To Sue or Not to Sue: An Experimental Study of Factors Affecting Hong Kong Liquidators Audit Litigation Decisions

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ABSTRACT. We report an experiment examining the effect of three factors on professional Hong Kong liquidators' decisions to bring legal action in negligence against auditors. Factors were (a) the strength (merit) of the supporting evidence (arguable vs. overwhelming), (b) the type of alleged audit failure (failure to report financial statement errors vs. management fraud) and (c) audit firm type (Big 6 vs. non-Big 6). We find evidence that liquidators' litigation decisions are influenced by case merit. We also find that liquidators were marginally more likely to institute legal action against a Big 6 than against a non-Big 6 auditor. However, we find no evidence that the type of alleged audit failure influences litigation decisions.

KEY WORDS: audit firm size, audit litigation, British common law, case merit, financial statement errors, management fraud

Introduction

Audit litigation is an issue of continuing concern to the accounting profession globally. As the International Federation of Accountants (IFAC) have stated:

> In recent years, despite auditors' adherence to professional standards, liability systems in many countries have produced an increasing amount of litigation against accountants. This litigation is having a detrimental effect on the accounting profession, as well as on the public it serves (IFAC, 1995, p. 2).

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Further, as Cloyd et al. (1998) conclude, there is little evidence that recent tort reform in the U.S. will significantly reduce either the amount or cost of litigation against public accountants. Thus there is a continuing need for research into a range of issues including factors that influence financial statement users' decision to institute legal action and the impact of differences in liability and procedure across legal regimes on these decisions (Cloyd et al., 1998; Palmrose, 1997).

To date, however, most audit litigation research has been based on the U.S. legal regime. Little, if any, research has been conducted in British Common Law (hereafter BCL) regimes such as Hong Kong within which up to a third of the world's auditors practice.[1] BCL regimes differ from the U.S. legal regime with respect to procedure and liability in potentially important ways. For example, in BCL regimes the loser in a legal action must bear a share of the winner's legal costs, trial by jury is not an option, and guidelines for punitive damages are so restrictive that the award of punitive damages is extremely rare. Despite calls for adoption of features of these regimes in the U.S. based on arguments that they will reduce the amount and cost of unwarranted audit litigation (AICPA, 1993; Arthur Andersen & Co. et al., 1992; Lochner, 1993), little empirical evidence on litigation decisions in this legal environment exists.

This study reports the results of an experiment examining the impact of three factors on litigation decisions in a British common law regime. Specifically, we examine the extent to which professional Hong Kong liquidators' decisions to institute legal action against an auditor for failure to detect or report financial misstatements are influenced by (a) the strength of the evidence

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(merit) supporting an action in negligence against the auditor (arguable vs. overwhelming) (b) the type of alleged audit failure (failure to detect and report errors vs. management fraud), and (c) audit firm type (Big 6 vs. non-Big 6).

Consistent with theory (Priest and Klein, 1984; Rosenberg and Shavell, 1985) but contrary to findings in the U.S. (Cloyd et al., 1996; Palmrose, 1988), we find that litigation decisions in a BCL regime are influenced by the legal merits of the case. Thus, by implication, our findings suggest that the frequency of unwarranted litigation, motivated by the ability to take advantage of frictions in the legal system to coerce often lucrative settlements, may be lower in BCL regimes. Also contrary to findings in the U.S., we find no effect of the type of alleged audit failure on litigation decisions. Liquidators in the present study were no more likely to institute legal action in cases of alleged failure to detect and report material misstatements resulting from management fraud than from accounting errors. Finally, consistent with prior findings in the U.S. and BCL regimes based on archival studies of actual litigation rates, we find some support for an effect of audit firm type on litigation decisions. Liquidators were marginally more likely to institute legal action against a Big 6 than non-Big 6 auditor. Importantly, while it may be rational from an economic standpoint to consider the potential defendant's ability to satisfy a judgment against them, from a legal and ethical standpoint such considerations should nonetheless be irrelevant to the decision to pursue litigation and serve to weaken the relation between merit and litigation (Arthur Andersen & Co. et al., 1992; Palmrose, 1988). Thus, by implication, this finding suggests that as in the case of the U.S. legal regime, litigation decisions in BCL regimes may also be affected by factors unrelated to the merit of the case.

