of a damage caused by other party should equal to the value of loss plus the gains lost from this damage. Moreover, article No. 247 states that the judge determines the value of the damage.

- Article No. 228, states that, if the damage is caused by more than one party, each party has the liability to compensate the complete damage (joint and several liability rules); and the compensation is divided between them according to the wrong doing of each party.

The researcher notes that the Kuwaiti legislations do not include legal texts specific only to the external auditors. But, there are general rules may be apply when the responsibility of the external auditor is held as he is considered a professional. Exceptionally, the Companies Law; which explained the responsibility of the external auditor in just one article which is inaccurate and came in general.

As can be seen that these laws did not give a clear and specific definition of third party who has the right to litigate the external auditor in the case of audit failure. It is also noticeable the lack of existence of adequate and organized legislative texts that mentioned the limits of responsibility of the external auditor toward the third parties clearly and comprehensively.

With regards to the Law of the regulation of securities and the establishment of investment funds No. 31 for the year 1990, it indicates some articles referred to external auditors and their criminal responsibility for any failure, negligence, and fraud committed while performing their work. Moreover, it states, in part, that the auditor is responsible for any negligence or imposture occurring while he is performing his auditing duties. This law did not include any articles regarding the damage potentially occurring for the investors from a wrongdoing of the auditor. These articles devoid from any provisions relating to civil liability of the company or its auditors for the benefit of the buyer of securities that issued by the company. Especially, when he may inflict damage due to his dependence on the attached financial statements in subscription bulletin and the auditor's report. This law did not decide any civil rights for buyer of securities against auditors; whom their negligence is proved during the auditing. Furthermore, it did not include any provisions relating to the rights of investor who deal with securities in the stock market. It was supposed that this law includes clear texts expose to the limits of external auditors' liability for normal negligence, huge negligence, and fraud toward the third parties. It should determine the definition of third parties and the measure on which the court depends to estimate the damage that required compensation to the plaintiff.

2.4.2 The disciplinary responsibility for the external auditor:

Article 9 of Law No. 5 for the year 1981 in the matter of practicing the profession comptrollers, states that the auditor; who is applying to register in the record of auditors; should swear before starting audit that he will lead his work honestly, taking into his account the rules of the profession. Moreover, swear that he will not hide the truth to the stakeholders and will not reveal the secrets of his customers or any information that entrusted to him during the work. Besides, abiding the charter of honor

which organizes the profession. Under article 283 of the same law: the disciplinary sanctions that may apply on auditor are as follow:

- Alarm.
- Suspension from practicing the profession for a period of not more than 3 months.
- Erase his name from the record of auditors.

The auditor can appeal against the decision of the Disciplinary Committee; which issued a disciplinary punishment, at the Kuwaiti courts.

Practically, it is noted that the professional organization in Kuwait are not interested in monitoring the audit profession to activate the disciplinary responsibility contained in the Kuwaiti constitution for profession. As a result, the performance quality of the audit profession has not being controlled by the professional organisation. Accordingly, there are many calls for placing legal liability on auditors in order to affect the audit quality positively.

The researcher believes that to activate legal system for the responsibility of the external auditor, it requests the attention in the role of professional organizations. Importantly, seek to organize the role of these professional organizations in the scope of control on the external auditors' professional performance. This includes that organisations should participate in the development of technical controls for audit profession. As well as, participation in the preparation of accounting and auditing standards and raise awareness about them. Also, includes creating local professional practices in order to correspond with international auditing standards, requirements of globalization, and the required qualifications to face the international competition in services. It also requires the sustained rehabilitation and continuing education for practitioners of audit profession in order to keep up with the rapid developments in this area and to increase the confidence of the audit profession.

Accordingly, there is a weakness in the Kuwaiti legal environment regarding auditor liability, as the rules applied are general and do not mention the auditor's overall responsibility towards third parties. This is owing to:

- less comprehension for the auditor liability from the users of financial statements and investors particularly;
- non-existence of a legal system governing the securities trading in the Kuwaiti capital markets, and the dissemination of financial reports;
- the slowness of litigations in the Kuwaiti courts and the shortage of compensation for the injured.

Furthermore, the rank of Kuwait in the worldwide governance indicators (WGI) of the World Bank (Kaufmann *et al.*, 2008), which covers six dimensions of governance, have not improved since the inception of the WGI, in 1996. The rank of the State of Kuwait in the WGI (the rank from 1 for low rank to 100 for high rank) is summarised in the following table:

Table (2.1): Rank of Kuwait in the worldwide governance indicators

Governance dimension	1996	2010
Voice and accountability	45	32
Political stability	50	60
Government effectiveness	60	58
Regulatory quality	56	55
Rule of Law	69	66
Control of corruption	78	67

This indicates a weak environment for investment and auditing professions, thus reflecting the needs of information users for a liability system to prompt investment process for the general economic wellbeing of developing regions.

The researcher believes that it is necessary for the litigation climate in Kuwait to be characterized as follows:

- Easy litigation proceedings
- The expected compensation for the benefit of plaintiffs should fit with the size of damage caused to them due to their dependence on the external auditors' report; whom negligence or fraud is proved.
- Educating users of financial statements to know their legal rights.
- The availability of adequate insurance for the external auditors against litigation risk.

2.5 The Decision Made by Financial Statement Users

The main use of the audited financial statements is for decision-making. A major consideration when making decision is the legal environment; hereafter, the researcher considers the decisions by users. The Financial Accounting Standard Board (FASB) defines users of accounting information as (FASB, 1978):

> *'members and potential members of some group-such as owners, creditors, and employees- have or contemplate having direct economic interests in particular business enterprises…Members of other group- such as financial analysis and advisors, regulatory authorities, and labour unions-have derived or indirect interests'* (Braiotta *et al*., 2010).

From this, we can categorise the external users of accounting information as follows: investors, creditors, and financial and government organisations. The needs of each user category may differ according to the use they wish to make of the accounting information. Investors (i.e. potential investors and stock holders), for example, depend on reports and financial statements when making purchasing, selling or holding decisions, using them to obtain the information necessary for the evaluation of various issues, such as investment risk and return, management's ability to use available economic resources effectively to achieve a positive cash return for investors, and the

firm's ability to continue its operations. In this regard, Titman & Trueman (1986) created a model to examine the potential benefits of audit quality for investors when evaluating stocks and shares, as auditing processes can prove valuable to investors should they reduce any uncertainty in regard to financial reports prepared by management.

Franz *et al*. (1998), however, suggest another value for audit services. Aside from the likelihood of uncovering any management fault or fraud, users may also regard auditing as insurance; in other words, they may consider the auditor to be a partial guarantor for the value of an investment in a firm's securities, as any losses in value owing to deficiencies in the financial statements will be covered by the management through legal action against the auditor.

Creditors (i.e. banks, financial credit firms and lenders) use accounting information to help them calculate credit risk by evaluating the ability of a firm to generate positive cash flows in the future. This determines the firm's ability to repay borrowings and interest over time, which in turn affects the creditors' ceiling and investment costs, rather than considering simply the firm's asset value.

With consideration to the requirements of financial authorities (e.g. the Stock Exchange) and government agencies (e.g. the tax service), accounting information enables them to determine whether or not a firm is in compliance with its obligations as per the relevant rules and regulations.

This study is particularly interested in the effects of an alternative legal liability system concerning the decisions of financial statement users in relation to investment in a firm. The researcher believes that there are several reasons for this:

1. Investors usually represent the largest category of users of accounting information.
2. Investors' decisions are considered one of the most important determinants of a society's resource allocation and thus future economic growth.
3. Investors' decisions may be used as a basis for creditors' decisions because their goals, and their intended use of accounting information, are similar. Both investment and credit activities serve to make available financing for a firm to pursue its own investment projects, and it is this similarity of

purpose, and the possibility of economic damage resulting from reliance on a misleading audit report, which may encourage either party to decide to sue the auditor.

2.6 Conclusion

The liability rules governing the auditor's liability will vary across different societies based on whether or not it depends on common law or a code law system, or whether the economy is a developed or an emerged economy. There is no agreement regarding the liability rules applied or the level of the liability of the auditor towards third parties. In the USA, for example, there is restricting auditor legal responsibility towards the third party, with normal negligence applied in the case of auditing failure if the auditor does not know the third party. On the other hand, serious negligence is applied if the auditor knows the third party. In the UK, the Institute of Charted Accountants indicates in its bulletins that creditors and investors are primary users of the audited financial reports, and can therefore litigate the auditor for any damage caused by negligence if proved. In an emerged market like Kuwait, however, there remain weaknesses in the legal system, which may cause users to be less concerned with the financial reports and the auditing services. This environment cannot support investment, and thus is a dire need for a legal system to improve audit quality and thereby increase investment level in such emerging markets.

The next chapter is literature review of audit quality and auditors' responsibility.

Chapter Three: Literature Review of Audit Quality and Auditors' Responsibility

3.1 Overview

In any business organisation, the company's progression is considered as a basis for, amongst other things, decision-making and as an indicator for evaluating the firm's overall performance. A financial analysis or evaluation is a tool documenting current and future financial situations in order to determine a financial strategy to assist achieve organisational objectives. In actual fact, economic growth and the separation of capital possessions from its management have the greatest role in terms of increasing auditing importance, and so auditors have a great role within society. This requires them to maintain their distinguished professional position through resuming providing professional services of the highest levels to gain the confidence of the public.

Auditing in any business is the inspection and verification of the precession of financial statements based on accounting records and procedures. It is well known that a firm that does business with stock on a registered stock exchange or otherwise arranges to issue new shares of stock must agree to an external audit. Moreover, an external audit is used to give the financial users a true and fair statement of a company's financial position. With this, auditors make sure that the business has fully followed the procedures and steps in preparing financial statements and report. As part of this preparation and investigation, auditors compare the current financial statements with the past years' in order to identify inconsistencies. If they establish lapses, they will create a picture or report the financial position to the Board of Directors. Moreover, the job of external auditors also involves the inspection of assets to determine whether their value is overstated. Moreover, liabilities and debts are also checked to ensure that they have not been understated.

Importantly, the emerging crises gripping many of the multinational corporations lately (Enron, for instance) have raised questions concerning the role adopted by the auditor in preparing opinions concerning financial statements and doubts surrounding the

performance of auditors, thus heightening legal responsibility and potential prosecution in the face of negligence.

In light of the above, many have questioned the credibility of the auditor's job and the quality of the auditing outcome, the legal responsibility of the auditors is scrutinised, urging a professional review to improve performance quality and eventually rationalise the decisions made by financial statement users. However, despite professional and academic efforts in this area, a deficient reaction is cited, thus necessitating a reconsideration of the quality issue from a comprehensive perspective with greater controls to devise new approaches to the improvement in auditing quality.

Auditing quality—a multi-faceted concept—is concerned with all participants in the auditing process and beneficiaries; however, both parties view the auditing process differently. Shareholders, on the one hand, are known to evaluate quality in a different way to that of creditors, who view quality differently to investors. Undoubtedly, other parties using financial information will also perceive quality differently from the auditing team owing to a number of reasons relating to auditing standards, economic considerations, professional accountability, and cultural backgrounds. Essentially, although quality traits or factors influencing them have not been defined clearly, they need to be appropriately stated to identify their relevance to the legal accountability of external auditors.

Nevertheless, despite the fact that the professional organisation of auditing does not guarantee the attainment of a desired level in terms of professional performance, with the quality control standard in place, professional development should be able to reduce chances of failure; thus, the consistent pursuit of improving quality of professional performance is one major characteristic to enable the auditor to confront the fallout brought about by the legal liability arising from the auditing process.

Since the external auditor's performance is considered the mainstay when making decisions, the financial statements which have been audited are considered the basis on which decision makers rely; this necessitates that auditors deliver the highest professional performance in terms of quality.

Trust in financial statements, as released by companies, is one of the fundamentals helping to support and activate financial markets, and so the role adopted by an external

auditor from the aspect of validating and authenticating the issued financial statements is of great importance as the basis for decision-making. Legislature in terms of accounting and auditing seeks to forge controls, criteria and guidelines, all of which would generate better trust in the external auditor's performance.

Importantly, the users of financial statements assume that auditors are supposed to perform the following tasks:

1. conduct auditing efficiently, honestly, independently and objectively;
2. improve auditing effectiveness from the quality perspective;
3. provide more useful information to financial statement users about the nature and results of the auditing process including early warnings about the survival of firms; and
4. ensure clearer communications with the auditing committees, or other concerned parties charged with the preparation of financial reports, used to rationalise the decisions by such users.

Various studies have examined this issue; however, they have not been able to determine a definite and comprehensive framework addressing the different dimensions making up the relationship of legal responsibility to the auditing process so as to provide a measure for quality level of auditing. Therefore, there is a crucial need for researchers and practitioners to develop existing approaches to quality control, suggesting new ones that would protect equity and enhance performance quality so that decisions made by financial statements users are rationalized.

This research contributes the accounting literature through finding answers to the following questions:

1. What are the liability rules that improving audit quality within society?
2. What are the factors affecting auditor activity and audit quality?
3. Is there a relationship between investment level and liability rules applied and audit quality?

The problem in this regard is thus summarised in regard to the lack of a crystal clear framework addressing different dimensions governing the legal liability of external auditors, as viewed by the different parties involved in the auditing process, so that the quality of the auditor's performance is scrutinised besides the absence of an approach

that would control the auditing quality through the careful review of various dimensions, eventually serving the rationalisation of decisions made by users of financial statements.

To limit the zone of the study and to thereby achieve its goals, the study will be limited in terms of reviewing the accounting literature for auditing quality and studying the auditor's civil legal responsibility towards clients and third parties so as to analyse the relationship between the alternative legal rule regulating this responsibility on the one hand, and the auditing quality and decisions of financial statements' users related to the determination of their investment volume in their business establishments on the other. Moreover, the study will also enable us to establish the way in which the legal system of external auditors impacts the responsibility of the auditor and the decisions of auditors, as well as the users of financial statements.

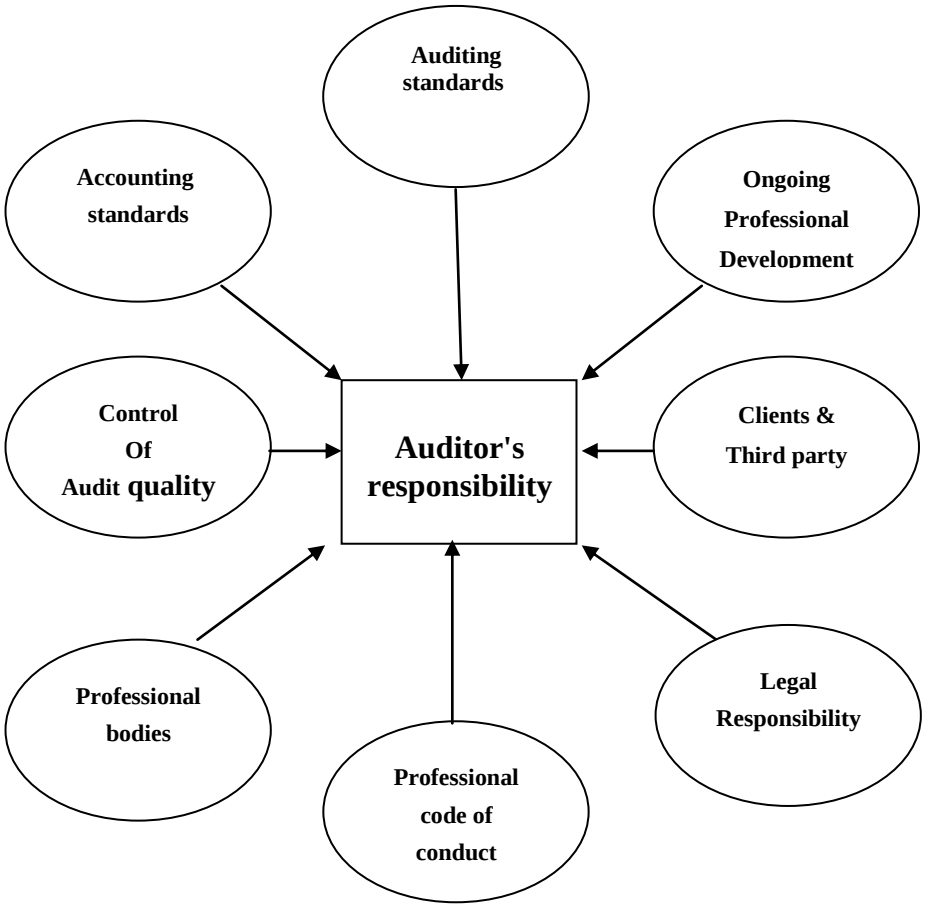
Based on the above-mentioned, the researcher will study and analyse the issues concerned with auditing quality, and accordingly analyse the auditor's civil legal responsibility towards the different parties so as to determine the conceptual frame for this responsibility through dealing with the following points:

3.2 Auditors' Responsibility towards the Client and the Third Party

The aim of the audit of financial statements is to enable the auditor to give his opinion on whether or not the financial statements of the company under audit accurately reflect—in all significant respects—the financial position of the company and its income results and cash flows.

Importantly, the auditor plays a significant role in the development of a certain business and is responsible for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor 1995). Noted below are various factors influencing the auditor's responsibility:

Figure (2): Factors influencing the auditor's responsibility



An external auditor may be exposed to civil legal responsibility towards a client (business firm which audited its accounts) or the third party of user financial statements if it is confirmed that he failed in doing his professional duties according to the required care and professional skill. This means that, in the case of auditor negligence or if he committed a fraud by giving an inappropriate opinion about financial statements, the auditor becomes responsible for compensating for incurred injuries.

Rulings passed by courts in different countries with established judiciary practices, such as the USA and the UK, and which deal with legal problems raised by accounts audits, state that external auditors exert due professional care. The problematic pivot became an explanation for the meaning of due professional care.

3.2.1 Due Professional Care

Due professional care, as one of the general principles governing the auditing process, indicates the care level, diligence, personal judgment, skills and professional competencies familiar to other auditors working in the same conditions in which the auditor works or in similar conditions. This means that the auditing process and the compiling of reports is carried out with the same degree of care, competence, learning and experience available to other members in the auditing and accounting profession, as required by professional standards (Guy, Alderman & Winters 1999).

As auditors are required to exercise personal judgment, care, regular skills and expected skills from other auditors, this means that evaluating auditors when investigating negligence cases requires comparisons to be drawn between the auditing procedures carried out by auditors with the care criterion; this includes procedures that other auditors would follow in the same conditions, i.e. if it is confirmed that an auditor was remiss in carrying out these procedures, thus he became negligent (Kadous 2000).

Thus, in practice, due professional care is determined, or the performance level is compared with auditor performance (defendant) in order to explore the extent of negligence when carrying out professional duties, which is carried out by the experts appointed by the courts before which the case against this auditor is raised. This means establishing the level of due professional care for a particular situation completed after the auditor has completed the auditing process. As a result of this, researchers agree that the due care criterion is vague as the auditor does not know in advance before beginning auditing. Furthermore, experts appointed by the court may have more information than what the auditor had relied upon when giving his opinion; this may lead to a hindsight of due care, or well-known hindsight, resulting from late awareness (Anderson *et al*., 1997; Kadous 2000).

In the same context, the study of Kadous (2000) indicates that determining the due care criterion after completing the auditing process may lead to auditing failure consequences on the care level of the required auditing. This study concludes that there is a forward relationship between the intensity of results based on auditing failure on the one hand and the due care level of the auditor on the other hand—an increased intensity of results or losses (e.g. workers lose their jobs, expose to several parties to

loss, firm failure), increase of due care level determined by the court. Some authors (Bonner *et al.*, 1998) suggest that the nature of the fraud committed in financial statements has an influence on the understanding of the jury and judges of the auditor's responsibility.

Some authors (Schwartz 1997; Radahakrishnan 1999) argue that the inability of auditors to predicate the due care criterion shall be used in evaluating their performance, which may be an incentive for them to increase their auditing effort or present more conservative opinions in terms of auditing reports so as to reduce the possibility of their exposure to litigation risk or to negligence (Kinney & Nelson 1996).

3.2.2 The Third Party

Generally, we can define the third party, i.e. those with the right to litigate the auditor legally (Boynton & Kell 1999) as:

- Primary beneficiary: indicates a known person, his name given in advance to the auditor, as he will be the main user or primary beneficiary of the auditing results and auditing reports. For example, a client informs an auditor before beginning the auditing. Then this auditing report will be used in obtaining a loan from a particular bank. In this case, the bank is considered as the primary beneficiary of the auditing.
- Other beneficiaries: a category of users, their names are not given in advance to the auditor, but they depend on his opinion when making their decisions related to audited firms. Examples of this category are stockholders, prospective investors, creditors and others who use financial statements.

From the above-mentioned, it is clear that the third party who has the right to litigate auditors, due to injuries incurred resulting from his depending on misleading financial statements accredited by the auditor, belongs to different categories with branched and conflicting interests. Nobody calls an auditor to reconcile between the interests of these categories or to care for their interests to the same degree. Moreover, opening the door to legal responsibility for the third party to litigate the auditor ultimately exposes the auditor to arbitrary requirements, causing the greatest injury to the auditing profession.

3.3 Impact of Litigation Risk on the Auditing Profession

Markedly, litigation risk is viewed as being an element of risk associated with final auditing, which means losses or physical or moral injury to which an auditor may be exposed if the auditor is presented with an inappropriate technical opinion concerning financial statements. More specifically, auditing risk is achieved when an auditor makes a mistake. This mistake takes two forms. The first is represented in a mistaken conclusion by the auditor, with him being convinced that there are fundamental mistakes which caused him to present an adverse report; an appropriate report, on the other hand, must be unqualified. Accordingly, an auditor's report causes serious injury to audited firms, thus resulting in the client litigating the auditor and potentially defaming his professional reputation and causing the loss of several current and prospective clients. The second form is represented in the inability of the auditor to discover the fundamental errors included in financial statements, and so the auditor issues an unqualified report when the appropriate one is an adverse report. This causes injuries to the parties depending on the auditor's report when making their decisions related to audited firms, thus resulting in litigating the auditor and claiming him responsible for losses incurred by such parties owing to their dependence on the auditor's report.

During the last decade, the auditing profession has witnessed several crises resulting from an increase in litigation risk to which auditors were exposed and who may subsequently suffer from heavy economic losses owing to the litigation raised against them by third parties. Litigation and compensation required to be paid increased remarkably in the last decade of the past century, thus raising disputes in auditing and the legal settings in several countries, such as the USA, where costs incurred by large audit firms for defence and litigation fees increased from over 7% of its annual revenue from accounting and auditing services in 1990 to 9%, in 1991, equating to almost US$477 million. This percentage increased suddenly to 19%, in 1993 owing to legal allegations, therefore estimated at almost US$30 billion; this is owing to widening the scope of legal responsibility of auditors and increasing the possibility of the third party to litigate an auditor due to negligence (Dennis, Engle & Stephens 1996; Tucker & Zurich, 1993).

The study of Palmrose (1988) supposes a reverse relationship between the quality of professional performance and audit cases, and concluded—depending on a sample including 472 cases with alleged auditing failure against the largest 16 audit firms working in the USA—that auditors belonging to eight large audit firms (now only four) were exposed to a lower rate of litigation compared with smaller firms depending on the fact that large audit firms present auditing reports with high quality, thus reducing the possibility of litigation.

Moreover, the study of Khurana & Raman (2004)—which is related to the litigation risks and financial reporting credibility of big4 firms and non-big4 firms in Anglo-American countries—shows that the exposure to litigation risk is the driver for perceived audit quality more so than brand name protection. In this regard, their study revealed that there is a relationship between auditing quality and litigation risk and the level of damage facing the auditor, and that decreases in auditor litigation risk could have unintended results for the perceived audit quality in the USA. This study has further established the degree of responsibility of an auditor in accordance with their profession, as stated in the papers of Simunic & Stein (1996) and Venkataraman, Weber & Willenborg (2008).

In contrast, large auditing firms dispute the fact that they are exposed to litigations not relying on law, but that such litigations result from plaintiffs who are convinced that firms have the financial ability to pay juridical requirements (Anderson *et al*., 1992). This is indicated by the study of Dunbar & Juneja (1993), which concludes after investigating fraud cases related to securities that:

a. The predicted value of payments is higher when the auditor is the defendant in the litigation.
b. The payment's size is determined by the ability of the defendants to pay.

Thus, plaintiffs have greater incentives to litigate auditors when the latter belong to large audit firms (Raghunandan & Rama 1999). In spite of this, Lys & Watts (1994) did not find a correlation between the size of auditing firms and the number of auditing cases. The authors justified this result by stating that there was no sufficient variety for the variable of size in the study sample as the most important items were belonging to large auditing firms.

The auditing response to increased litigation risks is crystallised on two main axes. The first is an attempt to reduce the possibility of auditing failure through setting quality control standards, introducing an auditing concept by peer review as a way of self-regulating auditing and adopting recommendations issued by the Threadway Commission (Krishnan & Krishnan 1997). Moreover, the study of Pratt & Stice (1994) provides various arguments for auditors, seeking to reduce the possibility of auditing failure through supporting auditing planning procedures. This study concludes that auditors seek to classify client characteristics related with litigation (as financial states and assets structures) when determining the auditing argument appropriated for this contract. From this, we can conclude that an auditor designs appropriate auditing procedures that are sufficient to balancing them with litigation risks. This is reflected in the possibility of detecting errors contained in financial statements.

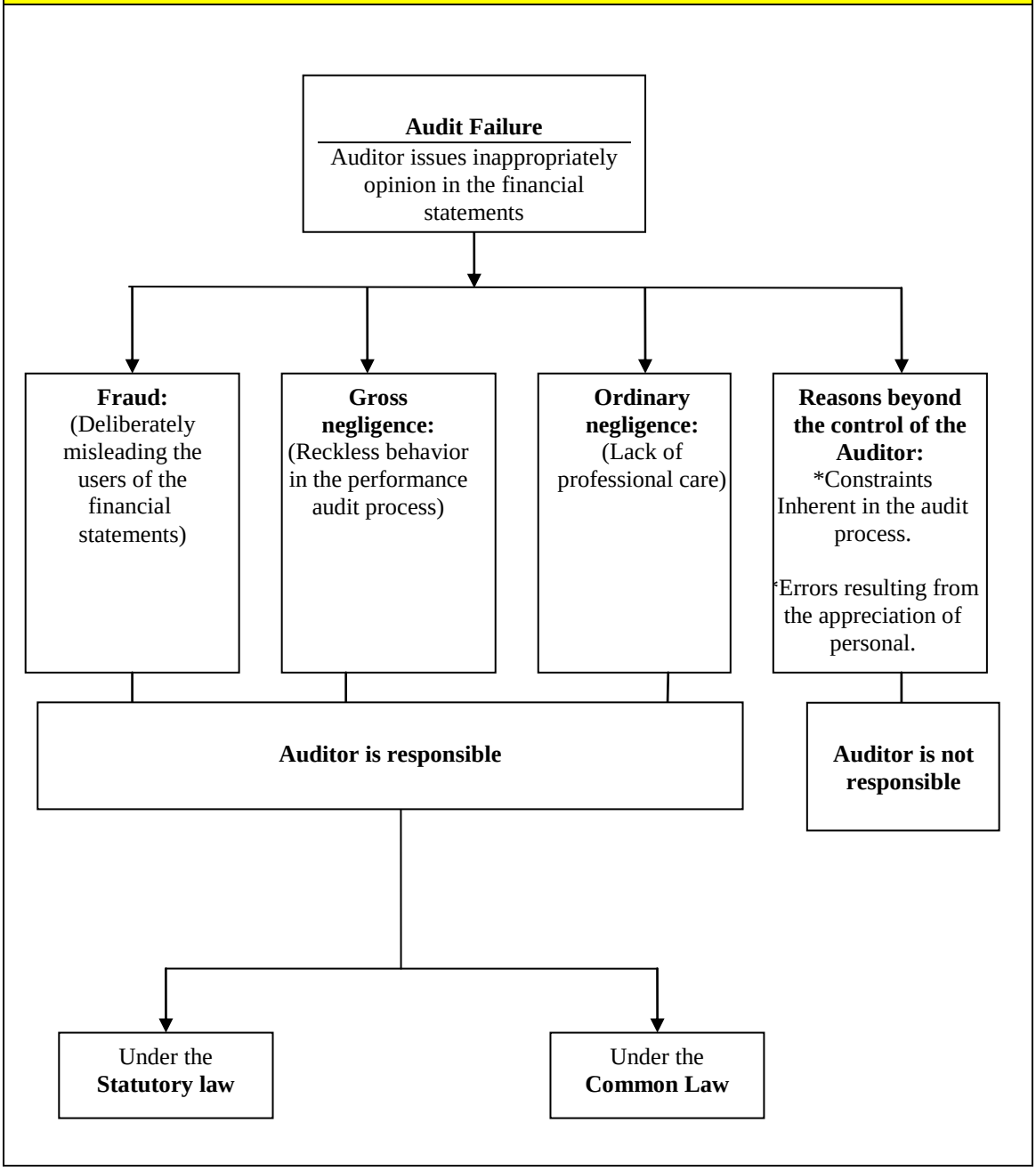
The second axis is represented by a group of other acts reducing litigation risks, which can be resorted to in cases where auditing failure is not the main determinate for litigation risks. One example of such an act is caution in auditing contracts for clients with a high degree of risks: for instance, directing towards expanding issuing restrained opinions (Krishnan & Krishnan 1997).

3.4 Results and Reasons for Audit Failure

An auditor may be exposed to litigation, regardless of auditing failure. Sullivan (1992) indicates that a number of litigations against six large auditing firms in the USA (now only four) resulted from an examination of the accounts of public shareholding firms equal to three times the real number of auditing failure cases (Krishnan & Krishnan 1997). Also, Stice (1991) indicates that litigation against auditors may not result directly from auditing failure as the auditor may be a target for litigation owing to financial ability or otherwise due to the low cost of defendants' characterisation. In actual fact, plaintiffs have a strong incentive to litigate the auditor—even if there are no predicated benefits for this procedure (Raghunandan & Rama 1999).

Below, some of the reasons for audit failure are noted along with the responsibility of the auditor and its sources:

Figure (3): Reasons for audit failure



Lys & Watts (1994) dealt with the relationship between the issuance of a qualified opinion and the possibility of exposure of the auditor to litigation, indicating that a qualified opinion may reflect a sound opinion in financial statements through finding and reporting an accounting problem. In these cases, we can observe a reverse relationship between reporting the auditor a qualified opinion and the possibility of his exposure to litigation. This relationship remains valid, unless it is clear from the auditor's reservations that he has failed to find an accounting problem and to report it in

the previous years. This means that a qualified auditor's opinion increases the possibility of litigation. In the same context, Carcello & Palmrose (1994) conclude that presenting the auditor with a qualified opinion reduces the possibility of exposure to litigation, whereas a small percentage of 10% of qualified reports in auditing cases were observed in the sample of the study. Observance of this percentage, regardless of its reduction, supports the statement that issuing qualified auditing reports prior to exposing the client to bankruptcy may not protect the auditor from the consequences of legal responsibility.

In the above-mentioned, the auditing profession must induce caring of audit quality to reduce the possibility of auditing failure and thus secure an appropriate minimum of auditor professional performance. In this regard, the activation of even a legal system for the auditor's civil responsibility is viewed as being one of the effective guarantees for auditing quality.

3.5 Auditing Quality

The definition of 'auditing quality' is provided by De Angelo (1981a), who is considered to be the most accepted of authors, in the field of auditing. He defines the term as detecting breaches in clients' accounting systems and reporting such (DeAngelo, 1981a). Consequently, according to this definition, auditing quality means the increased ability of the auditor to detect accounting faults and to accordingly increase independence. Others define auditing quality as the degree of confidence provided by the auditor in regard to financial statements' users (Arrunada, 2000), as it is recognised that the purpose of auditing is to induce confidence in financial statements. Accordingly, the researcher can therefore state that auditing quality relates to free financial statements from essential faults and contraventions.

