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Accounting misstatements following lawsuits against auditors ☆

Clive Lennox [a,*], Bing Li [b]

[a] Nanyang Technological University, Singapore 639798
[b] City University of Hong Kong, Tat Chee Avenue, Hong Kong

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ABSTRACT

This study investigates whether an auditor's experience of litigation in the recent past affects subsequent financial reporting quality. At the audit firm level, we find accounting misstatements occur significantly less (more) often after audit firms are sued (not sued). At the audit office level, the negative association between past litigation and future misstatements is stronger for offices who were directly implicated in the litigation than for the non-accused offices of sued audit firms. Therefore, the litigation experiences of both audit firms and audit offices are incrementally significant predictors of future financial reporting quality.

1. Introduction

Numerous studies in the accounting literature examine the antecedents of litigation against auditors (*e.g.*, Bonner et al., 1998; Carcello and Palmrose, 1994; Heninger, 2001; Lys and Watts, 1994; Palmrose, 1988; Palmrose and Scholz, 2004). In contrast, the purpose of this study is to examine the *consequences* of being sued. In particular, we are interested in whether auditors learn from their litigation experiences and whether this subsequently has an effect on financial reporting quality.

In analytical models of rational learning, imperfectly informed agents update their beliefs using Bayes' rule whenever their new experiences convey decision-relevant information (Harsanyi, 1967; Kihlstrom and Mirman, 1975; Townsend, 1978; Feldman, 1987). The revisions to agents' beliefs in turn affect agents' subsequent actions. Anecdotally there is some evidence in the law and criminology literatures that agents learn from their experiences of punishment and revise their future actions. For example, a driver who is caught speeding rationally revises upwards his assessment of the probability of being caught again in the future if he continues to speed. Thus, the driver is less likely to speed again in the future (Andenaes, 1966). Conversely, a driver who is not caught speeding rationally revises downward his assessment of the risk of being

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* Corresponding author. Tel.: +65 67904637.
E-mail address: cslennox@ntu.edu.sg (C. Lennox).

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caught and chooses to speed more often in the future. In short, experiences affect beliefs which then affect subsequent actions.

Similarly, we posit that auditors learn from their experiences of being sued (not sued). Learning occurs because the experience of being sued (not sued) signals new information to the auditor causing a change to the auditor's beliefs. Auditors learn from these experiences and this in turn affects their subsequent actions. For example, a lawsuit can cause an audit firm to downgrade its assessment of the competence and integrity of its personnel or the reliability of its quality control procedures. The audit firm may then respond by giving its personnel more training or introducing superior quality control procedures. Conversely, an auditor would have greater confidence in the quality of its personnel and its quality control procedures if it has no recent experiences of litigation, which could cause the auditor to become complacent and audit quality to drop. In short, an auditor's recent experiences with litigation can convey new information to the auditor about the quality of its audit work. The arrival of new information causes the auditor to update his beliefs and this in turn affects future audit quality.

Such learning can affect audit quality at both the audit firm level and the office level. At the audit firm level, a recent experience with litigation can signal audit quality deficiencies that are systemic to the entire audit firm. For example, a lawsuit may reveal flaws in quality-control procedures applied in all offices of the audit firm. Therefore, audit quality might be affected across the entire audit firm, not just at the office implicated in the lawsuit. On the other hand, a lawsuit may signal systematic problems at one audit office but these problems may not extend to other offices of the same audit firm. For example, an office may suffer from having low quality personnel but this problem may not contaminate the rest of the audit firm. Accordingly, we test whether past litigation affects quality at the audit office level and whether these office-level effects are incremental to any firm-wide effects.

We focus on the impact of litigation on future accounting misstatements for two main reasons (explained further in Section 2). First, a lawsuit typically alleges that the financial statements violated GAAP and therefore misled the investing public. A restatement announcement offers particularly tangible evidence to courts of a misstatement. Courts therefore draw stronger inferences from alleged GAAP violations if the company restates its financial statements. Accordingly, an accounting restatement is often a trigger for a lawsuit to be filed (Kinney and McDaniel, 1989; Palmrose and Scholz, 2004; Johnson et al., 2007; Hennes et al., 2008; Cheng et al., 2013). In contrast, an alleged accounting violation without an accompanying restatement announcement provides a weaker inference of audit failure (Pritchard and Sale, 2005). Therefore, there is a clear conceptual link between an auditor's past experience of litigation and the auditor's incentives to avoid future litigation by preventing future misstatements. In contrast, the conceptual link between litigation and alternative empirical proxies for audit quality (*e.g.*, audit opinions) is much less direct. For example, there is mixed evidence as to whether the issuance of a modified audit opinion reduces or increases the auditor's risk of being sued (Carcello and Palmrose, 1994; Lys and Watts, 1994; Kaplan and Williams, 2013).

Second, a misstatement of the audited financial statements occurs when a client's pre-audit financial statements are misstated *and* the auditor fails to detect and correct the misstatement. An improvement in audit quality can cause an improvement in the quality of a manager's pre-audit financial reporting due to the strategic nature of the interaction between auditors and managers. The incidence of accounting misstatements is expected to be lower following audit litigation due to both an improvement in audit quality and an improvement in the quality of a manager's pre-audit financial statements. By examining the incidence of accounting misstatements, we capture both of these channels through which litigation can affect financial reporting quality.

We identify 830 lawsuits citing auditors as defendants in the period 2001 to 2010. We measure each auditor's experience of litigation during the previous three years and investigate whether this experience predicts the likelihood of a misstatement in the following year.[1] If financial reporting improves (deteriorates) after auditors are sued (not sued), we expect fewer (more) accounting misstatements in the following year. Consistent with this, we find financial reporting quality is higher (lower) after auditors are sued (not sued). The improvements are observed at both the audit firm level and the audit office level.[2] Moreover, the effects are incrementally greater at offices directly involved in the litigation than at offices of the sued audit firms not caught up in the lawsuits. These results are not mechanically driven by improved financial reporting at the companies involved in auditor litigation because those companies are excluded from the estimation samples. Rather, our findings suggest that past auditor litigation affects future financial reporting quality at the clients that do *not* sue their auditors.

To our knowledge, this study is the first to examine whether lawsuits affect auditors' incentives to supply higher quality audits *after* they are sued. In contrast, the existing literature focuses on the determinants of lawsuits against auditors (Palmrose, 1988; Carcello and Palmrose, 1994; Lys and Watts, 1994; Heninger, 2001; Palmrose and Scholz, 2004). Our study also provides a new perspective on office-level and firm-level determinants of audit quality. Francis and Michas (2013) find earnings overstatements are often clustered within specific audit offices and such problematic audits do not necessarily

[1] These three year windows have two main advantages: 1) auditors need a reasonable amount of time to respond to their prior litigation experiences, and 2) lawsuits are relatively rare in any given auditor-year. Although the choice of three years is somewhat *ad hoc*, we obtain similar results using windows corresponding to the previous two years, four years, and five years. Moreover, in untabulated tests we find that auditors' litigation experiences matter more during the most recent three years than prior to this. Specifically, conditioning on auditor litigation during the prior three years, we find no incremental association between the likelihood of a misstatement in year t and litigation that occurred during year $t-4$ and $t-5$.

[2] Unfortunately, we are unable to test whether the firm-level effects are significant within the sub-sample of Big Four firms because there is essentially no variation in the litigation variables across the Big Four. Accordingly, our results at the audit firm level are likely driven by the non-Big Four firms. On the other hand, we find that the office-level effects are significant within the sub-sample of Big Four firms as well as the sub-sample of non-Big Four firms.