Journal of Contemporary Accounting & Economics 9 (2013) 170–182

Contents lists available at ScienceDirect

Journal of Contemporary Accounting & Economics

journal homepage: www.elsevier.com/locate/jcae

The effects on financial statements of the litigation cost rule in a civil action for negligence against the auditor

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ARTICLE INFO

Article history:
Received 10 August 2012
Revised 6 September 2013
Accepted 11 September 2013
Available online 27 September 2013

Keywords:
Auditor
Opportunistic earnings management
Litigation cost
Negligence
Fraud

ABSTRACT

The litigation cost rule relates to which of the two parties in a civil lawsuit has to pay the legal costs. In those countries where the American system applies, each has to pay their own legal costs. In most other countries, the British system applies and the loser pays all the legal costs. By means of a single person decision-theoretic model, I examine the effects of this on auditing and financial statements under certainty and uncertainty conditions. Generally, the American system has the effect of restraining shareholders from suing unless they are able to cover their legal costs, thereby providing scope for under- or over-statements, depending on management's wishes. This scope is denied under the British system and, as a result, audited financial statements will not be similarly biased.

1. Introduction

Although class actions by investors against auditors and management are common, opportunistic earnings management (and worse) is apparently widespread and most importantly, there is negligible deterrence. Almost all actions against auditors are settled out of Court with no admission of negligence.[1] Choi and Pritchard (2012) and Ramseyer and Rasmusen (2013) have argued that in the US, despite the Private Securities Litigation Reforms Act 1995, litigation rates are too high in the area of securities litigation, bringing an otherwise fair and efficient legal system into disrepute. What is more, the litigation costs fall largely on the defendant corporation,[2] its shareholders bearing the cost.

There are probably many reasons for this occurrence. Coffee (2001) hypothesises that as the costs arising from litigation risk diminish accounting irregularities should increase and cites empirical evidence by Heninger (2001) of a positive relationship between measures of earnings management and litigation against auditors. This paper examines two related aspects: (1) the effect of the litigation cost rule as to who pays the costs (the plaintiff or the defendant) and, therefore, the likelihood of a class action and (2) the effects of this on auditing and opportunistic accounting.

The rules as to who incurs the legal costs in a legal action differ across countries. In some jurisdictions the loser pays not only its costs but those of the winner. This is known as the 'loser pays all', 'British' or 'European' system and applies in, for example, Canada, Australia, Hong Kong and most of Europe. Elsewhere, the American system operates in the US and Japan

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[1] In their study of US securities class actions for the period 1988–1999, Bajaj et al. (2003) found that 'Cases involving accounting firms rarely go to trial. Every case that involved a "Big 5" accounting firm 80 was settled, except for those that involved Ernst & Young. 8 of the cases involving Ernst &Young, 92.86% were settled. 82 in contrast, only 78.36% of cases involving underwriter co-defendants, were settled'. For more recent data see www.nera.com/recenttrends.

[2] Or its directors who are covered by personal liability insurance paid for by the corporation.

1815-5669/$ - see front matter
http://dx.doi.org/10.1016/j.jcae.2013.09.002

and, to a less extent, in China,[3] where each party pays its own legal fees irrespective of who wins. As a result, the American system creates significant 'transaction costs' for the winner (which may or may not be significant), whereas the British system does not.

The purpose of this paper is to investigate whether litigation costs and the litigation cost rule affect the financial statements and contribute to a bias in financial statements when the differences in opinion between management and auditor are sufficiently large as to affect the implied value of the corporation. In other words, Type II errors: when the auditor accepts financial statements that are materially misstated. An important and obvious constraint on the auditor's decision is the possibility of the shareholders as a class (or another party adversely affected) pursuing an action for negligence against it for misleading financial statements. If they win the action, they will have to pay their own costs under the American system. Therefore, they will only consider action if the expected damages are likely to exceed the costs incurred in bringing the action. Under the British system, as long as they win, they will incur no costs. Therefore, they are free to sue whatever the value of the damages.

