Limited Liability and Indemnification Clauses: Bankers' Perceptions of Auditor Independence and the Effects on Loan Decisions

Aisha G Meeks
Department of Accounting, Finance and Applied Economics
Dalton State College, School of Business, 650 College Drive, Dalton, GA 30720
Email: ameeks@daltonstate.edu

ABSTRACT:
Auditor liability is critical to preserving the perception of auditor independence. In recent years, the audit profession has been prohibited from the use of liability limiting and indemnification clauses. The SEC asserts that such agreements remove the incentive to be objective and weakens a firm's independence. Yet, the AICPA contends certain agreements do not impair independence. These limited liability agreements and indemnification clauses are presented in the audit-client engagement letter of which third parties, such as bank loan officers, are unaware. In an experiment, I examine the potential effect knowledge of the use of LLAs have on bankers' perception of independence and the impact on loan decisions. In regard to limited liability agreements, they affect bankers' perceptions of auditor independence; I find that bankers' perceptions of independence decline when auditor liability is limited and that loan decisions are adversely impacted when auditors use LLAs. These findings provide evidence to support the position taken by standard setters such as SEC and the FFIEC.

Keywords: auditor liability, limited liability agreements, independence, Securities Exchange Commission, The American Institute of Certified Public Accountants, Profession Ethics Examination Committee

INTRODUCTION

This study investigated the effects of including limited liability and indemnification agreements (LLAs hereafter), in the external audit-client engagement letter. Two highly debated LLAs are examined: 1) *Damages Not to Exceed Fees Paid*, which requires the institution to agree to limit the external auditor's liability to the amount of audit fees paid for services without regard to the extent of damages, and 2) *Knowing Misrepresentation by Management*, which is a client's agreement to compensate the auditor for claims made by third parties; yet this clause does not protect the auditor from claims by the client. As evidenced by the reduction in number of Big Four audit firms, the audit profession has been impacted by excessive litigation. Simunic and Stein (1996) assert that a consequence of the high rate of litigation against auditors is the possibility of business failure or one or more audit firms. According to Lathan and Linville (1998) litigation places a significant cost on auditors. The use of LLAs is a method of mitigating litigation costs, or a defense action used as a second-order effect of the increase in liability.

Many standard-setters and regulators have differing views on the use of LLAs. The Securities Exchange Commission (SEC) is definite in its position regarding the use of such provisions. The SEC asserts that an engagement letter with a clause to release, indemnify, or hold harmless from any liability and costs weakens a firm's independence (SEC, 2004). Additionally, the SEC states that an agreement to indemnify an accountant from his own negligible act eliminates the incentive to be objective and unbiased by encouraging departure from standards of objectivity and impartiality as implied by auditor independence (SEC, 2003). The American Institute of Certified Public Accountants (AICPA) states that certain types of LLAs are not problematic as long as auditors are exposed to actual damages and perform duties in compliance with professional standards (AICPA, 2006). After much debate and the issuance of exposure drafts in 2005 and 2006, Proposed New Interpretation 101-16 under Rule 101 *Indemnification, Limitation of Liability, and ADR Clauses in Engagement Letters,* the AICPA Profession Ethics Examination Committee (PEEC) issued Interpretation 501-8 in 2008. This ethics interpretation included in the AICPA Code of Professional Conduct (Rule 501 – Acts Discreditable) does not specifically mention restriction or prohibiting use of LLAs; yet the interpretation is clear regarding compliance with governing bodies and holds the auditor responsible for compliance with governing bodies (AICPA, 2008). Yet, the AICPA asserts that inclusion of an indemnification clause such as "knowing misrepresentation by management" does not impair independence (AICPA, 2012).

The debate among standard-setters and regulators regarding the use of LLAs and their impairment of auditor independence may be explained by incentive theory. Incentive theory of motivation asserts that reward or reinforcement from the external environment has an effect on behaviors (Killeen, 1982). The possibility of exposure to litigation motivates the auditor to act responsibly when performing an audit. The existence of legal liability is an attribute associated with auditor independence (Farmer, Rittenberg, & Trompeter, 1987). Additionally, the authors found the threat of litigation appears to be a factor that affects the auditor's willingness to oppose a client's accounting position. Ultimately, third parties (including bank loan officers) may view the threat of litigation as extrinsic motivation influencing auditors' decisions.

The 2005, AICPA Professional Ethics Examinations Council (PEEC) document indicates certain indemnification or limitation of liability agreements would result in an unacceptable threat to a member's independence which could not be mitigated sufficiently through the application of safeguards. The exposure draft clearly states the PEEC's position that an indemnification or limitation of liability provision that seeks to limit or eliminate a member's liability arising from the client's knowing his or her

misrepresentation, willful misconduct, or fraudulent behavior would not impair independence (AICPA 2005). In 2006, nearly one year after the 2005 exposure draft containing proposed guidance regarding the use of indemnification and limitation of liability provision, the PEEC agreed to revisions and reiterated its position that certain types of indemnification or limitation of liability agreements pose an unacceptable threat to auditor independence.

