

Auditor Litigation, Audit Office Pricing and Client Acceptance

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Abstract:

This study examines how lawsuits against auditors affect the audit pricing and client acceptance strategies of both the audit offices responsible for the failed audit and other audit offices of the same audit firm. We find that non-litigation offices of litigation audit firms decrease their fees following the filing of a lawsuit. However, audit offices involved in litigation increase their audit fees following the filing of the lawsuit. Further analyses indicate that the increase in audit fees charged by litigation offices is driven by clients' high switching cost, and low bargaining power. We also find that both litigation and non-litigation offices of audit firms involved in litigation are less likely to have new engagements following the start of the litigation and that the new clients are likely to be smaller, have higher abnormal accruals, and have had recent restatements compared to their existing clients. However, compared to new engagements before litigation, new engagements of litigation offices after litigation are likely to be larger, have lower leverage, and are less likely to receive a going concern opinion. Our results suggest that litigation has a significant impact not only for auditors involved in litigation, but also for non-litigation clients of the litigation office and litigation firm.

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1. Introduction

Enron and WorldCom demonstrated that even major auditing firms like Arthur Anderson LLP can become enmeshed in significant accounting scandals. Further, liability costs for auditing firms appear to have increased over the last two decades in the US, potentially because the number of third parties to whom accountants are liable and, also, the size of damage awards associated with lawsuits against public accountants have increased substantially. For example, claims against auditors, across the country, have increased by about 35% to 40% between 2005 and 2011 (Eigelbach 2011).¹ Following this rising trend in litigation, insurers have increased auditor liability insurance premiums resulting in substantial costs for audit firms. For instance, Linville and Thornton (2001) report that some small audit firms are left without profits after paying for legal liability and associated insurance premiums. Apart from these direct costs, there are also significant indirect costs of litigation for auditors. These indirect costs include investments to enhance quality control, as well as potential opportunity costs arising from reputational damage linked to litigation (Palmrose 1988; Francis 2011). Given the magnitude of these direct and indirect costs, and also the uncertainties inherent in the determination of legal liability, it is reasonable to presume that auditors will take actions to both compensate for litigation-related losses and to avoid future litigation. In this paper we explore these issues by examining the pricing and client acceptance strategies of audit offices following litigation related to client misconduct.

¹ For example, in 2005, Deloitte agreed to pay \$50 million to settle U.S. securities regulators' claims over the company's role as the auditor of bankrupt cable company Adelphia Communications Corp; KPMG agreed to pay \$22 million to settle the U.S. Securities and Exchange Commission's charges that the accounting firm allowed Xerox to manipulate its accounting reports from 1997 through 2000; In 2007, PricewaterhouseCoopers LLP agreed to pay \$225 million to settle an investors' class-action suit over an accounting scandal at Tyco International Ltd. (Eigelbach 2011).

We focus on how audit firms' change their pricing and client acceptance strategies at the audit office level following litigation. It seems quite likely that auditors would change the audit fees for clients who are involved in disclosure –related litigation. However, following litigation associated with a client at a particular audit office, whether litigation auditors would change audit fees for other clients of the same audit office, who are *not* involved in litigation, or for clients of other non-litigation offices is an empirical question. To answer this question, we examine how audit fees change for (1) non-litigation clients at the same office as the auditors' litigation clients, and (2) non-litigation clients at audit offices other than those of the auditors' litigation clients. Henceforth, we refer to audit offices that conduct the audits that resulted in litigation against the audit firm “litigation offices” and non-litigation offices of the audit firm involved in litigation “litigation firm, non-litigation (LF-NL) offices”.

In addition, we investigate whether litigation has any impact on new client acceptance strategies at both the litigation and LF-NL offices, and explore the characteristics of the new clients. The issues that we investigate in this paper are interesting for the following reasons. First, the existing literature on auditor litigation largely focuses on the determinants of lawsuits against auditors and how *ex-ante* auditor litigation risk affects auditor behavior (e.g. Stice 1991; Carcello and Palmrose 1994; Lys and Watts 1994; Palmrose and Scholz 2004). Lennox and Li (2014), the first study which examines the consequences of auditors being sued, focuses on whether litigation affects the subsequent financial reporting quality of clients of both litigation and LF-NL offices. We extend Lennox and Li (2014) by investigating how auditor litigation impacts subsequent audit pricing and new client acceptance strategies for both litigation and non-litigation offices of audit firms involved in litigation.

Second, although auditors are likely to charge higher audit fees for clients involved in litigation if they continue with the firm due to reassessed increased litigation risk, there is no research evidence on whether there is an accompanying “spillover” increase in audit fees for the auditors’ non-litigation clients. Lennox and Li (2014) find that, following a lawsuit, both litigation and LF-NL offices improve their audit quality. This increase in post-litigation audit quality may suggest an increase in audit effort and, in turn, audit fees following litigation. Litigation and LF-NL offices may also increase their fees following a lawsuit to account for a perceived increase in litigation risk for non-litigation clients. However, there is also evidence that reputational damage can have a negative impact on audit fees. For instance, Davis and Simon (1992) find that new clients of auditors sanctioned by the SEC received a fee discount. Litigation may lead existing and potential clients to lower their assessment of the auditor’s quality, and this reputational damage may result in auditors having to reduce their audit fees, even though they increase their audit effort. These competing influences suggest that auditors may increase or decrease audit fees for their non-litigation clients following litigation.

Finally, prior literature has focused on how *ex ante* litigation risk affects client acceptance decisions and found mixed results. For instance, Johnstone and Bedard (2003) find that new clients have a lower *ex ante* litigation risk than continuing clients. However, Stice (1991) finds that auditors face a higher likelihood of litigation from new clients. We extend the prior literature by examining the effect of litigation on *ex-post* client acceptance decisions. On the one hand, because of the reputational damage following auditor litigation, both litigation and LF-NL offices may have fewer new engagements. On the other hand, due to the increased likelihood of dismissal by clients after a significant audit failure (Skinner and Srinivasan 2012), litigation offices may be willing to take on more clients, even if they are riskier, to recover their

revenue losses. Thus, it is not clear how litigation will impact the *ex-post* client acceptance strategies of audit firms.

We focus on a sample of 491 auditor litigation cases between 2000 and 2011 obtained from *Audit Analytics*. Following Lennox and Li (2014), we investigate the pricing strategies of auditors involved in litigation cases that were initiated in the prior three years. Using a matched sample and a difference-in-difference design, we find that audit firms with prior litigation charge higher audit fees for the non-litigation clients of litigation offices compared to audit firms that do not have prior litigation. However, audit firms with prior litigation charge lower fees for clients of LF-NL offices compared to audit firms without prior litigation. These results suggest that the reputational damage from litigation has a negative effect on audit fees. But for litigation offices, it appears that the increased audit effort or reassessed client litigation risk outweigh the reputational damage. To further explore the increase in audit fees charged by litigation offices after the litigation, we examine whether clients' switching costs and bargaining power have an effect on the association between litigation and audit fees. Litigation offices may be more likely to increase audit fees for risky clients and when the auditor is an industry expert.. In contrast, large and important clients have more bargaining power over auditors. Thus, litigation offices may not be able to increase audit fees for such clients. Consistent with our expectations, we find that, for litigation offices, the increase in audit fees following litigation is magnified by clients' switching cost, which is proxied by client financial reporting risk (client's absolute abnormal accruals are greater than the sample median), client information risk (client's bid-ask spread is greater than the sample median), and auditor industry expertise (whether the audit office is an industry leader within the city), and is mitigated by clients' bargaining power, which is measured by both client size (client's total assets are greater than the sample median), and client

importance (client's fee is greater than 10% of the auditor office's total revenue).² Further, for clients of LF-NL offices, audit fees decrease to a greater extent the closer the LF-NL office is to the litigation office, suggesting that the reputational damage from litigation would likely be greater for non-litigation offices that are closer to the litigation office, thus increasing the pressure on these offices to decrease audit fees. Finally, we find the fee effect is not driven by Big 4 auditors and that the clients' fees for litigation office are positively associated with settlement amounts.

Concerning client acceptances, we find that both litigation and LF-NL offices are less likely to receive new engagements if the auditor has prior litigation. This result suggests that either clients shy away from auditors who have recently experienced litigation or that auditors involved in litigation become more selective regarding potential clients following litigation. Further analysis shows new clients of both litigation offices and LF-NL offices are likely to be smaller, have higher abnormal accruals, and have recent restatements compared to their existing clients. These results are consistent with the argument that potential clients perceive litigation against audit firms as an indicator of lower audit quality, forcing audit firms with recent litigation to accept less desirable new engagements both in terms of size and financial reporting quality compared to their existing clients.³ However, compared to new engagements before litigation, the new engagements of litigation offices after the litigation are larger, have lower leverage, and are less likely to receive a going concern opinion. These results suggest that litigation offices may become more conservative in their new clients acceptance strategies following litigation

² None of the cross-sectional analyses holds for LF-NL offices.

³ The results for audit fees and new engagements appear to be inconsistent for litigation offices, as reputational damage appears to affect the likelihood of new engagements following litigation but not the audit fees charged to clients. However, this inconsistency may be explained by the costs to clients of switching audit firms. These switching costs would not factor into a potential client's decision to engage the litigation audit firm but would factor into an existing client's decision to either accept the increased audit fees or change auditors.

compared to the new clients acceptance strategies in the pre-litigation period.⁴ We do not find significant changes in the new client acceptance strategies for LF-NL offices.

