Tax Litigation as a Signal of Accounting Confidence

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Abstract: This study explores whether the decision to engage in tax litigation against the Internal Revenue Service (IRS) serves as a meaningful signal regarding the likelihood of fraud, and accounting quality more generally. Given that tax litigation involves scrutiny of financial information by a third-party and the possible deposition of management, we predict that firms will only take this step if they are confident in the quality and integrity of their financial reporting. Using a novel dataset of court cases filed against the IRS, we find that tax litigation is associated with a lower likelihood of both overall fraud and accounting fraud specifically. Additionally, we find that tax litigation is negatively associated with the likelihood of restatements and corporate violations. Additional analysis reveals that the signal provided by tax litigation is stronger when the cases are conducted outside the U.S. Tax Court (i.e., the U.S. District Courts or U.S. Court of Federal Claims) where the discovery process is more extensive. We contribute to the literature on predictors of accounting fraud and signals of accounting quality more generally by examining the signal contained in a management action rather than financial disclosures or ratios.

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1. Introduction

Accounting fraud represents a severe form of low-quality accounting, which can destabilize capital markets and impose significant costs on numerous stakeholders. Consequently, the academic literature has focused considerably on identifying factors predicting accounting fraud (Dechow, Ge, Larson, and Sloan 2011; Amiram, Bozanic, and Rouen 2015; Bao, Ke, Li, Yu, and Zhang 2020; Li, Li, and Zhang 2023). While recent research has become increasingly creative in identifying signals of accounting fraud, it ultimately relies on detecting footprints of fraud in firms' financial statements and other disclosures. We compliment this work by introducing a new signal about the quality of firms' accounting information that is revealed by a management action rather than through accounting or disclosure choices. Specifically, we examine whether firms' decisions to litigate disputed tax positions provides a signal about the quality of their accounting information.

Our study is an indirect extension of Erickson, Hanlon, and Maydew (2004), who find that firms engaging in fraud were willing to overpay their taxes in order to inflate accounting earnings. In contrast, the decision to litigate a tax dispute represents a more extreme outcome of the tax audit process and is an observable action by managers that can serve as an indicator of accounting quality and reduced fraud risk. Firms that choose to litigate are subject to a discovery process, during which the tax authority can request financial documents relevant to the dispute. Further, managers can also be deposed as part of the litigation proceedings.

Prior research indicates that tax authorities are likely to request additional financial information during litigation. Indeed, Hanlon, Hoopes, and Shroff (2014) contend that the government is firms' largest minority shareholder because it has a significant claim on firm profits. Consequently, the Internal Revenue Service (IRS), like any large shareholder, has a keen interest in firms' financial reporting quality. The authors find that increased tax enforcement is associated

with better financial reporting quality. Building on this idea, we argue that managers are aware of the IRS's interest in their accounting information, and that the choice to engage in tax litigation represents a willingness on the part of management to subject the firm to additional scrutiny—not only of its tax positions, but of its financial reporting more generally. Conversely, if management is engaged in fraud, or has concerns about the quality of their accounting, we expect that they will be more likely to settle tax disputes and avoid litigation. As such, we predict that the decision to litigate a tax dispute is a positive signal about the quality of a firm's accounting information and an indication that the risk of accounting fraud is low.

To examine whether the decision to litigate serves as a signal of fraud risk, we collect a sample of 101 cases, representing 338 firm-years under litigation from 2000 to 2017. We employ entropy balancing to construct a control group of firm-years based on a set of covariates used to predict the likelihood that a firm is engaged in tax litigation against the IRS. To test our prediction, we follow fraud prediction models used in prior research (Dechow et al. 2011; Donelson, Kartapanis, McInnis, and Yust 2021) to examine the association between the choice to engage in tax litigation and a range of accounting outcomes, including fraud, financial irregularities, and financial restatements. We also examine whether tax litigation is associated with a lower risk of other forms of corporate malfeasance in the form of corporate violations.

To provide initial evidence, we first assess whether the decision to litigate signals a firm's accounting quality. Specifically, among all financial statement areas, we expect this signal to be most relevant for firms' tax accounts as these accounts are typically subject to additional scrutiny by tax authorities over the course of litigation. Accordingly, we expect litigating firms to have superior tax accounting quality relative to non-litigating firms. Using the measure of tax accrual quality developed by Choudhary, Koester, and Shevlin (2016), we find that firms engaging in tax

dispute-related litigation exhibit higher levels of tax accrual quality. This result suggests that tax litigation provides a credible signal of a firm's tax accounting quality.

Having established that tax litigation is a signal of tax accounting quality, we test our main hypothesis by examining whether the decision to litigate a tax dispute is associated with the likelihood of fraud. Consistent with our primary prediction, we find that tax litigation is associated with a lower likelihood of both overall fraud and accounting fraud specifically. We also find that tax litigation is negatively associated with future restatements. This result holds true for Big R, irregularity, and tax-specific restatements. Additionally, we also find that firms engaged in tax litigation face a lower likelihood of corporate violations, which include issues related to employment, consumers, financial, competition, and government contracting. Thus, our results suggest that tax litigation is a signal not only of a lower likelihood of low quality or fraudulent accounting, but also of a lower likelihood of corporate malfeasance in general.

To provide additional insight and reinforce our primary findings, we examine whether the association between tax litigation and the likelihood of fraud varies predictably in the cross-section. Specifically, we consider whether the association varies by the type of court where a firm chooses to litigate its tax dispute. Firms can litigate tax issues in the U.S. Tax Court (Tax Court), the U.S. Court of Federal Claims, or the U.S. District Courts. Most tax litigation in the U.S. occurs in the Tax Court, which has the notable advantage of not requiring taxpayers to pay the disputed amounts prior to the case being heard. Tax Court cases are bench trials where the judges oversee fact finding and make the decision on the case. Moreover, the judges in the Tax Court are tax experts who only hear tax cases. Importantly, the discovery process for cases tried in the Tax Court is narrow in comparison to the more extensive discovery processes in the U.S. District Courts and

the U.S. Court of Federal Claims.[1] In U.S. District Courts, firms have the option of a jury trial, which they may find advantageous in certain cases. In the U.S. Court of Federal Claims, firms must prepay their tax liability, but jury trials are not available. In general, the judges in both the U.S. District Court and the U.S. Court of Federal Claims are generalists, rather than tax specialists. Given these differences, we expect that firms' accounting information is likely to receive greater scrutiny in the U.S. District Court and the U.S. Court of Federal Claims relative to cases filed in the Tax Court. Thus, we predict that the association between tax litigation and the likelihood of fraud will be more pronounced when the lawsuit takes place in either the U.S. District Court or the U.S. Court of Federal Claims relative to the Tax Court.

Although the discovery process is narrower for the Tax Court, we still expect our predictions to hold across all court venues. Even in the narrower context of the Tax Court discovery process, we expect that firms engaging in fraud or with poor accounting quality are incentivized to settle disputes before discovery begins to avoid the exposure of significant financial reporting issues. However, given the broader and more extensive discovery process in the U.S. District Courts and the U.S. Court of Federal Claims, we expect the decision to litigate tax issues in these courts to be a stronger signal of low fraud risk or higher accounting quality than the decision to litigate in Tax Court. As such, we conduct our next set of tests examining Tax Court and non-Tax Court litigation separately. To be clear, all of these are tax cases, but we differentiate based on where the case is litigated.

