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Managerial legal liability and Big 4 auditor choice

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ABSTRACT

This study investigates the effect of directors' and officers' (hereafter D&O) liability insurance coverage on auditor choice. Based on a sample of 671 Taiwanese listed firms with D&O legal liability insurance data, our evidence shows that companies with excess D&O liability insurance coverage are less likely to appoint Big 4 auditors. Furthermore, we find that Big 4 auditors are more likely to issue unclean opinions and to constrain the abnormal accruals and 'beating or meeting' earnings benchmarks for their clients with excess D&O liability insurance coverage. The findings document that a higher level of D&O liability insurance coverage increases Big 4 auditors' concerns about the credibility of financial statements. Given this, Big 4 auditors have incentive to require more conservative accounting choices for these clients in order to minimize possible litigation risk and reputation damage.

1. Introduction

This study investigates whether director and officer (hereafter D&O) liability insurance coverage affects the choice of a Big 4 auditor. The existing literature on D&O liability insurance coverage is mainly based on data from the United States and Canada (Chalmers, Dann, & Harford, 2002; Chung & Wynn, 2008; Wynn, 2008). Very little has been done outside of North America, especially in terms of emerging markets. In contrast to the United States and Canada, high ownership concentration is a feature of listed companies in East Asia. Most controlling owners also hold management positions in their controlled companies (Classens, Djankov, & Lang, 2000; Yeh, Lee, & Woidtke, 2001). Prior research indicates that tight control allows controlling owners to make decisions on auditor choice in East Asia, including Taiwan (Fan & Wong, 2005; Hung, Lu, & Ou, 2008). D&O liability insurance policy is also affected by controlling owners (Chi, Weng, Chen, & Huang, 2013). Thus, we would like to investigate the association between D&O liability insurance and auditor choice in emerging markets.

Taiwan provides an ideal setting for investigating the relationship between D&O liability insurance coverage and auditor choice. Due to severe information asymmetry in Taiwan, a number of mechanisms for reducing this information asymmetry are employed in practice. For example, an audit opinion is a commonly used tool for communicating credible information about a company's financial position to investors. While over 94% of listed companies in the United States and Canada (Chung, Hillegeist, & Wynn, 2012) employ Big 4 auditors, only 75% of listed companies in Taiwan appoint Big 4 auditors (Chen, Lin, & Lin, 2009). It is worth testing for the differences between Taiwanese companies audited by Big 4 and those audited by non-Big 4 firms. Moreover, because Taiwan is currently the only emerging country that mandates that publicly listed companies disclose the details of their D&O liability insurance policies, this information can help us to investigate whether managerial legal liability affects auditor choice in emerging markets.

There are several arguments on the role of D&O liability insurance. One view is that D&O liability insurance plays a monitoring role, because D&O liability insurance insurers thoroughly scrutinize the ensured and coverage limits (Griffith, 2005; Holderness, 1990; O'Sullivan, 1997). Another view is that D&O liability insurance reduces the effectiveness of litigation as a device to monitor managers, since it insulates directors and officers from the threat of litigation (Chung & Wynn, 2008; Core, 1997; Wynn, 2008). Although the empirical evidence is mixed on this issue, D&O liability insurance still serves as an important protection for companies from the defense and settlement of lawsuits.

Serious information asymmetry exists between companies and investors in emerging markets (e.g. Taiwan). In order to have symmetrical beliefs about the probability and distribution of director and officer losses, investors typically estimate a company's risk conditions by attempting to understand their financial positions. This creates an environment in which a high-quality auditor is able to play an information mediation role. Thus, companies with higher level of D&O liability insurance coverage might be more likely to appoint Big 4 auditors to eliminate agency conflicts. However, recent studies support the argument that excess D&O liability insurance coverage reflects ex ante managerial opportunism in accounting policy choice (Chalmers et al., 2002; Chung & Wynn, 2008; Core, 1997; Wynn, 2008). This argument for managerial

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opportunism suggests that managers who carry abnormally high D&O liability insurance tend to behave opportunistically and create moral hazard problems (Lin, Officer, & Zou, 2011). As a result, managers have reduced incentive to act in the best interests of shareholders and the temptation to engage in opportunistic activities that benefit themselves. However, if opportunistic managers hire Big 4 auditors, they are less likely to achieve opportunistic goals, because Big 4 auditors are capable of thoroughly scrutinizing their earning quality. Given this, opportunistic managers may be less inclined to hire Big 4 auditors. Since empirical research investigating the relationship between managerial legal liability and auditor choice is lacking, exploring this relationship could potentially open up a new avenue of research on corporate governance.

To address the issue of potential endogeneity, we employ a series of econometric analyses, an instrumental variables approach, a propensity-score matching method and the Heckman two-stage model. We find that companies with excess D&O liability insurance coverage are less likely to appoint Big 4 auditors, indicating that managerial opportunistic behavior is an important determinant of auditor choice. Furthermore, additional tests reveal that Big 4 auditors are more likely to issue unclean opinions, to constrain abnormal accruals and to exceed or meet earning benchmarks of clients with excessively high D&O liability insurance coverage. The results indicate that Big 4 auditors have a high incentive to provide conservative accounting. It is in their interest to prevent future litigation exposure and possible reputation damages where the protection of D&O insurance might induce moral hazard problems for well-protected directors and officers.

