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# Legal audit : a tool for assessing the quality of financial information - Literature review

# L'audit légal : outil d'évaluation de la qualité de l'information financière - Revue de littérature

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**Abstract**

This literature review aims to present a reading of previous research that has treated our topic on legal audit consideration as a tool that can assess the quality of financial information, that is considered as a heated debate in the recent years within organizations in order to make it more credible for all stakeholders and be able to reduce the problem of asymmetric financial reporting between these parties. The intervention of the legal auditor emphasizes a continuous debate on its importance and the obligation to improve the quality of financial information and financial security as a means to increase the substance of financial reporting. More specifically, we will present the impact of the quality of the legal auditor on the reliability of financial communications by mobilizing some theories that have put the relationship between the quality of financial information and other variables on the quality of financial reporting legal audit firm.

**Keywords:** legal audit; information asymmetry; stakeholders; quality of financial information; financial security.

**Résumé**

Cette revue de littérature vise à présenter une lecture sur les recherches antérieures qui ont traitées notre thème sur la considération de l'audit légal un outil qui peut évaluer la qualité de l'information financière, que cette dernière fait l'objet d'un débat au cours des dernières années au sein des organisations dans la mesure où de la rendre plus crédible pour toutes les parties prenantes et de réduire le problème de l'asymétrie de l'information financière entre ces dernières. L'intervention du commissaire aux comptes met l'accent sur un débat continu sur son importance et l'obligation d'amélioration de la qualité de l'information financière ainsi que la sécurité financière. Plus précisément, nous allons présenter l'impact de la qualité du commissaire aux comptes sur la fiabilité des communications financières en se mobilisant par certaines théories qui ont mis la relation entre la qualité de l'information financière et d'autres variables sur la qualité du cabinet de l'audit légal.

**Mots clés :** audit légal ; asymétrie de l'information ; parties prenantes ; qualité de l'information financière ; sécurité financière.

## Introduction

The wealth created by organizations goes through a generalized process along the economic chain, from the consumption of resources to the supply of products and services. From this point of view, accounting is an essential function to build relevant information, which draws up a balance sheet of the operations carried out within an organization. This constructed information is widely used in contractual relations between stakeholders, both internally and externally, insofar as the internal use of financial information focuses on performance management, and the external use focuses on investment prospects in capital markets. On the other hand, financial information faces a problem of opportunism by managers, who may alter or falsify certain data to ensure their own interests.

Consequently, the internal and external stakeholders of the economic chain face a major constraint related to the reliability and transparency of the financial information generated by the organization. Jensen and Meckling (1976) mention the need for the dissemination of relevant financial information in order to ensure the continuity of the company's operations and to perpetuate the organization, since it is a source of confidence in the agency relationship. Thus, financial information asymmetry is limited by the presence of transparent financial information circulated between managers, shareholders and investors (Fan Yu, 2005). It also leads to a climate of understanding between stakeholders and improves the decision-making process.

But the influx of financial scandals that have broken out in recent years, such as the ENERON[1] affair, which has focused the attention of economic agents on the fraud committed by the firm Arthur Andersen by manipulating the company's accounts. Numerous failures have been raised as a result of these financial scandals, which have highlighted the dysfunction of financial security, given that some accounts have been certified by large firms despite the presence of several anomalies.

As a result of these major dysfunctions in the process of improving the reliability of financial information, investors have been led to question the financial communications published, insofar as these do not correctly reflect the entire financial situation of the organizations. Consequently, the quality of the external audit and governance are two topics that are being debated, particularly in view of the important need to improve control systems, since these

[1] The ENRON scandal broke in October 2001, resulting in the bankruptcy of the 7th largest company in terms of revenue in the United States and the dissolution of the 5th largest audit network in the Big 5.

