Fraud Type, Frequency and Auditor Litigation: An Analysis of the Impacts of Sarbanes-Oxley Act

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ABSTRACT

This research paper demonstrates differences in fraud type, fraud frequency, and auditor litigation risk before and after the enactment of the 2002 Sarbanes-Oxley Act (SOX). It also identifies the SOX sections that are in a greater extent result in these changes in the fraud type, fraud frequency, and auditor litigation risk. To address these issues, I will collect data frauds present in the financial statements of companies that were the subject of Accounting and Auditing and Enforcement Releases (AAERs) by the Securities and Exchange Commission for the years 2001 and 2008, designate each fraud as commonly occurring and/or as arising from fictitious transactions, and examine the association of these fraud types with litigation against auditors in multivariate analyses. These results are of interest to audit firms in that risk assessments and auditing procedures will be more consciously made as well as the acceptance or rejection of clients. They also have implications for the plaintiff/defendant attorney in that my study provides more updated information on recent complaints and its respective defenses.

I. INTRODUCTION

This research paper demonstrates differences in fraud type, fraud frequency, and auditor litigation risk before and after the enactment of the 2002 Sarbanes-Oxley Act (SOX). It also identifies the SOX sections that are in a greater extent result in these changes in the fraud type, fraud frequency and auditor litigation risk.

Accounting scandals arise from the disclosure by trusted executives of financial statements intentionally deviated from the Generally Accepted Accounting Principles (GAAP) guidelines. These accounting deviations can amount to fraud and be subject to lawsuits by parties of interest and/or governmental investigations.

Although in the early 30's the government has imposed regulations on publicly traded companies and their independent auditors, the independent auditor liability with regard to undetected frauds committed by management of public companies has increased.

The 2002 the Sarbanes-Oxley Act (SOX) was enacted by Congress as a result of accounting scandals that conveyed billionaire losses to investors. According to an interview of Senator Paul S. Sarbanes, the act is to build a durable framework upon the foundation of the Securities Acts of 1933 and 1934 and provide standards for honest, transparent, and ethical business practices in public companies and provide safety mechanisms to keep them in place (Lucas, 2004).

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If so, I would expect that subsequent to the implementation of SOX, the number of frauds will decrease, and the fraud type will change. In addition, auditor litigation risk will decrease. In this research, I will investigate these changes due to SOX enactment.

The results will provide up-to-date information on what types of frauds are independent auditors confronted with and which frauds are more probable to result in lawsuits against them. The results may help independent auditors use better audit procedures to detect frauds.

Previous research demonstrates that the existence of any type of fraud is a significant factor in auditor litigation. Auditor litigation is a significant factor that affects the supply side of these services; therefore, it is important for auditors to have information regarding the existence of new fraud types that are different from the results of earlier studies (Bonner, Palmrose, & Young, 1998)

As more information is available to independent auditors, the probability that the auditor will discover and report fraud will increase. Thus, audit quality will increase and independent auditor litigation decrease (Deis & Giroux, 1992). Hence, in this study, I will also analyze the relationships between fraud and auditor litigation risk.

While the primary focus of this study is on the fraud type and auditor litigation relationship, this research will also examine the changes in dimensions expressed in monetary terms as well as frequency of settlements against trials. The results will identify the most significant sections of the SOX that triggered these changes in fraud type and other case characteristics that are distinguished among companies with auditor litigation, other litigation and no litigation.

These results are of interest to audit firms in that risk assessments and auditing procedures will be more consciously made as well as the acceptance or rejection of clients. They also have implications for the plaintiff/defendant attorney in that my study provides more updated information on recent complaints and its respective defenses.

To address these issues, I will collect data frauds present in the financial statements of companies that were the subject of Accounting and Auditing and Enforcement Releases (AAERs) by the Securities and Exchange Commission (SEC) for the years 2001 and 2008, designate each fraud as commonly occurring and/or as arising from fictitious transactions, and examine the association of these fraud types with litigation against auditors in multivariate analyses.

The remaining sections of this article are organized as follows: Section II provides insight for the use of the SEC enforcement actions; Section III outlines the hypotheses regarding frauds and auditor litigation; and Section IV outlines the research design.

II. SEC ENFORCEMENT ACTIONS

The issuance of AAERs is used as a proxy for fraud used in the literature (e.g. Bonner, Palmrose, & Young, 1998). This proxy is extremely important since it intends to identify most occasions where publicly traded corporations are subject to SEC actions as a result of issuing fraudulent financial statements, including accounting malpractices and bribery from corporate board members to clients. SEC actions capture most of the fraudulent financial reporting since previous research shows that 80 percent of bankrupt public companies with fraud and auditor litigation have SEC enforcement actions (Bonner, Palmrose, & Young, 1998).

