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Do Effective Corporate Audit Committees Reduce the Likelihood of Litigations Against External Auditors?

Dr. Young Park
Professor Accounting
Grove City College

ParkYK@gcc.edu

1. Synopsis and Introduction

This paper investigates the role of audit committees in the corporate financial reporting and auditing process, as reflected in the frequency of litigation against the firm's external auditors. Specifically, this paper investigates whether differences in client firms' audit committee characteristics and internal governance structures contribute to the incidence of litigation against external auditors. The empirical analysis examines a sample of seventy-five audit client firms whose external auditors were sued for alleged audit failures during the period 1978-1992 and a control sample of seventy-five matched audit client firms by time period, stock exchange, industry, and size.

Empirical results indicate that the likelihood of auditor litigation is related to corporate financial governance characteristics, even after controlling for factors associated with both corporate governance structure and the likelihood of auditor litigation. The likelihood of auditor litigation decreases (1) when client firms have more independent outside directors on their audit committees; (2) when audit committee members hold more outside directorships in other corporations; (3) when audit committee members have greater tenure on the client firm's board of directors; (4) when audit committees meet more frequently; and (5) when directors and officers have greater stock ownership in their firms. However, the likelihood of auditor litigation increases when the CEO of the client firm simultaneously serves as the chairman of the client firm's board. In addition, after controlling for audit committee characteristics and internal governance structures, certain factors which have been found in previous research to be related to the likelihood of auditor litigation, e.g., client firm financial condition and growth rate, are no longer significantly associated with auditor litigation.

These findings provide empirical evidence supporting the proposition that internal governance processes also monitor and control the corporate financial reporting and auditing process and therefore, firms with ineffective audit committees and weak internal governance structures are more likely to have financial reporting and auditing problems. These results also provide one explanation for the mixed findings of prior research, which has not considered the audit committees' oversight role and internal governance structures in the financial reporting and auditing process.

Overall, the results of this paper provide support for the importance and effectiveness of audit committees and internal corporate governance structure in the financial reporting and auditing process. As such, these results support the public and regulatory efforts to increase the quality of financial reporting by enhancing the corporate financial governance process.

The remainder of this paper is organized as follows: Section 2 describes the background and motivation. Section 3 develops the theoretical relation between various audit committee characteristics and the likelihood of litigation against external auditors. Section 4 explains the research design. Section 5 describes sampling procedures and sample characteristics. Section 6 presents the empirical results and discussions. Section 7 concludes this paper.

2. Background and Motivation

In the wake of the increased incidence of fraudulent and misleading financial reporting and alleged audit failures, public concern and regulatory initiatives have been prominent recently regarding the quality of financial reporting and the audit committee's oversight role in the financial reporting and auditing process (The Securities Exchange Commission "SEC" 1979; AICP A National Commission on Fraudulent Financial Reporting "Treadway Commission" 1987; AICPA Public Oversight Board "POB" 1993, 1994). The SEC (1979) emphasizes the importance of audit committee oversight of internal controls, auditing, and financial reporting. The Treadway Commission (1987) identifies audit committees as essential parts of any system designed to prevent fraudulent financial reporting. Audit committees have been considered "a significant element of corporate accountability and governance" and "help engender a high degree of integrity in the financial reporting process, which is an essential element of an efficient securities market" (Braiotta 1994). Among the recommendations from the groups noted above are that the audit committee of a publicly-held company be composed primarily of outside directors, and that audit committees should be informed, vigilant and effective overseers of the financial reporting process and the company's internal controls.

While the public and regulatory bodies attribute a significant monitoring role to outside directors, other writers have raised doubts as to whether outside directors are effective monitors (Paton and Baker 1987; Jensen 1993; Monks and Minow 1996). Similarly, the available empirical evidence concerning the effectiveness of active oversight by outside directors in the financial reporting and auditing process is relatively limited to date (Gerety and Lehn 1991; Beasley 1996; Livingston 1997). Consequently, to the extent that audit committees are made up of potentially ineffective outside directors, the effectiveness of audit committees is questionable. Some critics argue that audit

committees are limited in effectively discharging their oversight roles because they lack a clear definition of their authority, responsibility, and liability (Wallace 1995) and because they do not want to "rock the boat" (Berton 1995). Some critics even consider audit committees "creatures of the company's management rather than watchdogs over shareholders' interests" (Weschler 1989, 132) and as "established for cosmetic purposes" (Menon and Williams 1994, 131). Moreover, Sommer, the chairman of the POB of AICPA, raises serious doubts concerning the overall effectiveness of audit committees (1991, 91):

> While there are no reliable figures available to indicate the number of audit committees that operate effectively, there is considerable anecdotal evidence that *many, if not most, audit committees fall short of doing what is generally perceived as their duties .... they do not appear to be asking the hard questions or fulfilling the full range of what is expected of them.* [emphasis added]

Despite such significant concerns regarding the effectiveness of audit committees in their oversight role, empirical research in this area has yet to provide very conclusive evidence on this issue (McMullen 1996). Some studies report results consistent with audit committees playing a meaningful oversight role (DeFond and Jiambalvo 1991; Dechow et al 1996; McMullen 1996; Wild 1996), while others do not (Jones 1986; Crawford 1987; Beasley 1996). The research noted typically assesses the effectiveness of audit committees by measuring the existence of audit committees. However, the mere presence or absence of an audit committee may not be a good indicator of effective monitoring. In a study of 119 fraudulent financial reporting actions brought by the SEC from 1981 to 1986, the Treadway Commission (1987) finds that sixty-nine percent of the firms charged with fraudulent financial reporting by the SEC had audit committees. The Treadway Commission concludes that the mere presence of an audit committee does not necessarily indicate that an audit committee is fulfilling its oversight role. On the other hand, Menon and Williams (1994) argue that the absence of an audit committee is not sufficient to imply the absence of effective monitoring in the financial reporting process. Instead, it may signal that the full board, composed of vigilant outside directors, has accomplished the oversight role without having a formal audit committee.

The preceding discussion suggests that the mere presence or absence of audit committees is inadequate to capture their effectiveness. Instead, characteristics of audit committees and their operations may provide more direct evidence and insight into the relationship between the

effectiveness of audit committees and the quality of corporate financial reporting and auditing.

The first motivation of this paper, therefore, is to extend current research by identifying and analyzing audit committee characteristics that may be associated with the effective functioning of audit committees in the financial reporting and auditing process. Recently, accounting researchers began exploring the relation between some characteristics of audit committees and certain financial reporting consequences (Beasley 1996; McMullen and Raghunandan 1996). Beasley (1996) examines differences in audit committee compositions between 26 financial reporting fraud firms and 26 no-fraud firms. On a univariate basis, he finds that the financial reporting fraud firms have a significantly lower average percentage of outside directors on their audit committees than no-fraud firms. McMullen and Raghunandan's survey (1996) reports that the audit committees of firms with financial reporting problems meet less frequently and have fewer outside directors than firms without financial reporting problems. Yet, the research in this area is at an early stage, and its empirical evidence is limited.