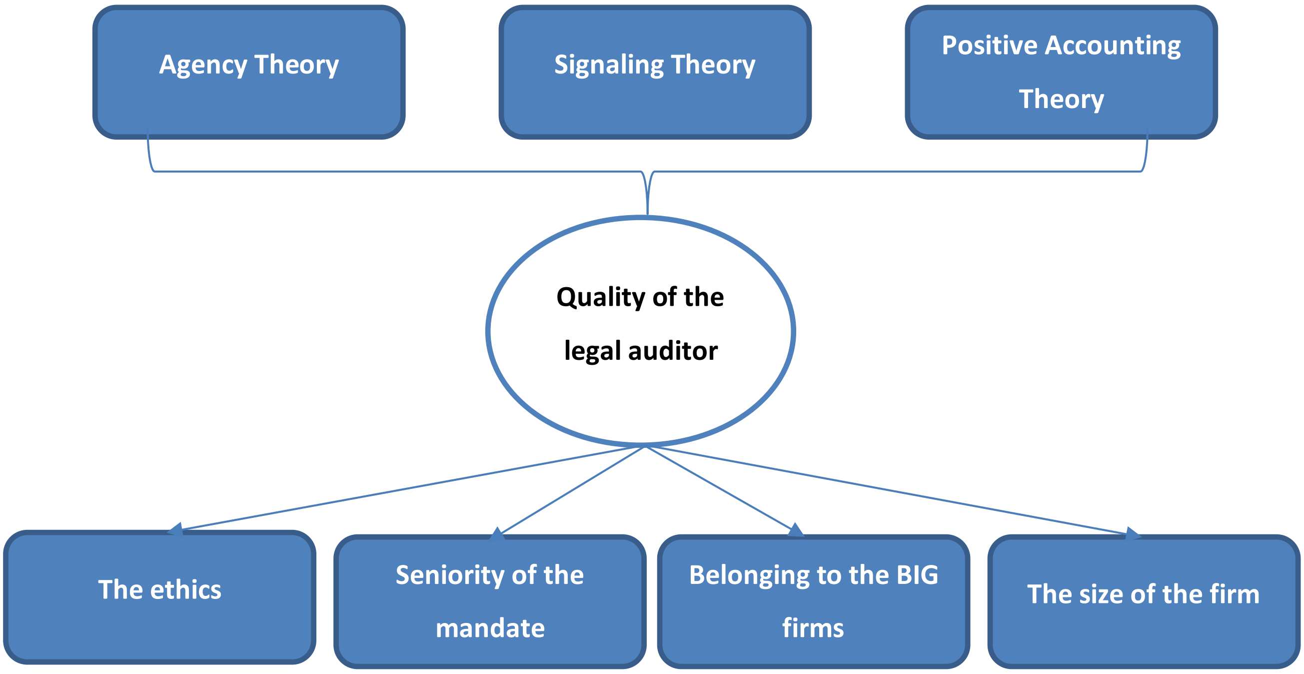
systems make it possible to regain the confidence of investors. The findings raised during these debates have led to the introduction of an arsenal of laws such as the Financial Security Act (LSF) and the Sabarnes-Oxley Act (SOX), not to mention the creation of new bodies ensuring independent control, notably the Haut Conseil du Commissariat aux Comptes in France and the Public Company Accounting Oversight Board in the United States.

This legal arsenal has led to a reform of the information circuit by integrating more the importance of the legal auditor as an independent agent who watches over the reality, the sincerity and the image of the organization's summary statements, as well as his contribution in the appreciation of the quality of the accounting and financial data communicated to the participants of the circuit. In the same way, these laws have implicitly modified the structure of the profession by bringing more responsibility for control and supervision in order to perfect the quality of the legal audit. The importance of a quality audit can be largely appreciated in view of the requirements in terms of financial information, since it is widely used in the contractual relations between the various stakeholders (Moussamir & Aouina, 2020).

This article thus aims to demonstrate that the perceived quality of financial information is possibly based on the quality of the statutory audit and to provide elements of an answer to the following question: "Is the quality of the statutory audit a fundamental variable in the evaluation of financial information?".

