

**Litigation Risk, Auditor Conservatism and An Overview of Turkey Characteristic**Fatih Şentürk^aÖzgür Özkan^b

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Abstract

In case of the occurrence of uncertain situations regarding the future, the investor is expected to assume that he is in a risky situation and act in a rational way. In this way, the investor will have been prudent and protected his capital. Auditor Conservatism is an approach that aims to make a more conservative audit by foreseeing a high audit risk for the financial statement disclosures of the company audited and thus protect the capital, creditors and investors. It is a likely outcome for the investor to encounter with the litigation case due to the possible presence of revenue losses that may be experienced and negatively affect the investment decisions of the third parties who will use the tables on which the auditor will express an opinion. Therefore, auditors will want to set a high degree of audit for possible inconsistencies and choose the secure option against the case risk in order to protect the reputation of himself and the audit company against the possibility of audit failure by displaying a conservative approach. In this study, the relationship between the litigation risk and the auditor's conservative approach will be examined and these concepts will be comparatively assessed in terms of the accounting audit procedures.

1. Introduction

Those falling into disagreement will have to make some decisions during the settlement of the dispute. Perhaps the most important of these decisions is that they cannot solve the disagreement with reconciliation. The parties will negotiate either directly or with the help of a mediator in order to reach a consensus, and if they understand the options they can choose, they will make the best decision for their own benefit. Decision analysis or risk analysis is a systematic approach to making the right decision. This method provides for the prediction of what will be the most appropriate solution to the problems and provides a preliminary understanding of the outcome. In fact, this can be regarded as a necessity for act of prudence.

Decision analysis, which is also used to simplify the complexities that are encountered by business management in the process of taking decisions and to eliminate uncertainty, has recently been used as an option to facilitate decision making in complex litigations. The decision analysis term refers to the decision tree analysis showing what decisions are made and the uncertainties in them, in the form of trees. Therefore, the method is a systematic method of thinking that helps to find the right decision. This method is also used in the financial and accounting profession, especially as an intermediary in discrepancy cases.

The concept of risk society theory, which has emerged in relation to advanced capitalism in the developed countries of North America and Europe, is based on the assumption that the next generation will be even worse, especially in times of economic crisis, since people cannot survive in prosperity. In a modern risk society, risks can now become more global, ceased to be personal. Today's accounting and auditing professions are now faced with the possibility of a failure not only due to their own special operations but also because of the work and transactions carried out by another professional member on the other side of the country and around the world.

Thus, accounting is now influenced not only by internal sourced risks but also by external sourced risks and developments, at the same time it is confronted with the decisions taken by the risk community and the reactions they have given. The existence of these situations may increase the audit risk of the information generated by the accountant and may cause the traditional audits to be insufficient to value the entity's assets / resources. In case of uncertain future conditions, the investor must make a rational decision and act accordingly,

assuming that it is in a risky condition economically. In this way the investor has been cautious and will keep his capital.

The auditor's conservatism is an approach that aims to provide more conservative supervision by foreseeing a high audit risk for the audited company's financial statement declarations, thus protecting the users of such financial information. However, if these financial information users are damaged due to the investment decisions they make, it is probable that a court action against the auditor's opinion is filed. For this reason, the auditor will set a high audit risk for a possible inconsistency and will adopt a more conservative approach to avoid the risk of auditing failure of both the company and the financial information users and to choose the option that is safe against the risk of litigation in order to protect its own reputation. In this study, the relationship between the risk of discrepancy and the conservative approach of auditors will be examined and an assessment will be made of these concepts in terms of accounting audit activities.

2. Litigation Risk and Auditing in Modern Risk Society

Audit failure may have a complex structure depending on the interaction of auditing company employees and the conditions of the audited firm. In case of doubtful accounting records and audit decisions, the audit company will have to find a legal solution. Here, the most important support of the audit company is "*reasonable assurance*". If the determination of suspicious accounting records remains within reasonable limits of assurance, the audit firm will secure itself. In his study Palmrose (1988) suggested that four steps should be followed to resolve disputes over audit services.