The U.S. Sarbanes-Oxley Act was signed into law in 2002. Table 1 provides a brief explanation of the Sections of the SOX:

TABLE 1
SOX Overview

1. Public Company Accounting Oversight Board (PCAOB):
Title I establishes the Public Company Accounting Oversight Board to provide independent oversight of public accounting firms, supply audit services. It also creates a central oversight board tasked with registering auditors, defining the specific processes and procedures for compliance audits, inspecting and policing conduct and quality control, and enforcing compliance with the specific mandates of SOX.

2. Auditor Independence:
Title II establishes standards for external auditor independence to limit conflicts of interest. It also addresses new auditor approval requirements, audit partner rotation, and auditor reporting requirements. It restricts auditing companies from providing non-audit services (e.g., consulting) for the same clients.

3. Corporate Responsibility:
Title III mandates that senior executives take individual responsibility for the accuracy and completeness of corporate financial reports. It defines the interaction of external auditors and corporate audit committees, and specifies the responsibility of corporate officers for the accuracy and validity of corporate financial reports. It enumerates specific limits on the behaviors of corporate officers and describes specific forfeitures of benefits and civil penalties for non-compliance.

4. Enhanced Financial Disclosures:
Title IV describes enhanced reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. It requires internal controls for assuring the accuracy of financial reports and disclosures, and mandates both audits and reports on those controls. It also requires timely reporting of material changes in financial condition and specific enhanced reviews by the SEC or its agents of corporate reports.

5. Analyst Conflicts of Interest:
Title V includes measures designed to help restore investor confidence in the reporting of securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of knowable conflicts of interest.

6. Commission Resources and Authority:
Title VI defines practices to restore investor confidence in securities analysts. It also defines the SEC's authority to censure or bar securities professionals from practice and defines conditions under which a person can be barred from practicing as a broker, adviser or dealer.

7. Studies and Reports:
Title VII is concerned with conducting research for enforcing actions against violations by the

TABLE I (continued)

SEC registrants (companies) and auditors. Studies and reports include the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations and enforcement actions, and whether investment banks assisted Enron, Global Crossing and others to manipulate earnings and obfuscate true financial conditions.

8. Corporate and Criminal Fraud Accountability:
Title VIII referred to as the *"Corporate and Criminal Fraud Act of 2002*" describes specific criminal penalties for fraud by manipulation, destruction or alteration of financial records or other interference with investigations, while providing certain protections for whistle-blowers.

9. White Collar Crime Penalty Enhancement:
Title IX called the *"White Collar Crime Penalty Enhancement Act of 2002"* increases the criminal penalties associated with white-collar crimes and conspiracies. It recommends stronger sentencing guidelines and specifically adds failure to certify corporate financial reports as a criminal offense.

10. Corporate Tax Returns:
Title X states that the Chief Executive Officer should sign the company tax return.

11. Corporate Fraud Accountability:
Title XI consists of seven sections. Section 1101 recommends a name for this title as *"Corporate Fraud Accountability Act of 2002"*. It identifies corporate fraud and records tampering as criminal offenses, and joins those offenses to specific penalties. It also revises sentencing guidelines and strengthens their penalties. This enables the SEC to temporarily freeze large or unusual payments.

In broad terms, SOX mandates reforms to enhance corporate responsibility, financial disclosure, and oversight of the public accounting and auditing profession. It requires companies to file reports under either Section 13(a) or 15(d) of the U.S. Securities Exchange Act of 1934, including but not limited to: Issuers of securities on nationally-traded exchanges or over the counter bulletin board, unlisted companies with public debt, and unlisted companies with more than US $10 million in total assets and greater than 500 shareholders (Canada, Kuhn, & Sutton, 2008).

The SEC required registrants to comply with all SOX Sections with the exception of Section 404 (Management Assessment of Internal Controls). Table 2 shows how the exemption disappeared over a period of almost three years.

As non-U.S. companies listed on NYSE have combined market capitalization of US$ 3.8 trillion making up 30% and 450 more on NASDAQ Exchange have a large share in the U.S., these companies are seriously affected by the SOX too. SOX caused European and Australian

TABLE II
Expire dates and filers of Section 404 report exemption.

Date	Filers	Report
Nov. 15, 2004	Domestic accelerated filers[1]	Section 404
July 15, 2006	Foreign registrants meeting accelerated filer requirements	Section 404
July 15, 2007[2]	Domestic and foreign non accelerated filers	Section 404

companies that operate in the U.S. to worry about it, since compliance itself is costly because expert advice is necessary (Canada, Kuhn, & Sutton, 2008).

