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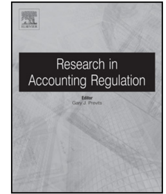

Regular Paper

Litigation risk, financial reporting and auditing: A survey of the literature ☆

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ABSTRACT

This paper surveys the literature on the determinants and consequences of securities class action lawsuits against firms and auditors from a financial reporting quality perspective. The survey is motivated by the important role that law plays in protecting stakeholders' interests against managerial misdeed. Litigation is, thus, an important topic and numerous studies investigate the determinants and consequences of firm and auditor lawsuits. The underlying premise of these studies is built on the notion that large financial and reputational penalties associated with successful securities class actions can discipline management and deter them from future wrongdoing. The survey documents that poor quality financial reporting as evidenced in earnings restatements has been the primary antecedent for class action lawsuits against the firm and auditors. Lawsuits against auditors affect audit fees, audit planning decisions and client portfolio adjustment decisions. Although significant progress has been made in terms of further understanding the causes and consequences of litigation against auditors, major challenges remain in the area of proper measurement of litigation risk.

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1. Introduction

The paper surveys the literature on the determinants and consequences of securities class action lawsuits from the financial reporting and audit quality perspectives. The survey is motivated by the important role that law plays in protecting stakeholders' interests against managerial misdeed. Some of the important functions performed by the legal system include regulation of behavior (deterrence function), resolution of conflict, and damage recovery (Simpson, 1988; Vago, 1988).

From a financial reporting and auditing perspective, the law ensures that conflicts among participants are resolved in an orderly fashion. Shareholders demand protection from the law when self-serving managers provide misleading and biased information to maximize their personal gains (Watts & Zimmerman, 1986). While out-of-pocket monetary penalties have historically been minimal for officers and directors due to director and officer (D&O) insurance, litigation entails other costs such as loss of reputation, loss of time, and the stress associated with being a defendant in a lawsuit (Black, Cheffins, & Klausner, 2006; Klausner & Hegland, 2010). Litigation risk therefore is an important external governance mechanism (Laux, 2010).[1] If certain industries are inherently more litigious, then litigation risk,

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[1] For key trends in securities class action lawsuits in the US refer to 2011 litigation study by PricewaterhouseCoopers (PwC). The PwC Securities Litigation database contains shareholder class actions filed since 1994. A variety of information including court, circuit, company location, class period, GAAP allegations, earnings restatements, SEC investigations, and lead plaintiff type, is summarized in the database. Information come from a variety of sources including case dockets, news articles, press releases, claims administrators, and SEC filings.

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at least partially, is reflected in inherent risk and is not a mechanism to be adjusted at management's discretion. However, as discussed in the survey, management may change its litigation risk by its disclosure behavior, supporting the validity of the mechanism argument.

Notwithstanding the importance of class action litigation, the success of securities litigation in deterring managerial fraudulent behavior and compensating aggrieved shareholders has been an issue of intense debate in the US (Laux & Stocken, 2012). Managers often view liability thresholds as too low, subjecting them to frivolous suits that result in unnecessary waste of time and resources. However, if the liability threshold is too high, then officers and directors will not be subject to the discipline of valid suits, thereby getting away with low punishment. This imposes additional agency costs on shareholders, as officers and directors are tempted to extract private benefits from the firm at shareholder expense. Litigation is, thus, an important research topic and numerous studies have been published. The underlying premise of these studies is that large financial and reputational penalties associated with successful securities class actions can discipline management and deter them from future wrongdoing.

The cumulative findings from prior studies concentrated in the US suggest that litigation risk matters. For example, Skinner (1994) and Kasznik and Lev (1995) report that firms are more likely to preempt large, negative earnings surprises than any other type of earnings news, in order to reduce the threat of litigation. Baginski, Hasell, and Kimbrough (2002) find that Canadian firms, which face less litigation risk, are more likely than US firms to issue management forecasts. However, it is virtually impossible to separate the impact of litigation risk to the corporation, and personal litigation risk on the officers and directors, since in almost all the lawsuits, CEOs are sued jointly with the corporation (Klausner & Hegland, 2010).