In addition, other researchers suggest a variety of other definitions of auditing quality. For instance, there is that of who defines auditing quality as a measure of the auditing ability in relation to reducing bias of accounting information and improving its overall accuracy (Carey & Simnett 2006). On the other hand, another researcher defines auditing quality as the accuracy of information provided by auditors to investors (Deis, 1992). A third researcher defines auditing quality as a counterpart of information

accuracy of the auditor's report, and the overall capacity of the auditor to detect and exclude essential faults and contraventions in net income disclosed by financial statements (Butler *et al*., 2003), and to further consider the possibility that auditors may issue non-clean reports concerning financial statements, which may contain essential faults (Becker *et al*., 1998). Finally, a fourth researcher suggests that auditing quality, from the perspective of many professional organisations, is determined to mean the degree of auditor compliance with professional standard issued by such organisations (Francis, 2004).

Based on the above-mentioned, we can state that auditing quality suggests the degree to which auditing ability is able to detect essential faults and contraventions in financial statements, and accordingly announces such in addition to asymmetry between management and stockholders, thus protecting the interests of investors under separation property from management.

In actual fact, an auditor must run the auditing process with its different phases according to accepted auditing standards, containing principles, the main measures and related guidelines. Furthermore, an auditor must also conduct the auditing process considered necessary under the surrounding conditions in order to ascertain whether or not all financial statements are free from any significant errors. In this regard, he can plan and do auditing depending on reasonable professional doubt, recognise that there are conditions resulting from significant mistakes, impacting financial statements, and accordingly collect an enough and suitable degree of confirming arguments to conclude appropriate results, upon which he can build his opinions; in this regard, arguments in auditing are persuasive rather than definitive arguments. In addition to the above-mentioned, auditors (the auditing firm) must apply policies and quality control procedures designed to ascertain that auditing processes are supported according to recognised auditing standards. Moreover, auditors may also ask for assistance from individuals with professional skills and efficiencies, thus enabling them to carry out their tasks satisfactorily, as auditing processes assigned to individuals have a degree of practical training and have necessary professional qualifications.

Many researchers have found evidence to support that large auditing firms carry out an auditing process of high quality and accordingly impart more accreditation to the client's financial statements compared with small auditing firms. This opinion depends

on large auditing firms carrying out an auditing process of higher quality, as such organisations enjoy human and physical resources, thus enabling them to attract more skilful professional competencies and the availability of physical resources required to train auditors and conduct examinations.

In this regard, DeAngelo (1981b) argues that eight large auditing firms (now four) have more incentives for discovering errors in financial reports prepared by management, and subsequently issuing accurate audit reports to maintain the brand name reputation formed by these firms, not risking losing this reputation and their clients, and accepting lower fees (Lennox, 1999a). From the evidence supporting this opinion, the firm Arthur and Andersen—which provided accounting and auditing services—lost many of its clients months following the collapse of the firm, where this situation gave a justification to the clients of the audit firm to get rid of auditors belonging to this firm, especially under abnormal interest directed at them owing to the litigations of stockholders against them, as well as avoiding exposure to the strict control of organisational bodies in the case of continuing employing the auditors for serving Arthur and Andersen (Weber, Henry & Lavelle 2001).

Similarly, DeFond & Jiambalvo (1991) indicate that the clients of large audit firms have reduced the possibility of committing errors or irregularities that cause the manipulation of profitability. Such authors emphasise, in the following study, the increased possibility of conflict between the auditor and the management of the auditing client concerning the incentives for the client to manipulate profitability when such firms employ auditors belonging to large audit firms (DeFond & Jiambalvo, 1993). In the same context, the study of Becker *et al*. (1998) concludes that the auditors of client accounts belonging to large audit firms reduce the possibility of the management inflating income through abnormal accruals and thus restricting the firm's exercises relating to accounting estimates. The study also indicates that the Big Six auditing firms at the time (now four only) offered auditing of higher quality than other small audit firms.

Lennox (1999a) concludes that large audit firms give accurate observations with regard to financial distress when giving audit opinions and increasing the possibility of issuing the appropriate opinion concerning the ability of the firm to continue; this is because large auditing firms have the technical ability to investigate opportunities of continuity

or to otherwise have a large number of clients suffering from problems relating to the continuity of their firms, and so have greater experience with such situations (Wooten, 2003).

Some researchers (Nichols & Smith, 1983; Eichenseher, Hagigi & Shields, 1989; Lennox, 1999a) indicate a positive reflection within the stock market when auditing firms turned to large audit firms compared with small audit firms. Furthermore, firms produce new issues in terms of the pricing problems of pricing their securities less than the fair price when utilising large auditing firms (Balvers *et al*., 1988).

3.5.1 The Need for Auditing Quality

The determination of auditing quality is viewed as being one of the most difficult matters owing to the difference in terms of its nature and the variety of beneficiaries of such. Auditing quality is viewed as being a main demand for all beneficiaries of auditing owing to the following reasons (Clarkson & Simunic, 1994; DeFond, 1992):

1. auditors must carry out auditing with the highest possible quality to ensure credibility on their report;
2. the management of the auditing establishment should want to impart confidence in its financial statements, thus requiring the performing of auditing with the highest possible quality;
3. professional organisations should consider achieving quality when carrying out auditing tasks, and guarantee fulfilment of auditing with its responsibilities towards all concerned parts; and
4. due to severe competition amongst auditing firms, both auditors and clients pay attention to auditing quality as a predominance factor when distinguishing between auditing firms.

As a result of the urgent need to improve auditing quality, various researches and studies in this field have focused on the fact that auditing quality is one of the most important questions at both academic and applied levels, as the Chairman of the Securities and Exchange Commission (SEC), in 1998, indicates that, in order to decrease the number of cases where auditors fail to perform their work with the required level of quality, there is the need to develop professional standard and legislations, organising auditing to guarantee improvement in terms of auditors' overall

quality performance. This ensures adequately serving users of published financial statements, and accordingly helps them to make rational investment decisions (Heninger, 2001).

3.5.2 Measuring Auditing Quality

Various studies have made use of direct measures for measuring auditing quality. For example, some studies have analysed control measurements on applied quality in real auditing tasks, with such being used in order to distinguish between different levels of auditing quality (Schaner, 2001). Furthermore, other studies have utilised the results of counterpart auditing for measuring auditing quality (Krishnan & Schauer 2000). On the other hand, auditing quality measures adopted in one study depend on the degree to which the auditor ensures compliance with accepted auditing principles and standards, as well as legislations concerning organising auditing. This compliance directly relates to the possibility of detecting auditors' fundamental faults and contraventions (Wong, 2004). However, in terms of measuring auditing quality, some researchers have utilised the Client-Bid-Ask spread, which is the difference between the demand price and supply price of stock in audited establishment (Balsam *et al*., 2003).

From the above-mentioned, the researcher can conclude that, although there is no general agreement amongst studies on particular measures for auditing quality, researches specifying a group of measures can be dependent upon measuring auditing quality under auditor's legal liability.

3.5.3 The Relationship between Auditing Fees and Auditing Quality

The paper of Jensen & Payne (2005) argues that auditing quality and quality fees in response agency costs are also important in terms of auditing—and even in any business. The use of advanced auditing methods is related to employing auditors with good skills and industry experience. The study adds that advanced methods have little effect on auditing fees; however, in some cases, an increase in quality is not necessarily related to higher auditing fees. Moreover, it is suggested that it is not clear whether or not focusing on fees leads to a significant increase in audit quality.

In connection to this, the study of Abbott, Parker & Peters (2006) reveals that auditing fees reduce with income reduction discretionary accruals and vice versa. They also identify that the increase in auditing fees for positive discretionary accruals is significant for firms with higher price earnings, which may be owing to auditors' prejudice; such prejudice results from irregular law suits, meaning the audit risk model does not sufficiently explain the auditor's attitude with regard to audit planning and investment, and that the litigation risk component of auditor production function is useful in terms of maintaining higher auditing quality.

Moreover, various authors (Palmrose 1986; Craswell, Francis & Taylor, 1995) have dealt with the relationship between the quality of the auditing process and the size of the auditing firm, making use of auditing fees as an indicator of quality, as they supposed differences in quality of professional performance between audit firms, and under the competitive market, there was a reflection of supposed differences in quality in auditing fees. The results indicate that large audit firms obtain more fees than small audit firms, in spite of controlling the variables related to audit risks, client size and the overall complexity of the auditing process. It was found that there was a subsidiary on auditing fees based on the size of the audit firm to which the auditor belongs (Colbert & Murray, 1998).

Attempts have been made to determine whether or not there is a relationship between subsidiaries obtained by large audit firms and offering services of higher quality failed. In spite of the possibility of the existence of a positive correlation between auditing fees and the quality of the auditing process, as the literature indicates, until now, there has been no scientific evidence confirming the existence of such a relationship (Elitzur & Falk, 1996; Wooten, 2003).

3.5.4 The Relationship between Auditing Specialisation and Auditing Quality

Auditing remains a bit of an ambiguity to those who are not familiar with the concept, as this process becomes more technical and sophisticated. Since the process is highly technical and complicated, it is necessary that it be handled by an individual who is an expert in this procedure. Thus, as indicated in the paper of Hogan & Jeter (1999), specialisation should be assigned enough importance to maintain the reliability of auditing procedures. For instance, whilst best practice has evolved and established certain tools for analytical audit or establishing audit trails, an element of subjective judgment remains as auditors determine what evidence to contain. Accordingly, the study of Low (2004) imposes a proposition that the auditor's knowledge of the client's industry improves the auditor's overall ability to understand audit risks. The results indicate that the auditor's knowledge of the client's industry improves their audit risk assessments and directly affects the quality and nature of their audit planning decision. Aside from this, the study has found that the auditor's knowledge of the client's industry directly influences the way in which the auditor modifies the audit procedures.

In this regard, Craswell, Francis & Taylor (1995) argue that there is a cost incurred by large auditing firms to form their brand name reputation and specialisation in a particular industry, which justifies obtaining a subsidiary in addition to fees to cover the costs. This study illustrates that, from the sample composed of 1484 firms registered on the Australian stock market, specialised large audit firms obtained more fees than non-specialised audit firms and large audit firms generally obtained more fees than other audit firms. Such results confirm a prevailing attitude towards demanding higher quality through using large audit firms. Their study was consistent with the study of Hogan & Jeter (1999) since this study has found that there is a positive association between audit specialisation in a specific industry, as well as the quality of the professional performance. This was based on the fact that an audit organisation dealing with many clients and belonging to the same industry is most likely to have deeper knowledge of the auditing risks and, in particular, the problems relating to this industry. It is recognised that this will lead to reducing litigation risk. Moreover, the study of Behn, Chai & Kang (2008) states that forecast accuracy is higher when firms hire industry specialist auditors owing to high audit quality. Notably, Kwon, Lim & Tan (2007) aimed in their study to explore whether the effects of industry specialists

auditors on earnings quality dependent on legal settings. The study found that the effect of auditor industry specialisation on earnings quality increases as the legal environment weakens, and there is also a role for industry specialists' auditors within the legal environment. On the other hand, the profits of companies increase when such companies are audited by specialists.

3.5.5 Strong Control Procedures

Conversely, various individuals indicate the existence of a relationship between raising the auditing quality, on the one hand, and audit firms applying strong control procedures on the quality of the auditing performance, on the other hand. This result relies on the opinion that auditing firms are committed to the design and application of a more appropriate and comprehensive system for controlling the quality, thus leading to reductions in the possibility of not discovering fundamental errors during the implementation of audit works. As Malone & Robert (1996) state, an increase in the strength of control systems for the quality to which auditors are subjected reduces the possibility of the auditor's involvement in behaviours resulting in a reduction of audit quality, such as inappropriately overlooking various auditing procedures as there is a reverse relationship between the auditor's awareness to strengthen the control system for the quality and the procedures they follow in the audit firm, and between their awareness of sanctions' strictness that the audit firm may apply if they committed actions leading to a reduction in auditing quality on the one hand and acts of auditors leading to reducing the possibility of quality on the other hand. The same study indicates that reducing the possibility of auditors' acts that have special incentives to realise personal achievements and success on an individual level.

As seen in the paper of Bedard, Deis, Curtis & Jenkins (2008), the auditing procedure is a fragile task and is crucial to the auditing firm, auditors and the company involved. With this in mind, Bedard, Deis, Curtis & Jenkins (2008) evaluate the risks monitoring and control practices in audit firms, and from their study, identify 46 questions which are a subject for further study in relation to risk management within the auditing process. Their evaluation indicates that risk management in the auditing procedure must be observed carefully. As part of risk management, the informing procedure

should be dealt well and, in accordance with this development, external auditor should exercise the auditing procedures in cooperation with the administration; this includes everything from the internal audits of quantitative exposure measurement models to the audits of accounting management procedures and policies. In essence, this process includes evaluation in terms of whether or not its management process works efficiently. This must be done so as to judge whether the firm under auditing addresses the risks and problems identified in the first process. Without this step, businesses would not be able to devise regulations and policies concerning standards, and also would not be able to determine whether their controlling processes are effective enough to recommend improvements of their processes and profit.

In actual fact, with regard to investors' rights and protection, auditing creates a good role and function. The study of Newman, Patterson & Smith (2005) states that an increase in auditor sanctions for undiscovered expropriation leads to a total investment increase as well as an increase of audit fees and an increase in insider's penalties; hence, the probability of audit failure will be less in such circumstances.

3.5.6 Independence of the Auditor and Audit Quality

It is worth noting that the ability of reporting in terms of affecting errors in financial statements depends on the independence of the auditor, and is considered to be a cornerstone in the auditing profession. From this perspective, we can define 'auditor independence' as the ability of the auditor to compile a report on deficiency aspects in the client's financial reports. Accordingly, an auditor who enjoys a relatively high degree of independence has a higher possibility of reporting such errors (Calbert & Murry, 1998).

The need for independent auditing has grown in order to improve the information flow between the management and users of financial statements, give confidence to the financial statements, increase the degree of dependence of various parties that may be used in evaluating the efficiency of the administration, and thereby determine the market value of the shares of the company under audit. With this in consideration, the paper of Mayhew & Pike (2004) has investigated whether or not investor selection of auditors improves auditor independence. The study found that giving investors the

authority to employ and remove auditors ultimately decreases auditor independence breaches, which will lead to enhanced economic surplus.

There is no doubt that an increase in auditors' independence will lead to an opinion expressed with full transparency and sincerity concerning the financial statements.

Authors, such as Goldman & Barlev (1974), define 'auditor independence' as the ability of the auditor to resist management's attempts to intervene in their work and press upon him behavioural and decision-related changes. The sources of client strength (management) to press on the auditor are: choosing a management amongst a large number of alternative audit firms, changing the auditor if he did not satisfy the management's desires and determining his fees. If an auditor is subjected to personal or financial pressures, his professional independence may be suspected or a user of financial statements may see the dependence on his work as ineffective, thus increasing the possibility of audit failure.

Auditing independence is viewed as being a factor related with audit cases, whereas the attitudes of auditors not to declare errors discovered through their work is viewed as being one of the factors causing auditing failure. Significantly, if the client has the power to pressure on the auditor not to report detected errors, the possibility of the auditor litigation increases. In this regard, Watts & Zimmerman (1981) indicate that the possibility of an auditor's exposure to civil allegation when issuing a unqualified opinion depends on issuing the client misleading financial statements and the failure of the auditor to report this fact owing to not discovering the deficiency or errors in the client's account systems (deficiency of competence) or otherwise owing to the inability of the auditor to declare found errors in spite of their discovery (weakness of independence) (Lys & Watts, 1994).

It is generally recognised that large audit firms are less exposed to less independence, which is a belief potentially attributed to two reasons: the first is that large audit firms are less dependent on particular clients compared with other audit firms as large firms have several clients, and so auditor fees from one client represent a scant ratio from the gross income of the firm, thus meaning there is no justification to expose its reputation to risk; the second is the nature of the work in small audit firms, which is characterised by special features, leading to the loss of independence, such as the small volume of

clients, a personal tendency in performing the audit service, and the auditor's personal, close relationship with the clients (Shockley, 1981).

3.5.6.1 Maintenance of the Independence of Auditing:

Palmrose (1988) offers evidence to support that large audit firms reduce their exposure to litigation through maintaining their independence, with the reflection of this independence in high-quality auditing compared with small audit firms. Upon this, we can conclude that the auditor's legal responsibility enhances the auditor to carry out audits of a higher quality.

In this regard, DeFond, Raghunandan & Subramanyam (2002) have explained that the risk threatening auditors in terms of being exposed to litigation gives them a strong incentive to maintain their independence and interest in auditing quality—especially in the USA, where large audit firms incurred, in 1993 alone, more than US$1 billion as expenses related to litigation. The study indicates that there are incentives concerned with the market, which markedly enhance the auditor's capacity to maintain independence. Such incentives are most keenly related to reputation and litigation expenses. Lennox (1999b) investigates several reasons as for why large auditing firms carry out audits more accurately than small audit firms. These reasons concentrate on auditor reputation and financial ability, and conclude that large auditing firms are more exposed to litigation, in some situations, despite their accuracy compared with small audit firms. Markedly, this conflicts with the reputation hypothesis but agrees with the financial ability hypothesis for large audit firms, where the study has found that such firms enjoy larger financial abilities, thus making them a fruitful target for litigation. Accordingly, such firms must have greater accuracy in terms of offering their professional services.

3.5.7 Length of Auditor Tenure

On the other hand, during the last period, interest in studying the relationship between the continuity of an auditor in terms of auditing the accounts of the same client and audit failure was increased. This interest crystallised in calling for the American stock market (SEC) to carry out more research in this regard. Furthermore, the interest of several professional and organisational bodies in different countries to settle this dispute was raised on an international level with regard to obligatory auditor change to support his independence and objectivity.

The study of Kealey, Lee & Stein (2007) illustrates that the length of the relationship between the customer and the auditors is a source of interest for congress, thus suggesting that the period is not in excess of 5 years and issued an act for obligatory changing auditors. Geiger & Raghunandan (2002) consider this on the contrary since their study indicates that, if the period of the audit tenure is increased, the auditor would then gain better experience and a deeper understanding of the risks associated with the client, therefore leading to auditing quality. The study concludes with the absence of empirical evidence linking the length of auditor tenure in cases of audit failure; therefore, it does not support the view that states that mandatory auditor rotation is necessary to improve audit quality.

Moreover, audit failure may be more common in cases of short period auditor continuity with the same client, as the auditor—after accepting the new client—needs some time to understand the nature of the client's process, which causes the auditor not to discover physical errors in financial statements; whereas, with a long period employment of an auditor, the auditor acquires better experience and a deep understanding of the risks associated with the client firm, as well as the way in which their accounting systems work as well as the strong and weak points in the systems. Accordingly, the auditor is able to determine zones characterised with a high degree of risks, increase the possibility of significant errors in these systems, thus inducing him to exert more effort and more time when examining such financial statements, and therefore performing a high-quality audit (Turner & Godwin 1999; Geiger & Raghunandan 2002).

Similarly, Stice (1991) considers that there is an increase in risks owing to failing to discover errors in preliminary audit periods owing to the non-familiarity of the auditor with special operations in audited firms, which increases the possibility of auditors overlooking errors in financial statements, audit failure, and subsequently increasing the possibility of litigation against the auditor with a decreased period in auditing the client's accounts (3 years and less). Stice (1991) depends on what is explained by Pierre & Anderson (1984) in terms of educating in the field of auditing, which occurs with an increase in experience of dealing with the client of an audit firm and thus the efficiency of an auditor to evaluate events increases.

Although an increase in the continuity of the auditor auditing the accounts of the same client at an exaggerated degree may lead to an audit operation of low quality, Deis & Giroux (1992) suggest that the quality of the audit decreases with the increase of auditor continuity as it is considered that long correlations between the auditor and client mean consolidated relations between them, and so the auditor loses his independence and objectivity where the auditor has the desire to satisfy the client as he performs less accurate auditing and accepts confirmation from management easily and loses renewed sight, which makes the auditing process more effective. Accordingly, the auditor has no incentive to innovate in auditing and accuracy in committing with its procedures. In this regard, Lys & Watts (1994) indicate that, when a relationship between the auditor and his client is consolidated, the auditor's independence decreases and increases the possibility of his overall exposure to litigation.

3.5.7.1 Obligatory Alternation Policy:

Darbyshire (1992) suggests that the existence of a regular alteration policy for auditors supports auditing quality where the auditor is changed following a particular period and does not go back to the same client, except after a particular period.

Elitzur & Falk (1996) indicate that there is a passive effect for the obligatory alternation policy on auditor planning for audit quality, where the study indicates that the planning of the audit quality for any period depends on receipts expected to be obtained in the future, and so determining a particular period for the auditor's contract with the client ensures the current value of expected receipts in the next period decrease

with the passing of time, thus reducing the planned level of audit quality. Similarly, Geiger & Raghunandan (2002) conclude that there is no practical evidence for a relationship between an auditor's long period of continuity and audit failure cases in those firms that have declared their bankruptcy during the period 1996–1998.

3.5.8 Compensation Level and Auditing Quality

Auditing standards are viewed as being one of the most important components for activating the auditor's legal responsibility and incentives for committing to such standards are directly related to the level of applied sanctions for not committing to these standards. There is no doubt that the compensation level associated with civil legal responsibility, as a monetary sanction, has a great deterring effect on the auditor's behaviour.

Results of many studies in the field of the auditor's legal responsibility indicate that there is a correlation between audit quality and the compensation level imposed upon the auditor (Palmrose, 1988; Melumad & Thoman, 1990; Dye, 1995; Schwartz, 1997; King & Schwartz, 2000; Zhang & Thoman, 1999), whereas such studies suggest that an increase in auditor's commitment with regard to paying compensation for injuries results from auditing failure, which subsequently increases auditing quality as a particular threat for payment associated with legal responsibility, which creates an incentive for the external auditor to work and report honestly (Melumad & Thoman, 1990). Moreover, the auditor chooses the effort level, which reduces the costs of the audit in addition to payments of expected civil responsibility in the case of audit failure, as costs associated with audit effort increase with surges in auditing effort, whereas costs associated with legal responsibility decrease with the increase in audit effort. Subsequently, auditors must balance the two forms of costs when making decisions with regard to the level of effort offered during auditing (Schwartz, 1997).

The study of King & Schwartz (2000) explain that financial sanctions are imposed upon the auditor in a funnel effect, where they observe more changes in auditing efforts in the near period of imposing the sanction, with such changes decreasing when imposing the sanction period. This study also concludes that, in spite of this, economic models suppose that experiment items adopt their strategy under the sanction, and that

the financial sanction does not encourage the individual to modify their strategies; however, results indicate that financial sanction affects the auditor's choice of audit effort in the following periods as such sanctions lead to a shock and increase in the intensity of the variety of exerted efforts.

Moreover, Elitzur & Falk (1996) suggest that the planned level of auditing quality is positively related to the expected payments in the following periods. As the contracting period—according to the model on which the study is based—is determined and the date of the end of the contract is established and known absolutely, the current value of the payments during the following periods decreases with time. The same matter occurs for the planned quality level. The previous result agrees with the results presented by Deis & Giroux (1992), who noticed, in practice, a decrease of auditing quality with time.

In spite of the difficulty in terms of controlling the auditing quality, it is possible to establish guarantees that provide confidence in terms of auditing quality. The most important of these guarantees include the following:

a. following controlling methods on the quality of auditing processes;
b. formation of auditing commissions; and
c. activating a balance system for the auditor's legal responsibility.

3.6 Legal Responsibility Rules and their Impact on Auditing Quality and Investments Value

It has been recognised that there are many disputes concerning the rules of legal responsibility that achieve optimal levels of auditing quality and the size of investments in business firms. Although many previous studies (Palmrose, 1988; Melumad & Thoman, 1990; Elitzur & Falk, 1996) indicate that there is a positive correlation between levels of expected compensation imposed by legal rules regulating the auditor's civil responsibility, on the one hand, and auditing quality, on the other hand, the studies of Narayanan (1994) and Patterson & Wright (2003) adopt another direction: imposing an increase in the auditor's civil responsibility in itself does not guarantee a corresponding increase in terms of effort level (auditing quality), as some particular legal rules increase the auditing quality or reduce the possibility of audit

failure, in spite of imposing little responsibility upon the auditor, compared with other alternative rules that are more strict on auditors.

On the other hand, Schwartz (1997) and King & Schwartz (2000) indicate that the legal system for civil responsibility achieves the greatest level of effort (auditing quality), but does not necessarily produce the greatest efficiency in terms of society, as payments of civil responsibility do not just encourage auditors to increase their audit effort but do make available insurance for investors against investment losses in business firms. Upon this, imposing increasing levels of civil responsibility on the auditor may encourage the investors of user financial statements to exaggerate in terms of investments and assets with higher degrees of risk compared with optimal investment level for society. Rather, an excessive increase in the level of legal responsibility may lead to encouraging unjustified civil cases against auditors. On the other hand, Shibano (2000) and Yu (2001) indicate that imposing high levels of legal responsibility upon the auditor makes the auditor more conservative in his report, thus leading to a greater possibility of refusing auditors for client's financial reports, subsequently making it difficult for business firms to obtain funds necessary for practicing their investment activities, although such activities have investment opportunities for society.

Accordingly, it is considered necessary for legislators in any country to be careful in terms of differentiating amongst alternative legal rules, at the level of each of the dimensions of responsibility, including legal rules that work jointly to improve the efficiency of society resources allocation, recognising that every alternative legal rule has a different effect on the decisions associated with auditing quality and investment in business firms.

3.6.1 Alternative Rules for the Legal Responsibility of Auditors

In practice, it has been observed that there are additional alternatives for every legal rule, regulating the dimensions of the auditor's civil responsibility. Such alternatives differ amongst themselves in regard to the responsibility level imposed upon the auditor and the compensation level, which must be paid, if it is judged that he was responsible for the injury incurred by the plaintiff. Importantly, regulating the auditor's

civil legal responsibility depends on combining the rules regulating the dimensions considered below.

- Determination of the scope of the parties with the right to litigate the auditor civically; we can see that there are many alternative rules for this dimension, including:
    a. The rule of participation in the contract (particularly by contracting).
    b. Beneficiary rule (primary user).
    c. Rule of beneficiary who must be expected.
    d. Rule of beneficiary who can be expected.

- Incident creating the auditor's responsibility:
    a. Full responsibility rule.
    b. Negligence responsibility rule.

- Scale used in estimating damage necessitating compensation:
    a. The scale of real damage related with investment – OOP (full compensation).
    b. Independent measure from real investment – IOI.

- Responsibility for paying compensation determined by the court for the sake of the plaintiff:
    a. Joint and several liability rule.
    b. Pure proportional rule.
    c. Hybrid proportional liability rule.

These rules are considered from the aspect of insurance amount against the deficit firm (client) which the auditor must make available in favour of the plaintiff. It must be noted that, in the case of the financial ability of all defendants who must pay all their shares in the compensation, there are no differences in terms of applying the previous rules (paying compensation rules), as there are no unpaid sums in terms of compensation. In this case, the responsibility for paying the compensation is allocated according to contributions to the errors and the fraud in which they participated, as determined by the court.

The joint and several liability rule offers insurance that can be described as complete insurance for the plaintiff (investor) since the auditor (defendant) must pay his share of the compensation determined by the Court, in addition to the unpaid share that must be paid by other defendants—regardless of the amount of injury caused by the auditor and ratified by the court. This means that auditors may afford the bankruptcy of other defendants, whatever their share of responsibility (Hillegeist, 1999).

According to the pure proportional liability rule, the defendant (auditor) who is responsible is required to pay only a share that represents a percentage of the compensation sum ratified by the court. This sum is determined depending on the degree of their participation in the error or fraud. This percentage may be 10%, 20% or 30%, but not 100%. This rule is applied currently in Canada. It is clear that this percentage does not present insurance from the auditor against the deficiency of other defendants. Thus, the auditor's responsibility is exclusively his share of damages ratified by the Court, and so plaintiffs must afford the full risk of bankruptcy of other defendants (Hillegeist, 1999).

The hybrid proportional liability rule is placed between the other two rules, where the auditor is responsible for only a share of the bankruptcy of other defendants; thus, the auditor provides a limited insurance for investors against the deficiency of other defendants (Hillegeist, 1999).

From the above-mentioned, under the existence of more alternatives for each legal rule composing the system, it may be stated that there are many alternative systems determining the auditor's legal responsibility, where the legislative authority in the state differentiates between them when selecting the most appropriate legal system, as it is supposed that every alternative system has a different effect on both the auditing quality and the investor's decisions in terms of determining the volume of his investment.

3.7 Importance of Accounting Information for Making Decisions

In spite of the importance of audited accounting information for the various parties who use them when making decisions (for example, the project's management, owners and

users, government bodies, creditors and suppliers, banks and other financial institutions), there are those who believe that the financial information is not more important than the non-financial information when analysing a stock recommendation. Moreover, balance sheet information is not more important than other financial information. Furthermore, information provided by analysts affects the ultimate decisions of investors and the firm value, and motives must be given to analysts to provide extra information and to determine considerations that drive particular security recommendations (Breton & Taffler, 2001). With this in consideration taken into account, the paper of Ball & Shivakumar (2008) reviews and estimates the importance of profits in terms of providing new information to the stock market, and through the auditing procedure it was found that the average quarterly earnings announcement is related at approximately 1%–2% of the total annual information. Accordingly, this result supports the view that the reported earnings are not timely in terms of giving new information to the stock market; however, they have found that their subject company has participated more to return volatility in recent years, which may emphasise that earnings have increased significance as a source of new information.

In actual fact, audited financial statements provide information concerning the possibilities of future success or the profitability of the business firm, as it summarises the current economic state in the business firm, which gives a good indication about the future profits. Accordingly, the auditing process aims at reducing uncertainty related to future cash flows for this business firm, as audit value created from reducing losses might be the result of relying on misleading financial statements and making investment decisions in relation to such statements. As such, the value of accounting information contained in financial statements depends on auditing quality, as the auditing service may offer valuable information to society through the auditing process with reasonable quality, as these statements enable establishing the financial state in the firm and also facilitate excluding the non-profit firms, thereby avoiding society from incurring damages resulting from exercising non-profit activities.

Financial statements are, according to Jensen & Meckling (1976), the universally accepted tools for the analysis of a business entity, therefore managerial behaviour, agency costs and the ownership structure that builds the firm should be carefully evaluated. If properly understood, they provide users with understanding of company's

progression and its performance. They are, at best, an estimation of the economic reality due to the selective reporting of economic events by the accounting system, associated with alternative accounting methods and estimates (Dopuch, Ingberman & King 1997). The objective of financial statements is to give users (business owners, lenders, managers, suppliers, customers, attorneys, litigants, employees and job seekers) with a set of financial data which, in summary, fairly represents the financial performance and strength of a business (Titman & Trueman, 1986; Breton & Taffler, 2001; Hillegeist, 1999). Importantly, they expose prospects and thus provide security against financial dangers. Ideally, financial statements analysis provides information that is useful to present, to potential investors, creditors and other users in terms of making rational investments, credit risk monitoring, and other similar decisions (Bedard, Deis, Curtis & Jenkins, 2008). Furthermore, they are comparative measurements of risk and return to make investments or credit decisions as they provide a basis for predicting future earnings and cash flows.

In this regard, the role of auditors is concentrated on providing users of financial statements with authenticity on accounts presented by client, in order to improve their decisions associated with the allocation of capital as investors may not provide the necessary financing (capital or credit) unless auditor reports indicate the good financial situation of the firm. This improvement associated with the allocation of capital can be considered as an audit value.