[1] The informal discover process is unique to the Tax Court. The taxpayer meets with the IRS lawyer, the parties exchange documents and information in what is referred to as a Branerton meeting. Once that meeting is concluded then the parties can use the more formal route of requests for admissions, interrogatories, and document requests.

We find that both Tax Court and non-Tax Court litigation are negatively associated with the likelihood of overall fraud. However, only the non-Tax Court cases are negatively associated with accounting specific fraud. Similarly, we find that both Tax Court and non-Tax Court litigation are negatively associated with restatements, but only non-Tax Court litigation is significantly associated with the larger "Big R" restatements. Together, these results confirm our expectation that non-Tax Court litigation is an even stronger signal about the likelihood of fraud and higher quality accounting information than Tax Court litigation. Also consistent with expectations, we find that only non-Tax court litigation is associated with a lower likelihood of corporate violations. Collectively, our results suggest that the decision to litigate a tax dispute provides a signal about the likelihood that a firm is committing fraud, financial misreporting, or other forms of corporate malfeasance.

We make two important contributions to the literature. First, we contribute to the literature on the predictors of accounting fraud. Most fraud prediction models rely on publicly available financial accounting data (Beneish 1999; Cecchini et al 2010; Dechow et al. 2011; Bao et al. 2020). These models have become increasingly sophisticated moving from the use of financial ratios to machine learning. Our goal is not to identify or develop a signal that is superior to these models, but merely to examine whether incorporating the signal contained in managements' decision to engage in tax litigation provides incremental information about the likelihood of fraud. Earlier work by Caskey and Hanlon (2013) finds that firms' dividend paying status is negatively associated with the probability of committing accounting fraud. They build on the idea that the availability of cash to pay dividends constrains managements' ability to manipulate earnings. We contribute to this small area of research by examining another form of management action, tax litigation, as a signal about the likelihood of accounting fraud or other corporate malfeasance.

Second, we contribute to the literature on the relation between tax and financial reporting aggressiveness. While several prior studies predict or find evidence of a positive relation between tax reporting and financial reporting aggressiveness (e.g., Frank, Lynch, and Rego 2009; Desai 2005), Lennox, Lisowsky, and Pittman (2013) find conflicting evidence that fraud firms actually exhibit more tax aggressiveness. In contrast to these studies that broadly examine tax aggressive behavior as any action that reduces a firm's overall tax burden, we focus specifically on tax litigation, an important dimension of firms' overall strategy to manage their outstanding tax positions. This is an important distinction because, although litigation against tax authorities may be viewed as a tax aggressive action, we provide evidence to show that this action is associated with a lower incidence of aggressive financial reporting behavior.

2. Literature Review and Hypothesis Development

Donelson, Glenn, and Yust (2022) identify three main sources of tax litigation: disputes with tax authorities, derivative or securities class action lawsuits by investors, or regulatory action by the SEC or other agencies. In contrast to Donelson et al. (2022), we focus exclusively on disputes with tax authorities as managers have a choice to either litigate or settle. Tax disputes typically arise following an IRS audit when the two parties cannot agree on a settlement to a disputed position. Both parties know that litigation is costly, and thus have a strong incentive to settle most disputes without engaging in litigation. We acknowledge that there are likely situations where either the taxpayer feels the facts are so strongly in their favor or the dollar amounts at stake are so large that litigation is unavoidable. However, in most cases, we view the decision to litigate as discretionary on the part of managers. Wilson (2009) examines a sample of firms engaging in tax sheltering that is mostly identified through litigation. Many of these cases involve disputes over transfer prices or whether the tax shelter transactions have an underlying business purpose.

The nature of these disputes is such that there is a great deal of judgment and discretion involved in setting arm's length transfer prices or ascertaining whether a particular transaction has a true business purpose. As such, we expect that in most cases, there is meaningful uncertainty for both parties around the decision to litigate even when they feel the facts are in their favor. We expect that managers engage in some type of net present value (NPV) analysis in conjunction with legal counsel to evaluate whether the likely outcome of the litigation warrants the necessary legal costs and management time.

Desai, Dyck, and Zingales (2007) argue that tax authorities and outside investors have a shared interest in monitoring insiders. Because managers' efforts to obscure information is helpful for both avoiding taxes and extracting rents, there is a spillover benefit for outside shareholders that is derived from increased tax authority monitoring. As Hanlon et al. (2014) point out, diversion can be interpreted broadly to include actions taken by managers to manipulate earnings in an effort to increase current and future compensation at the expense of both investors and the tax authority. To test their theory, Desai et al. (2007) examine a sample of Russian firms after an increase in tax enforcement by newly elected President Vladimir Putin in 2000. Consistent with their theory, they find an increase in stock prices following this spike in enforcement for firms engaged in tax avoidance. Other studies reinforce this connection between tax authority enforcement and reduced fraud risk. For example, Guedhami and Pittman (2008) find that tax authority enforcement lowers the cost of financing, consistent with a reduction in agency costs between outside investors and controlling shareholders. El Ghoul, Guedhami, and Pittman (2011) apply this reasoning to equity and find that tax enforcement also lowers the cost of equity capital.

We expect that managers are aware of the IRS's incentive for monitoring to prevent any opportunistic diversion of resources. This reasoning aligns with Erickson et al. (2004) who observe

that some firms are willing to pay taxes on fraudulent or "fake" earnings. Along these same lines, Mason and Williams (2020) find that higher levels of IRS monitoring are associated with a reduced risk of fraud. Their results are consistent with our assertion that mangers have an awareness that the IRS serves a monitoring role. Consequently, we expect that if managers are engaging in any form of malfeasance, then the perceived cost of litigation for those managers will increase significantly with the increased risk of detection. For this reason, we expect these managers would be extremely reluctant to engage in tax litigation even if they would otherwise view the decision to litigate as a positive NPV proposition. Karpoff, Lee, and Martin (2008) track the consequences to 2,206 individuals identified as responsible for SEC and DOJ enforcements. They find that 93 percent of these individual lose their job and that most are explicitly fired. Implicated individuals also incur significant costs in the form of reduced likelihood of future employment, their shareholdings in the firm, and SEC fines. Further, they find that a sizable group (28 percent) face criminal charges, including jail sentences averaging 4.3 years. In summary, the consequences for managers engaged in fraud are dire and we expect that they will take any necessary step to reduce external scrutiny particularly from the IRS, who has an incentive to detect this type of malfeasance. This leads to our primary hypothesis:

H1: Firms actively engaging in tax litigation have a significantly lower likelihood of being identified as engaging in fraud relative to firms that are not engaging in tax litigation.

3. Sample Selection

3.1 Court Case Sample

To examine our research question, we construct a comprehensive dataset of court cases involving U.S. public companies that initiate litigation against the IRS. We employ a multi-step approach, using several data sources to collect court cases from the three venues where taxpayers

can litigate a tax dispute: Tax Court, U.S. Court of Federal Claims, and the U.S. District Courts. We begin by downloading a list of court cases in each of these venues from Westlaw, using the search fields for court and topic to filter for cases involving tax issues in the applicable venues. Our initial sample from Westlaw covers tax cases with publicly available written court opinions dated from 1980 to 2020. We then supplement this sample of cases using data from Bloomberg Law and the Federal Judicial Center (FJC) – two legal databases that have been used in prior research to examine securities and corporate litigation (e.g., Esmer, Ozel, and Sridharan 2023; Franke, Huang, Li, and Wang 2024; Billings, Holthausen, Petrovits, and Wang 2024). Specifically, Bloomberg Law extends our coverage of Tax Court and U.S. Court of Federal Claims cases, while the FJC database provides comprehensive coverage of cases filed in U.S. District Courts. As a final step, we use a keyword search in Direct Edgar for 10-K filings that mention "U.S. Tax Court" within twenty-five words of "petition" and manually hand-collect all dockets from the U.S. Tax Court website for firms identified through this search procedure. Overall, the intersection of these independent data sources should provide us with comprehensive case coverage of tax litigation against the IRS.