The second motivation of this paper is to examine the effectiveness of the audit committee's oversight role in the financial reporting process, as revealed by the incidence of auditor litigation. This paper empirically documents the relationship between audit committee characteristics and the likelihood of litigation against external auditors. Specifically, after controlling for corporate governance structures and firm-specific non-governance characteristics, this paper examines whether some characteristics of audit committees and their members contribute to the likelihood of external auditor litigation. To the extent that audit committees do not effectively perform their oversight role, they may not be able to ensure the quality of corporate financial reporting, and hence may fail to prevent fraudulent financial reporting. While such potential ineffectiveness may have several consequences, an important one is subsequent "alleged audit failures." These alleged audit failures, in turn, frequently result in subsequent litigation against the external auditors (Sommer 1991; Bacon 1993). Sommer (1991, 92) notes that:

> One of the less obvious losers when an audit committee fails to fulfill its responsibilities is the external auditors .... The audit committees with their constant access to the internal auditor and other corporate personnel, may often be the first non-management group of people to catch a whiff of irregularity. And if they do, they can direct the scrutiny of the external auditor to the problem and thereby forestall the sort of situation that often is alleged in litigation as a faulty audit.

Thus, despite public and regulatory efforts to increase the quality of the corporate financial reporting system, allegations of audit failures associated with fraudulent financial reporting have been constantly increasing. One consequence has been significantly increased litigation activities against external auditors. The number of legal claims against non-Big 6 auditors increased by 67 percent between 1987 and 1991 (O'Malley 1993). Furthermore, the Big 6 report that in 1992 alone they spent eleven percent of their total revenues on protecting their practices against litigation (Dalton et al 1994). As of 1994, the estimated aggregate legal claims against accounting professions were reported to exceed $30 billion (Hanson and Rockness 1994).

The high frequency of litigation against independent auditors strongly suggests the importance of understanding the factors associat~d with auditor litigation. As argued by Sommer (1991) and Bacon (1993), the inherent ineffectiveness of audit committees often leads to alleged audit failures, and thus results in auditor litigation. Thus, this paper investigates and empirically documents evidence as to whether auditor-litigated firms and non-litigated firms differ with respect to characteristics of their audit committees and other features of their internal governance structure. Understanding the relation between audit committee characteristics and the incidence of auditor litigation is particularly important to the accounting profession. By understanding audit committees and the internal governance structure, auditors may be able to anticipate and thus avoid financial reporting problems, improve the quality of the financial reporting and auditing process, reduce alleged audit failure, and avoid subsequent auditor litigation.

3 **Theory and Hypothesis Development**

I identify and analyze the following five audit committee characteristics as factors that are likely to be related to the likelihood of auditor litigation: Independence, Stock Ownership, Quality, Tenure, and Activity Level. Some of these factors may be interrelated; however, I will address each one independently

3.1 Independence of Audit Committee Directors

One factor that might account for some of the apparent shortcomings of audit committees to date has been identified by Vicknair, et al. (1993) as the audit committee's lack of effective

independence from management. Specifically, they identify the existence of a significant number of "grey" directors as "a potential source of violations of audit committee independence." Vicknair, et al. (1993,53) argue:

> Although the NYSE guidelines specifically preclude affiliates, officers, and employees of the company from serving on audit committees, corporate boards of directors are given considerable discretion in electing to the audit committee directors whose views may be biased toward management's. --- Thus, the *discretion given to potentially management-dominated boards by the NYSE to elect "grey" area directors to the audit committee may compromise the committee's independence and, therefore, reduce its effectiveness.* [emphasis added.]

The corporate governance literature (e.g., Weisbach 1988) classifies outside directors as either "independent" or "grey." Outside directors are classified as "independent" if they are free of any apparent affiliation or business ties with client firm and its management other than board membership. Outside directors are classified as "grey" if they are affiliated with the corporation or its management although they are not its full-time employees. These grey directors generally include interlocking directors, suppliers or customers, affiliated bankers, lawyers, consultants, former employees, or relatives of management. Because these grey directors frequently have family and/or business ties with management, they are less likely to be effective monitors (Weisbach 1988; Byrd and Hickman 1992; Shivdasani 1993). Beasley (1996) finds that the proportion of independent outside directors on the board has a significant negative effect on the likelihood of financial reporting fraud. In addition, McMuiIen and Raghunandan (1996) find that firms without financial reporting problems are more likely to have audit committees consisting entirely of outsiders.

The theory and evidence presented above suggest that independent outside directors are in a better position than insiders/grey directors to monitor management adequately, have more freedom of independence, and have greater incentives to discipline management. With stronger monitoring incentives, independent outside directors are more likely to limit the manager's discretion over accounting procedures and choices, thereby reducing the "noise" in the financial reporting system. Therefore, an audit committee that is composed of more independent outside directors relative to insiders or grey directors is more likely to execute its oversight responsibility effectively, thereby reducing the incidence of alleged audit failures and subsequent litigation against external auditors.

3.2 The Extent of Stock Ownership by Audit Committee Directors

Some corporate governance critics have asserted that a limitation on outside directors' motivation to protect and promote shareholders' interest stems from the fact that outside directors typically have an insignificant personal stake in the firm (Paton and Baker 1987; Jensen 1993). Recent empirical findings support this incentive effect of stock ownership by outside directors. Shivdasani (1993) finds that outside directors in hostile takeover target firms have a significantly lower ownership level than those in non-target firms. Shivdasani (1993, 195-196) concludes:

> This negative relation between outside directors' stock ownership and likelihood of hostile takeover suggests, however, that the outside directors of hostile takeover targets have a lesser financial incentive in monitoring managers .... This supports the views of those skeptical of the governance functions performed by corporate boards, who claim that *without a significant equity stake, directors have few incentives to monitor.* [emphasis added.]

Further, two studies on the relationship between the extent of a board's stock ownership and financial reporting fraud suggest the positive effect of outside directors' stock ownership on the effective oversight of corporate financial governance and the financial reporting process. First, Gerety and Lehn (1991) report that as the board's stock ownership increases, the likelihood of a firm committing accounting fraud decreases. Second, Beasley (1996) reports that the outside directors of firms without any incidence of financial reporting fraud had a significantly greater ownership stake in the firm than outside directors of firms with financial reporting fraud. These findings support Jensen's (1993) assertion that encouraging outside directors to hold a substantial ownership position in the firm would provide these directors with better incentives to monitor management closely.

The above theory and empirical findings suggest that as the audit committee directors' equity interests in the firm increase, they are more likely to identify themselves with significant shareholders and have stronger incentives to closely monitor top managers and carefully oversee internal control and the financial reporting process.

3.3 Quality of Audit Committee Directors as Good Monitors

Fama (1980) and Fama and Jensen (1983) argue that outside directors are better motivated to monitor managers than inside directors because the managerial labor market will discipline those outside directors who fail to protect and promote shareholders' interests. Outside directors will

therefore have an incentive to maintain or establish reputations as good monitors. They also have incentive to ensure the effective operation of the company because being directors of well-run companies signals their competence to the managerial labor market (Fama 1980; Fama and Jensen 1983; Weisbach 1988).