Our study contributes to the auditor litigation literature in the following ways. First, changes in an auditor's litigation environment are likely to affect how the auditor operates. For example, the response letters of the Big 4 accounting firms to the PCAOB Inspection Reports indicate that they made organizational and structural changes after SOX.⁵ Empirical studies also find that auditors are more likely to issue going-concern opinions after SOX, either in general, or, particularly, for important clients. However, there is limited evidence on whether a major audit failure event, such as auditor litigation, impacts auditor operating strategies. In addition, most prior studies consider the effects of *ex ante* litigation risk on auditor decisions. The only study that we are aware of examining the effects of lawsuits on subsequent audit engagements is Lennox and Li (2014), which finds an increase in audit quality for both litigation and LF-NL offices following litigation. While an increase in audit quality could be consistent with a corresponding increase in audit fees, the reputational damage that auditors suffer as a consequence of client misreporting and litigation can have a potentially adverse effect on their ability to maintain their fee levels. Thus, the issue of how audit fee levels for audit firms post-litigation change is an empirical question. We extend prior research by examining the effects of auditor litigation on subsequent audit fees and client acceptance decisions.

⁴ In a time line sense, the new engagements prior to the litigation become the existing clients after the litigation. However, the proportion of new engagements should be small in the offices' total client portfolio. Thus, for litigation offices, although the new engagements after the litigation is less riskier than the new engagements before the litigation we still find on average, the new engagements after the litigation is riskier than the existing clients.

⁵ For example, KPMG in the 2005 response letter states: "we have further strengthened our commitment to quality, made fundamental changes to our business and landmark improvements to our risk management structure; and put cultural and governance reforms into effect that reflect the highest ethical standards." The PCAOB's inspection reports are available from the following website: http://www.pcaobus.org/Inspections/Public_Reports/index.aspx"

Second, our results show that while there is a decrease in audit fees for clients of litigation firms' non-litigation offices potentially due to the reputational damage, there is actually an increase in audit fees for non-litigation clients of litigation offices. This finding is interesting because arguably the reputational damage should be the greatest for litigation offices. But instead of a fee discount, litigation offices are able to charge even higher fees than non-litigation audit firms. We argue that this could be either because litigation offices increase their audit effort after litigation to a greater extent than the litigation firms' non-litigation offices, or because their clients' litigation risk is reassessed at a higher level relative to the clients' risk associated with non-litigation offices.⁶ We also provide evidence that client switching costs and bargaining power have an impact on how litigation offices charge audit fees.

The rest of the paper is organized as follows. Section 2 discusses the prior literature and develops our hypotheses. Section 3 explains our sample selection process and empirical models. The results of our empirical tests are presented in Section 4. Section 5 contains additional analyses, and Section 6 concludes the paper.

2. Literature Review and Hypotheses

2.1 The impact of ex-ante auditor litigation risk on auditor behaviors

Ex-ante litigation risk has been shown to be an important determinant of auditor-client engagements and audit pricing. Prior studies find that audit firms collect and assess information about client risks (Huss and Jacobs 1991, Gendron 2001) and that they are less likely to accept clients with higher risks from the pool of available prospective clients (Asare and Knechel 1995; Cohen and Hanno 2000; Johnstone 2000; Asare et al. 2001; Johnstone and Bedard 2003). For

⁶ For example, Francis and Michas (2013) find that one client's restatement is associated with a higher likelihood of other clients' restatements in the same audit office.

example, Shu (2000) and Krishnan and Krishnan (1997) find that incumbent auditors are more likely to resign from clients who expose the auditors to increased litigation risk. Johnstone and Bedard (2003) find auditors are more likely to decline an engagement if the litigation risk is too high.

Auditors' *ex-ante* litigation risk has also been documented to influence audit fees. Using US data, Simunic and Stein (1996) find that audit fees are adjusted according to auditors' potential exposure to lawsuits. Seetharaman et al. (2002) find that UK audit firms charge higher fees when their clients access the US capital market, due to the higher litigation risk these clients are exposed to in the US.

Some other studies examine how changes in the overall litigation environment affect auditor behavior. Krishnan et al. (2007) find earnings conservatism increased for both former Andersen clients and non-Andersen clients in the post-Enron environment, suggesting that auditors attempt to mitigate litigation risk by requiring their clients to recognize bad news in a timely fashion. Geiger et al. (2006) find that auditors are more likely to issue going-concern opinions in the post-SOX period, implying more conservative reporting behavior. Together, the evidence suggests that auditors become more conservative in response to increases in the *ex-ante* litigation risk arising from a change in the regulatory environment.

2.2 Costs associated with auditor litigation

Litigation imposes significant direct monetary costs on auditors arising both from case settlements and also from increases in malpractice insurance premiums. An insurance agency survey shows a sharp increase in malpractice claims against accounting firms since 2006, and claims against auditors have increased about 35 to 40 percent across the country (Eigelbach 2011). For example, Ernst & Young LLP agreed to pay \$99 million to settle an investors' class-

action lawsuit against former officials and auditors of Lehman Brothers Holdings Inc. Another direct cost of litigation to auditors involves increases in business liability insurance premiums following litigation (Linville and Thornton, 2001).

In addition, practitioners and researchers argue that there are significant indirect monetary costs associated with litigation for auditors. One of these indirect costs involves investments to enhance quality control. For example, a lawsuit can cause an audit firm to downgrade its assessment of the competence and integrity of its personnel or the reliability of its quality control procedures. The audit firm may then respond by giving its personnel more training or introducing superior quality control procedures. Another indirect cost is damage to the auditor's reputation because litigation potentially signals audit quality deficiencies (Palmrose 1988). For example, Franz et al. (1998) find that clients, while not involved in litigation, experience significant negative returns when litigation against their audit firms is announced, suggesting that the market interprets auditor litigation as a signal of inferior audit quality. Chaney and Philipich (2002) find that Arthur Andersen's clients experienced a statistically significant negative market reaction when the auditors admitted that they shredded a significant number of Enron documents, suggesting that investors downgraded the quality of the audits performed by Andersen. In addition, companies that were audited by Andersen's Houston office suffered a more severe decline in abnormal returns (Chaney and Philipich 2002).

2.3 Spillover effect on non-litigation clients of litigation and LF-NL offices

There is evidence showing that the effect of financial restatements goes beyond the restating company itself. Kedia et al. (2011) find that companies are more likely to manipulate earnings after the public announcement of a restatement by another company in the same industry or located in the same city, suggesting that companies may mimic their peers' earnings

manipulation. However, such imitative behavior is absent if the restatement is associated with SEC enforcement or a class action lawsuit. Gleason et al. (2008) find that non-restating companies in the same industry as a restating company also experience negative market reactions following the announcement of the restatement, reflecting that investors extend their concern regarding accounting quality to other companies in the same industry. In addition, Francis and Michas (2013) show that one client's restatement is associated with a higher likelihood of other clients' restatements in the same audit office, indicating that there may potentially be a spillover effect on the quality of other concurrent audits conducted by that office. Similarly, as discussed earlier, clients not involved in litigation also experience significant negative returns at the announcement of litigation against their audit firm (Franz et al. 1998; Chaney and Philipich 2002), suggesting evidence of a perception of a contagion effect in accounting malpractice. Thus, we expect that the litigation risk of litigation office clients, and possibly LF-NL office clients, may also be perceived to increase after an auditor is sued consequent to a client's accounting malpractice.

2.4 Audit fees for non-litigation clients of litigation and LF-NL offices subsequent to the auditor litigation

After being sued for a client's accounting misconduct, an auditor is likely to charge higher audit fees to cover an increase in audit effort for non-litigation clients of the litigation and LF-NL offices. Following a lawsuit, auditors may evaluate client risk at a higher level for their non-litigation clients and, thus, exert more effort in auditing all of their clients to reduce the probability of future litigation. The increased effort includes establishing new quality control systems, and providing more training to their personnel. Consistent with this argument, Lennox and Li (2014) find that following a lawsuit against an auditor, there is a lower likelihood of a

future client misstatement for both the particular audit office involved in the lawsuit and the other non-litigation offices of the same litigation audit firm.

Therefore, it appears that auditors increase audit effort to improve audit quality following auditor litigation. Prior literature has shown that increasing audit effort will lead to an increase in audit fees (e.g. Bedard and Johnstone 2004; Bell et al. 2001). Auditors could also charge non-litigation clients of the litigation and LF-NL offices higher risk premiums reflecting any expected increase in risk, as prior studies suggest that audit fees reflect both the amount of audit evidence collected and an additional premium to cover litigation risk (Pratt and Stice 1994).

On the other hand, as discussed earlier, litigation is likely to damage the auditor's reputation. Because audit firms' reputations are positively associated with audit fee premiums (Beatty 1989; Francis et al.2005; Ferguson et al.2003), reputational damage to an auditor is likely to reduce its ability to charge high audit fees. Davis and Simon (1992) find that SEC disciplinary actions against an audit firm adversely affect the firm's audit fees and market share. Specifically, they find that after controlling for other factors shown to affect audit fees, new clients of sanctioned accounting firms receive a fee discount over and above that normally received by clients switching auditors. The implication of this result is that the impairment of reputation resulting from government disciplinary action reduces the auditor's bargaining power with new clients, leading to a reduction in audit fees. Drawing on the findings of the impact of auditor reputational loss on audit fees, auditor litigation could have a negative effect on audit fees for the non-litigation clients.

To sum up, auditors are expected to charge their non-litigation clients higher fees to cover the increase in audit effort and/or to reflect higher litigation risk. On the other hand, auditors could reduce their audit fees in response to the reputational loss caused by litigation.

Further, these competing influences may affect litigation offices and LF-NL offices differently. Because litigation offices are responsible for the failed audits which result in litigation, the pressure to improve audit quality through increased audit effort would likely be greater for litigation offices than for the other offices of litigation firms. For example, the litigation offices may need to hire more competent and qualified auditing staff. In addition, because the other non-litigation clients of litigation offices may have a higher likelihood of misstatement due to the spillover effect (Francis and Michas 2013), the risk premium for them should also be higher than that for the clients of LF-NL offices. However, at the same time, the reputational damage to the litigation office is likely to be greater than the damage to the LF-NL offices. Thus, the overall impact of auditor litigation on audit fees for non-litigation clients of the litigation and LF-NL offices is unclear. Our first hypothesis is as follows (stated in the null form):

H1a: Following the filing of a lawsuit, there is no significant change in audit fees for the non-litigation clients of litigation offices, compared to the audit fees charged by the offices of non-litigation audit firms.