Next, we employ a fuzzy matching algorithm to match petitioner names in cases to names of firms in Compustat and CRSP.[2] We manually audit these matches to ensure that each case is correctly assigned to the appropriate firm, requiring that the petitioner firm have an available GVKEY in the year that the case is filed. We collect case filing and termination end dates for each docket in our sample from the Public Access to Electronic Court Records (PACER), the U.S. Tax Court website, the U.S. Court of Federal Claims website, and the FJC database. Following these

[2] In the U.S. Tax Court, the party who files the lawsuit is referred to as the "petitioner." However, in the U.S. Court of Federal Claims and U.S. District Courts, the party who files the lawsuit is referred to as the "plaintiff." For consistency across venues and simplicity, we refer to the firm that files the lawsuit as the "petitioner" or "petitioner firm."

steps, we identify 1,166 unique dockets filed between 1988 and 2020 involving petitioner firms with non-missing total assets from Compustat in the fiscal year of case filing.

While we are interested in firms' decision to initiate litigation against the IRS, our theory predicts that the usefulness of this signal depends on the credibility of management's intention to pursue litigation in court as opposed to settling. Indeed, many firms may choose to file a case in court solely as a bargaining tool to pressure the IRS into a more favorable settlement. In such cases, firms will initiate a case with the intention of pursuing settlement without trial, formal discovery, or the judge's intervention. Accordingly, such cases will generally display a relatively short case duration, marked by a settlement shortly after the case is filed. However, because the large majority of tax lawsuits end in settlement, firms may still ultimately settle with the IRS even if their initial intent was to proceed through all stages of litigation (Jones 2001). Thus, removing all cases that ultimately settle without assessing a firms' intention would not be appropriate for our study.

Instead, we proxy for the credibility of management's intention by identifying whether a judgment is rendered to resolve the dispute. This procedure allows us to identify only cases where the firm demonstrates a level of intent to litigate that necessitates a judge's intervention to resolve the dispute in court. Specifically, for cases in the Tax Court and the U.S. Court of Federal Claims, we retain only cases where the judge issues a publicly available court opinion because opinions are issued to outline the judge's reasoning for deciding a case and has been used in prior legal research to identify and analyze Tax Court decisions that do not reach a settlement prior to trial (Bommarito, Katz, and Isaacs-See 2011; Lederman 1998). For cases in U.S. District Courts, we retain cases where the FJC database has a non-missing value for the case judgement field, which indicates whether the case was disposed of via judgement and who the judgment was decided in favor of. We believe that retaining only these cases reduces the likelihood of introducing noise to

our sample from firms that file cases with little intention of progressing the case through the litigation process. Untabulated descriptive analysis of terminated cases filed between 1988 and 2020 supports this notion, as cases with judgments have a median duration of 4.6 years, which is more than two times the median duration of 1.8 years for cases without judgments. Thus, it appears that cases without judgments are more likely to involve settlements shortly after initiating a case in court.

3.2 Data and Sample Selection

In addition to our case data, we obtain financial data from Compustat, stock return data from CRSP, securities class action data from Donelson et al. (2021), restatement data from Audit Analytics, corporate violation data from Good Jobs First, and firm-level government exposure data from Armstrong, Glaeser, and Hoopes (2024). Our sample of firm-years begins in 2000 because Audit Analytics' coverage of restatements and Good Jobs First's coverage of corporate violations both begin in 2000. Our sample ends in 2017 to allow sufficient time for cases to resolve. Because we are interested in firms that initiate litigation in U.S. courts, we restrict our sample to firms that are incorporated and headquartered in the U.S. Furthermore, we drop firms in financial and utility industries because firms in these regulated industries face differing tax and financial reporting incentives. After removing firm-years with missing data needed to construct the variables in our empirical analysis, we are left with 46,284 total firm-years, including 338 firm-years where a firm is actively engaged in tax litigation against the IRS. Table 1 Panel A presents a breakdown of our sample selection criteria.

Table 1 Panel B presents a breakdown of the sample of unique dockets (i.e., cases) by court and by filing year for the cases that appear in our final sample. The earliest case in our sample was initiated in 1990, illustrating that the duration of a case can extend over many years given that our

sample of firm-years begins in 2000. Table 1 Panel C presents the number of cases in our sample that are active in each court by year. Over our sample period, there is a general decline in the number of active cases over time, potentially reflecting the growing resource constraints faced by the IRS (Nessa, Schwab, Stomberg, and Towery 2020) and the stated policy of the IRS Office of Appeals to avoid the "hazards of litigation" (Allen 2016). Panels A and B also reflect a larger proportion of cases filed in the Tax Court relative to other venues. Legal scholars have attributed this preference to the reluctance of taxpayers to pay the disputed amount of tax as a requirement to initiating litigation, a feature unique to the Tax Court and unavailable in other court venues (Greenway 2008).

4. Research Design

4.1 Measures of Fraud and Accounting Quality

We use securities class action lawsuits to capture the incidence of fraud committed in a firm, applying the following criteria recommended by Donelson et al. (2021) to identify lawsuits with credible fraud allegations: (1) the lawsuit contains Rule 10b-5 (fraud) allegations, and (2) the lawsuit is settled. Specifically, we construct two variables: (1) *AllFraud*, which is an indicator variable equal to one when any part of the firm-year overlaps with the class period of a settled securities class action lawsuit containing Rule 10b-5 allegations, and zero otherwise, and (2) *AcctgFraud*, which is an indicator equal to one if the conditions of *AllFraud* are met and the lawsuit also alleges GAAP violations, and zero otherwise (Donelson et al. 2021). Thus, *AcctgFraud* captures fraud due to intentional GAAP violations, whereas *AllFraud* captures a broader set of fraud activities not exclusive to those arising from intentional accounting specific manipulation.

To complement our measures of fraud, we also use restatements as a broader measure of firms' accounting quality. The variable *Restate* captures all types of restatements and is an indicator

variable equal to one for firm-years that are subsequently restated, and zero otherwise. We then construct three additional variables analogous to *Restate* but for specific types of restatements: (1) material restatements that require reissuance and 8-K disclosure (i.e., "Big R" restatements) (*BigR_Restate*); (2) irregularity restatements, following the classification used in Hobson, Mayew, and Venkatachalam (2012) (*Irreg_Restate*); and (3) tax-related restatements (*Tax_Restate*). By examining different types of restatements, we assess whether the informativeness of litigation as a signal varies depending on the severity or source of the restatement.