This study adds the following contributions to the extant literature. First, unlike prior studies, which focus primarily on whether D&O liability insurance policy is associated with disclosure behavior and corporate decisions (Chalmers et al., 2002; Chung & Wynn, 2008; Lin et al., 2011; Wynn, 2008), this study provides the first empirical evidence to show that D&O liability insurance coverage affects the appointment of auditors. We find a significantly negative association between excess D&O liability insurance and Big 4 auditor choice. Given the managerial opportunism hypothesis, we indicate that managerial opportunistic behavior plays an essential role in explaining auditor choice decisions. Second, we extend the literature on auditor characteristics by investigating the accounting policies of Big 4 auditors towards clients with excess D&O liability insurance coverage. Our findings suggest that Big 4 auditors tend to be more conservative with clients carrying abnormally high D&O liability insurance. Therefore, Big 4 auditors have incentive to require more conservative accounting choices for these clients in order to minimize possible litigation exposure and reputation damage.

The remainder of this paper is organized into five sections. Section 2 describes the institutional background and reviews relevant literature. Section 3 shows our research design and data sample. Section 4 reveals the empirical results and findings, and Section 5 presents our conclusions.

2. Institutional background and literature

2.1. The legal system in Taiwan

Before the end of the 1990s, most stock investors in Taiwan were individuals, who usually hesitated to take legal action when their rights were infringed upon, either because they lacked sufficient information on the provision or because they regarded the filing of a lawsuit as an action that consumes both time and money. Therefore, in order to improve the protection of investors[1], the Taiwanese Securities and Futures Bureau (TSFB) promulgated the Securities Investors and Futures Trader Protection Act (SIFTP Act) and the Securities and Futures Investors Protection Center (hereafter SFIPC) under the Act.

Since the legal environment has changed in the early 2000s, the Taiwan Insurance Institute reported that listed companies purchasing D&O liability insurance coverage increased from 8.5% in 2002 to 33% in 2006 (Taiwan Insurance Institute, 2010). There was a sharp increase in the demand for D&O liability insurance by listed companies in Taiwan. The Institute also reported that nearly 75% of claims against listed companies have been made by investors, 12% made by creditors and 13% made by others (e.g. customers, employees and other related parties).

Board directors and officers have the following duties specified in the Company Law and Securities and Exchange Act in Taiwan. Pursuant to the Company Law, the board of directors and officers are responsible for their company's behavior and should fulfill their fiduciary obligations with the cane of a good administration to check the company's financial reports. If management negligence causes any loss on the part of the company, management should be held responsible for *reimbursing* investors for their covered losses[2]. Pursuant to the Securities and Exchange Act (which is similar to the Securities and Exchange acts of 1933 and 1934 in the United States), a company's board members should *reimburse* genuine investors as victims of the company's false financial reports[3]. Moreover, the government-supported organization "SFIPC" has begun to simulate American-style securities class actions; Article 28 of the SIFTP Act states that a class-action lawsuit can be filed when more than twenty securities investors authorize the SFIPC to apply for indemnification payments. Since this act was established, the SFIPC in Taiwan has dealt with 57 class-action cases and more than 60,300 plaintiffs required a total amount of indemnification of about US $0.9 billion as of the end of 2008 (SFIPC 2008 annual report). Under the supervision and guidance of competent authorities, the SFIPC has made significant progress in the fulfillment of class actions and in the protection of shareholders' equity. Furthermore, their success in acquiring reimbursement for investors in these cases marks a significant step in Taiwan's efforts to protect investors.

2.2. D&O liability insurance coverage and auditor choice

Big 4 auditors are organized as national partnerships with national administrative offices. They are more likely to invest in staff recruitment and training, information technology, standardized audit programs and knowledge-sharing practices. Numerous studies have investigated the notion that Big 4 auditors provide higher-quality services than non-Big 4 auditors. Theoretical support for such a quality differentiation is provided by DeAngelo (1981), who shows that larger audit firms have greater incentives to detect and reveal management misrepresentation in financial reporting. Several empirical studies provide evidence consistent with DeAngelo's result. DeFond and Jiambalvo (1993) find that clients of Big 4 auditors are less likely to have financial reporting errors or irregularities. Becker, DeFond, Jiambalvo, and Subramanyam (1998) also report lower discretionary accruals for Big-4-audited companies. Therefore, Big 4 auditors have brand-name reputations and are widely viewed as producing higher quality of audit service, which enables them to perform a stronger monitoring role than non-Big 4 auditors.

There are a number of determinants of Big 4 auditor choice. First, as agency problems increase, Big 4 auditors are demanded because greater assurance is seen to reduce information asymmetry (Carey, Simnett, &

[1] The Company Law allows derivative actions by shareholders owning 3% of a company continuously for a year, who may petition supervisors to sue directors and bring such suits directly if supervisors fail to do so (Article 214 of Company Law). Even so, class action litigation in Taiwan is more costly and unusual. There are several reasons for this. First, there is a serious, out-of-pocket economic disincentive to plaintiffs, and, second, there is no civil discovery in Taiwan. As a result, information costs to plaintiffs can be high. Third, securities class actions often involve some expertise without which judges find it difficult to examine the legal and factual issues.

[2] Article 23 of Company Law stipulates that board directors are jointly liable with the company to reimburse any person who suffers damages or losses resulting from his/her wrongful act which is within the scope of the company's business.

[3] Article 20 of the Securities and Exchange Act stipulates that directors and officers, who violate the provision of financial reports or any other relevant financial or business documents filed or publicly disclosed by an issuer in accordance with the act containing no misrepresentations or nondisclosures, shall be held liable for damages sustained by bona fide purchasers or sellers of the securities.