The pressure by foreign countries was increased as a consequence of implementing SOX. For example: Australian regulatory environment over corporate governance is of equivalent quality to that provided through the SOX mandates. Under the pressure from these countries, the SEC somewhat diluted the regulatory power of the SOX by the extension of Section 404 filing several times. Given that more concerns exist regarding the implementation of SOX, it is important for the legislators and regulators to justify whether the benefits of SOX overrides the extremely high cost. I will try to address this issue by investigating where SOX changes the fraudulent behavior of public companies and the auditor litigation risk.

III. HYPOTHESES DEVELOPMENT

The overall hypothesis is that SOX will change fraud type, decrease its frequency, and decrease auditor to litigation risk. This premise is based on the idea that strict regulation will prevent public companies form GAAP deviations. It is also important to mention that information regarding auditor litigation will increase their overall awareness on the level of risks assessment on each engagement. Diagram 1 illustrates the overall hypothesis and takes into account the possibility that litigation could be shifted to other parties' aside independent auditors (See Diagram 1).

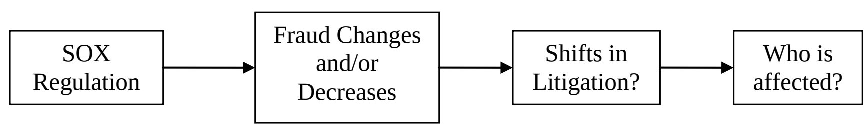
There are four important sections in the SOX that could lead to the changes in auditor litigation risk. First, SOX Section 3 and 10 imbed on the senior executives the full responsibility for the accuracy of the corporate financial statements and tax return. More specifically, Subsection 302 of SOX requires the principal executive(s) to certify the corporation's financial reports for free of misstatements and fair representation. It also makes them responsible for the establishment and maintenance of internal controls as well as its effectiveness, and must report any deficiencies, fraud and/or changes in internal controls. Second, Subsection 1001 of SOX requires top executives to sign the federal income tax return as a way to make them responsible for illegal actions that diminish the corporate tax burden. Third, the Subsection 101 of SOX the

[1] Defined by the SEC in the Exchange Act Rule 12b-2 as companies with grater than US$ 75 million market capitalization.

[2] Date is subject to changes by the US government.

creation of the PCAOB to oversee, regulate and provide guidance to public accounting firms. It intends to reestablish the confidence of investors and society in general. Fourth, in Section 2, auditor independence scope is broadened. Financial statement users are more willing to rely on

DIAGRAM I



CPA's reports as they expect an unbiased viewpoint of the company's financial condition.

Limpberg (1985) explains the basic function of the independent auditor and sheds light in the need of auditor independence by companies in the following:

> "If the community wants to be truly served by the function of the confidential agent, then it cannot be satisfied with an unqualified opinion of the enterprises employee accountant. Te community asks for an independent opinion of the accounts of the stewardship of the managers, and that can apparently not generally be expected of one who is in the service of the manager and who, organizationally speaking, has to dance to that manager's tune."

Subection 201 of the SOX also provides restrictions on providing non-audited services by accounting firms to the same audit client and regulations on auditor partner rotation. However it remains questionable whether these important sections are strong enough to significantly shift the auditor exposure to litigation. Are these sections effectively expose top management of public companies and their independent auditor litigation?

This discussion leads to the following hypothesis:

H1: Increase in regulation provided by the SOX will change and/or decrease fraud, and decrease independent auditor litigation.

IV. RESEARCH DESIGN

The most common source of lawsuits against auditors is from clients. There are a lot of sources by which auditors can be held liable. They can be liable to clients because of breach of contract and/or tort action; to third parties under common law for reliance on misleading financial statements; to original purchasers of securities under the Securities Act of 1933; to secondary purchasers of securities under the Securities Act of 1934, and people that relied on misrepresented financial statements under criminal liability for accountants (Elder, Beasley, & Arens, 2008). All these broad categories by which the auditors may be held liable for any financial misrepresentation, have made auditors be increasingly aware of who are they auditing and what characteristics are associated with lawsuits against them (Schipper, 1991). They deal with these characteristics in order to reduce their propensity to cause litigation and increase its possibilities of being hired and its ability to mount a successful defense in the event of a lawsuit (Schipper, 1991; Allen, Linville, & Stott, 2005).

In addition to these characteristics utilized as preventive information and previously mentioned Section 1 and 2 of SOX, I considered independent auditor experience and specialization important aptitudes to consider when the reduction of propensity to cause litigation is desired.