4.2 Empirical Design

Since the decision to initiate litigation against the IRS is non-random, there is a possibility that our results are driven by differences between firms that choose to litigate and firms that do not. To address this form of endogeneity, we employ entropy balancing, a pre-processing procedure that reweights observations to achieve covariate balance between treatment and control groups (Hainmueller 2012). Specifically, we estimate the following entropy balancing equation to predict firms that are engaged in active tax litigation against the IRS:

$$Litigate_{i,t} = \delta_0 + \delta_1 LogMVE_{i,t} + \delta_2 Leverage_{i,t} + \delta_3 ROA_{i,t} + \delta_4 IRS\_Exposure_{i,t} + \delta_5 Trend_{i,t} + CircuitFE + \varepsilon_{i,t} \quad (1)$$

where subscript *i* and *t* represent firm and year, respectively. The dependent variable *Litigate* is an indicator variable equal to one if the firm has an active case ongoing against the IRS at any point in the year, and zero otherwise. Following Lindsey, McDonnell, and Moser (2023), we use firm's market capitalization (*LogMVE*), leverage (*Leverage*), and performance (*ROA*) as variables that influence the resolution of firms' tax disputes in court. However, since the opportunity to litigate is conditional on having a dispute with the IRS, we also add the firms' level of exposure to the IRS (*IRS_Exposure*), using the text-based measure from Armstrong et al. (2024). *IRS_Exposure* is

measured as the number of sentences in a firm's 10-K that contain a reference to the IRS and an "agency action" word, divided by the total number of sentences in the 10-K (Armstrong et al. 2024). We control for *IRS_Exposure* in all subsequent tests to account for differences in firms' propensity to have tax disputes with the IRS.

Furthermore, we add a time trend variable (*Trend*) equal to the current fiscal year minus the first year of the sample to capture the general decline in tax litigation over time noted in Panel C of Table 1. We then add circuit fixed effects (*CircuitFE*) to account for time invariant characteristics in the litigation environment of the regional circuit where the firm is headquartered.[3] In Table 2 Panel C, we report the mean and variance of the covariates in Equation (1) before and after entropy balancing. We entropy balance on the first and second moments and use the default tolerance of 0.015 for all our empirical analyses. All continuous variables are winsorized at the 1st and 99th percentile to address the potential effect of outliers.

We begin our analysis by investigating the effect of tax litigation on firms' tax reporting quality. Specifically, we expect litigating firms to have superior financial reporting quality for their income tax accounts. To test our expectation, we estimate the following entropy balanced weighted regression using ordinary least squares (OLS):

$$TaxAQ_{i,t} = \alpha_0 + \alpha_1 Litigate_{i,t} + \alpha_2 Disc\&Extra_{i,t} + \alpha_3 PTBI\_Vol_{i,t} + \alpha_4 TaxLoss_{i,t} + \alpha_5 ForeignTax_{i,t} + \alpha_6 Size_{i,t} + \alpha_7 Predicted\_UTB_{i,t} + IndustryFE + YearFE + \varepsilon_{i,t} \quad (2)$$

where *TaxAQ* is the cross-sectional measure of tax accrual quality estimated by industry-year (Choudhary et al. 2016; Drake, Goldman, Lusch, and Schmidt 2024). In Equation (2), we include control variables based on the ones used by Choudhary et al. (2016) to predict firms' tax accrual

[3] We identify the location of firms' headquarters using data from Jennings, Lee, and Matsumoto (2017).

quality and we cluster standard errors by firm. If our expectation is correct, we expect a positive α_1. All variables are defined in Appendix A.

To examine the relation between engaging in tax litigation and the likelihood of fraud and restatements, we estimate the following equation by OLS:

$$Misreport_{i,t} = \beta_0 + \beta_1 Litigate_{i,t} + FraudControls + \beta_2 IRS\_Exposure_{i,t} + IndustryFE + YearFE + \varepsilon_{i,t} \quad (3)$$

where *Misreport* represents one of the following: *AllFraud*, *AcctgFraud*, *Restate*, *BigR_Restate*, *Irreg_Restate*, and *Tax_Restate*, as previously defined. Following the fraud prediction model in Donelson et al. (2021), we include a vector of control variables (*FraudControls*), including: accruals (*RSST_Accruals*), change in receivables (*Chg_Receivables*), change in inventory (*Chg_Inventory*), soft assets (*SoftAssets*), change in cash sales (*Chg_CashSales*), change in return on assets (*ChgROA*), issuance of equity or debt (*Actual_Issuance*), membership in a litigious industry (*LitigiousIndustry*), sales growth (*SalesGrowth*), firm size (*Size)*, return volatility (*ReturnVolatility*), cumulative abnormal returns (*CAR*), return skewness (*ReturnSkewness*), and share turnover (*ShareTurnover*). We also control for the quality of the firms' auditor (*BigN*) because prior literature suggests that Big N auditors affect the incidence of fraud and firms' financial reporting quality (Lennox and Pittman 2010; DeFond, Erkens, and Zhang 2017). Finally, we include industry and year fixed effects to control for unobservable industry-specific or time characteristics, respectively. Although the dependent variables used in Equation (3) are binary outcomes, we estimate this equation using OLS to accommodate the use of higher dimensional

fixed effects.[4] Our hypothesis predicts a negative β_1, consistent with tax litigation signaling a reduced likelihood that the firm is engaging in fraud or other misreporting.

5. Empirical Results

5.1 Descriptive Statistics

Table 2 presents the descriptive statistics for the variables used in our empirical analyses, partitioned into two panels. Panel A provides summary statistics for the full sample. The variable *Litigate* reports a mean of 0.007 for firm-years engaged in disputes with the IRS. *TaxAQ* has a mean of -0.016 reflecting some variability in firms' tax reporting quality. Furthermore, indicators of poor accounting quality such as *AllFraud* and *Restate* show that approximately 3.6% of firm-years are associated with settled securities fraud cases, while 16.5% are linked to financial restatements. The mean values of *TaxAQ*, *AllFraud*, and *Restate* are comparable to similar outcomes reported in prior studies (e.g., Choudhary et al. 2016; Armstrong, Jagolinzer, and Larcker 2010; Lee, Naiker, and Stewart 2022).

Panel B contrasts the outcome variables between firms involved in tax litigation and those that are not. The panel shows significant differences in financial reporting quality and corporate misconduct between the two groups. Firms engaged in tax litigation tend to have higher tax accrual quality, with a mean *TaxAQ* of -0.011, compared to -0.016 for non-litigating firms, with the differences in means being statistically significant ($p < 0.01$). Additionally, firms involved in litigation show lower incidences of fraud and restatements. For example, the occurrence of *AllFraud* (fraud) and *Restate* (financial restatements) is notably lower among litigating firms (1.8% and 5.3%, respectively) than in non-litigating firms (3.7% and 16.6%, respectively), with

[4] In untabulated analyses, our inferences remain qualitatively similar to those reported in the paper if we instead use a logit model to estimate Equation (3).

the differences in means also being statistically significant ($p < 0.10$ and $p < 0.01$, respectively). Material restatements, *BigR_Restate*, are also less frequent in firms that litigate against the IRS, further supporting the notion that these firms exhibit superior accounting quality ($p < 0.01$).

Interestingly, despite better tax reporting and lower fraud incidence, univariate results suggest that firms involved in tax litigation are more likely to face violations with significant penalties. The variable *Viol_Penalty*, which measures the monetary penalties from corporate violations, is substantially higher for litigating firms, with a mean of 3.241 compared to 0.544 for non-litigating firms. This suggests that while these firms may be more diligent in certain aspects of financial reporting, they could also be subject to heightened regulatory scrutiny, leading to more severe violations. Overall, the univariate statistics indicate that firms engaged in tax litigation tend to report higher tax accrual quality and face fewer instances of financial misreporting but may incur larger penalties from corporate violations.