H1b: Following the filing of a lawsuit, there is no significant change in audit fees for the clients of litigation firm, non-litigation (LF-NL) offices, compared to audit fees charged by the offices of non-litigation audit firms.

2.4 Client acceptance decisions after litigation

Auditors experience significant reputational damage after litigation (Palmrose 1988). Further, Hennes et al. (2014) find that auditors are more likely to be dismissed by their clients after restatements, consistent with the argument that restating companies switch auditors to restore financial reporting credibility. Studying events around a substantial audit failure of one of the largest Japanese audit firms, Skinner and Srinivasan (2012) find that around one quarter of the clients left the auditor after the audit failure, indicating that auditor reputation is important in client retention. Similarly, potential clients may perceive auditors that have recently been sued as

having lower audit quality, and may, therefore, be less willing to engage with these auditors, leading to fewer new engagements for litigation auditors compared to non-litigation auditors.

From the auditors' perspective, litigation auditors have competing incentives regarding new client acceptance decisions following a lawsuit. On the one hand, litigation auditors may become more conservative in assessing potential clients' risk characteristics after lawsuits, and may forego some risky new engagements that they would otherwise have accepted to avoid increased litigation risk. This would result in fewer new engagements for litigation auditors compared to non-litigation auditors. On the other hand, to cover the economic losses (increased client dismissals, settlement payments, increase in insurance premiums, etc.) caused by lawsuits, litigation auditors have incentives to increase revenues by accepting more new clients, even if these clients are riskier than their existing clients. These competing incentives make it ambiguous as to whether auditors would be willing to accept more or fewer new clients following litigation. The above arguments lead to our second hypothesis (stated in the null form):

H2: Following the filing of a lawsuit, there is no difference in the likelihood of new engagements for litigation offices and litigation firm, non-litigation (LF-NL) offices, compared to the offices of non-litigation audit firms.

In considering how auditors decide whether to serve potential new clients, Simunic and Stein (1990) propose that audit firms not only consider how prospective clients compare with each other but also how they compare with the characteristics of the existing client portfolio. Due to the monetary costs resulting from litigation, the reputational damage caused by litigation, and the desire to avoid future litigation, it is possible that auditors change the way in which they evaluate potential clients following litigation. Therefore, we next investigate how the characteristics of auditors' new clients differ from those of existing clients following litigation.

As noted above, an important factor in client acceptance decisions is the client's *ex ante* litigation risk. Johnstone and Bedard (2004) find that auditors practice risk avoidance and that new clients are less risky than existing clients. Following a lawsuit, the auditor is likely to be under increased scrutiny from regulators and investors. Audit offices would have strong incentives to decrease the risk profile of their client portfolio. Therefore, audit offices may be less likely to accept potential clients with higher *ex ante* litigation risk, such as those in high litigation industries or those with poor financial reporting quality.

However, as discussed earlier, the reputational damage from the lawsuit may decrease the size of the auditor's potential client pool because potential clients may be less willing to engage with these auditors. This leaves the auditor with fewer choices for low-risk new clients. Further, the economic incentive of increasing revenues to cover the costs of the litigation may lead auditors to deviate from risk avoidance and accept more new clients, even if they are risky.⁷

To examine if new clients engaged by auditors following litigation differ from existing clients on various client characteristics, such as litigation risk, size, and profitability, for litigation offices and LF-NL offices, we ask the following research question:

RQ1: Following the filing of a lawsuit, how do the characteristics of new clients differ from those of existing clients for litigation offices and litigation firm, non-litigation (LF-NL) offices?

3. Main Variables, Sample and Empirical Models

3.1. Main Variables Definition

For each litigation case, we have two treatment groups, non-litigation clients of litigation offices (*LIT_OFFICE*), and clients of litigation firms' non-litigation offices (*LF_NL OFFICE*),

⁷ Stice (1991) shows that the likelihood of litigation against an audit firm is heightened for newly accepted clients, suggesting that newly accepted clients may be riskier than existing clients, after controlling for the determinants of litigation.

and two periods, a pre-litigation period and a post-litigation period. Following Lennox and Li (2014), we define the post-litigation period as the three years following the year in which the lawsuit is filed. Similarly, the pre-litigation period is defined as the three years before the year in which the lawsuit is filed. Accordingly, we create four indicator variables. $LIT_OFFICE_{i,(t-3,t-1)}$ ($LIT_OFFICE_{i,(t+1,t+3)}$) equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years (in the following three years), and zero if a company is a client of a non-litigation audit firm. $LF_NL_OFFICE_{i,(t-3,t-1)}$ ($LF_NL_OFFICE_{i,(t+1,t+3)}$) equals one if a company is engaged with an auditor that had a lawsuit filed against it in the prior three years (in the following three years), but is not audited by the office responsible for the lawsuit, and zero if a company is a client of a non-litigation audit firm. We also create an indicator variable to represent the litigation time period ($POSTLIT$), which equals one if an observation is from the post-litigation sample, and zero if an observation is from the pre-litigation sample.

3.2 Sample Selection

Our data are from *Audit Analytics* and *Compustat*. There are 1,832 legal cases with at least one auditor as defendant in the litigation database in *Audit Analytics* from 2000 to 2011. We deleted 763 cases that are unrelated to accounting and disclosure malpractice, which results in 1,069 cases. We manually collect litigation firm data that are not available in the *Audit Analytics* litigation database over the internet using the case name and/or the court identified docket number. Since our analyses focus on the audit offices that get sued, we require the audit office information of each litigation firm-year to be identified in *Audit Analytics*, resulting in 491 cases involving 32 audit firms and 221 audit offices.

For the overall sample, we start with 141,071 firm-year observations with non-zero audit fee data from *Audit Analytics*, covering the period 2000 to 2011. We exclude 87,517 observations without auditor opinions, auditor local office information or with missing *Compustat* data needed to calculate necessary control variables. Following Lennox and Li (2014), we exclude the litigation clients from our analyses.⁸ The above procedures reduce our sample to 52,169 firm-year observations, which includes 6,666 client firm-year observations for audit offices with at least one lawsuit filed against them in the previous 3 years or in the following 3 years (*LIT_OFFICE*) and 21,149 client firm-year observations for non-litigation offices with at least one lawsuit filed against the audit firm in the previous three years or in the following 3 years (*LF_NL_OFFICE*).

Because the litigation risk of clients of litigation offices and LF-NL offices may be different from clients of non-litigation audit firms, and the *ex-ante* litigation risk is associated with audit fees, we next match clients of litigation offices and LF-NL offices with clients of non-litigation audit firms based on their litigation risk for our audit fee analyses.⁹ The matching design also allows us to identify the event year (i.e. the litigation starting year) for control groups so we can conduct difference-in-difference analyses. To perform the matching, we first calculate the *ex-ante* litigation probability as per the model in Kim and Skinner (2012)¹⁰. Then for each treatment observation (i.e. $LIT_OFFICE_{i,(t-3,t-1)}=1$ or $LIT_OFFICE_{i,(t+1,t+3)}=1$ or $LF_NL_OFFICE_{i,(t-3,t-1)}=1$ or $LF_NL_OFFICE_{i,(t+1,t+3)}=1$), we find a matched observation by identifying a client of non-

⁸ Because the litigation clients bear a large portion of the responsibility for the lawsuit against the auditor and because the litigation clients would likely pay higher fees even if they switch auditors, we do not think there is any question that the litigation clients' fees will increase following litigation and untabulated tests confirm this. We exclude the litigation clients from our sample to avoid biasing the results.

⁹ We cannot perform matching for new engagement analyses because we are interested in the likelihood of getting new engagements for each audit office, thus, we need to keep all the client firm-year observations for the individual audit office to conduct the analysis.

¹⁰ The litigation risk matching model is based on Kim and Skinner (2012): a litigious industry indicator variable (*FPS*), firm size (*SIZE*), sales growth (*SALES_GROWTH*), stock return (*RETURN*), return skewness (*RETURN_SKEWNESS*), return standard deviation (*RETURN_STDDEV*), and stock turnover (*TURNOVER*).

litigation audit firms with the closest litigation probability in the same fiscal year. After eliminating the observations that cannot be paired due to missing data available to construct the litigation probability, we have a sample of 7,734 observations for the audit fee analysis of H1a, which consists of 3,867 non-litigation client observations for litigation offices and 3,867 matched client observations for non-litigation firms. We also have a sample of 19,940 observations for the audit fee analysis of H1b, which consists of 9,970 client observations for LF-NL offices and 9,970 matched client observations for non-litigation firms.

