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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

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. *J. Account. Public Pol.* 25 (6), this issue] provide some valuable insight on auditors’ choice of going concern audit reports in an environment where the civil justice system affords, from the standpoint of the plaintiff, fewer remedies and is more difficult to file a complaint than it is in the US. Hence, from the auditor’s standpoint, this environment can appropriately be described as a “low litigation risk environment”. In this comment, I first question whether a disclaimer of an opinion is any indication of either a quality audit or professionalism. Secondly, three alternative explanations for the empirical regularities are discussed. *The Gatekeeper Story* suggests auditors are simply not

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willing to risk reducing their reputational capital by acquiescing to clients that are not likely to survive their own financial distress. *The Herding Story* suggests that, when auditors are faced with uncertainties or a gap in the authoritative literature, auditors will herd together to form a common response that mimic one-another. *The Value of Incumbency Story* holds that as the value of incumbency declines with the client's inability to survive, auditors will have fewer incentives to incur the incremental costs to gather sufficient competent evidential matter necessary to support an unqualified opinion.

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1. Introduction

Lam and Mensah (2006) have identified an important area of study that has long been of interest to many in the academic and practitioner accounting communities. Auditors' decision to issue different types of going concern reports remains one of the few areas in which the auditors have virtually no professional guidance and, hence, have considerable discretion to issue whatever report they believe is best. The question remains whether auditors use this discretion to serve their own interests, their clients' interests, and/or the public/investors' interest. To the extent that auditors are using this discretion to serve the interest of the investment community (e.g., signals of various degrees of financial distress), then it could be argued that no further professional guidance (i.e., intervention) or strengthening of the civil justice system is necessary. Thus, this rigorous empirical study has made an important contribution to the body of accounting literature on public policy.

Lam and Mensah (2006) conclude that since the degree of financial distress is correlated with the probability of auditors issuing a disclaimer in both a high and low "litigation risk environments" then "maintenance of a high litigation risk environment does not appear to be a necessary pre-requisite for high quality audits". Given the empirical results of this study and others, it is probably safe to conclude that *high litigation risk is not the sole determinant of auditors' choice to disclaim an opinion*. However, the authors also conclude that, "These findings suggest that litigation risk, even if important in high risk environments, may not be any more important than the professionalism and reputation of the auditor". Since the authors have not measured (1) high quality audits, (2) professionalism, or (3) reputation, I am not convinced they can make any valid inferences about any of these three constructs. Furthermore, there are simply too many alternative explanations for their findings. To generalize the empirical findings from a sample of going concern reports to a much broader context (e.g., high quality audits) seems to me to be an over generalization. Firstly, issuing a disclaimer, which is not required by professional

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