The Effect of Financial Reporting Quality on the Relationship between Stock Price Crash Risk and Litigation Risk Against the Auditors

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Abstract

Objectives: The purpose of this study is to investigate the effect of financial reporting quality on the relationship between stock price crash risk and litigation risk against auditors.

Design/methodology/approach: This research utilizes multivariate regression to analyze the hypotheses. The statistical population of this study includes all firms listed on the Tehran Stock Exchange, with 131 firms selected using a systematic elimination sampling method. The study covers a period of 9 years, from 2014 to 2022.

Results: The testing of the first hypothesis revealed a direct and significant relationship between stock price crash risk and litigation risk against auditors. The second hypothesis demonstrated that financial reporting quality has a significant and inverse relationship with stock price crash risk and litigation risk against auditors. Additionally, financial reporting quality was found to have a significant and inverse relationship with litigation risk against auditors.

Contribution: This research provides evidence that stock price crash risk can increase auditors' litigation risk, and suggests that financial reporting quality can play a crucial role in this context.

Keywords: Stock Price Crash Risk, Litigation Risk, Financial Reporting Quality.

1. Introduction

If we want to provide a complete and comprehensive definition of the possibility of auditors being sued for their work and the high sensitivity of their position in the future, especially in cases of litigation against them or audit firms, we should refer back to the definition provided by Binez et al. (2012). They stated in their study that there are various scenarios that could arise due to the sensitivity of the audit job. Lawsuits may be filed against auditors in the future, and as defined by D'Angelo (1981), the quality of financial reporting is closely tied to the quality of the audit. If auditors perform their duties with the required quality, financial statements will be free of significant fraud and distortions (Baghomian and Rajabdorry, 2019).

Statistics and research conducted worldwide confirm that the most significant issue in the auditor community over the past three decades has been the level of litigation and complaints raised against auditors globally. In 2012, Badrestcher et al. reported that approximately $5.66 billion in damages were paid due to complaints against auditors, a figure of great concern (the American Audit Quality Center). Similarly, in Iran, Professor Dastgir's study highlighted official statistics on complaints against auditors, which are not publicly available but have shown an increasing trend. This rise in complaints has resulted in significant financial losses for many individuals. Apart from financial obligations to pay damages, this can severely damage their professional reputation, work quality, and the credibility of their institutions, sometimes irreparably (Ghadimpour and Dastgir, 2016).

Empirical and theoretical research findings indicate that audit scandals, which have led to criminal charges and the collapse of firms, coupled with the issue of stock price depreciation due to concealed information by corporate managers, necessitate greater involvement of the accounting community and auditors in addressing problems such as the risk of future stock price drops. Auditors play a crucial role in ensuring the quality of financial statements presented to the market, as evidenced by various studies (Wall, 2017; Akhlaghi et al., 2023).

The sudden fluctuations in stock prices have drawn the attention of academics and capital market professionals in recent years, both in terms of price drops and increases. Given the significance of stock returns to investors, the phenomenon of stock price declines, resulting in sharp decreases in returns, has garnered more research interest compared to price increases (Ebrahimi et al., 2017). Diversification in research has identified financial reporting quality as a potential solution to mitigate future stock price declines. One of the primary objectives of accounting reporting is to provide valuable information about an entity's financial performance to a wide range of users. The income statement, when prepared and presented in accordance with accounting standards, offers valuable insights into a firm's financial performance for shareholders and investors (Izedi et al., 2021; Akhlaghi et al., 2024).

Many researchers attribute stock price declines to internal firm management practices. When information is disseminated randomly in the market, regardless of its nature, firms do not experience sudden drops in stock value. If firms prioritize spreading positive news over negative news and keep negative information hidden, it can lead to a buildup of negative news, resulting in a sudden decline in stock value. Auditors are the final checkpoint to verify the accuracy of corporate financial information. Failure to identify inaccuracies intentionally or unintentionally can result in backlash from shareholders and stakeholders (Fakhari and Nasiri, 2013).

Given the significance of this issue and the risks faced by the audit profession, this study aims to explore the impact of stock price crash risk on firms on litigation and the likelihood of lawsuits against auditors.