Next, we examine whether tax litigation acts as a signal of firms' accounting quality. To do so, we investigate the impact of litigation on tax accrual quality (*TaxAQ*) and test Equation (2). We report the results in Table 3. In column 1, the baseline results show that firms involved in tax litigation (*Litigate*) are associated with greater tax accrual quality, with a positive and statistically significant coefficient of 0.002 ($p < 0.10$). This suggests that firms engaged in litigation with the IRS tend to exhibit higher quality tax-related financial reporting, consistent with the idea that IRS scrutiny may serve as a signal of higher tax reporting quality. In column 2, which includes additional control variables, the positive relation between tax litigation and tax accrual quality remains significant, with the coefficient on *Litigate* remaining at 0.002 ($p < 0.01$). This further reinforces the finding that firms engaged in tax litigation tend to have higher-quality tax accruals in the presence of additional controls. Overall, the results in Table 3 suggest that tax litigation is a

strong positive predictor of better tax reporting practices, even after accounting for various firm characteristics and potential confounding factors.

5.2 Analysis of Tax Litigation and Financial Misreporting

We next investigate the likelihood of financial misreporting in relation to firms' decisions to engage in litigation with the IRS by testing Equation (3). First, we examine the impact of litigating the IRS and the likelihood of committing fraud. We proxy for fraud using *AllFraud* and *AcctgFraud* and report the analysis in Table 4. In column 1, we find that firms involved in tax litigation are significantly less likely to have years that overlap with the class period of a settled securities class action lawsuit alleging fraud (*AllFraud*). Specifically, the coefficient on *Litigate* (-0.034, $p < 0.01$) suggests that firms litigating the IRS have a 3.4% lower likelihood of committing fraud compared to non-litigating firms. Column 2 shows a similar result for *AcctgFraud*, with a negative and significant coefficient on *Litigate* (-0.029, $p < 0.01$), indicating a 2.9% decrease in the likelihood of committing accounting fraud for litigating firms. Taken together, the results in Table 4 provide evidence that litigating the IRS is associated with a reduced likelihood of fraud, both in all types of fraud and specifically in accounting-related instances of fraud, suggesting that firms actively engaged in tax litigation are more likely to uphold higher levels of financial integrity.

Next, we examine how litigating the IRS is related to restatements. To do so, we look at four categories of restatements: (1) all restatements cases (*Restate*), (2) Big R restatements, which are material restatements requiring reissuance and 8-K disclosure (*BigR_Restate*), (3) irregularity restatements (*Irreg_Restate*), and (4) tax-related restatements (*Tax_Restate*). We then re-estimate Equation (3) and present the results in Table 5.[5]

[5] The sample size in Column 2 of Table 5 examining the relation between *Litigate* and *BigR_Restate* is smaller than the remaining columns because Audit Analytics' coverage of Big R Restatements began in 2004. Accordingly, we restrict our sample used to examine the relation between *Litigate* and *BigR_Restate* to observations starting in 2004.

In column 1, using *Restate* as the dependent variable, we find a positive and significant coefficient on *Litigate* ($p < 0.01$), suggesting that, for litigating firms, there is a 7.7% lower likelihood of issuing any type of restatement compared to non-litigating firms. Column 2 shows a similarly negative and significant relationship for *BigR_Restate*, with a coefficient of -0.030 on *Litigate* ($p < 0.01$), suggesting that litigating firms are 3.0% less likely to issue material restatements. In column 3, we use restatements due to irregularities (*Irreg_Restate*) as the dependent variable and again find a negative coefficient of -0.038 on *Litigate* ($p < 0.01$), indicating a 3.8% reduced likelihood of irregularities in financial reporting for litigating firms. Lastly, column 4 examines tax-related restatements (*Tax_Restate*) and finds a coefficient of -0.029 ($p < 0.01$), supporting the conclusion that firms litigating the IRS are approximately 2.9% less likely to restate tax-related financial information. Overall, the results from Table 5 suggest that litigating the IRS serves as a potential indicator of higher accounting quality, as firms engaged in such litigation appear to be more attentive in avoiding restatements, particularly those that are material, irregular, and tax-related.

5.3 Additional Analyses - Corporate Violations and Litigation by Court Venue

5.3.1 Corporate Violations

As a supplemental test, we also examine whether litigating firms are less likely to commit other forms of corporate misconduct. To examine this outcome, we use the Violation Tracker data from Good Jobs First. Although the Violation Tracker data tracks all corporate violations with penalties of $5,000 or more, we expect the litigation signal to be more informative of violations that result in more severe penalties as opposed to violations that are likely immaterial to the firm. Accordingly, we restrict our sample of violations to those with penalty amounts of $500,000 or

greater and estimate the following equation by OLS to test the association between tax litigation and the likelihood of corporate violations:

$$Violation_{i,t} = \gamma_0 + \gamma_1 Litigate_{i,t} + ViolationControls + \gamma_2 IRS\_Exposure_{i,t} + IndustryFE + YearFE + \varepsilon_{i,t} \quad (4)$$

where *Violation* represents either an indicator for whether a firm commits at least one violation in a given year (*Viol_Ind*) or the natural log of one plus the total penalty amount from violations committed in a given year (*Viol_Penalty*) (Raghunandan 2024). We include a set of controls (*ViolationControls*) for firm characteristics based on prior studies as well as industry and year fixed effects (Yost and Yu 2023; Raghunandan 2021, 2024). Similar to our primary hypothesis, we expect that litigating firms will commit significant violations at a lower rate.

In Table 6, we report the results from estimating Equation (4). For both dependent variables, we find a negative and significant relation for *Litigate*. Specifically, column 1 shows a negative and significant coefficient on *Litigate* (-0.053, $p < 0.05$), indicating that firms engaged in tax litigation are 5.3% less likely to commit corporate violations. Likewise, column 2 shows a negative relationship for *Viol_Penalty* (-0.819, $p < 0.05$), suggesting that litigating firms face approximately 56% lower penalty amounts compared to non-litigating firms.[6] These findings suggest that, after controlling for various firm characteristics, tax litigation is associated with a lower incidence of corporate violations and smaller penalties for violations, suggesting that litigating firms maintain higher compliance standards and are less likely to commit other forms of corporate malfeasance.

[6] The exponential of -0.819 minus one is equal to -0.559.

5.3.2 Cross Sectional Test of Litigation by Court Venue

We next investigate whether the effect of tax litigation on financial misreporting varies by court venue. Specifically, we differentiate between cases litigated in the Tax Court and those in non-Tax Court venues (i.e., U.S. District Courts and the U.S. Court of Federal Claims). Although we expect tax litigation to be a useful signal across all venues, we posit that the signal may be stronger in non-tax court venues because of differences in the level of scrutiny faced by firms in non-tax court venues relative to the Tax Court. Specifically, the discovery process for cases tried in the Tax Court are subject to a less formal discovery process, whereas cases tried in U.S. District Courts and the U.S. Court of Federal Claims are subject to a more formal discovery process that is both lengthier and broader in scope. Additionally, firms that wish to litigate the IRS are not required to prepay their tax liability to initiate a case in the Tax Court, whereas firms are required to prepay their tax liability to initiate a case in the non-Tax Court venues. Accordingly, we predict that the association between tax litigation and accounting quality will be more pronounced when firms litigate in non-Tax Court venues relative to the Tax Court.

