Audit Litigation Research: Do the Merits Matter? An Assessment and Directions for Future Research

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This article reviews audit litigation research and discusses suggestions for future research. Recent reforms in federal and state laws related to accounting and auditing services increase the opportunities for research. An overarching issue in the public policy debate over legal reforms is the role of merits in bringing and resolving lawsuits against auditors; this issue frames the discussion of audit litigation research. © 1997 Elsevier Science Inc.

1. Introduction

This article discusses the status of audit litigation research and suggests some directions for future research. It also describes my database (Palmrose forthcoming) and provides some insights on how the database might be used in future research. The article considers audit litigation research and research opportunities from the perspective of the public policy debate over legal reform. A focus of this debate, and therefore this article, is the role of merits in bringing and resolving lawsuits against independent auditors.

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This focus means that I neither review all extant audit litigation research nor discuss all potentially important questions for future research. Simunic and Stein (1996) reviewed some literature on litigation risk and the pricing of audit services; Dopuch and King (1992) and Dopuch et al. (1994) discussed alternative liability regimes and experimental market research in auditing. Discussions of opportunities for audit litigation research include Elliott (1993), Hill (1994), and Kinney (1993, 1994). Dye (1995) provided an economic perspective on auditors' liability research.
Litigation is of long-standing importance to the public accounting profession. For example, Olson (1982, p. 15) has stated that "the effects of litigation were the root causes of most of the changes that occurred in the profession during the 1970s." Even so, the public accounting profession's active participation in the legal reform movement creates new and different opportunities for research. Both advocates and opponents of reform have sought evidence to support their positions. Systematic evidence continues to be in short supply.\(^2\)

Successful reform efforts, such as the recent legislation which changed portions of the federal securities laws (The Private Securities Litigation Reform Act of 1995), should increase not diminish research opportunities. Both the need for and the impact of the legislation require assessment. Given the contentiousness of the legislation and the uncertainties of its implications (e.g., see Jacobs and Felsenthal 1995; King and Schwartz 1997; Palmrose 1994), the results of this assessment will be of widespread interest.\(^4\)

Furthermore, the public policy debate over legal reform is not limited to federal legislation; it extends to activities at the state level in at least three ways. First, legal reforms have occurred at the state level,\(^5\) and efforts continue for further state reforms with support from the public accounting profession ("Texas enacts tort reform bills" 1995). Second, opponents of reform have seen opportunities at the state level to mitigate the effects of federal legislation. For example, class action plaintiffs' attorneys led ballot initiatives in California to undermine the requirements of the federal legislation (e.g., see Henry 1995, p. B2; Lewis 1996, p. A13). Third, irrespective of changes in state laws, there is a possibility that the recent federal legislation will simply shift litigation to favorable state venues.

Noted plaintiffs' attorney, William S. Lerach (1993, p. 68), has commented

\(^2\)Legal reform has been on the accounting profession's agenda for some time. For example, in 1985, the AICPA appointed a Special Committee on Accountants' Legal Liability. The committee announced a program for legislative reform which included proportionate liability (rather than joint and several), suits by third parties and the privity rule, RICO, the costs of frivolous suits, and aiding and abetting liability (AICPA n.d.).

\(^3\)A widely-quoted statement by Senator Dodd illustrates this point. Senator Dodd said (1993, p. 280), "after a long hearing that lasted well into the afternoon, we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this subcommittee, I've never encountered an issue where there is such disagreement over the basic facts. We often argue about policy, we argue about ideology, we often argue about politics, but it is rare we spend so much time arguing about basic facts."

\(^4\)Federal legislation was enacted in December 1995 when the House of Representatives and the Senate voted to override President Clinton's veto of the legislation. This was the first override of a veto in Clinton's presidency (Abrams 1995, p. D1).

\(^5\)For example, Illinois enacted legislation eliminating joint and several liability in negligence cases where the CPA is found to be less than 25% responsible for the total damages suffered by a plaintiff, and barring any recovery by a plaintiff more than 50% responsible for total damages ("Illinois law to limit suits" 1992). Texas enacted legislation whereby, in most cases, defendants face joint and several liability only if found more than 50% responsible for the claim ("Texas enacts tort reform bills" 1995, p. 4).
that "[a] natural reaction to the increasingly chilly reception many class actions are receiving in the federal courts has been for more such cases to end up in the state courts." These activities at the state level increase the scope of and reinforce the need for audit litigation research.

Finally, the potential impact of court decisions should not be overlooked. Over time, independent auditor liability has changed through federal and state court decisions; some decisions have expanded liability while others have restricted it. Recent decisions restricting independent auditor liability, such as those regarding liability under the federal Racketeer Influenced and Corrupt Organizations Act (RICO)\textsuperscript{6} and aiding and abetting liability under the Securities Exchange Act of 1934 (The 1934 Act),\textsuperscript{7} raise questions about the need for additional restrictions on liability through legislation. Silicano (1997) discusses some of these court decisions.

