# Do the Auditors Bear the Consequences of Corporate Failures? The Case of Failed New Zealand Finance Companies

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**Abstract**

This paper examines whether auditors bear any negative consequence of the failures of finance companies in New Zealand. More than 60 finance companies failed since 2006 and these failures imposed massive financial loss on the investors. There is a wide perception of audit failure in the case of these failed finance companies. Therefore, it is important to examine whether there is evidence of poor audit quality in the case of failed finance companies. It is also important to investigate, from the perspective of audit theory and public policy, whether the auditors of these failed finance companies were punished after the failures. The study examines two consequences for the auditors – disciplinary actions against the auditors by Chartered Accountants Australia and New Zealand (CAANZ) and client loss. The paper also examines whether the auditor has been sued after the failure of any finance company.

The sample is comprised of 37 failed finance companies for which annual reports were available on the website of Companies Office New Zealand. The study finds that auditors who gave unmodified audit opinions are not more likely to face disciplinary actions than those who gave unmodified audit opinions with going concern explanation paragraphs and modified audit opinions. Furthermore, the study utilizes auditor turnover of public listed companies in New Zealand to test another consequence of finance company failures for the auditors – client loss. While there is no significant relationship between disciplinary actions and auditor turnover, a statistically significant relationship is observed between finance company failure and auditor turnover.

The study also analyses litigation effect on auditors who involved with finance company failures. Under the primary liability rule – joint and several liability – in New Zealand, auditor is held liable for the loss of the client.

The results of this study will be of interest to practitioners, standard setters and law makers, and will fill the literature gap on the impacts of corporate failures on auditors.

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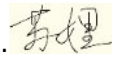
**Attestation of Authorship**

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.

Signature……..…  ……. Date…….22/07/2015……..…

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## 1. Introduction

This paper examines whether there is any evidence of audit failure in the case of finance companies that failed during 2005-2011 and whether auditors bear any negative consequence of the failures of finance companies in New Zealand. Since 2006 more than 60 finance companies failed in New Zealand.[1] Collapses of New Zealand finance companies have continued through and beyond 2012. According to one estimate, the amount and the number of deposits that were put to risk as a result of these failures were NZ$8.71 billion and 205,878, respectively.[2] Many of the directors of these failed companies were sentenced to jail and many are still facing trials in New Zealand courts (Kabir & Laswad, 2014). For example, the High Court in Auckland found former Bridgecorp directors guilty on making dishonest presentation in their prospectus and misleading investors (Fletcher, 2011). Former Bridgecorp Chairman Bruce Davidson was sentenced to nine-month home detention for misleading investors on 7 October 2011. He was also asked to pay NZ$500,000 in reparations that would be distributed among Bridgecorp's out-of-pocket investors and 200 hours of community work (Fletcher, 2011). The sheer number of failures and the magnitude of loss borne by investors create outrage among investors, media commentators and regulators.[3]

Such corporate debacles have prompted the public to criticize external auditors for failing to sound warning bells and blow the whistle (Porter, 2009). Commentators and

[1] The deep freeze list contains the list of finance companies that failed since 2006. The list is available at: http://www.interest.co.nz/saving/deep-freeze-list (accessed 21 October, 2014).

[2] The list of finance companies that failed and the magnitude of deposits that were put to risk are available at: http://www.interest.co.nz/saving/deep-freeze-list (accessed 21 October, 2014).

[3] For example, Sheather (2011) commented on huge magnitude of loss borne by the investors in failed finance companies. In commenting on the series of finance company failures, Chaplin (2010) asked what the message in the finance companies' mess is. A New Zealand editorial (2010) commented that the failure of South Canterbury Finance shook the financial foundation of the Canterbury region.

regulators raised questions about the quality of audits done by the auditors of the failed finance companies (Gaynor, 2007; Dann, 2008; Commerce Committee, 2008).

Given the massive financial loss borne by the investors and perception of audit failure, it is important to examine whether there is evidence of poor audit quality in the case of failed finance companies. It is also important to investigate, from the perspective of audit theory and public policy, the consequences of the finance company failures for the auditors.

It is important from the perspective of public policy because there is an ongoing debate in New Zealand on excessive litigation risks borne by New Zealand auditors (New Zealand Institute of Charted Accountants [NZICA], 2013). There are a variety of prior studies investigating the litigation against auditors (e.g., St Pierre & Anderson, 1984; Palmrose, 1987; Carcello & Palmrose, 1994; Bonner, Palmrose, & Young, 1998; Heninger, 2001; Khurana & Raman, 2004) and the consequences of audit litigation (e.g., Palmrose, 1988; Lennox & Li, 2014). Although litigation against auditors is much less frequent in New Zealand than in the U.S. (e.g., Seetharaman, Gul, & Lynn, 2002), New Zealand auditors are apprehensive of the excessive litigation risks created by the joint and several liability regime (NZICA, 2013). An examination of whether auditors who audited the last financial statements of the failed companies were sued in New Zealand courts would shed light on this problem.

The issue is also important to examine the consequences of finance companies' failures for the auditors because if auditors are not penalized for audit failures, they would have few incentives to implement the auditing and professional standards rigorously. Prior research has investigated the role of auditors in detecting and preventing earnings managements and financial misstatements (e.g., Hirst, 1994; Kinney & Martin, 1994; McConomy, 1998; Elliott & Tarpley, 2003). One important question is what motivates the auditors to explore earnings manipulation by

management. Empirical studies have provided implications for potential litigation risks related to issuing different audit opinions in audit reporting (e.g., Carcello & Palmrose, 1994; Mong & Roebuck, 2005; Kaplan & William, 2012). A stream of U.S.-based research reveals the significant impact of opinions of Public Company Accounting Oversight Board (PCAOB) reports on auditors' litigation exposure (e.g., Daugherty, Dickins, & Tervo, 2011; DeFond & Lennox, 2011; Song & Ye, 2014). Also, Hilary and Lennox (2005) find that peer-reviewed firms gain clients after receiving clean opinions and lose clients after receiving modified or adverse opinions.

In Sikka's (2009) study, the distressed financial enterprises in countries such as the U.S., the U.K., Germany, and so on received unmodified audit opinions on their last financial statements published immediately prior to their financial difficulties becoming publicly evident. In New Zealand, any member who breaches Rules of NZICA or NZICA Code of Ethics, the Disciplinary Tribunal of NZICA may impose penalties such as censuring the member, suspending the member from membership of NZICA for any period not exceeding five years, and ordering the member to pay a monetary penalty not exceeding $20,000 (NZICA, 2012, s 21.31). These issues motivate the current study to investigate the relationship between audit opinions and disciplinary actions against individual auditors.

The failure of finance companies in New Zealand since 2006 provides a unique opportunity to examine the consequence of corporate failure for auditors. Therefore, this paper examines the types of audit opinions published immediately before the failures of finance companies, the association between types of audit opinions and disciplinary actions against auditors by NZICA. It also investigates whether disciplinary actions against individual auditors in New Zealand and failures of finance companies influence these auditors' client base.