Considering Public Company Accounting Oversight Board (PCAOB) efforts to provide greater transparency to increase usefulness of the auditor's report bank loan officers' perceptions of auditor independence and audit quality when bankers are aware of LLAs in the audit-client engagement letter are examined. Bank loan officers' perceptions assessed by loan decisions have been studied for decades to include studies by Libby (1979). Additionally, I examine the impact knowledge of LLAs has bank loan officers' decisions. Bank loan officers work in a decision making environment and must anticipate defending their loan decisions before a loan committee (Danos, Holt, & Imhoff. 1989). Decision makers who must validate their judgments are capable of detecting and responding to subtle differences in routinely analyzed data (Danos et al. 1989) as simulated in this study.

In a 1 x 3 experiment design, where limited liability agreements (LLAs) are manipulated, I investigated bank loan officers' perceptions and loan decisions. Bank loan officers are solicited via a mailing list provided by Hugo Dunhill. The experiment instrument is adopted from Schneider and Church (2008) who study the effect of auditor internal control opinions on loan decisions. I find that bank loan officers' perceptions are consistent with the position taken by the Securities Exchange Commission (SEC) and the Federal Financial Institutions Examination Council (FFIEC) that including LLAs in the audit client engagement letter impairs independence. Additionally, the results of this study demonstrate that auditor liability impacts perceived audit quality consistent with Khurana and Raman (2004). Finally, loan decision results prove to be aligned with Danos et al. (1989) where they find that loan officers are dependent upon the financial accounting information provided and that lending decisions are not only based on financial information.

Implications of these findings confirm that standard setters are appropriately protecting third party interest by prohibiting the use of LLAs in the audit-client engagement letters. The use of LLAs weakens bank loan officers' perceptions of independence and audit quality. Secondly, bank loan officers demonstrate that the use of such clauses negatively impact their loan decisions. Finally, increased transparency regarding the

use of LLAs in the audit-client engagement letter may negatively impact perceptions and decisions of financial statement users.

The remainder of the paper is organized as follows. In the next section, I discuss the limited liability agreement background and prior literature, and present the research hypotheses. The following sections respectively provide description of the data, research method, and results. The final section concludes with a summary and discussion of limitations and future research.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Since the 2005 exposure draft, the PEEC considered guidance by other regulators including the SEC. However, in this case the PEEC noted that the FFIEC guidance is based on the impact said agreements have on the safety and soundness of financial institutions, whereas PEEC guidance is based on the impact on auditor independence (AICPA 2006, 5). In 2008, the PEEC issued Interpretation 501-8 *Failure to Follow Requirements of Governmental Bodies, Commissioners, or Other Regulatory Agencies on Indemnification and Limitation of Liability Agreements in Connection With Audit and Other Attest Services* and abandoned the 2005 and 2006 exposure drafts. While Interpretation 501-8 does not specifically mention restriction or prohibiting use of limited liability clauses, the interpretation is clear regarding compliance with governing bodies and holds the auditor responsible for compliance with governing bodies (AICPA 2008).

Standard Setters and Regulators Position on LLAs

Within the past ten years, standard setters and regulators have given much attention to the use of LLAs in the audit-client engagement letter. The current trend leans toward allowing professionals to limit their liability through contractual agreement; however, several regulatory agencies prohibit their use in certain circumstances such as indemnification on claims based on 1) auditor liability limited to the amount of loss occurring during the periods audited, 2) knowing misrepresentation by audit client management, and 3) auditors' limited liability for the amount of fees paid (Ehrlich & Williams, 2008). Yet, it is unclear under common law the degree to which CPAs may contractually limit their liability to clients (Ehrlich & Williams, 2008).

Regulated industries, insurance companies, and banks do not allow the use of LLAs per the 2006 advisory issued by the Federal Financial Institutions Examinations Council (FFIEC). The FFIEC contends that limiting external auditor liability may weaken the external auditors' objectivity, impartiality, and performance (Federal Register, 2006). The SEC prohibits use of LLAs when auditing publicly traded companies. Additionally, the SEC asserts that an engagement letter with a clause to release, indemnify, or hold

harmless from any liability and costs will weaken the firm's independence (SEC, 2004). The SEC also states that an agreement to indemnify an accountant from his own negligible act eliminates the incentive to be objective and unbiased by encouraging departure from standards of objectivity and impartiality as implied by auditor independence (SEC, 2003).

Damages Not to Exceed Fees Paid

Auditor's liability limited to the amount of fees paid, *Damages Not to Exceed Fees Paid*, requires the institution to agree to limit the external auditor's liability to the amount of audit fees paid for services without regard to the extent of damages. According to Dopuch and King (1992) it may be difficult for auditors to estimate the possible costs of audit failures since these costs can be influenced by factors under the control of the client. Liability rules determine the probability that an audit initiates liability in court and damage measures establish the amount of financial compensation auditors must pay (King & Schwartz, 2000).