Hypothesis development

The effect of case merit

An overarching issue in the audit litigation debate is the role of merit in instituting and resolving litigation (Palmrose, 1997). Theoretically, the strength or merit of the case should play a dominant role in decisions to bring suit and their resolution. For example, in Priest and Klein's (1984) model of the litigation decision process, case merit is the primary determinant of both the expected stakes and the probability of a favorable verdict. Practitioners, however, have long contended that merit plays little role in litigation. For example, in an oft-cited "Statement of Position" the (then) Big 6 argued, "the principal causes of the accounting profession's liability problems are unwarranted litigation and coerced settlements" (Arthur Andersen & Co. et al., 1992, p. 1).

Despite the importance of this issue to policy debates, little direct evidence on the role of merit in litigation decisions exists. Palmrose (1988), who examined litigation resolution in the U.S., found that 40% to 50% of audit litigation ended in dismissal or no payment by the auditor. To the extent that outcomes provide ex-post evidence on case merit, her findings support claims of substantial amounts of unmeritorious litigation (Palmrose, 1997). In an experimental study, Cloyd et al. (1996) found that merit had *no* effect on subject's (U.S. advanced students at law) recommendation to bring suit against the auditor and that a large majority (78%) recommended bringing suit even when the case lacked sufficient merit to be actionable under the principles of tort law. Contrary to theory (e.g. Priest and Klein, 1984) but consistent with the arguments raised by the accounting profession, these findings indicate that merit plays a limited role in litigation decisions in U.S. legal regimes. The impact of merit on litigation decisions in BCL regimes has not been empirically examined.

BCL regimes differ from the U.S. legal regime in potentially important ways. For instance, in BCL regimes, in addition to their own legal costs the loser in a legal action must also bear a portion of the winner's legal costs. These costs, known as "party-to-party costs," are normally in the region of two-thirds of the winner's actual legal costs.[2] Intuitively, as advocates of legal reform in the U.S. contend, to the extent that this effectively raises the cost of a failed lawsuit, case merit will play a more dominant role in litigation

decisions (AICPA, 1993; Arthur Andersen & Co. et al., 1992; Lochner, 1993). Analytical comparisons of the "British" vs. "American" cost allocation rules support this conclusion (Rosenberg and Shavell, 1985; Shavell, 1982). *Ceteris paribus*, then, merit is expected to have a stronger impact in litigation decisions in BCL regimes.

However, a critical assumption underlying these analyses is that court determined outcomes, and, hence, litigation decisions are based on merit (Palmrose, 1997). To the contrary, research indicates that jurors may be unable or unwilling to reach a verdict based on case merit alone and that plaintiffs' litigation decisions are influenced by the perceived ability to capitalize on such bias. For example, research has shown that audit litigation decisions are influenced by legally irrelevant factors such as losses to third parties (Kadous, 2000) and the presence of non-causal financial misstatements (Cloyd et al., 1996). Kadous (2000) also demonstrated that the standards of care to which auditors are held is an increasing function of the severity of losses, and that while juror's decisions are influenced by evidence on audit quality when losses are moderate, such information is ignored when losses are severe. Moreover, research by Cloyd et al. (1996) indicates that the decision to pursue litigation in the U.S. may often be predicated on an assumed ability to capitalize on such frictions in the legal system including the inability of jurors to accurately assess case merit. In their study, the most commonly reported reasons for recommendations to file suit, in order of frequency, were the effect of the suit and/or trial on the auditor's reputation, the inability of the court to accurately assess merit, the cost to the auditor of trial, and the auditors' "deep pockets" or ability to pay (Cloyd et al., 1996).