67 New Zealand finance companies failed during 2006-12.[4] Out of these 67 failed companies, annual reports of 30 finance companies are not available on the website of Companies Office New Zealand. The final sample is comprised of these 37 failed finance companies. The sample size is small but this small size is due to the small number of finance company failures in New Zealand. The study finds that auditors who gave unmodified audit opinions are not more likely to face disciplinary processes than those who gave unmodified audit opinions with going concern explanation paragraphs and modified audit opinions. Furthermore, the study utilizes auditor turnover of public listed companies in New Zealand to test another consequence of finance company failures for the auditors – client loss. While there is no significant relationship between disciplinary actions and auditor turnover, a statistically significant relationship is observed between finance company failure and auditor turnover.

The results of this study will be of interest to practitioners as they look for ways to mitigate their litigation risk, and for standard setters and law makers as they continue to examine revision to auditing standards and liability regimes. This study complements and extends the literature on audit opinions and disciplinary actions. It will fill the gap in the literature on the impacts of corporate failures on auditors.

There are some limitations of this study. First, the findings may be too conclusive because of the remaining 28 finance companies are assumed to face no disciplinary actions. Second, there are only two cases analysed in this study. Although the result is consistent with prior research, it might be still problematic to generalize the finding to all litigation cases of auditors involved with finance company failures in New Zealand.

The rest of this paper proceeds as follows. The second section reviews the prior literature documenting the usefulness of audit opinion and disciplinary actions against

[4] The deep freeze list contains the list of finance companies that failed from 2006 to 2012. The list is available at: http://www.interest.co.nz/saving/deep-freeze-list (accessed 21 October, 2014).

individual auditors. Section three outlines the hypotheses and research method. The findings of the research are presented in section four, and the fifth section provides additional analyses of litigation effect on auditors. The final section concludes the research.

## 2. Literature Review

### *2.1 Usefulness of Audit Opinion*

Jensen and Meckling (1976) believe that maximizing interests of the principal is not always at top of agents' priority list in decision-making. Auditing has been used to monitor contracts between principals and agents from mid-nineteenth century (Watts & Zimmerman, 1983). Nowadays, external auditors have been increasingly playing a crucial part in ensuring the credibility of the financial statements prepared by corporate managements (Porter, 2009). Meanwhile, there is a widespread belief that a person who has any interest in a company (e.g., shareholders, creditors, and potential investors) should be able to rely on its audited accounts as a guarantee of its solvency, propriety and business viability (Godsell, as cited in Koh & Woo, 1998). To notify interested parties about their audits, audit reporting serves as the auditors' most important communication device.

Empirical studies provide implications for potential litigation risks related to issuing different audit opinions in audit reporting. For example, Carcello and Palmrose (1994) examine the relationship between modified audit reports and litigation. They provide evidence that the audit firms with no litigation present much higher occurrence of modified reports than the audit firms with litigation and that the issuance of modified reports results in the highest incidence of dismissal (no payments to plaintiffs) and the lowest payments by auditors. Similarly, Mong and Roebuck (2005) find that a modified (but not qualified) audit report effectively serves on a 'red flag' and weakens potential litigants' propensity to initiate litigation. Moreover, a recent study using a simultaneous equations approach by Kaplan and William (2012) suggests that issuing a going concern report to financially distressed clients prevents auditors from lawsuits and reduces the likelihood of large financial settlements even if auditors are named in lawsuits.

Conclusively, the issuance of a modified report is inversely related to auditor litigation exposure. This is also consistent with analytical theory that independent auditors will avoid litigation costs when they figure out the 'bad states' of the auditees through the audit reports (Schwartz, 1997; Frantz, 1999; Pae & Yoo, 2001). Most of prior research on litigation effect on auditors in the literature is U.S.-based. However, the U.S. is much more litigious than other Anglo-American countries such as New Zealand (e.g., Baginski, Hassell, & Kimbrough, 2002; Seetharaman, Gul, & Lynn, 2002). In New Zealand, there are only few auditor litigation cases to validate the generality of findings of prior research. Since unmodified audit opinions on failed companies are more likely to indicate audit failure than unmodified audit opinions with going concern explanatory paragraph, auditors giving unmodified audit opinions on failed companies are more likely to have penalties (e.g., censure, suspension of license, or monetary penalty) on them than auditors issuing a going concern report. The failure of finance companies in New Zealand since 2006 provides a unique opportunity to examine the consequence of corporate failure for auditors. This paper examines the association of audit opinions with consequence of finance company failures – disciplinary actions against auditors by NZICA.

### *2.2. Disciplinary Actions against Auditors*

Prior research has investigated the role of auditors in detecting and preventing earnings managements and financial misstatements. Nelson, Elliott and Tarpley (2003) suggest that earnings management attempts primarily consist of misstatements of expenses and revenues, 52 percent and 22 percent, respectively. Auditors are sensitive to management-buyout-induced incentives and bonus-induced incentives to manipulate earnings through both income-increasing accruals and income-decreasing accruals; however, these incentives have no effects on auditors' judgments of the probability of

the existence of material misstatements (Hirst, 1994). The audit-related adjustments preponderantly cut down positive bias in pre-audit net earnings and net assets and prevent managers from obscuring the firms' intrinsic values (Kinney & Martin, 1994). In the context of earnings forecasts in prospectuses of initial public offerings, McConomy (1998) also demonstrates that audited forecasts involve significantly less positive bias than reviewed forecasts. In order to prevent management from manipulating earnings, Nelson et al. (2003) find that auditors require 42 percent misstatements of expense cases and 56 percent misstatements of revenue cases to be adjusted.

One important question is what motivates the auditors to explore earnings manipulation by management in order to comply with auditing and professional standards. The dominant explanation offered in the literature is disciplinary actions against individual auditors who are members of NZICA. Anyone who thinks his/her Charted Accountants breaching the professional and ethical standards is able to lodge a written complaint with sufficient supportive evidence (NZICA, 2012, s 21.1). On receipt of a complaint, NZICA would exchange comments between the complainant and the complained member until the details are sufficient to pass the complaint on to the Professional Conduct Committee (PCC) that is independent from NZICA itself and carries out the first stage of investigating the complaint (NZICA, 2007). By examining all the information generated from both parties or probably using an investigator to collect more information to facilitate its examination, the PCC shall make a decision and adopt one or more types of actions such as deciding no further action be taken, cautioning the member whether or not the member has breached the rules or the code of ethics, referring the matter to the Disciplinary Tribunal for a hearing, ordering the member to pay costs to the complainant and/or NZICA, etc. (NZICA, 2012, s 21.3).

If the complained member is found guilty of a charge, the Disciplinary Tribunal is likely to straightly issue penalties (NZICA, 2007). The common penalties on deficient members include censuring the member, removing the member's name from NZICA's register, suspending the member from membership of NZICA for any period not exceeding five years, and imposing a monetary penalty on the member not exceeding $20,000 (NZICA, 2012, s 21.31). Within 14 days after receiving a decision of the Disciplinary Tribunal, the member may appeal to the Appeals Council with a written statement (NZICA, 2012, s 21.41). After the hearing of any appeal, the Appeals Council has the power to confirm, vary or reverse any decision of the Disciplinary Tribunal and even to make fresh orders as to pay the costs of the appeal (NZICA, 2012, s 21.47).