Laux and Newman (2010) demonstrate how an increase in the potential damage payments to investors can lead to a reduction in client rejection rate and a higher expected damage payment implies that the business has to offer the auditor a larger audit fee. This is accomplished by an increase in the audit fee by an amount that is larger than the increase in the auditor's expected damage payment, resulting in a higher evaluation effort and a lower rejection rate (Laux & Newman 2010). Thus, if this theory holds true, including *Damages Not to Exceed Fees Paid,* LLA in the audit-client engagement letter complements the increase in audit fees as a safeguard for potential damage payments to the client. Latham and Linville (1998) suggest that as expected litigation costs rise, in order to maintain profit the auditor must increase fees. The use of LLA "damages not to exceed fees paid" is an effort to mitigate costs without increasing audit fees or a defensive action against a volatile liability regime.

Knowing Misrepresentation by Management

Company management is responsible for the fair presentation of financial statements in conformity with generally accepted accounting principles as indicated in the Statement on Auditing Standards No. 1 § 110.03 *Distinction Between Responsibilities of Auditor and Management* (AICPA, 2006). The responsibilities and functions of the independent auditor are clearly identified in the AICPA's Statements on Auditing Standards. Ultimately, the auditor remains exposed to clients, lenders, shareholders and other non-clients for damages relating to any actual harm caused.

One way that auditors attempt to mitigate the risk is through the use of the LLA *Knowing Misrepresentation by Management* in the audit-client engagement letter. The objective

is for the auditor to be held harmless from all claims, liabilities, losses, and costs related to misrepresentation of client management. Auditors have a legal liability for audit failure that represents a form of inherent insurance to outside investors (Laux & Newman 2010). Although the auditor may be able to counter unintentional disclosure, however; in the case of deliberate misstatement greater effort is unlikely to significantly increase the probability of discovery because management who wish to deceive will bear the audit in mind when perpetrating the act and will design its deceit accordingly to avoid auditor detection (O'Sullivan, 1993). Limiting an auditor's liability to the client does not remove legal liability to outside investors and other parties. Implicit in the contractual view of the firm is the existence of information irregularities between the firm's management and the other contracting parties which provide opportunity for management to issue biased reports for personal gain at the expense of other stakeholders. There are various ways risk opposed directors and officers seek protection from liability. This type of protection allows managers to share their reporting liabilities with the auditor. Auditing has a risk sharing view where auditors take on a legal environment in which they may be held liable to a wide range of corporate stakeholders (O'Sullivan 1993).

Bank Loan Officers as Third Party Users

Bank loan officers' perceptions assessed by loan decisions have been studied for decades and includes studies by Libby (1979) on bankers' perceptions of what the audit report communicates versus the auditors' perceptions resulted in minimal variation. Loan officers' decision process includes comprehension of the audit report as investigated by Bamber and Stratton (1997), who also found that loan officers' risk assessment, interest rate, and decision to grant a loan are affected by the audit report. In addition, Firth (1979) conducted a study in the United Kingdom on the impact of qualified audit reports and found that bank lending decisions are affected. The author concluded that auditors should provide more detail when making qualifications to further assist bankers with decision making.

Prior to the twentieth century, there was little empirical research assessing how accounting information was used for lending decisions. The results of Danos, Holt, and Imhoff's (1989) groundbreaking research reveal the evaluation process of loan decisions as well as the information gathering process. They found loan officers to be dependent upon the financial accounting information provided when making loan decisions. Additionally, they found the lending decisions were not only based on financial information but also on relationships. Miller, Reed, and Strawser's (1993) findings show bank loan officers ability to differentiate between management responsibility for financial statements and the auditor's responsibility. According to

Reinstein et al. (2009, 52), auditors have used indemnification and liability limitation agreements to help control costs related to engagements with clients in high-risk business environments.

Thus, it is plausible that bank loan officers will perceive the use of LLAs as a method to manage costs associated with accepting engagements for high risk clients by shifting a noticeable level of the risk and responsibility to the client for its company's financial statements. Including LLAs in the audit-client engagement letter may signal the possibility of an audit firm's attempt to manage its risk of financial loss by shifting risk to the client or that the auditor may fail to perform duties in accordance with prescribed standards. Furthermore, knowledge of LLAs in the audit-client engagement letter may be perceived as a as a volatile relationship with the potential to result in litigation to which the auditor may not be liable and creates a possible level of exposure to bankers. However, the use of LLAs is perceived by bank loan officers, their use in the engagement letter may negatively impact auditor independence and bank loan officers' decisions.