Research in this area defines financial reporting quality as the ability of financial statements to convey information about the firm's operations, particularly forecasting its expected cash flows to investors. This is based on the belief that accruals enhance the

informational value of profits by reducing the impact of unsustainable fluctuations in cash flows (Biddle et al., 2009). Financial reporting quality distinguishes useful information from other data, promoting the usefulness of information for investors, creditors, managers, and other stakeholders (Piri et al., 2014). Financial information transparency has always been considered one of the most influential variables in determining investment strategies in the market. Quality financial reporting can be defined as the accuracy of financial reporting in reflecting information about the operations and cash flows of a for-profit entity (Bashirimanesh and Pakdel, 2019).

When evaluating financial reporting quality, two general approaches are typically used: one focuses on the needs of users, while the other supports investors and shareholders. The user-oriented approach determines financial reporting quality based on the usefulness of financial information (relevance and reliability). On the other hand, the investor-oriented approach defines financial reporting quality in terms of full and fair disclosure for shareholders. In this context, financial reporting quality entails complete and transparent financial information that prevents misleading or creating ambiguity for users (Taghizadeh Khanghah and Zeinali, 2015; Azizi et al., 2023). Therefore, this study aims to investigate whether financial reporting quality influences the relationship between stock price crash risk and litigation risk against auditors.

Auditors, as trusted individuals and intermediaries between stakeholders and firms, frequently encounter risks in their roles, referred to as audit risks in audit standards. While previous research has extensively discussed risks such as undetected risks, the issue of lawsuits against auditors and its implications have received less attention (Jabbarzadeh Kangarloui et al., 2014). Given the importance of financial transparency in corporate reporting for shareholders, which can impact returns and stock prices, auditors may face legal and criminal issues if discrepancies arise. Investors and stakeholders rely on auditors to provide accurate financial statements, and any discrepancies

could lead to a decline in stock prices. This study aims to address the gap in research regarding the relationship between stock price crash risk and litigation risk against auditors.

The results of this research can serve as a guide for accounting and audit researchers, as well as managers and auditors, in understanding factors that may contribute to stock price crash risk. Considering that the quality of financial reports plays a crucial role in managing these risks, financial professionals should pay close attention to this aspect. Improving audit quality can help prevent potential complaints against auditors. This research aims to provide both practical and theoretical insights. The research structure includes expanding on theoretical foundations, hypotheses, and empirical bases, detailing the methodology and operational definitions of research variables, and presenting the findings and conclusions.

2. Theoretical Development of the Hypothesis

Conservative managers do not always have an incentive to disclose asymmetric information because in such a situation, the maintenance costs and non-disclosure of negative news will outweigh its benefits. However, in situations where information asymmetry between managers and investors is high, the costs of non-disclosure of negative news and their accumulation within the firm will be less than its benefits (Hajiha and Ranjbarnawi, 2018). Managers are motivated to hide negative news within the firm. When the sum of bad news reaches a tipping point, the accumulation of this bad news becomes inevitable, and it is likely to be disclosed to all foreign investors outside the market at once, leading to a drop in the stock price of firms (Foroughi & Mirzaei, 2012). Sometimes, information enters the market randomly, and the process of disseminating information, whether good or bad, is systematically carried out (Fakhari and Nasiri, 2020). In this case, the published information has a symmetric distribution and gradually reflects in the stock price, preventing price bubbles and stock price falls. However, when information asymmetry

between managers and investors is high, the costs of disclosing negative news and accumulating it within the firm will be less than its benefits (Hajiha and Ranjbar Navi, 2018). While the conservatism of managers is an important feature of the accounting information system and a stable principle in accounting, this factor can affect the risks of the firm's projects and increase overall risks. According to this view, the conservatism of the owner can increase audit risk and litigation risk against the auditor (Fendrersky & Safari Gerielli, 2018).

