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Auditor litigation: Evidence that *revenue* restatements are determinative

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ABSTRACT

This study extends the Palmrose and Scholz (2004) general litigation and general restatements study by focusing on *auditor* litigation and *revenue* restatements. We investigate all potential accounting issues, individually, instead of by their group method, with regard to auditor litigation. The impact of the individual accounting issues implicated in restatements is of concern to auditors and audit standard setters in gauging auditor litigation risk and audit risk. It also is important for financial analysis and securities valuation because investors' losses are greater, and recovery of losses on a percentage basis is lower, when the auditor is a defendant, and especially when the auditor has a more severe, negative litigation experience (Commolli et al., 2012). We examine financial reporting lawsuits filed from 2001 to 2008 and find that revenue restatements—far more than any other kind of restatements—are associated with auditors being named defendants and also auditors experiencing a more severe, negative outcome in the litigation.

Introduction

Restatements—of the misstatement genre—continue to be an important area of study because they provide an unusually clear signal that materially misstated or non-GAAP financial reporting actually occurred. The consequences to market participants who relied on the originally issued financial statements are not always conducive to definitive measurement. There are some restatements that, when announced, provide all the information about what occurred, though previously no financial reporting problems had been disclosed. Conversely, other restatements are announced via gradual, multiple disclosures (SEC, Advisory Committee on Improvements to Financial Reporting, 2008). Also, some shareholders purchased securities during the time of non-GAAP financial reporting but ceased to remain market participants by the time of the restatement announcement.

For all of these reasons, researchers have sought additional avenues of inquiry into restatements. One of these is litigation. Palmrose and Scholz (2004) found evidence that restatements that implicate a group of accounting issues, known as the core earnings, are more strongly associated with financial reporting litigation than restatements that only implicate the non-core earnings. This study extends their research in several ways in addition to the fact that their study only tangentially addressed auditor litigation.[1]

This paper investigates all the specific, individual accounting issues implicated in restatements, instead of a composite variable comprised of an aggregation of numerous accounting issues. This makes it possible to investigate their individual importance. While there are theoretical reasons why the core accounting issues, as a group, may be important, there are also theoretical reasons why the

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[1] Amoah and Tang (2013), like Palmrose and Scholz (2004), also investigated the characteristics that determine the general outcome of litigation related to restatements.

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specific accounting issue of revenue recognition may be important. Importance is analyzed in two ways. It is hypothesized that revenue recognition, when it is one of the accounting issues implicated in a restatement, is positively associated with auditors being named defendants in financial reporting litigation. It is also hypothesized that revenue recognition, when it is one of the accounting issues implicated in a restatement, is positively associated with a more severe, negative outcome for the auditor in financial reporting litigation.

The setting for our study is a large sample of financial reporting lawsuits, rather than a sample of restatements. This research design allows for a comparison between financial reporting lawsuits with restatements and financial reporting lawsuits without restatements. Wahlen (2004) noted that the lack of such a comparison was a limitation of the Palmrose and Scholz (2004) study.

This paper also extends Palmrose and Scholz (2004) by comparing financial reporting lawsuits with an auditor defendant to financial reporting lawsuits without an auditor defendant. This more conservative approach yields results of less statistical significance than comparing financial reporting lawsuits with an auditor defendant to scenarios where there is a nonoccurrence of a financial reporting lawsuit.[2] Only the approach used in this paper is theoretically defensible, because for an auditor to be sued, it is a precondition that there was a financial reporting lawsuit with one or more non-auditor defendants. These other defendants include—depending on the nature of the lawsuit—the company, management, directors, underwriters, transaction attorneys, and others.[3]

The impact of the individual accounting issues implicated in restatements is of concern not only to auditors in gauging auditor litigation risk, which is an important component of their engagement risk. It is also important in financial analysis and securities valuation, because prior research has suggested that investors' losses are greater, and recovery of losses on a percentage basis is lower, when the auditor is a defendant, and especially when the auditor has a more severe, negative litigation experience. Commolli, Miller, Montgomery, and Starykh (2012) document that this results in the largest losses being positively correlated with the largest settlements, but the largest settlements are negatively correlated with the fraction of investor losses (i.e., cents on the dollar) recovered. For example, cases with investor losses below \$20 million settle, on average, for 37.3% of investor losses, while cases with investor losses over \$10 billion settle for an average of 2.2% of investor losses (Commolli et al., 2012).

Revenue recognition is hypothesized to be the paramount accounting issue implicated in restatements. At times, even companies that perform at a net loss attract substantial investor interest if they report—or show promise in the future of reporting—substantial revenue. As Schilit (2002) noted, "Accounting tricks related to revenue recognition historically have been the most lethal to investors."

We examine financial reporting lawsuits filed against Big 4 audit clients from 2001 to 2008. Revenue restatements are associated with auditors being named defendants. Also, revenue restatements are associated with the auditor experiencing a more severe, negative outcome in the litigation. Four additional specific, individual accounting issues implicated in restatements are also sometimes associated with auditors being named defendants and/or the auditor experiencing a severe, negative outcome in the litigation, but not consistently. Their significance is conditioned on model specification.

The remainder of this study is organized as follows. In the next section, prior research on auditor litigation, restatements, and revenue is discussed. Based on the prior research, a theory is developed and hypotheses are stated. The third section describes the methods and sources for obtaining the data for the sample. The fourth section presents descriptive statistics and summarizes the results of the empirical analysis. The fifth section articulates the conclusions, limitations, and the implications for future research. The paper ends with an Appendix detailing the empirical analysis.

Literature review, theory, and hypotheses

Auditor defendants and auditor outcomes in litigation

Various characteristics have sometimes been shown to be associated with the auditor being named a defendant in litigation. However, there are only four factors that have been shown, in almost every prior research paper, to be positively associated with the auditor being named a defendant. One of these factors is a restatement of audited annual financial statements (Fuerman, 1997a). Another factor is bankruptcy. Bankruptcy of the audit client is positively associated with naming the auditor a defendant because this increases the need for economic resources to make a lawsuit economically viable (Fuerman, 1997a).

Class period length is positively associated with naming the auditor a defendant (Fuerman, 1997a) because it seems increasingly plausible, as a class period lengthens, that the auditor should have detected and disclosed the legally deficient financial reporting. For example, a CPA firm that performed several consecutive annual audits, *ceteris paribus*, is expected to be more likely to have detected and disclosed the legally deficient financial reporting than a CPA firm that performed only one audit.

Fraud—or, more precisely, evidence of fraud (since we cannot know how much fraud occurs that is undetected [ACFE 2014])—is also positively associated with naming the auditor a defendant (Fuerman, 2000).[4] First, if there is

[2] For example, using a bankruptcy sample, Carcello and Palmrose (1994) used the same variables in two multiple logistic regression models. Using the approach of comparing lawsuits with an auditor defendant to scenarios where there was a nonoccurrence of a lawsuit, they found that three of their variables were significant at .003 or better. Using the approach of comparing lawsuits with an auditor defendant to lawsuits without an auditor defendant, only one of their variables was significant at .05 or better.

[3] For example, the company sometimes is prevented from being a defendant due to a bankruptcy stay.

[4] Previously, researchers operationalized the fraud construct with the occurrence of an SEC Accounting and Auditing Enforcement Release. Now a broader operationalization is common, as in this paper: any kind of