LLAs Impact on Auditor Independence

The use of LLAs is the phenomenon stimulating recent discussion concerning independence. Some regulators and standard setters, such as the SEC, AICPA, and FFIEC disagree regarding the impact inclusion of LLAs in external audit engagement letters may have on auditor independence. This leads to the context of debates by standard setters regarding auditor independence in situations where auditor liability is limited via a clause in the engagement letter. Use of such clauses removes or mitigates the threat of litigation, which functions as incentive for auditor conduct. Incentive theory of motivation is based on reward or reinforcement, such as threat of litigation, from the external environment and the effect on behaviors (Killeen, 1982). Ultimately, the threat of litigation influences auditors' decisions, and motivates higher levels of performance.

I predict that the use of LLAs will negatively impact bank loan officer perceptions of auditor independence. The existence of legal liability is an attribute associated with auditor independence (Farmer et al. 1987). Thus, the existence of potential litigation is one component of reinforcement that influences auditor behavior and effects independence. According to Farmer et al. (1987), the threat of litigation appears to be a factor that affects the auditor's willingness to oppose a client's accounting position. This belief is consistent with the some standard setters' position that the use of litigation clauses will weaken auditor independence (SEC 2004, FFIEC 2006). To examine this contention, I tested the following hypothesis (stated in the alternative):

H1: Bank loan officers' level of confidence in auditor independence will decline when the auditor's legal liability is limited.

If bank loan officers demonstrate low levels of confidence in auditor independence, then this evidence should support the SEC and other standard setters' position regarding the use of LLAs. Conversely, finding no difference in perception of auditor independence when LLAs are present may possibly be a reflection of the level of trust placed in the audit profession. While this study is empirical evidence of independence in appearance it does not address independence in fact.

LLAs Impact on Loan Decisions

Including loan decisions as a measure of third-party perceptions, when liability is limited is based on the notion that the conceptual link between auditor assurance and bank officer lending decisions is that auditor assurance reduces information risk in the financial statements and related accounting schedules accompanying the loan application. As information risk decreases, so increases the expectation that a bank loan officer perceives the loan as less risky and thus is more likely to make a loan and to charge a lower interest rate on the loan (Bandyopadhyay & Francis 1995). According to Watts (2003), shareholder litigation is a potential source of conservatism and when assessing a potential loan lenders are interested in the likelihood the firm will have enough net assets to cover their loans. The use of LLAs may signal bank loan officers that the auditor is not independent. Therefore, I examined the direct relationship between loan decisions and the inclusion of LLAs in audit-client engagement letters.

Auditing has a risk-sharing view where auditors take on a legal environment in which they may be held liable to a wide range of corporate stakeholders (O'Sullivan, 1993). Bank loan officer knowledge of the inclusion of LLAs in the audit-client engagement letter may signal the possibility that the client is high risk and the auditor is attempting to mitigate the risk of financial loss by shifting risk to the client. According to Connelly, Certo, Ireland, and Reutzel (2011), signaling theory describes behaviors of two parties with access to different information. This asymmetric information is present when one party has to choose how to communicate information while the other party must choose how to interpret the signal. Use of LLAs is information known by client management and the auditors. Typically, third parties are not privy to details of the audit-client engagement letter. Providing information of the use of LLAs with bank loan officers may negatively impact the loan officer's assessment of risk and interest rate. As such, I predict bank loan officers lending decisions to be adversely affected as a result of

knowledge of LLAs in the audit-client engagement letter. To examine this assertion, I test the hypothesis below (stated in the alternative).

H2: Bank loan officers' lending decisions are adversely impacted when auditor legal liability is limited.

The probable result is consistent with Lowe and Pany (1995) who find that financially material business relationships between the CPA firm and audit client affected third party perceptions regarding loan decisions. Including LLAs in the audit-client engagement letter may prove to be information that is relevant to a making a loan decision. In groundbreaking research, Danos et al. (1989) found that loan officers are dependent upon the financial accounting information, and that their lending decisions are not only based on financial information but also on relationships.

EXPERIMENTAL METHOD

Research Design

To examine the relationship between LLAs and the impact on perceptions and decisions, this study implements a 1 x 3 between-subjects design. The design measures loan officers' perceptions of auditor independence, and impact on loan decisions when LLAs are included in the audit-client engagement letter. Auditor liability (LLA) are manipulated at three levels to include a control case (standard engagement letter without LLA), and two treatment groups. The primary purpose of an audit is to examine and confirm the accuracy of data. An audit is often performed by an independent group, and the rate of errors, p, and the distribution of the magnitude of the errors, U, are of primary interest. The sample size of an initial audit should therefore depend on the desired precision for estimating the error rate. Audit sizes have been discussed elsewhere and are based on standard formulas, (Shepherd & Yu, 2011).