The option of trial by jury, however, is not available in BCL regimes. In all BCL regimes, claims against auditors are tried before commercial judges. An important implication of this feature of BCL regimes is that the ability of plaintiffs' legal representatives to capitalize on frictions arising from juror bias or inability to understand and evaluate complex legal arguments may be significantly reduced. This follows from the fact that when judges try a case they, unlike juries, have to justify their judgments and awards. Consistent with this, Palmrose (1991) found that auditor success rates in the U.S. were significantly higher in cases tried before judges than before juries. In addition to legal cost allocation rules that should increase the role of merit, the absence of jury trials in BCL regimes may further serve to reduce frictions that weaken the relation between merit and litigation decisions. Based on these institutional features we expect that the strength of the case supporting action against the auditor will significantly influence litigation decisions in a BCL regime:

> H_{01}: The likelihood of instituting legal action against auditors for failing to detect or reveal misleading financial statement information will be greater when the evidence supporting the plaintiff's case is stronger.

The effect of the type of alleged failure: errors vs. management fraud

Universally, the accounting profession has long argued that their culpability and, accordingly, liability for failures to detect and report management fraud is less than that for failures to detect and report financial statement errors. For example, U.S. Statement of Auditing Standards 53 states, "because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity" (AICPA, 1988). Similarly, professional standards in Hong Kong (SAS 110), the setting for the present study, state:

> Because of the characteristics of fraud and other irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material fraud or other irregularity. . . . Also, audit procedures that will usually be effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client" (HKSA, 1991).[3]

Findings in the U.S., however, indicate that the arguments contained in the professional standards do not serve either to reduce litigation against auditors for failure to detect fraud as opposed to errors or provide strong defense (Palmrose, 1987). Although fraud is a relatively rare event (Albrecht and Willingham, 1993), Palmrose (1987) examined 472 cases of litigation against U.S. auditors during the period 1970 to 1985 and found that nearly half (46%) involved irregularities.[4] St. Pierre and Anderson (1984) and Sullivan (1992) report similar findings. More recently, Epstein and Geiger (1994) found that while 47% of U.S. investors surveyed expected the auditor to provide absolute assurance that financial statements were free from material error, 71% expected absolute assurance against misstatements resulting from management fraud. Contrary to the profession's arguments stressing the inherent limitations of an audit, these findings indicate that, *ceteris paribus*, litigation is significantly more likely in cases of alleged failures to detect management fraud than financial statement errors. Whether these findings generalize to a BCL regime, however, has not been examined.

An important difference between U.S. and BCL regimes may be the level of familiarity with the audit process possessed by litigants and the court. As Epstein and Geiger (1994) also found, knowledge of the nature and limitations of an audit moderate the standards to which auditors are held. The more educated respondents were regarding accounting, finance and the use of the auditor's report, the less likely they were to require absolute assurance against fraud (Epstein and Geiger, 1994). As discussed above, audit litigation in BCL regimes is tried before commercial judges who can reasonably be assumed knowledgeable with respect to accounting and auditing. Moreover, the plaintiffs themselves likely possess substantial knowledge of the accounting and auditing process. In BCL regimes the only party who can sue the auditor in cases of negligence is the company itself.[5] When a company goes into liquidation, however, this right devolves upon the liquidators who typically have professional backgrounds in accounting or commercial law. Extrapolating from Epstein and Geiger's findings in the U.S. to a BCL regime then, suggests both that plaintiffs in BCL regimes may be less likely to hold auditors to higher standards with respect to the detection of fraud as opposed to errors and that their ability to capitalize on the court's expectations regarding auditors' responsibilities may be significantly curtailed. Thus whether litigation is more likely to ensue over alleged failures to report management fraud in BCL regimes is unclear. To examine this proposition, the following hypothesis, stated in null form, is tested:

H_{02}: The likelihood of instituting legal action is independent of whether the allegedly failure to detect or report misleading financial statement information results from fraud as opposed to errors.