In the U.S., each non-U.S. or U.S. public accounting firm that audits U.S. issuer clients must be registered with the PCAOB (The Sarbanes-Oxley Act of 2002, s 102; The Sarbanes-Oxley Act of 2002, s 106; PCAOB, 2009). Moreover, the PCAOB shall conduct inspections to evaluate the extent to which these public accounting firms comply with the Sarbanes-Oxley Act of 2002 and the rule of PCAOB (The Sarbanes-Oxley Act of 2002, s 104). In 2004 and 2005, respectively, the PCAOB began its regular inspections of U.S. and non-U.S. audit firms (PCAOB, 2009). A variety of researchers have investigated whether and how the inspected audit firms and audit market are influenced by PCAOB inspections.

Studies based on inspections of U.S. auditors find the significant impact of PCAOB inspection on auditor deregistration. DeFond and Lennox (2011) reveal that 607 out of 1,233 small auditors with 100 or fewer issuer clients during the period from 2001 to 2008 exit the audit market following the passage of SOX and the beginning of PCAOB inspections. In addition, Daugherty et al. (2011) provide evidence that PCAOB deficiency reports of triennially inspected auditors are positively associated with auditor deregistration with the PCAOB. However, Song and Ye (2014) find that only 22 out of

178 non-U.S. audit firm voluntarily ceased to be registered with the PCAOB either during the inspection procedure or following the receipt of PCAOB deficiency reports, a reduction of 12 percent.

Some U.S.-based studies also examine the association of client loss with peer-review reports or PCAOB reports. Hilary and Lennox (2005) find that peer-reviewed firms gain clients after receiving clean opinions and lose clients after receiving modified or adverse opinions on the basis of 1,001 self-regulated peer reviews at accounting firms during 1997-2003. Besides, Daugherty et al. (2011) document that PCAOB deficiency reports of triennially inspected auditors are positively related to involuntary or voluntary client losses, gauged by dismissals by their clients and resignation from audits of their publicly traded clients. Nevertheless, there is not significant client loss of non-U.S. auditors firms performing audits of US publicly-traded companies after receiving PCAOB reports containing audit deficiencies, with 24 dismissal cases and only 4 resignation cases from the 1,604 clients of non-U.S. audit firms (Song & Ye, 2014).

Overall, PCAOB reports make much of a difference in studies examining voluntary deregistration, voluntary resignations, and involuntary dismissals of inspected U.S. audit firms from those of non-U.S. audit firms. Therefore, the difference in the impact of PCAOB reports on U.S. audit firms and non-U.S. audit firms motives this study to examine whether or not the disciplinary actions against individual auditors in New Zealand influence these auditors' client base.

## 3. Hypotheses and Research Method

### *3.1. Development of Hypotheses*

To examine the association of audit opinion with disciplinary actions against individual auditors and the association of disciplinary actions with auditor's client loss, the study develops two hypotheses.

#### *3.1.1. Audit Opinions before Finance Company Failures*

The recent procession of New Zealand finance companies to failure created perceptions of poor quality audits done by the auditors of failed finance companies. For example, Gaynor (2007) raised question about the quality of audits of failed finance companies. Further, the Commerce Committee (2008, p. 11) reported that the Registrar of Companies made the following comments on the quality of audits of failed finance companies:

> As a general observation, the audits of many of these finance companies lacked the rigour and analytical depth one would expect for entities managing substantial public investments. There is a view among receivers that if they had been rigorously audited, it is unlikely many of the failed finance companies would have continued in business for as long as they did.

The concerns of media commentators and regulators are consistent with prior literature on audit quality. Specifically, audit quality is defined as an outcome conditional on the extent to which the performance of an auditor is in line with Generally Accepted Auditing Standards (GAAS) to provide reasonable assurance that the financial statements and related disclosures are prepared in accordance with General Accepted Accounting Practice (GAAP) and are free of material misstatements due to either errors or frauds (Government Accountability Office, 2003; Tie, 1999; Krishnan &

Schauer, 2001). According to this definition of audit quality, material deviations from the standards are regarded as to imply poor audit quality.

Going concern assumption is a fundamental principle in the preparation of financial statements (External Reporting Board [XRB], 2012, New Zealand Equivalent to International Accounting Standard [NZ IAS] 1, para. 25). Before satisfying itself that the going concern basis is appropriate, management needs to take into account a wide range of factors involved with current and expected profitability, debt repayment schedules and potential sources of replacement financing in, at least but not limited to, next twelve months from the end of the reporting period (XRB, 2012, NZ IAS 1, para. 26).

Correspondingly, the auditor has responsibility to evaluate the appropriateness of management's use of the going concern assumption when preparing the financial statements and to infer the probability of uncertainty about the entity's ability to continue as a going concern (XRB, 2011, International Standard on Auditing (New Zealand) [ISA (NZ)] 570, para. 6). Consequently, the auditor shall consider whether the entity will continue in business in the relevant period, at least for next 12 months from the date of the auditors' current reports (XRB, 2011, ISA (NZ) 570, para. 13). Furthermore, paragraph 16 of ISA (NZ) 700 (XRB, 2011) prescribes that an unmodified audit opinion given by the auditor implies that financial statements comply with, in material respects, the applicable financial reporting framework. Hence, an entity that received an unmodified audit opinion without going concern explanation from the auditor is perceived to continue in business at least for next 12 months.

The distressed financial enterprises in countries such as the U.S., the U.K., Germany, and so on received unmodified audit opinions on their last financial statements published immediately prior to their financial difficulties becoming publicly evident (Sikka, 2009). Therefore, auditors are not more likely to provide going concern opinions

before the failures of finance companies. Because audit reporting serves as the auditors' most important communication device, the unreliable opinions given in the reports may mislead interested parties in a company or even the company itself.

### *3.1.2. Audit Opinions and Disciplinary Actions*

Pursuant to NZICA Act 1996, NZICA regulates Rules of NZICA and NZICA Code of Ethics that bind all members and direct them to perform professionally and ethically. For example, NZICA members must conduct professional work with honesty and sustain the credibility of accountancy profession (NZICA, 2014). When any member breaches Rules of NZICA or NZICA Code of Ethics, any person may file a complaint against the member (NZICA, 2012, s 21.1). On receipt of a complaint, the PCC shall perform the first stage of investigation and then make a decision on the adoption of actions (NZICA, 2012, s 21.3). If the member pleads guilty, the Disciplinary Tribunal may impose penalties such as censuring the member and suspending the member from membership of NZICA for any period not exceeding five years (NZICA, 2012, s 21.31). Since unmodified audit opinions on failed finance companies are more likely to indicate audit failure than unmodified audit opinions with going concern explanatory paragraph, auditors giving unmodified audit opinions on failed finance companies are more likely to have penalties (e.g., censure, suspension of license, or monetary penalty) on them than auditors issuing going concern reports.