Participants

The participants in this study are comprised of 107 bank loan officers. The list of randomly selected loan officers was provided by the Hugo Dunhill mailing list. Loan officers are viewed as both sophisticated users of financial statements and knowledgeable financial experts who rely on the audited financial statements of clients. A majority of the loan officers have over five years of loan experience and devote more than eighty-percent of their work hours to loan decisions. In general, participants are experienced, well-educated loan officers.

Procedures

The hypothetical case developed for this study is adapted from Schneider and Church (2008). The case involves a nonpublic company requesting a line of credit from a bank (lending institution). The company is in good financial standing and growing and the auditors issue a clean (unqualified) audit opinion. Additionally, a set of financial statements are included in the case materials. The loan officers are asked to express their perceptions of auditor independence and to make loan decisions.

The experiment is a 1 x 3 between-subjects design. I manipulate limited liability agreements at three treatment levels: control group, damages not to exceed fees paid, and knowing misrepresentation by management. The participant groups are distributed a case through random sampling. Each group receives a variation of the experimental case. In each case the CPA firm issues the company an unqualified (clean) opinion. Embedded in each of the cases is the independent variable at three levels (one control and two treatment groups). Participants are provided with identical cases, with the exception of the engagement letter detail regarding the LLAs manipulated between groups. Each participant is exposed to only one treatment (e.g. one manipulation) level. Unknown to the participants in this study, the cases do not test the same treatment variable.

Loan officer perceptions are obtained by prompting a response to questions regarding confidence level in auditor independence. They were given an 11-point Likert scale ranging from 0 (no confidence) to 10 (completely confident) to rank confident level in auditor independence. The loan questions address the impact LLAs have on loan decisions by ascertaining a response regarding the loan officers' 1) assessment of risk associated with extending the loan and 2) likelihood of granting a reasonable rate of interest. An 11-point Likert scale ranging from 0 (low risk) to 10 (high risk) is used for risk assessment and probability of granting a reasonable interest rate is 0% to 100%.

RESULTS

Demographic Statistics

Table 1 summarizes the demographic information for the participants in the experiment. The participants are fairly evenly distributed among the three groups: 1) Full Liability (Group 0), 2) Damages not to Exceed Fees Paid (Group 1) and 3) Knowing Misrepresentation by Management (Group 2).[1] Over 93 percent of the participants had more than 5 years of lending experience with 50 percent having over ten years of

[1] Using Chi-square test, there are no significant ($p<.05$) demographic differences found among the three groups of auditor liability and seven dependent variables suggesting that random assignment to experimental treatments was successful.

lending experience. A majority of the participants devoted over 80 percent of their time to loans and 63 percent worked with loans between $500k and $1mil. About 58 percent of the participants reported bank assets between one hundred million and one billion. Approximately 77 percent of the participants are between age 25 and 55 with about 77 percent having baccalaureate degrees. A vast majority, 82 percent, of the participants are male. In general, participants are experienced, well-educated loan officers who dedicate a majority of their time to lending.

Table 1
Demographic Information for Experimental Case Participants

	Group 0	**Group 1**	**Group 2**	**Total Count**	**Total Percent**
Auditor Liability[a]	**FL**	**DF**	**KMM**		
Group Size[b]	36	33	38	1	100
Loan Experience					
Less than 1 yr	0.00%	0.00%	0.00%	0	0.00%
Over 1 yr - 5 yrs	5.60%	3.00%	10.50%	7	6.50%
Over 5yrs -10yrs	41.70%	42.40%	44.70%	46	43.00%
10 yrs or more		54.50%	44.70%		50.50%
TOTAL	**100.00**	**100.00%**	**100.00%**	**10**	**100.00%**
Percent of Job Devoted to Loans					
Below 50%	2.80%	0.00%	0.00%	1	0.90%
50-69%	13.90%	6.10%	10.50%	11	10.30%
70-79%	33.30%	46.50%	34.20%	40	37.40%
Over 80%		46.50%	55.30%		51.40%
TOTAL	**100.00**	**100.00%**	**100.00%**	**10**	**100.00%**
Avg. Loan Size [d]					
Less than 500k	19.40%	24.20%	10.80%	19	17.80%
500 k – 1mil	55.60%	66.70%	68.40%	68	63.60%
Over 1mil – 3mil	22.20%	6.10%	16.40%	17	15.90%
Over 3mil – 5mil	0.00%	3.0%	18.40%	2	1.90%
Over 5mil		0.00%		1	0.90%
TOTAL	**100.00**	**100.00%**	**100.00%**	**10**	**100.00%**

Table 1 (continued)