3.7.1 Auditing Quality Imparts Authenticity on Accounting Information

Investment decisions by users of financial statements are considered to be vital decisions for any society depending on rational investments. Importantly, they lead to increasing net society wealth on an economic level, although it is inappropriate to classify the systems of legal responsibility of the auditor only from the perspective of auditing quality; this responsibility enhances its occurrence. As auditing effort is not a target in itself but rather a means to imparting authenticity on accounting information, investors and others users of financial statements may seek access to such data when making decisions related to the business firm. Accordingly, the most complete analysis within this field must test aspects relating to the decisions of users of financial

statements—depending, to a great extent, on the auditing process and the reflections of such decisions on social welfare—as a main aspect of determining the overall efficiency of resource allocation in any society. As such, it is required that the proficiency of the proposed legal responsibility rules be evaluated in terms of its effects on social welfare through testing the reflections of these rules on decisions associated with auditors (level of auditing effort) and investors (investment level).

The main purpose of evaluating legal responsibility rules is through presenting proposed help in the design of a civil legal responsibility system for auditors, thus producing a balance amongst the interests of parties associated with the auditing process. Accordingly, the situation requires reviewing the legal situation of accounting and auditing in Kuwait, and a description of the civil responsibility system to which the auditors are currently subjected, according to legal texts in related Kuwait legislations and problems in terms of practically implementing this system in Kuwait business settings.

3.8 Role of Auditing as a Source of Insurance for Investment Value

There are many studies analysing the reactions concerning alternative legal rules regulating the auditor's responsibility, on the one hand, and the decisions of users of financial statements—especially investors' decisions—on the other. Franz, Crawford & Johnson (1998) indicate another source for requiring an audit service, rather than obtaining reasonable authentication that management errors and fraud will be discovered and reported by them. There is a request for auditing as a source of insurance, as an auditor acts as a partial guarantor for the investment value in the business firm's financial statements, with losses resulting from the value of errors in financial statements covered by management through litigation against the auditor.

The experimental results of Dopuch & King's (1992) study—which simulated the roles of auditors, firm management and users of audit information, as they represent probable litigates—proposed that systems of civil legal responsibility provide incentives for auditors to balance the predicted costs of the audit, on the one hand, with payments of predicted civil responsibility on the other hand. The study also indicates that, in the case of the existence of legal responsibility systems and authenticated auditing, the firms (clients) have to audit service voluntary. This situation encourages making

investment decisions for costly investments, which produce higher levels of economic efficiency, leading to increases in total wealth and improved social welfare compared with the absence of this system regulating legal responsibility.

The study of Zhang & Thoman (1999) deals with the effects of legal responsibility rules on net social welfare owing to the auditing process, under a possible agreement between the investor (plaintiff) and auditor (defendant) on a pre-trial settlement. The study indicates that, with the settlement option, the trial will be uncertain. For this reason, through reducing trials, settlements may reduce unjustified juridical charges, which do not bring value to society.

3.8.1 Effect of Auditors' Legal Responsibility Level on the Investment

Some studies in the USA have dealt with the predicted effects of the auditor's legal responsibility level on investment decisions, such as Sarath & Wolfson (1993), who tested a model to analyse the audit's effect on the volume of trade and the effect of imposing sanctions on the auditor so as to guarantee a reasonable level of auditing effort. Those authors conclude that increasing the sanctions imposed upon auditors leads to a high-quality audit, although this higher level does not necessarily result from an increased investment value (Schwartz 1997).

Schwartz (1997) presents an analytical model aiming to discover the effects of the auditor's legal responsibility in terms of auditing quality and investment. This model is more keenly interested in the effects of damage measures as a main determinant of investment efficiency in a business firm. This model tested the effects of four different effects of auditor legal responsibility. Each of them was composed of a rule for determining the responsibility act (strict and vague negligence) with a damage measure (real damages related to investment [OOP]—independence measure from real investment [IOI]).

From the above-mentioned, the existence of an appropriate system for the auditor's legal responsibility is considered to be one of the most important guarantees for the quality of the auditor's professional performance under the availability of components to activate this system in a balanced manner.

3.9 Conclusion and Motivation for the Current Research

From the previous conceptual framework, a conflict between increasing auditors' liabilities and attaining audit quality can be seen. Audit quality supports the investment process in society and promotes development. This conflict requires further research concerning the optimal level of audit quality. The problem becomes more apparent in developing countries, where it is necessary that the auditor legal responsibility system in emerging countries, such as Kuwait, includes legal rules which enhance, at appropriate levels, the business settings, the audit effort and investment, which increases social welfare from auditing. This requires reviewing the needs of users of financial statements (e.g. investors) from auditing and establishing the reaction of auditors toward them, as well as their effects on the auditing profession and its costs. Moreover, it requires a review of the current legal responsibility regulating the audit civil responsibility, in Kuwait, as documented with related legislations, in Kuwait, determining problems that impair the activation of this system in practice, and establishing the need to modify legal texts in current legislations. Otherwise, new laws could be enacted in order to achieve aspects of civil responsibility within the legal system; this will help to achieve the desired social welfare and thus increase the profits of all parties relating to auditing, which subsequently enhances social welfare in emerging markets. So, in order to meet the study objectives, this research will seek to test four hypotheses and their associated sub-hypotheses, considering the users of financial statements (the demand side of the auditing services) at the first stage of the study. In the second stage of the study, the first and third hypotheses are tested, considering the auditors (the supply side of the auditing services). The four hypotheses are formulated as follows:

H1: The degree of the civil legal liability system within society has no effect on the auditing profession.

H1/1 The weakness of the civil legal liability system does not affect the demand on auditing services.

H1/2 The weakness of the civil legal liability system has no effect on the frequency of using published financial statements.

H2: The Legal liability rule is not the main factor affecting auditing quality.

H2/1 Increasing legal compensation will not increase audit quality.

H2/2 Whenever the period of auditor tenure increases, audit quality increases.

H2/3 Whenever auditor experience increases, audit quality increases

H2/4 Whenever there is an auditor industry specialisation, auditing quality increases.

H2/5 Whenever the audit firm size increases, audit quality increases.

H3: Increasing the legal liability of auditors will not increase audit quality.

H3/1 Applying a strict liability rule improves audit quality, whilst applying negligence rule has a lesser effect on audit quality.

H3/2 A liability system that depends on the legal compensation rule will not increase audit quality more than legal deterrence rule.

H3/3 Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase audit quality.

H3/4 Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase auditing quality.

H3/5 Increasing the auditor's liability in terms of paying unpaid compensation by other insolvent defendants will not increase auditing quality.

H4: Investment level within society is not dependent on the legal rules applied.

H4/1 Applying a strict liability rule increases investment level, whilst applying a negligence rule has a lesser effect on investment level.

H4/2 A liability system that depends on the legal compensation rule will not increase investment level more so than the legal deterrence rule.

H4/3 Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure will not increase investment level.

H4/4 Increasing the compensation amount (as determined by the Court for the plaintiff against the auditor charged with negligence) will not increase investment level.

H4/5 Increasing the auditor's overall liability for paying unpaid compensation by other insolvent defendants will not increase investment level.

The next chapter is the survey for financial reports' users, in which the four main hypotheses will be tested, in order to study the effects of the legal liability system and its subsequent impacts on society.

Chapter Four: Survey for Financial Reports Users

4.1 Introduction

In order to achieve the study objectives, the researcher carried out a field study so as to survey the opinion of the community concerning the auditor's responsibility and the liability system, as well as its effects on the auditing quality and investment level within society. The researcher divided the study into two stages: the first stage concerned the users of the financial statements as they represent the demand side for the auditing services; the second stage considered the auditors as they represent the supply side for the auditing services. Finally, a comparison between the views of the two groups was undertaken with the aim of drawing a conclusion for the optimal legal liability system for society. Importantly, this chapter is dedicated to the first stage of the study, whilst the following chapters consider the subsequent stages.

In the first stage of the study, four main hypotheses will be tested so as study the effects of the legal liability system and its subsequent impacts on society. The first hypothesis has been designed to test whether the degree of the civil legal liability system in society has an effect on the auditing profession. To test the effect of legal liability rules on audit quality, a second hypothesis was designed to test the most importance factor affecting auditing quality, including the legal liability rules applied as a main quality factor. Subsequently, in order to explore the preferable rules amongst different liability rules, a third hypothesis was dedicated to testing which liability rules affect auditing quality. Finally, a fourth hypothesis tests which of the liability rules mentioned in the third hypothesis affect the investment level on the society with the objective to study the effects of these rules on investment level.

4.2 Survey Instrument and Sample

Some studies (Saunders *et al*., 2009; Bryman and Bell, 2007; Saunders *et al*., 2006; Collis & Hussey, 2003) indicate that the data can be gathered by various methods (surveys, case studies, experiments, etc.).The used approach depends on research

questions (Avison *et al.*, 1999). Many studies used questionnaire method for data collection (Bobek *et al*., 2012; Ng, 2007; Hail & Leuz, 2006; Kachelmeier & Towry, 2002; Nelson *et al*., 2002; Rudolph & Welker, 1998; Flory *et al*., 1992). With is in mind, using questionnaire is consider easy to be distributed in many places during a short time, reaching wide range of participants, and is less costly (Bryman & Bell, 2007; Yin, 2009).

Therefore, in order to achieve the study objectives, this research used quantitative approach by questionnaire, since it is consider the most suitable and appropriate tool for this field study compared with other approaches in aim to survey the opinion of two groups as previously mentioned.

The survey instrument was developed following the review of related literatures in this field, and was accordingly tested with a pilot study, including 10 financial statement users.

The questionnaire included individual data for the respondents concerning their jobs, education level, number of years' experience, and the frequency of using financial statements.

The questionnaire utilised rating questions used to garner opinion data, which are a strong set of questions or items considered as indicators of a construct or concept (Corbetta 2003). Rating questions most frequently adopt a Likert-scale rating in which the respondent is questioned about how strongly she or he agrees or disagrees with a statement or series of statements, generally on a four-, five-, six- or seven-point scale (Saunders, 2009). Thus, the present study has adopted a Likert scale with 5 degrees, ranging from 1 to 5 (5 = strongly agree; 4 = agree; 3 = No opinion; 2 = disagree; and 1 = strongly disagree).

The questionnaires were distributed to different categories, mainly those who are related or use financial reports and investment, in Kuwait. This included the Kuwait Exchange market dealers, brokerage companies, commercial banks, and securities investment companies. Such firms were randomly selected from existing firms currently working in Kuwait State, as illustrated in the following table (4.1).

Table 4.1: Number of firms in the research sample		
Type	**No. of Selected firms**	**No. of Firms Working in Kuwait**
Brokerage firms	6	14
Investment firms	6	24
Commercial Banks	4	9
Stock Exchange	1	1

In order to ensure that the research sample was unbiased and representative of all users of financial statements, the sample included different categories, all of which used financial statements; therefore, they are classified as investors, financial managers, creditors, financial analysts, and others. Moreover, prior to conducting the empirical study, the researcher counted all institutions working in the state of Kuwait (brokerage firms, commercial banks, and securities investment companies), and accordingly ranked them by capital and randomly selected the 16 institutions to be the field of study in proportion to their size. Following, the questionnaires were randomly distributed to the users of financial statements, all of whom were known to be working or dealing with these institutions, as well as to investors dealing directly with the Kuwait stock exchange. All procedures were carried out in order to ensure that the responses would not be biased. Indeed, after analysing the responses, it became clear that there is no indication of a systematic response across the respondents' categories.

As well as the results of Kolmogorov-Simirov test, the responses are shown to be subject to normal distribution, which gives reliability to the results of the questionnaire; therefore, the results can be generalised across all of society. Table (4.2) illustrates the results of this test.

Table 4.2: Normality test (Kolmogrov-Smirnov) for users' response

Variable	N	Statistic	Sig	Variable	N	Statistic	Sig
Q1.1	105	3.160	.000	Q10.1	105	2.757	.000
Q1.2	105	3.135	.000	Q10.2	105	3.399	.000
Q1.3	105	2.615	.000	Q10.3	105	2.148	.000
Q1.4	105	2.559	.000	Q10.4	105	2.962	.000
Q1.5	105	2.495	.000	Q10.5	105	2.685	.000
Q1	105	2.553	.000	Q10	105	1.967	.001
Q2.1	105	2.540	.000	Q11.1	105	3.212	.000
Q2.2	105	2.737	.000	Q11.2	105	2.468	.000
Q2.3	105	2.673	.000	Q11.3	105	3.080	.000
Q2.4	105	3.007	.000	Q11.4	105	2.365	.000
Q2.5	105	2.917	.000	Q11.5	105	2.579	.000
Q2	105	1.610	.011	Q11	105	1.866	.002
Q3.1	105	2.350	.000	Q12.1	105	2.985	.000
Q3.2	105	3.176	.000	Q12.2	105	2.871	.000
Q3.3	105	3.228	.000	Q12.3	105	2.669	.000
Q3.4	105	2.948	.000	Q12.4	105	2.421	.000
Q3.5	105	3.008	.000	Q12.5	105	2.889	.000
Q3	105	1.634	.010	Q12	105	2.271	.000
Q4.1	105	3.254	.000	Q13.1	105	3.530	.000
Q4.2	105	2.055	.000	Q13.2	105	3.770	.000
Q4.3	105	2.669	.000	Q13.3	105	2.788	.000
Q4.4	105	3.479	.000	Q13.4	105	2.639	.000
Q4.5	105	2.679	.000	Q13.5	105	2.612	.000
Q4	105	1.384	.043	Q13	105	1.461	.028
Q5.1	105	2.696	.000	Q14.1	105	3.157	.000
Q5.2	105	2.220	.000	Q14.2	105	3.655	.000
Q5.3	105	2.492	.000	Q14.3	105	2.498	.000
Q5.4	105	3.128	.000	Q14.4	105	3.110	.000
Q5.5	105	2.726	.000	Q14.5	105	2.597	.000
Q5	105	1.303	.067	Q14	105	1.463	.028
Q6.1	105	2.035	.001	Q15.1	105	3.717	.000
Q6.2	105	2.320	.000	Q15.2	105	3.898	.000
Q6.3	105	2.402	.000	Q15.3	105	2.958	.000
Q6.4	105	3.091	.000	Q15.4	105	2.694	.000
Q6.5	105	2.245	.000	Q15.5	105	2.460	.000
Q6	105	1.582	.013	Q15	105	1.925	.001
Q7.1	105	3.104	.000	Q16.1	105	2.882	.000
Q7.2	105	2.743	.000	Q16.2	105	3.457	.000
Q7.3	105	2.843	.000	Q16.3	105	3.033	.000
Q7.4	105	2.336	.000	Q16.4	105	2.945	.000
Q7.5	105	2.124	.000	Q16.5	105	2.446	.000
Q7	105	1.859	.002	Q16	105	1.815	.003
Q8.1	105	2.814	.000	Q17.1	105	4.108	.000
Q8.2	105	3.109	.000	Q17.2	105	3.065	.000
Q8.3	105	2.175	.000	Q17.3	105	3.401	.000
Q8.4	105	2.558	.000	Q17.4	105	2.750	.000
Q8.5	105	2.941	.000	Q17.5	105	2.648	.000
Q8	105	1.156	.138	Q17	105	1.819	.003
Q9.1	105	3.067	.000				
Q9.2	105	4.306	.000				
Q9.3	105	2.428	.000				
Q9.4	105	2.870	.000				
Q9.5	105	3.118	.000				
Q9	105	1.977	.001				

287 questionnaires were distributed in the period February–April, 2010, with returned questionnaires amounting to 112 (39%), as illustrated in Table (4.3).

Table (4.3): Number of distributed and received questionnaires

Date		Investors	Financial Managers	Creditors	Financial Analysts	Others	Total	Response Ratio
18/02/2010	Distributed	25					25	32.00%
	Received	**8**					**8**	
22/02/2010	Distributed	14					14	35.71%
	Received	**5**					**5**	
24/02/2010	Distributed		1		3	2	6	33.33%
	Received		**1**		**1**	**0**	**2**	
03/03/2010	Distributed		2	9	3	4	18	44.44%
	Received		**1**	**4**	**1**	**2**	**8**	
04/03/2010	Distributed		1		6	1	8	37.50%
	Received		**0**		**2**	**1**	**3**	
08/03/2010	Distributed	18	1		2		21	28.57%
	Received	**6**	**0**		**0**		**6**	
10/03/2010	Distributed		3	7	2	3	15	40.00%
	Received		**2**	**2**	**1**	**1**	**6**	
14/03/2010	Distributed		5		5	5	15	46.67%
	Received		**2**		**2**	**3**	**7**	
17/03/2010	Distributed	9	1		2	2	14	28.57%
	Received	**3**	**0**		**1**	**0**	**4**	
22/03/2010	Distributed		4	6	1	2	13	53.85%
	Received		**2**	**4**	**0**	**1**	**7**	
28/03/2010	Distributed	12	1		2	2	17	35.29%
	Received	**5**	**1**		**0**	**0**	**6**	
30/03/2010	Distributed		6		4	7	17	52.94%
	Received		**3**		**2**	**4**	**9**	
04/04/2010	Distributed	13	1		3	2	19	31.58%
	Received	**5**	**1**		**0**	**0**	**6**	
07/04/2010	Distributed		4		6	3	13	38.46%
	Received		**1**		**2**	**2**	**5**	
13/04/2010	Distributed	11			2		13	38.46%
	Received	**4**			**1**		**5**	
18/04/2010	Distributed		5		3	5	13	38.46%
	Received		**2**		**1**	**2**	**5**	
20/04/2010	Distributed		2	7	3	1	13	53.85%
	Received		**1**	**5**	**1**	**0**	**7**	
28/04/2010	Distributed	33					33	39.39%
	Received	**13**					**13**	
Total	Distributed	135	37	29	47	39	287	
	Received	**49**	**17**	**15**	**15**	**16**	**112**	**39.02%**
Response Ratio		**36.30%**	**45.95%**	**51.72%**	**31.91%**	**41.0%**	**39%**	

After reviewing the returned questionnaires, it appeared that 7 questionnaires were invalid for analysis owing to a lack of data; meaning that the net valid questionnaires for analysis were 105 (36.5%). The individual characteristics data for this sample is detailed accordingly in Table 4.4.

Table 4.4: Users' characteristics data		
Characteristics of Respondents	**N = 105**	**%**
Respondents Job:		
1) Investor	47	44.8 %
2) Financial Manager	16	15.2 %
3) Creditor	12	11.4 %
4) Financial Analyst	14	13.3%
5) Other	16	15.3 %
Respondents Education:		
1) Professionals	30	28.5 %
2) PhD	9	8.6 %
3) MSc	7	6.7 %
4) BSc	44	41.9 %
5) Less	15	14.3 %
Respondents years of experience:		
1) More than 10 years	34	32.4 %
2) More than 5 years & less than 10 years	51	48.6 %
3) Less than 5 years	20	19.0 %
Respondents no. of using financial reports:		
1) Very frequently	28	26.7 %
2) Frequently	39	37.1 %
3) Occasionally	29	27.6 %
4) Rarely	6	5.7 %
5) Never	3	2.9 %

4.3 Results of the Hypotheses Test

This first stage of the study includes testing the previously detailed four main hypotheses, in order to study the effects of the legal liability system and its impacts on society. The first hypothesis tested the effect of the legal liability rules on the demand for auditing services, and then tested the ranking of the factors affecting auditing quality, including the legal liability rules, through the second hypothesis. The third hypothesis was dedicated to testing which liability rules affect auditing quality, and finally, a fourth hypothesis tested the effects of liability rules on the investment level within society. Such hypotheses were divided into secondary hypotheses for performing tests from several different dimensions, as discussed below.

4.3.1 The Effect of the Civil Legal Liability System on the Auditing Profession

The first hypothesis was designed to test the extent of the effect of auditor civil legal liability system on the auditing profession within society.

H1: The degree of the civil legal liability system within society has no effects on the auditing profession.

This hypothesis was tested by creating two secondary hypotheses: the first secondary hypothesis was used in order to illustrate the effects of civil legal liability on the demand on the auditing profession in society; the second secondary hypothesis tested the effect of civil legal liability on the frequency of using the published and audited financial statements.

H1/1: *The weaknesses of the civil legal liability system do not affect the demand on auditing services.*

Testing this hypothesis comprised five statements concerning demand for auditing profession without the civil legal liability system, as illustrated in Table 4.5.

Table 4.5: Tests for hypothesis 1/1
The weaknesses of the civil legal liability system do not affect the demand on auditing services.

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Mean	SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q1. The absence of a civil legal liability system will:								
1	decrease the number of clients seeking auditing services.	96.857 (0.00)**	91 (87%)	4.14	0.975	11.98 (0.00)**	3.95	4.33
2	decrease the auditing fees.	55.333 (0.00)**	74 (70%)	3.70	1.151	6.23 (0.00)**	3.48	3.93
3	decrease the auditor assessment of clients' risk.	61.143 (0.00)**	80 (76%)	4.02	1.126	9.28 (0.00)**	3.80	4.24
4	increase the probability of audit failure.	62.571 (0.00)**	79 (75%)	4.05	1.121	9.59 (0.00)**	3.83	4.26
5	decrease the number of certified public accountants.	71.238 (0.00)**	82 (78%)	4.12	0.978	11.73 (0.00)**	3.93	4.31
	Average score	**102.076** (0.00)**	**79 (75%)**	**4.008**	**0.931**	**11.09 (0.00)****	**3.827**	**4.188**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the Chi square test, it appears that we cannot accept the null hypothesis as the respondents do not have any preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending upon the means for the participants' responses and *t*-test, we can determine their preferred answer.

From the above-mentioned responses, it appears that 75% of respondents see that the lack of the civil legal liability system affects the demand for auditing professions within society (response mean 4.008).

Markedly, 87% consider that this lack as being able to reduce the number of clients seeking auditing services, whilst 70% of consider that this will reduce auditing fees owing to a reduced demand for auditing. Furthermore, 76% see that this conduct auditor decreases the assessment of a client's risk in order to increase the number of auditing processes carried out by him. Moreover, 75% consider that this will increase the overall probability of auditing failure, whilst 78% view this as potentially reducing the number of certified public accountants in society.

The second secondary hypothesis was designed in order to test the effects of the civil legal liability on the frequency of using financial statements.

H1/2: *The weakness of the civil legal liability system has no effect on the frequency of using published financial statements.*

Testing this hypothesis included five statements concerning whether or not the existence of the auditor's civil legal liability system would increase the use of financial statements, and thereby increase dependence on them, as illustrated in Table 4.6.

Table 4.6: Tests for hypothesis 1/2
The weakness of the civil legal liability system has no effect on the frequency of using published financial statements.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q2. Do you think the existence of a civil legal liability system will:								
1	increase the investors' dependence on audited financial reports	39.19 (0.00)**	80 (76.2%)	4.03	0.814	12.96 (0.00)**	3.87	4.19
2	increase the publishing of interim financial reports	74.76 (0.00)**	81 (77.1%)	4.01	0.872	11.86 (0.00)**	3.84	4.18
3	increase the need for high-quality accounting standards	92.76 (0.00)**	90 (85.7%)	4.22	0.899	13.90 (0.00)**	4.05	4.39
4	enhance the publishing of financial reports on a timely basis	103.52 (0.00)**	91 (86.7%)	4.31	0.891	15.06 (0.00)**	4.14	4.49
5	enhance management in terms of voluntary disclosure	108.57 (0.00)**	92 (87.6%)	4.18	0.782	15.46 (0.00)**	4.03	4.33
	Average score	**74.09 (0.00)****	**80 (76%)**	**4.15**	**0.518**	**22.74 (0.00)****	**4.05**	**4.25**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

It appears from the answers that 76% of those respondents see that the existence of civil legal liability system would increase the usage of financial statements and would also increase the overall dependence on them (response mean 4.15).

Since 76.2% see that this could lead to an increase in the dependence on audited financial reports, 77.1% consider that this would increase the publishing of interim financial reports. Furthermore, 85.7% see that this will lead to increasing the need for high-quality accounting standards, and 86.7% consider that this would enhance the publishing of financial reports on a timely basis. As a final result, 87.6% see that this will enhance overall management in terms of voluntary disclosure in the financial statements.

The results of the first main hypothesis test confirm that the respondents support the necessity of the existence of a civil legal liability system within the community, rationalising that this would support the demand on the auditing profession and thereby increase the use of financial reports. This result shows that users in need of the auditing service understand the auditor's role in society, acknowledging that they play a significant role in the development of a certain business and are also responsible for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor,

1995). Notably, users hold the view that, in order to achieve the optimal result of the auditing services, there is a need for a civil legal liability framework.

4.3.2 Factors Affecting Auditing Quality

Auditing quality is affected by many factors, namely auditor tenure, auditor experience, auditor specialisation, and the size of the auditing firm, as well as the existence of a civil legal liability system. The second hypothesis was designed to test the most important factor affecting auditing quality.

H2: The Civil legal liability rule is not the main factor effecting audit quality.

This hypothesis was tested through putting forward five sub-hypotheses in order to test the different factors relating to auditing quality, which are increased legal compensations imposed on auditors, increased auditing tenure, increased auditing experience, industry specialisation, and increased size of auditing firm. In each of these five sub-hypotheses, five statements were used to measure the effect of such factors on auditing quality. The first sub-hypothesis was formulated as follows:

H2/1: Increasing legal compensation will not increase audit quality.

Table 4.7: Tests for hypothesis 2/1
Increasing legal compensation will not increase audit quality.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q3. An increase in expected compensation will:								
1	increase the confidence in financial statements	38.66 (0.00)**	81 (77.1%)	4.09	0.81	13.78 (0.00)**	3.93	4.24
2	decrease the risk of audit failure	102.48 (0.00)**	86 (81.9%)	4.02	0.83	12.56 (0.00)**	3.86	4.18
3	increase supervising and co-ordination of audit team	92.86 (0.00)**	86 (81.9%)	4.01	0.93	11.06 (0.00)**	3.83	4.19
4	increasing auditor due care	72.56 (0.00)**	96 (91.4%)	4.36	0.72	19.30 (0.00)**	4.22	4.50
5	reduce the bias in auditor judgment	95.71 (0.00)**	90 (85.7%)	4.14	0.89	13.08 (0.00)**	3.97	4.32
	Average score	**62.51 (0.00)****	**78 (74.3%)**	**4.124**	**0.59**	**19.59 (0.00)****	**4.010**	**4.238**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The five statements included in the questionnaire, as shown in Table 4.7, were considered so as to study whether or not the increase of legal compensation imposed on auditors would increase auditing quality. Notably, it may accept the alternative hypothesis, which states that respondents have a preference for one of the five responses. The result of this sub-hypothesis agree with the results of many studies in the field of auditors' legal responsibility, indicating that there is a correlation between auditing quality and the compensation level imposed upon the auditor (Palmrose, 1988; Melumad & Thoman, 1990; Dye, 1995; Schwartz, 1997; King & Schwartz, 2000; Zhang & Thoman, 1999), whereas such studies suggest that an increase in auditor commitment with regard to paying compensation for injuries resulting from audit failure increase audit quality.

H2/2: Whenever the period of auditor tenure increases, audit quality increases.

Table 4.8: Tests for hypothesis 2/2
Whenever the period of auditor tenure increases, audit quality increases.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q4. Increasing the period of auditor tenure will:								
1	increase the confidence in financial statements	57.48 (0.00)**	12 (11.4%)	2.70	0.786	-3.91 (0.00)**	2.54	2.85
2	decrease the risk of audit failure	45.62 (0.00)**	21 (20.0%)	2.69	0.954	-3.32 (0.00)**	2.50	2.87
3	increase supervising and co-ordination of audit team	72.86 (0.00)**	17 (16.2%)	2.75	0.864	-2.96 (0.00)**	2.59	2.92
4	increasing auditor due care	62.20 (0.00)**	8 (7.6%)	2.59	0.817	-5.14 (0.00)**	2.43	2.75
5	reduce the bias in auditor judgment	39.95 (0.00)**	7 (6.7%)	2.44	0.808	-7.10 (0.00)**	2.28	2.59
	Average score	**59.05 (0.00)****	**0 (0%)**	**2.63**	**0.586**	**-6.43 (0.00)****	**2.519**	**2.746**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The five statements were included in order to test whether or not auditor tenure increase would lead to increased auditing quality. We may reject the null hypothesis and accept the alternative hypothesis, which states that respondents have a preference

for one response included in the questionnaire, as the mean indicates that the result is not in favour of increasing audit tenure. This result agrees with Lys & Watts (1994) and Deis & Giroux (1992), with such working emphasising that the quality of auditing decreases with the increase of auditor continuity, as it is considered that long correlations between the auditor and client create a relation between them, and thus the auditor loses his independence and objectivity. Notably, where the auditor has the desire to satisfy the client, the auditor's independence decreases, thus affecting audit quality; it also increases the possibility of exposure to litigation. This result is found to be in contrast with Geiger & Raghunandan (2002) since their study indicates that, if the period of the auditing tenure is increased, the auditor would then gain better experience and a deeper understanding of the risks associated with the client, thus resulting in auditing quality.

H2/3: Whenever auditor experience increases, audit quality increases.

Table 4.9: Tests for hypothesis 2/3
Whenever auditor experience increases, audit quality increases.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q5. Auditor with more experience will:								
1	increase the confidence in financial statements	89.33 (0.00)**	88 (83.8%)	4.24	0.883	14.38 (0.00)**	4.07	4.41
2	decrease the risk of audit failure	30.58 (0.00)**	68 (64.8%)	3.92	0.840	11.22 (0.00)**	3.76	4.09
3	increase supervising and co-ordination of audit team	61.81 (0.00)**	63 (60.0%)	3.68	0.882	7.90 (0.00)**	3.51	3.85
4	increasing auditor due care	50.77 (0.00)**	70 (66.7%)	3.71	0.805	9.03 (0.00)**	3.56	3.87
5	reduce the bias in auditor judgment	79.33 (0.00)**	60 (57.1%)	3.57	0.842	6.93 (0.00)**	3.41	3.73
	Average score	**63.11 (0.00)****	**48 (45.7%)**	**3.825**	**0.4825**	**17.52 (0.00)****	**3.731**	**3.918**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The statements were aimed at studying whether or not increased auditor experience would increase auditing quality. We may reject the null hypothesis and accept the

alternative hypothesis, which shows that the respondents have a preference for one response in the questionnaire.

H2/4: Whenever there is an auditor industry specialisation, audit quality increases.

Table 4.10: Tests for hypothesis 2/4
Whenever there is an auditor industry specialisation, audit quality increases

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q6. Auditor industry specialisation will:								
1	increase the confidence in financial statements	16.94 (0.001)**	65 (61.9%)	3.86	0.955	9.22 (0.00)**	3.67	4.04
2	decrease the risk of audit failure	37.90 (0.00)**	66 (62.9%)	3.74	1.038	7.30 (0.00)**	3.54	3.94
3	increase supervising and co-ordination of audit team	15.42 (0.001)**	48 (45.7%)	3.48	0.952	5.16 (0.00)**	3.29	3.66
4	increasing auditor due care	81.43 (0.00)**	43 (41.0%)	3.50	0.889	5.76 (0.00)**	3.32	3.67
5	reduce the bias in auditor judgment	50.00 (0.00)**	37 (35.2%)	3.15	0.978	1.57 (0.00)**	2.96	3.34
	Average score	**77.70 (0.00)****	**43 (41%)**	**3.545**	**0.7117**	**7.84 (0.00)****	**3.407**	**3.682**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The statements were devised in order to study whether or not increased auditor industry specialisation would accordingly increase auditing quality; however, the alternative hypothesis may be accepted, which suggests that the respondents have a preference for one response included in the questionnaire. Although the results of the study by Low (2004) indicate that the auditor's knowledge of the client's industry improves audit risk assessments, there is no evidence to suggest that the audit quality will improve. On the other hand, the study by Craswell, Francis & Taylor (1995) notes that there is a positive link between the auditing specialisation in a specific industry and the quality of professional performance.

H2/5: Whenever the audit firm size increases, audit quality increases.