- Phase One: Causes of Loss
- Phase Two: Preliminary Studies
- Phase Three: Legal Actions
- Phase Four: Final Decision

In research conducted by Latham and Linville (1998) and Kinney (1993) they suggest a general model that reflects the risk of litigation that can be used in a particular audit task. According to this model, it can be expressed as *Discrepancy (litigation) Risk = f (Audit-Company contribution, Audit-Customer contribution, Others)*. This model expresses the likelihood that, whatever the ultimate judgment of the litigation risk, the audit firms will

have legal rights as a result of the relationship with the client. In Watts (2003) study "*Conservatism in Accounting Part I: Explanations and Implications*", he has determined that there is a relationship between the audit firm's fee for service and the risk of incompatibility. On the other hand, there was no correlation between the number of auditors working in the audit company, the structure of the auditor and the nature of the audit industry and the risk of incompatibility.

It is possible to define the audit activity as a process of reducing the risk of financial users. Audit can be perceived as a risk-based approach. During the initial phase of the audit, all companies are assessed for their business risk and participate in the assessment of all business locations and organizational structures including today's economic environment. Although the methods to be used can vary from firm to firm, the use of the entire risk model includes not only the control risk but also assessment of the risks involved. This inherent risk assessment is widely applied in various industries. Where there is less than a significant risk, the auditor will use the existence of the self-assurance to reduce the amount of analytical and other important procedures applied to that particular area (Schmidt, 2012:1036).

Modern supervision of large audits by leading auditing firms is becoming increasingly complex and technologically dependent. Technology can be used in two ways in the process of audit activity. The transfer of information, communication and documentation between the audit firm and the client is mostly provided in electronic form. Secondly, technology provides more information on client risk factors, business processes and strategic analyzes. Finally, objective evaluation of evidence is still necessary. Auditors should still use professional judgment, but this is sometimes insufficient. The responsibilities of the auditor will continue to be an important issue, no matter what changes are made in the audit methods. Auditors may not be able to predict adequately the risk of auditing to escape responsibility (Green, 1999:343).

If the auditors are willing to reduce their responsibilities, the risks of financial users will increase. By limiting their responsibilities, auditors can expose users to a greater information risk. Principles of the audit activity should be reviewed. If auditors are to take less responsibility, it will be questioned why audits and auditors are required for companies. If auditors only want to reduce their bids during negotiations for smaller

audits, privileged rights can be rethought. If auditors fail to provide or do not want to provide certain guarantees regarding the future of the client, the likelihood of other units providing this service should be considered. As a minimum, we can expect more debate about uncertain side effects and some conflicts about the benefits of well-tuned global strategies for the professions (Green, 1999:344).

Audit responsibility is not a new problem and is being discussed for a long time. However, the risk of discrepancy (litigation) has become increasingly prevalent throughout the 1990s. Due to the fact that big auditing firms do business on the global scale, there is a "*liability assurance market*" on the international platform. The audit strategy is similar in many places. The critique of the documents used by the auditor in all cases proves the consistent model of the arguments which are dependent on the repeated instances of several times. The capital market pricing will be effective in the audit requests of the established companies and in the auditor fee decisions of the companies. On the other hand, the attitude of the auditor against the risk of litigation regarding the auditor fees determines the auditor's audit supply. As a result, audit supply and demand determines the auditor conservatism and audit quality. The following conclusions can be drawn as a result of this relationship (Lu and Hareh, 2009:4)

- Low operating risk causes the auditor to act aggressively, while high operating risk causes the auditor to behave conservatively. There is a positive relationship between the firm's business risk and conservatism.
- If conservatism is applied, the increasing client impact on the auditor affects audit quality. If the auditor acts aggressively, the increasing client pressure on the auditor damages the quality of audit.
- The auditor's pressure on the client is always worse than what is commonly known. If the auditor is a conservative, it is determined that there is client pressure.

In these circumstances it is appropriate for the audit industry to claim that auditing is more risky. But something has to be done to guide the problems of audit firms. We must expect that the expectation of auditors will change as the expectations of the economy and users have changed. Despite all socio-economic changes, auditors continue to maintain a

standard view of financial conditions that are less changed earlier. In this context, for financial information users, the independence of the auditing and auditor are of great importance.