Demographic Information for Experimental Case Participants

Auditor Liability[a]	Group 0 FL	Group 1 DF	Group 2 KMM	Total Count	Total Percent
Group Size[b]	36	33	38	107	100
Bank Asset					
Less than 50 mil	0.00%	9.10%	5.30%	5	4.70%
50 mil – 100 mil	25.00%	30.30%	26.30%	29	27.10%
Over 100 mil -1bil	69.40%	54.50%	52.60%	63	58.90%
Over 1 bil			15.80%	10	9.30%
TOTAL	**100.00**	**100.00%**	**100.00**	**107**	**100.00%**
Age					
Under 25	0.00%	0.00%	2.60%	1	
25-40	47.20%	48.50%	39.50%	48	
41-55	36.10%	27.30%	34.20%	35	
Over 55			23.70%	23	
TOTAL	**100.00%**	**100.00%**	**100.00%**	**107**	**100.00%**
Highest Degree					
Less than	0.00%	3.00%	13.20%	6	5.60%
Baccalaureate	75.0%	81.80%	76.30%	83	77.60%
Master's	25.0%	12.10%	10.50%	17	15.90%
Doctorate	0.00%	0.00%	0.00%	0	0.00%
Other				1	0.90%
TOTAL		**100.00%**	**100.00%**	**107**	**100.00%**
Title					
President/CEO	8.30%	3.00%	2.60%	5	
Vice President	30.60%	21.20%	34.20%	31	29.00%
Loan Officer	55.60%	63.60%	55.30%	62	57.90%
Credit Analyst	0.00%	3.00%	2.60%	2	1.90%
Other	5.60%		5.30%	7	
TOTAL	**100.00%**	**100.00%**	**100.00%**	**107**	**100.00%**
Gender					
Male	77.80%	84.80%	84.20%	88	82.20%
Female	22.2%		15.80%	19	17.80%
TOTAL	**100.00%**	**100.00%**	**100.00%**	**107**	**100.00%**

[a]The auditor liability conditions are: 1) FL-Full Liability, 2) DF-Damages Not to Exceed Fees Paid, and 3) KMM –Knowing Misrepresentation by Management. [b] Using Chi-Square test, there are no significant differences between groups. [c]Loan Experience

Test of H1: Auditor Independence

The ANOVA results support the hypothesis (H1) that bank loan officers' perceptions of independence declines when auditor legal liability is limited. The results, as shown in Table 2 Panel A, indicate significant differences across each group at varying levels of

auditor liability (F = 12.544, df = 2, p < .001, two tailed). The means between groups related to auditor independence were varied at a wide range for Full Liability (FL) to Damages Not to Exceed Fees Paid (DF), and from FL to Knowing Misrepresentation by Management (KMM), but closely tied between DF and KMM. The means for independence are 7.028, 5.576, and 5.579 for FL, DF and KMM liability levels, respectively. Table 2 Panel B provides a post hoc analysis to determine which groups are significantly different for the independence dependent measure. Results indicate a statistically significant difference (p < .001, one tailed) in bank loan officers' perceptions when the auditor assumes FL rather than to limit liability for DF or KMM. However, there is not a significant difference between bank loan officers' perceptions of auditor independence as it relates to the type of LLA used in the audit client engagement letter.

Table 2
Hypothesis 1
Perceptions of Auditor Independence When Auditor Liability is Limited[a]

Panel A: Mean Confidence By Condition

GROUP	Independence Mean (St. Dev.)
Full Liability (FL) n = 36	7.028 (1.362)
Damages Not To Exceed Fees Paid (DF) n = 33	5.576 (1.001)
Knowing Misrepresentation by Management (KMM) n = 38	5.579 (1.734)
Significance of overall[b] differences across groups	F = 12.544 **p< .001**

Panel B: Scheffe Test Of Multiple Comparison

Pairwise Differences[c]	Independence
FL and DF	**p< .001**
FL and KMM	**p< .001**
DF and KMM	p = .500

[a]Participants are asked 1) "How confident are you that T&B CPA firm was independent when they performed the audit?" Measured on a 11-point Likert Scale anchored on 0 for No Confidence to 10 for Complete Confidence. [b]F-statistic (with 2 degrees of freedom) [c]p values are one tailed. Significant results are in bold.

Overall, these findings indicate that bank loan officers' level of confidence in auditor independence decline when auditor liability is limited. This is consistent with the position of standard setters such as the Securities Exchange Commission (SEC, 2004) and is also aligned with concerns expressed by the Federal Financial Institutions Examination Council (Federal Register 2006). Thus, hypothesis 1 is supported. The results suggest that limiting auditor liability in the audit-client engagement letter does in fact negatively impact bank loan officers' perceptions of independence.

Test of H2: Loan Decisions

The third hypotheses examines whether the auditor liability affects the bank loan officers' lending decisions. According to Bandyopadhyay and Francis (1995), as information risk decreases, so increases the expectation that a bank loan officer perceives the loan as less risky and thus is more likely to make a loan and to charge a lower interest rate on the loan. This study uses two measures of loan decisions: risk assessment (RA), and interest rate probability (IR).