Table 4.11: Tests for hypothesis 2/5
Whenever the audit firm size increases, audit quality increases

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q7. Increasing the size of audit firm will:								
1	increase the confidence in financial statements	136.19 (0.00)**	98 (93.3%)	4.25	0.744	17.21 (0.00)**	4.10	4.39
2	decrease the risk of audit failure	66.54 (0.00)**	92 (87.6%)	4.20	0.726	16.93 (0.00)**	4.06	4.34
3	increase supervising and co-ordination of audit team	48.79 (0.00)**	77 (73.3%)	3.91	0.774	12.04 (0.00)**	3.76	4.06
4	increasing auditor due care	41.55 (0.00)**	78 (74.3%)	4.03	0.765	13.79 (0.00)**	3.88	4.18
5	reduce the bias in auditor judgment	31.19 (0.00)**	68 (64.8%)	3.88	0.829	10.87 (0.00)**	3.72	4.04
	Average score	**125.16 (0.00)****	**76 (72.4%)**	**4.053**	**0.501**	**21.53 (0.00)****	**3.956**	**4.150**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The five statements were devised in order to determine whether or not an increased size of auditing firm would increase auditing quality; however, the alternative hypothesis may be accepted, which states that the respondents have a preference for one response included in the questionnaire. The study of DeFond & Jiambalvo (1991) indicates that clients of large audit firms have reduced the possibility of committing errors or irregularities causing the manipulation of profitability. In the same context, the study of Becker *et al*. (1998) indicates that the Big Six auditing firms at that time (now four) offered auditing of higher quality than other small audit firms.

In light of the previous tests, the number and percentage of respondents in agreement were arranged for the five statements in the frame of the five sub-hypotheses in a descending order, ranging from upper response to lower response as follows in Table 4.12.

Table 4.12: Summary of the responses for the five sub-hypotheses for the second main hypothesis						
	Statement	Increase legal compensation	Increase size of audit firm	Increase audit experience	Industry specialisation	Increase auditor tenure
1	increase the confidence in financial statements	77.1 %	93.3 %	83.8 %	61.9 %	11.4 %
2	decrease the risk of audit failure	81.9 %	87.6 %	64.8 %	62.9 %	20.0 %
3	increase supervising and co-ordination of audit team	81.6 %	73.3 %	60 %	45.7 %	16.2 %
4	increasing auditor due diligence	91.4 %	74.3 %	66.7 %	41.0 %	7.6 %
5	reduce the bias in auditor judgment	85.7 %	64.8 %	57.1 %	35.2 %	6.7 %
	Average score	**74.3 %**	**72.4 %**	**45.7 %**	**41.0 %**	**0 %**

From these results, it appears that legal compensations imposed upon auditors is the main factor affecting auditing quality (74.3% of the sample), then, in approximate degree, the size of auditing firm (72.4%).

As 77.1% of the sample show that increased legal compensations will increase their confidence in financial statements, 81.9% consider that increases will decrease the risk of auditing failure as a result of auditors seeking to avoid exposure to such compensations. Importantly, 81.6 % of the sample state that increases in legal compensation cause auditors to exert a greater degree of effort in terms of supervising team work, and also increases coordination degree amongst them. Moreover, 91.4% of the sample states that increased volume of compensation will increase the overall volume of auditors' professional care, with 85.7% stating that increased compensation volume will reduce bias in auditors' judgment.

The results of the second main hypothesis test confirm that the respondents support the notion that the civil legal liability system is the main factor affecting auditing quality This result agrees with the studies of Palmrose (1988), Melumad & Thoman (1990) and Elitzur & Falk (1996), which state that there is in general, positive correlation between the level of compensation expected by the plaintiff as a result of auditors' liability towards them and auditing quality. Moreover, the study of Khurana & Raman (2004), which is related to the litigation risks and financial reporting credibility of the Big 4 companies and non-Big 4 companies in Anglo-American countries, shows that the

exposure to litigation risk is the driver for perceived auditing quality more so than brand name protection.

4.3.3 The Effect of Increasing Civil Legal Liability of Auditors on Auditing Quality

The third hypothesis was designed to test the effect of auditors' civil legal liability system on the auditing quality.

H3: Increasing the civil legal liability of auditors will not increase audit quality.

This hypothesis was tested through putting forward five secondary hypotheses. The first hypothesis was used in order to test the effect of auditor civil legal liability nature on auditing quality, testing whether or not the auditor should have full rather than limited responsibility for any fault in financial statements when performing auditing to increase auditing quality. The second secondary hypothesis tests whether or not imposing physical punishment (compensations) rather than imposing nonphysical punishment will be more effective on auditing quality. The third secondary hypothesis tests whether the increase of parties litigating auditor owing to auditing failure will increase auditing quality. The fourth secondary hypothesis is to test whether or not increases of the compensation amount imposed upon the auditor will increase auditing quality. The five secondary hypotheses test whether or not, if the auditor bears any obligations for defendants in the case of their insolvency for paying compensations, this will increase auditing quality.

H3/1: Applying a strict liability rule improves audit quality, whilst applying negligence rule has a lesser effect on audit quality.

Testing of this hypothesis included five statements concerned with whether bearing the auditor the civil legal liability for any fault in financial statements will provide greater protection to investors, thereby encouraging the investment process, as illustrated in Table 4.13.

Table 4.13: Tests for hypothesis 3/1
Applying a strict liability rule improves audit quality, whilst applying negligence rule has a lesser effect on audit quality.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q8. Requiring auditors to have full rather limited responsibility is likely to:								
1	increase auditor's effort beyond the auditing standards	97.81 (0.00)**	91 (86.7%)	4.20	0.859	14.31 (0.00)**	4.03	4.37
2	increase the conservatives in auditor's opinions	88.47 (0.00)**	83 (79.0%)	3.97	0.882	11.26 (0.00)**	3.80	4.14
3	decrease the rate of accepted clients' risk	17.78 (0.00)**	72 (68.8%)	3.94	0.979	9.83 (0.00)**	3.75	4.13
4	increase the quality assessment of audit evidences	98.38 (0.00)**	90 (85.7%)	4.21	0.768	16.14 (0.00)**	4.06	4.36
5	increase the effectiveness of the audit committee	31.50 (0.00)**	75 (71.4%)	3.83	0.935	9.09 (0.00)**	3.65	4.01
	Average score	**35.677** (0.001)**	**66 (62.8%)**	**4.03**	**0.679**	**15.53 (0.00)****	**3.899**	**4.162**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the above-mentioned responses, it appears that 62.8% of respondents support that imposing upon the auditor the civil legal liability for any fault in financial statements will increase audit quality (responses mean 4.03) as 86.8% support the fact that civil legal liability will increase auditors' efforts beyond auditing standards, whereas 79% see that civil legal liability for any fault in financial statements will increase the conservatives in auditors' opinions. Moreover, 68.8% see that this will cause the auditor to reduce the rate of accepted client risk, and 85.7% consider that this will increase the quality assessment of auditing evidence. Finally, 71.4% believe that this will increase the overall effectiveness of auditing committees; notably, this result is not in agreement with the studies of Schwartz (1997) and Radahakrishnan (1999), who argue that the inability of auditors to predicate the due care criterion (there is no strict rule to judge the auditors due care) to be used in evaluating their performance may be an incentive for them to increase their auditing effort or otherwise to present greater conservative opinions in auditing reports to reduce the possibility of their exposure to litigation risk or to negligence.

H3/2: A liability system that depends on the legal compensation rule will not increase audit quality more than legal deterrence rule.

The testing of this hypothesis included five statements concerning whether or not auditors' civil legal liability system—which depends on investors' compensation rule rather than non-physical punishment rule—will increase audit quality, as illustrated in Table 4.14.

Table 4.14: Tests for hypothesis 3/2
A liability system that depends on the legal compensation rule will not increase audit quality more than legal deterrence rule.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q9.Requiring auditors to <u>compensate</u> users for audit judgment errors rather than non-financial penalties is more likely to :								
1	increase auditing effort	103.62 (0.00)**	90 (85.7%)	4.12	0.851	13.48 (0.00)**	3.96	4.29
2	increase the number of auditing hours	142.58 (0.00)**	92 (87.6%)	3.92	0.689	13.68 (0.00)**	3.79	4.06
3	increase skills and professional competence of auditing team	19.99 (0.00)**	71 (67.6%)	3.86	0.935	9.42 (0.00)**	3.68	4.04
4	increase auditing cost	51.46 (0.00)**	88 (83.8%)	4.27	0.824	15.79 (0.00)**	4.11	4.43
5	issue more qualified opinions	39.72 (0.00)**	78 (74.3%)	3.86	0.924	9.53 (0.00)**	3.68	4.04
	Average score	**99.40 (0.00)****	**69 (65.7%)**	**4.006**	**0.593**	**17.37 (0.00)****	**3.89**	**4.12**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

It appears from the response mean that 65.7% of the respondents support imposing physical compensations on the auditor as opposed to imposing non-physical punishments, with 85.7% considering that this will increase auditing effort. On the other hand, 87.6% see that this will increase the number of auditing hours. Moreover, 67.6% consider that such an approach would increase the skills and professional competence of auditing costs, with 83.3% stating that this will increase audit costs. Finally, 73.3% believe that the auditor will issue more qualified opinions. This result agrees with the results of many studies in the field of auditors' legal responsibility. Importantly, there is a recognised correlation between auditing quality and the compensation level imposed upon the auditor (Palmrose, 1988; Melumad & Thoman,

1990; Dye 1995; Schwartz, 1997; King & Schwartz, 2000; Zhang & Thoman, 1999), with such studies suggesting that an increase in auditor commitment with regard to paying compensation for injuries resulting from auditing failure, thereby creating an incentive for the auditor to work and to report honestly (Melumad & Thoman, 1990). In turn, it is considered that this will increase auditing quality. The auditor is required to choose the effort level, thus reducing the costs of the audit in addition to payments of expected civil responsibility in the case of audit.

H3/3: Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase audit quality.

The testing of this hypothesis included five statements concerning whether or not increasing the number of parties who can litigate the auditor for any damage incurred owing to auditing failure will increase auditing quality, as illustrated in Table 4.15.

Table 4.15: Tests for hypothesis 3/3
Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase audit quality.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q10.Allowing more than <u>one party</u> to sue the auditor for judgment errors will:								
1	increase legal consultants by auditor	59.23 (0.00)**	91 (86.7%)	4.29	0.717	18.43 (0.00)**	4.15	4.42
2	reduce acceptance of risky business clients	108.19 (0.00)**	90 (85.7%)	4.06	0.897	12.10 (0.00)**	3.88	4.23
3	make auditors more documentation of audit process	16.03 (0.00)**	70 (66.7%)	3.90	0.970	9.50 (0.00)**	3.71	4.08
4	increase advanced education of financial information users	96.48 (0.00)**	89 (84.8%)	4.12	0.840	13.66 (0.00)**	3.96	4.29
5	improve definition of legal rules	18.39 (0.00)**	66 (62.8%)	3.67	0.977	7.02 (0.00)**	3.48	3.86
	Average score	**55.93 (0.00)****	**73 (69.5%)**	**4.006**	**0.688**	**14.97 (0.00)****	**3.87**	**4.14**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the responses, it is clear that 69.5% support the increased number of parties litigating the auditor in the case of auditing failure, as the responses mean was 4.006, with 86.7% considering that this would increase legal consultants with regard to the auditor's work. Furthermore, 85.7% recognise that this will cause the auditor to limit his acceptance of clients with high-risk activities. Notably, 66.7% believe that this will

make auditors provide more documentation of the auditing process, with 84.8% considering that this increases the advanced education of financial information users. Finally, 62.8% see that it would improve the definition of legal rules.

Increasing the number of parties having the right to litigate the auditor means that the quality of the auditor's performance is scrutinised by more than one party, which could benefit society as a whole—not only the client of the auditing profession. In contrast, in the USA, by the 1980s, there was a strong direction calling for restricting the zone of the auditor's legal responsibility owing to the negative effects exposed by the auditing profession and business environment; this is recognised as being due to an increased number of parties having the right to litigate auditors, this meaning increased exposure to litigation risk.

H3/4: Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase auditing quality.

Testing this hypothesis included five statements regarding whether or not increasing the compensation amount to be paid by the auditor owing to auditing failure would increase auditing quality, as shown in the following table (Table 4.16).

Table 4.16: Tests for hypothesis 3/4
Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase auditing quality.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q11.Increasing <u>compensation amount</u> sought from the auditor due to audit judgment errors will:								
1	increase audit fees	100.19 (0.00)**	80 (76.2%)	3.90	0.808	11.41 (0.00)**	3.74	4.05
2	improve auditing programmes	51.53 (0.00)**	88(83.8%)	4.19	0.773	15.77 (0.00)**	4.04	4.34
3	increase tests of internal control accuracy	84.29 (0.00)**	79(75.2%)	3.90	0.865	10.66 (0.00)**	3.73	4.06
4	increase the size of audit sample	38.12 (0.00)**	82(78.1%)	4.10	0.831	13.56 (0.00)**	3.94	4.27
5	decrease acceptable audit risk	97.62 (0.00)**	91(86.6%)	4.24	0.815	15.59 (0.00)**	4.08	4.40
	Average score	**95.94 (0.00)****	**77 (73.3%)**	**4.06**	**0.502**	**21.70 (0.00)****	**3.97**	**4.16**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The results indicate that 73.3% of the respondents support increasing the compensation amount to be paid by the auditor as a result of auditing failure, with the response mean shown to be 4.6%. Clearly, 76.2% of the respondents believe that, owing to the increase in the compensation amount that the auditor has to pay in the case of auditing failure, the auditor's fees will increase. Moreover, 83.8% state that the auditor will improve auditing programmes in order to reduce the probability of auditing failure. Furthermore, 75.2% hold the belief that the auditor will increase the tests of internal control accuracy in order to reduce auditing failure probabilities. Moreover, 78.1% state that the auditor will increase the size of the auditing sample in order to achieve the same goal. Finally, 86.6 % consider that the auditor will decrease the acceptable auditing risks, thus avoiding auditing failure and reducing the likelihood of auditor litigation, consequently bearing more compensation for injured persons as a result of auditing failure.

The result supports the studies of Palmrose (1988), Melumad & Thoman (1990), Dye (1995), Schwartz (1997), King & Schwartz (2000) and Zhang & Thoman (1999), which suggest that an increase in auditor commitment with regard to paying compensation for injuries resulting from auditing failure will increase auditing quality. In this regard, future payment for compensation resulting from audit failure will drive auditors to improve their audit planning and ensure greater levels of due care and attention.

H3/5: Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants, will not increase audit quality.

Testing this hypothesis involved five statements concerning whether or not making the auditor responsible for any loss—regardless of who shared in the wrongdoing—would increase auditing quality, as illustrated in Table 4.17.

Table 4.17: Tests for hypothesis 3/5
Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants, will not increase audit quality.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q12. Applying joint & several liability rule when suing auditors will:								
1	increase control over acts of management	37.29 (0.00)**	78 (74.3%)	4.14	0.994	11.75 (0.00)**	3.95	4.34
2	achieve effective co-ordination between different parties	52.67 (0.00)**	72 (68.6%)	3.75	1.036	7.41 (0.00)**	3.55	3.95
3	increase understanding of the client's business	52.48 (0.00)**	63 (60.0%)	3.60	0.967	6.35 (0.00)**	3.41	3.79
4	increase size of disclosure about errors and illegal acts	34.70 (0.00)**	81 (77.1%)	4.11	0.870	13.07 (0.00)**	3.95	4.28
5	promote multiplicity of auditors in client's firms	48.86 (0.00)**	77 (73.3%)	3.85	1.246	6.99 (0.00)**	3.61	4.09
	Average score	**67.43 (0.00)****	**68 (64.8%)**	**3.89**	**0.856**	**10.65 (0.00)****	**3.72**	**4.05**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The results indicate that 64.8% of the respondents support the view that the auditor should pay compensation, regardless of the extent to which other parties shared in the wrongdoing of the financial statements (joint and several liability). As can be seen from the table, 74.3% believe that this would increase the control over acts of management, whereas 68.6% consider that this would help to achieve effective co-ordination between different parties concerned with the preparation and review of financial reports. Furthermore, 60% see that the auditor will increase understanding of the client's business, while 77.1% hold the view that this will increase size of disclosure concerning errors and illegal activity. Finally, 73.3% state that this will promote the multiplicity of auditors in clients' firms.

The results of the third main hypothesis test confirm that the respondents support increasing civil legal liability system within the community as it has a direct impact on the quality of audit. This result agrees with the model of Sarath & Wolfson (1993), which concludes that increasing the sanctions imposed upon auditors will lead to a greater degree of quality in terms of the audit. This result should be considered carefully as Schwartz (1997) and King & Schwartz (2000) indicate that the legal system for civil responsibility achieves the highest level of effort (auditing quality), but does not necessarily produce the greatest efficiency for society. Moreover, Narayanan

(1994) and Patterson & Wright (2003) conclude that imposing an increase in the auditor's civil responsibility does not, in itself, guarantee a corresponding increase in effort level (auditing quality).

4.3.4 The Effect of Civil Legal Liability Rules on Investment Levels

The fourth hypothesis was designed to test the effect of the auditor's civil legal liability system on the investment level within society.

H4: Investment level within society is not depended on the legal rules applied

This hypothesis was tested by creating five secondary hypotheses. The first hypothesis was used in order to test whether or not the auditor should have full rather than limited responsibility for any fault in financial statements when performing auditing, so as to increase investment level. The second secondary hypothesis tested whether a liability system depending on the legal compensation rule would increase investment levels more so than the legal deterrence rule. The third secondary hypothesis considered whether an increase in the number of parties able to litigate the auditor as a result of auditing failure would increase investment level. The fourth secondary hypothesis tested whether increasing the compensation amount imposed upon the auditor will increase investment level. The five secondary hypotheses examined whether or not the auditor should bear any obligations for defendants in the case of their insolvency for paying compensations, and whether this would increase investment level.

H4/1: Applying strict liability rule increase investment level, whilst applying negligence rule has a lesser effect on investment level

Testing of this hypothesis included five statements concerning whether bearing the auditor the civil legal liability for any fault in financial statements will have an effect on investment level in society, as illustrated in Table 4.18.

Table 4.18: Tests for hypothesis 4/1
Applying strict liability rule increase investment level, whilst applying negligence rule has a lesser effect on investment level.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q13. Making auditors fully responsible for any error will encourage investors to:								
1	increase their investments value	111.04 (0.00)**	103 (98.1%)	4.32	0.596	22.69 (0.00)**	4.21	4.44
2	increase the volume of trading in stock exchange	54.23 (0.00)**	98 (93.3%)	4.22	0.554	22.56 (0.00)**	4.11	4.33
3	ignore investment risk	82.09 (0.00)**	86 (81.9%)	4.10	0.887	12.70 (0.00)**	3.93	4.28
4	reduce the use of the audited financial reports	17.88 (0.00)**	89 (84.8%)	4.21	0.689	17.99 (0.00)**	4.08	4.34
5	less diversification of investments	36.67 (0.00)**	77 (73.3%)	4.12	0.829	13.84 (0.00)**	3.96	4.28
	Average score	**62.52 (0.00)****	**85 (80.9%)**	**4.19**	**0.420**	**29.13 (0.00)****	**4.115**	**4.28**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The results indicate that 80.9% of the respondents support that forcing the auditor to bear the civil legal liability for any fault in financial statements would increase the investment level more so than in the case of applying the negligence rule, as it has been found that 98.1% support making auditors fully responsible for any errors, and that this would increase their investments value. On the other hand, 93.3% state that this will increase the volume of trading in stock. Moreover, 81.9% see that investors will ignore investment risk, with 84.8% believing that this will reduce the use of audited financial reports. Finally, 73.3% consider that this could lead to a lesser diversification of investments.

H4/2: A liability system that depends on the legal compensation rule will not increase investment level more than legal deterrence rule.

The testing of this hypothesis included five statements concerning whether or not auditors' civil legal liability system—which depends on investors' compensation rule

rather than non-physical punishment rule—will increase investment levels in society, as illustrated in Table 4.19.

Table 4.19: Tests for hypothesis 4/2
A liability system that depends on the legal compensation rule will not increase investment level more than legal deterrence rule.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q14. Requiring auditors to compensate users for audit judgment errors rather than being fined is more likely to:								
1	encourage investors to trade in stock exchanges	84.52 (0.00)**	97 (92.4%)	4.28	0.628	20.88 (0.00)**	4.15	4.40
2	Increase the volume of trading	117.82 (0.00)**	97(92.4%)	4.14	0.595	19.63 (0.00)**	4.03	4.26
3	encourage banks to support business	31.04 (0.00)**	79 (75.2%)	4.02	0.888	11.77 (0.00)**	3.85	4.19
4	increase the relationship between stock prices and published financial statements	27.14 (0.00)**	95 (90.5%)	4.38	0.656	21.55 (0.00)**	4.25	4.51
5	increase the number of litigation cases made against auditors	35.91 (0.00)**	83 (79.0%)	4.09	0.921	12.12 (0.00)**	3.91	4.26
	Average score	**64.50 (0.00)****	**79 (75.2%)**	**4.18**	**0.533**	**22.69 (0.00)****	**4.07**	**4.28**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the response mean, it appears that 75.2% of the respondents support imposing physical compensations upon the auditor as opposed to non-physical punishments in order to increase the investment levels in society, with 92.4% considering that this will encourage investors to trade in stock exchanges, this increasing the overall volume of trading. Furthermore, 75.2% see that this will encourage banks to support business, whilst 90.5% believe that this will increase the relationship between stock prices and published financial statements. Finally, 79% maintain that it will also increase the number of litigation cases made against auditors.

H4/3: Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase investment level.

The testing of this hypothesis included five statements concerning whether or not increasing the number of parties able to litigate the auditor for any damage incurred due to auditing failure would increase the investment level, as illustrated in Table 4.20.

Table 4.20: Tests for hypothesis 4/3
Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase investment level.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q15.Increasing the <u>number of parties</u> who can litigate the auditor will:								
1	provide protection to shareholders	130.39 (0.00)**	98 (93.3%)	4.12	0.600	19.12 (0.00)**	4.01	4.24
2	provide oversight on management's acts	126.96 (0.00)**	98 (93.3%)	4.15	0.551	21.38 (0.00)**	4.05	4.26
3	encourage unjustified litigation against auditors	73.24 (0.00)**	79 (75.2%)	3.91	0.942	9.89 (0.00)**	3.73	4.10
4	improve the efficiency of resource allocation within society	73.25 (0.00)**	95 (90.5%)	4.28	0.700	18.73 (0.00)**	4.14	4.41
5	reduce the probability of auditing failure	50.38 (0.00)**	67 (63.8%)	3.93	1.031	9.24 (0.00)**	3.73	4.13
	Average score	**74.77 (0.00)****	**75 (71.4%)**	**4.08**	**0.486**	**22.75 (0.00)****	**3.986**	**4.17**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the responses, it appears that 71.4% believe that increasing the number of parties able to litigate the auditor in the case of auditing failure will increase the investment level in society, with 93.3% considering that this will provide protection to shareholders and further provide oversight in regard to the management's acts; however, 75.2% state that it would cause unjustified litigation against auditors. Markedly, 90.5% state that the efficiency of resource allocation would be improved within society, with 63.8% stating that this will reduce the probability of auditing failure.

H4/4: Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase investment level.

Testing this hypothesis included five statements concerning whether or not increasing the compensation amount to be paid by the auditor as a result of auditing failure would increase investment level, as demonstrated in the following table (Table 4.21).

Table 4.21: Tests for hypothesis 4/4
Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase investment level.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q16.Increasing the compensation amount sought from the auditor due to audit judgment errors will:								
1	make the investors ignore investment risk	80.03 (0.00)**	97 (92.4%)	4.30	0.664	20.06 (0.00)**	4.17	4.42
2	decrease the supply of auditing services	91.23 (0.00)**	79 (75.2%)	3.87	0.621	14.35 (0.00)**	3.75	3.99
3	increase the number of security trading process	39.34 (0.00)**	81 (77.1%)	3.94	0.928	10.37 (0.00)**	3.76	4.12
4	enhance disclosure in financial statements	122.95 (0.00)**	95 (90.5%)	4.22	0.734	17.03 (0.00)**	4.08	4.36
5	increase the number of new investors entering into the market	50.69 (0.00)**	85 (80.9%)	4.13	0.735	15.75 (0.00)**	3.99	4.28
	Average score	**97.18 (0.00)****	**79 (75.2%)**	**4.09**	**0.482**	**23.19 (0.00)****	**3.99**	**4.18**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the opinions of the respondents, it appears that 75.2% of them support increasing the compensations amount to be paid by the auditor following auditing failure, and that this will lead to increasing the investment level. Moreover, 92.4% see that increasing the compensation amount to be paid by the auditor in the case of auditing failure would make investors ignore investment risk, whereas 75.2% see that it will decrease the supply of auditing services. Furthermore, 77.1% consider that this would increase the number of the security trading process, and 90.5% believe that this will enhance disclosure in financial statements. Finally, 80.9% maintain that this will increase the number of new investors entering the market.

H4/5: Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants, will not increase investment level.

Testing this hypothesis included five statements concerning whether or not making the auditor responsible for any loss regardless of who shared in the wrongdoing will increase investment level, as illustrated in Table 4.22.

Table 4.22: Tests for hypothesis 4/5
Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants, will not increase investment level.

	Statement	Chi Sq. Test	Respondents agreeing* Number (%)	Mean	SD	t- test †	95% Confidence interval	
							Lower limit	Upper limit
Q17. Applying joint & several liability rule when suing auditors will:								
1	increase the number of cases against auditors	126.12 (0.00)**	103 (98.1%)	4.64	0.606	27.73 (0.00)**	4.52	4.76
2	decrease reliability of management report	76.29 (0.00)**	97 (92.4%)	4.39	0.658	21.64 (0.00)**	4.26	4.52
3	decrease investor care for investment decision	86.05 (0.00)**	85 (80.9%)	3.96	0.678	14.50 (0.00)**	3.83	4.09
4	increase the period of issuing auditor report	17.20 (0.00)**	90 (85.7%)	4.28	0.700	18.73 (0.00)**	4.14	4.41
5	increase investment level	41.86 (0.00)**	82 (78.1%)	4.18	0.794	15.22 (0.00)**	4.03	4.33
	Average score	**88.07 (0.00)****	**89 (84.8%)**	**4.29**	**0.410**	**32.20 (0.00)****	**4.21**	**4.37**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

From the opinion of the respondents, it appears that 84.8% support that the auditor should pay compensation, regardless of the extent to which other parties shared in the wrongdoing in financial statements. Although 98.1% see that this will increase the number of cases against auditors, 92.4% see that it will decrease the overall reliability of the management report. Furthermore, 80.9% consider that this will lead to a decrease in investor care for investment decisions. On the other hand, 85.7% believe that this will increase the period of issuing an auditor report. Finally, 78.1% state that this will increase investment level.

The results of the fourth main hypothesis test confirm that the respondents support increasing the civil legal liability system within the community, as it has a direct positive impact on the investment level within the community. This result further supports the study of Newman, Patterson & Smith (2005), which states that an increase in auditor penalties for undiscovered expropriation leads to a total investment increase.

On the other hand, some (Schibano, 2000, in Yu, 2000) argue that greater levels of legal responsibility may force the auditor to show discretion when issuing reports, a development that would notably result in the potential rejection of financial statements issued by the auditor, subsequently causing business firms to experience difficulties in obtaining funds needed for conducting investment activities, despite being beneficial to

society. Also, Schwartz (1997) and King & Schwartz (2000) indicate that the legal system that might attain auditing quality is not necessarily the most efficient for society as legal responsibility enforces more accurate auditing besides protecting users of financial statements against potential losses. As a result, greater levels of legal accountability for auditors may prompt investors (amongst users of financial statements) to exaggerate investment compared with ideal levels for society.

4.4 Tests for the Users of Financial Reports Characteristics Effect

The questionnaire distributed to the users include information relating to users' characteristics, such as their jobs, education, experience, and the frequency of using financial reports, in order to study whether these characteristics have an effect on users' responses. For instance, it assumes that an investor prefers a responsibility system for the auditing procedures so as to save his investment, due to the fact that his only source of information is published financial statements; on the other hand, for the creditor, there is a lesser need for a liability system as funds can be protected through terms of credit covenant. Moreover, educated users are supposed to be more aware of the liability system consequence.

In order to illustrate the effects of individual characteristics on the respondents' opinions with regard to the effects of the civil legal liability system on the auditing profession, a multi linear regression analysis was carried out in consideration of the results of the questionnaire. This was done after converting individual data into a quantitative measure for use in the regression analysis, using dummy variables to express the respondent's characteristics. The dummy variables for each respondent's characteristic are illustrated by the number of variables equal to the number of classes of each character taking the value of "0" or "1" creating 18 variables as follows in Table 4.23.

Table (4.23): Dummy variables used in tests for Users' Characteristics effect					
Job:	**J1**	**J2**	**J3**	**J4**	**J5**
Investor	1	0	0	0	0
Financial manager	0	1	0	0	0
Creditor	0	0	1	0	0
Financial Analysts	0	0	0	1	0
Others	0	0	0	0	1
Education:	**Ed1**	**Ed2**	**Ed3**	**Ed4**	**Ed5**
Professional	1	0	0	0	0
Ph.D.	0	1	0	0	0
MSc	0	0	1	0	0
BSc	0	0	0	1	0
Less than BSc	0	0	0	0	1
Experience:	**Ex1**	**Ex2**	**Ex3**		
More than 10 yrs	1	0	0		
Less than 10 yrs & more than 5 yrs	0	1	0		
Less than 5 yrs	0	0	1		
Frequency of using Financial Information:	**U1**	**U2**	**U3**	**U4**	**U5**
Very Frequently	1	0	0	0	0
Frequently	0	1	0	0	0
Occasionally	0	0	1	0	0
Rarely	0	0	0	1	0
Never	0	0	0	0	1

The average answers for the seventeenth main questions are regressed against each one of the four characteristics in a separate model, in order to capture the effect of each character on their responses, creating 68 models.

By regressing all the 18 dummy variables representing the four characteristics in one model will cancel the effect of some characteristics in the output results. Accordingly, the researcher avoided it through processing the 68 models, 4 models for each one of the seventeenth main questions. The regression model applied as follow:

$$Q_i = f \{ \text{Characteristic}_i \}$$

Where:

Qi = Q1, Q2, …., Q17

Characteristic: Job: J1, J2, J3, J4, J5

Education: Ed1, Ed2, Ed3, Ed4, Ed5

Experience: Ex1, Ex2, Ex3

Frequency of using financial information: U1, U2, U3, U4, U5

The test's results relating to the four characteristics using linear regression, demonstrate $\boldsymbol{\beta}$ coefficient for each class of characteristic, this coefficient represents the average opinion for each class regarding the dependent variable, measured on Likert scale used

in the questionnaire (from score of 5 representing to strongly agree to score of 1 representing to strongly disagree). An adjusted one-side t-test applied to measure the significance answers that agree with the dependent variable (with a score more than 3 "neutral"). The results of the tests are discussed below.

