On Litigation Risk and Disclosure Complexity: Evidence from Canadian Firms Cross-Listed in the US

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Abstract

We find that D&O insurance premiums for Canadian firms cross-listed in the US are more than twice those of Canadian-only listed firms, and audit fees are approximately 50\% higher. While this supports the view that both service-providers view the US as a more litigious environment, our findings also suggest that these differentials for cross-listed firms reflect premia for both litigation risk and the complexity of firms’ financial disclosures. In particular, we show that D&O liability insurers charge differently for cross-listed firms that have different levels of disclosure; while D&O premiums are significantly higher for all cross-listed firms, they increase and then decrease with increased disclosure complexity. In contrast, audit fees increase monotonically as the filing complexity increases. We also find that auditors appear to price abnormal premiums charged by D&O insurers. Thus, audit fee premia for cross-listed firms appear to capture aspects of both litigation risk and increased disclosure complexity.

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1. Introduction

This study contributes to several areas of empirical accounting and finance literature studying aspects of litigation risk, disclosure complexity, and how such features are priced by Directors’ and Officers’ (D&O) liability insurers and auditors. Of note, prior work suggests the potential for differential audit effort, and possibly differential exposure to litigation risk conditioned on cross-listing status and the firms’ disclosure choices.

Our findings suggest that audit fees and D&O premiums for cross-listed firms vary with firms’ disclosures, indicating that both litigation risk and increased disclosure complexity drive the cross-listing premium in audit fees. We also confirm prior findings that audit fees and D&O insurance are larger for cross-listed firms, but find that the differences are much larger than those reported for earlier time periods (for our sample, audit fees are almost 50% higher and D&O insurance premiums more than double those of non-cross-listed firms).

Our focus on Canadian firms provides a unique experimental setting for studying these issues as information pertaining to both D&O insurance purchases (premiums, coverage, and deductibles) and audit fees is available. Moreover, during our sample period, under an agreement between United States (US) and Canadian regulators, the Multi-Jurisdictional Disclosure System (MJDS)-eligible Canadian firms are allowed to use their home country documents when cross-listing and thus satisfy the US disclosure requirements without a review by the Securities and Exchange Commission (SEC). As a result, the firms we examine operate in different regulatory regimes (Canada or the US) and, as we discuss in further detail below, they also have different levels of disclosure complexity.

This, in turn, suggests variation in litigation risk based on these differences, and consequently variation in the fees charged by auditors and D&O insurers. Our results are supportive of those reported by Callaghan, Parkash, and Singhal (2008) in that we find that Canadian cross-listed firms using the MJDS have lower audit fees than those not using the MJDS. However, we also find that audit fees and D&O premiums are generally higher for all cross-listed firms, and that the specific type of disclosure is important in audit fee pricing. These findings also suggest that caution is warranted when generalizing from studies of cross-listed firms to the US environment. Thus, more generally our work contributes to the literatures on audit fee pricing, disclosure complexity, and how these and D&O insurance relate to corporate litigation risk and suggest caution when generalizing from.

The paper proceeds as follows. Section 1 provides background details and reviews the literature on audit fees, D&O insurance, and cross-listing. Section 2 describes our data and sample selection, Section 3 presents univariate analyses, while Section 4 describes the multivariate approach and discusses the results. Section 5 concludes.

2. Background and hypothesis development

2.1. The role of D&O insurers and auditors

Empirical evidence supports the view that both insurers’ and auditors’ assets are at risk in the event of shareholders suits. For example, in their September 2007 10-Q, the Sun-Times
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