The ANOVA results support hypothesis (H2a) that bank loan officers' loan decision: risk assessment (RA) measure will increase when LLAs are included in the audit-client engagement letter. The results, as shown in Table 4 Panel A, indicate that bank loan officers' loan decision: risk assessment (RA) measure is statistically significant ($F = 27.442$, $df = 2$, $p < .001$, two-tailed). The means for full liability (FL), damages not to exceed fees paid (DF), and knowing misrepresentation by management (KMM) for risk assessment are 5.583, 8.030, and 7.500 respectively. Thus bank loan officers' loan decisions are impacted when auditor liability limited, resulting in a higher risk assessment.

Table 3 Panel B provides a post hoc analysis to determine which groups are significantly different for the RA loan decision measure. The results show that there is a statistically significant difference between RA when auditors are FL compared to when liability is limited by the DF condition ($p< .001$, one-tailed). In addition, the results demonstrate a statistically significant difference between RA when auditors FL in contrast to when liability is limited to the KMM condition ($p < .001$, one-tailed). Yet, there is not a significant difference between DF and KMM for the RA measure.

Table 3
Hypothesis 2
Loan Decisions When Auditor Liability is Limited[a]

Panel A: Mean Confidence by Condition

	Loan Decisions	
	Risk Assessment[b]	Interest Rate[c]
Group	Mean (Standard Deviation)	
Full Liability (FL) n = 36	5.583 (0.996)	51.94% (25.28)
Damages Not to Exceed Fees Paid (DF) n = 33	8.030 (1.287)	22.12% (16.54)
Knowing Misrepresentation by Management (KMM) n = 38	7.500 (1.900)	29.47% (24.38)
Significance of overall differences across groups [d]	F= 27.442 **p< .001**	F= 16.611 **p< .001**

Panel B: Scheffe Test of Multiple Comparison

Pairwise Differences [e]	Risk Assessment	Interest Rate
FL and DF	**p< .001**	**p< .001**
FL and KMM	**p< .001**	**p< .001**
DF and KMM	p = .158	p = .198

[a]Participants are asked 1) “What is your assessment of the risk associated with extending the $5,000,000 line of credit to IGT Book Wholesaler?” and2)”What is the probability that you would extend the $5,000,000 line of credit to IGT Book Wholesalers at a reasonable rate of interest as determined by your financial institution?”
[b] Risk associated (risk assessment) with extended the loan measured on an 11-point Likert scale anchored at 0 for Low Risk to 10 for High Risk.
[c] Probability of extending the line of credit based on each bank loan officers specific case. Measured on a scale of 0% to 100%. [d]F-statistic (with 2 degrees of freedom) ,[e] Reported p-value is one-tailed, alpha level at .05. Significant results are in bold.

The ANOVA results support hypothesis (H2b) that bank loan officers’ loan decisions: interest rate probability (IR) measure will be lower when LLAs are included in the audit-client engagement letter. The results, as shown in Table 3 Panel A, indicate that bank loan officers’ loan decisions: interest rate probability (IR) measure is statistically

significant (F = 16.611, df = 2, p < .001, two-tailed). The means for FL, DF, and KMM conditions expressing the probability of granting a reasonable rate of interest (IR) are 51.94%, 22.12%, and 29.47% respectively. Thus, bank loan officers' loan decisions are negatively impacted when auditor liability limited, resulting in a decreased likelihood of extending a line of credit at a reasonable interest rate. Table 3 Panel B provides a post hoc analysis to determine which groups are significantly different for the IR loan decision measure. The results show that there is a statistically significant difference between the IR measures when auditors are FL compared to when liability is limited by the DF condition (p < .001, one-tailed). In addition, the results demonstrate a statistically significant difference between IR when auditors FL in contrast to when liability is limited to the KMM condition (p < .001, one-tailed). Yet, there is not a significant difference between DF and KMM for the IR measure.

The results for the between-subject experiment provide support for hypothesis 1: that bank loan officers' perceptions of independence declines when auditor legal liability is limited. Additionally, the experiment examines bank loan officers' loan decisions related to risk assessment and the likelihood of granting a line of credit at a reasonable interest rate. The results demonstrate that bank loan officers' loan decisions are impacted when auditor liability limited, resulting in a higher risk assessment and a decreased likelihood of granting a line of credit at a reasonable interest rate. Overall experiment results support the position taken by standard setters such as the Securities Exchange Commission and the Federal Financial Institutions Examination Council that including LLAs in the audit client engagement letter impairs independence. Furthermore, the loan decision results prove to be aligned with Danos et al. (1989) where they find loan officers are dependent upon the financial accounting information provided and that lending decisions are not only based on financial information.

In all, this suggests that bank loan officers' assess risk as being greater when auditor liability is limited. The interest rate measure for loan decision reflects decreased likelihood of extending a line of credit at a reasonable interest rate when auditor liability is limited. Bank loan officers' response to the loan decision IR and RA measures demonstrate an inverse relationship consistent with Bandyopadhyay and Francis (1995). In regard to limited liability agreements, they affect bankers' perceptions of auditor independence; I find those bankers' perceptions of independence decline when auditor liability is limited and that loan decisions are adversely impacted when auditors use LLAs. In addition to providing support for Hypotheses 3a and 3b, these results imply that increased transparency in the standard auditor's report regarding auditor liability may impact lending decisions.

