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Auditor decision-making in different litigation environments: The Private Securities Litigation Reform Act, audit reports and audit firm size

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Abstract

The adoption of the *Private Securities Litigation Reform Act of 1995* had a marked impact on public accounting firms in the US by significantly reducing their liability exposure with respect to litigation involving publicly traded audit clients. This shift in the litigation environment of public accounting firms has been argued to have been manifest in changed auditor decisions regarding their audit clients. While this tort reform legislation was intended to benefit all audit firms, recent research suggests that it may have differentially affected auditors based on audit firm size. In this study, we examine the impact of the change in litigation environment ushered in by the *Private Securities Litigation Reform Act* and Big 6 membership on going-concern modification decisions for companies entering bankruptcy before and after the new legislation. Our findings, based on analyses of 694 financially stressed firms that entered into bankruptcy during the period 1991 to 2001, indicate that the likelihood of a going-concern modified

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opinion decreased significantly after the *Private Securities Litigation Reform Act*, and the change was particularly pronounced for the Big 6 audit firms. These results suggest that this important litigation reform had a significant effect on auditor decision-making, and that it had more of an effect on audit decisions of the Big 6 firms in comparison to the non-Big 6 firms.

Keywords: Private Securities Litigation Reform Act; Audit reports; Audit firm size

1. Introduction

The Private Securities Litigation Reform Act of 1995 (hereafter *Reform Act*) was enacted into law late in December 1995, and significantly altered the litigation environment for public accounting firms in the US. Some observers of the public accounting profession have argued that prior to 1995 the litigious environment faced by accounting firms was detrimental to the public accounting profession and created a drag on economic growth (Gottlieb and Doroshow, 2002). After a concerted effort on the part of the profession, public accountants were afforded significant tort liability relief with the passage of the *Reform Act*.

It has been argued that the Big 6 audit firms were the primary beneficiaries of the litigation relief brought forth by the *Reform Act*, and that the effects of the *Reform Act* on auditor decision-making may be more pronounced for the Big 6 firms than for the non-Big 6 (Johnson et al., 1995; Coffee, 2002). To examine the possible effects to different sized audit firms due to the adoption of the litigation reduction provisions of the *Reform Act*, in this study we examine whether the *Reform Act* produced a differential effect on the Big 6 firms compared to non-Big 6 firms with respect to final audit reporting decisions. Specifically, we examine whether the Big 6 audit firms were differentially less likely to render going-concern modified audit reports to subsequently bankrupt clients in comparison to the non-Big 6 audit firms after the enactment of the *Reform Act*.

In a recent study, Lee and Mande (2003) find that the Big 6 audit firms were differentially *less* conservative following the enactment of the *Reform Act* in allowing their clients to report significantly higher income-increasing discretionary accruals than allowed by non-Big 6 firms for their clients after the *Reform Act*. Lee and Mande (2003) argue that their results are consistent with the view that because of the significantly greater "wealth at risk" of the Big 6 audit firms, the impact of the reduction in litigation exposure brought about by the *Reform Act* was more pronounced for the Big 6 firms than for the non-Big 6 firms. The evidence from Lee and Mande (2003) about the differential effect of the *Reform Act*'s effect on different sized audit firms' decision-making is