3.2. Empirical models and variable definitions

The auditor pricing model draws on Simunic (1980), Beatty (1993), Francis et al. (1994) and Bell et al. (2001) to identify variables that influence audit fees. We employ a difference-in-difference design and specify our OLS audit fee models as the following:

$$\begin{aligned}
 \text{AUDITFEE}_{i,t} = & \beta_0 + \alpha_1 \text{LIT_OFFICE}(\text{LF_NL_OFFICE}) + \alpha_2 \text{POSTLIT} \\
 & + \alpha_3 \text{LIT_OFFICE}(\text{LF_NL_OFFICE}) * \text{POSTLIT} + \beta_1 \text{SIZE}_{i,t} + \beta_2 \text{SALE}_{i,t} \\
 & + \beta_3 \text{LOSS}_{i,t} + \beta_4 \text{SEGNUM}_{i,t} + \beta_5 \text{FOREIGN}_{i,t} + \beta_6 \text{LITINDUSTRY}_{i,t} \quad (1) \\
 & + \beta_7 \text{EQUITYISSUE}_{i,t} + \beta_8 \text{BKMK}_{i,t} + \beta_9 \text{GC}_{i,t} + \beta_{10} \text{RESTATE}_{i,t} \\
 & + \beta_{11} \text{BIG6}_{i,t} + \beta_{12} \text{DELAY}_{i,t} + \beta_{13} \text{BUSYMONTH}_{i,t} \\
 & + \beta_{14} \text{YEAR} + \beta_{15} \text{INDUSTRY} + \varepsilon_{i,t}
 \end{aligned}$$

For H1a, *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero if a company is a matched non-litigation audit firm's client. For H1b, *LF_NL_OFFICE* equals one if a company is engaged with an auditor that had a lawsuit filed against it in the prior three years or in the following three years, but is not audited by the office responsible for the lawsuit, and zero if a company is a matched non-litigation audit firm's client. Our testing variable is the interaction between *LIT_OFFICE* (*LF_NL_OFFICE*) and *POSTLIT*, which captures the incremental effect of the change in audit fees from pre-litigation period to post-litigation period for litigation office clients (LF-NL office clients) compared to non-litigation audit firms' clients. We do not have a

signed expectation for the coefficients on the interactions because of the two competing arguments behind H1.

Based on the prior literature, (Simunic 1980; Beatty1993; Francis et al.1994; Bell et al. 2001), we expect that larger companies, companies with worse financial health and more complexity will pay higher fees. We include the natural log of total assets (*SIZE*), the ratio of the sales to the total assets (*SALE*), whether the company reports negative net income (*LOSS*), number of business segments (*SEGNUM*) and whether the company has foreign earnings (*FOREIGN*) in the model, and predict that they will be positively associated with audit fees. Companies in litigious industries (*LITINDUSTRY*) and those that issue new equities (*EQUITYISSUE*) also pay higher audit fees. We include controls for the book-to-market ratio (*BKMK*) and whether a client received a going concern opinion (*GC*), and predict that *BKMK* will be negatively associated with audit fees and that *GC* will be positively associated with audit fees. Companies that announced financial reporting restatements (*RESTATE*) and are audited by BIG 6 auditors (*BIG6*) also pay higher audit fees. In addition, we include the length of the audit delay (*DELAY*) and whether the companies' fiscal year-end date falls in December, January and February (*BUSYMONTH*) and predict them to be positively associated with audit fees. Year fixed effects and industry fixed effects based on Fama-French 48 industries are also included. Table 1 summarizes the definition of the variables. Because there are multiple firm-year observations, we adjust for firm clustering effects in Model (1).

----- Insert Table 1 here -----

Our H2 tests whether the litigation offices and LF-NL offices are more or less likely to have new engagements in the three years after the filing of a lawsuit against the audit firm. We

use the following logistic regression model to examine the impact of litigation on the likelihood of new engagement:

$$\begin{aligned} \text{NEWENG}_{i,t} = & \gamma_0 + \delta_1 \text{LIT_OFFICE}_{i,(t-3,t-1)} + \delta_2 \text{LF_NL_OFFICE}_{i,(t-3,t-1)} + \\ & \delta_1 \text{LIT_OFFICE}_{i,(t+1,t+3)} + \delta_2 \text{LF_NL_OFFICE}_{i,(t+1,t+3)} + \gamma_1 \text{SIZE}_{i,t} + \gamma_2 \text{LITINDUSTRY}_{i,t-1} + \\ & \gamma_3 \text{BKMK}_{i,t-1} + \gamma_3 \text{GC}_{i,t-1} + \gamma_4 \text{ROA}_{i,t-1} + \gamma_5 \text{RESTATE}_{i,t-1} + \gamma_6 \text{ABACCRUAL}_{i,t} + \gamma_7 \text{BIG6}_{i,t} + \\ & \gamma_8 \text{BUSYMONTH}_{i,t} + \gamma_9 \text{CLI_IMPORTANCE}_{i,t} + \gamma_{10} \text{YEAR} + \gamma_{11} \text{INDUSTRY} + \varepsilon_{i,t} \end{aligned} \quad (2)$$

NEWENG equals one if a company is a new engagement of an audit office in year *t*, and zero otherwise. The control sample in Model (2) is clients of non-litigation audit firms during our sample period. If there is a difference in the likelihood of new engagement between our treatment group and control group in the post-litigation period, an alternative explanation is that such a difference always exists. To help rule out this alternative explanation, we include both the post-litigation period (*LIT_OFFICE*_{*i,(t-3,t-1)*}, *LF_NL_OFFICE*_{*i,(t-3,t-1)*}) and pre-litigation period (*LIT_OFFICE*_{*i,(t+1,t+3)*}, *LF_NL_OFFICE*_{*i,(t+1,t+3)*}) for litigation office clients and LF_NL office clients in Model (2), and test if such a difference exists only after the litigation begins.¹¹ Because of the competing arguments behind H2, we do not have signed expectations on *LIT_OFFICE* and *LF_NL_OFFICE*. We obtain the new engagement data from auditor change announcements in *Audit Analytics*. We control for size (*SIZE*), client litigation risk (*LITINDUSTRY*), financial health (*BKMK*, *GC* and *ROA*), and financial reporting quality (*RESTATE* and *ABSACCRUAL*). We also control for auditor type (*BIG6*), whether the fiscal year-end date falls in the busy months for the audit firms (*BUSYMONTH*), and the importance of the client to the audit office (*CLI_IMPORTANCE*). We include year and industry fixed effects

¹¹ We do not include interactions between litigation (LF-NL) offices and post-litigation period dummy like Model (1) because we do not have the event year for control companies. As explained earlier, we cannot perform matching procedures for the new engagement analysis because we are interested in the likelihood of getting new engagements for each audit office, thus, we need to keep all the client firm-year observations for the individual audit.

based on the Fama-French 48 industry model. We adjust for firm clustering effects in Model (2) as well.

4. Empirical Results

4.1. Post litigation audit fees of the litigation office and LF-NL office clients

Table 2 provides summary statistics for the variables in the audit fee analyses and compares means and medians for the litigation office clients, the LF-NL office clients, and their respectively matched control groups, i.e., clients of non-litigation audit firms. Both the mean and median results in Table 2 show that compared to their matched control group, litigation office clients have higher audit fees, more total assets, lower sales, have more segments, are more likely to have foreign transactions, are more likely to be audited by Big 6 audit firms, and more likely to have busy month fiscal year endings. Compared to their matched control group, LF_NL_OFFICE clients have more total assets, lower sales, and more segments, are more likely to have foreign transactions, and are more likely to be audited by Big 6 audit firms.

----- Insert Table 2 here -----

Table 3 presents the regression results for H1a. The coefficient on *LIT_OFFICE* is significantly positive (coefficient = 0.058, p -value = 0.001), meaning that litigation office clients pay higher fees in the three years before litigation compared to the matched control firms. To test whether the audit fees charged by litigation offices increased to a greater extent following the filing of the lawsuit compared to non-litigation audit firms, we examine the interaction of *LIT_OFFICE* and *POSTLIT*. The coefficient on the interaction term is significantly positive (coefficient = 0.048, p -value = 0.019), suggesting that compared to non-litigation audit firms, litigation audit offices significantly increase audit fees for their clients following litigation. Economically, after controlling for the other determinants of audit fees, the audit fees charged to

non-litigation clients of the litigation offices increased by 4.9% in the three years after litigation began, compared to the audit fees charged to the clients of non-litigation audit firms. Thus, the audit fees paid by non-litigation clients of the litigation offices increase after auditors are sued¹².

----- Insert Table 3 here -----

Table 4 presents the regression results for H1b. The coefficient on LF_NL_OFFICE is significantly positive, implying that prior to the commencement of litigation, LF-NL offices charge clients higher fees than non-litigation audit firms. Our test variable, the interaction of LF_NL_OFFICE and POSTLIT, is significantly negative (coefficient = -0.042, p -value = 0.029), which suggests that following litigation, the non-litigation offices of litigation firms decrease their audit fees more compared to matched non-litigation audit firms. Economically, after controlling for the other determinants of audit fees, the audit fees charged to clients of the LF-NL offices decreased by 4.1% in the three years after litigation began, compared to the audit fees charged to the clients of non-litigation audit firms. Thus, it appears as though the reputational damage to the non-litigation offices of the litigation firms outweighs any incentives for these offices to increase audit fees following litigation.

As for control variables in Tables 3 and 4, consistent with prior literature, we find that larger firms, firms with higher sales, more losses, more business segments, foreign transactions, equity issuances, going concern opinions, and restatement announcements, and firms with lower book-to-market value, higher abnormal accruals and longer audit delays pay higher audit fees. In addition, firms in litigious industries, and those audited by Big 6 auditors pay higher audit fees.

----- Insert Table 4 here -----

4.2. The effects of switching costs on audit fees of litigation offices

¹² Because audit firms are likely to charge low fees to clients in the first few years of the engagements to attract new clients (Deangelo 1981), we run the same regression after excluding the new engagements from the sample to eliminate the “low balling” effect, and find the results hold.

Our previous results suggest that litigation offices increase the audit fees charged to their non-litigation clients to a significantly greater extent following the start of litigation compared to non-litigation audit firms. This result raises the question of why these clients would agree to pay higher fees rather than switch to a different audit firm. The answer to this question might be that the costs for these clients to switch auditors are high. We argue that riskier clients have higher switching costs. Using simultaneous equation analysis, Boone et al. (2011) find a negative association between client-specific litigation risk and abnormal accruals and a positive association between abnormal accruals and the likelihood of litigation. These results suggest that auditors are likely to view clients that engage in earnings management through accruals manipulation as having a higher litigation risk. Auditors may also view clients with lower disclosure quality as riskier. We use the bid-ask spread as a proxy for disclosure quality and argue that clients with higher spreads are likely to be riskier (Welker 1995; Healy et al. 1999; Leuz and Verrecchia 2000). Both the absolute value of abnormal accruals (LAGABSAA) and bid-ask spread (SPREAD) are measured at year t-1. Specifically, we divide the audit office sample from Table 3 into subsamples according to whether the client's prior-year absolute value of abnormal accruals (bid-ask spread) is above the sample median.