Test for Q1:

This question relates to the effects of the civil legal liability system on the demand of auditing services, with the effects of individual characteristics results on responses as follows (Table 4.24):

Table 4.24: The effects of users characteristics for Q1 (Imposing an legal compensation rule on auditor)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q1 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5				
Job	Investor (J1)	4.63	0.085	54.16	19.176	Yes
	Financial manager (J2)	4.12	0.146	28.11	7.671	Yes
	Creditor (J3)	4.00	0.169	23.6	5.917	Yes
	Financial Analysts (J4)	3.34	0.156	21.31	2.179	Yes
	Others (J5)	2.62	0.146	17.89	-2.603	No
Reg. Statistic	**R2 =0 .98**	**F-test = 1101**	**N=105**			
		Model: Q1 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5				
Education	Professional (Ed1)	3.78	0.169	22.31	4.615	Yes
	Ph.D. (Ed2)	4.04	0.309	13.05	3.366	Yes
	MSc (Ed3)	3.80	0.351	10.82	2.279	Yes
	BSc (Ed4)	4.21	0.14	30.07	8.643	Yes
	Less than BSc (Ed5)	3.92	0.239	16.33	3.849	Yes
Reg. Statistic	**R2 =0 .95**	**F-test = 391**	**N=105**			
		Model: Q1 = β1 Ex1 + β2 Ex2 + β3 Ex3				
Experience	More than 10 yrs (Ex1)	4.35	0.155	27.95	8.710	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	3.83	0.127	30.13	6.535	Yes
	Less than 5 yrs (Ex3)	3.87	0.203	19.06	4.286	Yes
Reg. Statistic	**R2 = 0.95**	**F-test = 683**	**N=105**			
		Model: Q1 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5				
Using financial reports	Very Frequently (U1)	4.62	0.141	32.56	11.489	Yes
	Frequently (U2)	4.18	0.12	34.8	9.833	Yes
	Occasionally (U3)	3.60	0.139	25.81	4.317	Yes
	Rarely (U4)	2.80	0.306	9.13	-0.654	No
	Never (U5)	2.33	0.433	5.38	-1.547	No
Reg. Statistic	**R2 =0 .96**	**F-test = 609**	**N=105**			

From the results, it can be seen that the most effective characteristics in the questionnaire were the job. Moreover, it has been established that investors were at the front in terms of supporting the necessity of existence of the civil legal liability system, with financial managers and creditors following subsequently with a possibility rate of 98%.

On the other hand, the education and experience factors also have an effect on the opinions of the respondents.

With regards to the frequency of using financial reports, it has been found that the most supporting categories believing that the lack of the civil legal liability system will affect the auditing profession in the community were those who frequently use the financial reports; meaning that the increase of using financial reports requires the existence of a civil legal liability system.

Test for Q2:

This question related to the effects of civil legal liability system on the frequency of using financial reports and the dependence on them by the community. The effects of individual characteristics results on responses are as follows (Table 4.25):

Table (4.25): The effects of users characteristics for Q2 (Imposing a legal deterrence rule on auditor)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q2 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.45	0.058	75.53	25.000	Yes
	Financial manager (J2)	4.28	0.101	42.41	12.673	Yes
	Creditor (J3)	3.71	0.116	31.84	6.121	Yes
	Financial Analysts (J4)	3.65	0.108	33.84	6.019	Yes
	Others (J5)	3.87	0.101	38.33	8.614	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2226**	**N=105**			
	Model: Q2 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4	0.093	42.9	10.753	Yes
	Ph.D. (Ed2)	4.06	0.17	23.89	6.235	Yes
	MSc (Ed3)	4.2	0.193	21.76	6.218	Yes
	BSc (Ed4)	4.17	0.0769	54.19	15.215	Yes
	Less than BSc (Ed5)	4.41	0.131	33.47	10.763	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1388**	**N=105**			
	Model: Q2 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.25	0.088	47.89	14.205	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.09	0.072	56.41	15.139	Yes
	Less than 5 yrs (Ex3)	4.13	0.115	35.67	9.826	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 2249**	**N=105**			
	Model: Q2 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.45	0.09	48.99	16.111	Yes
	Frequently (U2)	4.13	0.076	53.77	14.868	Yes
	Occasionally (U3)	4	0.089	44.82	11.236	Yes
	Rarely (U4)	3.86	0.196	19.71	4.388	Yes
	Never (U5)	3.53	0.277	12.73	1.913	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1570**	**N=105**			

From the results, it was observed that the most effective characteristics in the questionnaire was the job, with supporters of this hypothesis who consider that the existence of the civil legal liability system increases the usage and dependence of

financial reports in the community recognised as the investors, followed by financial managers, with a possibility rate of 99%. Notably, the other factors also have a converging effect.

Test for Q3, Q4, Q5, Q6, and Q7:

The effects of the individual characteristics of the respondents with regards to their opinions concerning the most important factors having an effect on auditing quality are captured through the questionnaire in five sections include the same statements about audit quality, each section discuss the effect of a five different factors on audit quality. These factors are legal liability (table 4.26), auditor tenure (table 4.27), auditor experience (table 4.28), auditor industry specialization (table 4.29), and audit firm size (table 4.30).

Table (4.26): The effects of users characteristics for Q3 (Increase expected compensation on auditors)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q3 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5				
Job	Investor (J1)	4.36	0.062	69.32	21.935	Yes
	Financial manager (J2)	4.18	0.107	38.79	11.028	Yes
	Creditor (J3)	4.56	0.124	36.64	12.581	Yes
	Financial Analysts (J4)	3.78	0.115	32.8	6.783	Yes
	Others (J5)	3.31	0.107	30.69	2.897	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1934**	**N=105**			
		Model: Q3 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5				
Education	Professional (Ed1)	4.13	0.107	38.59	10.561	Yes
	Ph.D. (Ed2)	4.08	0.195	20.91	5.538	Yes
	MSc (Ed3)	3.91	0.221	17.65	4.118	Yes
	BSc (Ed4)	4.23	0.088	47.85	13.977	Yes
	Less than BSc (Ed5)	3.9	0.151	25.79	5.960	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1038**	**N=105**			
		Model: Q3 = β1 Ex1 + β2 Ex2 + β3 Ex3				
Experience	More than 10 yrs (Ex1)	4.22	0.1	42	12.200	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.121	0.082	50.19	13.671	Yes
	Less than 5 yrs (Ex3)	3.96	0.131	30.2	7.328	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1731**	**N=105**			
		Model: Q3 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5				
Using financial reports	Very Frequently (U1)	4.4	0.093	47.08	15.054	Yes
	Frequently (U2)	4.22	0.079	53.21	15.443	Yes
	Occasionally (U3)	4.02	0.091	43.71	11.209	Yes
	Rarely (U4)	3.1	0.202	15.33	0.495	No
	Never (U5)	3.26	0.285	11.42	0.912	No
Reg. Statistic	**R2 =0 .98**	**F-test = 1464**	**N=105**			

Table (4.27): The effects of users characteristics for Q4 (Increase the period of auditor tenure)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
		Model: Q4 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5				
Job	Investor (J1)	2.95	0.072	40.81	-0.694	No
	Financial manager (J2)	2.5	0.124	20.13	-4.032	No
	Creditor (J3)	2.01	0.143	14.06	-6.923	No
	Financial Analysts (J4)	2.5	0.132	18.83	-3.788	No
	Others (J5)	2.38	0.124	19.22	-5.000	No
Reg. Statistic	**R2 = 0.96**	**F-test = 598**	**N=105**			
		Model: Q4 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5				
Education	Professional (Ed1)	2.37	0.099	23.89	-6.364	No
	Ph.D. (Ed2)	2.73	0.181	15.07	-1.492	No
	MSc (Ed3)	2.11	0.205	10.28	-4.341	No
	BSc (Ed4)	2.77	0.082	33.81	-2.805	No
	Less than BSc (Ed5)	2.92	0.14	20.79	-0.571	No
Reg. Statistic	**R2 =0 .96**	**F-test = 495**	**N=105**			
		Model: Q4 = β1 Ex1 + β2 Ex2 + β3 Ex3				
Experience	More than 10 yrs (Ex1)	2.8	0.099	28.27	-2.020	No
	Less than 10 yrs & more than 5 yrs (Ex2)	2.54	0.081	31.4	-5.679	No
	Less than 5 yrs (Ex3)	2.56	0.129	19.78	-3.411	No
Reg. Statistic	**R2 =0 .95**	**F-test = 725**	**N=105**			
		Model: Q4 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5				
Using financial reports	Very Frequently (U1)	2.92	0.105	27.67	-0.762	No
	Frequently (U2)	2.61	0.089	29.17	-4.382	No
	Occasionally (U3)	2.44	0.103	23.48	-5.437	No
	Rarely (U4)	2.26	0.228	9.91	-3.246	No
	Never (U5)	2.66	0.323	8.25	-1.053	No
Reg. Statistic	**R2 = 0.95**	**F-test = 466**	**N=105**			

Table (4.28): The effects of users characteristics for Q5 (Auditor with more experience)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
		Model: Q5 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5				
Job	Investor (J1)	4.05	0.06	66.63	17.500	Yes
	Financial manager (J2)	3.37	0.104	32.35	3.558	Yes
	Creditor (J3)	3.95	0.12	32.79	7.917	Yes
	Financial Analysts (J4)	3.65	0.111	32.79	5.856	Yes
	Others (J5)	3.65	0.104	34.99	6.250	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1772**	**N=105**			
		Model: Q5 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5				
Education	Professional (Ed1)	3.72	0.086	42.9	8.372	Yes
	Ph.D. (Ed2)	3.64	0.158	22.98	4.051	Yes
	MSc (Ed3)	3.6	0.179	20.02	3.352	Yes
	BSc (Ed4)	3.93	0.071	54.81	13.099	Yes
	Less than BSc (Ed5)	3.92	0.122	31.91	7.541	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1358**	**N=105**			
		Model: Q5 = β1 Ex1 + β2 Ex2 + β3 Ex3				
Experience	More than 10 yrs (Ex1)	3.79	0.082	46.14	9.634	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	3.77	0.067	56.25	11.493	Yes
	Less than 5 yrs (Ex3)	4	0.107	37.31	9.346	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 2228**	**N=105**			
		Model: Q5 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5				
Using financial reports	Very Frequently (U1)	3.97	0.088	44.7	11.023	Yes
	Frequently (U2)	3.79	0.075	50.32	10.533	Yes
	Occasionally (U3)	3.83	0.087	43.85	9.540	Yes
	Rarely (U4)	3.4	0.192	17.68	2.083	Yes
	Never (U5)	3.53	0.271	13	1.956	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1387**	**N=105**			

Table (4.29): The effects of users characteristics for Q6 (Auditor industry specialization)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
	Model: Q6 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	3.67	0.092	39.49	7.283	Yes
	Financial manager (J2)	4.12	0.159	25.88	7.044	Yes
	Creditor (J3)	3.31	0.184	18.02	1.685	Yes
	Financial Analysts (J4)	3.1	0.17	18.19	0.588	No
	Others (J5)	3.15	0.159	19.76	0.943	No
Reg. Statistic	**R2 =0 .97**	**F-test = 655**	**N=105**			
	Model: Q6 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	3.47	0.123	28.03	3.821	Yes
	Ph.D. (Ed2)	3.84	0.226	16.99	3.717	Yes
	MSc (Ed3)	3.6	0.256	14.03	2.344	Yes
	BSc (Ed4)	3.7	0.102	36.25	6.863	Yes
	Less than BSc (Ed5)	3	0.175	17.12	0.000	No
Reg. Statistic	**R2 =0 .96**	**F-test = 575**	**N=105**			
	Model: Q6 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	3.54	0.119	29.75	4.538	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	3.68	0.097	37.93	7.010	Yes
	Less than 5 yrs (Ex3)	3.19	0.155	20.55	1.226	No
Reg. Statistic	**R2 =0 .96**	**F-test = 915**	**N=105**			
	Model: Q6 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	3.84	0.13	29.51	6.462	Yes
	Frequently (U2)	3.57	0.11	32.39	5.182	Yes
	Occasionally (U3)	3.32	0.127	25.97	2.520	Yes
	Rarely (U4)	3.3	0.281	11.73	1.068	No
	Never (U5)	3	0.397	7.54	0.000	No
Reg. Statistic	**R2 =0 .96**	**F-test = 557**	**N=105**			

Table (4.30): The effects of users characteristics for Q7 (Increase size of audit firm)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
	Model: Q7 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.08	0.074	55.09	14.595	Yes
	Financial manager (J2)	4.03	0.127	31.77	8.110	Yes
	Creditor (J3)	4.11	0.146	28.05	7.603	Yes
	Financial Analysts (J4)	4.01	0.135	29.54	7.481	Yes
	Others (J5)	3.96	0.127	31.18	7.559	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1334**	**N=105**			
	Model: Q7 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.05	0.086	47.08	12.209	Yes
	Ph.D. (Ed2)	4	0.157	25.45	6.369	Yes
	MSc (Ed3)	3.85	0.178	21.64	4.775	Yes
	BSc (Ed4)	4.22	0.071	59.47	17.183	Yes
	Less than BSc (Ed5)	3.66	0.121	30.12	5.455	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1555**	**N=105**			
	Model: Q7 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	3.91	0.084	46.43	10.833	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.06	0.068	59.03	15.588	Yes
	Less than 5 yrs (Ex3)	4.25	0.11	38.63	11.364	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 2377**	**N=105**			
	Model: Q7 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.17	0.093	44.73	12.581	Yes
	Frequently (U2)	4.02	0.079	50.8	12.911	Yes
	Occasionally (U3)	4.08	0.091	44.48	11.868	Yes
	Rarely (U4)	3.63	0.201	18.01	3.134	Yes
	Never (U5)	3.86	0.285	13.55	3.018	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1413**	**N=105**			

From the above results, it can be seen that the job factor has an essential effect on the sample responses with regards to the factors having the most effect on the increase of auditing quality. The supporters who believe that increased legal compensations imposed on auditors is the most important factor affecting auditing quality are creditors, followed by investors, financial managers, financial analysts, and finally others.

Test for Q8:

Table (4.31) shows the effects of individual characteristics on the respondents' opinions with regards to whether the auditor bearing the civil legal liability for any fault in financial statements will provide a greater degree of protection to investors.

Table (4.31): The effects of users characteristics for Q8 (Requiring auditors to have full rather limited responsibility)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q8 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.22	0.093	45.29	13.118	Yes
	Financial manager (J2)	3.67	0.159	23.01	4.214	Yes
	Creditor (J3)	3.66	0.184	19.88	3.587	Yes
	Financial Analysts (J4)	4.32	0.17	25.35	7.765	Yes
	Others (J5)	3.83	0.159	24.03	5.220	Yes
Reg. Statistic	**R2 =0 .97**	**F-test = 839**	**N=105**			
	Model: Q8 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.06	0.122	33.2	8.689	Yes
	Ph.D. (Ed2)	4.2	0.223	18.78	5.381	Yes
	MSc (Ed3)	4	0.253	15.77	3.953	Yes
	BSc (Ed4)	3.86	0.101	38.24	8.515	Yes
	Less than BSc (Ed5)	4.34	0.173	25.09	7.746	Yes
Reg. Statistic	**R2 = 0.97**	**F-test = 759**	**N=105**			
	Model: Q8 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.31	0.111	38.54	11.802	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	3.95	0.091	43.27	10.440	Yes
	Less than 5 yrs (Ex3)	3.75	0.145	25.71	5.172	Yes
Reg. Statistic	**R2 = 0.97**	**F-test = 1339**	**N=105**			
	Model: Q8 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.12	0.129	31.98	8.682	Yes
	Frequently (U2)	4.02	0.109	36.75	9.358	Yes
	Occasionally (U3)	4.04	0.126	31.91	8.254	Yes
	Rarely (U4)	3.63	0.278	13.03	2.266	Yes
	Never (U5)	3.86	0.394	9.8	2.183	Yes
Reg. Statistic	**R2 = 0.97**	**F-test = 731**	**N=105**			

From the results of the regression test, it appears that there is an effect for job factor, as it has been found that financial analysts were at the front for supporting bearing auditor the legal labiality for any fault in the financial statements, with investors following.

With regard to the experience factor, persons with more than 10 years' experience are greater supporters for bearing auditor the civil legal liability for any fault in the financial statements. Moreover, the effect of education and frequency in terms of using financial reports has the same effect.

Test for Q9:

The effects of individual characteristics on the respondents' opinions with regards to whether or not imposing physical compensations on auditor rather than imposing non-physical punishment will increase audit quality, as can be seen from Table (4.32).

Table (4.32): The effects of users characteristics for Q9 (Requiring auditors to compensate users for audit judgment errors rather than non financial penalties)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q9 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.17	0.065	63.32	18.000	Yes
	Financial manager (J2)	4.21	0.112	37.28	10.804	Yes
	Creditor (J3)	4.23	0.13	32.45	9.462	Yes
	Financial Analysts (J4)	4.05	0.12	33.59	8.750	Yes
	Others (J5)	3.08	0.112	27.33	0.714	No
Reg. Statistic	**R2 =0 .98**	**F-test = 1665**	**N=105**			
	Model: Q9 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.06	0.108	37.45	9.815	Yes
	Ph.D. (Ed2)	3.97	0.198	20.07	4.899	Yes
	MSc (Ed3)	3.71	0.224	16.52	3.170	Yes
	BSc (Ed4)	3.95	0.089	44.16	10.674	Yes
	Less than BSc (Ed5)	4.17	0.153	27.18	7.647	Yes
Reg. Statistic	**R2 =0 .97**	**F-test = 953**	**N=105**			
	Model: Q9 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.14	0.095	43.58	12.000	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.09	0.077	52.65	14.156	Yes
	Less than 5 yrs (Ex3)	3.55	0.124	28.61	4.435	Yes
Reg. Statistic	**R2 =0 .98**	**F-test = 1829**	**N=105**			
	Model: Q9 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.18	0.104	40.03	11.346	Yes
	Frequently (U2)	4.06	0.088	45.84	12.045	Yes
	Occasionally (U3)	3.98	0.102	38.79	9.608	Yes
	Rarely (U4)	3.3	0.225	14.61	1.333	No
	Never (U5)	3.2	0.319	10.02	0.627	No
Reg. Statistic	**R2 =0 .98**	**F-test = 1104**	**N=105**			

From the results, it appears that there is a middle effect for job factor on the opinions of respondents, where creditors were at the front for supporting the notion that imposing physical compensations on auditor as opposed to imposing non-physical punishment would increase audit quality, with financial managers and investors following. On the

other hand, the experience factor also has a middle effect on the opinions, appearing that persons with more than 10 years' experience were greater supporters for bearing auditor compensations for any faults in financial statements. With regard to using the financial reports factor, the most supportive categories believing that imposing physical compensations on auditor instead of imposing non-physical punishment would increase audit quality were those who very frequently use financial statements.

Test for Q10:

Table (4.33) shows the effects of individual characteristics on the respondents' opinions with regard to whether or not increasing the number of parties litigating auditor would increase audit quality.

Table (4.33): The effects of users characteristics for Q10 (Allowing more than one party to sue the auditor for judgment errors)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q10 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.19	0.087	47.81	13.678	Yes
	Financial manager (J2)	4.11	0.15	27.37	7.400	Yes
	Creditor (J3)	4.15	0.173	23.92	6.647	Yes
	Financial Analysts (J4)	4.08	0.16	25.43	6.750	Yes
	Others (J5)	3.17	0.15	21.13	1.133	No
Reg. Statistic	**R2 = 0.98**	**F-test = 939**	**N=105**			
	Model: Q10 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	3.94	0.121	32.42	7.769	Yes
	Ph.D. (Ed2)	4.22	0.221	19.03	5.520	Yes
	MSc (Ed3)	3.51	0.251	13.97	2.032	Yes
	BSc (Ed4)	4.18	0.1	41.72	11.800	Yes
	Less than BSc (Ed5)	3.7	0.171	21.57	4.094	Yes
Reg. Statistic	**R2 = 0.97**	**F-test = 762**	**N=105**			
	Model: Q10 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.11	0.115	35.51	9.652	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.05	0.094	42.87	11.170	Yes
	Less than 5 yrs (Ex3)	3.68	0.151	24.34	4.503	Yes
Reg. Statistic	**R2 =0 .97**	**F-test = 1230**	**N=105**			
	Model: Q10 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.15	0.121	34.32	9.504	Yes
	Frequently (U2)	4.22	0.102	41.12	11.961	Yes
	Occasionally (U3)	3.75	0.119	31.58	6.303	Yes
	Rarely (U4)	3.2	0.261	12.23	0.766	No
	Never (U5)	3.8	0.37	10.27	2.162	Yes
Reg. Statistic	**R2 = 0.97**	**F-test = 824**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q10 (R^2 = 97-98%).

The investors, the PhD educated, those with more than 10 years' experience, and those who use financial reports frequently are the more accepting for Q10.

Test for Q11:

The effects of individual characteristics on the respondents' opinions with regards to whether or not increasing the compensation amount to be paid by auditor as a result of auditing failure would increase auditing quality, as shown in Table (4.34).

Table 4.34: The effects of users characteristics for Q11 (Increasing compensation amount sought from the auditor due to audit judgment errors)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q11 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.12	0.073	56.25	15.342	Yes
	Financial manager (J2)	3.88	0.125	30.94	7.040	Yes
	Creditor (J3)	4.15	0.145	28.6	7.931	Yes
	Financial Analysts (J4)	4.12	0.134	30.74	8.358	Yes
	Others (J5)	3.95	0.125	31.44	7.600	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1374**	**N=105**			
	Model: Q11 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.14	0.09	45.88	12.667	Yes
	Ph.D. (Ed2)	3.88	0.164	23.61	5.366	Yes
	MSc (Ed3)	3.94	0.186	21.11	5.054	Yes
	BSc (Ed4)	4.15	0.074	55.76	15.541	Yes
	Less than BSc (Ed5)	3.81	0.127	29.88	6.378	Yes
Reg. Statistic	**R2 =0 .99**	**F-test = 1422**	**N=105**			
	Model: Q11 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.06	0.084	48.26	12.619	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	3.96	0.068	57.7	14.118	Yes
	Less than 5 yrs (Ex3)	4.31	0.109	39.24	12.018	Yes
Reg. Statistic	**R2 =0 .99**	**F-test = 2399**	**N=105**			
	Model: Q11 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.08	0.092	44.18	11.739	Yes
	Frequently (U2)	4.07	0.078	51.97	13.718	Yes
	Occasionally (U3)	4.17	0.09	45.92	13.000	Yes
	Rarely (U4)	3.73	0.199	18.69	3.668	Yes
	Never (U5)	3.4	0.282	12.03	1.418	No
Reg. Statistic	**R2 = 0.99**	**F-test = 1451**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q11 (R^2 = 98-99%). Markedly, creditors, BSc educated, the ones of average years of experience less than 5 years, and the one's using financial report occasionally are the more accepting for Q11

Test for Q12:

The following table (Table 4.35) shows the effects of individual characteristics on the respondents' opinions with regards to whether or not making the auditor responsible for any loss—regardless of who shared in the wrongdoing—will increase auditing quality.

Table 4.35: The effects of users characteristics for Q12 (Applying joint & several liability rule when suing auditors)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q12 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	3.87	0.112	34.44	7.768	Yes
	Financial manager (J2)	4.38	0.192	22.77	7.188	Yes
	Creditor (J3)	4.18	0.222	18.8	5.315	Yes
	Financial Analysts (J4)	4.1	0.205	19.9	5.366	Yes
	Others (J5)	3.05	0.192	15.83	0.260	No
Reg. Statistic	**R2 = 0.96**	**F-test = 541**	**N=105**			
	Model: Q12 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.1	0.137	29.8	8.029	Yes
	Ph.D. (Ed2)	4.48	0.251	17.84	5.896	Yes
	MSc (Ed3)	3.88	0.285	13.62	3.088	Yes
	BSc (Ed4)	3.95	0.113	34.79	8.407	Yes
	Less than BSc (Ed5)	2.9	0.194	14.91	-0.515	No
Reg. Statistic	**R2 = 0.96**	**F-test = 564**	**N=105**			
	Model: Q12 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	3.95	0.142	27.77	6.690	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.03	0.116	34.67	8.879	Yes
	Less than 5 yrs (Ex3)	3.41	0.185	18.35	2.216	Yes
Reg. Statistic	**R2 = 0.95**	**F-test = 769**	**N=105**			
	Model: Q12 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.1	0.152	26.91	7.237	Yes
	Frequently (U2)	4.12	0.129	31.98	8.682	Yes
	Occasionally (U3)	3.62	0.149	24.19	4.161	Yes
	Rarely (U4)	3.06	0.329	9.32	0.182	No
	Never (U5)	3.13	0.465	6.73	0.280	No
Reg. Statistic	**R2 = 0.96**	**F-test = 492**	**N=105**			

From results of regression, it appears that the individual factors have an effect, although it is weak. With regard to the job factor, it has been found that the financial managers are the most dominant supporters, believing that making auditor pay compensation, in the case of insolvency of other parties, regardless of his fault ratio in the financial statements, will increase auditing quality, with creditors and financial analysts following subsequently.

With regard to the education factor, Ph.D. holders were most supportive, followed by professional certificates holders. Experience and use of financial reports factors were extremely weak in terms of effects.

Test for Q13:

Table (4.36) shows the effects of individual characteristics on the respondents' opinions with regards to whether or not making the auditor fully responsible for any errors in financial statements, as opposed to having limited liability, will give greater protection to investors and increase investment levels within society.

Table (4.36): The effects of users characteristics for Q13 (Making auditors fully responsible for any error)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q13 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.09	0.059	68.83	18.475	Yes
	Financial manager (J2)	4.27	0.102	41.89	12.451	Yes
	Creditor (J3)	4.13	0.117	35.08	9.658	Yes
	Financial Analysts (J4)	4.18	0.109	38.37	10.826	Yes
	Others (J5)	4.46	0.102	43.73	14.314	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2221**	**N=105**			
	Model: Q13 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.22	0.076	54.88	16.053	Yes
	Ph.D. (Ed2)	4.13	0.14	29.44	8.071	Yes
	MSc (Ed3)	4.4	0.159	27.64	8.805	Yes
	BSc (Ed4)	4.2	0.063	66.29	19.048	Yes
	Less than BSc (Ed5)	4.05	0.108	37.27	9.722	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2085**	**N=105**			
	Model: Q13 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.1	0.068	59.7	16.176	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.14	0.056	73.99	20.357	Yes
	Less than 5 yrs (Ex3)	4.48	0.089	50.03	16.629	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 3846**	**N=105**			
	Model: Q13 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.13	0.08	51.27	14.125	Yes
	Frequently (U2)	4.2	0.068	61.45	17.647	Yes
	Occasionally (U3)	4.24	0.079	53.51	15.696	Yes
	Rarely (U4)	4.2	0.174	24.1	6.897	Yes
	Never (U5)	4.26	0.246	17.31	5.122	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2029**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q13 (R^2 = 99%). The Others, the MSc education, those with an average of less than 5 years' experience, and those that never use financial reports are the more accepting for Q13.

Test for Q14:

Table (4.37) shows the effects of individual characteristics on the respondents' opinions with regards to whether or not auditors' civil legal liability system—which

depends on investors' compensations rule rather than non-physical punishment rule—will increase investment levels within society.

Table (4.37): The effects of users characteristics for Q14 (Requiring auditors to compensate users for audit judgment errors rather than being fined)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q14 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.14	0.071	57.92	16.056	Yes
	Financial manager (J2)	4.25	0.122	34.65	10.246	Yes
	Creditor (J3)	4.26	0.141	30.13	8.936	Yes
	Financial Analysts (J4)	4.61	0.131	35.19	12.290	Yes
	Others (J5)	3.77	0.122	30.78	6.311	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1529**	**N=105**			
	Model: Q14 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.32	0.096	44.63	13.750	Yes
	Ph.D. (Ed2)	4.28	0.176	24.23	7.273	Yes
	MSc (Ed3)	4.14	0.2	20.64	5.700	Yes
	BSc (Ed4)	4.12	0.08	51.56	14.000	Yes
	Less than BSc (Ed5)	4	0.137	29.18	7.299	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1303**	**N=105**			
	Model: Q14 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.35	0.089	48.85	15.169	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.05	0.072	55.61	14.583	Yes
	Less than 5 yrs (Ex3)	4.21	0.116	36.19	10.431	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 2262**	**N=105**			
	Model: Q14 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.17	0.101	41.06	11.584	Yes
	Frequently (U2)	4.19	0.086	48.64	13.837	Yes
	Occasionally (U3)	4.23	0.1	42.34	12.300	Yes
	Rarely (U4)	3.93	0.219	17.89	4.247	Yes
	Never (U5)	4	0.31	12.86	3.226	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1265**	**N=105**			

From the results, it is clear that there is an effect for the job factor as the determination coefficient was 98%. Moreover, it has been found that the most supportive categories who believe that the auditor's civil legal liability system, i.e. giving compensation to users hurt by auditing failures, will increase investment levels in society more so than other systems, such as fines, were financial analysts.

Test for Q15:

The effects of individual characteristics on the respondents' opinions with regards to whether or not increasing the number of parties who can litigate the auditor will increase investment level in society are as follows (Table 4.38):

Table (4.38): The effects of users characteristics for Q15 (Increasing the number of parties who can litigate the auditor)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
	Model: Q15 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.08	0.067	60.47	16.119	Yes
	Financial manager (J2)	4.3	0.115	37.1	11.304	Yes
	Creditor (J3)	4.11	0.133	30.76	8.346	Yes
	Financial Analysts (J4)	4.18	0.123	33.78	9.593	Yes
	Others (J5)	3.71	0.115	32.03	6.174	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 1629**	**N=105**			
	Model: Q15 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.09	0.085	48.03	12.824	Yes
	Ph.D. (Ed2)	4.28	0.155	27.56	8.258	Yes
	MSc (Ed3)	3.71	0.176	21.05	4.034	Yes
	BSc (Ed4)	4.17	0.07	59.36	16.714	Yes
	Less than BSc (Ed5)	3.81	0.12	31.64	6.750	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 1607**	**N=105**			
	Model: Q15 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.12	0.084	49.07	13.333	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.04	0.068	58.99	15.294	Yes
	Less than 5 yrs (Ex3)	4.09	0.109	37.33	10.000	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 2427**	**N=105**			
	Model: Q15 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.1	0.087	46.79	12.644	Yes
	Frequently (U2)	4.16	0.074	56.06	15.676	Yes
	Occasionally (U3)	4.1	0.086	47.58	12.791	Yes
	Rarely (U4)	3.53	0.189	18.63	2.804	Yes
	Never (U5)	3.53	0.268	13.18	1.978	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1623**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q15 (R^2 = 98- 99%). The Financial Managers, the PhD educated, those with an average of more than 10 years' experience, and those using financial reports frequently are the most accepting for Q15.

Test for Q16:

Table (4.39) shows the effects of individual characteristics on the respondents' opinions with regards to whether or not increasing the compensations amount to be paid by the auditor in the case of auditing failure would increase investments level.

Table 4.39: The effects of users characteristics for Q16 (Increasing the compensation amount sought from the auditor due to audit judgment)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
	Model: Q16 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.14	0.065	63.79	17.538	Yes
	Financial manager (J2)	4.13	0.111	37.12	10.180	Yes
	Creditor (J3)	4.4	0.128	34.18	10.938	Yes
	Financial Analysts (J4)	4.07	0.119	34.17	8.992	Yes
	Others (J5)	3.66	0.111	32.86	5.946	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1772**	**N=105**			
	Model: Q16 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.06	0.089	45.51	11.910	Yes
	Ph.D. (Ed2)	4.24	0.162	26.06	7.654	Yes
	MSc (Ed3)	4.08	0.184	22.12	5.870	Yes
	BSc (Ed4)	4.06	0.073	55.23	14.521	Yes
	Less than BSc (Ed5)	4.13	0.126	32.76	8.968	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1472**	**N=105**			
	Model: Q16 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.05	0.083	48.69	12.651	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.11	0.068	60.44	16.324	Yes
	Less than 5 yrs (Ex3)	4.09	0.108	37.63	10.093	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 2479**	**N=105**			
	Model: Q16 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.19	0.091	46	13.077	Yes
	Frequently (U2)	4.08	0.077	52.92	14.026	Yes
	Occasionally (U3)	4.07	0.089	45.51	12.022	Yes
	Rarely (U4)	3.9	0.196	19.81	4.592	Yes
	Never (U5)	3.73	0.278	13.41	2.626	Yes
Reg. Statistic	**R2 = 0.98**	**F-test = 1511**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q16 (R^2 = 98%). The Creditors, the PhD educated, those with less than 10 years' and more than 5 years' experience, and those using financial report very frequently are the more accepting for Q16.