Effect of audit firm type

Our final hypothesis examines the effect of audit firm type (Big 6 vs. non-Big 6) on litigation decisions. *A-priori*, there are several reasons why audit firm type may influence litigation decisions. First, a successful plaintiff can be prevented from enjoying the fruits of legal victory by the defendant's inability to satisfy the judgment. Thus, all else equal, potential plaintiffs may be more likely to institute legal action against a defendant who has the means or "deep pockets" to satisfy a judgment. Among audit firms, the (then) Big 6 clearly possess the deepest pockets. *Ceteris paribus* then, potential plaintiffs may be more likely to institute legal action against a Big 6 than against a non-Big 6 auditor (Dye, 1993).

In addition, due to their higher reputation for quality, Big 6 firms also face potentially greater costs of lost reputation resulting from litigation (DeAngelo, 1981). Reputation for quality is critical to a public accounting firm's success (Firth 1990). Considerable evidence from the U.S. (e.g. Becker et al., 1998) and BCL regimes such as the U.K. (e.g. Lennox, 1999) and Hong Kong (Gul, 1999; Gul and Tsui, 1998) shows that larger firms provide higher quality audits and lend greater credibility to client financial statements. Litigation against the firm, however, can seriously impair perceived audit quality.

Moreover, with regard to reputation for quality, the allegation of failure alone matters, not its merits (Palmrose, 1991). Such increased costs in turn may increase the perceived likelihood and amount of settlement. Therefore, if auditor reputation costs also enter into plaintiffs' litigation decisions they may be more likely to institute legal action against a Big 6 than against a non-Big 6 auditor (DeAngelo, 1981). Importantly, although rational from an economic standpoint, the influence of a potential defendant's ability to pay or willingness to avoid publicity on litigation decisions nonetheless serves to weaken the relation between merit and litigation (Arthur Andersen & Co., et al. 1992; Palmrose, 1988).

Results from archival studies of the relation between audit firm type and litigation, however, have been mixed. Palmrose (1988), in a study of cases against auditors in the U.S. found that (then) Big 8 firms were *less* likely to be involved in litigation than non-Big 8 firms. Stice (1991), however, found no association between auditor type (Big 8 vs. non-Big 8) and the frequency of litigation in his U.S. sample. More recently, Lennox (1999) found a *positive* association between firm type (Big 6 vs. non-Big 6) and litigation in the U.K.

Several features of these archival studies increase the difficulty of interpreting their results. First, archival data are subject to a "selection bias" in that only data related to lawsuits actually filed are available and data related to lawsuits that are settled are often sealed via agreement (Cloyd et al., 1996). If, as auditors claim, out of court payments and settlements are often made to avoid legal and reputation costs even when claims against them lack merit (Arthur Andersen & Co. et al., 1992), archival data may understate the amount of opportunistic litigation (Palmrose, 1988). Second, and more importantly, audit quality, and hence case merit, can only be inferred ex-post from litigation rates and outcomes and, as such, interpretation of findings depends on an assumed relation between merit and litigation decisions and outcomes. Thus, whether larger firms, holding case merit constant, are more likely to be targets of litigation remains an open question. In the present study we provide additional evidence on this question by examining the effect of audit firm type on litigation decisions while controlling for case merit via test of the following hypothesis, stated in null form:

H_{03}: There will be no difference in the likelihood of instituting legal action in negligence against a Big 6 as against a non-Big 6 auditor.

Method

Experiment design

The present study employed a 2 × 2 × 2 factorial design. Two factors, *evidence strength* (arguable vs. overwhelming), and *audit firm type* (Big 6 vs. non-Big 6) were manipulated between subjects. The third, *type of audit failure* (failure to detect or report misleading financial information resulting from errors vs. management fraud), was manipulated within subject. The dependent variable, the likelihood that participants would institute legal action against the auditor, was elicited on an 11-point scale bounded by zero and ten with endpoints labeled "Highly Unlikely" and "Highly Likely," respectively.