In addition, because prior studies find that industry expert auditors at the city-level are able to charge audit fee premiums, and clients employing industry expert auditors in turn enjoy lower cost of equity and cost of debt (Ferguson et al. 2003; Francis et al. 2005; Li et al. 2010; Krishnan et al. 2013), clients of city-level industry leaders arguably have higher switching costs. Thus industry expert auditors may be more likely to increase audit fees to cover the increased audit cost after litigation. We measure an audit office's industry expertise by whether the audit office is an industry leader (has the highest market share for a particular two-digit SIC code) in

the city (*INDEXP*). Similarly, we split the litigation office sample into clients of industry expert litigation offices and clients of non-industry expert litigation offices.

Table 5 Panel A presents the results for the two subsamples based on the abnormal accruals in year $t-1$. The results show that for the higher abnormal accrual subsample, the coefficient on the interaction term, *LIT_OFFICE*POSTLIT*, is significantly positive (coefficient = 0.068, p -value = 0.013), suggesting that litigation offices increase their audit fees more for clients with high financial reporting risk following litigation. However, for clients in the lower prior-year abnormal accrual subsample, the coefficient on *LIT_OFFICE*POSTLIT* is negative but not significant, which suggests that there is no significant increase in the audit fees for clients of litigation offices with low financial reporting risk following litigation compared to non-litigation firm clients.

Table 5 Panel B presents the results for the prior-year's bid-ask spread. For the subsample of clients with high bid-ask spread, the coefficient on the interaction term, *LIT_OFFICE*POSTLIT*, is significantly positive (coefficient = 0.140, p -value = 0.001), suggesting that litigation offices are able to increase their audit fees more for clients with high information risk following the litigation. The coefficient on *LIT_OFFICE*POSTLIT* for the subsample with low ask-bid spread is negative but insignificant, which indicates that litigation offices do not increase their fees more for clients with low information risk compared to non-litigation audit firms.

Table 5 Panel C presents the results for industry expert auditors. We find that for the industry expert subsample, the coefficient on the interaction term, *LIT_OFFICE*POSTLIT*, is significantly positive (coefficient = 0.048, p -value = 0.035), suggesting that industry expert litigation offices are able to increase their audit fees to a greater extent than non-litigation audit

firms following litigation. However, for the non-industry expert subsample, the coefficient on *LIT_OFFICE*POSTLIT* is positive but insignificant, indicating that post-litigation non-industry expert litigation offices do not significantly increase their fees relative to non-litigation audit firms. .

----- Insert Table 5 here -----

4.3. *The effects of bargaining power on audit fees of litigation offices*

Another reason that litigation office clients would agree to pay higher fees rather than switch to a different audit firm may lie in the relative bargaining power of clients over their auditors. Because large and important clients have higher bargaining power over auditors, litigation offices may be less able to increase audit fees for these clients (Casterella et al. 2004; Huang et al. 2007). To investigate the effect of client bargaining power on audit fees following the litigation, we identify large clients based on whether the client's total assets are above the sample median (*LARGE_CLIENT*), and important clients according to whether the client's audit fees are greater than 10% of the audit office's total revenue (*IMPORTANT_CLIENT*). We then split the sample from Table 3 into large (important) clients and small (less important) clients.

Table 6 Panel A reports the results based on client size. It shows that for the subsample of large clients, the coefficient on *LIT_OFFICE*POSTLIT* is positive but insignificant, which suggests that there is no significant increase in audit fees for the large litigation office clients. However, for small clients, the coefficient on the interaction term, *LIT_OFFICE*POSTLIT*, is significantly positive (coefficient = 0.099, *p*-value = 0.001), suggesting that litigation offices are able to increase their audit fees for small clients following litigation to a greater extent than non-litigation audit firms.

Table 6 Panel B reports the results based on client importance. For the important client subsample, the coefficient on the interaction term, $LIT_OFFICE*POSTLIT$, is negative but insignificant. For the less important client subsample, the coefficient on the interaction term, $LIT_OFFICE*POSTLIT$, is positive and marginally significant (coefficient =0.029, p -value = 0.097), which provide some support for the argument that litigation offices are able to increase their audit fees for less important clients following litigation to a greater extent than non-litigation audit firms.

In sum, we find that high client switching costs and low client bargaining power help explain how auditors are able to charge higher fees for litigation office clients following litigation. Specifically, litigation offices are only able to increase audit fees for clients with higher switching costs, i.e. clients with higher financial reporting risk, larger bid-ask spread, and employing industry specialist auditors. Further, litigation offices are only able to increase audit fees for smaller and less important clients, not larger and important clients.¹³

----- Insert Table 6 here -----

4.3. *The likelihood of getting new engagements after litigation*

As discussed earlier, the occurrence of lawsuits may lead to a change in the client portfolios of the litigation auditors. Therefore, we next examine the likelihood of new engagements after the litigation is filed to test H2. Prior research has documented that auditors are likely to resign from high risk clients (Shu 2000). Therefore, to eliminate the effect of losing clients, we exclude auditor turnovers due to dismissals and resignations from our sample which results in 31,184 observations for the client portfolio analyses.

Table 7 reports the results for the analysis of new engagements. The testing variables are $LIT_OFFICE_{i,(t-3,t-1)}$, and $LF_NL_OFFICE_{i,(t-3,t-1)}$, which, respectively, indicate that the

¹³ We run the same cross-sectional analyses for LF-NL offices, but do not find any cross-sectional variations.

observation is a client of a litigation office or LF-NL office in the three years after litigation. The coefficient on $LIT_OFFICE_{i,(t-3,t-1)}$ is significantly negative (coefficient = -0.549, p -value = 0.022), as is the coefficient on $LF_NL_OFFICE_{i,(t-3,t-1)}$ (coefficient = -0.725, p -value = 0.023). Thus, our evidence suggests that both litigation and LF-NL offices are significantly less likely to have new engagements after the litigation begins compared with non-litigation auditors. An alternative explanation for this result is that litigation offices and LF-NL offices always have fewer new engagements for reasons unrelated to the litigation. Therefore, we also examine the likelihood of new engagements for litigation offices and LF-NL offices in the three years before litigation begins with the variables, $LIT_OFFICE_{i,(t+1,t+3)}$ and $LF_NL_OFFICE_{i,(t+1,t+3)}$. The coefficients on both of these variables are insignificant. Economically, the likelihood of getting a new engagement for litigation offices and LF-NL offices after litigation begins are 36.6% and 32.6% lower, respectively, than that for the control group. Thus, the negative impact of auditor litigation on audit offices' likelihood of new engagements is economically large.

----- Insert Table 7 here -----

4.4. Client portfolio changes after the lawsuits

RQ1 investigates the differences in client characteristics between new engagements and existing engagements for the litigation offices and LF-NL offices after the lawsuits begin. We examine RQ1 using the sample of litigation offices and LF-NL offices only and restrict it to the three years after the litigation starts. As shown in Table 8, the mean test suggests that for both litigation offices (Panel A) and LF-NL offices (Panel B), new clients are smaller, have significantly higher abnormal accruals, and are more likely to have announced a restatement in the prior two years than existing clients. These results indicate that litigation audit firms seem to

be more willing to accept new clients with higher financial reporting risk, compared to their existing client portfolio.

----- Insert Table 8 here -----

We next further examine whether the new engagements of litigation offices and LF-NL offices differ before and after the litigation. Table 9 presents the results of this comparison. The sample is restricted to new engagements of litigation offices and LF-NL offices in the three years prior to the litigation and three years after the litigation. In Panel A, the mean test suggests that for litigation offices, the new engagements following litigation are likely to be larger, have lower leverage, and are less likely to receive a going concern opinion compared to the new engagements before the litigation. For LF-NL offices in Panel B, we find that new engagements following the litigation do not significantly differ from new engagements prior to the litigation on any of the characteristics examined. Combining the results in Table 8, we find that although new engagements for litigation offices appear to have higher financial reporting risk compared to existing engagements following the litigation, the new engagements following the litigation seem to have better financial performance compared to the new engagements prior to the litigation. Thus, although the new clients of litigation offices are riskier than the existing clients, litigation offices appear to become more conservative in the new clients acceptance strategies following the litigation compared to their new clients acceptance practice before the litigation.

----- Insert Table 9 here -----

To summarize, our results provide evidence that audit offices responsible for the failed audit that resulted in litigation charge significantly higher audit fees during the first three years after the filing of the lawsuits. However, non-litigation offices of the litigation firms charge significantly lower fees after litigation begins. Further analyses suggest that the increase in audit

fees charged by litigation offices is driven by clients' high switching costs and low bargaining power. The likelihood of receiving new engagements is also significantly reduced not only for litigation offices, but also for LF-NL offices. Moreover, compared to existing clients, new clients are smaller and have lower financial reporting quality for both litigation offices and LF-NL offices in the three years following the litigation. However, for litigation offices, the new clients following the litigation are larger, have lower leverage, and are less likely to receive a going concern opinion compared to the new clients prior to the litigation.