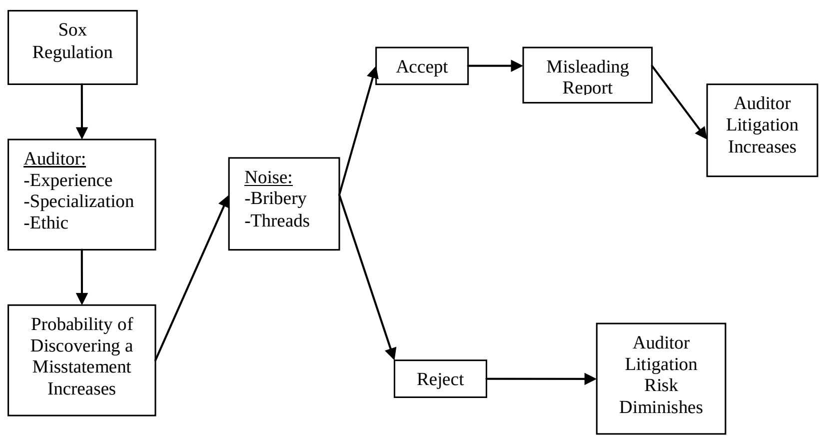
Cenker and Nagy (2008) conclude that these aptitudes tend to decrease litigation risks against auditing firms hence, improving audit quality. DeAngelo (1981a) defines audit quality as the probability that an auditor will both discover and report a breach in the clients accounting system. Deis, Jr. and Giroux (1992) support Cenker and Nagy (2008) in that the probability of reporting the error depends on the auditors technical capabilities and the probability of reporting the error depends on the auditor's independence. Previous research assume that the probability of discovering a breach of GAAP standards is positive and fixed, (i.e., that all auditors are technically capable) and that the auditor independence is a key issue. Consequently, without these technical capabilities (i.e., auditor experience, education, professionalism, and firm audit structure), capability and independence are difficult to disentangle (Cenker & Nagy, 2008).

Although, all auditors are technically able to discover deviations from GAAP standards, their integrity is often jeopardized by the lack of independence in the services they provide, and therefore do not report misstatements. For example: the Power-Conflict Explanation theory centers on the ability of the auditor to resist pressure from the client to violate professional standards. The balance of power tilts toward the client whenever the auditor places more attention to the rewards mediated by the client, than the client places on the rewards mediated by the auditor. Auditor expertise holds little value for the audit engagement, since the client desires a clean opinion to influence particular third parties. Thus, the client put pressures on the auditor by bribing and/or discharging the auditor from work since it is easier and less costly to the client to replace the auditor than it is for the auditor to replace lost business (Deis & Giroux, 1992).

In contrast, the auditor's capability to withstand client pressure is dependent on the economics of the contract, the state of professional ethics, the probability of detection of poor quality, and the vigor and visibility of enforcement actions by the profession among others (Deis & Giroux, 1992). These variables enhance audit quality and increase the value (credibility) of financial statements and therefore, decrease fraud and auditor litigation.

Moreover, in the research conducted by Bonner, Palmrose and Young (1998), it is said that the simple existence of any type of fraud is a significant factor in auditor litigation. They further investigate if the kind of fraud matters in the occurrence of litigation against auditors. From the study of judges' behavior, it is consistent with the attribution theory and found that there was actually higher incidence of auditor litigation when a company's financial statements contain a fraud that commonly occurred or that involves fictitious transactions and events. In Palmrose (1988) auditor failure is viewed as an excellent trigger of auditor litigation therefore, I expect auditor experience, specialization and, preventive information; previously mentioned variables, would increase audit quality and diminish auditor litigation. Experience is defined as the "ability, acquired by practice, to perform qualitatively well in a particular task domain" (Bedad & Chi, 1993). Specialization is a proxy of expertise and is based on training and practical experience gained from auditing in a particular industry (Lowensohn, Johnson, Elder, & Davies, 2007). Therefore, if auditors have these aptitudes, the likelihood that an error in financial statements will be discovered increases and audit failure decreases (Lowensohn, Johnson, Elder, & Davies, 2007). Other than that, auditor litigation is present since they have financial resources available to pay for damages (Lennox, 1999). Diagram two illustrates how auditor litigation is less probable if auditors follow auditing and SOX standards, are specialized, experts and, practice high ethical standards. In contrast if noise (Bribery and Threads) is present and intense, auditors often choose to follow their clients' desires and make a clean opinion which more likely lead to auditor litigation (See Diagram 2).

DIAGRAM II



Overall, this discussion emphasizes the importance of auditor specialization, experience and litigation risk in encouraging auditors conduct high quality audit work. Therefore, I use a multivariate model to examine whether there are changes in fraud frequency, fraud type and auditor litigation:

1. Fraud frequency/type = *f* (SOX sections, auditor specialization, experience, client characteristics and other case characteristics).

2. Auditor litigation = *f* (SOX sections, fraud frequency, fraud type, auditor specialization, experience, client characteristics, and other case characteristics).

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