Instrument

In the experimental materials, participants were asked to assume the role of liquidator for a hypothetical company registered in Hong Kong, which had been "wound up" (placed in liquidation) by the court in June 1997 pursuant to a creditor's petition presented in June 1996.[6] Participants were told that the company was wound-up because developments in the first half of 1996 left it unable to pay its debts. Background information included information pursuant to the company's last three annual statutory audits conducted by the original auditors and excerpts from the published financial statements. Participants were further told that their suspicion being aroused by its dramatic collapse, they had had the accounts of the

company for the period ending 31 December 1995 audited by another firm. Excerpts from the financial statements corresponding to both the original and second audit were presented in tabular form (Table I). The excerpts indicated that the 1995 financial statements corresponding to the original audit contained a material overstatement of current assets, material understatement of current liabilities, and an overstatement of profit before tax in excess of HK$1 billion.[7]

Background information identified the original auditor as either a Big-6 or non-Big-6 firm. Following presentation of this information, participants indicated the likelihood that they would institute legal action against the original auditors in each of two scenarios: the original auditor was negligent in failing to detect or reveal false or misleading financial statement information resulting from (a) financial statement errors, and (b) management fraud. The order in which the two scenarios were presented was reversed for one-half of the participants.[8] Information introducing this task informed participants that based on the advice of legal counsel, the evidence supporting legal action was either (a) arguable, or (b) overwhelming.

Participants

To assist in obtaining participants, the office of the Hong Kong Official Receiver provided the names and addresses of the 120 professional liquidators on file as insolvency practitioners handling the liquidation of companies wound up by order of the court. In addition, Section 253 of the Companies Ordinance requires that the name and address of every liquidator involved in a voluntary winding up be published in the *Gazette*. Another 200 professional liquidators were randomly selected from those whose appointments as liquidators were published in the *Gazette* during the period January to June 1997. A cover letter requesting their assistance and one version of the instrument was sent to these 320 liquidators. Instruments corresponding to the eight experimental conditions were randomly assigned to participants. A total of 98 useable responses, representing a response rate of 30%, were received. Response rates by condition are presented in Table II.

Table III presents information on participants' background. As indicated, most participants (84%) had a professional background in public

TABLE I
Financial statement excerpts

Item	From the re-audited accounts as at:	From the original accounts as at:		
	31 December 1995 HK$ '000 000	31 December 1995 HK$ '000 000	31 December 1994 HK$ '000 000	31 March 1994 HK$ '000 000
Fixed assets	2061	2191	76	24
Current assets	1246	1977	1364	398
Long-term investment and other assets	3212	2774	351	198
	6519	**6942**	**1791**	**620**
Shareholders' funds	2402	2449	866	459
Long-term bank loan	1369	2140	37	23
Current liabilities	2260	1424	599	138
Minority interests	488	929	289	0
	6519	**6942**	**1791**	**620**
Profit/(Loss) before taxation	(277)	763	722	326

TABLE II
Response rates by cell

Audit firm type	Evidence strength: Arguable	Evidence strength: Overwhelming	
Big 6	35% (28/80)	29% (23/80)	32%
Non-Big 6	26% (21/80)	31% (25/80)	29%
	31%	30%	30%

TABLE III
Participant background information

	No.	%
Panel A: Professional background		
Law	6	6.1
Accounting	82	83.7
Other	10	10.2
Total	**98**	**100**
Panel B: Accountants' firm type		
Big 6		9
Non-Big 6		51
Non response		22
Total		**82**
Panel C: Age and experience, Mean (standard deviation)		
Age		41 (6.6)
Years of experience as liquidator		7 (5.2)
Number of engagements as liquidator		29.3 (14.6)

accounting (Panel A) and, on average, had served as liquidator in 29 engagements (Panel C).

