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Litigation risk and audit fees: evidence from UK firms cross-listed on US markets[☆]

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Abstract

Two ingredients necessary to examine the relation between litigation risk and audit pricing are (a) a litigious legal environment, and (b) publicly disclosed auditor remuneration. We combine both ingredients by focusing on UK firms offering to sell their securities publicly in the United States. We find that UK auditors charge higher fees for their services when their clients access US, but not non-US, capital markets. Further, we show that the higher fees cannot be fully explained by the SEC's extensive disclosure requirements. Rather, these findings are consistent with audit fees reflecting risk differences across liability regimes. © 2002 Elsevier Science B.V. All rights reserved.

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Keywords: Audit fees; Litigation risk; Cross-listing; Cross-border listing

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1. Introduction

The auditing profession's vulnerability to negligence lawsuits has been described as a crisis. The profession's aggregate liability exposure, which exceeds \$30 billion (Arens and Loebbecke, 1997), indicates the seriousness of the problem. Besides potential liability payments, litigation against an audit firm can damage its reputation for the quality of its services (Palmrose, 1988). Litigation claims are also associated with auditor decisions to leave the profession (Dalton et al., 1994, 1997), and with decisions to downsize or declare bankruptcy. Furthermore, Menon and Williams (1994) suggest that investors price securities in a way that reflects their right to recover potential losses through auditor litigation. This threat of litigation makes it incumbent upon auditors to continually assess their exposure to lawsuits and to incorporate that assessment into the planning and pricing of audit services. Audit fees should, therefore, be sensitive to litigation risk differences across client groups. Yet, empirical evidence linking litigation risk to audit fees, especially from countries that require the public disclosure of audit fees, is weak. For example, from Australia, Francis (1984) finds no support, Francis and Stokes (1986) find very limited support, while Beatty (1993) and Craswell and Francis (1999) find evidence mostly consistent with the proposition that audit fees are litigation-risk adjusted. Results from the UK (Chan et al., 1993; Pong and Whittington, 1994), Canada (Chung and Lindsay, 1988; Anderson and Zeghal, 1993), New Zealand (Firth, 1985; Johnson et al., 1995), Hong Kong (Gul and Tsui, 1998), and Norway (Firth, 1997) exhibit little or no support, while results from the US (Simunic, 1980; Palmrose, 1986a; Simunic and Stein, 1996) generally support the litigation risk-audit fee hypothesis. On balance, as observed by Simunic and Stein (1996), no generalizations can be made about non-US evidence.

The inability of previous research to find evidence appears to be due mostly to a lack of a large enough risk component in the audit fees. There are two components necessary to comprehensively address the litigation risk-audit fee hypothesis empirically: (a) public disclosure of auditor remuneration, and (b) a litigious legal environment. The legal environment in the US is relatively litigious, but US companies are not required to publicly disclose auditor remuneration. Conversely, countries that require the disclosure of auditor remuneration (e.g., the UK, Hong Kong, and Australia) have a relatively mild litigation environment. Non-US companies offering to sell their securities in the United States are, however, exposed to liability under US securities laws. Additionally, case law suggests that the antifraud provisions of the Securities Exchange Act of 1934 have transnational jurisdiction, applying, in particular, to non-US auditors. Thus, when foreign firms offer to sell their securities publicly in the US, their auditors are potentially exposed to liability under US securities laws. The attendant, above-average litigation risk should motivate the auditors to (a) implement measures (increase effort) in defense against the increased likelihood of future litigation (Simunic, 1980; Simunic and Stein, 1996); and/or (b) charge an insurance premium to cover possible future litigation losses (Pratt and Stice, 1994; Gramling et al., 1998). In either case, auditor remuneration should increase. Foreign firms offering to sell their securities publicly

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