5. Additional Analyses

5.1 The effect of geographic distance on audit fees

Because the effects of litigation may not affect LF-NL offices uniformly, we examine the impact of distance from the nearest litigation office on audit fees charged by the LF-NL offices after the litigation begins. We start by restricting our sample to the U.S. audit offices of the litigation audit firms. We further restrict the sample to the clients of the LF-NL offices whose audit firm experienced litigation in the prior three years or in the subsequent three years (i.e. $LF_NL_OFFICE_{i,(t-3,t-1)}=1$ and $LF_NL_OFFICE_{i,(t+1,t+3)}=1$, respectively). We then calculate the geographical coordinates of each office using the *Statistical Analysis System (SAS)* Geocoding procedure. Specifically, we use the *SAS* Geodist function to calculate the geodetic distance in miles between the litigation offices and the LF-NL offices of the same audit firm. Then we use the natural logarithm of the geodetic distance between an LF-NL office and the closest litigation office within the same audit firm that had its litigation begin in the prior three years or in the subsequent three years as our measure of distance from litigation source (*DISTANCE*).

The results in Table 10 show that the interaction between *DISTANCE* and *POSTLIT* is significantly positive (coefficient=0.132, p-value<0.01), indicating that litigation audit firms

decrease audit fees to a lesser extent for audit offices farther away from the litigation office, compared to those close to the litigation offices. One explanation for this result is that the reputational damage arising from litigation would likely be greater for offices closer to the litigation office, which would lead these offices to decrease their audit fees to a greater extent than LF-NL offices that are located farther away from the litigation source.

----- Insert Table 10 here -----

5.2 The effect of Big 4 Auditors

In the U.S., most audits of public companies are conducted by the Big 4 audit firms, and most lawsuits in our sample involve Big 4 audit firms. Therefore, an alternative explanation for our results for audit fees is that the effects of auditor litigation are driven by the effects of Big 4 audit firms. To rule out this explanation, we investigate whether our results hold for non-Big 4 auditors. The untabulated results show that consistent with Table 3, the interaction between LIT_OFFICE and POSTLIT are significantly positive after we delete all the observations audited by Big 4 auditors from our sample, indicating that the results for litigation offices hold for non-Big 4 audit firms. However, for LF-NL offices, the interaction between LF_NL_OFFICE and POSTLIT is negative, but not significant at the conventional level.

5.3 The effect of the severity of the cases

For auditors that experience higher legal costs, the risk assigned to litigation clients and their LF-NL offices will likely also be higher. We focus on a subsample of settled cases for which data on the actual amounts paid as settlements are available. We replace the first three variables in Model (1) with a continuous litigation cost variable (*Settlement*), which is the logarithm of the settlements paid by the auditor. The untabulated results show that consistent with our expectation, *Settlement* is significantly positive for litigation offices. Thus, this provides

evidence that the litigation cost borne by auditors is associated with the subsequent audit fees the litigation audit offices charge their clients.¹⁴

Conclusion

This study examines how lawsuits against auditors affect the audit pricing and client acceptance strategies of both the audit offices responsible for the failed audits and also the other audit offices of the litigation audit firms. We find that audit fees increase significantly for non-litigation clients of the litigation office but significantly decrease for clients of the litigation audit firm's other, non-litigation offices in the three years after the filing of the lawsuit. Additional tests show that (1) audit fees do not increase for clients with low financial reporting risk and information risk and clients of litigation offices that are not city-level industry experts, (2) audit fees for litigation offices do not increase for large and important clients with more bargaining power, (3) for LF_NL office clients, the decrease in fees is lower the farther the LF-NL office is from the litigation office, (4) the results are robust to considering only non-Big 4 auditors, and (5) for litigation office clients, audit fees are positively associated with settlement amounts.

With respect to auditors' client acceptance strategies, we find that litigation audit offices and LF-NL offices have fewer new engagements following lawsuits. We also find that new clients of litigation offices and LF-NL offices are likely to be smaller and have poorer financial reporting quality compared to their existing clients. These results are consistent with the arguments that potential clients view litigation audit firms as having lower audit quality, forcing the latter to accept less desirable new engagements both in terms of size and financial reporting quality. However, we also find that post-litigation, the new clients of litigation offices are larger, have lower leverage, and are less likely to receive a going concern opinion compared to the new

¹⁴ We do not find a significant correlation between settlement payment and the audit fees charged by LF-NL offices.

clients of the litigation offices prior to litigation. This result suggests that litigation offices become more conservative in accepting new clients following the litigation compared to their new client acceptance practices before the litigation.

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Table 1: Model Variable Definitions

Panel A: Model for audit fees

LIT_OFFICE _{i,t}	1 if company i is a non-litigation client of a litigation office, and 0 if company i is a matched client of a non-litigation audit firm.
LF_NL_OFFICE _{i,t}	1 if company i is a client of a non-litigation office of a litigation audit firm, and 0 if company i is a matched client of a non-litigation audit firm.
POSTLIT _{i,t}	1 if the observation is from the post-litigation matched sample
SIZE _{i,t}	natural logarithm of company i's total assets at the end of year t.
SALE _{i,t}	sales scaled by total assets of company i at the end of year t.
LOSS _{i,t}	1 if company i's net income in year t is negative, and 0 otherwise.
SEGNUM _{i,t}	number of segments of company i in year t.
FOREIGN _{i,t}	1 if company i has foreign income in year t, and 0 otherwise.
LITINDUSTRY _{i,t}	1 if company i is in a high litigation-risk industry, and 0 otherwise.
EQUITYISSUE _{i,t}	1 if company i issued equity in year t, and 0 otherwise.
BKMK _{i,t}	book to market ratio of company i at the end of year t..
GC _{i,t}	1 if company i received a going concern opinion for year t, and 0 otherwise.
RESTATE _{i,t}	1 if company i restated the financial statements in the prior 2 years, and 0 otherwise.
BIG6 _{i,t}	1 if company i is audited by one of the Big 6 audit firms in year t, and 0 otherwise.
DELAY _{i,t}	natural log of the number of days between fiscal year-end and the audit report date
BUSYMONTH _{i,t}	1 if company i 's fiscal year-end falls in December, January or February, and 0 otherwise.

Table 1 (continued)

Panel B: Model for the new engagements

LIT_OFFICE _{i,(t-3,t-1)}	1 if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years, and zero if a company is a client of a non-litigation audit firm.
LF_NL_OFFICE _{i,(t-3,t-1)}	1 if a company is engaged with an auditor that had a lawsuit filed against it in the prior three years, but is not audited by the office responsible for the lawsuit, and zero if a company is a client of a non-litigation audit firm.
LIT_OFFICE _{i,(t+1,t+3)}	1 if a company is engaged with an audit office that was responsible for a lawsuit filed in the following three years, and zero if a company is a client of a non-litigation audit firm.
LF_NL_OFFICE _{i,(t+1,t+3)}	1 if a company is engaged with an auditor that had a lawsuit filed against it in the following three years, but is not audited by the office responsible for the lawsuit, and zero if a company is a client of a non-litigation audit firm.
SIZE _{i,t}	natural logarithm of company i's total assets at the end of year t.
LITINDUSTRY _{i,t}	1 if company i is in a high litigation-risk industry, and 0 otherwise.
BKMK _{i,t}	book to market ratio of company i at the end of year t.
GC _{i,t}	1 if company i received a going concern opinion for year t, and 0 otherwise.
ROA _{i,t}	Return on assets of company i at the end of year t.
RESTATE _{i,t}	1 if company i restated the financial statements in the prior 2 years, and 0 otherwise.
ABACCRUAL _{i,t}	abnormal accrual of company i in year t based on modified Jones model.
BIG6 _{i,t}	1 if company i is audited by one of the Big 6 audit firms in year t, and 0 otherwise.
BUSYMONTH _{i,t}	1 if company i's fiscal year-end falls in December, January or February, and 0 otherwise.
CLI_IMPORTANCE _{i,t}	the percentage of company i's audit fee in the audit office's total revenue during year t.

Table 2 Descriptive Statistics

	LIT_OFFICE CLIENTS		CONTROL		t		LF_NL OFFICE		CONTROL		t		Z	
	N=3867		N=3867				N=9970		N=9970					
	MEAN	MEDIAN	MEAN	MEDIAN			MEAN	MEDIAN	MEAN	MEDIAN				
AUDFEE	14.24	14.19	13.53	13.54	9.00*	9.14*	14.23	14.19	14.29	14.24	0.42	-1.02		
SIZE	7.14	7.19	6.06	5.94	8.64*	8.80*	7.20	7.35	5.84	5.71	9.01*	9.20*		
SALE	0.98	0.83	1.12	0.94	2.89†	-2.75†	0.99	0.85	1.11	0.93	-1.85	-1.77		
LOSS	0.35	0.00	0.25	0.00	1.51	1.41	0.40	0.00	0.32	0.00	1.67	1.51		
SEGNUM	6.31	6.00	5.75	5.00	2.65†	2.06†	6.40	6.00	5.41	5.00	3.83†	4.03*		
FOREIGN	0.60	1.00	0.48	0.00	3.98*	3.97*	0.60	1.00	0.45	0.00	4.35	4.35		
LITINDUSTRY	0.51	1.00	0.47	0.00	1.35	1.35	0.50	0.00	0.45	0.00	1.21	1.21		
EQUITYISSUE	0.51	1.00	0.74	1.00	-0.71	7.82*	0.84	1.00	0.80	1.00	0.79	5.14		
BKMK	0.52	0.42	0.57	0.50	-1.43	-2.68†	0.56	0.48	0.59	0.50	-0.57	-0.87		
GC	0.03	0.00	0.03	0.00	-0.81	-0.81	0.03	0.00	0.04	0.00	-1.23	-1.23		
RESTATE	0.07	0.00	0.08	0.00	-0.21	-0.21	0.07	0.00	0.07	0.00	0.01	0.01		
BIG6	0.89	1.00	0.80	1.00	8.99*	8.88*	0.92	1.00	0.75	1.00	8.09*	8.05*		
DELAY	4.04	4.06	4.12	4.17	-1.59	-6.98*	4.04	4.06	4.12	4.13	-1.21	-4.99*		
BUSYMONTH	0.76	1.00	0.68	1.00	2.87†	2.87†	0.70	1.00	0.72	1.00	-0.57	-0.57		

Variables are defined in Table1.* significant at the 0.01 level; † significant at the 0.05 level; and ‡ significant at the 0.10 level.