The paper is arranged as follows. In Section 2, I review the literature on which the analysis is based. In Section 3, I examine the costs and benefits arising to the auditor relating to disagreements with management in the context of a single-person decision theoretic model. I show that, in the absence of transaction costs for the plaintiff under the British system (if it wins) the auditor will act independently and, as a result, audited financial statements are unlikely to be biased. In Section 4, I introduce legal costs arising to the plaintiff from a legal action against the auditor for negligence (the American system). I show that not only do these create scope but provide an incentive for bias, although it is unclear how large the size of the bias is. In Section 5, I discuss some of the implications of this analysis in practice. In Section 6, I relax the certainty assumption and examine how asymmetric information may affect the results. I show that whilst the impact on accounting bias is largely unchanged, the likelihood of an action is significantly different under the two systems. Finally, in Section 7, I discuss the welfare aspects and the implications of the results.

2. The issues and literature relating to auditing

Investors' welfare depends on the expected costs of litigation. This is affected by two factors: the probability that the defendant/auditor will be found liable (the probability effect) which is different under the strict liability and due care regimes (the probability is lower under the latter) and size of the audit penalty which according to Radhakrishnan (1999) under the due care regime (the penalty effect). He argues that the investors' expected costs of litigation are determined by the audit penalty and the recovery fraction and that with the recovery fraction, investors' welfare is higher under the due care regime. In the due care regime, the auditor is only held liable if it is 'negligent'. Under the strict liability regime the auditor is held liable even if it was not at fault or negligent.

I build on the work of Barnes (2011) and Boritz and Zhang (1997, 1999) using a decision theoretic model to examine the effect of the threats of investor litigation against the auditor and an audit switch on audit bias in these alternative cost litigation systems when management wishes its corporation's financial statements to imply a different value to that which the auditor thinks they should. In respect of the resulting level of litigation, equilibrium is viewed as the outcome of a non-cooperative game (which could be either simultaneous or sequential) where the plaintiff maximizes its expected litigation returns and the defendant minimizes its expected total payments. It should be noted that this paper is the first to examine the effects of these on the auditor's decision. Like Smith and Tidrick (1998) I only look at Type II errors and focus on a single period decision, but I do not agree with them that, therefore, switching is irrelevant. In my view, the threat is an important consideration for the incumbent auditor. There is considerable empirical evidence (mainly from the US) to suggest the auditor may not always act independently. See for example, Mutchler (1984, 1985), Campisi and Trotman (1985), Krishnan and Krishnan (1996) and Matsumura et al. (1997). For contrary evidence, see Louwers (1998). The risk of litigation (Farmer et al., 1987), the size of the audit fee (Simunic, 1980; Simunic and Stein, 1996) and the risk of losing a client may all influence auditor judgment (Shockley, 1981; Knapp, 1985). This may be made worse if the auditor provides other services (DeAngelo, 1981; Beck et al., 1988; Magee and Tseng, 1990) although there is little empirical support for the decisions in the US to place restrictions on it (Frankel et al., 2002; Ashbaugh et al., 2003; Chung and Kallapur, 2003; Kinney et al., 2004).[4]

The cost variables (notably threat of litigation, audit switch, and loss of reputation) used in the model apply to audit decisions *generally* and have been used in similar studies (Chaney et al., 2003; Barnes, 2004). My focus is similar to that of Boritz and Zhang (1999): on the corporation's value, as opposed to its reported income. I use value as opposed to earnings so as to include all audit decisions relating to material changes in the financial statements.[5] Of course, the auditor does not directly

[3] See Hodges et al. (2009) for a detailed study of the practices in 34 jurisdictions and how certain countries have recently changed their rules, e.g. Belgium and Portugal. Nevertheless, they find that the British system is the general rule, the principal exception being the United States. In Japan, cost shifting is the formal rule, but not in practice. In China, it only applies to a limited extent. In some countries, some types of costs may be shifted to the loser but not others. For example, in France and Taiwan, litigation expenses (Court fees and witness costs) may be shifted but not lawyers' fees. Hodges et al. (2009) make the important point that where the cost shifting rule is applied, it is 'almost always' not the entire costs as invariably the Court has discretion.

[4] Also see DeFond et al. (2002) who cite a large body of research to support the counter-argument that the threat to the auditor's reputation acts is sufficient to protect its independence.

[5] 'Material' is defined as what 'an average prudent investor ought reasonably to be informed before purchasing the security' (SEC, 1999). This may extend as far as, for example, the continuity, or going concern decision, which hinges on the probability of failure in the foreseeable future which materially determines its current value.