An overarching issue in the legal reform debate is the role of merits in bringing and resolving lawsuits. Advocates of reform argue that the current system is not merit-based, so that, on average, merits are of little or no consequence. For example, a \textit{Statement of Position} by the Big Six (Arthur Andersen & Co. et al. 1992, p. 1) asserts that "the principal causes of the accounting profession's liability problems are unwarranted litigation and coerced settlements." This argument resonates in a public-policy setting; it gives credibility to requests by defendant groups for legislative relief from the costs imposed on them by non-merit based and frivolous litigation.\textsuperscript{8} Yet, extant evidence on this issue is neither extensive nor unambiguous. Because it is central to the public policy debate, the role of merits frames much of my discussion of audit litigation research.\textsuperscript{9}

Before summarizing theoretical arguments for why the merits might not matter, the next section introduces the framework developed by Kinney (1993) for defining meritorious litigation against independent auditors. Later sections consider evidence from empirical research for insights on the role of merits in independent audit litigation and discuss directions for

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\textsuperscript{7}See \textit{Central Bank of Denver v. First Interstate Bank of Denver}, 114 S.Ct. 1439 (1994). The effect and implications of this decision have been the subject of considerable debate. At the time of the decision, there was speculation that plaintiffs would simply recast their complaints to circumvent the holding. Instead of charging auditors with secondary aiding and abetting liability, they would charge them with primary liability (Palmore 1994, p. 55).

\textsuperscript{8}In the context of securities class actions, frivolous lawsuits are also known as strike suits.

\textsuperscript{9}From a societal perspective, the objectives of legal liability are equity (justice) and economic efficiency, which involve compensating victims and deterring accidents. For optimal deterrence, the social goal could be to minimize the sum of costs of care and the expected costs of accidents (Shavell 1987, p. 7). (In an audit context, an accident is an audit failure.) Concerns over the role of merits assume that optimal deterrence cannot be achieved when litigation is not merit-based. Dunbar et al. (1995) provided a discussion of merit-based securities litigation and deterrence; they found evidence consistent with the securities laws providing both too little and too much deterrence. Some independent audit litigation research relates to deterrence issues, e.g., see Narayanan (1994, p. 39) (moving to proportionate liability may increase audit quality), Krishnan and Krishnan (1997) and Scholz (1996) (deterrence through client retention decisions).
future research using, to some extent, Kinney's framework. The last two sections describe my database (Palmrose forthcoming), provide suggestions for how it might be used in future research, and recognize additional lines of research related to the role of merits in audit litigation.

2. Defining Meritorious Litigation

Based on Kinney (1993, p. 351), meritorious claims against independent auditors require three elements: substandard financial statements, substandard audits, and compliance with relevant legal standards. Kinney's flowchart of the causal links in auditing (Figure 1) provides a framework

![Figure 1](image-url)
for considering the three elements of meritorious claims.\(^1\)\(^0\) As Kinney (1993, p. 351) explained, substandard audits (link a) and substandard financial statements (link b) together yield substandard audited financials. “Substandard audited financials (link c) and/or other investment factors (link d) cause a third party inappropriately to invest in an entity. Also, substandard audited financials (link e) and/or other loss factors (link f) lead to a decline in investment value” (Kinney 1993, p. 352). In turn, users incur losses from these declines in investment value (link g).

The first two elements of meritorious claims—substandard audits and substandard financial statements—are explicit in the Kinney (1993) flowchart via links a and b. Generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) help determine substandard audits and financial statements, respectively. The third element—compliance with relevant legal standards—is reflected in a number of the remaining sections of the flow chart (either explicitly or implicitly). To illustrate, detrimental reliance is a common legal requirement in claims against independent auditors. This means third parties justifiably rely on (substandard) audited financial statements in making investments (link c) which result in losses (link h) because the investments subsequently decline in value (link g) with revelations that the financial statements contain material omissions or misstatements (link e). Under some legal provisions, reliance (link c) is established by demonstrating the plaintiff read specific substandard audited financials and appropriately relied on them in making the investment decision. However, securities class actions involving public companies with claims under The 1934 Act section 10(b) and Rule 10b-5 often use fraud-on-the-market theory to meet the reliance requirement. This theory assumes, as the prices of securities traded in an informationally efficient market reflect all value-relevant information on a timely basis, plaintiffs can reasonably rely on the integrity of the market price in making investment decisions (Francis et al. 1994a, pp. 137–138).

In summary, the Kinney (1993) framework helps distinguish between meritorious and non-meritorious claims against independent auditors. According to Kinney (1993, p. 352), logically, the independent auditor’s potential responsibility for third-party losses should be eliminated (or at least reduced) to the extent that substandard audits (a), investments that relied on substandard audited financial statements (c), or declines in investment value with revelations of substandard audited financial statements (e) are not present, and/or to the extent substandard financials (b), other causes of investments (d), and other causes of declines in investment

\(^{1}\) This discussion focuses on claims by third parties; it emphasizes the rather unique position of independent auditors among professionals in having important responsibilities to third-parties, not just clients. As discussed in a later section, my database should facilitate research that pursues these issues by considering types of plaintiffs in auditor litigation.
value (f) are present. The latter presence of (b) is consistent with management having primary responsibility for the financial statements. The framework emphasizes that distinguishing between substandard audits (a) and substandard financials (b) can be important in considering meritorious/non-meritorious claims against independent auditors. The next section reviews the theoretical arguments for why the merits may be of little or no consequence in litigation against independent auditors.

3. Do the Merits Matter? Theoretical Background

Alexander (1991) provided one of the most comprehensive and influential explanations for non-merit based securities litigation. Alexander (1991, p. 500) argued that structural characteristics common to securities class actions produce outcomes which are not a function of the substantive merits of the case. These structural characteristics consist of a “combination of factors including the parties’ economic incentives, transaction and agency costs, procedural and substantive rules of law, and the existence of insurance” (Alexander 1991, p. 505). Regarding the latter, directors and officers are typically sued in their individual capacities. Naming directors and officers as defendants gives plaintiffs access to directors’ and officers’ liability insurance as a source of recovery. However, directors’ and officers’ insurance generally is only available to fund settlements, not trial judgments. This occurs because insurers often take the position that if the allegations of the complaint are true there is no coverage, either because an exclusion applies or because the policy was obtained by fraud (Alexander 1991, p. 552). Settlement agreements, on the other hand, can be drafted to fall outside the fraud exclusions. Together, according to Alexander (1991, p. 505), these characteristics “combine to make trial an unthinkable alternative.”