Recent empirical results support this "ex-post settling up" hypothesis in that the managerial labor market for outside directorships rewards effective outside directors with additional directorships, but disciplines outside directors who have a record of poor monitoring performance. Kaplan and Reishus (1990) report that top managers of dividend-reducing firms have fewer opportunities to serve as outside directors on other boards after the dividend cut than do managers of non-dividend-reducing firms. Gilson (1990) finds that outside directors who leave the board of financially-distressed firms hold significantly fewer outside directorships three years after their departure. Gerety and Lehn (1991) find that directors of a sample of firms charged with accounting and disclosure violations by the SEe were significantly more likely to lose their other directorships than were directors of a control sample of firms never charged with such violations for the period of 1981-1987. These findings suggest that managerial reputations as good monitors, measured as the number of additional outside directorships, would provide outside directors with substantial incentives to be effective overseers of corporate governance.

The preceding discussion suggests that the audit committee whose directors have a reputation for good monitoring is more likely to effectively oversee the financial reporting process and internal control and, thus, preserve the quality of financial reporting. This, in turn, will reduce the incidence of alleged audit failures and subsequent litigation against external auditors.

3.4 Tenure of Audit Committee Members

The tenure of audit committee directors is hypothesized to be positively associated with the effective functioning of the audit committee in its oversight role. Because outside directors are literally outsiders, they begin with an information disadvantage with respect to the firm's financial, operational, and economic conditions. However, the longer the outside directors have served on the board, the more firm-specific knowledge they are likely to have. This, in turn, may reduce their dependence on management as the source of their information, and thus increase their effectiveness as monitors (Hermalin and Weisbach 1991). Hermalin and Weisbach (1991) find a positive relationship between

the tenure of outside directors on the board and the firm's profitability as measured by Tobin's Q. This finding suggests that outside directors with longer tenure may be better able to monitor management and thus improve firm performance. In addition, Kosnik (1990) finds that the longer the average tenure of outside directors, the more likely the firm is to resist the "greenmail" transaction. Kosnik concludes that outside directors may become more effective monitors as their tenure increases.

Likewise, as outside directors serve longer on the board, they become more familiar with the firm-specific financial and operational conditions, and thus become more capable of overseeing the firm's financial reporting process effectively. A recent empirical study reports that those firms whose directors have a longer tenure are also more likely to prevent financial reporting fraud. Beasley (1996) finds that as the average tenure of outside directors on the board increases, the likelihood of financial reporting fraud decreases. His result implies that as outside directors serve longer on the board, they may become more effective overseers of the financial reporting process. The preceding theory and empirical findings suggest that the longer the tenure of audit committee directors, the more likely the audit committee is to effectively achieve its oversight responsibility.

3.5 Audit Committee Activity Level

The effective functioning of an audit committee's oversight role requires a substantial amount of time, effort, attention, and preparation from its members. Thus, the degree of an audit committee's diligence constitutes an additional significant factor influencing the effective functioning of audit committees. Bacon (1993, 13) identifies audit committees' lack of due diligence as one factor in the ineffective oversight functioning of audit committees in alleged audit failures:

> Auditing the far-flung operations of a large and diversified company is a complex process; monitoring the auditing firm's effectiveness requires diligent oversight by the committee. *An increasing number of lawsuits against accounting firms in the wake of corporate bankruptcies or failures, which allege inadequate auditing, have raised questions about audit committees and their degree of diligence.* [emphasis added]

In addition, Kalbers and Fogarty (1993, 24), in a survey of audit partners, directors of internal auditing, and chief financial officers associated with the audit committees of ninety US. corporations, report that "the will to act (diligence) constitutes the most significant power source affecting audit committee effectiveness." However, while the Treadway Commission (1987) suggests that the audit committee meet regularly with the internal auditor, external auditor and corporate legal counsel, some

audit committees appear to have been created for cosmetic purposes (Menon and Williams 1994). Menon and Williams (1994) report that thirty-nine percent of their sample firms had fewer than two meetings a year. They argue that such relatively inactive audit committees ?fe unlikely to perform their oversight effectively. Thus, it has been suggested that in order to be effective, audit committees should meet three or four times a year (e.g., Price Waterhouse 1993). McMullen and Raghunandan (1996, 80-81) assert that "such frequent meetings enable the committee to stay on top of accounting and control-related matters and send a signal that the committee intends to remain informed and vigilant."

Recent empirical evidence supports the view that a more active audit committee is more likely to be an effective overseer. McMullen and Raghunandan (1996) report that firms without financial reporting problems are more likely to have an active audit committee than are firms with financial reporting problems. For their sample, only twenty-three percent of audit committees of companies with financial reporting problems had regularly scheduled meetings three or more times a year. In contrast, forty percent of audit committees of companies without problems met at least three times annually. These results suggest that an audit committee that intends to carry out its oversight role effectively needs to maintain a relatively high level of activity.

4 Research Design

4.1 Matching Sample Design

To test the relationship between audit committee characteristics and the likelihood of auditor litigation, I use a matched-pairs design to analyze a sample of auditor-litigated client firms and a comparison sample of non-litigated client firms that are similar to the auditorlitigated firms in time period, stock exchange, industry, and size. These matching variables are chosen based on prior research which suggests that audit committee characteristics may vary systematically with these variables (Baysinger and Butler 1985; Hermalin and Weisbach 1988; Rosenstein and Wyatt 1990; Shivdasani 1993; Bacon 1993; Menon and Williams 1994; Simonetti and Andrew 1994; McMullen 1996; Jiambalvo 1996). Further, these matching variables are likely to be associated with the occurrence of auditor litigation (Palmrose 1987; Kothari et al 1988; Stice 1991; Lys and Watts 1994; Carcello and Palmrose 1994; McMullen 1996; Dechow et al 1996). Then, I focus on the audit committee characteristics of litigated firms and non-litigated firms.

4.2 Control Variables

In order to enhance the reliability of inferences from the empirical analysis, I control for certain differences in internal governance structures and firm-specific non-governance characteristics. The agency literature suggests that various internal and external governance mechanisms can set boundaries on managerial behaviors and align interests of managers with those of shareholders (Fama 1980; Fama and Jensen 1983; Jensen 1993; Lin 1996). Such mechanisms include a board of directors headed by the chairman, audit committees, managerial stock-ownership, monitoring by external auditors, and monitoring by large block-holders unaffiliated with management. (Fama and Jensen 1983; Jensen 1993; Dechow et al 1996; Lin 1996). These governance mechanisms also monitor and control the corporate financial reporting and auditing process (Dechow, et aI1996).

At the same time, the importance and effectiveness of audit committees in the corporate financial reporting process may also depend on internal governance structures. That is, since a variety of mechanisms are used to achieve an alignment of the interests of shareholders and managers, the level of a particular mechanism should be influenced by the levels of other mechanisms which simultaneously operate in the firm (Demsetz and Lehn 1985; Rediker and Seth 1995; Bathala and Rao 1995; Daily 1996). Indeed, the audit committee is only one of several corporate governance mechanisms. If other mechanisms can effectively monitor the corporate financial reporting and auditing process, there is less need for the audit committees to playa significant oversight role (Menon and Williams 1994). To the extent that these internal governance mechanisms are effective, they will influence the incremental effects of audit committees on the quality of the financial reporting and auditing processes. Furthermore, because there are monitoring costs associated with implementing and maintaining these governance mechanisms, the most effective combination of monitoring mechanisms may differ across firms depending on such firm-specific non-governance factors as the financial and operating environments (Demsetz and Lehn 1985; Bathala and Rao 1995; Lin 1996).