The majority of failed finance companies in New Zealand declare financial difficulties within twelve months after they received unmodified audit reports from auditors. On the basis of prior discussion, these auditors may be punished by NZICA. Therefore, this leads to the following hypothesis:

**H1**: Auditors who gave unmodified audit opinions are more likely to face disciplinary actions than those who gave unmodified audit opinions with going concern explanation paragraphs and modified audit opinions.

*3.1.3. Disciplinary Actions and Auditor Turnover*

Some U.S.-based studies investigate client loss of audit firms after receiving modified or adverse peer-review reports and PCAOB deficiency reports. Specifically, audit firms lose clients if they received modified or adverse opinions from peer reviewers (Hilary & Lennox, 2005). Also, U.S.-auditors are more likely to be dismissed by their clients or resign from their clients after receiving PCAOB reports containing audit deficiencies (Daugherty et al., 2011). However, the influence of PCAOB deficiency report on client loss of non-U.S. auditors is not significant (Song & Ye, 2014).

Commentators and regulators raised questions about the quality of audits done by the auditors of the failed finance companies in New Zealand (Gaynor, 2007; Dann, 2008; Commerce Committee, 2008). Along with the occurrence of finance company failures in New Zealand, NZICA has continued punishing auditors involved with finance company failures. On the basis of prior research, this study examines whether disciplinary actions against auditors influence audit market share in New Zealand. Due to the lack of confidence in auditors' work provided to failed finance companies, this study proposes that auditors involved with finance company failures are more likely to lose clients after being punished by NZICA. This leads to the following hypothesis:

**H2**: Auditors who were punished by NZICA due to the involvement with finance company failures are more likely to lose the existing clients.

**Table 1 Sample Selection Procedure**

| | |
|---|---|
| Number of failed finance companies in Deep Freeze List | 67 |
| Less number of companies with no annual report on Companies Office website | 30 |
| Final Sample | 37 |

*3.2. Sample and Data*

67 New Zealand finance companies failed during 2006-12.[5] The sampled companies are required to have annual reports published immediately prior to their failures. Out of these 67 failed companies, annual reports of 30 finance companies are not available on the website of Companies Office New Zealand. [6] The final sample is comprised of the remaining 37 failed finance companies. Table 1 describes the process of deriving the sample and Table 2 lists the names and failure dates of sample companies. The sample size is small but this small size is due to the small number of finance company failures in New Zealand. There are numerous quantitative studies that use a small sample size (Kabir & Laswad, 2014). Especially the corporate failure literature is replete with small sample size studies.

I collect audit opinions from last annual reports before finance company failures and collect data on disciplinary actions against individual auditors involved with finance company failures from the CAANZ website, the website of New Zealand Herald, and the website of Stuff. Annual reports of failed finance companies are available from the website of Companies Office New Zealand. [7] And I collect data on auditor turnover from annual reports of New Zealand listed companies from Company Research Database of Auckland University of Technology Library. The database includes annual

[5] The deep freeze list contains the list of finance companies that failed from 2006 to 2012. The list is available at: http://www.interest.co.nz/saving/deep-freeze-list (accessed 21 October, 2014).
[6] The website of Companies Office New Zealand is available at: https://www.business.govt.nz/companies (accessed 14 July, 2015).
[7] The website of Companies Office New Zealand is available at: https://www.business.govt.nz/companies (accessed 14 July, 2015).

reports of 154 public listed companies. 41 companies started their businesses after 2006. To test the association of auditor turnover and disciplinary actions against auditors involved with finance company failures since 2006, the sample only comprised of companies that continually operate in business from 2006 until 2013. This leads to a final sample of 113 New Zealand public listed companies for the period 2006-2013.

**Table 2 Names of Failed Finance Companies**

| Sequence | Finance Company Name | Date Failed | Sequence | Finance Company Name | Date Failed |
|---|---|---|---|---|---|
| 1 | National Finance 2000 | May-06 | 20 | North South Finance | Jun-08 |
| 2 | Provincial Finance Ltd | Jun-06 | 21 | St Laurence | Jun-08 |
| 3 | Western Bay Finance | Jun-06 | 22 | Hanover Finance | Jul-08 |
| 4 | Bridgecorp Capital Ltd | Jul-07 | 23 | Hanover Capital | Jul-08 |
| 5 | Bridgecorp Inv | Jul-07 | 24 | United Finance | Jul-08 |
| 6 | Nathan Finance | Aug-07 | 25 | Strategic Finance | Aug-08 |
| 7 | Chancery Finance | Aug-07 | 26 | Orange Finance | Dec-08 |
| 8 | Property Finance Securities | Aug-07 | 27 | Mascot Finance | Mar-09 |
| 9 | Five Star Consumer Finance | Aug-07 | 28 | Vision Securities | Apr-10 |
| 10 | LDC Finance | Sep-07 | 29 | Rural Portf Capital | May-10 |
| 11 | Beneficial Finance | Oct-07 | 30 | Rockforte Finance | May-10 |
| 12 | Capital + Merchant | Nov-07 | 31 | Viaduct Capital | May-10 |
| 13 | Numeria Finance | Dec-07 | 32 | Mutual Finance | Jul-10 |
| 14 | OPI Pacific Finance Ltd | Mar-08 | 33 | Allied Nationwide Fin | Aug-10 |
| 15 | Boston Finance | Mar-08 | 34 | South Canterbury Fin | Aug-10 |
| 16 | Lombard Finance | Apr-08 | 35 | Equitable Mortgages | Nov-10 |
| 17 | Belgrave Finance | May-08 | 36 | Finance & Leasing | Jan-11 |
| 18 | IMP Diversified Fund | Jun-08 | 37 | NZF Money | Jul-11 |
| 19 | Dominion Finance | Jun-08 | | | |

*3.3. Research Method*

I use chi-square test to test the association between audit opinion type and disciplinary action. The independent variable is types of audit opinions – unmodified vs unmodified with going concern explanation paragraph and the dependent variable is a categorical variable that takes 1 if the auditors faced any disciplinary actions and 0 otherwise. Auditors giving unmodified audit opinions are more likely to face disciplinary actions than auditors issuing a going concern report. Furthermore, since the sample size is small, I will provide detailed information about the nature of the disciplinary actions imposed by NZICA and the reasons therefor in my study.

To identify whether there is a negative association between disciplinary action and client loss, chi-square test is utilized. The independent variable is whether or not auditors were punished by NZICA because of the involvement with finance company failures and the dependent variable is a categorical variable that takes 1 if there is auditor turnover and 0 otherwise.

## 4. Findings

### *4.1. Audit Opinions before Finance Company Failures*

Table 3 shows, the auditors of 37 failed finance companies gave unmodified audit opinions in their last audit reports and only 11 of 37 auditors' reports presented going concern explanation paragraphs. The data of failed finance companies in New Zealand are consistent with Sikka's (2009) study. In his study, the distressed financial enterprises in countries such as the U.S., the U.K., Germany, and so on received unmodified audit opinions on their last financial statements published immediately prior to their financial difficulties becoming publicly evident. In this study, out of 37 failed finance companies, 34 companies failed less than 12 months after the audit report sign-off date. In the sub-sample for which the company failed within 12 months after the issuance of last audit report, 24 companies received unmodified audit opinions and 10 companies received unmodified audit opinions with going concern explanation paragraphs. This result is consistent with Carcello and Palmrose' (1994) study that concludes 70 percent of their observation have no modified reports as the subject of auditor litigation.