The option of trial to verdict is critical for merit-based resolutions of legal disputes. With the trial option, litigants rationally compare their expected positions after trial with settlement proposals (taking the related costs of litigation and settlement into account). If either the plaintiff or the defendant expects his or her position after verdict to exceed proposed settlements, the trial option is exercised (Alexander 1991, p. 502; Palmrose 1991, p. 150). Eliminating trial as a viable option for litigants severs the connection between the strength of the case (the merits) and settlements.

Even in securities litigation, where the trial option may not exist for most litigants, independent auditors are considered a possible exception. Alexander (1991, pp. 528–568) explained why participants—including plaintiffs, plaintiff attorneys, corporate defendants (the corporation, officers, and directors), underwriter defendants, defendant attorneys, and judges—have an incentive to settle legal disputes. However, Alexander (1991, p. 534) used a litigation posture argument to suggest the indepen-
dent auditor may be the one litigant potentially willing to try cases to verdict. According to this argument, independent auditors as repeat players recognize the reputational effects of being sued and therefore "adopt a policy of aggressively litigating cases and refusing to pay money to settle any cases in order to deter future suits" (Alexander 1991, p. 534).¹¹

Notwithstanding the suggestion that unique considerations characterize independent auditor defendants, independent auditors argue that they too are the victims of a high level of non-meritorious (frivolous) securities litigation (Arthur Andersen & Co. et al. 1992). Independent auditors attribute the problem, in part, to joint and several liability (Arthur Andersen & Co. et al. 1992, p. 1; Mednick and Peck 1994, p. 867). Under joint and several liability, a single defendant can be held liable for all damages in an action. Independent auditors believe they end up as the classic deep pocket defendant, sued not because they are at fault, but because they have resources. Replacing joint and several with proportionate liability is a primary objective of the public accounting profession.¹² A proportionate liability scheme assesses damages against each defendant found to be liable based on that defendant's determined degree of fault.

There is some theoretical support for auditors' arguments. Based on their model (under joint and several liability), Holloway et al. (1995, p. 3) found that the independent auditor's settlement share falls below the merits (i.e., the independent auditor's fair share) when legal costs are sufficiently low and the manager is fully solvent. However, the independent auditor's settlement share increases relative to merits, and can exceed the merits, as either litigation becomes more costly or the manager's wealth becomes more constrained. And, settlements are more likely to exceed the merits when the independent auditor's fault is low.

In summary, theoretical research raises concerns that the merits play an inadequate role in bringing and resolving suits against independent auditors. Alexander (1991) argued that the legal system does not work (at least the pre-reform system did not), while Holloway et al. (1995) asked, even if the system works, are there circumstances under which settlements may diverge from merit-based resolutions? Their (1995) answer was yes and their research identified some of these circumstances. I now turn to

¹¹Palmrose (1991) provided a more complete discussion of the reputation effects of audit litigation. Palmrose (1988) contains some evidence on litigation posture; however, this evidence is very preliminary and this is an area for future research.

¹²Regarding independent auditors, The Private Securities Litigation Reform Act of 1995 keeps joint and several liability in allocating damages for knowing violations of the Securities Exchange Act of 1934; otherwise damages are allocated using proportionate liability. There are some exceptions to the latter specified in the Act for uncollectible judgments (see King and Schwartz 1997). (The Act also reforms joint and several liability for outside directors for non-knowing violations of Section 11 of the Securities Act of 1933).
empirical research which provides some limited evidence on the role of merits in audit litigation. This evidence is discussed in the next two sections.

4. Do the Merits Matter? Preliminary Evidence from Empirical Research Related to Audit Litigation Occurrences and Outcomes

This section examines descriptive evidence from research on litigation occurrences and outcomes for insights on the role of merits in audit litigation. Research on outcomes in addition to describing the amounts, if any, paid by independent auditors, documents the extent to which independent auditors use trials to help resolve legal disputes.

4.1 Occurrences

Research reveals some selectivity by plaintiffs when it comes to including independent auditors as defendants in securities litigation. The O'Brien and Hodges (1993) sample of over 500 securities class actions from 1988–1993 had less than 25% with independent auditors as defendants (Palmrose 1994, p. 62). Bunsis and Drake (1995, Tables 1 and 2) found 21.8% of their IPO lawsuits from 1980 to 1994 involved independent auditors as defendants and, when they partitioned their sample into two subperiods of 1980–1989 and 1990–1994, the percentage of IPO litigation with independent auditors as defendants declined from 34.8% to 5.6%. The decline in the rate at which independent auditors were included as defendants occurred in conjunction with an increase in the overall IPO litigation rate (from 3.9% pre-1990 to 5.3% since 1990) (computed from Bunsis and Drake 1995, Table 1). Although Bunsis and Drake (1995, pp. 15–23) examined a number of factors, their preliminary analysis does not provide a complete explanation for this decline in independent auditor involvement in IPO litigation.

Unfortunately, selectivity in suing independent auditors does not mean that merit-based considerations drive lawsuits. For example, non-merit

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13 O'Brien and Hodges (1993) primarily relied on Securities Class Action Alert (previously Investors Class Action Monitor) to identify a sample of securities class actions. A number of studies have used this data source. Examples of studies which provide some analysis of independent auditor defendants using this source include Dunbar and Juneja (1993), Dunbar et al. (1995), and Marino and Marino (1994). Examples of studies which used this source but did not focus on audit-related litigation include Francis et al. (1994a, 1994b, and 1994c), Lev (1995), and Skinner (1995). Until about 1994, Securities Class Action Alert primarily reported settlements and, therefore, may not be a particularly reliable source for court dismissals of securities actions.