Audit risk is the risk of not discovering significant distortions in accounting information related to profit, cash flow, and financial situation by auditors. Auditors are required to obtain reasonable assurance of the absence of such distortions as a result of the audit (Dulabi, 2019). Identifying bad news and the possibility of breaching debt conditions leading to financial crises and bankruptcy increases the risk of the firm. Therefore, it is more likely that shareholders of firms facing a crisis and higher risk will file complaints against their auditor, increasing the risk of lawsuits against the auditor. In firms where managers accumulate negative news and do not disclose it, the firms are likely to experience a crisis and a drop in stock price. As a result, blame is often placed on the auditors (Abdi et al., 2018). This forms the basis of the first hypothesis of the research presented as follows:

H1: There is a significant relationship between the risk of a stock price crash and the risk of litigation against the auditor.

Many researchers believe that the decline in stock prices is attributed to the management of internal information. In cases where information is unintentionally leaked to the market, and the process of distributing information is systematic, regardless of its nature, it can be said that the published information has an asymmetric distribution. In other words, if managers promptly disclose all information, it will lead to an asymmetric distribution in the returns of shares. This implies that the average positive returns on good news should be equal to the average negative returns on bad news. Business unit managers often try to conceal bad news while promoting good news about the firm (Kothari et al., 2009).

Financial reporting quality serves as the criteria that distinguish useful information from other information and enhance the utility of information. Furthermore, financial reporting quality pertains to the usefulness of financial statements for investors, creditors, managers, and other stakeholders, ensuring that all news and facts about the firm are conveyed in the quality financial reports (Mehravar and Kargar, 2019). Accurate and timely financial reporting holds significant value, and individuals exposed to the opportunities and risks of capital market fluctuations are well aware of its importance. Considering the value of accounting information, it is imperative to explore various aspects of this information, such as calculation, presentation, quantity, quality, and other related factors, through different research studies (Nikbakht and Khan Beigi, 2018).

The impact of the quality of disclosed information is that higher quality information disclosed by a firm reduces the emotional behavior of investors. A superior disclosure policy alleviates investor concerns regarding confidential transactions within the organization and inappropriate selection issues. Previous research findings indicate that disparities in the quality of accounting information provided by firms have an asymmetric influence on investor confidence, with higher quality accounting information easing investment complexities. Independent auditors play a crucial role in instilling confidence in investors by meticulously reviewing firm financial statements. Conflicts of interest and potential events involving reporting and fraudulent activities drive auditors to enhance the quality of audits, significantly reducing information asymmetry between internal and external stakeholders. Competent and skilled auditors are able to prevent legal disputes by thoroughly examining financial statements, presenting accurate statements, and enhancing audit quality (Ebrahimi Kordlar & Javani Ghalandari, 2016).

Given the theoretical foundations and the notion that stock price crash risk stems from concealing and accumulating negative news and a lack of transparency in financial reporting, improving financial reporting quality will undoubtedly mitigate the risk of stock price crashes. The second hypothesis posits that the primary responsibility for verifying and transferring financial reporting quality outside the auditor's firm lies in reducing the risk of stock price crashes.

H2: The quality of financial reporting significantly affects the relationship between stock price crash risk and litigation risk against the auditor.

3. Background of the Research

Zhao (2021) emphasizes in a study titled "Auditor Unusual Fee and Stock Price Risk" that the occasional widespread stock price fluctuations in the global stock market underscore the importance of researching the risk of stock price declines. It is crucial to consider the impact of unusual audit costs on the risk of stock price drops. The relationship between risk reduction and abnormal costs: Audits can serve as an early warning system for potential stock price declines. The results indicate a significant correlation between abnormal audit costs and the risk of stock price crashes.

Demeyst et al. (2020), in a study titled "Practical Summary of Factors Affecting the Results of Legal Claims Against Auditors," summarized the factors influencing legal claims against auditors based on interviews with 27 leading litigation attorneys. They discussed the factors contributing to lawsuits against auditors in the United States and how these factors impact the outcomes of such lawsuits. These findings have significant implications for audit firms, particularly auditors. Factors such as the motivation behind legal claims, the extent of financial losses suffered by firms, auditors' ability to pay, and the anticipated costs of litigation are crucial in determining the outcomes of these cases. Unlike court settlements, many claims can be resolved through negotiation.

