

# POSTGRADUATE SEMINAR SERIES

## Research Findings Seminar

**Topic Title :** **Two Essays on the Tax Consequences of Auditor Litigation Risk: Evidence from Quasi-Natural Experiments**

**Presenter :** **Mr OWUSU Felix**  
PhD Student of Accountancy

**Abstract :** In the United States, auditors have legal liability to third parties under federal securities law and state common laws, which vary in the degree of liability. Whereas auditors are liable to security traders for fraud under the federal securities law, they are liable for ordinary negligence under common law. Using a sample of company-year observations from 1982 to 2015, I examine the implications of the adoption of common law statutes on audit client tax outcomes. My thesis consists of two essays. The first one examines how the staggered adoption of these common law principles that increased third-party auditor legal liability affects corporate tax avoidance as measured by GAAP effective tax rate (ETR) and cash ETR. My analysis shows that increasing auditor liability lowers tax avoidance among treatment companies after accounting for other factors that affect tax avoidance. To strengthen this finding, I also examine New Jersey and California, which decrease auditor litigation risk during the sample period, and confirm that firms in these two states have higher tax avoidance. Further, I find that the effect is stronger for financially constrained companies, companies in high-risk industries, companies with high ex-ante tax avoidance in their state-industry group, and clients of Big N auditors. My second essay investigates auditors' role in managing corporate tax risk. I find that higher auditor litigation risk is associated with a decrease in tax risk after controlling for other determinants. Further analysis reveals that this reduction is brought about by an improvement in tax accruals quality. I conduct separate tests involving New Jersey and California, which reduce auditor litigation risk during the sample period, and find that firms in those two states experience an increase in tax risk. In additional analyses, I find that auditor litigation risk reduces auditor provided tax service (APTS), and clients' tax-related restatement. However, it increases auditor industry expertise, auditor reporting of tax-related internal control weaknesses, and IRS attention. Overall, the findings suggest that elevating third-party auditor legal liability improves the quality and reliability of the tax information reported by audit clients. By responding to calls for more research on the net benefit of increased auditor litigation risk, this study contributes to the nascent tax risk, tax avoidance, and APTS literature from the perspective of auditor litigation exposure. It addresses the identification problem between auditor incentives and corporate tax outcomes and explains the moderating role played by the former. My study implies that auditors have litigation-avoidance incentives to ensure the production of quality and reliable tax information. Lastly, it informs ongoing debates over increasing liability to third-party claims to incentivize auditors to perform high-quality audits.

**Date :** **6 April 2023, Thursday**  
**Time :** **10:00 am – 11:30 am**  
**Venue :** **SEK104, 1/F, Simon & Eleanor Kwok Building**  
**Language :** **English**



\*\*\* All are Welcome \*\*\*