Results

Due to unequal cell response rates, analysis was conducted using a GLM procedure. The results of the mixed between-repeated-measures ANOVA are summarized in Table IV.

H_{01}: The effect of case merit.

H_{01} predicts that the likelihood of instituting legal action against auditors for failing to detect or reveal misleading financial statement information will be greater when the evidence supporting the plaintiff's case is stronger. As indicated in Table IV, evidence strength had a significant effect on litigation decisions. The likelihood that liquidators would instigate litigation when the evidence against the auditor was overwhelming was significantly higher than when it was arguable (mean = 0.60 and mean = 0.52, respectively). Thus, H_{01} was supported. This result is consistent with theoretical models of the role of merit in BCL regimes (e.g. Rosenberg and Shavell, 1985; Shavell, 1982), but inconsistent with prior empirical findings in the US (Cloyd et al., 1996; Palmrose, 1988). Contrary to findings in the U.S., litigation decisions in a BCL regime do in fact appear to be influenced by the merits of the case.

H_{02}: The effect of type of audit failure.

TABLE IV
ANOVA results

	DF	SS	Mean square	*F* value	*P*-value (two-tailed)
Within subjects					
Type of audit failure (error vs. fraud)	1	0.0019	0.0019	0.03	0.427
Between subjects					
Audit firm type (Big 6 vs. non-Big 6)	1	0.1278	0.1277	2.25	0.067
Evidence strength	1	0.1865	0.1865	3.29	0.035

H_{02} examines whether the type of alleged failure influences the likelihood of legal action against an auditor in a BCL regime. As indicated in Table II, the likelihood that liquidators would institute litigation in the case of an alleged failure to detect material financial misstatements resulting error did not differ significantly from the case of alleged failure to detect financial misstatements resulting from fraud (mean = 0.56 and mean = 0.57, respectively). Thus, the null form H_{02} cannot be rejected. This finding is inconsistent with prior studies in the U.S. legal regime (e.g. Epstein and Geiger, 1994; Palmrose, 1987; St. Pierre and Anderson, 1984) which indicate that the likelihood of litigation is significantly higher when claims against the auditor are based in an alleged failure to detect and report fraud than failure to detect and report errors. For our sample of respondents in a BCL regime, however, we find no evidence that the type of alleged audit failure influences litigation decisions.

H_{03}: The effect of audit firm type.

H_{03} states that there will be no difference in the likelihood of a liquidator instituting legal action in negligence against a Big 6 versus non-Big 6 auditor. As indicated in Table IV, audit firm type had a marginal effect ($F = 2.25$, $p < 0.07$) on litigation decisions. Liquidators were marginally more likely to institute legal action against a Big 6 than against a non-Big 6 audit firm (mean = 0.58 and mean = 0.53, respectively). This result is consistent with the findings of Lennox (1999), but inconsistent with those of Palmrose (1988). Importantly, it suggests that factors unrelated to the merit of the case, which should be irrelevant to the decision to pursue litigation, may also influence legal decisions in a BCL regime.

Conclusion, limitations, and future research

This study reports the results of an experiment examining the impact of three factors on professional Hong Kong liquidators' decision to institute legal action against an auditor for failure to detect or report financial misstatements. Factors were (a) the strength of the evidence supporting an action in negligence against the auditor, (b) the type of alleged failure (failure to detect and report errors vs. management fraud), and (c) audit firm type (Big 6 vs. non-Big 6).