In the sample of failed finance companies in New Zealand, for example, Nathan Finance received an unmodified audit opinion on 5 September 2006. In August 2007, 11 months later, the company collapsed down owing around 7000 investors NZ$174 million (Krause, 2011). Similarly, Belgrave was put into liquidation and receivership in May 2008. Later on, it collapsed down owing retail investors more than NZ$20 million. Nevertheless, it received an unmodified audit report from its auditors just 9 months before its bankruptcy. South Canterbury Finance, the locally owned finance company, received an unmodified audit opinion with going concern explanation paragraph on 30 September 2009. In August 2010, the company was placed into receivership and the Government, consequently, stepped into immediately pay NZ$1.6 billion to cover

35,000 debenture holders' deposits as a result of its retail deposit guarantee scheme (Bennett, 2010).

The result notifies that these finance companies still collapsed down even their auditors ascertained the health of their last financial statements, with 11 finance companies receiving unmodified audit opinions with going concern explanation paragraphs and 26 finance companies receiving unmodified audit opinions.

**Table 3 Audit Opinions in Last Audit Reports of Failed Finance Companies in New Zealand**

| Name of Finance Company | Date Failed | Auditor | Financial statement reporting period ended | Last audit report sign date | Audit opinion gi |
|---|---|---|---|---|---|
| National Finance 2000 | May-06 | O'Halloran & Co, Chartered Accountants | 31 March 2005 | 21 July 2005 | Unmodified opin |
| Provincial Finance Ltd | Jun-06 | Ernst & Young, Chartered Accountants | 31 March 2005 | 3 June 2005 | Unmodified opin |
| Western Bay Finance | Jun-06 | Ingham Mora, Chartered Accountants | 31 March 2005 | 30 June 2005 | Unmodified opin |
| Bridgecorp Capital Ltd | Jul-07 | PKF Chartered Accountants & Business Advisors | 30 June 2006 | 10 November 2006 | Unmodified opin |
| Bridgecorp Inv | Jul-07 | PKF Chartered Accountants & Business Advisors | 30 June 2006 | 10 November 2006 | Unmodified opin |
| Nathan Finance | Aug-07 | Staples Roadway | 30 June 2006 | 5 September 2006 | Unmodified opin |
| Chancery Finance | Aug-07 | Staples Roadway | 30 June 2006 | 5 September 2006 | Unmodified opin |
| Property Finance Securities | Aug-07 | Ernst & Young, Chartered Accountants | 31 March 2006 | 28 July 2006 | Unmodified opin |
| Five Star Consumer Finance | Aug-07 | BDO Spicers Chartered Accountants & Advisors | 31 March 2006 | 25 September 2006 | Unmodified opin |
| LDC Finance | Sep-07 | Sherwin Chan & Walshe | 31 March 2007 | 27 April 2007 | Unmodified opin |
| Beneficial Finance | Oct-07 | BDO Spicers Chartered Accountants & Advisors | 31 March 2007 | 26 June 2007 | Unmodified opin |
| Capital + Merchant | Nov-07 | BDO Spicers Chartered Accountants & Advisors | 31 March 2007 | 7 November 2007 | Unmodified opin |
| Numeria Finance | Dec-07 | BDO Spicers Chartered Accountants & Advisors | 31 March 2007 | 7 November 2007 | Unmodified opin explanation |
| OPI Pacific Finance Ltd | Mar-08 | Sherwin Chan & Walshe | 31 March 2007 | 16 August 2007 | Unmodified opin |
| Boston Finance | Mar-08 | Markhams MRI Auckland | 31 March 2007 | 28 June 2007 | Unmodified opin |
| Lombard Finance | Apr-08 | KPMG | 31 March 2007 | 30 May 2007 | Unmodified opin |
| Belgrave Finance | May-08 | Hayes Knight Audit | 31 March 2007 | 11 July 2007 | Unmodified opin |
| IMP Diversified Fund | Jun-08 | PricewaterhouseCoopers | 30 June 2007 | 28 September 2007 | Unmodified opin explanation |
| Dominion Finance | Jun-08 | BDO Spicers Chartered Accountants & | 31 March 2007 | 13 July 2007 | Unmodified opin |

| Name of Finance Company | Date Failed | Auditor | Financial statement reporting period ended | Last audit report sign date | Audit opinion gi |
|---|---|---|---|---|---|
| | | Advisors | | | |
| North South Finance | Jun-08 | BDO Spicers Chartered Accountants & Advisors | 31 March 2007 | 13 July 2007 | Unmodified opin |
| St Laurence | Jun-08 | KPMG | 31 March 2008 | 21 May 2008 | Unmodified opin |
| Hanover Finance | Jul-08 | KPMG | 30 June 2007 | 29 August 2007 | Unmodified opin |
| Hanover Capital | Jul-08 | KPMG | 30 June 2007 | 29 August 2007 | Unmodified opin |
| United Finance | Jul-08 | KPMG | 30 June 2007 | 29 August 2007 | Unmodified opin |
| Strategic Finance | Aug-08 | KPMG | 30 June 2008 | 29 August 2008 | Unmodified opin explanation |
| Orange Finance | Dec-08 | Grant Thornton | 31 March 2008 | 30 June 2008 | Unmodified opin explanation |
| Mascot Finance | Mar-09 | Martin Wakefield Timaru NZ | 31 March 2008 | 11 June 2008 | Unmodified opin |
| Vision Securities | Apr-10 | Ernst & Young, Chartered Accountants | 31 March 2009 | 9 July 2009 | Unmodified opin explanation |
| Rural Portf Capital | May-10 | PricewaterhouseCoopers | 30 June 2009 | 3 September 2009 | Unmodified opin explanation |
| Rockforte Finance | May-10 | Grant Thornton | 31 March 2008 | 27 June 2008 | Unmodified opin explanation |
| Viaduct Capital | May-10 | BDO Spicers Chartered Accountants & Advisors | 31 March 2009 | 31 August 2009 | Unmodified opin explanation |
| Mutual Finance | Jul-10 | PKF ROSS MELVILLE AUDIT | 31 March 2009 | 15 July 2009 | Unmodified opin explanation |
| Allied Nationwide Fin | Aug-10 | PricewaterhouseCoopers | 30 June 2009 | 30 September 2009 | Unmodified opin explanation |
| South Canterbury Fin | Aug-10 | Woodnorth Myers & Co. Charted Accontants | 30 June 2009 | 30 September 2009 | Unmodified opin explanation |
| Equitable Mortgages | Nov-10 | PricewaterhouseCoopers | 31 March 2010 | 30 June 2010 | Unmodified opin |
| Finance & Leasing | Jan-11 | Martin Wakefield Timaru NZ | 31 March 2010 | 6 July 2010 | Unmodified opin |
| NZF Money | Jul-11 | Grant Thornton | 31 March 2010 | 17 June 2010 | Unmodified opin |

*4.2. Audit Opinions and Disciplinary Actions*

NZICA publishes the details of disciplinary decisions of the Disciplinary Tribunal and the PCC's orders in the Chartered Accountants Journal and its website. [8] However, NZICA does not fully disclose the names of clients. Instead, NZICA only discloses that the auditor failed to exercise due care and diligence when he/she audited Company X. Therefore, only 9 cases of disciplinary actions against individual auditors involved with finance company failures are available from the public resources. The study assumes the remaining auditors do not face disciplinary actions.