Huck (2020), in a study titled "The Role of Audit Firms in Detecting Fraud in Preventing Claims Against Auditors," highlights the negative impact of financial and economic crises on developing countries and their populations. The research emphasizes the vital role audit firms play in the economy by helping firms conduct their business activities efficiently. The failure of audit firms can have devastating consequences for themselves, their clients, and shareholders. The study also suggests that audit firms may face conflicts of interest arising from controversial situations.

Cheng et al. (2020), in a study titled "Transparency of Operating Cash Flows and Stock Price Crash Risk," suggest that opaque operating cash flows can increase the risk of stock price crashes, while accruals management can significantly affect stock price crash risks.

Hay and Ron (2018) examined the relationship between financing constraints and the risk of stock price crashes, finding that increased financing restrictions lead to a higher risk of stock price crashes.

Chen et al. (2017) investigated the link between profit smoothing and the risk of stock price crashes. They found that high levels of profit smoothing are associated with an increased risk of stock price crashes, especially for firms with fewer analysts and smaller institutional shareholders, as well as positive voluntary accruals. Profit smoothing was also linked to significant negative returns in the three months following the profit announcement.

Wall (2017) suggested that increasing the use of information technology can reduce the risk of litigation against auditors.

Alder and Besley (2017), in a study focusing on information technology and auditing, pointed out that improper use of technology and hacking of confidential documents can pose risks to auditors, potentially increasing litigation risks. They found a significant relationship between the level of information technology in firms and litigation against auditors.

Yuan and Zhang (2016), in a study on "Real Effects on Corporate Financial and Accounting Statements," demonstrated how lawsuits and fraud disclosures can significantly devalue a firm, disrupt financing and investment, and reduce the firm's reputation. This can lead to difficulties in obtaining foreign funds and a decrease in foreign financing, hindering profitable investments.

Yangyang et al. (2015) discovered that lawsuits against auditors and complaints from owners can influence auditor behavior and prompt both parties to proceed cautiously.

Casterolla et al. (2007) argued that litigation against auditors stems from negligence, audit failures, and a lack of auditing quality. They defined litigation against auditors as defects in professional procedures that result in legal action due to audit quality issues.

4. Research Method

Due to the basic theoretical foundations related to the variables being studied, the present study is classified as applied research in terms of its purpose and method of execution. It is categorized as descriptive-causal research because it does not manipulate independent variables to measure their effects on dependent variables, but rather observes them as they are. Historical and post-event data were collected using library and archival methods to test the research hypotheses.

The statistical population of the study includes all firms listed on the Tehran Stock Exchange. After excluding firms with financial periods ending at times other than the end of March, firms that changed their financial period during the research period, those with insufficient information for comparability, as well as investment firms, banks, and insurance firms, a sample of 131 firms was selected using a systematic screening pattern.

Data from these firms were collected over a 9-year period from 2014 to 2022 to ensure a sufficient sample size for analysis. The combined data were homogenized to account for the different nature of the firms' activities and reports. Regression analysis was then conducted using Eviews 12 software, logistic regression, and other appropriate statistical methods to test the research hypotheses.

5. Regression models of research

The first model:

$$\text{LIT SCORE}_{j,t} = \beta_1 + \beta_2\, \text{NCSKEW}_{i,t} + \beta_3\, \text{M/B}_{i,t} + \beta_4\, \text{ROA}_{i,t} + \beta_5\, \text{LOSS}_{i,t} + \beta_6\, \text{DEBT}_{i,t} + \beta_7\, \text{LEV}_{i,t} + e_{i,t}$$

The second model:

$$\text{LIT SCORE}_{j,t} = \beta_1 + \beta_2\text{NCSKEW}_{i,t} + \beta_3\, \text{FRQ}_{i,t} + \beta_4\, (\text{NCSKEW}_{i,t} * \text{FRQ}_{i,t}) + \beta_5\, \text{M/B}_{i,t} + \beta_6\, \text{ROA}_{i,t} + \beta_7\, \text{LOSS}_{i,t} + \beta_8\, \text{DEBT}_{i,t} + \beta_9\, \text{LEV}_{i,t} + e_{i,t}$$

