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Fraudulent Audited Annual Financial Statements in Post-PSLRA Private Securities Class Actions: Determinants of Auditor Litigation

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Our two stage investigation of financial disclosure-related private securities class actions begins with the enactment of the Private Securities Litigation Reform Act of 1995 on December 22, 1995, and ends when the Securities Litigation Uniform Standards Act of 1998 became law on November 3, 1998. We find, in the first investigative stage, that the risk of an auditor being named a defendant is de minimis unless fraudulent audited annual financial statements are alleged. In the second stage, in multivariate analysis, we find that fictitious transaction frauds, bankruptcy, government prosecution, and non-routine restatements of audited annual financial statements are associated with naming auditor defendants. Also, we find that omitted disclosures are associated with naming the auditor a defendant. This last finding is new. It suggests that auditors should scrutinize footnote disclosures more carefully both to reduce their litigation risk and to prevent the issuance of fraudulent financial statements.

INTRODUCTION

Financial disclosure that is accurate and unbiased is essential to facilitate securities market efficiency and low cost of capital, and the outside accountant occupies a special gatekeeping role (Bushman and Smith 2001). How well that role is played is a function of the existing incentives. The outside accountant is a reputational intermediary and thus has an incentive to safeguard his valuable reputation (Kraakman 1986). Additional incentives are provided by the self-regulatory mechanisms of public accounting and by litigation. Litigation includes criminal prosecution, governmental civil prosecution, and private securities lawsuits. The role of auditors in this last genre of litigation is the focus of this study.

Research on the characteristics associated with auditors being named defendants in private securities lawsuits is important for public policy because it provides insights into the nature of the incentives that this litigation provides auditors. Coffee (2001) asserts that auditors have insufficient incentives to motivate them to perform their gatekeeping role well and are