Table 7 presents the results of this analysis. In Panel A, we find that litigation in both Tax Court and non-Tax Court venues is associated with a reduced likelihood of all types of fraud (*AllFraud*) and restatements (*Restate*) (columns 1 and 3, respectively), consistent with the signal remaining relatively informative across all court venues. For example, in column 3, the coefficient on *TaxCourt* (*NonTaxCourt*) is -0.073 ($p < 0.05$) (coefficient = -0.079, $p < 0.05$), indicating a 7.3% (7.9%) lower likelihood of issuing a restatement for firms litigating in the Tax Court (non-Tax Courts). In contrast, the results in column (2) suggest that only litigation in non-Tax Court venues is negatively associated with accounting fraud as the coefficient on *NonTaxCourt* is negative and significant (coefficient = -0.039, $p < 0.01$) but the coefficient on *TaxCourt* is not significant at

conventional levels ($p > 0.10$). Moreover, the difference in the coefficients between *TaxCourt* and *NonTaxCourt* is marginally significant ($p = 0.11$), providing evidence consistent with our prediction that the signal is stronger for firms litigating in non-Tax Court venues. Similarly, when we examine Big R restatements in column (4), only litigation in non-Tax Court venues is negatively associated with Big R restatements as the coefficient on *NonTaxCourt* is negative and significant (coefficient = -0.042, $p < 0.01$) but the coefficient on *TaxCourt* is not significant at conventional levels ($p > 0.10$).

In Panel B, we examine corporate violations and find that firms litigating in non-Tax Court venues are associated with a significantly lower likelihood of committing violations (*Viol_Ind*) and facing lower penalties (*Viol_Penalty*), with coefficients of -0.085 ($p < 0.05$) and -1.324 ($p < 0.05$), respectively. However, we do not find a significant effect of Tax Court litigation on corporate violations, supporting our conjecture that the effect of tax litigation is likely to be stronger in non-Tax Court venues. In sum, the results of Table 7 provide evidence that the effect of tax litigation is stronger for firms litigating in non-Tax Court venues relative to the Tax Court for accounting specific fraud, Big R restatements, and corporate violations.

5.4 Omitted Variable Bias

5.4.1 Impact Threshold for a Confounding Variable

We recognize that financial misreporting and tax litigation are likely influenced by various endogenous factors. Therefore, our documented results may be affected by correlated omitted variables that impact both tax litigation and the likelihood of financial misreporting. To address this concern, we follow prior studies (Larcker and Rusticus 2010; Christensen, Mikhail, Walther, and Wellman 2017; Call, Martin, Sharp, and Wilde 2018) and use the impact threshold for a confounding variable (ITCV). This method quantifies the sensitivity of our results to a potentially

confounding omitted variable. Specifically, the ITCV indicates how difficult it would be for an omitted variable to overturn the significant relationship we have documented between tax litigation and financial misreporting. A high ITCV suggests that the results are robust to omitted variables, while a low ITCV implies the opposite.

Based on the OLS results from Table 4, we compute the ITCV for our key measures of financial misreporting in Panel A of Table 8. The ITCV for *AllFraud* is 0.0019 and for *AcctgFraud* is 0.0020. This implies that the raw correlations between an unobserved confounding variable and *AllFraud* or *AcctgFraud* would need to exceed 0.044 and 0.045, respectively, to invalidate the significant relationship between tax litigation and misreporting. To put this in context, it would require a confounding variable with a larger impact than several of the strongest control variables in our model to overturn the results. Overall, assuming our model contains a good set of control variables, the likelihood that an omitted variable is driving our results appears low given that we primarily base our set of controls on variables used in fraud prediction models from prior studies (Dechow et al. 2011; Donelson et al. 2021).

5.4.2 Unobservable Selection and Coefficient Stability (Oster, 2019)

While the ITCV addresses the concern of a single source of selection bias, it is possible that multiple confounders could influence our results. To account for this, we follow Oster (2019) and apply the coefficient of proportionality, denoted as δ, which quantifies the extent of unobserved selection necessary to overturn the documented results. This method relies on changes in the coefficient for *Litigate* and the overall R-squared value before and after including observed controls. We use an R_{max} of 1.3 multiplied by the R-squared from the OLS regressions in Table 4 to compute δ. Oster (2019) suggests that values of δ greater than 1.00 provide evidence of robustness.

In Panel B of Table 8, we report the estimates of δ. For *AllFraud* and *AcctgFraud*, we find a δ of 3.055 and 2.813, respectively. These results indicate that unobservable factors would need to be more than three times as important as observable control variables to invalidate the results for *AllFraud*, and nearly three times for *AcctgFraud*. In summary, these findings suggest that unobservable selection is unlikely to drive the relationship between tax litigation and financial misreporting. Therefore, we can conclude that the results are robust to both observable and unobservable factors.

6. Conclusion

This study examines whether a firm's decision to engage in tax litigation against the IRS provides a valuable signal about its likelihood of fraud and the overall quality of its financial reporting. We predict that firms are unlikely to engage in tax litigation unless they are confident in the accuracy and integrity of their financial information. Consistent with our expectations, we find that engaging in tax litigation is negatively associated with the likelihood of fraud, restatements, and other forms of corporate malfeasance.

Our results contribute to the broader literature on fraud prediction by demonstrating that managerial actions—specifically, the decision to litigate against tax authorities—can serve as signals of a firm's accounting quality. This shifts the focus from conventional indicators, like financial disclosures, towards actions that reveal management's confidence in the firm's financial reporting practices. Furthermore, by identifying litigation as a signal of accounting quality, our findings raise important implications for regulators and investors, who can focus on tax litigation activities as a way to better identify firms that are less likely to engage in fraudulent activities and that demonstrate a higher level of diligence in their financial reporting.

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Appendix A. Variable definitions

Variable	*Definition*
AcctgFraud	An indicator variable equal to 1 if the class period of a settled securities class action lawsuit alleging fraud due to GAAP violations overlaps with any part of the firm-year, and 0 otherwise. (DKMY)
Actual_Issuance	An indicator variable equal to 1 if the value of share issuance (SSTK) or long-term debt issuance (DLTIS) is positive, and 0 otherwise. (CS)
AllFraud	An indicator variable equal to 1 if the class period of a settled securities class action lawsuit alleging fraud overlaps with any part of the firm-year, and 0 otherwise. (DKMY)
BigN	An indicator variable equal to 1 if the auditor (AU) in the year is one of the Big N auditors, and 0 otherwise. (CS)
BigR_Restate	An indicator variable equal to 1 if the financial statements in the year are subsequently restated due to a material error requiring an 8-K disclosure, and 0 otherwise. (AA)
BTM	The book value of equity (CEQ) divided by the market value of equity (PRCC_F*CSHO). (CS)
CAR	The sum of monthly abnormal stock returns over the fiscal year. Abnormal stock returns are calculated as the monthly stock return minus the monthly return from the value-weighted index. (CRSP)
Cash	Cash and cash equivalents (CHE), scaled by beginning of year total assets (AT). (CS)
Chg_CashSales	The percentage change in cash sales from year t-1 to year t. Cash sales are measured as sales (SALE) minus the change in receivables (RECT) from year t-1 to year t. (CS)
Chg_Inventory	The change in inventory (INVT) from year t-1 to year t, scaled by the average of total assets (AT) from year t-1 to year t. (CS)
Chg_Receivables	The change in receivables (RECT) from year t-1 to year t, scaled by the average of total assets (AT) from year t-1 to year t. (CS)
ChgROA	The change in return on assets from year t-1 to year t. Return on assets is calculated as income before extraordinary items (IB) divided by the average of total assets (AT) from year t-1 to year t. (CS)
Disc&Extra	An indicator variable equal to 1 if extraordinary items and discontinued operations (XIDOC) is greater than 1% of total revenue (REVT), and 0 otherwise. (CS)
ForeignTax	An indicator variable equal to 1 if foreign tax expense (TXFO) is nonzero and not missing, and 0 otherwise. (CS)
FraudControls	The vector of control variables used in to estimate the effect of tax litigation on the likelihood of fraud and the likelihood of restatements, including *RSST_Accruals*, *Chg_Receivables*, *Chg_Inventory*, *SoftAssets*, *Chg_CashSales*, *ChgROA*,