5.1. Variable definition

Dependent Variable: Litigation Risk Against Auditor (LITSCORE)

Because lawsuits against auditors can be influenced by various factors, it is necessary to utilize a comprehensive model for investigation. This model should be based on previous findings (Shu, 1999) and research conducted by Krishnan and Zhang (2005), JabbarZadeh et al. (2014), and RajabDorry and Baghoumian (2019). The investigation into litigation risk against auditors will be conducted as follows:

$$\text{LITSCORE} = 0.276*\text{SIZE} + 1.153*\text{INV} + 2.075*\text{REC} + 1.251*\text{ROA} + 1.501*\text{LEV} + 0.301*\text{GROWTH} - 0.371*\text{RET} + 0.235 - 10.049$$

as follows:

LIT SCORE: Litigation Score Against Auditor

SIZE: Natural logarithm of total assets at the end of the year

INV: Inventory divided by total assets

REC: accounts receivable by total assets

ROA: Return on assets

LEV: Total liabilities divided by total assets

GROWTH: Sales – Last year's sales / last year's sales

RET: Rate of return on stocks: stock price of the year $(t+1)$ - stock price of the year (t) + dividend / stock price of the year (t)

We use the equation provided above to assess the litigation risk against the auditor. We then categorize the sample firms into high-risk and low-risk groups. Firms with scores above the average will be classified as high risk, while others will be considered low risk. The high-risk group will be ranked as (1) and the low-risk group as (0).

Independent Variable: Stock Price Crash Risk (NCSKEW):

The Negative Skew Model of Return on Equity:
To measure this criterion, the negative coefficient of skewness of Chen et al. (2001) and Cheng (2020) is used as follows: The higher the negative coefficient of skewness, the more likely the firm is to fall in the stock price.

$NCSKEW_{i,t} = -n(n-1)^{2.3} \sum w_{j,t}^3 / (n-1)(n-2)(\sum w_{j,t}^2)^{2.3})$

NCSKEW: Negative Skew Specific Monthly Returns of the Firm i per month t during the fiscal year

$W_{i,t}$: The firm's specific month returns I in week t.

N: The number of months whose returns are calculated.

To measure the firm's specific monthly returns, the relationship (1) is used:

$$W_{jt} = Ln \ (1 + \varepsilon_{j,t})$$

$W_{j,t}$: Firm j specific monthly returns at month t during the fiscal year.

$E_{J,t}$: Thr residual term of the following model:

$r_{j,t} = \beta_0 + \beta_1 r_{mt-2} + \beta_2 \ r_{mt-1} + \beta_3 \ r_{mt} + \beta_4 \ r_{mt+1} + \beta_5 \ r_{mt+2} + \varepsilon_{j,t}$

$r_{J,t}$: return on J's stock in month t during the fiscal year.

$R_{m,t}$ is the market return in month t (To calculate the monthly market return, the index at the beginning of the month is deducted from the end of the month and the result is divided by the index at the beginning of the month).

Moderating Variable: Financial Reporting Quality (FRQ)

To calculate the quality of financial reporting, accruals quality has been used in this study.

Jones' modified model is the strongest model for measuring accruals quality. Based on the modified Jones model (1995), the quality of accruals is calculated based on model (1).

Model (1)

$$\frac{TAC_{it}}{TA_{it-1}} = \alpha_0 \left(\frac{1}{TA_{it-1}}\right) + \alpha_1 \left(\frac{\Delta REV_{it}}{TA_{it-1}}\right) \\ - \alpha_2 \left(\frac{\Delta REC_{it}}{TA_{it-1}}\right) + \alpha_3 \left(\frac{PPE_{it}}{TA_{it-1}}\right) \\ + \varepsilon_{it}$$

In this model:
$TAC_{i,t}$ =total accruals of the firm i in year t
$TAC_{i,t}$ = $E_{i,t} - OCF_{i,t}$
$E_{i,T}$ =Net Profit
$OCF_{i,t}$ =Operational cash flow
$\Delta REV_{i,t}$: change in firm sales revenue from year t to t-1
$\Delta REC_{i,t}$: Changes in accounts receivable from year t to t-1
$PPE_{i,t}$: Gross property, plant, and equipment at year t
$TA_{i,T-1}$: Total book value of assets of the firm I at year T-1
$\varepsilon_{i,t}$: The residuals of the model.
In this research, to obtain the quality of accruals, the error of the absolute value model is taken and multiplied by the negative number 1.