14 Selectivity does, however, undermine the insurance hypothesis (Francis 1994, pp. 101–102). According to the insurance hypothesis, investors view independent auditors as guarantors of financial statements and, in a sense, as guarantors of investments (Menon and Williams 1994, p. 341). (For additional discussions of this hypothesis, see Baber et al. 1995; Kohari et al. 1988; Lys and Watts 1994). Evidence on the resolution of independent auditor litigation further undermines this hypothesis.
based factors such as adequate (inadequate) resources available from other defendants may be a rationale for excluding (including) independent auditors from suits. Carcello and Palmrose (1994) examined audit litigation using a large sample \((n = 655)\) of bankrupt public clients of Big Six firms from 1972–1992; this represents a setting where at least some potential nonauditor defendants may not have had adequate resources. Contrary to anecdotal evidence, when a company fails the independent auditors are not always sued. Carcello and Palmrose (1994, p. 2) found an independent auditor litigation rate of 18% for bankrupt public companies. However, this rate is higher than a comparable independent auditor litigation rate for non-bankrupt companies of less than 3% (Carcello and Palmrose 1994, p. 2).\(^{15}\) And, independent auditors are included as defendants in the majority (70%) of financial reporting and disclosure litigation that occurs on bankrupt clients (Carcello and Palmrose 1994, p. 2).

Because the trial option is crucial for maintaining merit-based litigation, research examines trial rates for audit-related litigation. Regrettably, a lack of good benchmarks hampers this work. We do not know what trial rates should be under a merit-based system. Independent auditor trial rates can be compared to rates for civil securities actions, but, evidence on the latter is not particularly definitive. Nonetheless, independent auditor trial rates appear to be higher (about 10%) than trial rates for non-auditor defendants in securities actions (less than 5%), with some variation among types of audit cases (Palmrose 1991, p. 149). This evidence does not preclude the viability of the trial option for independent auditors.

### 4.2 Outcomes

Evidence on outcomes of independent auditor litigation likewise suggests merits may not be disconnected from resolutions. Recall the litigation posture argument predicts that independent auditors will aggressively litigate cases and will refuse to pay money to settle cases as a deterrence against future suits. Empirical evidence provides some support for this argument in that independent auditor dismissal and no-payment rates average between 40% and 50% (Palmrose 1988, p. 71; Palmrose 1994, p. 63). Even though adjudication without trial, such as by summary judgment, is considered unavailable as a practical matter on securities class actions (Alexander 1991, p. 505), summary judgment and procedural dismissals are important sources of resolutions for independent auditors (Palmrose 1994).\(^{16}\) Independent auditors achieve these favorable outcomes

\(^{15}\)Palmrose (1988, p. 64) discusses the sensitivity of independent auditor litigation rates to various measures and estimates for the denominator.

\(^{16}\)Summary judgment for independent auditor defendants means the court dismisses a case after viewing the evidence in a light most favorable to plaintiffs.
with some effort (cost). For example, it takes independent auditors 4.3 years, on average, to dispose of actions by summary judgment (Palmrose 1994, p. 67).

To the extent that resolution time correlates with defense costs, the evidence is consistent with a costly disposition process. To the extent that dismissals and no payments indicate weak claims (albeit ex-post weak claims), the evidence is consistent with a significant level of weak claims against independent auditors. Although these data may reveal independent auditors' willingness to aggressively litigate cases, the data also reveal weak claims as a potential problem for independent auditors in spite of the previous evidence indicating some selectivity in including independent auditors as defendants in securities litigation.

Outcome evidence describes payments on audit-related litigation. Regrettably, the evidence does not resolve whether independent auditors pay, on average, more or less than their fair share. Even so, this descriptive evidence yields insights on whether or not the merits matter; therefore, it is briefly discussed. Independent auditors do make some large payments; yet, considering just those cases in which independent auditors pay something, resolutions reveal independent auditors tend to be secondary contributors to the total amounts paid plaintiffs. Palmrose (1994, p. 64) found that in the majority of cases where independent auditors contribute, they contribute less than 50% of the total payments to plaintiffs. Indeed, in the cases with contributions by independent auditors, independent auditors most frequently contribute 10% or less of the total (Palmrose 1994, p. 64). The same study documents that 88% of independent auditor litigation is joint with other defendants (Palmrose 1994, p. 59). Also, independent auditors are not the only defendants with resources. Independent auditors tend to be non-contributors or secondary contributors even when total defense payments are large (Palmrose 1994, pp. 65–66).

Turning to a setting where resources available from non-auditor defendants may be constrained, outcome evidence yields somewhat different insights. Marino and Marino (1994, p. 155) found that accountants' mean and median settlement payments were greater on bankrupt clients. This result occurred even though median settlements were no different between bankrupt and non-bankrupt companies in their overall sample (1994, p. 141). (Accountants were defendants in about half of the 229 suits in their

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17Marino and Marino (1994, p. 158) found that accountants' settlement payments were greater with flagrant fraud. They (1994, p. 123) defined flagrant fraud to include events such as insider trading for which independent auditor responsibility is problematic. Marino and Marino (1994) did not examine the joint effect of bankruptcy and fraud on accountants' settlements.
sample; their sample focused on suits against professional defendants (1994, p. 146). Considering all types of outcomes, not just settlements, Carcello and Palmrose (1994, p. 23) found that means for both independent auditors’ payments and total payments by all defendants were greater in their sample of bankrupt public companies than in samples which included all types of audit litigation. Also, independent auditor rates for dismissals (from lawsuits)/no payments were lower on bankrupt public companies (Carcello and Palmrose 1994, p. 23).