Independence in the audit process has been one of the main principles of auditing. There are two levels in which auditing independence is defined. Firstly; it is independence of the process or independence of the approach. The independence of the auditor means that the auditor has the expertise to act in an impartial manner while explaining the real situation of an account and will do so without affecting the client. At the second level, which is often referred to as independence of appearance, the decisions that financial information users make are likely to depend on whether the auditor is likely to be independent. Since financial information users cannot observe the movements of the auditor, the reliance on independence depends on the auditor-client relationship (Green, 1999:345).

3. Conservative Approach to Accounting and Precautionary Principle

Conservatism or cautiousness in accounting is important concept underlying financial information produced by the accountant. In accordance with this concept, enterprises should choose a cautious approach when determining income and expenses, but should not make any accounting until the time of finalization for possible income and profits, they need to set aside the provision for possible expenses and losses. In the shortest possible time, he proposes to take action for items that constitute the passive side of the balance sheet. This important feature of accounting provides useful information to parties when agreements are made between managers, shareholders and banks. Auditors require clients to make no misrepresentations in the financial statements. For this reason, auditors have an important expectation from clients that the financial statements to be audited should bear an appropriate level of conservatism.

The precautionary principle is derived from the conservatism approach that is fundamental to accounting. The conservatism approach involves the protection of the capital and the protection of the creditors. Because, in doubtful situations, the trader should make his own decisions, assuming he is poorer, and act on this assumption. In this way the trader will act cautiously and prudently and will protect his capital. The protection of the capital will bring both continuity and protection of the rights of the buyers. In this context, precautionary principle tries to satisfy the expectation of both internal and

external users in a balanced manner, and it coincides with the principle of the continuity of the business. The consequences of the conservatism approach will be achieved by using the precautionary principle to protect the interests of the creditors and the capital. Precautionary principle consists of four principles: (Kutlan, 2003; 2)

Principle	Realization Policy	Foresight Policy	Policy for valuation with the lowest	Policy for valuation with the
Doctrine	The Income Statement only orders the receipt of realized	It stipulates that possible costs should be taken into	Assets of the balance sheet will be evaluated with the lowest value if	The liabilities of the balance sheet will be valued at the highest of the

Various scientific investigations have been carried out on the role of corporate reputation or the pressure of litigation in the audit activity processes where the audit conservatism and precaution are predominant in the last period. One of these studies, in the study *“Litigation Risk and Auditor Conservatism: A UK-US Comparison”*; Li, Beekes and Peasnell (2009) have found that large audit firms are more conservative than others, given consistency in the first place. In the study, the authors examined the levels of conservatism in the two countries (England and the United States) and found that these levels differed. They have determined that there is more discrepancy (litigation) risk in the United States of America and the less in the UK. Because laws such as the United Kingdom and the United States demonstrate the development of a legal system, the laws protect the rights of shareholders having little share against the public pressure that has arisen from the management of companies. In addition, in the study it was determined that the pressure of the lawsuit for auditors is higher in the United States than in the United Kingdom. Some of the important results related to the subject in the study are as follows (Li, Beekes, Peasnell, 2009:3)

- A comparative analysis of the levels of conservatism in the United States and in the UK has been conducted and it has been determined that UK is as good as the United States when testing the relationship between auditor conservatism and the company's profits.

- Despite the fact that audit companies' reputation and effectiveness are excluded, the importance of the litigation risks that audit firms may face when addressing the auditor's appropriate level of conservatism is mentioned and this matter is highlighted.
- As a result of the examinations, the positive relationship between the auditor's dominance area and the conservatism ratios determined that the auditors of the branded audit firms differed between the two countries as a result of the nature of the companies that the clients had in addition to conservatism.

The study found no evidence that auditors working in large audit firms were more conservative in the two countries than in the other after the level of financial stress in the audit was controlled. However, in the statements prepared by the client pressure, it is considered that there is an institutional difference between the United Kingdom and the United States. While this does not make a visible difference in the UK, auditors from large auditing firms in the US have recently expressed the view that they are choosing conservatism that will allow them to show more profits for high-rated borrowed clients.