Failure to consider these variables, which may be correlated with the characteristics of audit committees and the likelihood of auditor litigation, could bias tests of the hypotheses. Based on a review of prior literature on auditor litigation, financial reporting, and corporate governance, I include the following four internal governance structure variables: the type of external auditors, the presence of unaffiliated block-holders, corporate leadership structure, and the extent of managerial ownership. I also include three additional firm-specific non-governance characteristics: growth, financial condition,

and client size.[1]

4.2.1 Internal Governance Structure

Type of External Auditors

The type of external auditors is likely to be associated with characteristics of audit committees, the internal governance structure, and the likelihood of auditor litigation. The voluntary formation of audit committees is positively associated with the type of external auditors (Pincus et al1989; Menon and Williams 1994). In addition, Menon and Williams (1994) report a significant positive correlation between the number of audit committee meetings and the type of external auditors. While Stice (1991) and'Lys and Watts (1994) find a "no-effect" of type of outside auditors on the likelihood of auditor litigation, Palmrose (1988, p. 72) finds that "non-Big Eight firms as a group had higher litigation occurrence rates than the Big Eight."

Presence of Unaffiliated Block-holders

Recent empirical evidence suggests that monitoring by unaffiliated block-holders may affect the corporate governance structure in general and the board composition in particular. Specifically, large block-holders may influence the effectiveness and compositions of the board and subcommittees in various way by influencing the selection of members (Fromson 1990). At the same time, large block-holders with a significant financial stake in the firm may closely monitor the financial reporting and auditing process (DeFond and Jiambalvo 1991; Beasley 1996; Dechow et al 1996). This, in turn, is expected to reduce the material omissions and misstatements in financial statements, the extent of audit failures, and thus, the probability of litigation against auditors.

Corporate Leadership Structure

The effectiveness of audit committees is likely to be affected by the common corporate leadership structure among US corporations that have a CEO who also serves as the chairman of the board. In recent years, critics have asserted that (1) the ineffectiveness of corporate boards stems from their being dominated by top management, especially by CEOs; and (2) firm managers have exercised excessive influences over the selection and tenure of board members, the composition of board

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[1] These variables are included as control variables because it is more practical to include them as control variables rather than consider them as part of the matching process.

committees, the agenda of board meetings, and information flows (Fama and Jensen 1983; Paton and Baker 1987; Jensen 1993; Monks and Minow 1996). At the same time, the duality structure of corporate leadership, in which the CEO or president of a firm simultaneously serves as the chairman of its board, is likely to be associated with the probability of auditor litigation. Empirical evidence suggests that the duality leadership structure would negatively influence the corporate financial reporting process (Loebbecke et al 1989; Dechow et a11996; Livingston 1997). represent creditors and block-holders, and change their board composition. At the same time, empirical evidence indicates that a firm's financial condition is often an indicator of erroneous financial statements (Kinney and McDaniel 1989). In addition, several studies on auditor litigation argue that a poor client financial condition such as bankruptcy is likely to increase the likelihood of auditor litigation (Lys and Watts 1994 , Stice 1991; Palmrose 1987; St. Pierre and Anderson 1984).

Client Size

To explore the relation between audit committee characteristics and the likelihood of litigation against auditors, this study compares two samples, a sample of auditor-litigated firms and a control sample of non-auditor-litigated firms. Each control firm is matched with each auditor-litigated firm based on time period, stock exchange, industry, and size, measured as the market value of the firms. It is conceivable, however, that even after this one-to-one matching process, sample firms vary in terms of their size; sample firms would range from a very small company traded on NASDAQ/OTC to a very large company traded on NYSE. That is, there would be a wide variation in terms of client size among sample firms. The firm size may affect the corporate governance structure in general and characteristics of audit committees in particular. At the same time, prior research on auditor litigation suggests that the likelihood of auditor litigation is positively associated with the client firm size (Stice 1991; Lys and Watts 1994; Carcello and Palmrose 1994). Therefore, for this study I control for differences in firm size, measured as the natural logarithm of total assets of client, because I have already controlled the size of the firm by matching the market value of the client firm.

4.3 Empirical Model

The following multivariate logistic regression is used to test hypotheses relating characteristics of audit committees and the likelihood of auditor litigation, while controlling for differences in internal governance structure and firm specific non-governance characteristics across litigated firms and non-litigated firms (parentheses show predicted signs):

$$\begin{aligned} LITIGATION = {} & \beta_0 + \beta_1 IND + \beta_2 STKOWN + \beta_3 QUALITY + \beta_4 TENURE + \beta_5 MEETING \\ & + \beta_6 AUDITOR + \beta_7 BLOCKHLD + \beta_8 DUALITY + \beta_9 MGTSHR \\ & + \beta_{10} FC + \beta_{11} GROWTH + \beta_{12} LOGASSET \end{aligned}$$

where:

Sign	Variable	Definition
	LITIGATION	a dummy variable with a value of one if external auditors are litigated and a value of zero otherwise
-	IND	the percentage of independent outside directors to total AC directors
-	STKOWN	the total percentage of the firm's stock that is owned by AC directors
-	QUALITY	the average number of outside directorships held by AC directors
-	TENURE	the average tenure of AC directors on board
-	MEETING	the total number of AC meetings
-	AUDITOR	a dummy variable with a value of one if the auditor is a Big Six auditor and a value of zero otherwise
-	BLOCKHLD	a dummy variable with a value of one if there exists a block-holder who holds at least 5 % of common stock and not affiliated with management and a value of zero otherwise
+	DUALITY	a dummy variable with a value of one if a CEO or a president is also the chairman of the board and a value of zero otherwise
-	MGTSHR	the cumulative percentage of stock-ownership held by management
-	FC	financial condition measured by Altman-Z (1974) scores
+	GROWTH	the percentage change in sales for two years
+	LOGASSET	the natural log of the total asset of the client firms

5 **Sample Procedure and Data**

5.1 Sampling Procedure

This section summarizes sampling and matching procedures as described in Table 1. The sample used in this study was obtained by following several steps:

(1) A total of 372 auditor litigation cases were identified using the following sources:

A) The *Dow Jones Retrieval* database of *Wall Street Journal (WSJ)* abstracts during 1978-1995 for articles on auditor litigation;

B) Cases during 1978-1995 reported in *Mead Data's Lexis* system;

C) Auditor litigation news from reviewing *News Abstract* and *Periodicals Abstract* databases;

D) Lawsuits mentioned in studies of accounts' liability or auditor litigation (e.g., St. Pierre and Anderson 1984; Palmrose 1991a; Palmrose 1991b);

E) Litigation news from accounting periodicals such as the *Journal of Accountancy.*

(2) The identified cases were deleted when years of alleged wrongdoing were not available (72 cases), or when proxy statement or financial statement data were not available (167 cases). This procedure yielded 133 cases.

(3) I matched auditor-litigated firms with non-litigated firms based on time period, stock exchange, industry, and size. One case was deleted when no matching firm could be identified. This matching procedure yielded 132 matching cases.

(4) Since this study examines audit committee characteristics, I deleted 34 cases when either the auditor-litigated firms or the matched non-litigated firms did not have an audit committee. This audit committee screening procedure yielded 98 cases.