One interpretation for these results is that bankruptcy disadvantages defendants with resources such as independent auditors. The AICPA’s engagement risk model recognizes this possibility through the client’s business risk component (the risk associated with the entity’s survival and profitability) (AICPA 1995, p. 7). Bankruptcy may represent a setting described in Holloway et al. (1995) where manager’s wealth is constrained and litigation is costly, so that auditor payments exceed the merits. It also may be that resolutions and merits are disconnected, thereby increasing the amounts paid by deep-pocket defendants. If so, it is curious that independent auditors are not defendants in other litigation that occurs on bankrupt clients. For example, for financial reporting and disclosure litigation without independent auditor defendants, Carcello and Palmrose (1994, p. 25) reported lower mean and median resolutions than amounts reported for securities class actions generally. Although low settlements may reflect weak claims, if outcomes and merits are indeed disconnected, why not sue the independent auditors too? This leads to another possible interpretation for higher payments by independent auditors on bankrupt clients, whereby claims against independent auditors are more meritorious for bankrupt clients. This interpretation assumes a connection between claims and merits.18

In summary, although far from conclusive, extant evidence on lawsuit selectivity, the use of trials, and outcomes does not rule out a role for merits in bringing and resolving suits against independent auditors. However, the question remains, how meaningful is this role? As Dunbar et al. (1995, p. 16) pointed out, the real issue is not whether the merits matter at all, but whether the merits matter enough. The next section pursues this question by examining research on the determinants of lawsuits against independent auditors and the determinants of outcomes of such suits.

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18Carcello and Palmrose (1994, pp. 25–27) found that independent auditors may be excluded from other litigation because these suits tend to involve disclosures outside the financial statements, that is, disclosures more remote from those with independent auditor involvement and responsibility. A press release with optimistic statements about the company’s future prospects is an example of a more remote disclosure.) This result suggests a role for merits in bringing suits against independent auditors.

To further examine the role of merits in audit litigation, this section discusses evidence from four types of empirical studies, namely: 1) studies of lawsuits against independent auditors; 2) studies of companies with/without independent auditor litigation; 3) a study of bankrupt public companies with/without independent auditor litigation\textsuperscript{19}; and 4) a study of securities class action settlements which includes some independent auditor defendants. Only the last two studies have outcome evidence.

St. Pierre and Anderson (1984) documented a number of characteristics associated with lawsuits against public accountants (for all types of services, not just audit services) using a sample of cases from 129 legal citations during 1960–1978. Among client characteristics associated with higher litigation rates were public companies and certain industries such as financial services (1984, pp. 248–249). St. Pierre and Anderson (1984, p. 256) also found a meaningful presence of bankrupt clients, new clients (defined as three years or less), and problems with GAAS/GAAP interpretations (estimates and judgments) and the failure to detect fraud (rather than procedural errors) in their sample. Other studies (e.g., Palmrose 1987, p. 101; Sullivan 1992, pp. 56–57) likewise have documented the presence of client bankruptcy/severe financial distress and irregularities (fraud) in lawsuits against independent auditors. Whereas the univariate analyses in these studies identified some circumstances surrounding audit litigation, multivariate analyses simultaneously considered a more comprehensive set of factors.

Multivariate analyses of determinants of lawsuits against independent auditors include Stice (1991) and Lys and Watts (1994). Both studies used matched-pairs of COMPUSTAT companies with/without independent audit litigation, but their matching and measurement procedures differed along with the time-periods (1960–1985 versus 1955–1994) and sample sizes ($n = 49$ versus $n = 153$). The studies used different models of the determinants of lawsuits. Both models were significant, even though they each left much unexplained variance (adjusted $R^2$s of .30 and .18, respectively) (Stice 1991, p. 530; Lys and Watts 1994, p. 86). Each study included a number of insignificant variables; significant results were not robust among analyses within studies, and variables common to both studies were not consistently significant.

\textsuperscript{19}Companies with no independent auditor litigation have no financial reporting and disclosure litigation.
With this background information, significant variables in Stice (1991, p. 530) include the ratio of accounts receivable to total assets (+), the ratio of inventory total assets (+), financial condition index (Altman-Z score)(−), variance of abnormal returns (+), and (ln)market value (+). Variables with significant coefficients in Lys and Watts (1994, p. 86) include the probability of bankruptcy (Ohlson (1980) model) (unexpectedly −), the probability of acquisition (Palepu (1986) model) (+), accruals to total assets (−),\(^2\)21 size as measured by the log of total assets (+), and the proportion of revenues from the client as measured by the ratio of client sales to total sales audited (+). Size-related variables (market value and assets, respectively) were the ones similarly significant in both models, although Lys and Watts (1994, p. 80) matched on size which complicated the interpretation of their results (Francis 1994, p. 99).

Client size has been consistently associated with financial reporting and disclosure litigation (Francis et al. 1994b, p. 2; Skinner 1995, p. 23). Carcello and Palmrose (1994, p. 14) in their study of bankrupt public companies with/without independent auditor litigation, likewise found that larger clients are more likely to have independent auditor litigation. The two other significant coefficients in the Carcello and Palmrose (1994, p. 14) model were dichotomous variables for net income in the last financial statements before bankruptcy (or litigation, whichever came first), and SEC enforcement actions. (Their model had an adjusted \(R^2\) of .35 (1994, p. 14).