In order to approach the problematic of this article, a first section is dedicated to the exploration of the different theories that deal with the contribution of the auditor as an evaluator and guarantor of the quality of financial information, notably that of the agency theory, the signal theory, and the positive theory of accounting. A second section is dedicated to the criteria relating to the quality of the auditor according to his ethics, the length of his mandate, his membership in a big network and finally the size of his firm. This sequence can take the form of the following diagram:

**Figure N°1 : Conceptual model**




**Source : Authors**

## 1. Exploration of the main theories mobilized

In order to begin our research work, we have collected several works highlighting several ideas relating to the link between the quality of legal auditing and that of financial information. We are going to evoke some theories in the framework of our research by instance the agency theory, the signal theory, and the positive theory of accounting, then we are going to treat researches and studies which refer to our thematic.

### 1.1. The statutory existence of the auditor in the agency theory

The agency relationship is defined as "a contract by which one or more persons (the Principal) engages another person (the Agent) to perform some task on his behalf that involves delegation of some decision-making power to the Agent" (Jensen & Meckling, 1976). Thus, there is a need to distinguish between two stakeholders, on the one hand the managers and on the other the owners, whose aims are not necessarily convergent as mentioned by Watts (1977). The lack of convergence between the interests of these two parties often leads to conflicts, which sometimes push the managers to serve their own interests. This situation is a matter of opportunism on the part of managers, who do not necessarily align themselves with the shareholders.

The solution evoked by Jensen and Meckling (1976), which makes it possible to reduce the asymmetry of information on the one hand and to reduce the conflicts between the various stakeholders on the other hand, is the solicitation of an agent carrying out an independent mission, in particular the statutory auditor. This professional in the accounting and financial field carries out an assignment in order to certify the summary statements, which makes it possible to reduce agency costs.

Furthermore, the agency theory stipulates the existence of a different typology of stakeholders, namely insiders and outsiders, emphasizing the risk of asymmetry based on the degree of access to financial information, which is considered very important on the side of managers. On the other hand, stakeholders outside the company are very demanding with respect to the financial information disseminated, as it is involved in their decision-making process. At this level, Lin and Hwang (2010) present the external auditor as a solution for reducing information asymmetry by ensuring the fair dissemination of relevant financial information. Thus, the information certified by the statutory auditor represents an opportunity to reduce costs and information asymmetry.

### 1.2. Signal theory and statutory auditing

The work of Akerlof (1970) on the scale of the vehicle market, that of Spence (1973) on the labour market, and the studies carried out by Ross (1977) on the subject of financial structure played an important role in the introduction of signal theory. The latter emphasizes the imbalance in access to financial information between the stakeholders involved in the management of the firm. At this stage, the readers of the summary statements do not have the same privilege as the managers (insiders) regarding the consistency of the goods and services produced by a specific company, which highlights an information asymmetry. Moreover, managers are strongly required to signal on the quality of their companies and quote them in financial publications, in order to allow investors to properly evaluate securities listed on capital markets (Mezghani & Ellouze, 2007).

The signaling theory is based on the importance of sending a strong signal in order to mark the perception of consumers and regain their confidence. This process is similar to the approach taken in the financial market, since the signals emitted by the issuing companies are studied and analyzed by all investors in order to evaluate the securities. The analysis undertaken by investors is mainly interested in financial communication, which represents a major risk, controlled by the intervention of the statutory auditor, since the latter ensures the fair distribution, the sincerity and the reliability of financial information.

### 1.3. Extension of information asymmetry in positive accounting theory

Positive accounting theory is an extension of the agency theory mobilized by Watts and Zimmerman (1978), and is particularly interested in the behavior of those who prepare financial statements. This theory describes in detail the practices of management accounting officers and the impact of these practices on financial market behavior.

The main idea of the positive accounting theory is that financial statement preparers are often driven to choose management practices that maximize their self-interest. According to Bushman and Smith (2001), the primary goal of accounting research is to provide evidence that the information conveyed by accounting reduces agency problems.