Table 4 shows the types of audit opinions and disciplinary actions. From the table, only one auditor who gave an unmodified audit opinion with going concern explanation paragraph was punished by NZICA. The remaining 8 auditors facing disciplinary actions all gave unmodified audit opinions on their clients' last financial statements published immediately before their failures. Nevertheless, there are still 18 auditors who gave unmodified audit reports but do not face disciplinary actions. The last 10 auditors in the sample neither directly gave clean opinions (unmodified audit reports) nor faced disciplinary actions.

The chi-square statistic is 1.9734. The P value is 0.160086. This result is not significant at $p < 0.10$. Therefore, the data do not support hypothesis 1.

Conclusively, Auditors who gave unmodified audit opinions are not more likely to face disciplinary actions than those who gave unmodified audit opinions with going concern explanation paragraphs and modified audit opinions.

**Table 4 Association of Audit Opinions with Disciplinary Actions**

| | Unmodified audit report | Unmodified audit report with going concern explanation | Total |
|---|---|---|---|
| Disciplinary action | 8 | 1 | 9 |
| No disciplinary action | 18 | 10 | 28 |
| Total | 26 | 11 | 37 |

[8] The website is available at: http://www.nzica.com/dt.aspx (accessed 15 July, 2015).

Table 5 summarizes the types of negligence or offence and the disciplinary actions against individual auditors. The Code of Ethics is based on a number of Fundamental Principles. Quality Performance, as one of the Fundamental Principles, prescribes that members of NZICA must exercise due care and diligence when performing their professional work, which is known as Rule 9 of the Code of Ethics (NZICA, 2014). Also, members must carry out their professional obligations in accordance with the relevant technical and professional standards appropriate to the work, which is known as Rule 11 of the Code of Ethics (NZICA, 2014).

**Table 5 Types of Negligence or Offence and The Punishments on Individual Auditors**

| | | | | In breach of the Code of Ethics | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Name of Finance Company** | **Date Failed** | **Audit Firm** | **Auditor** | **Rule 2** | **Rule 7** | **Rule 9** | **Rule 11** | **Be censured** | **b** |
| National Finance 2000 | May-06 | O'Halloran & Co, Chartered Accountants | Bruce Arnold Mincham & Michael Derek Wood | Y | | Y | Y | Y | |
| Nathans Finance | Aug-07 | Staples Roadway | Christopher John Hughes | | | Y | Y | Y | |
| Beneficial Finance | Oct-07 | BDO Spicers Chartered Accountants & Advisors | Peter John McNoe | | | | Y | Y | |
| Beneficial Finance | Oct-07 | BDO Spicers Chartered Accountants & Advisors | Robert Scott Innes-Jones | | | | Y | Y | |
| Capital + Merchant | Nov-07 | BDO Spicers Chartered Accountants & Advisors | Peter John McNoe | | | Y | Y | Y | |
| Boston Finance | Mar-08 | Markhams MRI Auckland | Craig Paull Hemphill | | | Y | Y | Y | |
| Belgrave Finance | May-08 | Hayes Knight Audit, Chartered Accountants & Business Advisors | Colin Bruce Henderson | | | | Y | Y | |
| Hanover Finance | Jul-08 | KPMG | Bill Wilkinson | | | | Y | Y | |
| Mascot Finance | Mar-09 | Martin Wakefield Timaru NZ | Richard John White | | Y | Y | | Y | |
| South Canterbury Fin | Aug-10 | Woodnorth Myers & Co. Charted Accontants Timaru | Byron John Watson Pearson | | | Y | Y | Y | |

In the sample, the majority of the punished individual auditors are in breach of Rule 9 and Rule 11 of the Code of Ethics. For example, Bruce Arnold Mincham and Michael Derek Wood, auditors of National Finance 2000, failed to exercise due care and diligence in breach of Rule 9 of the Code of Ethics because they failed to report in writing to the Covenant Trustee Company breaches by the audit client of its trust deed. [9] Another auditor, Craig Paull Hemphill issued an unmodified audit opinion on Boston Finance Limited's financial statement for the year ended 31 March 2007 when more than NZ$6 million reported interest received in the cash flow statement had not been adjusted to reflect the capitalized interest on loans. Therefore, he breached Rule 9 of the Code of Ethics since he failed to exercise due care and diligence in his assessment of Boston Finance Limited's 2007 financial statement. [10] Meanwhile, he failed to fully comply with the Institute's Technical Standards in breach of Rule 11 of the Code of Ethics since he did not comply with Auditing Standards that require auditors to establish and adhere to quality control procedures and to base the audit opinion on sufficient appropriated audit evidence. [11]

Such common punishments for auditors who breached the Rules of the Institute of Chartered Accountants of New Zealand are censure, membership suspension, and monetary penalty. For instance, pursuant to Rule 21.31 (k) of the Rules of the Institute of Chartered Accountants of New Zealand, the Disciplinary Tribunal ordered that Bruce

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[9] Disciplinary Tribunal of New Zealand Institute of Charted Accountants published its final decision of disciplinary actions against Bruce Arnold Mincham and Michael Derek Wood on June 30, 2008. The file is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2008 (accessed 25 June, 2015).

[10] Disciplinary Tribunal Decision on Craig Paull Hemphill is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2011 (accessed 25 June, 2015).

[11] The decument is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2011 (accessed 25 June, 2015).

Arnold Mincham and Michael Derek Wood, who were auditors of National Finance 2000, be censured. [12] Moreover, in accordance with Rule 21.33 of the Rules of the Institute of Chartered Accountants of New Zealand, Craig Paull Hemphill was required to pay NZ$19,550 in respect of the costs and expenses of the hearing before the Disciplinary Tribunal. [13]

The disciplinary actions against individual auditors by NZICA effectively serves as one way to motivate auditors to explore manipulation on financial statements by management in order to strictly comply with the auditing and professional standards. Otherwise, if any member pleads guilty, penalties such as censure, suspension of license, or monetary penalty may be imposed on the member. If so, it will impact on the member's future careers.

*4.3. Disciplinary Actions and Auditor Turnover*

Hypothesis 2 assumes that there is a positive relationship between disciplinary actions and client loss. To test Hypothesis 2, I collect data on auditor turnover of New Zealand public listed companies for the period 2006-2013. I choose this period because the financial companies in New Zealand collapsed down from 2006 and the 2013 annual reports of public listed companies are the latest ones that are available from Company Research Database of Auckland University of Technology Library.

The database includes annual reports of 154 public listed companies. 41 companies started their businesses after 2006. To test the association of auditor turnover and

[12] Disciplinary Tribunal of New Zealand Institute of Charted Accountants published its final decision of disciplinary actions against Bruce Arnold Mincham and Michael Derek Wood on June 30, 2008. The file is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2008 (accessed 25 June, 2015).