Consistent with theory (Rosenberg and Shavell, 1985; Shavell, 1982) we find that case merit has a significant effect on litigation decisions in a BCL regime. Importantly, this finding is contrary to the results of research in the U.S. by Cloyd et al. (1996) and Palmrose (1988) which indicate that merit may play little role in audit litigation decisions. One implication of this finding is that it suggests that the validity of claims by the accounting profession that "the principle causes of the accounting profession's liability problems are unwarranted litigation" (Arthur Anderson & Co. et al., 1992, p. 1) may be overstated outside of the U.S. legal regime. This finding also provides some support for claims that adoption of features of BCL regimes in the U.S., such as the so-called "British rule" under which the loser in a legal action must bear not only their own but also a share of the winner's legal costs, will reduce the amount and cost of unwarranted audit litigation (AICPA, 1993; Arthur Andersen & Co. et al., 1992; Lochner, 1993). However, an important caveat is that, as discussed above, BCL regimes differ in several potentially important ways from the U.S. legal regime. By design our study examines the effects of all of these features. As a result, the potential impact of adoption of any one or even several of the features of BCL regimes in the U.S. is an important issue that awaits further research.

We also find no evidence that the type of alleged audit failure influenced decisions by Hong Kong professional liquidators to institute legal actions against auditors. This finding is inconsistent with prior research in the U.S. which indicates that litigation against auditors is more likely to occur in cases of alleged failure to detect and report management fraud than financial statement errors (Epstein and Geiger, 1994; Palmrose, 1987; St. Pierre and Anderson, 1984). Importantly, in contrast to these findings,

our results indicate that litigation decisions in BCL regimes, under certain conditions, are not necessarily inconsistent with the arguments presented in the professional standards that, despite the greater severity of the audit client's infraction in cases involving fraud, the auditors' ability to provide assurance against fraud is less than that for errors. One explanation for this finding is that participants in the present study, who possess substantial experience in accounting and law and are cognizant that the judge will possess similar knowledge, may have incorporated knowledge of professional standards of due care in their decisions. This interpretation is consistent with more recent findings in the U.S. (Epstein and Geiger, 1994) that knowledge of the nature and limitations of auditing moderates the level of assurance against fraud expected by financial statement users. Another explanation, as discussed above is that, contrary to the U.S., in BCL regimes the award of punitive damages is extremely rare. In general, the plaintiff can only recover such loss as has been actually suffered. Thus, the underlying cause of the audit failure will have no impact on the size of award. Future research in a controlled institutional environment, however, will be necessary to assess the individual impact of these factors.

In addition, we also find some support for the effect of audit firm type on litigation decisions. Consistent with prior findings by Lennox (1999) in the U.K., we find some evidence that Hong Kong liquidators are more likely, albeit marginally so, to institute legal claims against Big 6 than non-Big 6 auditors. Importantly, this result attains in the present study while controlling for case merit. This finding likely reflects a fact that is fundamental to all legal regimes. Because litigation is prompted by the desire to recover losses caused by the defendant, all else equal, a plaintiff is more likely to sue a party with greater means to satisfy any potential judgment. While justifiable from an economic standpoint, the influence on litigation decisions of factors such as a potential defendant's ability to pay or their willingness to avoid damaging publicity nonetheless serves to weaken the relation between merit and litigation (Arthur Andersen & Co. et al., 1992; Palmrose, 1988). Similar to findings in the U.S. (Cloyd et al., 1996) then, this result indicates that litigation decisions in a BCL regime are also influenced by opportunistic factors unrelated to case merit.

This study makes several contributions. First, most audit litigation research has been based on the U.S. legal regime. Little, if any, research has been conducted in BCL regimes such as Hong Kong within which up to a third of the world's auditors practice. Thus, despite calls for adoption of features of BCL regimes in the U.S. based on arguments that they will reduce the amount and cost of audit litigation (AICPA, 1993; Arthur Andersen & Co. et al., 1992; Lochner, 1993), little empirical evidence on litigation decisions in this legal environment exists. As such, our findings should be of interest both in light of on-going legal reform debate in the U.S. and elsewhere, and to public accounting firms operating in BCL regimes. In addition, participants in the present study, professional liquidators, typically have a professional background in either public accounting or commercial law and, pursuant to their appointment as liquidator have the right to institute legal action against the auditor should conditions warrant. Thus, our results provide insight into the litigation decisions of experienced individuals in a familiar task setting.