Control variables

ROA: Net profit is divided by total assets.
DEBT: Long-term liabilities divided by total assets.
MB: The market value of the capital to the book value of the capital at the end of the financial year.
LOSS: A dummy variable that takes 1 if the firm's income is negative in the current period, and 0 otherwise.
LEV: the sum of the total liabilities divided by the sum of the total assets is used.

Research Findings

Descriptive statistics of research variables: The findings of the research include descriptive statistics and inferential statistics, which are first presented in the table below descriptive statistics.

For instance, the average value for the financial leverage variable is 0.57, indicating that the majority of the data is centered around this point. One of the most crucial measures of dispersion is the standard deviation. The standard deviation for Market value to book value is 3.07, while for the financial reporting quality variable it is -0.09. This suggests that these two variables have the highest and lowest standard deviations, respectively. The minimum and maximum values reflect the lowest and highest values within each variable. For instance, the highest financial leverage amount is 12.1, which is a hundredfold increase.

As can be seen in Table 3, the total number of firms under investigation is equal to 1179, of which 625 firms ,equivalent to 53.01% of the firms ,have the possibility of filing a lawsuit against the auditor, and in 554firm-years, that means that 46.99% of the year - there was no risk of filing a lawsuit against the auditor.

As can be seen in Table 4, the total of the surveyed firms is 1179. Among them, the number of 126 firms, equivalent to 10.69 percent of the firms, has been a loss of 1053 firm-years, i.e., 89.31 percent of the firm-years, and has not been unprofitable.

The results of Table 6 show that the Stock Price Crash Risk has a positive coefficient (0.089) and a significance level of less than 5% (0.028), indicating a significant relationship with Litigation Risk.

Therefore, the first hypothesis is accepted. Additionally, all control variables demonstrate a significant relationship with the dependent variable.

McFadden's coefficient is calculated as 0.17, suggesting that 17% of the changes in the dependent variable are likely numerically between zero and one. The LR statistic is 280.04, with a significance level of less than 5%, confirming that the fitted model is valid.

The results of Table 8 show that the interaction between Financial Reporting Quality and Stock Price Crash Risk has a negative coefficient of -1.04, with a significance level of less than 5% (0.016), indicating that the second hypothesis is accepted. Additionally, financial reporting quality has a negative coefficient of -0.32, with a significance level of less than 5% (0.004), suggesting an inverse and significant relationship with Litigation Risk. Furthermore, all control variables exhibit a significant relationship with the dependent variable.

McFadden's coefficient is calculated to be 0.17, indicating that 17% of the changes in the dependent variable are likely numerically between zero and one. The LR statistic is 66.286, with a significance level of less than 5%, indicating that the fitted model has sufficient validity.

According to the results of Table 9, it is evident that the accuracy percentage of model predictions in the research models is over 50%, demonstrating the fitness and accuracy of the model.

According to the results of Table 10, it can be seen that the level of significance of the Hosmer-Lemeshow test for the model research is greater than 5%, indicating an optimal fit of the regression model.

Table (1): Descriptive statistics of quantitative research variables

Variable	Mean	Max.	Min.	Std. v
NCSKEW	-1.10	3.95	-3.97	1.62
FRQ	-0.10	-0.010	-0.46	-0.09
ROA	0.17	0.47	-0.010	0.13
MB	4.42	9.99	1.11	3.07
LEV	0.57	1.12	0.14	0.20
DEBT	0.068	0.29	0.004	0.007