Difficulties arise in considering whether any of these significant explanatory variables captures the merits of claims against independent auditors.\(^2\)22 Each variable is subject to multiple interpretations. Essentially, each variable involves both meritorious and non-meritorious litigation explanations. For example, consider client size variables. A meritorious litigation explanation is that client size and litigation are linked through damages. Size is related to damages and more meritorious claims lead to larger damages (ceteris paribus),\(^2\)23 i.e., greater aggregate losses incurred by

\(^2\)\(^2\)\(^2\)20Higher Altman-Z scores indicate a lower likelihood of bankruptcy, so that stronger client financial condition lessens the likelihood of independent auditor litigation.

21Measured as annual depreciation and amortization expense plus the change in deferred taxes and investment tax credit minus the change in working capital (excluding cash), all divided by total assets. The larger the accrual, the more reduced net income and assets and the less likely a lawsuit.

22Although not a focus of my discussion, similar difficulties arise in considering the insignificant explanatory variables in the studies discussed. This is important because using an unambiguous proxy for the merits of claims with insignificant results undermines a meaningful role for merits (subject to the normal caveats that occur with insignificant results).

23Research examines the proposition that size is related to damages, and larger estimated damages attract litigation because damages are related to settlements. Dunbar et al. (1995, p. 33) and Francis et al. (1994b, p. 4) documented a nonlinear relation between estimated damages and actual settlements. Because settlements do not increase proportionally with investor losses, Dunbar et al. (1995, p. 34) concluded that settlements can be constrained by the availability of assets and insurance coverage.
potential plaintiffs. A non-meritorious litigation story is that larger companies are more likely to have resources (including officers and directors insurance) to pay plaintiffs and their attorneys. For example, larger companies tend to have enough insurance to provide adequate fees for plaintiffs' attorneys (even after covering the relevant defendants' defense costs), thus making it worthwhile for attorneys to file lawsuits.

Another example is the likelihood of financial distress variable (as measured by a financial condition index). Researchers (Lys and Watts 1994, p. 68) view this variable as proxying for the likelihood that misstatements occur because "managers' incentives to mislead increase when the firm is in financial distress" and "discovery of reporting problems is more likely the higher the probability of bankruptcy." This interpretation is compatible with a meritorious litigation story. However, as previously discussed, researchers (e.g., Stice 1991, p. 521) likewise view this variable as proxying for plaintiff incentives (via incurring losses) to attempt to recover from deep pocket defendants such as auditors (Stice 1991, p. 521)—a non-meritorious litigation story.

The one significant variable arguably closest to capturing the merits involves the fraud/irregularities-type variable, in particular, the SEC enforcement action variable in the Carcello and Palmrose (1994, p. 7) study. SEC enforcement actions are external evidence of egregious reporting and disclosure violations. Even this variable is exposed to criticism because subjects of enforcement actions typically consent without admitting or denying the merits of the SEC's allegations. Furthermore, SEC enforcement actions differ in their nature and severity. And, independent auditors need not have responsibilities in conjunction with these material omissions and misstatements (Feroz et al. 1991, Table 7, pp. 120–121). These concerns are addressed in the next section.

Turning to evidence on the determinants of outcomes, results are few and somewhat disappointing from the standpoint of merits. The Carcello and Palmrose (1994, p. 24) ordinary least squares (OLS) regression model with independent auditor payments (including zero) as the dependent variable yielded no significant results. In fact, they (1994, p. 24) reported the model was not significant, so nothing can be inferred about the role of merits from a lack of significance, in particular for the SEC enforcement

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24 In computing estimated damages, researchers rely on market loss (investor loss) models that appear to significantly overstate legal damages (i.e., recoverable damage estimates prepared by litigants during the course of litigation) (see Class Action Reports March-April 1993, p. 251). Using private information, Dunbar et al. (1995, p. 33) found cases with both higher investor losses and higher plaintiffs' damage estimates have higher settlements.

25 There exists a certain degree of endogeneity. One objective of SEC enforcement activities is to facilitate civil litigation.
action variable. To address whether the merits matter, Dunbar et al. (1995, p. 34) added two variables to their multiple regression analysis, with settlement amounts as the dependent variable. The variables are the presence or absence of a security offering during the class period (because Section 11 liability has an easier burden of proof for plaintiffs), and a government agency investigation, either ongoing or with an adverse outcome. Dunbar et al. (1995, p. 34) argued that these two variables are, in theory, indicative of the merits. They found neither variable was significant.

In summary, research on both the determinants of lawsuits against independent auditors and the determinants of outcomes provides few insights on the role of merits. Admittedly, none of the studies discussed include a stated objective of determining whether or not the merits matter, except Dunbar et al. (1995). However, future research can extend this determinants literature to explicitly consider the role of merits. The subsequent section provides some suggestions for doing so.

6. Do the Merits Matter? Suggestions for Future Research

The Kinney (1993) flowchart of causal links in auditing can be used in developing models to examine the role of merit-based variables on the determinants of lawsuits against independent auditors and on the determinants of outcomes. The framework allows more precise consideration of the effects of potential variables. For example, both Stice (1991, p. 520) and Lys and Watts (1994, pp. 67–70) used ratios of accounts receivable/total assets and inventory/total assets as variables to capture the likelihood of departures from GAAP (link b in Figure 1). However, these variables may capture circumstances which make it more difficult for independent auditors to defend against the failure to detect any material misrepresentations, given extreme values for common ratios (i.e., defend

26 There is limited additional evidence using the Palmrose (1994) data. I ran three separate OLS regressions with: 1) independent auditors' percentage contribution; 2) independent auditors' inflation-adjusted payments (including zero), and 3) total inflation-adjusted resolution amounts (including zero) as dependent variables. Adjusted $R^2$s were 0.14, 0.30, and 0.08, respectively. In the first regression, coefficients for the presence of non-audit defendants, bankrupt clients, and SEC enforcement actions against independent auditors were significant (negative, positive, and positive). In the remaining two regressions, the coefficient for multiple independent auditor defendants was significant (positive). The only other significant coefficient was for SEC enforcement actions against clients in regression (2); it was positive.