## 2. Key assumptions about the links between legal auditing and the quality of financial reporting

In this respect, the statutory auditor is perceived as a provider of quality services thanks to his function as controller and supervisor of the good accounting practices of the managers. Therefore, the statutory auditor constitutes a relevant indicator in the evaluation of the quality of financial information, in other words, the more the quality of the statutory audit is reinforced, the more the behavior of the preparers of summary statements will be up to standard.

### 2.1. Relationship between the ethics of the legal auditor and the assessment of the quality of financial information

According to Piot (2005), the reliability of financial information is linked to the quality of the statutory audit, which is considered to be an essential criterion that provides the statutory auditor with the necessary leeway to validate the accuracy of the accounts. The quality of the legal audit has several definitions depending on the authors' assumptions, as for example De Angelo (1981) stresses the importance of competence and independence, insofar as the legal auditor must not only be able to raise the finding or detect the anomaly, but also to pass on this discovery to the shareholders.

This definition distinguishes between two different concepts, on the one hand the auditor's ability to detect misstatements in the accounts of the audited entity, thanks to his professional competence and experience, and on the other hand the auditor's independence in reporting findings to the relevant persons. These two notions represent the essential basis for the ethics of the audit.

The work of the legal auditor is closely linked to his ethics, as Lynn Turner (2000) points out in a speech at the 27th anniversary of the Securities Regulation Institute. The former director of accounting affairs at the Securities and Exchange Commission emphasizes the importance of competence in the conduct of an auditing engagement, since it is about serving the public interest by ensuring an independent audit of a given entity's accounts in order to disseminate correct and reliable information. During this speech, the former director also mentioned that the independence of the auditor is only ensured by the absence of external pressure.

Piot (2005), however, does not agree with Turner's postulate, since in practice the management of the company is often faced with conflicts of interest, from which the legal auditor cannot escape. This reflection has its origin in the nature of the relationship between the auditor and the audited entity, because the auditor has to fulfill a mandate remunerated by a fee fixed with the management. Therefore, the ethics of the external auditor must resist the pressures exerted by certain stakeholders in order to carry out his mission under the right conditions and result in a relevant evaluation of the financial information disseminated. According to the studies centered around this subject, we can formulate the following hypothesis:

***Hypothesis 1: The quality of information would be associated with the ethics of the legal auditor.***

### 2.2. The link between the length of the auditor's mandate and the quality of financial information

On another level, the independence of the statutory auditor is often related to the length of his mandate, which binds him to the audited entity. Indeed, Tan (1995) has pointed out that the length of the mandate is correlated with the relationship between the legal auditor and the audited entity, which often leads to a decrease in vigilance and consequently to the alteration of the judgments made by the audit mission. This observation is also demonstrated by Bertin (2002), insofar as a longer mandate often leads to the broadcasting of an irrelevant signal. The following hypothesis emerges from the above discussion:

***Hypothesis 2: The length of the legal auditor's mandate would impact the transparency of financial communication.***

### 2.3. The relationship between belonging to "big" firms and the assessment of the quality of financial information

Moreover, audit ethics are not the only variable impacting the quality of financial information; it remains relative to other parameters. DeAngelo (1981) introduced the fact that the auditor belongs to a so-called "big" firm as a criterion reflecting quality financial information, knowing that big firms have highly qualified professionals with the necessary skills to raise anomalies. Anderson and Zeghal (1994) share the same view, as they emphasize the reputational constraint that drives big firms to produce work distinguished by a good brand image. This observation leads to the formulation of the following hypothesis:

***Hypothesis 3: The legal auditor's belonging to a big network would influence the quality of the financial information***

