



# A reply to Randall E. LaSalle: “The civil justice system and going-concern audit reports: Comments on ‘Auditors’ decision-making under going-concern uncertainties in low litigation-risk environments: Evidence from Hong Kong’ ”

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## Abstract

In a dissent from the conclusion reached in Lam and Mensah [Lam, K, Mensah, Y.M., 2006. Auditors’ decision-making under going-concern uncertainties in low Litigation-risk environments: Evidence from Hong Kong. *Journal of Accounting and Public Policy*, 25 (6), 706–739], Lasalle has proposed a number of alternative plausible explanations for our findings that Hong Kong auditors issued disclaimer of opinions in a manner associated with the eventual outcome to the clients. We examine these explanations and attempt to relate them to relevant empirical evidence in the literature. We find that none of his plausible explanations is consistent with the limited empirical evidence available.

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Thus, we continue to believe that a high litigation-risk environment is not a necessary pre-requisite for high quality audits.

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## 1. Introduction

LaSalle (2006) has expressed the view that the conclusion in Lam and Mensah (2006) that “litigation-risk, even if important in high risk environments, may not be any more important than the professionalism and reputation of the auditor” is not supported by the evidence we presented in the study. His counter-arguments rest on two main premises:

1. The issue of disclaimer of opinions in severe financial distress situations is an equivocal measure of “audit quality”;
2. There are three alternative explanations for the issue of disclaimers in a low litigation-risk environment, namely (a) the gatekeeper story; (b) the herding story; and (c) the value of incumbency story.

We examine below LaSalle’s counter-arguments and provide reasons why we believe the conclusion reached in Lam and Mensah (2006) is fully justified.

## 2. Issue of “disclaimer of opinion” as an indicator of “high quality audits”

Auditors provide a service to users of the financial statements, so the economic value of audits is derived from what incremental information the audit opinion conveys to users. Therefore, a high quality audit is one where the audit opinion conveys information to financial statement users, that is, not otherwise discernible from the financial statements themselves. This definition of “high quality audit” is implicit in most of the going-concern auditing literature, as in Elias and Johnston (2001) and Holder-Webb and Wilkins (2000) (based on US data), Bessell et al. (2003) (based on Australian data), and Lennox (1999) (based on UK data).

This user-orientation definition of “high quality audit” has the advantage that it closes the “expectations gap” between what the auditing profession believes is required of the audit opinion, and what financial statements users evidently expect of the same audit opinion. Venuti (2004) reports that 12 of the largest bankruptcy filings in US history took place in 2001 and 2002, and that none of these 12 firms received qualified going-concern opinions in their most recent audit report prior to bankruptcy. The passage of the Sarbanes–Oxley

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