(5) I deleted 23 cases when client firms were in the financial industry. This criterion is imposed to facilitate data analysis and enhance comparisons with prior studies which have imposed this criterion (Stice 1991; Beasley 1996). This procedure yielded a final sample of 75 auditor-litigated firms and a control sample of 75 non-litigated firms.

The sample used in thi.s study is limited to publicly-held companies because information on audit committee characteristics is only available from proxy statements filed with the SEe. Litigation

cases encompass audit services rendered for the 15 year period from 1978 through 1992. I choose this time period because since 1978 the NYSE has required listed firms to have independent audit committees. I cut off the sample at 1992 because there is a time lag for discovering and reporting alleged audit failures.

5.2 Sample Description

Table 2, Panel A provides the sample distributions of auditor litigation cases classified by median alleged audit failure years.[2] The time series pattern of median audit failure years is comparable to patterns described in Lys and Watts (1994), Kothari et al. (1988), and Palmrose (1987) in several ways. First, the high incidence of cases in the 1980-1981 and 1983-1985 periods occurs during or following major economic downturns. Second, the number of lawsuits per year remains relatively constant after 1985. Third, the number of sample auditor litigation cases in the most recent period is relatively biased downward because of lags in discovering and reporting lawsuits.

Table 2, Panel B presents the frequency distribution of auditor-litigated firms classified by Stock Exchange Listings at the time of the alleged audit failure year. Forty-eight (64 percent) firms of the sample firms were listed in NASDAQ/OTC, twenty-three (31 percent) firms were listed in NYSE, and four (5 percent) firms were listed in AMEX.

Table 2, Panel C provides the industry classification of the 75 external auditor-litigated firms by the two-digit SIC code. Thirty different codes are represented in the final sample. The pattern of industry distribution is comparable to patterns reported in Stice(1991), Palmrose (1988), and Dechow et al (1996). The sample firms are heavily clustered in high-tech industries. The industry with the largest representation is Industrial Equipment and Machinery (SIC code 35) with 13 (17 percent) observations; followed by Instrument & Related Products (SIC code 38) with 8 (11 percent) observations; Business Services (SIC code 73) with 7 (9 percent) observations; and Electronic & Electric Equipment (SIC code 36) with 6 (8 percent) observations.

5.3 Matching Results

Table 3 indicates that the matching procedure has been successful. The results from both parametric t-tests and non-parametric Wilcoxon rank sum tests indicate that the market value does not

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[2] Consistent with Lys and Watts (1994), I choose median alleged audit failure years, because during median years, clients would be more likely to reveal their weak and ineffective audit committee structures.

statistically differ between the auditor-litigated sample and the non-litigated sample. Also, firms are matched closely based on time, stock exchange, and industry. Sixty-three (84 percent) firms are matched based on the 4 digit SIC code, seven (9 percent) firms are matched based on the 3 digit SIC code, and five (7 percent) firms are matched based on the 2 digit SIC code.

5.4 Data Source and Definitions of Research Variables

Data on audit committee and other corporate governance characteristics were obtained from proxy statements and annual reports in SEC microfiche files. Data on financial variables were obtained from COMPUSTAT and Moody's. Table 4 provides the definitions of the research variables and describes the hypothesized relation between these variables and the likelihood of auditor litigation.

6. Empirical Analysis and Discussion

6.1 Descriptive Statistics and Univariate Analysis

Table 5, Panel A and B provides descriptive statistics and the univariate analysis comparing the litigation and control samples. Three audit committee characteristics differ significantly in the hypothesized direction between the litigation and control samples. Compared to control firms, audit committees of litigation firms have fewer independent outside directors, have members with shorter board tenures, and meet less frequently. Likewise, three internal governance characteristics differ significantly between the litigation and non-litigation firms. Litigation firms have fewer unaffiliated block-holders and more frequent CEOs serving as board chairmen. Directors and officers of litigation firms own less stock in their firms[3]. These results are consistent with previous research in financial disclosure litigation (DeFond and Jiambalvo 1991; Dechow et al 1996). Furthermore, all of the three firm-specific characteristics differ significantly between two groups. Compared to the control group, the litigation group has worse financial conditions[4], higher sales growth, and greater assets. These results are consistent with prior auditor litigation research (St. Pierre and Anderson 1984; Palmrose 1987; Stice 1991; Lys and Watts 1994).

6.2 Analysis of Correlation and Checking of Multicollinearity

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[3] Only the difference in the mean is significant.
[4] Only the difference in the median is significant.

The overall significance of the univariate results may be misstated if the independent variables are correlated, because multicollinearity among independent variables leads to unstable, biased parameter estimates. I check multicollinearity by examining correlation coefficients among independent variables and by calculating the variance inflation factors (VIPs). As Table 6 indicates, none of the correlation coefficients between independent variables exceeds 0.50, the conservative cut-off point suggested by Johnston (1980). In addition, OLS regression was performed to obtain VIPs (not reported here). No VIPs exceed 2, which is far less than the cut-off point of 10 suggested by Myers (1990). Thus, it is concluded that multicollinearity is not a serious problem.

6.3 Multivariate Analysis

Table 7 reports the multivariate logistic regression results. Pseudo R2 is 21.8% and the chi-square statistic for the model's fit is 41.197 (12 degrees of freedom), significant at the 0.0001 level, thus rejecting the null hypothesis that the coefficients are simultaneously zero.[5]

6.3.1. Audit Committee Characteristics

Independence of Audit Committee Directors

Consistent with previous research in financial reporting and disclosure litigation (Beasley 1996; McMullen and Raghunandan 1996) and the univariate results, the results in Table 7 show that the coefficient for IND, which represents the percentage of independent outside directors on the audit committee, is negative and significant ($p < 0.004$). As hypothesized, the likelihood of the external auditor being litigated decreases as the percentage of independent outside directors on the audit committee increases.

The results provide evidence that audit committees with a high proportion of independent outside directors are more likely to challenge management discretion over accounting policies, resulting in less fraudulent financial reporting and auditor litigation. The results also support Vicknair et a!' s (1993) concerns that "grey" directors, because of their personal, social, and business ties to management, may not be effectively independent from management and, therefore, cannot meaningfully perform their oversight roles. This evidence supports public and regulatory efforts to

[5] I conducted multivariate analysis using ordinary least square (OLS), probit, and logistic regression. The OLS and probit results are essentially the same as the logistic results, so only the latter are reported.

improve the quality of financial reporting and reduce the incidence of fraudulent financial reporting by encouraging active oversight by independent outside directors.

Extent of Stock Ownership held by Audit Committee Directors

The coefficient for STKOWN, which represents the total percentage of a firm's stock that is owned by AC directors, is unexpectedly positive but marginally significant ($p < 0.107$). That is, the extent of stock ownership by audit committee directors is weakly and positively associated with the likelihood of auditor litigation. This finding is inconsistent with previous research (Gerety and Lehn 1991; Beasley 1996; Dechow et al 1996), which finds a negative effect of stock ownership by outside directors or boards on the likelihood of financial reporting fraud.