3.1. The Nature of Auditor and Accountant

Statements of financial position provide information to shareholders and potential investors about the company's future expectations and management's performance. The auditors thus reveal deficiencies and material disclosure mistakes that would cause the shareholders to misinterpret the financial statements. In addition, these declarations are used in the performance premium contracts to be made with the bank. For this reason, it is possible to expect the managers to condition their activities in order to keep the performance premium high and to report the company's earnings as it does to their business. The role of an auditor is to provide guarantees for the protection of interests of shareholders and banks and to ensure that financial statements are prepared sincerely. Since companies can logically change direction of accounting statements of financial statements or the way they deal with certain items together with auditors, perhaps the nature of the client's earnings is now directly influenced by the auditor (Li, Beekes, Peasnell, 2009:3).

Branded audit firms are identified with a much better audit quality than their reputation holds. Well-known audit firms have more credits and less difficult status at risk than smaller audit firms due to their corporate identity. It is therefore necessary to emphasize that large audit firms are very rigorous in conducting their business and are exposed to a lower pressure threshold than small audit firms when declaring their opinions on structuring problems to clients. Findings from studies in the literature on the subject have shown that major audit firms are less tolerant and offer better accounting and auditing qualities.

For example, Becker, DeFond, Jiambalvo and Subramanyam (1998) have linked auditors of major audit firms to optional low interest rate delays. In addition, large auditing firms reduce the threshold level for the renewal of audit reports where the audit risk level is high. For example, large auditing firms prefer to regulate audit reports once again for companies with high level accounting accruals. Therefore, if there is uncertainty about the performance of companies in the earnings of the companies, a higher auditing level is desired by the major audit companies. Similar movements can be expected from the auditors who will follow to increase the conservatism of the demands that the timing of bad news changes according to good news.

3.2. Profit Timing and Conservatism in Accounting

This is important for the conservatism and coherence of the auditor's report as it is of great importance in terms of timing and quality in the reporting of profit information to financial users at the end of the period. If firms do financial reporting on time, they can improve investment decisions to be taken by these shareholders. This allows an effective review of the financial situation of the company without loss of time for managers and auditors (Ball, Kothari, Robin, 2000:5).

It is expected that there is a correlation between the profitability of the businesses and the good and bad news about the business. Bad news is examined deeply within the time specified under accounting precaution. This demonstrates that good news is a profit-enhancing effect than evil. The managers strive to reveal bad news for the time specified in order to protect themselves against potential future lawsuits. On the other hand, the incentive bonuses paid by the company will help increase the performance bonus for the manager's personal benefit, thereby enabling managers to speed up good news and delay

bad news. However, a significant effect of the pressure from the auditor of the company during the auditing process is that the conservatism in the published financial statements exceeds the level of the operating profits (Skinner, 1994:5).

3.3. Client-Auditor Negotiations

In negotiations between the client and the audit firm regarding the audit of financial statements, the client prefers the financial tables with high profits than financial tables with low profits. The audit firm would prefer to reflect the true situation as accurately as possible. Negotiations are based on mutual agreements structured in a regular supervision. Auditors review the financial statements of the company, call evidence to verify the presentations in the financial statements, or refute the claims of the management's financial statements. The traditional view is that the auditor may be willing or unwilling to have a positive view of the issue on the management statements. However, if the auditor is reluctant to hold a positive opinion, he will explain the reasons and will give a positive opinion if he finds the presentations of the management appropriate. As a result, the company may accept both of the proposed revisions. Whether or not agree on same thing (and the conditional opinion report); if the client and the audit firm cannot agree on the financial statements, the client either submits the job to a new audit company or may request the audit firm to start by correcting the first impressions of the audit within the rules (Lu and Hareh, 2009:4).

If the client and the auditor agree on a cost sharing arrangement, there may be some disagreement between the parties. The most important of these, the audit fee, relates to the costs and details of the investigation. For solution, the auditor wishes to improve the offer made to the customer to some extent. The most useful way to achieve this is to share the details of the expenses of an extended audit with the parties. Thus, optimal cost sharing is achieved by establishing a balance between both the auditor and the client benefits and costs. It does not matter that upon agreement, the contract will be structured with the advantage of one side of the contract with the other. The auditor is extremely conservative when client paying audit for an extended time. When the client pays, the auditor demands a lot of things. The auditor-client precaution in the cost sharing contract is at the highest level (Lu and Hareh, 2009:6).