Finally, several potential limitations of this study should be noted. First, as discussed above, all BCL regimes share the same essential legal features. As such, we believe our findings with respect to the case of Hong Kong should generalize to other BCL regimes. A potential caveat here, however, is that in addition to the legal framework set in place, litigation decisions are likely also influenced by political and social factors. For example, the court's willingness to hear cases alleging auditor negligence, and in turn litigation decisions, may be influenced by the general attitudes toward shareholder rights and government concerns over the impact of such litigation on both foreign and domestic investment. Thus, future research examining litigation decisions in other BCL regimes, or comparing litigation decisions across regimes, would be valuable. Second, as with all studies that employ postal data collection procedures, it is

always possible that the decisions of respondents differ systematically from those that would be made by non-respondents. A more important potential limitation in this regard, however, is that surveys of this type can only measure respondent's stated intention; whether liquidators' stated likelihood of instituting legal action accurately reflects the extent to which they would in fact take legal action is unknown. Third, to reduce the demands placed on participants' time, the materials used in the study were highly condensed. Although pilot testing indicated that the information provided was sufficient for the decision at hand, the decisions reported here were nonetheless made in an artificial environment with limited data provided to respondents. Additional evidence drawn from a richer task setting would be useful. For example, drawing on our basic findings, methods such as protocol analysis set in a richer task environment could provide valuable insight into both how the mental representation of litigation decisions differs across legal regimes and specific evidence on the importance of individual features that differ across regimes in these decisions.

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Notes

[1] In addition to the United Kingdom, BCL is found in Australia, New Zealand, the West Indies, Canada, and in the majority of the former British colonies in Africa (Nigeria, Kenya and South Africa to name just three) and Asia (Hong Kong, Malaysia, Singapore, Brunei, India and Sri Lanka).

[2] Party-to-party costs are typically determined via negotiation between litigants or, failing that, by the court based on a predetermined fee schedule. Indirect or intangible costs (i.e. reputation) are not eligible for reimbursement.

[3] As in other BCL regimes, HK SAS 110 follows UK SAS 110 which states "the likelihood of detecting errors is higher than that of detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence, such as management introducing transactions without substance, collusion between employees or falsification of records" (U.K. Auditing Practices Board Auditing Handbook, 1996).

[4] Palmrose uses the term "irregularities" to encompass management fraud and employee defalcations. Nearly all the cases covering irregularities involved management fraud.

[5] Creditors, shareholders and members of the public are third parties to the contract between an auditing firm and its client relating to the annual statutory audit. In BCL regimes, a third party who incurs a loss because they relied on negligently audited annual accounts does not have the requisite proximity with the auditor to maintain an action in tort. Thus creditors, shareholders and members of the public cannot seek to make good their losses by suing the auditor who performed the annual statutory audit. This follows from the decision of the House of Lords in *Caparo Industries plc v. Dickman* [1990] 1 All ER 568.

[6] This scenario was chosen based on findings that litigation occurs frequently in cases of bankruptcy. St. Pierre and Anderson (1984) report that 50% of the audit litigation cases in their sample involved financial failure or severe distress. Palmrose (1987) found that bankruptcy was involved in 40% of the cases in her sample.

[7] The materials were drawn from an actual case alleging auditor negligence. The High Court of Hong Kong granted our application to do a search of the court file on our express undertaking that we would not identify the case. To this end, all non-essential and individuating information and information pursuant to the particulars and outcome were purged from materials provided to participants.

[8] The order in which the two scenarios (error vs. fraud) appeared in the materials was counter-balanced across conditions. ANOVAs with presentation order as the independent variable revealed no significant

effect of presentation order on subjects' responses and no significant interaction between presentation order and the other independent variables.

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