Test for Q17:

The effects of individual characteristics on the respondents' opinions with regards to whether or not making the auditor responsible for any loss, regardless of who shared in the wrongdoing, will increase investments level, as shown in Table (4.40):

Table 4.40: The effects of users characteristics for Q17 (Applying joint & several liability rule when suing auditors)						
Effect	**Independent Variables**	**Estimated Coefficient β**	**Standard Error**	**t-test**	**Adj. t-test**	**Significance at 95%**
	Model: Q17 = β1 J1 + β2 J2 + β3 J3 + β4 J4 + β5 J5					
Job	Investor (J1)	4.33	0.059	72.52	22.542	Yes
	Financial manager (J2)	4.11	0.102	40.17	10.882	Yes
	Creditor (J3)	4.33	0.118	36.65	11.271	Yes
	Financial Analysts (J4)	4.22	0.109	38.63	11.193	Yes
	Others (J5)	4.36	0.102	42.61	13.333	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2304**	**N=105**			
	Model: Q17 = β1 Ed1 + β2 Ed2 + β3 ED3 + β4 Ed4 + β5 Ed5					
Education	Professional (Ed1)	4.26	0.075	56.43	16.800	Yes
	Ph.D. (Ed2)	4.26	0.138	30.91	9.130	Yes
	MSc (Ed3)	4.2	0.156	26.83	7.692	Yes
	BSc (Ed4)	4.27	0.062	68.5	20.484	Yes
	Less than BSc (Ed5)	4.42	0.106	41.4	13.396	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2253**	**N=105**			
	Model: Q17 = β1 Ex1 + β2 Ex2 + β3 Ex3					
Experience	More than 10 yrs (Ex1)	4.34	0.069	62.42	19.420	Yes
	Less than 10 yrs & more than 5 yrs (Ex2)	4.2	0.056	74	21.429	Yes
	Less than 5 yrs (Ex3)	4.4	0.09	48.45	15.556	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 3906**	**N=105**			
	Model: Q17 = β1 U1 + β2 U2 + β3 U3 + β4 U4 + β5 U5					
Using financial reports	Very Frequently (U1)	4.26	0.077	54.68	16.364	Yes
	Frequently (U2)	4.25	0.066	64.34	18.939	Yes
	Occasionally (U3)	4.32	0.076	56.43	17.368	Yes
	Rarely (U4)	4.53	0.168	26.91	9.107	Yes
	Never (U5)	4.2	0.238	17.63	5.042	Yes
Reg. Statistic	**R2 = 0.99**	**F-test = 2269**	**N=105**			

As the results show, all four characteristics (Job, Education, Experience, Using financial reports) have a converging effect on the users' views for Q17 (R^2 = 99%). The Investors & Creditors, those with less than BSc education, those with less than 5 years' experience, and those using financial reports rarely are the more accepting for Q17.

4.4.1 Summary of the Users of Financial Statements Characteristics Effect

Table 4.41: Summary of the Users of financial statements characteristics effect

Question	Job	Education	Experience	Using financial reports
Q1	Investor	BSc	More than 10 years	Very frequently
Q2	Investor	Less than BSc	More than 10 years	Very frequently
Q3	Creditor	BSc	More than 10 years	Very frequently
Q4	-	-	-	-
Q5	Investor	BSc	Less than 5 years	Very frequently
Q6	Financial manager	PhD	More than 5 years & less than 10 years	Very frequently
Q7	Creditor	BSc	Less than 5 years	Very frequently
Q8	Financial Analysts	Less than BSc	More than 10 years	Very frequently
Q9	Creditor	Less than BSc	More than 10 years	Very frequently
Q10	Investor	PhD	More than 10 years	Frequently
Q11	Creditor	BSc	Less than 5 years	Occasionally
Q12	Financial Manager	PhD	More than 5 years & less than 10 years	Frequently
Q13	Others	MSc	Less than 5 years	Never
Q14	Financial Analysts	Professional	More than 10 years	Occasionally
Q15	Financial manager	PhD	More than 10 years	Frequently
Q16	Creditor	PhD	More than 5 years & less than 10 years	Very frequently
Q17	Others	Less than BSc	Less than 5 years	Rarely

As is shown from the summary, the effect of users' experience with more than 10 years and those who use financial reports very frequently are the common characteristics affecting the answers of the respondents, whilst for the Job and Education characteristics, there is no pattern regarding users' views.

4.5 Conclusion:

The field research performed on the users of the financial statements has taken into account four issues, the first of which is the demand for auditing services. The study reveals that the existence of a civil legal liability system will increase the demand for auditing services, meaning that the users trust the audited financial reports, in the case of the existence of civil legal liability system. In turn, it is recognised that this will also increase the frequency of using published financial statements by the users. This result highlights a relationship between the effectiveness of the auditing services within society and the civil legal liability system.

The second issue concerns the motivation for auditing quality. The researcher has studied the number of factors relating to auditing quality, such as auditing tenure, auditor experience, industry specialisation, and auditing firm size, in addition to the civil legal liability system. The study reveals that the civil legal liability system is considered by users as being the factor most commonly affecting audit quality, with exposure to litigation risk the driver for perceived audit quality.

The third issue in this research concerned studying the effect of increasing the civil legal liability of auditors in regard to auditing quality. The research has studied the different opposite rules applied by different legal systems in the world. The results indicate that users prefer to apply the strict liability rule rather than the negligence rule, and also have a preference for increasing the number of parties with the right to litigate the auditor, as opposed to limiting the litigation rights to the client only. Also, users prefer to increase the compensation amount sought from the auditor rather than depending on the deterrence rule, and also have a preference for applying joint and several liability rules for unpaid compensation amount by other insolvent defendants.

The last issue in this research was the effect of increasing auditor liability on the investment level within society. With this in mind, users prefer to increase civil legal liability on auditors in order to gain protection for their investments. In turn, this will promote users' investment within society.

The previous result of the study on users show that most users' characteristics effect on the answers is the categories of users with more experience and those users more commonly using financial reports, whilst the jobs of users and their education have no effect on their answers, thus indicating that those users who are wholly engaged and more dependent on audited financial reports are those who support the liability system for auditing.

Chapter Five: Survey for Auditors

5.1 Introduction

The previous chapter considered users' views in regard to the civil legal liability system in the auditing profession. Applying a strict liability system on the auditors is known to affect auditor performance. With this in mind, in an attempt to study this effect, a second questionnaire has been designed to capture the views of auditors regarding their performance under different liability rules. The questionnaire includes two parts: the first poses joint questions to capture any resemblance or difference between the users' and auditors' views; the second part questions auditors only. The questionnaire includes factors relating to individual data for the respondents concerning their title, education level and number of years' experience in order to study the effects of such factors.

Finally, in order to support the usefulness of the second questionnaire, a statistical comparison was carried out in Chapter Six with the objective to compare the results of the users' questionnaire and auditors' questionnaire.

5.2 Survey Instrument and Sample

The population of the auditing office, in Kuwait, comprises 50 offices (22 local and 28 international), as illustrated in Table 5.1:

Table 5.1: Population and sample of auditing firms

	Population of Auditing firm's		Selected Sample	
	No. of Firms	**No. of Auditors**	**No. of Firms**	**No. of Auditors**
Local auditing firms	28	288	6 (21%)	39 (13.5%)
International Auditing firms	22	1317	4 (18%)	145 (11%)
Total	**50**	**1605**	**10 (20%)**	**184 (11.5%)**

The questionnaire was distributed randomly to auditors to ensure that the responses would not be biased. Indeed, after analysing the responses, it became clear that there was no systematic response across the respondents' categories. Moreover, the results of the Kolmogorov-Smirov test show that the responses are subject to normal distribution,

thus delivering reliability in regard to the results of the questionnaire; therefore, the results can be generalised in regard to all of society. Table (5.2) shows the results of this test.

Table 5.2: Normality test (Kolmogrov-Smirnov) for auditors' response

Variable	N	Statistic	Sig	Variable	N	Statistic	Sig
Q1.1	96	3.024	0.000	Q7.1	96	2.655	0.000
Q1.2	96	2.515	0.000	Q7.2	96	3.306	0.000
Q1.3	96	2.676	0.000	Q7.3	96	2.891	0.000
Q1.4	96	2.437	0.000	Q7.4	96	3.131	0.000
Q1.5	96	2.428	0.000	Q7.5	96	2.480	0.000
Q1	96	2.184	0.000	Q7	96	1.486	0.024
Q2.1	96	2.799	0.000	Q8.1	96	3.077	0.000
Q2.2	96	3.334	0.000	Q8.2	96	2.772	0.000
Q2.3	96	2.649	0.000	Q8.3	96	3.065	0.000
Q2.4	96	2.690	0.000	Q8.4	96	3.955	0.000
Q2.5	96	2.736	0.000	Q8.5	96	4.478	0.000
Q2	96	1.463	0.028	Q8	96	1.765	0.004
Q3.1	96	2.698	0.000	Q9.1	96	3.252	0.000
Q3.2	96	2.615	0.000	Q9.2	96	2.806	0.000
Q3.3	96	2.858	0.000	Q9.3	96	2.750	0.000
Q3.4	96	2.434	0.000	Q9.4	96	2.388	0.000
Q3.5	96	2.555	0.000	Q9.5	96	2.601	0.000
Q3	96	1.298	0.069	Q9	96	1.015	0.254
Q4.1	96	2.222	0.000	Q10.1	96	3.308	0.000
Q4.2	96	4.214	0.000	Q10.2	96	4.025	0.000
Q4.3	96	2.324	0.000	Q10.3	96	3.840	0.000
Q4.4	96	2.459	0.000	Q10.4	96	4.560	0.000
Q4.5	96	2.522	0.000	Q10.5	96	3.497	0.000
Q4	96	1.510	0.021	Q10	96	1.866	0.002
Q5.1	96	2.897	0.000	Q11.1	96	3.263	0.000
Q5.2	96	2.791	0.000	Q11.2	96	2.722	0.000
Q5.3	96	3.114	0.000	Q11.3	96	3.144	0.000
Q5.4	96	3.728	0.000	Q11.4	96	2.416	0.000
Q5.5	96	2.248	0.000	Q11.5	96	2.241	0.000
Q5	96	1.697	0.006	Q11	96	1.787	0.003
Q6.1	96	3.849	0.000	Q12.1	96	3.628	0.000
Q6.2	96	3.273	0.000	Q12.2	96	3.347	0.000
Q6.3	96	2.340	0.000	Q12.3	96	3.899	0.000
Q6.4	96	2.304	0.000	Q12.4	96	2.938	0.000
Q6.5	96	2.963	0.000	Q12.5	96	3.295	0.000
Q6	96	1.124	0.159	Q12	96	1.466	0.027

The 184 questionnaires were distributed during the period February 2011–April 2011, with the returned questionnaires amounting to 98 (53%), as illustrated in Table 5.3.

Table 5.3: Number of distributed and received questionnaires for auditors					
Date	**Type of the audit firm**	**No. of Staff**	**Distributed**	**Received**	**Response Rate**
13/02/2011	Local	20	5	4	80%
15/02/2011	International	100	22	13	59%
17/02/2011	Local	10	6	5	83%
24/02/2011	Local	17	8	5	62%
28/02/2011	International	90	32	16	50%
12/03/2011	International	350	62	34	54%
24/03/2011	Local	16	7	3	42%
29/03/2011	Local	16	8	5	62%
31/03/2011	Local	11	5	2	40%
05/04/2011	International	130	29	11	38%
	Total	**760**	**184**	**98**	**53%**

After reviewing the received questionnaires (98), two questionnaires were found to be invalid for analysis. The number of valid questionnaires for analysing therefore amounted to 96. The individual characteristics data for this sample is detailed in Table 5.4.

Table 5.4: Auditors' characteristics data		
Characteristics of Respondents	**N = 96**	**%**
Respondents title:		
1. Auditor	54	56.2%
2. Senior Auditor	19	19.8%
3. Partner	7	7.3%
4. Others	16	16.7%
Total	**96**	
Respondents Education:		
1. PhD	4	4.2%
2. MSc	9	9.4%
3. BSc	69	71.8%
4. Less	14	14.6%
Total	**96**	
Respondents years of experience:		
1. More than 10 years	8	8.3%
2. More than 5 years & less than 10 years	26	27.1%
3. Less than 5 years	62	64.6%
Total	**96**	
Respondents carrying Professional Certificate		
1. Yes	32	33.3%
2. No	64	66.6%
Total	**96**	

As can be seen from the table, most respondents are auditors with experience of less than 5 years with education levels of BSc. This fact may provide some degree of indication concerning those respondents with less knowledge in terms of how to deal with liability rules, and how they prefer to work with more due care in order to steer away from the consequences of auditing liability.

5.3 Results of the Hypotheses Test

The test of the hypotheses for auditors' view includes two main hypotheses; these hypotheses were divided into secondary hypotheses for performing tests from several dimensions.

5.3.1 The Effect of Civil Legal Liability System on the Auditing Profession

The first hypothesis was designed to test the extent of the effects of the auditor civil legal liability system on auditing within society.

H1: The degree of the civil legal liability system within society has no effects on the auditing profession.

This hypothesis was tested by creating two secondary hypotheses: the first secondary hypothesis was used in order to illustrate the effects of civil legal liability on the investors demand for the auditing services in society; the second secondary hypothesis tested the effect of civil legal liability on the frequency of using the published and audited financial statements.

H1/1: The weaknesses of the civil legal liability system do not affect the demand on auditing services.

Testing this hypothesis included five statements in Question 1 and five statements in Question 2 concerning the demand for auditing services without a civil legal liability system, as illustrated in Table 5.5.

Table 5.5: Tests for hypothesis 1/1
The weaknesses of the civil legal liability system do not affect the demand on auditing services

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q1. The absence of a civil legal liability system will:								
1	decrease the number of clients seeking auditing services	69.833 (0.00)**	11 (11.5%)	1.99	1.081	-9.159 (0.00)**	1.78	2.20
2	decrease the auditing fees	61.083 (0.00)**	8 (8.3%)	1.94	1.014	-10.269 (0.00)**	1.74	2.14
3	decrease the auditor assessment of clients' risk	61.604 (0.00)**	8 (8.3%)	1.98	1.026	-9.751 (0.00)**	1.78	2.18
4	increase the probability of audit failure	67.854 (0.00)**	7 (7.3%)	1.88	0.932	-11.828 (0.00)**	1.70	2.06
5	decrease the number of certified public accountants	65.667 (0.00)**	6 (6.2%)	1.90	0.946	-11.440 (0.00)**	1.71	2.08
	Average score	**1.676** (0.00)**	**11 (11.5%)**	**1.935**	**0.949**	**-10.991** (0.00)**	**1.75**	**2.12**
Q2. As an auditor do you accept:								
6	liability rules will increase the cost of auditing	1.108 (0.00)**	87 (90.6%)	4.23	0.747	16.130 (0.00)**	4.08	4.38
7	that you works with a limited number of customers and without civil legal liability	99.167 (0.00)**	14 (14.6%)	1.98	0.598	-16.729 (0.00)**	1.86	2.10
8	increase your assessment of client's risk due to liability rules	70.000 (0.00)**	88 (91.6%)	4.29	0.679	18.631 (0.00)**	4.16	4.42
9	to be liable for any audit failure	22.562 (0.00)**	85 (88.5%)	4.27	0.657	18.963 (0.00)**	4.14	4.40
10	to be liable for any business failure	76.396 (0.00)**	6 (7%)	1.93	0.874	-12.034 (0.00)**	1.76	2.10
	Average Score	**83.896** (0.00)**	**74 (77%)**	**3.340**	**0.364**	**9.147** (0.00)**	**3.27**	**3.41**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q1 indicates that we cannot accept the null hypothesis as the respondents do not have a preference from the five given responses detailed in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and the *t*-test, we can determine their preferred answer.

From the above-mentioned responses for Q1, it appears that 11.5% of the respondents see that the lack of civil legal liability system affects the demand for auditing professions within society (response mean 1.935), since 11.5% consider that this lack will reduce the number of clients seeking auditing services. Moreover, 8.3% of them consider that this will reduce the auditing fees owing to reduced demand for auditing. Furthermore, 8.3% believe that this will make auditors decrease the assessment of clients' risk in order to increase the number of auditing processes carried out. In addition, 7.3% state that this will increase the probability of auditing failure, with 6.2% seeing that this will reduce the number of certified public accountants in society. Finally, these results for Q1 indicate that auditors do not believe that the lack of civil legal liability has an effect on the demand for auditing services.

For Q2, the Chi square test indicates that we cannot accept the null hypothesis as the respondents do not have a preference of the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

From the above-mentioned responses for Q2, it appears that 77% of the respondents consider the civil legal liability system as affecting the demand for auditing services (response mean 3.34) since 90.6% believe that a civil legal liability system causes the increase in audit cost. On the other hand, 14.6% prefer to work with a limited number of customers and thus not bear a civil legal liability, with a 91.6% stating that a civil legal liability system will cause them to increase their assessment of clients' risk. Markedly, 88.5% of auditors agree to be liable for any auditing failure, with 7% of auditors agreeing to be held liable for business failure. Importantly, the results for Q2 indicate that the auditors agree that the civil legal liability system has an effect on the demand for auditing services. Dopuch & King (1992) suggest that the presence of a legal liability system and a credible audit process encourages firms (i.e. clients) to demand auditing services voluntarily.

From the researcher's point of view, the contradictions between Q1 and Q2 indicate that auditors do not think that the demand for auditing services (and the number of clients) will be affected by the absence of civil legal liability system. Essentially, there is a significant role for the auditor in the development of a certain business, who is

responsible for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor, 1995). Still, this impacts the auditing profession, which is a result in support of other studies, such as those of Shibano (2000) and Yu (2001), which indicate that imposing high levels of legal responsibility on the auditor makes the auditor more conservative in his report, subsequently leading to a higher possibility of refusing auditors for clients' financial reports.

The second secondary hypothesis was designed to test the effect of the civil legal liability on the frequency of using financial statements.

H1/2: The weakness of the civil legal liability system has no effect on the frequency of using published financial statements.

Testing this hypothesis included five statements in Question 3 and five statements in Question 4 concerning whether or not the existence of the auditor's civil legal liability system will increase the use of financial statements and thus increase the overall dependence on them, as illustrated in Table 5.6.

Table 5.6: Tests for hypothesis 1/2
The weakness of the civil legal liability system has no effect on the frequency of using published financial statements.

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q3. Do you think the existence of a civil legal liability system will:								
11	increase the investors' dependence on audited financial reports	64.417 (0.00)**	87 (90.6%)	4.34	0.792	16.615 (0.00)**	4.18	4.50
12	increase the publishing of interim financial reports	95.667 (0.00)**	83 (86.5%)	4.19	0.758	15.344 (0.00)**	4.04	4.34
13	increase the need for high-quality accounting standards	43.500 (0.00)**	76 (79%)	4.00	0.846	11.581 (0.00)**	3.83	4.17
14	enhance the publishing of financial reports on a timely basis	46.833 (0.00)**	80 (83.3%)	4.17	0.777	14.714 (0.00)**	4.02	4.32
15	enhance management in terms of voluntary disclosure	60.146 (0.00)**	70 (72.9%)	3.93	0.920	9.868 (0.00)**	3.75	4.11
	Average score	**70.562** (0.00)**	**91 (94.8%)**	**4.125**	**0.500**	**22.031** (0.00)**	**4.03**	**4.22**
Q4. As an auditor do you accept:								
16	that there is a difference in the effort excreted in auditing financial statements in case of existence of civil legal liability system	26.833 (0.00)**	7 (7.3%)	2.31	0.850	-7.926 (0.00)**	2.14	2.48
17	increase auditor effort beyond the auditing standards	1.343 (0.00)**	4 (4.2%)	2.81	0.529	-3.470 (0.00)**	2.71	2.91
18	increase supervision and co-ordination of audit team	38.083 (0.00)**	77 (80.2%)	4.14	0.829	13.424 (0.00)**	3.98	4.30
19	to audit interim financial reports	45.750 (0.00)**	80 (83.3%)	4.22	0.771	15.497 (0.00)**	4.07	4.37
20	Issue your report on a timely basis	72.021 (0.00)**	76 (79.2%)	4.07	0.849	12.381 (0.00)**	3.90	4.24
	Average score	**85.500** (0.00)**	**80 (83.3%)**	**3.510**	**0.413**	**12.10** (0.00)**	**3.43**	**3.59**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q3 indicates that we cannot accept the null hypothesis as a result of the respondents not having any preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the

respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

From the above-mentioned responses for Q3, it appears from the answers that 94.8% of those respondents consider that the existence of a civil legal liability system will increase the usage of financial statements and thus increase the dependence on them (response mean 4.125) since 90.6% believe that this will lead to an increase in the dependence on audited financial reports. Moreover, 86.5% consider that this will increase the publishing of interim financial reports. Furthermore, 79% state that this will lead to an increase in the need for high-quality accounting standards, with 83.3% maintaining that this will enhance the publication of financial reports on a timely basis. As a final result, 72.9% consider that this will enhance management in terms of voluntary disclosure in the financial statements.

For Q4, the Chi square test indicates that we cannot accept the null hypothesis considering that the respondents do not have any preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents do not have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

From the above-mentioned responses for Q4, 83.3% agree that the existence of a civil legal liability system will affect the frequency of using financial statements (response mean 3.51) since 92.7% (7.3% agree) refused to accept that existence of civil legal liability system as having an effect on their auditing efforts. In addition, 95.8% (4.2% agree) refused to increase their efforts beyond the auditing standards owing to the existence of civil legal liability.

Notably, 80.2% agree to increase their supervision, with 83.3% agreeing to audit interim financial reports. Finally, 79.2% agree to issue their reports on a timely basis owing to the existence of a civil legal liability system.

The results of the first main hypothesis is not conclusive for Q1 as the auditors do not support the belief that the civil legal liability system will affect the demand for the auditing services, whilst for Q2, the results support that the existence of a liability system will increase the use of financial reports. The studies of Narayanan (1994) and

Patterson & Wright (2003) suggest that heightening the legal responsibility of external auditors would not be able to strengthen the auditing profession, which is owing to the fact that certain legal rules may reduce or even demise the auditing process as a whole.

5.3.2 The Effect of Increasing the Civil Legal Liability of Auditors on Auditing Quality

The second main hypothesis was designed to test the effect of auditor' civil legal liability system on auditing quality.

H2: Increasing the civil legal liability of auditors will not increase audit quality.

This hypothesis was tested through putting forward four secondary hypotheses. The first hypothesis was used to test whether or not increasing parties litigating the auditor owing to auditing failure will increase quality.

The second secondary hypothesis tested the effect of the auditor's civil legal liability nature on auditing quality, considering whether or not the auditor should have full rather than limited responsibility for any faults in financial statements when performing the auditing so as to increase auditing quality.

The third secondary hypothesis tested whether or not an increase in compensation amount imposed upon the auditor would increase auditing quality.

The fourth secondary hypothesis sought to establish whether or not the auditor should bear any obligations towards defendants in the case of their insolvency and thus pay compensations, and whether this would increase auditing quality.

H2/1: Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase audit quality.

Testing this hypothesis included five statements in Question 5 and five statements in Question 6 concerning whether or not increasing the number of parties able to litigate the auditor for any damage incurred as a result of auditing failure would increase auditing quality, as illustrated in Table 5.7.

Table 5.7: Tests for hypothesis 2/1
Increasing the numbers of parties litigating auditor for any damages he may cause due to auditing failure, will not increase audit quality

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q5.	**Allowing more than one party to sue the auditor for judgment errors will:**							
21	increase legal consultants by auditor	77.417 (0.00)**	91 (94.8%)	4.42	0.675	20.552 (0.00)**	4.29	4.55
22	reduce acceptance of risky business clients	69.083 (0.00)**	85 (88.5%)	4.19	0.685	16.976 (0.00)**	4.06	4.32
23	make auditors more documentation of audit process	59.583 (0.00)**	78 (81.2%)	3.99	0.788	12.304 (0.00)**	3.84	4.14
24	increase advanced education of financial information users	1.044 (0.00)**	15 (15.6%)	3.06	0.678	0.904 (0.368)	2.93	3.19
25	improve definition of legal rules	32.083 (0.00)**	71 (74%)	4.02	0.821	12.19 (0.00)**	3.86	4.18
	Average score	**106.583** (0.00)**	**91 (94.8%)**	**3.935**	**0.437**	**20.94** (0.00)**	**3.85**	**4.02**
Q6.	**As an auditor do you think:**							
26	audit quality will increase when you liable towards other parties rather than the parties participate in the audit contract	94.417 (0.00)**	1 (1%)	2.59	0.642	-6.20 (0.00)**	2.46	2.72
27	only the client have the right to litigate the auditor for audit failure	82.583 (0.00)**	85 (88.5%)	4.09	0.727	14.749 (0.00)**	3.95	4.23
28	you should make your best efforts to serve the expected users, as the financial reports is a public goods	39.000 (0.00)**	74 (77%)	4.06	0.779	13.367 (0.00)**	3.91	4.21
29	there is a need to define the primary users of financial statements	38.083 (0.00)**	76 (79.2%)	4.11	0.806	13.547 (0.00)**	3.95	4.27
30	you only liable towards the auditing standards setters	1.007 (0.00)**	3 (3.1%)	1.90	0.801	-13.506 (0.00)**	1.74	2.06
	Average score	**43.375** (0.00)**	**73 (76%)**	**3.352**	**0.407**	**8.475** (0.00)**	**3.27**	**3.43**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q5 indicates that we cannot accept null hypothesis owing to the fact that the respondents do not have any preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

From the responses to Q5, it appears that 94.8% of auditors support increasing the number of parties litigating the auditor in the case of auditing failure as the response mean was 3.935; with 94.8% therefore considering that this would increase legal consultants by the auditor with regard to his work. Moreover, 88.5% see that this would cause the auditor to limit his acceptance of clients with high-risk activities. Markedly, 81.2% consider that this would cause auditors to provide more documentation of the auditing process, with 15.6% believing that this would increase the advanced education of financial information users. Finally, 74% state that this would improve the definition of legal rules.

For Q6, the Chi square test indicates that we cannot accept the null hypothesis owing to the respondents not having any preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The response for Q6 shows that 76% of auditors agree that an increase in the number of parties having the right to litigate auditors will increase auditing quality (response mean 3.352). Notably, 99% disagreed (1% agree) the view that auditing quality depends on the number of parties having the right to litigate the auditors. Moreover, 88.5% agree that only the client (one party) should have the right to litigate the auditor, whilst 77% agree with the view that the auditor should serve the expected users of financial reports. Furthermore, 79.2% hold the view that there is the need to define the primary users of financial statements, with 96.9% of auditors refusing (3.1% agree) to be liable only to auditing standard-setters.

Finally, the answers for Q5 and Q6 are not conclusive in regard to the auditors' views concerning the effect of number of parties having the right to litigate the auditors, whilst the auditors' answers for Q6 agree that increasing the number of parties having the rights to litigate the auditors for auditing failure will increase auditing quality. With this in mind, there is the indication that auditors prefer to be liable only to one party (the client), which is in agreement with the work of Chan & Wong (2002), who tested the effects of the expansion of third-party scope, drawing the conclusion that, as the scope of auditor liability towards non-clients is limited, there is a clear improvement in efficiency. Moreover, in regard to the direction adopted in the USA during the 1980s,

calling for restricting the zone of auditors' legal responsibility as a result of negative effects exposed by the auditing profession and business environment due to an increased number of parties having the right to litigate auditors, it is supported that exposure to litigation risk increases.

The researcher's view concerning this issue is that expanding the number of parties with the right to litigate the auditor will increase the burden on auditors towards the procedures to avoid litigation over the consideration to increase auditing efficiency.

H2/2: Applying a strict liability rule improves audit quality, whilst applying negligence rule has a lesser effect on audit quality.

Testing this hypothesis included five statements in Question 7 and five statements in Question 8 concerning whether or not the auditor should bear civil legal liability for any fault in financial statements, shows that more protection will be delivered to investors, thus encouraging investment, as illustrated in Table 5.8.

Table 5.8: Tests for hypothesis 2/1
Applying a strict liability rule improves audit quality, whilst applying negligence rule has a lesser effect on audit quality.

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q7.Requiring auditors to have full rather limited responsibility is likely to:								
31	increase auditor's effort beyond the auditing standards	88.479 (0.00)**	81 (84.4%)	4.15	0.794	14.132 (0.00)**	3.99	4.31
32	increase the conservatives in auditor's opinions	88.917 (0.00)**	85 (88.5%)	4.08	0.691	15.366 (0.00)**	3.94	4.22
33	decrease the rate of accepted clients' risk	73.375 (0.00)**	75 (78%)	3.97	0.900	10.549 (0.00)**	3.79	4.15
34	increase the quality assessment of audit evidences	20.438 (0.00)**	83 (86.5%)	4.38	0.715	18.855 (0.00)**	4.24	4.52
35	increase the effectiveness of the audit committee	40.167 (0.00)**	78 (81.2%)	4.12	0.837	13.175 (0.00)**	3.96	4.28
	Average score	**70.542** (0.00)**	**89 (92.7%)**	**4.140**	**0.560**	**19.919** (0.00)**	**4.03**	**4.25**
Q8. As an auditor do you think that full responsibility rule rather than negligence rule will:								
36	affect your performance and opinion	89.625 (0.00)**	7 (7.3%)	1.91	0.930	-11.524 (0.00)**	1.73	209
37	increase the number of evidence collected by you	1.298 (0.00)**	92 (95.8%)	4.33	0.675	19.343 (0.00)**	4.20	4.46
38	increase the time of auditing	99.938 (0.00)**	81 (84.4%)	4.06	0.805	12.926 (0.00)**	3.90	4.22
39	increase auditor due care	1.462 (0.00)**	10 (10.4%)	3.01	0.533	0.191 (0.849)	2.91	3.11
40	have no effect on audit programme and risk estimates	1.954 (0.00)**	3 (3.1%)	2.94	0.406	-1.510 (0.134)	2.86	302
	Average score	**56.667** (0.00)**	**67 (69.8%)**	**3.25**	**0.301**	**8.122** (0.00)**	**3.19**	**3.31**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q7 indicates that we cannot accept the null hypothesis as the respondents do not have a preference from the five given responses in the questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can subsequently determine their preferred answer.

From the above-mentioned responses, it is clear that 92.7% of the respondents support the fact that the auditor bearing civil legal liability for any fault in financial statements will increase auditing quality (responses mean 4.14). Notably, 84.4% support that this civil legal liability will increase auditors' efforts beyond normal auditing standards, whereas 88.5% consider that the auditor bearing the civil legal liability for any fault in financial statements will increase conservatives, in auditors' opinions. Furthermore, 78% believe that the auditor will be forced to reduce the rate of accepted client risk. Moreover, 86.5% state that this will increase the quality assessment of auditing evidences, with 81.2% further noting that it would increase the overall effectiveness of auditing committees.

For Q8, the Chi square test indicates that the null hypothesis cannot be accepted owing to the fact that the respondents do not have any preference from the five given responses in the questionnaire. However, the alternative hypothesis can be accepted, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The auditors' views regarding applying the full responsibility rule show that 69.8% agree that it would increase auditing quality. Notably, the answers demonstrate that 92.7% disagreed (7.3% agree) that applying full responsibility will affect their performance and opinions, whilst 95.8% agree that it will increase the volume of auditing evidence, and 84.4% agreeing that it will increase the time of auditing.

Furthermore, 89.6% of the respondents refused (10.4% agree) that applying the full responsibility rule would affect their due care, with 96.9% also refusing that it would affect the auditing programme and risk estimates.