An auditor has a vital role in demonstrating the nature of the entity's accounting information and branded audit firms want to be associated with a higher quality audit. A fiasco on auditing is that they will want to know the consequences or the cost to them, since they have a lot to lose and a major loss of reputation (Palmrose, 1988:57). Therefore, reputation theory recommends that well-known large auditors be well-informed about the statements of the client's financial statements in order to maintain their reputation in the market and reduce the likelihood of audit failure, and to be conservative in the process of conducting the audit. Auditors therefore expect to be able to report potentially bad news on company reports in a timely manner, otherwise audit companies need to monitor precision and sensitive policies for auditing clients' financial statements (Li, Beekes and Peasnell, 2009:5).

In a study by Li, Beekes and Peasnell (2009), they found that while all other variables were fixed, conservatism profits were higher in firms audited by well-known audit firms. Large audit companies encourage auditors to be more conservative in audits by recommending that they be reputable institutions. However, the insistence on keeping auditor conservatism at high level may have been affected by legal lawsuits involving the potential conflict of interest arising from audit failure. As we have already pointed out, large audit firms can expect clients to be more conservative for corporate reputation concerns. However, even with auditor conservatism, there may be a case of potentially litigation that may result in the outcome of audit failure.

A study of large audit firms found that investors in the US-UK were more vulnerable to prosecution for losses from audit failures. The focal point of the lawsuits is a clean audit report to the audited entity for expenses that are shown or adjusted differently than they are, or less or more than what is needed. Therefore, investors and users of financial information can claim that they are misled for audited financial statements and given positive audit reports (Huijgen and Lubberink, 2005:1277). The expectation for the prevention of such situations is that the approach chosen by auditors is conservative. Therefore, the leading auditing firms have a tendency to use their strengths to recommend to those clients who are aware of the need, and to use more conservative accounting policies for financial information and statements. Scientific studies and researches show that because of the high litigation rate in the US due to the risk of conflict between the

potential audit report and the financial statements, the audit firms in this country have a more conservative approach than the UK. (Coffee,1999:12).

Another difference between the United States and the United Kingdom is the ability to show a different attitude from the UK and penalize corporations for profit manipulation, with some institutions and committees that the US has in its financial reporting regulations. The UK, on the other hand, may be more flexible in responding to complaints and media comments on the issue than the United States. Research by Li, Beekes and Peasnell shows that the levels of the lawsuits in the two countries are different, and that the US certainly has a structure more suited to litigation than the UK (Li, Beekes, Peasnell, 2009:7).

The response to questions about the frequency and risk of litigation against inspectors in the United Kingdom is less than that of the United States, which is due to the traditional debt structure of this country. British firms are prone to borrowing privately from banks, and at the same time they are more complex in terms of debt structures than the broad public debt market typical of the US. Traditionally, banks have assumed that public borrowers have informational advantages over bearers and are able to hedge interest without going to court. Moreover, the maturity date of bank debts is shorter than that of public debts. If the bank itself gets worse, the loan contract can be renewed or the investment can be transferred from one institution to another, thus protecting the borrower (Casterella, Jensen and Knechel, 2010:6).

Whether or not these differences have affected the degree of profit conservatism between the two countries in the financing examples is a question that remains to be resolved. Criminal penalties occur, when it is question that inflated profits be less than profits, For this reason, auditors naturally foster accounting conservatism. However, it is expected that the relationship between the auditor and conservatism will be sensitive to the level of litigation risk. Another comparison between the United States and the United Kingdom is that the relationship between profit conservatism and the nature of auditors is conditional on interesting tests of whether there is a risk of litigation. Based on the similarities between the United States and the UK and the impression given by the global reputation of large auditing firms, it is possible to predict lower profit conservatism in the UK and there are fewer cases under the circumstances (Li, Beekes, Peasnell, 2009:7).