One influence operating against the hypothesized effect is that increasing stock ownership by audit committee members may have countervailing influences on the effectiveness of audit committees. That is, a significant personal stake may impair the independence of audit committee directors and thus the effectiveness of audit committees. Under ordinary corporate governance circumstances, outside directors who hold substantial ownership in the firm may be inclined to provide better monitoring. Yet, these substantial personal interests sometimes may incapacitate the effective functioning of audit committees' oversight role. Analogous to the case of independence of external auditors, audit committee directors' independence would be questionable when they have non-trivial financial interests in the firms in which they serve. In addition, because of their significant personal interests, they may inappropriately influence the other audit committee members beyond reason (Price Waterhouse 1993). In fact, the results provide evidence supporting Price Waterhouse's recommendation (1993) and the requirement of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 that directors with a substantial personal financial stake in the firm should not serve on audit committees.

Quality of Audit Committee Directors as Good Monitors

The coefficient for QUALITY, which represents the average number of additional outside directorships held by AC directors, has an expected negative sign and is significant ($p < 0.049$). That is, as hypothesized, the likelihood of litigation against auditors decreases with the average number of additional outside directorships held by AC directors. The results are consistent with the view that directors who have a reputation for good monitoring are more likely to be effective monitors.

On the other hand, the results are contrary to the current concerns on "busy" directors. That is, audit committee directors who serve on too many boards may not be effective overseers since it is difficult for these directors to devote the necessary amount of time and effort to each company on whose board they serve. Two recent studies on the financial reporting process provide some evidence confirming this criticism and concern. McMullen and Raghunandan' s survey (1996) reports that the number of directorships held by audit committee directors does not significantly differ between companies with financial reporting problems and no-problem companies. Beasley (1996) finds that as outside directors of financial reporting fraud firms serve more on additional corporate boards, the likelihood of financial reporting fraud increases.

Nonetheless, the results suggest that audit committee directors with additional outside directorships are more likely to be concerned about their managerial reputations and thus have stronger incentives to monitor the auditing process and management's financial reporting behavior.

Tenure of Audit Committee Directors

The results in Table 7 support the hypothesized relation in that the coefficient for TENURE, which represents the average tenure of AC directors, is negative and it is marginally significant ($p < 0.099$). That is, as hypothesized, increasing the tenure of audit committee directors has a marginally significant effect on the likelihood of auditor litigation. This result is consistent with Beasley (1996), who finds a negative effect of the length of outside directors' tenure on the likelihood of financial reporting fraud.

A possible explanation for the marginal result is that greater audit committee tenure may have multiple confounding effects on the effective functioning of audit committees' oversight roles. That is, increasing tenure may include some cases in which audit committee members have been effectively co-opted by top management. Some audit committee members may have developed close relationships with top management, and hence do not act as independent and effective monitors of the firm's financial reporting and auditing process.

Activity Level of Audit Committee Directors

The results in Table 7 indicate that the coefficient for MEETING, which represents the total number of AC meetings, is negative and significant ($p < 0.009$), consistent with the hypothesized relation. That is, the likelihood of an external auditor being litigated is a decreasing function of the

total number of audit committee meetings, reflecting increased diligence by the audit committee. This results is consistent with McMullen and Raghunandan (1996) who finds a negative association between the independence of audit committees and the incidence of financial reporting problems. The results suggest that a more active audit committee is more likely to be an effective overseer. Finally, the results provide empirical evidence supporting the public and professions' efforts to improve the effectiveness of audit committees by having more active audit committees.

6.3.2 Corporate Governance Structure

Type of External Auditors

Consistent with previous research findings (Stice 1991; Lys and Watts 1994), the coefficient for AUDITOR, which represents a dummy variable with a value of one if the auditor is a Big 6 auditor and a value of zero otherwise, is positive but not statistically significant ($p< 0.153$). That is, the type of external auditor has no statistically significant effect on the likelihood of audit litigation.

Presence of Unaffiliated Block-holders

. The coefficient for BLOCKHLD, which represents a dummy variable with a value of one if there exists a block-holder who holds at least 5 % of common stock and is not affiliated with management and a value of zero otherwise, is negative but not statistically significant ($p < 0.176$). While not significant at conventional levels, the negative sign and the p-value are mildly consistent with findings from prior research that large block-holders with their significant financial states in the firms closely monitor the financial reporting and auditing process (DeFond and Jiambalvo 1991; Beasley 1996; Dechow et alI996).

A possible explanation for the weak results is that the presence of unaffiliated blockholders may increase the likelihood of litigation against auditors. First, because of their significant financial stakes in the firm, large shareholders may be able to influence management, bias the financial reporting and auditing process, and facilitate fraudulent financial reporting. Second, when audit failures are alleged and stock prices decline, large block-holders would experience more severe damages. Unaffiliated block-holders with these severe damages. would be more likely to file a lawsuit against external auditors to recover these damages.

Corporate Leadership Structure

The coefficient for DUALITY, which represents a dummy variable with a value of one if a CEO or a president is also the chairman of the board and a value of zero otherwise, has a positive sign and is significant ($p < 0.009$). That is, the likelihood of an external auditor being litigated increases when a client's CEO/president also serves as the chairman of the board.

The results are consistent with prior research findings in financial reporting and disclosure litigation, which document the negative effect of the duality leadership structure on the quality of the financial reporting and auditing process (Loebbecke et al 1989; Dechow et al 1996; Livingston 1997). The results support the view that when a CEO serves simultaneously as the chairman of the board, s/he could'dominate the internal governance process, override the systems of checks and balances, and commit financial reporting fraud, thus increasing an auditor's exposure to litigation.

Extent of Stock Ownership held by Management

The coefficient for MGTSHR, which represents the cumulative percentage of stockownership held by directors and officers, is negative and significant ($p < 0.047$). That is, the likelihood of litigation against the external auditor is a decreasing function of the cumulative percentage stock-ownership held by management. This suggests that as management increases their financial stakes in the firm, they act as significant shareholders and actively oversee the financial reporting process.

6.3.3 Firm-Specific Non-Governance Characteristics

Financial Condition

The coefficient for FC, which represents the client's financial condition measured by the Altman-Z score (1974), has a negative sign but is not statistically significant ($p<0.398$). That is, the client's financial condition is not significantly related to the likelihood of auditor litigation after controlling for audit committee characteristics and the internal governance structure. This finding is inconsistent with the extant findings (St. Pierre and Anderson 1984; Palmrose 1987; Stice 1991; Lys and Watts 1994) that a negative association exists between the client's financial condition and auditor litigation.

A possible explanation for these results is that when corporate governance is in effect, the firm's financial condition may not playa significant role in the financial reporting and auditing process: boards of directors and external auditors may adjust their monitoring efforts according to the firm's

financial condition. That is, clients with financial difficulties are more likely to attempt to disguise their financial difficulties by issuing material erroneous financial statement. By knowing this, external auditors are more likely to increase their audit efforts and detect material errors and omissions in financial statements, thereby decreasing their exposure to litigation for faulty audits (Raghunandan et al 1994). In addition, when firms experience financial difficulties, a board of directors may add more outside directors and change its composition to enhance better monitoring of management (Gilson 1990).

Growth

Contrary to the significant univariate results, the coefficient for GROWTH, which represents the percentage change in sales over the last two years, has a positive sign but is not significant ($p<0.151$). That is, firm growth no longer has a significant effect on the likelihood of auditor litigation after controlling for audit committee characteristics and internal governance structures. These mixed findings are consistent with prior research which has not considered audit committees and internal governance structures: Stice (1991) finds some evidence of a positive association between firm growth and the likelihood of auditor litigation, while Lys and Watts (1994) do not find a significant positive association.