### 2.4. Consideration of the firm's reputation and size in evaluating financial statements

Moreover, the reputation of the audit firm chosen by the audited entity has become a primary criterion in the eyes of investors for entrusting the mission to reputable professionals in the market and for giving credibility to the financial information disseminated, especially in the eyes of developed countries, which aim above all to protect public savings (Francis & Wang, 2006). This view is shared by Peasnell (2001) in his study of the stock market performance of listed companies, where the author demonstrated that accounts certified by reputable firms and integrated into international networks perform better than those audited by non-reputable firms. Other studies have been carried out in this respect, showing that the size of audit firms has a strong impact on the financial information disseminated, since the organization of large firms is characterized by sector specialization in several areas of activity. Sector specialization is also associated with reasonable assurance of the relevance of financial information (Gramling, 1999). However, this view is not shared by Lys and Watts (1994), who find no correlation between sector specialization and financial reporting quality. This finding allows us to formulate the following hypothesis:

***Hypothesis 4: The size of the statutory audit firm would have an impact on the quality of the financial information.***

## Conclusion

This article has served to present a transversal reading on the state of the art of the findings raised by several studies and researches, which share the opinion on the indispensability of the legal audit in the assessment of the quality of financial information, which serves as a basis in the decision-making process of the different stakeholders. This indispensability is strongly endorsed in view of the opportunism shown by the company's managers, as they have the possibility of altering data or retaining certain information, which calls into question the symmetry of the information. At this stage, the legal auditor is the guarantor of the fair distribution of financial information and the main assessor of the regularity, fairness and faithfulness of the accounts.

The perceived quality of financial information is subject to various criteria in the eyes of theorists and readers of summary statements. Among the criteria used to assess the quality of financial information, theorists have highlighted certain variables, such as the quality of the statutory audit, as being essential to guarantee a reliable measure of the financial information disseminated. Our literature review revealed a set of findings on the definition of the quality of the statutory audit. On the one hand, some authors find that the quality of the legal audit is closely related to the ethics of the legal auditor, which includes the criteria of independence and competence, which translates into his ability to detect and disclose.

Without the presence of these two characteristics, the quality of financial information is systematically threatened and questioned, and the intervention of the legal auditor hinders the principles of transparency and reliability, since he is in this case incompetent and dependent on the audited entity. This seriously affects the ability of investors, shareholders and other stakeholders to formulate relevant opinions on the financial situation of a given entity. This circumstance is reflected by the multiple financial scandals that have erupted in recent years, which have called into question the missions of audit firms, such as the case of Enron - Arthur Andersen.

On another level, some authors have pointed out that the ownership, the length of the mandate and the size of the firm are variables that largely influence the quality of the statutory audit. Indeed, the length of the mandate between the legal auditor and the audited entity can possibly impact his or her judgment, as the authors have shown that a longer mandate often leads to a certification subject to external pressures. Similarly, entities using big firms do not run the risk of being challenged, since these firms are quite reputable in the market and specialize in different sectors of activity thanks to the qualifications of their staff. In fact, auditing centers specialized in certain sectors are able to produce a certification that is all the more relevant in the eyes of investors. However, this view is not shared by all authors, since some find that specialization does not change the quality of financial information.

Finally, this literature review provides a set of information that is part of a preliminary phase of a doctoral thesis on the relevance of the quality of the statutory audit in the evaluation of financial information. In this same perspective, this article highlights four managerial implications that have a significant impact on the process of evaluating the quality of financial information, namely as :

- The ethics of the legal auditor, including independence and competence, represent an important and indispensable criterion in the reliability of the quality of financial information ;
- The seniority of the auditor's mandate drastically influences his mission and impacts to a degree his independence;
- Belonging to a big firm is a strong signal and is still quite apprehended by investors, since it reflects a reputation and a good image;
- The size of the firm, which is a parameter measured according to criteria that are subjective to investors' expectations, has an influence on the assessment of the quality of financial information, given the constraints of sector specialization.

However, each scientific study opens the door to perspectives and questions to be addressed in subsequent studies. This article provides an overview that can be empirically studied to :

- Demonstrate the absolute necessity of the CAC's involvement in the financial reporting process assessment ;
- Measuring the impact of each variable in the quality of the legal auditor on the evaluation of financial information by investors ;
- Assessing the quality of the statutory audit in the Moroccan context.

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