3.4. Discrepancy Risk in Turkey and Legislation Regarding Subject

Under the supervision of capital markets in Turkey, the Capital Markets Board, the Public Oversight Board, Banking Regulation and Supervision Board officials in such organizations and institutions supervision and regulation of markets and institutions are authorized. Independent auditing is carried out by audit firms which are accredited to regulatory and auditing institutions and organizations. Regulatory and auditing agencies and organizations also control the audits of independent auditing firms. These institutions and organizations may issue monetary penalties for auditing firms when they are faced with faulty and fraudulent financial reporting and even cancel inspection licenses. In case of dispute against investors' direct auditing companies, because of the failure to sue, it is possible to establish a relationship between the auditors and the sanctions of the regulatory and auditing bodies on the conservatism of the auditor. However, as in the case of the United Kingdom and the United States, the Specialized Courts in which investors may file lawsuits due to erroneous and fraudulent financial reporting and audits are not in our country, but in the European Union Progress Reports, the studies are carried out on increasing the Specialized Courts in various fields.

4. Result

The auditor's conservatism approach is derived from the precautionary concept of accounting. The conservatism approach naturally involves investors' protection of the capital and the protection of creditors. Because it is very important that the financial information is accurate and it reflects the truth in the decisions regarding the investment to be made. However, it is known that there is always a question mark as to whether the information in question always reflects exactly the truth. Therefore, all economic units based on financial information will act cautiously and try to preserve their capital with this assumption.

At this point, the reliability of the financial statements and the importance of the quality audit are emerging. The quality of the audit activity is important both for the protection of the investor and for the reliability of the companies to be invested. The most effective factor in ensuring this reliability by conveying healthy information to the public is how the audit process is carried out. As is known, one of the most important criteria that clients have in choosing audit firms in the audit process is the requested fee. Therefore, some

clients can only choose the auditor by evaluating the price. In fact, in some companies the subject matter may even be carried out through purchasing departments or commissions that are not related to accounting and auditing.

Naturally, the technical and practical experience of each audit company and the reputation in the local and international markets are not the same. For this reason, a choice to be made only by considering the price factor may be erroneous. The expectations of the company to be audited will not match those of the auditing company and will raise suspicions about the reliability of auditing. In addition, the recognition of the audit firm can affect the quality of the quote and audit procedures to be requested and the conservatism of the auditor. The need for the identification and collection of price agreements, which will negatively affect the independence of auditing in auditor client relations, has been expressed by both practitioners and theorists since long time.

Another issue is that branded audit firms are identified with a shield of reputation they possess and a much better audit quality. Large auditing firms have more credits and less difficult situations due to their corporate identity than small auditing firms even under adverse conditions. It should also underline that leading auditing firms are meticulous in their operations and that they are exposed to a lower pressure threshold than small auditing firms when declaring their ideas to clients for structuring problems. On the other hand, studies in the literature prove that the larger auditing firms that earn significant amounts of money are less tolerant, thus offering better accounting and auditing quality.

The main focus of the study is the risk of conflict; the fact that the auditor's report and the financial information are not actually consistent, in other words how much it reflects the actual situation. The likelihood of the occurrence of such traces or indications may encourage financial information users to sue. Today in our country, the number of lawsuits filed against this issue is less than in the UK, USA etc. the developed countries. As a result of the numerous discrepancy lawsuits filed in these developed countries, the auditing companies in these countries are also taking account of the company's international reputation for the quality of audit and the reliability of financial information and are taking a more conservative stance to establish a more qualified audit process. This kind of attitude is not necessarily reflected in the same way as the fees charged for the auditing conducted.

Another thing that is expected to be understood by the auditor's conservatism approach is the need to maintain self-sacrificing and higher risk threshold and audit activities, -With the influence of the lessons learned from the previous accounting audit scandals- while determining whether the information generated by the accountant in relation to the concept of precautionary accountancy is the same as it actually exists.

In case of specialized courts established in our country that smaller investors who are negatively affected by independent audited financial reporting can also file lawsuits directly to the audit firms, we have opinion that this leads both to increase the quality of the audit and leads the audit firms to carry out more rigorous studies.

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