The results provide evidence that audit committees and other governance mechanisms playa meaningful role in the financial reporting and auditing process: boards of directors and external auditors may adjust their monitoring efforts according to the firm's growth. By knowing that clients with rapid growth are more likely to have weak internal controls and material erroneous financial statements (Lys and Watts 1994), external auditors are more likely to increase their audit efforts and detect material errors and omissions in financial statements, thereby decreasing their exposure to litigation. In addition, when firms experience rapid growth, a board of directors may adjust its composition to enhance better monitoring of management (Baysinger and Hoskisson 1990; Bathala and Rao 1995; Fisch 1997).

Client Size

Consistent with prior research (Stice 1991; Lys and Watts 1994; Carcello and Palrnrose 1994), the coefficient for LOGASSET, which represents the natural log of the total asset of the client firms, has a positive sign and is significant ($p<O.OlO$). That is, the likelihood of auditor litigation increases with the client size, measured as the natural log of the total assets of the clients.

Client size may reflect the deep pocket of clients (Lys and Watts 1994), because larger clients are more likely to have resources and insur;mce to pay damages (Carcello and Palrnrose 1994). Client size may also reflect the estimated damages because larger estimated damages are more likely to be associated with litigation (Francis et a11994) and/or the net benefits of bringing lawsuits against external auditors (Lys and Watts 1994). Finally, client size may proxy for other omitted correlated factors associated with firm size and auditor litigation (Lys and Watts 1994).

7 **Conclusions**

This study investigates the audit committee's oversight role and the effect of the corporate govemance structure on the financial reporting and auditing process, particularly in the context of auditor litigation. Specifically, this study provides empirical evidence for the proposition that firms with effective audit committee characteristics and sound corporate governance structures are less likely to have financial reporting and auditing problems, and that external auditors of these clients are less likely to be litigated for alleged audit failures subsequent to audit engagements. Overall, the results of this paper provide some evidence on the importance and the effectiveness of both audit committees and internal corporate governance structures in the financial reporting and auditing process. As such, these results support the public and regulatory efforts to increase the quality of financial reporting by enhancing the corporate financial governance process.

The findings of this paper may be applied to the development of an effective audit plan. By understanding a client firm's audit committee characteristics and the internal governance structure, auditors can assess the appropriate audit risk associated with the client firm, .initiate appropriate audit procedures for the assessed risk level, and incorporate the litigation risk into setting the audit fees. In addition, auditors may be able to anticipate and thus help clients avoid financial reporting problems, improve the quality of the financial reporting and auditing process, reduce alleged audit failure, and avoid subsequent auditor litigation.

This study is subject to several limitations. While the sampling procedures have been designed to minimize the probability of the mis-specification of auditor-litigated firms as nonlitigated firms, some such probability remains and may impair the internal validity of the study. While I have

attempted to control for the differences in audit committee characteristics and corporate governance structures across firms by employing matching procedures and including
control variables, it is possible that potentially important variables have been omitted, which may bias the empirical results.

A possible extension will examine the determinants of the corporate financial governance structure. Based on agency/contracting theories, there has been considerable research on corporate governance in general, and the consequence (effect) of board of director compositions in particular. While empirical findings in "this area provide insight and understanding of the monitoring role of the board of directors in modem corporations, empirical research on the determinants of audit committee characteristics and internal governance structure remains in the preliminary stages, especially with regard to corporate financial governance. This study will enhance our understanding of relations among corporate financial governance mechanisms.

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Table 1
Summary of Sample Selection Procedure

Identified auditor litigation cases			372
Less	Client firms with alleged wrong doing years not available	(72)	
	Client firms with proxy statements or financial statement data not available	(167)	
	Client firms with matching non-auditor litigation firm not identifiable	(1)	
Subtotal of matched cases			132
Less	Matched cases where at least one of audit committees was not formed	(34)	
Subtotal of matched cases with audit committees			98
Less	Client firms in financial industry	(23)	
Total auditor litigation cases included in the final sample			75

Table 2
Sample Distribution of Auditor Litigation Cases Classified by Median Wrongdoing Year, Stock Exchange, and Industry

Panel A. Auditor Litigation Cases Classified by Median Wrongdoing Year

Median Wrongdoing Year	Sample	Percentage
1978	8	11 %
1978	1	1 %
1980	5	7 %
1981	7	9 %
1982	1	1 %
1983	7	9 %
1984	8	11 %
1985	8	11 %
1986	4	5 %
1987	3	4 %
1988	3	4 %
1989	3	4 %
1990	6	8 %
1991	6	8 %
1992	5	7 %
Total	75	100 %

Panel B. Auditor Litigation Cases Classified by Stock Exchange

Stock Exchange	Sample	Percentage
NYSE	23	31 %
AMS	4	5 %
NASD/OTC	48	64 %
Total	75	100 %

Table 2
Sample Distribution of Auditor Litigation Cases Classified by Median Wrongdoing Year, Stock Exchange, and Industry

Panel C: Auditor Litigation Cases Classified by Two-digit SIC code

SIC	Industry	Sample	Percentage
13	Oil & Gas Production	2	3 %
15	Building Contractors	1	1 %
17	Special Trade Contractors	1	1 %
23	Apparel & other Textile Products	1	1 %
25	Furniture & Fixtures	1	1 %
26	Paper & Related Products	1	1 %
28	Chemicals & Related Products	1	1 %
30	Rubber and Miscellaneous Plastics	2	3 %
32	Stone, Clay & Glass products	1	31 %
34	Fabricated Metal Products	2	3 %
35	Industrial Equipment, Machinery, and Computer	13	17 %
36	Electronic & Electric Equipment	6	8 %
37	Transportation Equipment	3	4 %
38	Instrument & Related Products	8	11 %
40	Railroad Transportation	1	1 %
48	Communications	1	1 %
49	Electric, Gas & Sanitary Services	2	3 %
50	Durable Wholesale Trade	2	3 %
51	Nondurable Wholesale Trade	1	1 %
52	Retail building Materials & Garden Supplies	1	1 %
53	Retail General Merchandise Stores	5	7 %
54	Retail Food Stores	1	1 %
56	Retail Apparel Stores	1	1 %
57	Retail Furniture & Home Furnishings	3	4 %
58	Dining & Drinking Places	1	1 %
59	Miscellaneous Retail	2	3 %
73	Business Services	7	9 %
78	Motion Pictures	1	1 %
82	Educational Services	1	1 %
87	Engineering & Management Services	2	3 %
	Total	75	100 %

Table 3
Matching Results

	Auditor Litigated Firms	Control Firms
Market value		
Mean	**250.639**	**287.602**
[Median]	**[74.358]**	**[87.389]**
(Standard Deviation)	**(556.776)**	**(713.730)**
Stock Exchange		
NYSE	**23**	**23**
AMX	**4**	**4**
NASDAQ/OTC	**48**	**48**
Industry Match Based on		
4 Digit SIC Codes	**63**	
3 Digit SIC Codes	**7**	
2 Digit SIC Codes	**5**	

Note: Paired t-tests for mean and Wilcoxon rank sum test for median were performed to test whether auditor litigated firms are statistically different from control firms based on market value. No statistically significant differences exist.