	Actual_Issuance, *LitigiousIndustry*, *SalesGrowth*, *Size*, *ReturnVolatility*, *CAR*, *ReturnSkewness*, *ShareTurnover*, and *BigN*.
Irreg_Restate	An indicator variable equal to 1 if the financial statements in the year are subsequently restated due to an irregularity, and 0 otherwise. We define an irregularity as a restatement flagged by Audit Analytics as involving "Financial Fraud, Irregularities, and Misrepresentations", an SEC investigation, or securities class action litigation, following Hobson et al. (2012). (AA)
IRS_Exposure	The number of sentences referring to the IRS and a related "action word," divided by the total number of sentences in the firm's 10-K. (AGH)
Leverage	Long-term debt, scaled by beginning of year total assets (AT). (CS)
Litigate	An indicator variable equal to 1 if the firm has active litigation against the IRS at any point during the year, and 0 otherwise. Active litigation involves only cases where the court renders a judgment. (HC)
LitigiousIndustry	An indicator variable equal to 1 if the firm's industry code is equal to any of the industries identified by Francis et al. (1994) as litigious, and 0 otherwise. (CS)
LogEmployees	The natural log of the number of employees (EMP). (CS)
LogMVE	The natural log of the market value of equity (PRCC_F*CSHO). (CS)
Loss	An indicator variable equal to 1 if net income (NI) is negative, and 0 otherwise. (CS)
Misreport	Either *AllFraud*, *AcctgFraud*, *Restate*, *BigR_Restate*, *Irreg_Restate*, or *Tax_Restate*.
NonTaxCourt	An indicator variable equal to 1 if the firm has active litigation against the IRS in the U.S. FCC or in any of the U.S. District Courts at any point during the year, and 0 otherwise. Active litigation involves only cases where the court renders a judgment. (HC)
Predicted_UTB	The firm's predicted UTB, following the prediction model in Rego and Wilson (2012). (CS)
PTBI_Vol	The standard deviation of the firm's scaled pre-tax income (PI / AT) from year t-4 to year t. (CS)
R&D	R&D expense (XRD), scaled by beginning of year total assets (AT). Missing values of XRD are set to zero. (CS)
Restate	An indicator variable equal to 1 if the financial statements in the year are subsequently restated, and 0 otherwise. (AA)
ReturnSkewness	The skewness of the monthly stock returns over the fiscal year. (CRSP)
ReturnVolatility	The standard deviation of the monthly stock returns over the fiscal year. (CRSP)
ROA	Net income (NI) divided by beginning of year total assets (AT). (CS)

RSST_Accruals	Change in working capital accruals plus change in long-term operating assets plus change in long-term operating liabilities, scaled by the average of total assets (AT) from year t-1 to year, following Dechow et al. (2011) and Richardson et al. (2006). (CS)
SalesGrowth	Change in sales (SALE) from year t-1 to year t, scaled by beginning of year total assets (AT). (CS)
ShareTurnover	The total trading volume of the firm's shares during the fiscal year divided by beginning of year shares outstanding. (CRSP)
Size	The natural log of total assets (AT). (CS)
SoftAssets	Total assets (AT) minus net property, plant, and equipment (PPENT) minus cash and cash equivalents (CHE), scaled by the average of total assets (AT) from year t-1 to year t. (CS)
Tax_Restate	An indicator variable equal to 1 if the financial statements in the year are subsequently restated due to a tax-related restatement, and 0 otherwise. We identify tax-related restatements by keyword search in the "Accounting Rule (GAAP/FASB) Application Failures" field in Audit Analytics. (AA)
TaxAQ	The standard deviation of the residuals from year t-4 to year t, estimated from the cross-sectional industry tax accrual quality model in Choudhary et al. (2016) and Drake et al. (2024). We multiply the standard deviation by negative one. We require at least 20 observations for each 2-digit SIC industry and year combination. (CS)
TaxCourt	An indicator variable equal to 1 if the firm has active litigation against the IRS in the U.S. Tax Court at any point during the year, and 0 otherwise. Active litigation involves only cases where the court renders a judgment. (HC)
TaxLoss	An indicator variable equal to 1 if the current tax expense (TXC) is less than zero, and 0 otherwise. (CS)
Trend	A time trend variable measured as the current fiscal year minus the first fiscal year in the sample period. (CS)
Violation	Either *Viol_Ind* or *Viol_Penalty*
ViolationControls	The vector of control variables used in to estimate the effect of tax litigation on the corporate violations, including *Size*, *BTM*, *ROA*, *Leverage*, *Loss*, *R&D*, *Cash*, *CAR*, *ReturnVolatility*, *SalesGrowth*, *ChgROA*, *LogEmployees*, and *BigN*.
Viol_Ind	An indicator variable equal to 1 if the firm has at least one corporate violation with penalty of at least $500,000 in the year, and 0 otherwise. (GJF)
Viol_Penalty	The natural log of one plus the sum of penalties from violations with penalties of at least $500,000 in the year. (GJF)

Data Sources:

AA: Audit Analytics

AGH: IRS exposure data from Armstrong et al. (2024)

CRSP:	CRSP
CS:	Compustat Fundamentals Annual or Compustat Segments
DKMY:	Securities class action data on fraud cases from Donelson et al. (2021)
GJF:	Good Jobs First Violation Tracker
HC:	Hand-collected case data from Bloomberg Law, the Federal Judicial Center, PACER, the U.S. Court of Federal Claims website and the U.S. Tax Court website

Table 1
Sample and Case Distribution

Panel A: Sample Selection

	Firm-Years	Case-Years	Cases
Total firm-years between 2000 and 2017 in Compustat	170,699	766	238
Less: missing CIK to match to Audit Analytics and Good Jobs First Data	(20,310)	(12)	(4)
Less: firms that are incorporated outside the US	(19,270)	(50)	(12)
Less: firms with headquarters outside of the US	(24,627)	(25)	(7)
Less: firms in Financial (SIC 6000 - 6999) and Utility (SIC 4900 - 4999) industries	(29,065)	(237)	(75)
Less: firm-years with missing values for variables in H1 tests	(31,143)	(104)	(39)
Sample used to test H1	**46,284**	**338**	**101**
Less: firm-years with missing values for variables in tax accrual quality tests	(21,276)	(113)	(25)
Sample used for tax accrual quality test	**25,008**	**225**	**76**