Although the answers to Q7 support the notion that applying full responsibility rules will affect auditing quality, the answers to Q8 do not show full support from the auditors in terms of applying the full responsibility rules. This result agrees with many empirical researches, such as the studies of Narayanan (1994) and Patterson & Wright (2003), which emphasise that imposing an increase in auditors' civil responsibility does not, in itself, guarantee a corresponding increase in effort level (auditing quality), as some particular legal rules increase the auditing quality or reduce the possibility of auditing failure, despite imposing little responsibility on the auditor, compared with

other alternative rules that are more strict on auditors. In addition, the study of Pacini, Martin & Hamilton (2000) shows that the full responsibility rules will lead to a diminished flow of information.

The study of Dopuch & King did not find any evidence to suggest that imposing a strict liability system on auditing services will achieve higher net benefits than a negligent liability system. On the contrary, results seem to indicate that markets operating a negligent liability system reflect higher levels of economic efficiency than those adopting other systems (e.g. strict liability). Notably, the use of auditors in strict liability markets was lower than predicted as auditors demanded higher fees for their services, resulting in lower investment by companies.

H2/3: Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase auditing quality.

Testing this hypothesis included five statements in Question 9 and five statements in Question 10 concerning whether or not increasing the compensation amount to be paid by the auditor as a result of auditing failure would increase auditing quality, as shown in the following table (5.9).

Table 5.9: Tests for hypothesis 2/3
Increasing the compensation amount (which is determined by the court for the plaintiff against the auditor who is charged due to his negligence) will not increase auditing quality.

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q9.	**Increasing compensation amount sought from the auditor due to audit judgment errors will:**							
41	increase audit fees	33.250 (0.00)**	90 (93.7%)	4.46	0.614	23.265 (0.00)**	4.34	4.58
42	improve auditing programmes	55.771 (0.00)**	22 (22.9%)	2.75	1.086	-2.256 (0.026)***	2.54	2.96
43	increase tests of internal control accuracy	50.833 (0.00)**	76 (79.2%)	4.02	0.754	13.272 (0.00)**	3.87	4.17
44	increase the size of audit sample	49.917 (0.00)**	81 (84.4%)	4.22	0.728	16.393 (0.00)**	4.08	4.36
45	decrease acceptable audit risk	63.583 (0.00)**	86 (89.6%)	4.28	0.676	18.572 (0.00)**	4.15	4.41
	Average score	**52.042** (0.00)**	**94 (97.9%)**	**3.946**	**0.418**	**22.171** (0.00)**	**3.86**	**4.03**
Q10.	**As an auditor do you think a full compensation of investment loss rather than an independent measure of loss will:**							
46	affect the supply of auditing profession	85.583 (0.00)**	81 (84.4%)	4.01	0.673	14.717 (0.00)**	3.88	4.14
47	prompt the rising of auditors competence	2.044 (0.00)**	6 (6.2%)	2.89	0.679	-1.655 (0.101)	2.76	3.02
48	improve auditing programmes	1.926 (0.00)**	8 (8.3%)	2.93	.0603	-1.186 (0.239)	2.92	2.94
49	increase understanding of the client's business	2.908 (0.00)**	6 (6.2%)	3.03	0.446	0.686 (0.494)	2.94	3.12
50	decrease the acceptance of risky business clients	1.473 (0.00)**	84 (87.5%)	4.03	0.688	14.696 (0.00)**	3.90	4.16
	Average score	**76.50** (0.00)**	**82 (85.4%)**	**3.377**	**0.267**	**13.820** (0.00)**	**3.32**	**3.43**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q9 indicates that we cannot accept the null hypothesis as the respondents do not have any preference from the five given responses in the questionnaire. However, the alternative hypothesis can be accepted as this shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The results of the answers of Q9 indicate that 97.9% of the respondents support increasing the compensation amount to be paid by the auditor following auditing failure as the response mean was 3.946. With this in mind, 93.7% of the respondents consider that, owing to the increase in compensation amount that the auditor has to pay in the case of auditing failure, the auditor will increase auditing fees. However, 22.9% see that the auditor will improve auditing so as to reduce the probability of auditing failure. Furthermore, 79.2% consider that the auditor will increase the tests of internal control accuracy so as to reduce auditing failure probabilities. Furthermore, 84.4% believe that the auditor will increase the size of the auditing sample so as to achieve the same goal. Finally, 89.6% suggest that the auditor will decrease the acceptable audit risks so that auditing failure will be avoided, reducing the possibility of litigating the auditor, consequently inducing greater compensation for injured persons resulting from auditing failure.

The Chi square test for Q10 suggests that we cannot accept the null hypothesis as the respondents do not have any preference from the five given responses in questionnaire. However, we can accept the alternative hypothesis, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The results of the answers to Q10 emphasise that 85.4% of the respondents agree that full compensation for investment loss owing to auditing failure will increase audit quality (mean response 3.377), with 84.4% of the auditors agreeing that applying full compensation will affect their supply of audit services, whilst 93.8% disagreed (6.25% agree) that it would prompt rising their competence. Moreover, 91.7% disagreed (8.3% agree) that it would improve the auditing programme, with 93.8% refusing (6.2% agreed) that it would increase overall understanding of clients' businesses. Finally, 87.5% of the auditors state that applying full compensation would decrease their acceptance of risky clients.

The answers to Q9 support the belief that increasing the compensation amount would affect auditing quality, which agrees with the studies of Palmrose (1988), Melumad & Thoman (1990) and Elitzur & Falk (1996). Moreover, the study of Laux & Newman (2010) states that auditing quality increases with the auditor's expected litigation losses resulting from auditing failures. The answers to Q10 do not show full support from auditors in terms of applying the full compensation rule, as this will affect their acceptance of risky clients.

The full compensation rule may be easier in terms of application, ensuring less conflict between the auditor and plaintiff; however, this rule may also create unjustified investment decisions by users creating unaffordable litigation, thus potentially affecting auditing services.

H2/4: Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants will not increase audit quality.

Testing this hypothesis included five statements in Question 11 and five statements in Question 12 concerning whether or not making the auditor responsible for any loss, regardless of who shared in the wrongdoing, would increase auditing quality, as illustrated in Table 5.10.

Table 5.10: Tests for hypothesis 2/4
Increasing the auditor's liability for paying the unpaid compensation by other insolvent defendants, will not increase audit quality.

	Statement	Chi Sq. Test	Respondents Agreeing* Number (%)	Answers Mean	Answers SD	t- test †	95% Confidence Interval	
							Lower limit	Upper limit
Q11.	**Applying joint & several liability rule when suing auditors will:**							
51	increase control over acts of management	1.182 (0.00)**	84 (87.5%)	4.08	0.790	13.431 (0.00)**	3.93	4.23
52	achieve effective co-ordination between different parties	54.833 (0.00)**	80 (83.3%)	4.10	0.747	14.490 (0.00)**	3.95	4.25
53	increase understanding of the client's business	89.312 (0.00)**	77 (80.2%)	3.96	0.882	10.651 (0.00)**	3.79	4.13
54	increase size of disclosure about errors and illegal acts	55.250 (0.00)**	83 (86.5%)	4.22	0.728	16.393 (0.00)**	4.08	4.36
55	promote multiplicity of auditors in client's firms	54.208 (0.00)**	70 (72.9%)	4.04	0.951	10.737 (0.00)**	3.85	4.23
	Average score	**92.125** (0.00)**	**89 (92.7%)**	**4.081**	**0.530**	**19.988** (0.00)**	**3.98**	**4.18**
Q12.	**Do you think the auditor should pay compensation:**							
56	in case of business failure	1.605 (0.00)**	4 (4.2%)	1.94	0.693	-15.022 (0.00)**	1.80	2.08
57	in case of audit failure	92.917 (0.00)**	87 (90.6%)	4.16	0.604	18.757 (0.00)**	4.04	4.28
58	according to his proportion in the wrongdoing	2.034 (0.00)**	11 (11.5%)	3.02	0.665	0.307 (0.759)	2.89	3.15
59	in full, in case of other parties bankruptcy	77.229 (0.00)**	9 (9.4%)	1.92	0.991	-10.709 (0.00)**	1.73	2.11
60	in limited amount of the damage	97.75 (0.00)**	82 (85.4%)	4.04	0.928	10.997 (0.00)**	3.86	4.22
	Average score	**84.625** (0.00)**	**36 (37.5%)**	**3.015**	**0.345**	**0.414** (0.680)	**2.95**	**3.08**

* The total number of agree & strongly agree observations.
** Significant level at 1%
† *t*-test for the difference of answers from 3 on the Likert scale (no opinion)

The Chi square test for Q11 indicate that we cannot accept null hypothesis as the respondents do not have any preference from the five given responses in the questionnaire. However, the alternative hypothesis can be accepted, which shows that the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The results indicate that 92.7% of the respondents support the auditor paying compensations, regardless of the extent to which other parties shared in the wrongdoing in financial statements (joint and several liability). As 87.5% see that this will increase control over various acts of management. Markedly, 83.3% consider that this will help in achieving effective co-ordination between different parties concerned with preparing and reviewing financial reports. Furthermore, 80.2% state that the auditor will increase understanding of the client's business, with 86.5% believing that this will increase the degree of disclosure concerning errors and illegal actions. Finally, 72.9% consider that it will promote multiplicity of auditors in clients' firms.

The Chi square test for Q12 indicates that we cannot accept the null hypothesis as the respondents do not have any preference from the five given responses in questionnaire. However, we can accept the alternative hypothesis as the respondents have a preferred answer. Depending on the means for the participants' responses and *t*-test, we can determine their preferred answer.

The results of the answers for Q12 indicate that most of the auditors refused (62.5%) that applying joint and several liability rule will increase audit quality (37.5% agree). It was found that 95.8% disagreed (4.2% agree) with the statement that the auditor should bear the compensation for business failure, 90.6% agreed that compensation should be paid in the case of audit failure. Moreover, 88.5% disagreed (11.5% agree) with paying compensation in proportion to the wrongdoing, whilst 90.6% disagreed (9.4% agree) to pay compensation in the case of other parties' bankruptcy. Finally, 85.4% agreed with paying compensation to a limited amount of the damage.

The answers of Q11 support applying the joint and several liability rule when suing auditors, which is believed to prompt auditing quality. This result agrees with the study of Khurana & Raman (2004), who state that the exposure to litigation risk is the driver for perceived audit quality. Moreover, this finding is also in accordance with the papers of Simunic & Stein (1996) and Venkataraman, Weber & Willenborg (2008). Importantly, the answers of Q12 do not show full support from the auditors in regard to applying the full compensation rule.

As a result of the H2 test, we can accept that increasing the civil legal liability of auditors will increase auditing quality, although auditors do not support increasing their liability.

In addition, increasing the civil legal liability affects auditing quality to a certain degree, and may cause unjustified investment process. Therefore, there is the need to balance the auditor liability to an optimum level, thus ensuring that users trust the auditing process.

5.4 Test of Auditors' characteristics Effect

The questionnaire distributed to the auditors include information relating to auditors' characteristics, such as their titles, education, professional qualification, and experience in order to study whether these characteristics have an effect on auditors' responses.

In order to test the effect of respondents' characteristics on auditors' views concerning the civil legal liability system, a multi linear regression analysis has been performed through quantifying the characteristics of respondents in order to perform the regression to test the effect of such characteristics on the answers of each question. This was done after converting individual data into a quantitative measure for use in the regression analysis, using dummy variables to express the respondent's characteristics. The dummy variables for each respondent's characteristic are illustrated by the number of variables equal to the number of classes of each character taking the value of "0" or "1" creating 13 variables as follow:

Table (5.11): Dummy variables used in tests for Auditors' Characteristics effect				
Title:	**Title1**	**Title2**	**Title3**	**Title4**
Auditor	1	0	0	0
Senior Auditor	0	1	0	0
Partner	0	0	1	0
Others	0	0	0	1
Education:	**Edu1**	**Edu2**	**Edu3**	**Edu4**
Ph.D.	1	0	0	0
MSc	0	1	0	0
BSc	0	0	1	0
Less than BSc	0	0	0	1
Professional Qualification:	**Prof.C1**	**Prof.C2**		
Professional certificate	1	0		
Non-Professional certificate	0	1		
Experience:	**Exper1**	**Exper2**	**Exper3**	
More than 10 years	1	0	0	
Less than 10 yrs & more than 5 yrs	0	1	0	
Less than 5 years	0	0	1	

The average answers for the twelfth main questions are regressed against each one of the four characteristics in a separate model, in order to capture the effect of each character on their responses, creating 48 models.

By regressing all the 13 dummy variables representing the four characteristics in one model will cancel the effect of some characteristics in the output results. Accordingly, the researcher avoided it through processing the 48 models, 4 models for each one of the twelfth main questions. The regression model applied as follow:

$$\mathbf{Q_i = f\ \{\ Characteristic\ _i\ \}}$$

Where:

Qi = Q1, Q2, …., Q12

Characteristic: Title: Title1, Title2, Title3, Title4

Education: Edu1, Edu2, Edu3, Edu4

Professional Certificate: Prof.C1, Prof.C2

Experience: Exper1, Exper2, Exper3

The test's results relating to the four characteristics using linear regression, demonstrate $\boldsymbol{\beta}$ coefficient for each class of characteristic, this coefficient represents the average opinion for each class regarding the dependent variable, measured on Likert scale used in the questionnaire (from score of 5 representing to strongly agree to score of 1 representing to strongly disagree). An adjusted one-side t-test applied to measure the

significance answers that agree with the dependent variable (with a score more than 3 "neutral"). The results of the tests are discussed below.

Test for Q1:

Table 5.12: The effects of auditors' characteristics for Q1 (lack of the legal liability system affects the demand for auditing professions in the society)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q1 = β1 title1 + β2 title2 + β3 title3 + β4 title4					
Title	Auditor (title1)	2.1	0.128	16.406	-7.031	No
	Senior Auditor (title2)	1.68	0.217	7.76	-6.083	No
	Partner (title3)	1.68	0.357	4.71	-3.697	No
	Others (title4)	1.82	0.244	7.48	-4.836	No
Reg. Statistic	**R^2 = 0.81**	**F-test =101**	**N=96**			
	Model: Q1 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4					
Education	Ph.D. (Edu1)	2.05	0.475	4.3158	-2.000	No
	MSc (Edu2)	1.57	0.316	4.9684	-4.525	No
	BSc (Edu3)	2.02	0.114	17.719	-8.596	No
	Less than BSc (Edu4)	1.714	0.254	6.748	-5.063	No
Reg. Statistic	**R^2 = 0.81**	**F-test = 100**	**N=96**			
	Model: Q1 = β1 prof.c1 + β2 prof.c2					
Professional Qualification	Professional certificate	1.71	0.166	10.301	-7.771	No
	Non-Professional certificate	2.04	0.117	17.436	-8.205	No
Reg. Statistic	**R^2 = 0.81**	**F-test = 204**	**N=96**			
	Model: Q1 = β1 exper1 + β2 exper2 + β3 exper3					
Experience	More than 10 years	1.7	0.336	5.0595	-3.869	No
	Less than 10 yrs & more than 5 yrs	1.8	0.186	9.6774	-6.452	No
	Less than 5 years	2.022	0.12	16.85	-8.150	No
Reg. Statistic	**R^2 = 0.81**	**F-test = 132**	**N=96**			

As the results show, there is no effect concerning the four characteristics (Title, Education, Professional certificate, Years' expertise) on the auditor views for Q1. Importantly, only 11% of the auditors agree that the absence of a civil legal liability system will affect the demand on auditing services.

Test for Q2:

Table 5.13: The effects of auditors' characteristics for Q2 (legal liability system affects the demand for auditing services)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q2 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	3.32	0.064	51.875	5.000	Yes
	Senior Auditor (title2)	3.49	0.109	32.018	4.495	Yes
	Partner (title3)	3.2	0.179	17.877	1.117	No
	Others (title4)	3.29	0.122	26.967	2.377	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1174**	**N=96**			
		Model: Q2 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3	0.179	16.76	0.000	No
	MSc (Edu2)	3.51	0.119	29.496	4.286	Yes
	BSc (Edu3)	3.34	0.043	77.674	7.907	Yes
	Less than BSc (Edu4)	3.31	0.095	34.842	3.263	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2082**	**N=96**			
		Model: Q2 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	3.31	0.064	51.719	4.844	Yes
	Non-Professional certificate	3.35	0.045	74.444	7.778	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 4014**	**N=96**			
		Model: Q2 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.22	0.127	25.354	1.732	Yes
	Less than 10 yrs & more than 5 yrs	3.43	0.07	49	6.143	Yes
	Less than 5 years	3.31	0.045	73.556	6.889	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2729**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q2 (R^2 = 98-99%). The senior auditors, MSc educated, those with non-professional certificates, and those with between 5 and 10 years' experience are the more accepting for Q2.

Test for Q3:

Table 5.14: The effects of Auditors' characteristics for Q3 (Existence of legal liability system will increase the usage of financial statements)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q3 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	4.14	0.089	46.517	12.809	Yes
	Senior Auditor (title2)	4.2	0.15	28	8.000	Yes
	Partner (title3)	4.08	0.247	16.518	4.372	Yes
	Others (title4)	4	0.168	23.81	5.952	Yes
Reg. Statistic	**R^2 = 0.97**	**F-test = 944**	**N=96**			
		Model: Q3 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	4.1	0.252	16.27	4.365	Yes
	MSc (Edu2)	4.15	0.168	24.702	6.845	Yes
	BSc (Edu3)	4.15	0.06	69.167	19.167	Yes
	Less than BSc (Edu4)	3.98	0.134	29.701	7.313	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1602**	**N=96**			
		Model: Q3 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	4.1	0.088	46.591	12.500	Yes
	Non-Professional certificate	4.13	0.062	66.613	18.226	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 3230**	**N=96**			
		Model: Q3 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	4.05	0.177	22.881	5.932	Yes
	Less than 10 yrs & more than 5 yrs	4.2	0.098	42.857	12.245	Yes
	Less than 5 years	4.1	0.063	65.079	17.460	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2149**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q3 (R^2 = 97-98%). The senior auditors, the MSc educated, those with non-professional certificates, and those with between 5 and 10 years' experience are the more accepting for Q3.

Test for Q4:

Table 5.15: The effects of Auditors' characteristics for Q4 (the existence of legal liability system will affect the frequency of using financial statements)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q4 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	3.57	0.073	48.904	7.808	Yes
	Senior Auditor (title2)	3.45	0.124	27.823	3.629	Yes
	Partner (title3)	3.34	0.205	16.293	1.659	Yes
	Others (title4)	3.42	0.14	24.429	3.000	Yes
Reg. Statistic	**R^2 =0. 97**	**F-test = 992**	**N=96**			
		Model: Q4 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3.1	0.204	15.196	0.490	No
	MSc (Edu2)	3.57	0.136	26.25	4.191	Yes
	BSc (Edu3)	3.54	0.049	72.245	11.020	Yes
	Less than BSc (Edu4)	3.42	0.109	31.376	3.853	Yes
Reg. Statistic	**R^2 =0. 98**	**F-test = 1773**	**N=96**			
		Model: Q4 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	3.58	0.072	49.722	8.056	Yes
	Non-Professional certificate	3.47	0.051	68.039	9.216	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 3488**	**N=96**			
		Model: Q4 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.4	0.146	23.288	2.740	Yes
	Less than 10 yrs & more than 5 yrs	3.47	0.081	42.84	5.802	Yes
	Less than 5 years	3.53	0.052	67.885	10.192	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2284**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q4 (R^2 = 97-98%). The auditors, the MSc educated, those with professional certificates, and those with an average of less than 5 years' experience are more accepting for Q4.

Test for Q5:

Table 5.16: The effects of Auditors' characteristics for Q5 (Increase number of parties litigating auditor in the case of auditing failure)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q5 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	3.92	0.075	52.267	12.267	Yes
	Senior Auditor (title2)	3.88	0.127	30.551	6.929	Yes
	Partner (title3)	3.8	0.21	18.095	3.810	Yes
	Others (title4)	4.14	0.144	28.75	7.917	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1186**	**N=96**			
		Model: Q5 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3.75	0.218	17.202	3.440	Yes
	MSc (Edu2)	3.8	0.145	26.207	5.517	Yes
	BSc (Edu3)	3.93	0.052	75.577	17.885	Yes
	Less than BSc (Edu4)	4.1	0.116	35.345	9.483	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1953**	**N=96**			
		Model: Q5 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	3.85	0.077	50	11.039	Yes
	Non-Professional certificate	3.97	0.054	73.519	17.963	Yes
Reg. Statistic	**R^2 =0. 98**	**F-test = 3904**	**N=96**			
		Model: Q5 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.85	0.156	24.679	5.449	Yes
	Less than 10 yrs & more than 5 yrs	3.96	0.086	46.047	11.163	Yes
	Less than 5 years	3.93	0.056	70.179	16.607	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2545**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q5 (R^2 = 98). The others, the lesser educated, those with non-professional certificates, and those with between 5 and 10 years' experience are the more accepting for Q5.

Test for Q6:

Table 5.17: The effects of Auditors' characteristics for Q6 (increase number of parties have the right to litigate auditors will increase the auditing quality)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q6 = β1 title1 + β2 title2 + β3 title3 + β4 title4					
Title	Auditor (title1)	3.4	0.075	45.333	5.333	Yes
	Senior Auditor (title2)	3.21	0.126	25.476	1.667	Yes
	Partner (title3)	3.28	0.208	15.769	1.346	No
	Others (title4)	3.37	0.142	23.732	2.606	Yes
Reg. Statistic	**R^2 = 0.97**	**F-test =872**	**N=96**			
	Model: Q6 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4					
Education	Ph.D. (Edu1)	3.15	0.202	15.594	0.743	No
	MSc (Edu2)	3.13	0.134	23.358	0.970	No
	BSc (Edu3)	3.39	0.048	70.625	8.125	Yes
	Less than BSc (Edu4)	3.34	0.107	31.215	3.178	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1652**	**N=96**			
	Model: Q6 = β1 prof.c1 + β2 prof.c2					
Professional Qualification	Professional certificate	3.3	0.072	45.833	4.167	Yes
	Non-Professional certificate	3.37	0.05	67.4	7.400	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 3242**	**N=96**			
	Model: Q6 = β1 exper1 + β2 exper2 + β3 exper3					
Experience	More than 10 years	3.27	0.144	22.708	1.875	Yes
	Less than 10 yrs & more than 5 yrs	3.29	0.08	41.125	3.625	Yes
	Less than 5 years	3.38	0.051	66.275	7.451	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2154**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q6 (R^2 = 97 - 98%). The auditors, the BSc educated, those with non-professional certificates, and those with less than 5 years' experience are the more accepting for Q6.

Test for Q7:

Table 5.18: The effects of Auditors' characteristics for Q7 (Requiring auditors to have full rather limited responsibility)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q7 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	4.12	0.097	42.474	11.546	Yes
	Senior Auditor (title2)	4.06	0.164	24.756	6.463	Yes
	Partner (title3)	4.14	0.27	15.333	4.222	Yes
	Others (title4)	4.26	0.184	23.152	6.848	Yes
Reg. Statistic	**R^2 = 0.97**	**F-test = 794**	**N=96**			
		Model: Q7 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	4	0.282	14.184	3.546	Yes
	MSc (Edu2)	4	0.188	21.277	5.319	Yes
	BSc (Edu3)	4.13	0.067	61.642	16.866	Yes
	Less than BSc (Edu4)	4.28	0.15	28.533	8.533	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1291**	**N=96**			
		Model: Q7 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	4.01	0.098	40.918	10.306	Yes
	Non-Professional certificate	4.2	0.069	60.87	17.391	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2660**	**N=96**			
		Model: Q7 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	4.1	0.2	20.5	5.500	Yes
	Less than 10 yrs & more than 5 yrs	4.1	0.11	37.273	10.000	Yes
	Less than 5 years	4.16	0.071	58.592	16.338	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1713**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q7 (R^2 = 97-98%). The others, the less educated, those with non-professional certificates, and those with less than 5 years' experience are the more accepting for Q7.

Test for Q8:

Table 5.19: The effects of Auditors' characteristics for Q8 (applying full responsibility rule rather than negligence rule)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q8 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	3.24	0.061	53.115	3.934	Yes
	Senior Auditor (title2)	3.28	0.103	31.845	2.718	Yes
	Partner (title3)	3.31	0.17	19.471	1.824	Yes
	Others (title4)	3.21	0.116	27.672	1.810	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1228**	**N=96**			
		Model: Q8 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3.3	0.152	21.711	1.974	Yes
	MSc (Edu2)	3.31	0.101	32.772	3.069	Yes
	BSc (Edu3)	3.25	0.036	90.278	6.944	Yes
	Less than BSc (Edu4)	3.18	0.081	39.259	2.222	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 2731**	**N=96**			
		Model: Q8 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	3.25	0.053	61.321	4.717	Yes
	Non-Professional certificate	3.25	0.037	87.838	6.757	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 5515**	**N=96**			
		Model: Q8 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.3	0.107	30.841	2.804	Yes
	Less than 10 yrs & more than 5 yrs	3.25	0.059	55.085	4.237	Yes
	Less than 5 years	3.24	0.038	85.263	6.316	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 3648**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q8 (R^2 = 98-99%). The partners, the MSc educated, and those with more than 10 years' experience are the more accepting for Q8. In regard to professional certificates, both those with and without professional certificates gave the same answers.

Test for Q9:

Table 5.20: The effects of Auditors' characteristics for Q9 (Increasing compensation amount sought from the auditor due to audit judgment errors)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q9 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	3.98	0.086	46.279	11.395	Yes
	Senior Auditor (title2)	3.81	0.145	26.276	5.586	Yes
	Partner (title3)	4.02	0.239	16.82	4.268	Yes
	Others (title4)	3.9	0.163	23.926	5.521	Yes
Reg. Statistic	**R^2 = 0.97**	**F-test = 920**	**N=96**			
		Model: Q9 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	4.15	0.208	19.952	5.529	Yes
	MSc (Edu2)	3.75	0.139	26.978	5.396	Yes
	BSc (Edu3)	3.96	0.05	79.2	19.200	Yes
	Less than BSc (Edu4)	3.91	0.111	35.225	8.198	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2140**	**N=96**			
		Model: Q9 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	4.03	0.073	55.205	14.110	Yes
	Non-Professional certificate	3.9	0.051	76.471	17.647	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 4338**	**N=96**			
		Model: Q9 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	4.05	0.146	27.74	7.192	Yes
	Less than 10 yrs & more than 5 yrs	3.81	0.081	47.037	10.000	Yes
	Less than 5 years	3.98	0.052	76.538	18.846	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2903**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q9 (R^2 = 97-98%). The partners, the PhD educated, those with professional certificates, and those with more than 10 years' experience are the more accepting for Q9.

Test for Q10:

Table 5.21: The effects of Auditors' characteristics for Q10 (full compensation for investment loss due audit failure will increase audit quality)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
	Model: Q10 = β1 title1 + β2 title2 + β3 title3 + β4 title4					
Title	Auditor (title1)	3.37	0.055	61.273	6.727	Yes
	Senior Auditor (title2)	3.46	0.093	37.204	4.946	Yes
	Partner (title3)	3.28	0.154	21.299	1.818	Yes
	Others (title4)	3.34	0.105	31.81	3.238	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1618**	**N=96**			
	Model: Q10 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4					
Education	Ph.D. (Edu1)	3.3	0.131	25.191	2.290	Yes
	MSc (Edu2)	3.51	0.087	40.345	5.862	Yes
	BSc (Edu3)	3.38	0.031	109.03	12.258	Yes
	Less than BSc (Edu4)	3.25	0.07	46.429	3.571	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 3939**	**N=96**			
	Model: Q10 = β1 prof.c1 + β2 prof.c2					
Professional Qualification	Professional certificate	3.43	0.047	72.979	9.149	Yes
	Non-Professional certificate	3.35	0.033	101.52	10.606	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 7740**	**N=96**			
	Model: Q10 = β1 exper1 + β2 exper2 + β3 exper3					
Experience	More than 10 years	3.3	0.094	35.106	3.191	Yes
	Less than 10 yrs & more than 5 yrs	3.41	0.052	65.577	7.885	Yes
	Less than 5 years	3.37	0.034	99.118	10.882	Yes
Reg. Statistic	**R^2 = 0.99**	**F-test = 5064**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q10 (R^2 = 98-99%). The senior auditors, the MSc educated, those with professional certificate, and those with between 5 and 10 years' experience are the more accepting for Q10.

Test for Q11:

Table 5.22: The effects of Auditors' characteristics for Q11 (Applying joint & several liability rule when suing auditors)

Effect	Independent Variables	Estimated Coefficient β	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q11 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	4.12	0.093	44.301	12.043	Yes
	Senior Auditor (title2)	4.15	0.157	26.433	7.325	Yes
	Partner (title3)	3.82	0.259	14.749	3.166	Yes
	Others (title4)	3.94	0.177	22.26	5.311	Yes
Reg. Statistic	**R^2 = 0.97**	**F-test = 838**	**N=96**			
		Model: Q11 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3.9	0.267	14.607	3.371	Yes
	MSc (Edu2)	4.22	0.178	23.708	6.854	Yes
	BSc (Edu3)	4.09	0.064	63.906	17.031	Yes
	Less than BSc (Edu4)	3.98	0.142	28.028	6.901	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1402**	**N=96**			
		Model: Q11 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	4.11	0.094	43.723	11.809	Yes
	Non-Professional certificate	4.06	0.066	61.515	16.061	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 2821**	**N=96**			
		Model: Q11 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.9	0.188	20.745	4.787	Yes
	Less than 10 yrs & more than 5 yrs	4.1	0.104	39.423	10.577	Yes
	Less than 5 years	4.09	0.067	61.045	16.269	Yes
Reg. Statistic	**R^2 = 0.98**	**F-test = 1878**	**N=96**			

As the results show, all four characteristics (Title, Education, Professional certificate, Years' expertise) have a converging effect on the auditors' views for Q11 (R^2 = 97-98%). The senior auditors, the MSc educated, those with professional certificates, and those with between 5 and 10 years' experience are the more accepting for Q11.

Test for Q12:

Table 5.23: The effects of Auditors' characteristics for Q12 (applying joint and several liability rule will increase audit quality)

Effect	Independent Variables	Estimated Coefficient *β*	Standard Error	t-test	Adj. t-test	Significance at 95%
		Model: Q12 = β1 title1 + β2 title2 + β3 title3 + β4 title4				
Title	Auditor (title1)	2.98	0.063	47.302	-0.317	No
	Senior Auditor (title2)	3.09	0.107	28.879	0.841	No
	Partner (title3)	3.08	0.176	17.5	0.455	No
	Others (title4)	2.98	0.12	24.833	-0.167	No
Reg. Statistic	**R^2 = 0.97**	**F-test = 989**	**N=96**			
		Model: Q12 = β1 Edu1 + β2 Edu2 + β3 Edu3 + β4 Edu4				
Education	Ph.D. (Edu1)	3	0.17	17.647	0.000	No
	MSc (Edu2)	3.2	0.113	28.319	1.770	Yes
	BSc (Edu3)	2.97	0.041	72.439	-0.732	No
	Less than BSc (Edu4)	3.11	0.091	34.176	1.209	No
Reg. Statistic	**R^2 = 0.98**	**F-test = 1873**	**N=96**			
		Model: Q12 = β1 prof.c1 + β2 prof.c2				
Professional Qualification	Professional certificate	2.98	0.061	48.852	-0.328	No
	Non-Professional certificate	3.02	0.043	70.233	0.465	No
Reg. Statistic	**R^2 = 0.98**	**F-test = 3640**	**N=96**			
		Model: Q12 = β1 exper1 + β2 exper2 + β3 exper3				
Experience	More than 10 years	3.07	0.123	24.959	0.569	No
	Less than 10 yrs & more than 5 yrs	3.02	0.068	44.412	0.294	No
	Less than 5 years	3	0.044	68.182	0.000	No
Reg. Statistic	**R^2 = 0.98**	**F-test = 2401**	**N=96**			

As the results show, only those educated to MSc level have an effect on auditors' views, whilst all others characteristics have no effect.