Litigation against auditors has been and continues to be a fruitful area of academic research. The classic agency problem between shareholders and corporate managers gives rise to the hiring of auditors who provide independent assurance to the investors that the firm's financial statements conform to Generally Accepted Accounting Principles (GAAP). In the absence of auditing, the degree of investor protection provided in other forms is weakened significantly. Because of the important role auditors play in the credible reporting of financial information, they are vulnerable to the threat of litigation in the event of an audit failure. Auditors are responsible for opining on whether financial statements are in accordance with GAAP. Since managers can use flexibility provided in financial reporting, some of the managerial actions may qualify as opportunistic while still legal. Therefore, auditors' legal liability pertains to managerial opportunism or expropriation not within GAAP.

The extent to which academic research on different facets of litigation risk can provide valuable insights for regulatory reforms, hinges to a large degree on the precise measurement of litigation risk faced by corporations and auditors. However, there remains significant concern as to the appropriate measure for litigation risk (Jones & Weingram, 1996; Kim & Skinner, 2012). This important strand of literature is reviewed to assess the validity of the measurement proxies used by researchers. We also evaluate studies to see whether consideration of the endogenous relationship between litigation risk and outcome measures has been appropriately accounted for. Researchers have taken various approaches to try to mitigate endogeneity concerns. Several studies focus on changes in litigation risk subsequent to an exogenous shock such as the passage of the Private Securities Litigation Reform Act of 1995 (hereafter PSLRA) (e.g., Johnson, Kasznik, & Nelson, 2001). Other studies use an instrumental variable approach to address endogeneity (e.g. Field, Lowry, & Shu, 2005).

The scope of this survey is limited to the determinants and consequences of securities class action lawsuits for firms and auditors in the US. Studies on litigation outside the US are not reviewed because private securities class action lawsuits are more common in the US than in other countries. Given the focus of this survey on financial reporting and auditing issues, almost all the surveyed papers come from accounting and auditing journals. Relevant tables summarize the research questions, sample(s) used, key findings, and litigation proxy used.

The paper proceeds as follows. The next section describes the litigation environment in the US. Section 3 reflects critically on studies that have operationalized the litigation risk construct. We discuss the various litigation measures used in academic research for a better assessment of the surveyed studies in the following two sections. Section 4 reviews the literature on financial reporting-related variables that give rise to class action lawsuits (litigation as dependent variable). Also surveyed in this section is the strand of literature that considers the effect of litigation risk on management forecasting decisions and financial reporting quality (litigation as independent variable). Section 5 reviews the auditor litigation literature, focusing on the post 1998 papers. Latham and Linville (1998), Palmrose (1998) and Cloyd, Frederickson, and Hill (1998) review the literature on the determinants and consequences of auditor litigation for the period of 1980–1998. Since then a large number of papers on or relating to auditor litigation have been published. Finally, Section 6 concludes the study.

2. Securities class action lawsuits in the US

2.1. Origin of securities class action lawsuits[2]

The US Congress enacted the Securities Exchange Act of 1934 to promote full disclosure of securities offerings after

[2] The discussion on the origins of securities class action lawsuits draws heavily on Rose (2008), pp. 1307–1318. For actual class action lawsuit details involving companies and auditors readers are referred to the website of Stanford Law School: Securities Class Action Lawsuits Clearinghouse. A recent example is Celera Corporation where the plaintiffs allege that during the Class Period, defendants issued false and misleading statements regarding the Company's business and financial results, repeatedly assuring investors that the Company would be able to increase the amount of its Lab Services business that was under contract. Defendants further assured investors that the Company was adequately reserving for its bad debts. However, it became evident that the company did not provide adequate

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