27 Dunbar et al. (1995, p. 34) found that including a public accounting firm as a codefendant adds about one-third to the expected settlement value of a case. However, this result likely reflects a correlated omitted variables problem. For example, the Dunbar et al. regression did not include a variable for bankruptcy/severe financial distress or a particularly satisfactory measure for fraud. In addition, note that the Dunbar et al. research focused on explaining settlements not outcomes, so that their samples likely understated occurrences of independent auditor dismissals/no payments.
that a GAAS audit was performed—link a in Figure 1). As Kinney emphasized, distinguishing between substandard audits and substandard financial statements (links a and b) can be important in considering meritorious/non-meritorious claims against independent auditors.

Even with the Kinney (1993) framework, the task of identifying merit-based variables is not an easy one. For example, Lys and Watts (1994, p. 66) used five factors to generate client and independent auditor characteristics expected to be associated with lawsuits. These five factors can fit within Kinney's model. Two factors are misleading financial statements (substandard financial statements, link b) and audit failure (substandard audit, link a). The remaining three factors are the existence of a loss, discovery, and net benefits to litigation (most of which can be related to the remaining links in the Kinney flowchart). Yet, as previously discussed, the variables derived from the five factors tend not to be easily delineated as merit/non-merit based. Hopefully, Kinney's framework and its explicit focus on merit-based versus non-merit based variables will allow researchers to extend the extant literature.

Finally, the Kinney (1993) framework may help adapt research from other areas to recognize the unique and interesting features of the audit setting. There is a large legal-economic literature, as well as a large legal-psychology literature, of potential relevance to audit research. However, these literatures need to be adapted to an audit setting. Holloway et al. (1995, p. 1) illustrates this point. They modified a legal-economic model to incorporate the conditional nature of independent auditor liability. In their model, independent auditors have no liability unless both independent auditors and managers are at fault. Consistent with Kinney (1993), for independent auditors to be liable, managers must have provided substandard financial statements and independent auditors must have provided substandard audits.

In addition to having a framework for considering the role of merits in audit litigation, research can benefit from a greater access to litigation data. This issue is discussed in the next section.

7. Audit Litigation Database and Suggestions for Future Research

Litigation research has been limited by data availability. Data on independent auditor litigation are costly to obtain. My monograph project (Palmrose forthcoming) addresses this problem. The monograph is sponsored by the American Accounting Association under a grant from the Accountants' Coalition. It is planned that the monograph will be available through

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28 Earnings manipulation research might be useful to consider from this standpoint (see Beneish 1997).

29 Nonetheless, there can be circumstances where only the independent auditor may be considered potentially liable by the court for substandard audited financial statements. For example, see In re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994).
the American Accounting Association in 1998. The objective of the monograph is to provide guidance for conducting empirical research in auditor litigation and to provide a database to aid research. (The monograph is also intended as a resource for teaching.) The monograph consists of text and diskette.

The text outlines the litigation process and explains how the data are related to that process. The outline provides a framework for discussing research design and data-gathering issues. The monograph describes the database, how the data were obtained, and the mechanics of using the database. Finally, the monograph discusses how the data might be supplemented.

The database diskette consists of over 1,000 clients (entities) of Big Six firms with litigation related to their financial statement audits from 1960–1995. For the observations, the database provides a wide variety of information about the client, accounting and auditing issues, legal and regulatory actions and the resolution of these actions. The data are based on publicly-available information, so that the database does not contain full and complete information for all observations. The database is designed for use with Microsoft Access 2.0.

The database should facilitate litigation research in a number of ways. It provides a large sample of audit-related litigation observations. The database also provides a wide variety of information about these observations. This information can be used to develop more powerful tests. To illustrate, studies tend to use long windows of audit litigation with observations from very different time-periods (examples of time-periods used by those researchers previously discussed are 1960–1985, 1955–1994, and 1972–1992). Studies that match test and control samples on time-period alleviate some but not all concerns. In addition, extant studies usually have combined all types of cases and claims into one sample. The database observations can be partitioned for more focused testing, while still yielding adequate sample sizes.

The database contains outcome information for independent auditors as well as other defendants in audit-related litigation. Not all observations have full and complete outcome information and a number have no information at all. This is because some cases remain unresolved for some or all defendants; and, I have been unable to acquire any relevant information for other cases. Nonetheless, opportunities for research on the determinants of outcomes, for example, should be improved by the database, as a lack of outcome data has hampered such research.

\footnote{For example, by including all types of cases and claims involving public clients into one sample, tests of the insurance hypothesis in Lys and Watts (1994, p. 74 and p. 88) implied that a 1983 New Jersey state court decision (\textit{Rosenblum v. Adler}, 461 A.2d 138 (N.J. 1983)) should similarly impact audit litigation in all federal courts and in state courts in all other states.}
Other illustrations for using the database relate to the role of merits. Given the database contains information about accounting, auditing, and legal issues, it should facilitate the analysis of the role of substandard financial statements, substandard audits, and legal requirements in bringing and resolving suits against independent auditors. Extant research previously reviewed considered research questions with merit-related variables as independent variables. Even so, analysis of the role of merits in audit litigation may involve research questions that consider merit-related variables as dependent variables. As the database includes information on a fairly comprehensive set of variables, it should likewise facilitate these inquiries.