5.4.1 Summary of Auditors' Characteristics Effect

Table 5.24: Summary of the auditors' characteristics effect

Question	Title	Education	Professional Certificate	Years of experience
Q1	-	-	-	-
Q2	Senior Auditor	MSc	Non professional	More than 5 & less than 10
Q3	Senior Auditor	MSc	Non professional	More than 5 & less than 10
Q4	Auditor	MSc	Professional	Less than 5
Q5	Others	Less	Non professional	More than 5 & less than 10
Q6	Auditor	BSc	Non professional	Less than 5
Q7	Others	Less	Non professional	Less than 5
Q8	Partner	MSc	Both	More than 10
Q9	Partner	PhD	Professional	More than 10
Q10	Senior Auditor	MSc	Professional	More than 5 & less than 10
Q11	Senior Auditor	MSc	Professional	More than 5 & less than 10
Q12	-	MSc	-	-

As can be seen from the summary, there is no apparent effect of the characteristics for the refused questions from the auditors' view (Q1, Q12), whilst for the other question there is no pattern towards any characteristics concerning auditors' views. In general, there is agreement in the views between different groups of auditors, regardless of their experience or education. Such results reinforce the results of the hypothesis test in relation to the auditor's survey.

5.5 Conclusion

In order to achieve the objectives of this thesis, another field research was performed on the auditors, with consideration to two issues, the first of which was concerned with the auditors' views concerning the effect of civil legal liability on the demand of auditing services. The study reveals that the auditors do not believe that their professional performance will be affected by the existence or non-existence of liability rules, although they do think that the existence of liability rules will make financial statement users more trustful in the financial information, and thus increase the number of users of audited financial reports. The second issue was concerned with the motivation for auditing quality. The auditors agree that a high burden liability will make them increase their efforts and due care, thus causing a high quality for auditing services. Although they don't agree with increasing the liability owing to auditing

failure as it will make the auditing services more costly (collecting more evidence, increase time of auditing, increase the samples size) and may also potentially cause unjustified investment decisions, exposing the auditors to unfair litigation from investors and limiting their acceptance for risky clients subsequently decreases the supply for auditing services.

Chapter Six: Comparison between Users' and Auditors' Views

6.1 Introduction

Two field studies were performed to capture users' and auditors' views regarding the civil legal liability system, with both agreeing that the increasing the civil legal liability system for auditors would increase the number of users of financial statements. Furthermore, both groups also agree that it would increase auditing quality.

Six joint questions were posed between the two studies, two of which concerned the effect of civil legal liability system on the auditing profession, whilst the remaining four questions considered the effect of increasing civil legal liability on auditing quality. For the joint questions, a *t*-test was performed in order to study the differences in answers.

6.2 Comparison of the Effect of the Civil Legal Liability System on the Auditing Profession

Table 6.1: Comparison between Users' and auditors' answers for the effect of civil legal liability system on the demand on auditing services

	Statements	Users		Auditors		Comparisons		
		Respondents agreeing	Answers mean	Respondents agreeing	Answers mean	Answers Mean Difference	t-test	Sig.
The absence of a civil legal liability system will:								
1	decrease the number of clients seeking auditing services	87%	4.14	11.5%	1.99	-2.153	-14.78	0.00
2	decrease the auditing fees	70%	3.70	8.3%	1.94	-1.767	-11.57	0.00
3	decrease the auditor assessment of clients' risk	76%	4.02	8.3%	1.98	-2.04	-13.44	0.00
4	increase the probability of audit failure	75%	4.05	7.3%	1.88	-2.173	-14.98	0.00
5	decrease the number of certified public accountants	78%	4.12	6.2%	1.90	-2.228	-16.42	0.00
	Average score	**75%**	**4.008**	**11.5%**	**1.935**	**-2.0722**	**-15.60**	**0.00**

From the above comparison, it can be seen that there is a significant difference between auditors and users concerning the effect of the civil legal liability system on the demand for auditing services. Whilst the users' view is that the absence of a civil legal liability system will decrease their demand for auditing services, the users in this case—more specifically, the investors—look for investment insurance through the auditing services. With this in mind, Schwartz (1997) and King & Schwartz (2000) indicate that payments of civil responsibility make insurance for investors available against investment losses in business firms.

On the other hand, the auditors' view is that the absence of a civil legal liability system will not affect the demand for their services as users are in need of an auditing service and understand the auditor's role within society in terms of the development of a certain business and also the responsibility for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor, 1995).

Table 6.2: Comparison between users' and auditors' answers for the effect of civil legal liability system on the frequency of using financial statements

	Statements	Users		Auditors		Comparisons		
		Respondents agreeing	Answers mean	Respondents agreeing	Answers mean	Answers Mean Difference	t-test	Sig.
Do you think the existence of a civil legal liability system will:								
1	increase the investors' dependence on audited financial reports	76.2%	4.03	90.6%	4.34	0.315	2.78	0.006
2	increase the publishing of interim financial reports	77.1%	4.01	86.5%	4.19	0.178	1.55	0.123
3	increase the need for high-quality accounting standards	85.7%	4.22	79%	4.00	-0.219	-1.78	0.077
4	enhance the publishing of financial reports on a timely basis	86.7%	4.31	83.3%	4.17	-0.148	-1.25	0.211
5	enhance management in terms of voluntary disclosure	87.6%	4.18	72.9%	3.93	-0.254	-2.1	0.037
	Average score	**76%**	**4.15**	**94.8%**	**4.125**	**-0.225**	**-0.35**	**0.723**

From the above comparison, it can be seen that, on average, there is no difference between users and auditors concerning the effects of a civil legal liability system on frequency of using financial statements. Although users are less accepting that the

existence of civil legal liability system will increase their dependence on audited financial reports, it is considered that this result may be owing to the fact that the auditors make considerations in their auditing for any liability that could affect them, whilst users in developing countries are less aware of the auditing process and the different legal rules.

On the other hand, users are more accepting that civil legal liability systems need high-quality accounting standards and enhanced voluntary disclosure. Despite users' need for a liability system to ensure that the input of their decision-making model is trustworthy, they perceive the quality of accounting standards and voluntary disclosure needs, which is in agreement with the auditors' view regarding that users are in need of auditing services and understanding of auditors' role within society.

6.3 Comparison for the Effect of Increasing the Civil Legal Liability of Auditors on Auditing Quality

Table 6.3: Comparison between Users' and auditors' answers for the effect of increasing parties litigating auditors on audit quality

	Statements	Users		Auditors		Comparisons		
		Respondents agreeing	Answers mean	Respondents agreeing	Answers mean	Answers Mean Difference	t-test	Sig.
Allowing more than <u>one party</u> to sue the auditor for judgment errors will:								
1	increase legal consultants by auditor	86.7%	4.29	94.8%	4.42	0.131	1.33	0.184
2	reduce acceptance of risky business clients	85.7%	4.06	88.5%	4.19	0.130	1.16	0.246
3	make auditors more documentation of audit process	66.7%	3.90	81.2%	3.99	0.094	0.76	0.448
4	increase advanced education of financial information users	84.8%	4.12	15.6%	3.06	-1.061	-9.9	0.00
5	improve definition of legal rules	62.8%	3.67	74%	4.02	0.354	2.79	0.006
	Average score	**69.5%**	**4.006**	**94.8%**	**3.935**	**-0.0703**	**-0.87**	**0.385**

From the above comparison, it can be seen that, on average, there is no difference between users and auditors concerning the notion that increasing parties having the right to litigate auditors will increase auditor quality. Although users are more accepting that it will increase their advanced education and less accepting that increasing the number of parties will improve the definition of legal rules, according to this rule, the users will be more aware of their rights in terms of the auditor, whilst the auditor, under this rule, requires a strict definition for those legal rules governing their duties and their liabilities towards third parties. For the auditor, this means there is the need to define, for other parties' rights, loss from auditing failure and the amount of compensation for each party involved in the benefits of the auditing process.

Table 6.4: Comparison between users' and auditors' answers for the effect of civil legal liability nature on audit quality

	Statements	Users		Auditors		Comparisons		
		Respondents agreeing	Answers mean	Respondents agreeing	Answers mean	Answers Mean Difference	t-test	Sig.
Requiring auditors to have full rather limited responsibility is likely to:								
1	increase auditor's effort beyond the auditing standards	86.7%	4.20	84.4%	4.15	-0.54	-0.46	0.643
2	increase the conservatives in auditor's opinions	79.0%	3.97	88.5%	4.08	0.112	1.006	0.316
3	decrease the rate of accepted clients' risk	68.8%	3.94	78%	3.97	0.026	0.195	0.845
4	increase the quality assessment of audit evidences	85.7%	4.21	86.5%	4.38	0.165	1.582	0.115
5	increase the effectiveness of the audit committee	71.4%	3.83	81.2%	4.12	0.296	2.372	0.019
	Average score	**62.8%**	**4.03**	**92.7%**	**4.140**	**0.1091**	**1.246**	**0.214**

From the above comparison, it can be seen that, on average, there is no difference between users and auditors concerning the notion that the full responsibility rule will increase auditing quality, although users are less accepting that the full responsibility rule will increase the overall effectiveness of the auditing committee.

The auditors' view regarding this point is that the full responsibility rule will cause them to increase their auditing evidence and auditing time in order to keep away from litigation. On the other hand, they do not show full support for applying full

responsibility rules. This result agrees with the studies carried out by Narayanan (1994) and Patterson & Wright (2003), which show that imposing an increase in auditors' civil responsibility does not, in itself, guarantee a corresponding increase in effort level (auditing quality).

Table 6.5: Comparison between users' and auditors' answers for the effect of increasing compensation amount on audit quality

	Statements	Users		Auditors		Comparisons		
		Respondents agreeing	Answers mean	Respondents agreeing	Answers mean	Answers Mean Difference	t-test	Sig.
Increasing <u>compensation amount</u> sought from the auditor due to audit judgment errors will:								
1	increase audit fees	76.2%	3.90	93.7%	4.46	0.563	5.591	0.00
2	improve auditing programmes	83.8%	4.19	22.9%	2.75	-1.440	-10.74	0.00
3	increase tests of internal control accuracy	75.2%	3.90	79.2%	4.02	0.126	1.1	0.273
4	increase the size of audit sample	78.1%	4.10	84.4%	4.22	0.114	1.036	0.301
5	decrease acceptable audit risk	86.6%	4.24	89.6%	4.28	0.043	0.41	0.682
	Average score	**73.3%**	**4.06**	**97.9%**	**3.946**	**-0.1189**	**-1.83**	**0.069**

From the above comparison, it can be seen that, on average, there is no difference between users and auditors concerning the belief increasing the compensation amount sought from the auditor will increase auditing quality, although the auditors are more accepting than users that increasing the compensation amount will cause them to raise their fees to meet any future compensations resulting from errors. On the other hand, auditors are less accepting that it will improve auditing programmes as they believe that they are doing their duty, regardless of the liability rule applied.

The final result of the comparison shows that auditing quality will increase when the auditor expects litigation losses from auditing failures, although it is clear that auditors do not show full support for applying the full compensation rule, as this will affect their acceptance of risky clients.

Table 6.6: Comparison between users' and auditors' answers for the effect of applying joint & several liability rule on audit quality								
	Statements	**Users**		**Auditors**		**Comparisons**		
		Respondents agreeing	**Answers mean**	**Respondents agreeing**	**Answers mean**	**Answers Mean Difference**	**t-test**	**Sig.**
Applying <u>joint & several liability rule</u> when suing auditors will:								
1	increase control over acts of management	74.3%	4.14	87.5%	4.08	-0.060	-0.47	0.638
2	achieve effective co-ordination between different parties	68.6%	3.75	83.3%	4.10	0.352	2.78	0.006
3	increase understanding of the client's business	60.0%	3.60	80.2%	3.96	0.358	2.75	0.007
4	increase size of disclosure about errors and illegal acts	77.1%	4.11	86.5%	4.22	0.104	0.926	0.356
5	promote multiplicity of auditors in clients' firms	73.3%	3.85	72.9%	4.04	0.194	1.247	0.214
	Average score	**64.8%**	**3.89**	**92.7%**	**4.081**	**0.1898**	**1.906**	**0.058**

From the above comparison, it can be seen that, on average, there is no difference between users and auditors concerning the belief that applying joint and several liability rules will increase auditing quality. Markedly, the exposure to litigation risk is the driver for perceived audit quality (Khurana & Raman, 2004), although the users are less accepting of the belief that applying this rule will make auditors achieve effective co-ordination between different parties. Moreover, they are also less accepting that it will make auditors increase their overall understanding of the client's business. The auditors perceive that applying the joint and several liability rule requires effective co-ordination between different parties involved in the auditing process, as well as a high degree of understanding in terms of the risks in the audited business.

6.4 Conclusion:

As a result of this test, both groups (users and auditors) agree that increasing the civil legal liability for auditors will subsequently increase auditing quality within society, as the risk threatening auditors to be exposed to litigation gives them a strong incentive to maintain their independence and interest in auditing quality (DeFond, Raghunandan & Subramanyam, 2002).

The comparison between both group views concerning the different rules for civil legal liability applied and its effects on auditing quality include a number of parties having the right to litigate the auditor, which emphasises that auditors need a strict definition for legal liability. The rule of full responsibility will cause them to increase their auditing evidence and auditing time in order to stay away from litigation, and is therefore not a factor in auditing processing efficiency. Furthermore, the rule of full compensation will affect the auditor accepting risky clients, which in turn has a negative impact on investment processes within society. In this regard, joint and several liability rules will prompt coordination between different parties involved in the auditing process, from the auditor's perspective.

On the other hand, there are different views concerning the effect of civil legal liability on the demand for auditing within society. The auditors' views are that the absence of a civil legal liability system will not affect the demand for their services as users are in need of auditing services and understand the auditor's role within society. In this regard, auditors do not belief that the existence of civil legal liability is the major factor in the demand of auditing services. Moreover, in their view, increasing liability will only increase their costs of doing business and the costs of procedures done to avoid litigation.

For users, especially investors, investment insurance is needed when utilising auditing services. Michas (2011) indicates in his study that auditing quality is lower in emerging market countries, with Chen *et al.* (2011) also pointing out that private firms have lower quality financial reporting owing to reduced market demand in the emerging markets. This provides an indication as to why users view auditing as a tool for ensuring their investments in less developed countries.

Chapter Seven: Conclusion, Recommendations, Limitations and Future Research

7.1 Conclusion and Recommendations

7.1.1 Conclusion

The researcher presents the development of civil legal liability rules for the auditing profession, comparing the situations in the USA and in the UK with regard to common laws and legislative laws. Moreover, the situation in the state of Kuwait is equally presented, where the civil legal liability for auditors is considerably weak. Furthermore, in the literature review, the researcher demonstrates the different liability rules governing the auditor in his work. In addition, a field study has been performed concerning the civil legal liability system for the auditing profession within society. The study has been performed in two distinct stages: the first stage was designed with the objective to study the views of different categories of users of financial reports, as they represent the demand on the auditing profession within society; the second stage was designed in order to study the views of auditors, as they represent the supply of the auditing profession within society. The second stage was carried out in order to draw out the features of a civil legal liability system that can be implemented within society and in the emerged market like Kuwait state, in particular.

The contributions of this research are:

- This research will enrich the literature by working to incorporate legal and accounting knowledge, in order to understand how the legal rules impact liability of external auditors and decisions of users of financial statements related to their investments level.

- The study also will determine various effects of alternative legal rules, thus enabling the legislator to control any of these effects, while formulating the rules governing legal liability of the auditor; it is then possible to suggest an appropriate system for auditor legal responsibility (ALR).

The summary for the result of the first stage of the study show that the users (especially the users with more experience and frequent users of financial statements) view that:

Users' responses:

- The demand for auditing services depends on the existence of a civil legal liability system controlling the auditing profession. As without the existence of civil legal liability rules there will be fewer clients seeking auditing services, there will also be an increase in cases of auditing failure.
- The existence of a civil legal liability system will increase reliance on published financial statements. This will induce more confidence in audited financial reports, and further prompt auditors to increase disclosures in the financial reports.

These results shows that users in need of the auditing service understand the auditor's role in society, acknowledging that they play a significant role in the development of a certain business and are also responsible for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor, 1995). Notably, users hold the view that, in order to achieve the optimal result of the auditing services, there is a need for a civil legal liability framework.

- The factors most commonly affecting auditing quality, in the users' view, is the existence of a civil legal liability system, more so than other factors, such as the size of the auditing firm, auditor experience, auditor specialisation, and auditing tenure, as this will prompt auditors to increase their due care and reduce biases in their opinions.

This result agrees with the studies of Palmrose (1988), Melumad & Thoman (1990) and Elitzur & Falk (1996), which state that there is in general, positive correlation between the level of compensation expected by the plaintiff as a result of auditors' liability towards them and auditing quality. Moreover, the study of Khurana & Raman (2004), shows that the exposure to litigation risk is the driver for perceived auditing quality more so than brand name protection.

- Users consider that auditing quality will increase with the application of a strict liability rule rather than limited liability for the auditor in case of any fault in the audited financial reports. Notably, users seek full protection when using financial reports.

This result is not in agreement with the studies of Schwartz (1997) and Radahakrishnan (1999), who argue that the inability of auditors to predicate the due care criterion (there is no strict rule to judge the auditors due care) to be used in evaluating their performance may be an incentive for them to increase their auditing effort or otherwise to present greater conservative opinions in auditing reports to reduce the possibility of their exposure to litigation risk or to negligence.

- Increasing the number of parties with the right to litigate the auditor will make the auditor care about legal consultation and thus will encourage additional documentation when conducting the auditing process, subsequently leading to improved audit quality.

This means that the quality of the auditor's performance is scrutinised by more than one party, which could benefit society as a whole—not only the client of the auditing profession. In contrast, in the USA, by the 1980s, there was a big trend calling for limiting the zone of the auditor's legal liability due to the passive impacts displayed by the auditing profession and business environment; this is recognised as being due to an increased number of parties having the right to litigate auditors, this meaning increased exposure to litigation risk.

- Increasing the compensation amount for any auditing failure will encourage auditors to increase their test for controls and auditing sample. This will improve auditing quality in the users' view.

The result supports the studies of Palmrose (1988), Melumad & Thoman (1990), Dye (1995), Schwartz (1997), King & Schwartz (2000) and Zhang & Thoman (1999), which suggest that an increase in auditor commitment with regard to paying compensation for injuries resulting from auditing failure will increase auditing quality. In this regard,

future payment for compensation resulting from audit failure will drive auditors to improve their audit planning and ensure greater levels of due care and attention.

- Applying joint and several liability rules will encourage auditors to achieve effective co-ordination between different parties in the auditing process and accordingly increase their understanding of the client's business, subsequently resulting in improved auditing quality.

These results confirm that the users support increasing civil legal liability system within the community as it has a direct impact on the quality of audit. This result should be considered carefully as Schwartz (1997) and King & Schwartz (2000) indicate that the legal system for civil responsibility achieves the highest level of effort (auditing quality), but does not necessarily produce the greatest efficiency for society. Moreover, Narayanan (1994) and Patterson & Wright (2003) conclude that imposing an increase in the auditor's civil responsibility does not, in itself, guarantee a corresponding increase in effort level (auditing quality).

- The users consider that applying the previously mentioned rules will increase the level of investment within society.

The results confirm that the users of financial statements support increasing the civil legal liability system within the community, as it has a direct positive impact on the investment level within the community. This result further supports the study of Newman, Patterson & Smith (2005), which states that an increase in auditor penalties for undiscovered expropriation leads to a total investment increase. On the other hand, some (Schibano, 2000, in Yu, 2000) argue that greater levels of legal responsibility may force the auditor to show discretion when issuing reports, a development that would notably result in the potential rejection of financial statements issued by the auditor, subsequently causing business firms to experience difficulties in obtaining funds needed for conducting investment activities, despite being beneficial to society. Also, Schwartz (1997) and King & Schwartz (2000) indicate that the legal system that might attain auditing quality is not necessarily the most efficient for society as legal responsibility enforces more accurate auditing besides protecting users of financial

statements against potential losses. As a result, greater levels of legal accountability for auditors may prompt investors (amongst users of financial statements) to exaggerate investment compared with ideal levels for society.

Auditors' responses:

The summary for the results of the second stage of the study show that the auditors' believe the following:

- The demand for auditing services will not be affected by the existence or non-existence of the civil legal liability system, and that due care is ensured regardless of the liability rules.

This result indicates that auditors do not think that the demand for auditing services (and the number of clients) will be affected by the absence of civil legal liability system. Essentially, there is a significant role for the auditor in the development of a certain business, who is responsible for the analysis of the financial statements of a certain business (Craswell, Francis & Taylor, 1995).

- The existence of a civil legal liability system will affect the auditing profession through increasing costs (owing to collecting more evidence, increase time of auditing, and increase the samples size), with lesser acceptance of risky auditors. This, in turn, may cause a decrease in the auditing services supplied within society.

- The existence of a civil legal liability system will increase both the number of users of financial statements and the frequency of using financial statements due to increasing confidence in the auditing profession and decreases in the risk of investment for the investors.
- Auditors do not prefer to apply the full responsibility rule in the case of auditing failure as this will cause an increase in the time of auditing and the evidence collected by auditors to protect themselves, accordingly increasing the cost of audit. Importantly, their due care and audit programmes will not be affected.

- Increasing the compensation amount will cause auditors to decrease their acceptance of risky clients, which will subsequently affect the investment level in some economic sectors.

This result supports the belief that increasing the compensation amount would affect auditing quality, which agrees with the studies of Palmrose (1988), Melumad & Thoman (1990) and Elitzur & Falk (1996). Moreover, the study of Laux & Newman (2010) states that auditing quality increases with the auditor's expected litigation losses resulting from auditing failures. This result not show full support from auditors in terms of applying the full compensation rule, as this will affect their acceptance of risky clients.

- There is not a preference for the application of the joint and several liability rules in the case of auditing failure. Moreover, they prefer to pay compensation in limited amounts in the case of auditing failure, and not in the case of business failure. This rule would cause auditors to increase their control over the act of management; this, in turn, will complicate the auditor's mission.
- Auditors agree that the existence of the previous mentioned rules will increase auditing quality.

Finally, a comparison has been carried out in order to compare the answers of the two groups (users and auditors), with both groups found to agree that increasing the civil legal liability for auditors will increase auditing quality within society. The comparison between both group views concerning the different rules for civil legal liability applied and its effect on audit quality include the number of parties having the right to litigate the auditor, which shows that auditors need a strict definition for legal liability. The rule of full responsibility will cause auditors to increase the volume of auditing evidence, as well as their auditing time, in order to ensure litigation is avoided, but is notably not a factor in terms of auditing process efficiency. Moreover, the rule of full compensation will affect the auditor's acceptance of risk clients, which in turn will have a negative effect on investment process within society. Furthermore, the joint and several liability rules will prompt coordination between different parties involved in the auditing process, from the auditor's view.

On the other hand, there are differences in views concerning the effect of the civil legal liability on the demand for auditing within society. The auditors' views are that the absence of a civil legal liability system will not affect the demand on their services, as users are in need of auditing services and understand auditors' roles within society. Accordingly, auditors do not believe that the existence of civil legal liability is the major factor in terms of the demand on auditing services. Furthermore, in their view, increasing their liability will only increase their costs of doing business and the costs of procedures implemented in order to avoid litigation, and to meet any future compensations resulting from errors in the audited financial statements.

This research differs from the other literature in several important ways: first, it studies the effects of the civil legal liability system from two views at the same time—those of the users and auditors; second, the study has been performed in an environment of weak governance, with the main findings showing that the users, besides their needs for auditing services, require auditors to provide collateral for their investment process in order to increase their investment level. Furthermore, auditors have been found to be reluctant to increase their liability in such an environment where increasing their liability may cause them to decrease their services within society, although the auditors nevertheless acknowledge that increasing liability will increase auditing quality.

According to the various effects of alternative legal rules, this study enabling the legislator to control any of these effects, while formulating the rules governing legal liability of the auditor; it is then possible to suggest an appropriate system for auditor legal responsibility (ALR).

7.1.2 Recommendations for Kuwaiti Legislation

In the Kuwaiti legal system, there is only one direct article concerning the auditor's responsibility (Article 165, Law no. 15, 1960) regarding the accuracy of financial information detailed within his report. Moreover, other articles in the Kuwaiti laws are general articles not specified for auditing profession; they govern the compensation for third party damages. In light of the previous findings, the researcher can recommend the following in regard to Kuwaiti legislation:

- the adoption of a complete civil legal liability system for the auditing profession: this will promote auditing quality and in turn promote investment in the state of Kuwait;
- auditor liability to clients (the firms under auditing), according to the agreement between the two parties;
- the auditor's liability for any auditing failure: the client should be compensated for any wrongdoing;
- the implementation of a strict definition of other parties that may benefit from the audited financial report: the auditor should be liable, according to the negligence rule, which will give the auditor protection against unfair lawsuits of irrational investors.

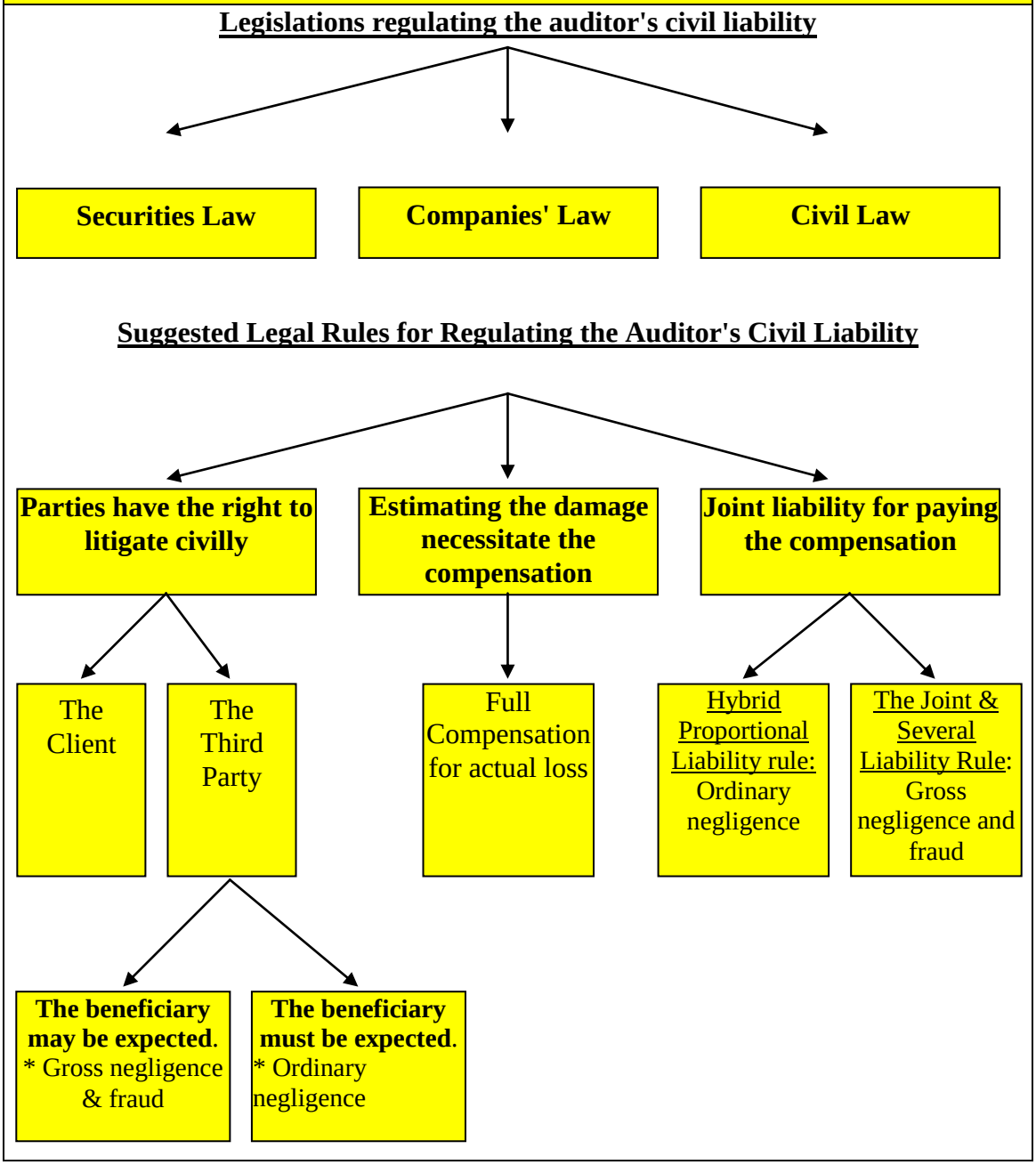
Also the researcher suggests:

- Adding a new legislative text to the law of the regulation of securities and the establishment of investment funds No.31 for the year 1990 includes civil liability of company management and its external auditors in the case of condemning them with committing fraud, deception and gross negligence, resulting in issuing misleading financial information in the front of users of financial statements whom dealing with the securities market in its financial stocks, and whom depend on this information in making their decisions relating to the company. Furthermore, adding a new text to the same law, including the rule on which the judge can depend when evaluating the sum of damage for the plaintiff in the case of financial stocks, thus reducing the degree of personal estimation.
- Adding a new legislative text to the law of the regulation of securities and the establishment of investment funds no. 31 for 1990 includes the necessity of appointing a judge share of all defendants whom have civil liability towards the plaintiff (users dealing in the financial stocks of the audited company) in the compensation judged by the court for the sake of the plaintiff. This civil liability should be limited to the external auditor's liability (solvent defendant) for his share determined in compensation. Furthermore, an additional sum (represent a determined ratio of his share) should be incurred in the case of insolvency of one (or some) of the defendants.

- Maintaining joint liability between defendants, in the case of condemning them with committing fraud or gross negligence, as well as applying joint liability amongst members of the auditing firm.
- Legal reformations must be formulated in a way that guarantees eliminating vagueness and obscurity, in terms of explaining the dimensions by different parties, as they could determine their legal position in the claim, soundly.

A framework for the civil legal liability can be suggested as follows:

Figure (4): Characteristics of a suggested civil legal liability for external auditors, in the State of Kuwait



7.2 Limitations and Future Research

7.2.1 Limitations

The main limitation of this study is that it was performed on the auditors and users in the state of Kuwait, only. Notably, there are many factors affecting the auditing environment, such as social, economic, and political factors, all of which differ from one country to another and may affect the views and results of the study.

The present study was limited in terms of testing the relationship between the civil legal liability of external auditors to the client (business firm subject to auditing) and the third party (users of financial statements); on the one hand, the quality of auditing process, and the decisions made by investors, on the other.

The present study's interests concerned testing the impact of civil legal liability on decisions made by users of financial statements, with emphasis placed on the analysis of decisions made by the different parties (investors in stocks market, investment management staff, credit service in banks operating in Kuwait, etc.), along with other users of financial statements.

This research did not consider the views of the government and legislators concerning the effects of the legal responsibility of external auditors on the auditing professions and investment level.

Quality determinants relating to psychological and behavioural factors are beyond the scope of the present study.

7.2.2 Future Research

Future research in civil legal liability rules should focus on the auditing standards regulating the auditing profession, and their effects on the auditing quality, and should also study whether users consider auditing standards as sufficient, in terms of judging auditor liability.

Also, additional research can be carried out in regard to the methods implemented by auditors striving to avoid liabilities towards their clients and third parties. The auditor

can resort to some methods to avoid liability without losing clients; such methods can affect auditing quality and financial information, thus having grave effects on the investment level.

Future research should also focus on the comparative studies between different countries concerning legal rules and auditing quality, which may help to develop acceptable worldwide liability rules that can be harmonised with international investments across the world.

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Appendix