Table 4
Variable Definitions

Variable	Predicted Sign	Definition
Audit Committee Characteristics		
IND	-	The percentage of independent outside directors to total AC directors
STKOWN	-	The total percentage of the firm's stock that is owned by AC directors
QUALITY	-	The average number of outside directorships held by AC directors
TENURE	-	The average tenure of AC directors on board
MEETING	-	The total number of AC meetings
Corporate Governance Structures		
AUDITOR	-	A dummy variable with a value of one if the auditor is a Big Six auditor and a value of zero otherwise
BLOCKHLD	-	A dummy variable with a value of one if there exists a blockholder who holds at least 5 % of common stock and not affiliated with management and a value of zero otherwise
DUALITY	+	A dummy variable with a value of one if a CEO or a president is also the chairman of the board and a value of zero otherwise
MGTSHR	-	The cumulative percentage of stock-ownership held by managemtn
Non-Governance firm-Specific Characteristics		
FC	-	Financial condition measured by Altman-Z (1974) scores
GROWTH	+	The percentage change in sales for two years
LOGASSET	+	The natural log of the total asset of the client firms

Table 5
Descriptive Statistics and Univariate Analysis
For Auditor Litigated Firms and Control Firms
For the period 1979-1992

Panel A: Continuous Variable

Variables		Predicted Sign	N	Mean	Median	Std. Dev.	Tests of Differences in Mean (p-value)	Tests of Differences in Median (p-value)
IND	Litigated	-	74	0.641	0.667	0.288	-3.685	-3.539
	Control		75	0.802	1.000	0.239	(0.001)	(0.001)
STKOWN	Litigated	-	74	0.057	0.010	0.113	0.815	0.363
	Control		75	0.044	0.008	0.087	(0.209)	(0.358)
QUALITY	Litigated	-	74	1.605	1.333	1.260	-1.216	-0.586
	Control		75	1.867	2.333	0.581	(0.114)	(0.279)
TENURE	Litigated	-	75	6.234	5.667	3.690	-1.991	-1.664
	Control		75	7.365	6.750	4.204	(0.030)	(0.048)
MEETING	Litigated	-	75	2.120	2.000	1.365	-2.941	-2.098
	Control		75	2.627	2.000	1.303	(0.002)	(0.018)
MGTSHR	Litigated	-	75	0.182	0.139	0.154	-1.583	-0.902
	Control		75	0.222	0.151	0.194	(0.059)	(0.184)
FC	Litigated	-	75	17.292	3.179	72.538	0.455	-4.800
	Control		75	13.237	6.118	28.111	(0.326)	(0.001)
GROWTH	Litigated	+	74	1.021	0.402	1.919	2.796	1.350
	Control		75	0.580	0.271	1.209	(0.004)	(0.089)
LOGASSET	Litigated	+	75	4.861	4.861	1.764	3.065	1.778
	Control		75	4.358	4.311	1.658	(0.002)	(0.038)

Note: Paired t-tests are used to evaluate the differences in means.
Wilcoxon rank sum tests are used to evaluate differences in medians.
P-values are based on one-tailed tests.

Table 5
Descriptive Statistics and Univariate Analysis
For Auditor Litigated Firms and Control Firms
For the period 1979-1992

Panel B: Discrete Variables

Variables	Predicted Sign		N	Proportions	Std. Dev of Proportions	T Statistics (p-value)	Chi-Squars Statistics (p-value)
AUDITOR	Litigated	-	75	0.880	0.327	0.244	0.060
	Control		75	0.867	0.342	(0.404)	(0.403)
BLOCKHLD	Litigated	-	74	0.419	0.497	-1.398	1.955
	Control		75	0.533	0.502	(0.082)	(0.081)
DUALITY	Litigated	-	74	0.689	0.467	0.298	8.456
	Control		75	0.453	0.501	90.002)	(0.002)

Note: T-tests are used to evaluate the differences in proportions.
Chi-square tests ae used to evaluate the associations.
P-values are based on one-tailed tests..

Table 6
Correlation Coefficients for Independent Variables

Variables	X1	X2	X3	X4	X5	X6	X7	X8	X9	X10	X11	X12
IND (X1)	1.00	-0.11	0.11	0.08	0.27 **	0.25 **	0.11	-0.09	-0.15	-0.11	-0.17 *	0.05
STKOWN(X2)		1.00	-0.07	-0.11	-0.11	-0.08	0.05	0.00	0.31 **	-0.03	0.14	-0.31 **
QUALITY (X3)			1.00	0.12	0.10	0.19 **	0.01	0.15	-0.12	-0.07	-0.13	0.23 **
TENURE (X4)				1.00	0.04	0.02	0.09	-0.09	-0.17 *	-0.13	-0.29 **	0.19 *
MEETING (X5)					1.00	0.21 *	0.19 *	0.05	-0.21 *	-0.01	-0.13	0.30 **
AUDITOR (X6)						1.00	0.04	0.12	-0.12	0.05	0.09	0.10
BLOCKHLD (X7)							1.00	-0.07	-0.08	0.03	0.01	0.07
DUALITY (X8)								1.00	-0.11	-0.08	-0.03	0.12
MGTSHR (X9)									1.00	0.04	0.23 **	-0.44 **
FC (X10)										1.00	0.17 *	-0.08
GROWTH (X110											1.00	-0.19 *
LOGASSET (X12)												1.00

2-tailed test
* Significant less than 0.05 ** Significant less than 0.01

Table 7
Multivariate Analysis - Logistic Regression

The empirical model to test is

$$LITIGATION = \beta_0 + \beta_1 IND + \beta_2 STKOWN + \beta_3 QUALITY + \beta_4 TENURE + \beta_5 MEETING + \beta_6 AUDITOR + \beta_7 BLOCKHLD + \beta_8 DUALITY + \beta_9 MGTSHR + \beta_{10} FC + \beta_{11} GROWTH + \beta_{12} LOGASSET$$

Coefficient	Variables	Predicted Sign	Estimated Coefficients	Std. Errors of Coefficients	Chi-square Statistic	(p-value)
β_0	Intercept	none	1.041	1.137	0.838	0.390
Audit Committee Characteristics						
β_1	IND	-	-2.118	0.801	6.995	0.004
β_2	STKOWN	-	2.708	2.176	1.548	0.107
β_3	QUALITY	-	-0.238	0.144	2.724	0.049
β_4	TENURE	-	-0.067	0.052	1.661	0.099
β_5	MEETING	-	-0.372	0.158	5.561	0.009
Other Internal Governance Structures						
β_6	AUDITOR	-	0.651	0.636	1.046	0.153
β_7	BLOCKHLD	-	-0.368	0.395	0.869	0.176
β_8	DUALITY	+	0.956	0.404	5.602	0.009
β_9	MGTSHR	-	-2.318	1.383	2.811	0.047
Firm-Specific Non-governance Characteristics						
β_{10}	FC	-	0.001	0.004	0.067	0.398
β_{11}	GROWTH	+	0.162	0.162	1.068	0.151
β_{12}	LOGASSET	+	0.140	0.140	5.447	0.010

Pseudo R^2 0.218
Chi-Square Test of Model's Fit 41.197, p=0.0001 (12 degrees of freedom)

P-values are based on one-tailed tests.
The variable definitions are the same as in Table 4.