Table 3: Post-litigation audit fees of litigation audit offices

DV=AUDFEE

Parameter	predicted sign	Estimate	t-stat.	p-value
Intercept		7.856	22.830	0.001
LIT_OFFICE	?	0.058	3.410	0.001
POSTLIT	?	-0.012	-0.950	0.343
LIT_OFFICE*POSTLIT	?	0.048	2.340	0.019
SIZE	+	0.497	95.840	0.001
SALE	+	0.114	11.080	0.001
LOSS	+	-0.303	-9.000	0.001
SEGNUM	+	0.041	17.620	0.001
FOREIGN	+	0.264	17.370	0.001
LITINDUSTRY	+	0.034	1.150	0.250
EQUITYISSUE	+	0.112	5.510	0.001
BKMK	-	-0.034	-3.600	0.000
GC	+	0.286	5.430	0.001
RESTATE	+	0.168	5.530	0.001
BIG6	+	0.364	14.260	0.001
DELAY	+	0.322	15.520	0.001
BUSYMONTH	+	0.085	5.490	0.001

N=7,734

Number of LIT_OFFICE Clients=3,867

Rsq=0.871

This table reports the regression results on the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 4: Post-litigation audit fees for litigation audit firms' non litigation offices

DV=AUDFEE

Parameter	predicted sign	Estimate	t-stat.	p-value
Intercept		8.205	42.740	0.001
LF_NL_OFFICE	?	0.074	5.670	0.001
POSTLIT	?	0.044	2.960	0.003
LF_NL_OFFICE*POSTLIT	?	-0.042	-2.180	0.029
SIZE	+	0.497	110.200	0.001
SALE	+	0.122	14.530	0.001
LOSS	+	-0.357	-19.160	0.001
SEGNUM	+	0.033	13.970	0.001
FOREIGN	+	0.232	16.470	0.001
LITINDUSTRY	+	0.016	0.910	0.364
EQUITYISSUE	+	0.072	5.040	0.001
BKMK	-	-0.037	-5.900	0.001
GC	+	0.258	9.750	0.001
RESTATE	+	0.094	3.370	0.001
BIG6	+	0.390	17.670	0.001
DELAY	+	0.239	15.280	0.001
BUSYMONTH	+	0.022	1.660	0.097

N=19,940

Number of LF_NL_OFFICE Clients=9,970

Rsq=0.852

This table reports the regression results on the relation between auditor litigation and audit fee strategies for the litigation audit firms' non-litigation offices (LF_NL OFFICE). The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LF_NL_OFFICE* equals one if a company is engaged with an auditor that had a lawsuit filed against it in the prior three years or in the following three years, but is not audited by the office responsible for the lawsuit, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 5: Effects of switching costs

Panel A: Effects of prior-year financial reporting quality

DV=AUDFEE

Parameter	predicted sign	HIGH_LAGABSAA=1			HIGH_LAGABSAA=0		
		Estimate	t Value	Pr > t	Estimate	t Value	Pr > t
Intercept		7.736	14.990	0.001	7.654	40.780	0.001
LIT_OFFICE	?	-0.005	-0.290	0.773	-0.012	-0.660	0.510
POSTLIT	?	0.057	2.040	0.041	0.060	2.130	0.033
LIT_OFFICE*POSTLIT	+	0.068	2.230	0.013	-0.007	-0.220	0.824
SIZE	+	0.087	2.090	0.037	-0.009	-0.180	0.859
SALE	+	0.482	59.780	0.001	0.532	64.540	0.001
LOSS	+	-0.049	-3.110	0.002	-0.020	-1.280	0.202
SEGNUM	+	-0.322	-5.270	0.001	-0.500	-6.510	0.001
FOREIGN	+	0.043	12.990	0.001	0.040	10.730	0.001
LITINDUSTRY	+	0.251	10.790	0.001	0.255	10.480	0.001
EQUITYISSUE	+	0.165	5.380	0.001	0.083	2.400	0.017
BKMK	-	0.119	7.820	0.001	0.115	6.490	0.001
GC	+	0.341	4.440	0.001	0.156	1.660	0.097
RESTATE	+	0.152	3.210	0.001	0.187	4.210	0.001
BIG6	+	0.355	9.550	0.001	0.375	9.160	0.001
DELAY	+	0.313	9.800	0.001	0.390	10.250	0.001
BUSYMONTH	+	0.090	4.020	0.001	0.069	2.630	0.009
			N=3,376			N=3,376	
			Rsquared=0.870			Rsquared=0.870	

This table reports the regression results on how client's prior financial reporting quality affect the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. *LAGABSAA* is the client's absolute value of abnormal accruals in the previous year. *HIGH_LAGABSAA* is equal to 1 if *LAGABSAA* is greater than the median of the sample, and 0 otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 5 Panel B: Effects of capital market pressure

DV=AUDFEE								
Parameter	predicted sign	HIGH_SPREAD=1			HIGH_SPREAD=0			
		Estimate	t Value	p-value	Estimate	t Value	p-value	
Intercept		8.478	30.710	0.001		7.407	15.160	0.001
LIT_OFFICE	?	-0.037	-1.990	0.047	?	0.017	1.070	0.287
POSTLIT	?	0.078	3.190	0.001	?	0.061	2.360	0.019
LIT_OFFICE*POSTLIT	+	0.140	4.030	0.001	?	-0.016	-0.600	0.548
SIZE	+	0.464	54.070	0.001	+	0.521	72.000	0.001
SALE	+	0.104	8.140	0.001	+	0.122	7.530	0.001
LOSS	+	0.203	8.850	0.001	+	0.164	6.320	0.001
SEGNUM	+	0.044	11.380	0.001	+	0.038	12.650	0.001
FOREIGN	+	0.252	11.590	0.001	+	0.278	12.440	0.001
LITINDUSTRY	+	0.078	1.970	0.049	+	-0.013	-0.280	0.779
EQUITYISSUE	+	0.125	4.900	0.001	+	0.089	1.920	0.055
BKMK	-	-0.042	-3.720	0.001	-	-0.091	-2.790	0.005
GC	+	0.269	4.650	0.001	+	0.600	3.800	0.001
RESTATE	+	0.223	4.830	0.001	+	0.099	2.560	0.010
BIG6	+	0.335	10.470	0.001	+	0.408	8.380	0.001
DELAY	+	0.274	10.070	0.001	+	0.355	10.200	0.001
BUSYMONTH	+	0.056	2.590	0.010	+	0.106	4.590	0.001
			N=3,721			N=3,721		
			Rsq=0.808			Rsq=0.842		

This table reports the regression results on how client capital market pressure affect the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. *SPREAD* is the client's prior-year bid-ask spread, and *HIGH_SPREAD* is an indicator variable equal to 1 if the observation is above the sample median for *SPREAD*, and 0 otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 5 Panel C: Effects of auditor industry expertise

DV=AUDFEE

Parameter	predicted sign	INDEXP = 1			INDEXP = 0			
		Estimate	t Value	Pr > t	Estimate	t Value	Pr > t	
Intercept		7.786	23.770	0.001	8.649	45.440	0.001	
LIT_OFFICE	?	-0.002	-0.110	0.914	?	-0.006	-0.290	0.773
POSTLIT	?	0.032	1.480	0.138	?	0.122	4.300	0.001
LIT_OFFICE*POSTLIT	+	0.048	1.810	0.035	?	0.012	0.370	0.709
SIZE	+	0.510	80.010	0.001	+	0.456	48.160	0.001
SALE	+	0.118	8.560	0.001	+	0.106	7.200	0.001
LOSS	+	0.200	9.340	0.001	+	0.149	5.760	0.001
SEGNUM	+	0.256	12.920	0.001	+	0.268	11.130	0.001
FOREIGN	+	0.000	-0.010	0.994	+	0.043	0.960	0.335
LITINDUSTRY	+	0.073	2.540	0.011	+	0.155	5.160	0.001
EQUITYISSUE	+	-0.029	-1.680	0.093	+	-0.062	-5.270	0.001
BKMK	-	0.038	12.610	0.001	-	0.044	12.240	0.001
GC	+	0.463	6.150	0.001	+	0.226	3.130	0.002
RESTATE	+	0.172	4.600	0.001	+	0.142	2.750	0.006
BIG6	+	0.459	12.590	0.001	+	0.295	8.120	0.001
DELAY	+	0.288	10.820	0.001	+	0.347	10.450	0.001
BUSYMONTH	+	0.102	4.980	0.001	+	0.052	2.180	0.030
			N=4,585			N=3,139		
			Rsq=0.885			Rsq=0.840		

This table reports the regression results on how the switching costs affect the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. *INDEXP* equals 1 if the audit office is the city-level industry leader in terms of total audit fees, and 0 otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 6: The effects of bargaining powers on post-litigation audit fees for litigation offices