Arguments for why the merits might not matter primarily center on a class action securities litigation setting where contingent fee arrangements compensate plaintiff attorneys and directors' and officers' insurance is an important source for recoveries. Litigation against independent auditors is not limited to this setting; independent auditors have responsibilities to a number of different types of third parties as well as to clients. Whether the role of merits differs among settings (types of plaintiffs) remains unexamined. As the database contains information on types of plaintiffs, types of claims, and class action suits, it should be useful in this research.

The impact of some past regulatory changes and court decisions can be addressed using the database. However, determining the nature and timing of any impact is not straightforward. Recent federal legislation (The Private Securities Litigation Reform Act of 1995) is no exception. The legislation makes a number of changes, including procedural changes, related to the Securities Act of 1933 and the Securities Exchange Act of 1934, in addition to changing some provisions regarding joint and several liability (see King and Schwartz 1997). Because of the other changes, determining the effect of changes in joint and several liability using revealed behavior of actual litigants (ex post data) will not necessarily be easy. This suggests an important role for other methodologies, including experiments (see McDaniel and Hand 1996). It also illustrates the need for theoretical (ex ante) research.

Furthermore, assessing the impact of the recent federal legislation will require supplementing the database with data subsequent to 1995. Supplementing the database will also be necessary to investigate litigation issues related both to financial statement audits by non-Big Six firms and to other services by all firms. For example, regarding the latter, the 1995 federal

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31Although not explicitly described as such, the study by Lys and Watts (1994, pp. 90–91) includes a methodology for examining the potentially changing role of merit/non-merit based variables over time.

32Non-Big Six firms are included in the database where lawsuits involve claims against both Big Six and non-Big Six firms. Likewise included are lawsuits with claims against Big Six firms involving both financial statement audits and other services.
legislation affects claims under various sections of The 1933 Securities Act, The 1934 Act, and RICO. While allegations of substandard financial statement audits involve claims under sections changed by the federal legislation, so may allegations of substandard review services, other assurance services (such as projections and forecasts), and tax opinion letters. These services are certainly worthy of research.

The Private Securities Litigation Reform Act of 1995 contains provisions that reaffirm the independent auditor’s responsibilities for detecting illegal acts (fraud33), identifying and disclosing related party transactions, and evaluating issuers as going concerns. The 1995 Act also contains new requirements for disclosing illegal acts (fraud) (King and Schwartz 1997, p. 104). The database includes information on illegal acts (fraud), related party transactions, and going-concern issues in the context of independent audit litigation. As such, the database should be a useful source of data for a variety of research projects related to independent auditors’ responsibilities in these areas.

As one last illustration, the database can be used in conjunction with other data, such as the data used in previously discussed research on securities class actions (O’Brien and Hodges 1993) and client bankruptcy (Carcello and Palmrose 1994), to pursue research related to a variety of issues. Two examples are the independent auditor’s responsibilities relative to the responsibilities of others, particularly management, for substandard financial statements (Kinney 1993) and the boundaries of independent auditors’ responsibilities for substandard financial reporting. Regarding the latter, the report of the Jenkins Committee (American Institute of Certified Public Accountants Special Committee on Financial Reporting 1993, p. 11), indicated that users want more interim reporting and recommended that users need more forward-looking and qualitative information. Evidence from past litigation in these areas, and why it includes/excludes independent auditors (accountants) as defendants, would be a useful contribution to the public policy debate over the nature and extent to which these recommendations should be implemented. Similar comments apply to the report of the Elliott Committee (The AICPA Special Committee on Assurance Services) (Elliott and Pallais 1997).

In summary, the database is intended to assist audit litigation research. It is unlikely to provide all the data needed for some research projects. It certainly will not provide the data needed for all projects. However, the database can be the key which unlocks the door to much litigation research.

33The 1995 Act (Title III, Section 301(f)) defines an illegal act as “an act or omission that violates any law, or any rule or regulation having the force of law.”
8. Summary and Concluding Remarks

My paper discussed the status of audit litigation research and suggested some directions for future research from the perspective of the public policy debate over legal reform. An overarching issue in this debate is the role of merits in bringing and resolving lawsuits against independent auditors. The role of merits framed my discussion of extant audit research and many of my suggestions for future research. Kinney (1993) was used to define merits; his flowchart of the causal links in auditing gave structure and perspective to the discussion of existing research and suggestions for future research.

In focusing on the role of merits in audit litigation, I did not discuss all types of research and research opportunities related to this issue. For example, to the extent that merits matter, we still need to understand how participants in the legal process, including judges and juries, determine the merits of claims involving accounting and auditing issues. To the extent that merits do not matter, it becomes more important to understand the role of non-merit based factors in bringing and resolving suits against independent auditors. Examples of studies related to these issues include Anderson et al. (1995), Buckless and Peace (1993), Cloyd et al. (1994, 1996), and Jennings et al. (1993).

In conclusion, there are a number of issues worthy of research involving the avoidance and resolution of disputes. Although this article discussed litigation, lawsuits are just one mechanism for settling disputes over audit services. The database (Palmrose forthcoming) recognizes alternate methods for resolving disputes by providing information on settlements to avoid litigation and arbitration where the data are available. I hope the database will likewise be useful for these other lines of research.

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References


Audit Litigation Research


In re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994).