CONCLUSIONS, LIMITATIONS, AND FUTURE RESEARCH

Standard setters and regulators have opposing views concerning the use of LLAs in external audit engagement letters. Currently, the AICPA and SEC are in contrasting positions concerning auditor limited liability for "damages not to exceed fees paid," and "knowing misrepresentation by management." The SEC asserts that engagement letters with clauses to release, indemnify, or hold harmless from any liability and costs will impair the firm's independence (SEC 2004). The SEC further states that an agreement to indemnify the accountant from his own negligible acts removes the motivation to be objective and unbiased by encouraging departure from standards of objectivity and impartiality as implied by auditor independence (SEC 2003). The AICPA asserts that inclusion of an indemnification clause such as knowing misrepresentation by management does not impair independence (AICPA, 2012).

The debate on LLAs has led to the need to empirically investigate their impact on the perceptions of third party users. In September 2005 and 2006, the AICPA Professional Ethics Executive Committee (PEEC) issued exposure drafts containing proposed ethics interpretations under Rule 101, *Independence* (AICPA 2005; AICPA 2006) addressing the impact that certain indemnification and limitation of liability agreements in client engagement letters would have on an auditor's independence. The results of the AICPA Exposure Drafts indicate that there are no state board rules, nor accountancy act provisions, which permit or prohibit the use of indemnification and limitation of liability agreements. However, banking and insurance regulators are opposed to the use of LLAs. At present, the AICPA Interpretation 501-8 has been issued by the PEEC to recognize that some regulators have adopted rules restricting the use of certain agreements in the engagement letter, and AICPA members should follow such restrictions when providing audit or other attestation services for regulated industries (AICPA 2008). Thus, I examined bank loan officers' perceptions and loan decisions when LLAs are included in the audit-client engagement letter.

This study contributes to the literature in various ways. First, this is the first known study to empirically examine the impact the use of LLAs have on bank loan officers' perceptions and loan decisions. Secondly, this study establishes an enhanced understanding of third party perceptions and loan decisions when LLAs are included in engagement letters. While there is literature on auditor liability and litigation, the literature does not specifically address the use of litigation related clauses in the audit client engagement letter. Secondly, this study contributes to the literature on the impact auditor client relationship may have on third parties. Specifically, it addresses the

question of whether changing the relationship between auditor and client through contractual language of LLAs has an impact on bank loan officers' perceptions of independence and loan decisions.

The results of this study demonstrate that transparency, knowledge of auditor liability or limitations through the use of LLAs or litigation related clauses in the audit-client engagement letter, in the standard auditor's report may ultimately effect bank loan officers perceptions' and lending decisions. This study found that the use of LLAs in the audit client engagement letter negatively impacts bank loan officers' perceptions of independence, and adversely affects loan decisions. Thirdly, this study provides support for the position taken by the PCAOB that enhanced transparency could provide useful information to financial statement users that might lead to an improvement in audit quality (PCAOB 2009). Danos et al. (1989) find that loan officers are not only dependent upon financial accounting information, but that lending decisions are also based on nonfinancial information. Therefore, making third parties aware of LLAs and other litigation related clauses would enhance transparency and may prove useful in their decision making process as evidenced in the results of lending decisions in this study. Finally, this study provides insight to whether third party users' support accounting standard setters and regulators regarding the use of LLAs. The results of this study find that bank loan officers' perceptions are aligned with the reasoning of several standard setters regarding the impact the LLAs may have on auditor independence. The Securities Exchange Commission states that an agreement to indemnify the accountant from his own negligible acts removes the motivation to be objective and unbiased by encouraging department from standards of objectivity and impartiality as implied by auditor independence (SEC 2003). These results are a clear indication that concerns of standard setters regarding the use of LLA and other litigation related clauses are warranted.

Limitations

A limitation of this research is that experiments are hypothetical and may not include all the factors a bank loan officer may encounter or need to make a loan decision. The study uses a case adapted from Schneider and Church (2008) who determine that the case is realistic. To keep the instruments at a reasonable length, some factors may have been omitted that are relevant to the loan approval process. Future research should include other litigation related clauses and LLAs. Another limitation is the generalization of the results of this study. The findings are exclusive to the bank loan officers who responded to these instruments.

Future Research

Future research should use other financial statement users such as investors, to gain their perceptions relating to the impact of the use of LLAs. Additionally, the research did not address all issues relative to the use of LLAs in the audit client engagement letter. This study examined one independent variable and the effect on auditor independence, objectivity, professional skepticism, audition quality, and the impact on loan decisions. Future research should explore how LLAs affect the audit firm and the client.

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