Panel A: Effects of client size

DV=AUDFEE

Parameter	predicted sign	LARGE_CLIENT=1			LARGE_CLIENT=0			
		Estimate	t Value	p-value	Estimate	t Value	p-value	
Intercept		7.489	20.820	0.001	8.789	52.690	0.001	
LIT_OFFICE	?	0.008	0.440	0.657	?	-0.031	-1.890	0.059
POSTLIT	?	0.009	0.370	0.708	?	0.143	5.810	0.001
LIT_OFFICE*POSTLIT	?	0.015	0.550	0.582	+	0.099	3.330	0.001
SIZE	+	0.565	71.640	0.001	+	0.400	37.070	0.001
SALE	+	0.127	8.020	0.001	+	0.102	8.050	0.001
LOSS	+	0.152	6.000	0.001	+	0.159	7.300	0.001
SEGNUM	+	0.035	11.750	0.001	+	0.038	10.340	0.001
FOREIGN	+	0.327	13.940	0.001	+	0.200	9.800	0.001
LITINDUSTRY	+	-0.101	-2.180	0.030	+	0.070	1.930	0.054
EQUITYISSUE	+	-0.076	-1.030	0.304	+	0.180	7.750	0.001
BKMK	-	-0.037	-1.900	0.057	-	-0.036	-3.420	0.001
GC	+	0.222	1.400	0.162	+	0.266	4.890	0.001
RESTATE	+	0.182	4.770	0.001	+	0.186	4.030	0.001
BIG6	+	0.349	5.400	0.001	+	0.389	13.110	0.001
DELAY	+	0.314	10.340	0.001	+	0.339	12.360	0.001
BUSYMONTH	+	0.127	5.320	0.001	+	0.036	1.840	0.066
			N=3,866			N=3,866		
			Rsqr=0.735			Rsqr=0.797		

This table reports the regression results on how client size affects the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. *LARGE_CLIENT* equals 1 if the client's *SIZE*, natural logarithm of total assets, is above the sample median, and 0 otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 6 Panel B: Effects of client importance

DV=AUDFEE

Parameter	predicted sign	IMPORTANT_CLIENT=1			IMPORTANT_CLIENT=0			
		Estimate	t Value	Pr > t	Estimate	t Value	Pr > t	
Intercept		8.265	28.800	0.001	7.797	21.470	0.001	
LIT_OFFICE	?	0.016	0.760	0.447	?	-0.003	-0.200	0.838
POSTLIT	?	0.155	3.030	0.003	?	0.082	4.390	0.001
LIT_OFFICE*POSTLIT	?	-0.060	-0.920	0.358	+	0.029	1.300	0.097
SIZE	+	0.541	46.560	0.001	+	0.471	79.830	0.001
SALE	+	0.146	5.430	0.001	+	0.106	9.880	0.001
LOSS	+	0.238	5.680	0.001	+	0.176	9.950	0.001
BKMK	-	0.038	7.580	0.001	-	0.039	15.230	0.001
SEGNUM	+	0.190	5.110	0.001	+	0.284	17.050	0.001
FOREIGN	+	-0.253	-3.580	0.001	+	0.085	2.680	0.007
LITINDUSTRY	+	0.134	2.830	0.005	+	0.121	5.380	0.001
EQUITYISSUE	+	-0.092	-3.330	0.001	+	-0.041	-3.940	0.001
GC	+	0.065	0.500	0.614	+	0.402	7.300	0.001
RESTATE	+	0.252	3.830	0.001	+	0.147	4.430	0.001
BIG6	+	0.334	7.120	0.001	+	0.448	12.850	0.001
DELAY	+	0.281	5.480	0.001	+	0.323	14.290	0.001
BUSYMONTH	+	-0.039	-1.050	0.294	+	0.094	5.500	0.001
			N=1,506			N=6,229		
			Rsqr=0.933			Rsqr=0.853		

This table reports the regression results on how the client's bargaining power affect the relation between auditor litigation and audit fee strategies for the litigation audit offices. The sample period is from 2000 to 2011. The dependent variable is the natural logarithm of audit fee. *LIT_OFFICE* equals one if a company is engaged with an audit office that was responsible for a lawsuit filed in the prior three years or in the following three years, and zero otherwise. *POSTLIT* equals one if an observation is from the post-litigation matched sample, and zero otherwise. *IMPORTANT_CLIENT* equals 1 if the audit fee paid by the client is greater than 10% of the audit office's total revenue during the year, and 0 otherwise. Variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.

Table 7: The likelihood of new engagements post-litigation

DV=NEWENG

	Estimate	Wald Chi-Square	p-value
Intercept	-1.360	172.866	0.001
LIT_OFFICE(t-3,t-1)	-0.549	5.213	0.022
LF_NL_OFFICE(t-3,t-1)	-0.725	5.139	0.023
LIT_OFFICE(t+1,t+3)	0.034	0.025	0.874
LF_NL_OFFICE(t+1,t+3)	-0.471	1.995	0.158
SIZE	-0.116	10.360	0.001
LITINDUSTRY	0.017	0.042	0.837
BKMK	0.033	3.422	0.064
GC	0.181	5.957	0.015
ROA	0.066	4.713	0.030
RESTATE	0.785	83.647	0.001
ABACCRUAL	0.183	3.238	0.072
BIG6	-0.408	1.614	0.204
BUSYMONTH	-0.016	0.119	0.730
CLI_IMPORTANCE	0.010	0.003	0.960

N=31,184

Rsq=0.094

This table reports the regression results on the relation between auditor litigation and the likelihood of new engagements in the first three years after the litigation begins. The sample period is from 2000 to 2011. The dependent variable is NEWENG which equals 1 if the firm-year observation is a new client to the audit office, and 0 otherwise. Variables are defined in Table 1.

Table 8: The client characteristics for new engagement and existing engagement post litigation

Panel A: Litigation offices

	Existing engagements N=2,554	New engagements N=117	t/Chi-Square	p-value
SIZE	6.500	6.110	2.260	0.024
LITINDUSTRY	0.360	0.308	1.360	0.174
BKMK	0.450	0.458	-0.810	0.420
GC	0.029	0.009	1.220	0.221
ROA	-0.030	-0.036	0.700	0.486
RESTATE	0.070	0.145	-1.710	0.088
ABACCRUAL	0.090	0.127	-1.880	0.060
LEVERAGE	0.220	0.198	0.620	0.537
BUSYMONTH	0.770	0.803	-0.200	0.840

This table compares the mean characteristics of the new clients and the existing clients of the litigation audit offices in the first three years after the litigation begins. Variables are defined in Table 1.

Panel B: Litigation firms' non-litigation offices

	Existing engagements N=7,700	New engagements N=365	t/Chi-Square	p-value
SIZE	6.350	5.460	8.100	0.001
LITINDUSTRY	0.320	0.323	-0.200	0.842
BKMK	0.460	0.480	-0.420	0.674
GC	0.038	0.040	-0.110	0.913
ROA	-0.040	-0.082	1.130	0.133
RESTATE	0.060	0.148	-6.760	0.001
ABACCRUAL	0.100	0.129	-3.460	0.001
LEVERAGE	0.240	0.241	-0.380	0.704
BUSYMONTH	0.760	0.707	1.360	0.184

This table compares the mean characteristics of the new clients and the existing clients of the litigation audit firms' non-litigation offices in the first three years after the litigation begins. Other variables are defined in Table 1.

Table 9: The client characteristics for new engagement in the pre-litigation and post-litigation period

Panel A: Litigation offices

	Pre-litigation N=298	Post-litigation N=117	t/Chi-Square	p-value
SIZE	5.643	6.110	-2.280	0.023
LITINDUSTRY	0.332	0.308	0.040	0.967
BKMK	0.519	0.458	0.640	0.525
GC	0.045	0.028	2.160	0.031
ROA	-0.121	-0.036	-1.500	0.134
RESTATE	0.097	0.145	-0.870	0.383
ABACCRUAL	0.116	0.127	-0.610	0.545
LEVERAGE	0.276	0.198	2.160	0.031
BUSYMONTH	0.742	0.803	-0.990	0.324

This table compares the mean characteristics of the new clients of the litigation audit offices in the three years prior to the beginning of the litigation and in the first three years after the litigation begins. Variables are defined in Table1.

Panel B: Litigation firms' non-Litigation offices

	Pre-litigation N=750	Post-litigation N=365	t/Chi-Square	p-value
SIZE	5.544	5.460	0.640	0.521
LITINDUSTRY	0.297	0.323	-0.880	0.378
BKMK	0.542	0.480	0.700	0.482
GC	0.038	0.040	-0.110	0.913
ROA	-0.110	-0.082	-0.980	0.329
RESTATE	0.164	0.148	0.690	0.492
ABACCRUAL	0.137	0.129	0.600	0.552
LEVERAGE	0.267	0.241	1.390	0.165
BUSYMONTH	0.751	0.707	1.560	0.119

This table compares the mean characteristics of the new clients of the litigation audit firms' non-litigation offices (LF_NL_OFFICE) in the three years prior to the beginning of the litigation and in the first three years after the litigation begins. Variables are defined in Table1.

Table 10: Effect of geographic distance on audit fees for litigation firms' non-litigation offices

DV=AUDFEE

Parameter	predicted sign	Estimate	t Value	Pr > t
Intercept		8.309	31.400	0.001
DISTANCE	?	0.001	0.120	0.903
POSTLIT	?	-0.909	-7.730	0.001
DISTANCE*POSTLIT	?	0.132	7.980	0.001
SIZE	+	0.472	93.680	0.001
SALE	+	0.132	13.130	0.001
LOSS	+	0.185	12.220	0.001
BKMK	-	-0.023	-3.120	0.002
SEGNUM	+	0.039	18.090	0.001
FOREIGN	+	0.258	16.740	0.001
LITINDUSTRY	+	0.081	3.010	0.003
EQUITYISSUE	+	0.096	4.400	0.001
GC	+	0.221	4.820	0.001
RESTATE	+	0.125	4.790	0.001
BIG6	+	0.446	9.140	0.001
DELAY	+	0.284	11.900	0.001
BUSYMONTH	+	0.089	5.950	0.001

N=6610

Rsq=0.851

This table reports the regression results of the effect of geographic distance on the audit fees charged by LF_NL offices. DISTANCE is the natural logarithm of the geographic distance in miles between a non-litigation office and its nearest litigation peer branch. Other variables are defined in Table 1. P-values are one tailed for variables with predicted signs, and two tailed for variables without predicted signs.