Table(2). Frequency risk of Litigation risk against

Description	Frequency	percentage
1	625	53.01
0	554	46.99
total	1179	100

Table(3). frequency of the firm's Loss variable

Description	Frequency	percentage
1	126	10.69
0	1053	89.31
total	1179	100

Table5: First hypothesis test result

Variable	Coefficients	Std	z statistic	Sig
NCSKEW	0.089	0.040	2.19	0.028
MB	-0.15	0.023	-6.44	0.000
ROA	4.66	0.66	6.98	0.000
LEV	6.59	0.47	13.88	0.000
LOSS	-0.73	0.24	-3.00	0.002
DEBT	3.03	0.99	-3.32	0.000
C	-3.39	0.23	-10.55	0.000
Other information statistics				
LR statistics		280.04		
Sig		0.0000		
McFadden Coefficient		0.17		

Table7: Second hypothesis test result

symbol	Coefficients	Std	z statistic	Sig
NCSKEW	0.19	0.061	3.23	0.001
FRQ	-0.32	0.11	-2.81	0.004
NCSKEW * FRQ	-1.04	0.43	-2.39	0.016
MB	-0.15	0.023	-6.42	0.000
ROA	4.54	0.67	6.73	0.000
LEV	6.51	0.47	13.66	0.000
LOSS	-0.78	0.24	-3.17	0.001
DEBT	-3.19	1.00	-3.19	0.001
C	-3.26	0.32	-9.39	0.000
Other information statistics				
LR Statistics		286.66		
Sig		0.0000		
McFadden Coefficient		0.17		

Table (9): accuracy percentages of model prediction

model name	Total forecast
(model) 1	70.31 percent
(model) 2	70.57 percent

Table10: The results of the Hosmer- Lemeshow test

hypothesis	test statistic	Sig
(model) 1	5.34	0.71
(model) 2	11.43	0.17

Findings and discussions

The purpose of this study is to investigate the impact of financial reporting quality on the relationship between stock price crash risk and litigation risk against auditors. The main hypothesis predicts a connection between stock price crash risk and litigation risk against auditors. The first hypothesis test revealed a direct and significant relationship between stock price crash risk and litigation risk against auditors, with a positive coefficient. This suggests that higher stock price crash risks increase the likelihood of audit lawsuits. Investors and stakeholders rely on auditors' reports for transparency in financial statements. In cases of fraud, auditors are often held accountable as stakeholders believe they failed to identify financial discrepancies leading to stock price collapse, losses, and potential bankruptcy. Therefore, experienced, unbiased auditors who perform their duties diligently can reduce the risk of future lawsuits by identifying and reporting violations promptly. Transparency in financial reporting can mitigate litigation risk against auditors. These findings align with Keyghobadi and Fathi (2019), who found a direct relationship between auditors' reports, work quality, and stock price crash risk. The second hypothesis explores whether financial reporting quality can decrease stock price crash risk by thoroughly examining and promptly disclosing important financial issues, thereby reducing litigation risk against auditors. According to the statistical results of the second hypothesis test in the fourth chapter, it was found that the interaction of financial reporting quality and the

stock price crash risk has a significance level of less than 5%. The negative and reverse coefficients can be attributed to the litigation risk against the auditor, which is quite impressive. Additionally, financial reporting quality with a negative coefficient shows a significant inverse relationship with the litigation risk against the auditor. As the quality of financial reports improves, the risk of lawsuits against the auditor decreases.

The main factor influencing decision-making by capital market agents and shareholders for investment is the continued cooperation with firms that provide transparent financial statements to the market, along with auditors' comments on them. When financial statements are transparent and free of significant distortions, investors can benefit in the future. However, problems arise when financial statements do not accurately reflect the realities of the firms, leading to a lack of transparency.

When a firm's true financial situation is revealed and stock prices drop, investors may believe that auditors failed to disclose the truth, increasing the likelihood of lawsuits against them. On the other hand, if auditors provide accurate information and financial reporting is done at a reasonable level, the firm's stock price will not drop significantly, reducing the risk of lawsuits against auditors.

The results of the second hypothesis of the research align with the findings of Foroughi et al. (2011) and Mehravar and Kargar (2019), who discovered that non-transparent financial information increases the risk of stock price collapse, while

transparent information decreases this risk. Similarly, Agility and Ghaderi (2015) and Rahimian et al. (2016) found that non-disclosure of important distortions (low quality of financial reporting) can increase the risk of litigation and lawsuits against auditors.

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