[13] The document is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2011 (accessed 25 June, 2015).

disciplinary actions against auditors involved with finance company failures since 2006, the sample only comprised of companies that continually operate in business from 2006 until 2013. This leads to a final sample of 113 New Zealand public listed companies for this period. Because some public listed companies started their business after 2006, the sample finally consists of 877 firm-years. The independent variable is disciplinary action against the auditor in year t-1 and no disciplinary action against the auditor in year t-1. And the dependent variable is auditor turnover in year t and no auditor turnover in year t.

The statistical results are shown in Table 6. In the sample, only 3 clients changed their auditors in year t when their auditors were punished by NZICA in year t-1. The chi-square statistic is 2.1656. The P value is 0.14113. This result is not significant at $p < 0.10$. Therefore, there is no significant relationship between disciplinary actions against auditors and auditor turnover. Hypothesis 2 should be rejected. In other words, auditor turnover is not causally related to the occurrence of disciplinary actions against auditors.

**Table 6 Association of Disciplinary Actions in Year t-1 with Auditor Turnover in Year t**

| | Disciplinary action against the auditor in year t-1 | No disciplinary action against the auditor in year t-1 | Total |
|---|---|---|---|
| Auditor turnover in year t | 3 | 30 | 33 |
| No auditor turnover in year t | 33 | 811 | 844 |
| Total | 36 | 841 | 877 |

Moreover, I test the relationship between finance company failures in year t-1 and auditor turnover in year t within the same sample, 877 firm-years. The independent variable is finance company failure in year t-1. And the dependent variable is auditor turnover in year t.

Table 7 shows the statistical results. From the table, the auditors who involved with and did not involve with failed finance companies in year t-1 experiencing removal by

clients in year t are 6 and 27, respectively. The chi-square statistic is 3.9258. The P value is 0.04755. This result is significant at $p < 0.10$. While there is no significant relationship between disciplinary actions and auditor turnover, a statistically significant relationship is observed between finance company failure and auditor turnover.

**Table 7 Association of Finance Company Failures in Year t-1 with Auditor Turnover in Year t**

| | Finance company failure in year t-1 | No finance company failure in year t-1 | Total |
|---|---|---|---|
| Auditor turnover in year t | 6 | 27 | 33 |
| No auditor turnover in year t | 166 | 678 | 844 |
| Total | 172 | 705 | 877 |

## 5. Additional Analyses – Litigation Effect on Auditors

In addition to disciplinary actions by the NZICA Disciplinary Tribunal and auditor turnover, litigation against the auditor also serves as an incentive mechanism for the auditor (Palmrose, 1987). Further, prior research finds that auditors who audited failed companies were sued after the failure (Palmrose, 1987). Therefore, this dissertation examines whether any auditor who audited the financial statements of the failed finance companies were sued after the failures.

With regard to auditor liability regimes, auditors are subject to either joint and several liability or proportionate liability. Under joint and several liability, the plaintiffs are able to recover full loss from any defendant, including an audit firm, regardless of the level of fault of the party; however, under proportionate liability, each defendant is held liable only for and must pay a proportionate share of the loss to the extent of relative fault determined by the judge or jury (Johnstone, Gramling, & Rittenberg, 2014, p. 116).

In New Zealand, for punishment, the rule of joint and several liability, under which each defendant found liable for the same loss or damage will be liable for the full extent of the loss or damage, is the primary liability rule since 1998 (Law Commission, 2012, chapter 2). In the past few decades, the rule has been the subject of considerable extensive discussion and debate in the wake of the leaky buildings crisis and the Global Financial Crisis (NZICA, 2013). Law Commission (2012, chapter 5) raises the question that whether the current rule have increased the potential liability of auditors, who sometimes might be the only defendants with funds available to meet a claim, to such an extent that some sort of limitation on their liability is justified. NZICA (2013), the professional body for Chartered Accountants in New Zealand, strongly opposes this rule because it is unfair for deep pocket defendants. NZICA's preferred approach is same as the one used in Australia: proportionate liability with the additional protection of

statutory capping of professional liability, which provides more safeguards for professionals and still protects public interests (NZICA, 2013). Otherwise, the unlimited liability negatively influences the attractiveness of the audit profession.

Combining suggestions from a number of groups such as local government, members of the accounting and legal professions, insurance firms and other professional advisers, some modifications are made to alleviate full application of the joint and several liability regime although the system of joint and several liability is still retained (Law Commission, 2014).

In prior audit litigation literature, negative financial information such as bankruptcy or significant client losses motivates the initiation of an error search by potential plaintiffs (St Pierre & Anderson, 1984). However, business failures have no significant effects on the incidence of litigation against the public accountants (Palmrose, 1987). Not surprisingly, management frauds are found to be highly associated with litigation cases alleging auditor failures and these management fraud cases constitute the majority of cases with large auditor payments (Palmrose, 1987). Specifically, auditors are more likely to be held responsible for failing to detect more frequent financial statement frauds (e.g., premature revenue recognition, overvalued assets and undervalued expenses/liabilities, and fictitious revenues) and fictitious transaction and event frauds (e.g., fictitious revenues, fictitious assets and/or reductions of expenses/liabilities, and fictitious related party sales) (Bonner et al., 1998).

Moreover, the probability of auditor litigation is positively related to higher abnormal accruals (Heninger, 2001), which acts as one of the factors influencing earnings quality (Dechow & Schrand, 2004). Furthermore, Palmrose (1988) assumes that litigation, a consequence of audit failures, is costly, and that higher quality auditors have incentives to avoid audit failures, and, thus, litigation costs, as well as costs associated with professional and regulatory punishments and with decreased reputation

for quality of service. In the subsequent studies, Khurana and Raman (2004) conclude that litigation exposure provides an incentive to Big 4 auditors in the U.S. for offering higher quality audits, and Lennox and Li (2014) demonstrate that misstatements of audited financial statements are less frequent with audit firms having past experiences of litigation.

Most of prior research on litigation effect on auditors in the literature is U.S.-based. However, the U.S. is much more litigious than other Anglo-American countries such as New Zealand (e.g., Baginski, Hassell, & Kimbrough, 2002; Seetharaman, Gul, & Lynn, 2002). Nevertheless, this difference in auditing litigation environment motivates the current research to examine litigation against auditors in less litigious country, New Zealand.

The first case analyzed here is Capital + Merchant Finance (CMF). CMF collapsed down in November 2007, owing retail investors NZ$167 million. The Official Assignee as liquidator for CMF brought a claim seeking unspecified damages as well as interest and costs, arguing that BDO Spicers who audited CMF's financial statements for the years to March 2006 and March 2007 failed to identify the wrongdoings of the company's accounts and failed to ensure a true and fair view of its prospectuses.

Specifically, the assets of CMF were overstated in its financial statements. The auditors did not adequately assess the booking value of goodwill of NZ$8.6 million in the group financial statements. Moreover, the auditors did not perform the audit with sufficient professional skepticism to ascertain the carrying value of the investment in Numeria Leasing of NZ$8.3 million in the Parent financial statements when Numeria Leasing had a negative carrying value of tangible assets. Furthermore, the auditors failed to obtain sufficient appropriate audit evidence to ascertain that the mortgages and

loans of NZ$180.2 million were recoverable. [14] However, NZ$73.7 million of CMF loans subject to insurance policies "were not covered by such insurance policies".

BDO Spicers issued unmodified audit reports for CMF's financial statements for the years to March 2006 and March 2007. Nevertheless, the auditors did not sufficiently document evidence to support the audit opinion. Therefore, the auditor's negligence contributed to huge losses for investors in CMF as the financial statements of CMF are misleading. A High Court case management conference was held on October 30 2012. Finally, BDO Spicers agreed to pay NZ$18.5 million to settle the claim in 2014 and this was the first recovered money to repay retail investors (Hunter, 2012).

The second case discussed is Belgrave Finance (Belgrave). The case arose from the liquidation and receivership of Belgrave. Belgrave collapsed down in May 2008, owing investors more than NZ$20 million. Later on, the auditing firm Hayes Knight Audit as one of the defendants was sued by Belgrave because the auditors negligently carried out its 2007 audit report. The auditor gave an unmodified audit opinion of Belgrave's financial statement for the year to March 2007 but they do not obtain sufficient audit evidence to support their assessment of, for example, the recoverability of mortgage advances. [15] Belgrave claimed that if the auditors carefully carried out the audit, then Belgarve would not suffer loss due to advancing about NZ$3.8 million funds and receiving about NZ$4.9 million deposits from Debenture Stockholders that it was unable to repay. However, the auditors denied the claim because they held the view that the alleged losses were too far removed from the alleged negligence.

Referring to a leading New Zealand case, *Sew Hoy & Sons Ltd (in Receivership and in Liquidation) v Coopers & Lybrand*, the High Court held the view that it is tenable for

[14] The document is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2012 (accessed 25 June, 2015).

[15] The document is available at: http://www.nzica.com/Technical/Professional-conduct-and-complaints/Recent-disciplinary-decisions/Disciplinary-decision-archive.aspx#2011 (accessed 25 June, 2015).

Belgrave to argue that the negligence of auditors caused Belgrave to continue in business and thereby suffer losses. If the auditors found out the difficulties in business, Belgrave could otherwise change the way it traded to avoid the losses or even bankruptcy. If the auditors did not ascertain the health of its 2007 financial statements, Belgrave would not issue its 2007 prospectus.

From this case, it is important for the High Court to consider which type of losses should be attributed to auditors. Under the current litigation regime - joint and several liability- in New Zealand, it is unfair if the auditors are held responsible for all losses (Fitzgerald & McNeely, 2012).

Carcello and Palmrose (1994) provide evidence that the audit firms with no litigation present much higher occurrence of modified reports than the audit firms with litigation and that the issuance of modified reports results in the highest incidence of dismissal (no payments to plaintiffs) and the lowest payments by auditors. Both of the auditors of analysed cases gave unmodified audit opinions and then were sued for failing to exercise due care. Moreover, they were required to pay monetary penalties for their negligence when performing audits of client companies.

However, the excessive litigation risks borne by New Zealand auditors have been a topic of much debate. The unlimited liability created by the joint and several liability regime negatively influences the attractiveness of the audit profession because no one would like to choose a highly risky occupation.

As the failed finance company cases begin to come before the Courts, it is necessary to review the current liability regime. It is important for governor and policy makers to understand the effect of current liability regime on individual auditors and auditing profession.

## 6. Conclusions

The primary focus of this study was to examine whether auditors who gave unmodified audit opinions are more likely to face disciplinary actions than those who gave unmodified audit opinions with going concern explanation paragraphs and modified audit opinions. This was motivated by the opportunity to combine the considerable literature on the usefulness of audit opinion and disciplinary actions against auditor literature.

Since unmodified audit opinions on failed companies are more likely to indicate audit failures than unmodified audit opinions with going concern explanatory paragraphs, auditors giving unmodified audit opinions on failed companies are more likely to have penalties (e.g., censure, suspension of license, or monetary penalty) on them than auditors issuing going concern reports. The failures of finance companies in New Zealand since 2006 provide a unique opportunity to examine the consequence of corporate failures for auditors.

67 New Zealand finance companies failed during 2006-2012. Out of these 67 failed companies, annual reports of 30 finance companies are not available on the website of Companies Office New Zealand. The final sample is comprised of these 37 failed finance companies. The sample size is small but this small size is due to the small number of finance company failures in New Zealand. The auditors of 37 failed finance companies universally gave unmodified audit opinions in their last audit reports and only 11 of 37 auditors' reports presented going concern explanation paragraphs. In the sample, 9 out of 37 auditors faced disciplinary actions, with only one auditor giving unmodified audit opinion with going concern explanation paragraph. Based on the sample, the study concludes that there is no significant relationship between unmodified audit opinions and disciplinary actions.

Furthermore, the study examines the association of disciplinary actions against auditors with auditor turnover. By examining 877 firm-years of 113 public listed companies in New Zealand, the study finds that there is no significant relationship between disciplinary actions against auditors and auditor turnover, which is consistent with prior studies. Moreover, I test the relationship between finance company failure in year t-1 and auditor turnover in year t within the same sample. The study finds that there is significant relationship between finance company failure and auditor turnover because the statistical result is significant at $p < 0.10$.

Litigation effect has severed as another incentive motivating the auditors to strictly follow the International Auditing Standards and the Code of Ethics. The two cases analysed in this study are consistent with prior research. The analyses in the study further confirm that audit firms issuing modified reports are less likely to have litigation and the issuance of modified reports is more likely to result in the incidence of dismissal (no payments to plaintiffs).

Under the primary litigation regime - joint and several liability - in New Zealand, each defendant, including an audit firm, found liable for the same loss or damage will be liable for the full extent of the loss or damage. This current liability rule negatively affects the attractiveness of the audit profession because auditors bear excessive litigation risks. As the failed finance company cases begin to come before the Courts, it is necessary for governor and policy makers to review the current liability regime.

There are some limitations of this study. First, the findings may be too conclusive. Hypothesis 1 assumes the auditors of the remaining 28 finance companies do not face disciplinary actions because of the limitation of data source. Meanwhile, this assumption has an impact on the test of hypothesis 2 because disciplinary action serves as the independent variable in the chi-square test. Further studies could be conducted when more disciplinary decisions are available from the public resources. Second, there

are only two cases analysed in this study. Although the result is consistent with prior research, it is still problematic to generalize the finding to all litigation cases of auditors involved with finance company failures in New Zealand. Future studies could collect more details of litigation cases to validate the generalization of prior litigation literature in business environment of New Zealand.

The results of this study will be of interest to practitioners as they look for ways to mitigate their litigation risk, and for standard setters and law makers as they continue to examine revision to auditing standards and liability regimes. This study complements and extends the literature on audit opinions and disciplinary actions. By investigating whether auditors faced any negative consequences of finance company failures in New Zealand, the study will fill the gap in the literature on the impacts of corporate failures on auditors. It will also shed light on the current debate on the auditor liability regime in New Zealand.

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