Table 1, continued

Panel B: Unique dockets (cases) by filing year

Year	U.S. Tax Court	U.S. Court of Federal Claims	U.S. District Courts	Total Dockets
1990	1	1	0	2
1991	0	0	0	0
1992	0	0	0	0
1993	0	0	0	0
1994	1	0	0	1
1995	4	2	0	6
1996	3	3	0	6
1997	8	1	1	10
1998	2	1	1	4
1999	5	0	0	5
2000	4	1	1	6
2001	0	5	2	7
2002	2	0	1	3
2003	0	3	3	6
2004	1	0	0	1
2005	0	1	2	3
2006	2	3	1	6
2007	2	0	0	2
2008	2	0	0	2
2009	2	0	1	3
2010	2	0	1	3
2011	5	0	0	5
2012	6	2	0	8
2013	1	2	0	3
2014	1	1	1	3
2015	1	0	1	2
2016	2	0	2	4
2017	0	0	0	0
	57	26	18	101

Table 1, continued

Panel C: Number of dockets (cases) active by year

Year	U.S. Tax Court	U.S. Court of Federal Claims	U.S. District Courts	Total Dockets	Total Firms
2000	24	7	3	34	27
2001	19	14	4	37	30
2002	16	10	4	30	25
2003	12	12	6	30	26
2004	11	11	5	27	23
2005	8	11	7	26	22
2006	10	11	6	27	23
2007	10	9	3	22	19
2008	10	8	3	21	18
2009	11	5	3	19	16
2010	12	3	3	18	15
2011	15	1	2	18	14
2012	19	3	0	22	15
2013	15	5	0	20	13
2014	16	3	1	20	13
2015	15	3	2	20	14
2016	15	2	4	21	14
2017	9	1	3	13	11
	247	119	59	425	338

This table presents our sample selection and the distribution of our case sample. Panel A presents our sample selection. Panel B presents the distribution of unique cases in our sample by the initial filing year of the case. Panel C presents the number of cases active by year in our sample period.

Table 2
Descriptive Statistics

Panel A: Summary Statistics

Variables	(1) N	(2) mean	(3) sd	(4) p25	(5) p50	(6) p75
***Litigate* and Outcome Variables**						
Litigate	46,284	0.007	0.085	0.000	0.000	0.000
TaxAQ	25,008	-0.016	0.011	-0.021	-0.013	-0.008
AllFraud	46,284	0.036	0.187	0.000	0.000	0.000
AcctgFraud	46,284	0.020	0.141	0.000	0.000	0.000
Restate	46,284	0.165	0.372	0.000	0.000	0.000
BigR_Restate	33,487	0.074	0.262	0.000	0.000	0.000
Irreg_Restate	46,284	0.068	0.252	0.000	0.000	0.000
Tax_Restate	46,284	0.036	0.186	0.000	0.000	0.000
Viol_Ind	46,284	0.037	0.188	0.000	0.000	0.000
Viol_Penalty	46,284	0.563	2.897	0.000	0.000	0.000
Control Variables						
Actual_Issuance	46,284	0.886	0.318	1.000	1.000	1.000
BigN	46,284	0.786	0.410	1.000	1.000	1.000
BTM	46,284	0.571	0.637	0.239	0.442	0.756
CAR	46,284	0.077	0.554	-0.209	0.050	0.329
Cash	46,284	0.242	0.293	0.040	0.135	0.338
Chg_CashSales	46,284	0.135	0.522	-0.045	0.061	0.195
Chg_Inventory	46,284	0.004	0.037	-0.003	0.000	0.013
Chg_Receivables	46,284	0.007	0.050	-0.010	0.004	0.025
ChgROA	46,284	-0.006	0.155	-0.041	-0.001	0.032
Disc&Extra	25,008	0.019	0.138	0.000	0.000	0.000
ForeignTax	25,008	0.642	0.479	0.000	1.000	1.000
IRS_Exposure	46,284	0.058	0.092	0.000	0.000	0.081
Leverage	46,284	0.193	0.236	0.000	0.117	0.299
LitigiousIndustry	46,284	0.395	0.489	0.000	0.000	1.000
LogEmployees	46,284	0.360	2.041	-1.165	0.346	1.818
LogMVE	46,284	6.035	2.095	4.527	6.035	7.436
Loss	46,284	0.371	0.483	0.000	0.000	1.000
Predicted_UTB	25,008	0.012	0.009	0.006	0.011	0.016
PTBI_Vol	25,008	0.098	0.433	0.027	0.051	0.101
R&D	46,284	0.066	0.121	0.000	0.008	0.083
ReturnSkewness	46,284	0.308	0.837	-0.253	0.259	0.816
ReturnVolatility	46,284	0.148	0.097	0.083	0.122	0.183
ROA	46,284	-0.036	0.237	-0.064	0.030	0.081
RSST_Accruals	46,284	0.010	0.189	-0.053	0.018	0.083
SalesGrowth	46,284	0.076	0.265	-0.029	0.052	0.167
ShareTurnover	46,284	2.202	2.138	0.786	1.594	2.837
Size	46,284	6.018	1.954	4.573	5.939	7.373
SoftAssets	46,284	0.556	0.261	0.358	0.577	0.755
TaxLoss	25,008	0.118	0.323	0.000	0.000	0.000
Trend	46,284	7.661	5.154	3.000	7.000	12.000

Table 2, continued

Panel B: Outcome Variables partitioned by *Litigate*

	Litigate = 1		Litigate = 0		Difference		
Outcome	Mean	N	Mean	N	Mean	p-value	
TaxAQ	-0.011	225	-0.016	24,783	0.005	0.000	***
AllFraud	0.018	338	0.037	45,946	-0.019	0.066	*
AcctgFraud	0.009	338	0.020	45,946	-0.011	0.133	
Restate	0.053	338	0.166	45,946	-0.113	0.000	***
BigR_Restate	0.013	338	0.075	33,257	-0.062	0.000	***
Irreg_Restate	0.030	338	0.069	45,946	-0.039	0.005	***
Tax_Restate	0.012	338	0.036	45,946	-0.024	0.017	**
Viol_Ind	0.207	338	0.035	45,946	0.172	0.000	***
Viol_Penalty	3.241	338	0.544	45,946	2.697	0.000	***

Table 2, continued

Panel C: Summary Statistics - Entropy Balancing

	Before Entropy Balancing					After Entropy Balancing			
	Treat		Control			Treat		Control	
	Mean	Variance	Mean	Variance		Mean	Variance	Mean	Variance
LogMVE	9.254	2.646	6.012	4.326	*LogMVE*	9.254	2.646	9.252	2.645
Leverage	0.216	0.019	0.193	0.056	*Leverage*	0.216	0.019	0.216	0.019
ROA	0.060	0.007	-0.037	0.057	*ROA*	0.060	0.007	0.060	0.007
IRS_Exposure	0.125	0.015	0.057	0.008	*IRS_Exposure*	0.125	0.015	0.125	0.015
Trend	7.027	26.150	7.665	26.560	*Trend*	7.027	26.150	7.025	26.140
2nd Circuit	0.101	0.091	0.102	0.091	*2nd Circuit*	0.101	0.091	0.101	0.091
3rd Circuit	0.074	0.069	0.086	0.078	*3rd Circuit*	0.074	0.069	0.074	0.069
4th Circuit	0.145	0.124	0.064	0.060	*4th Circuit*	0.145	0.124	0.145	0.124
5th Circuit	0.112	0.100	0.102	0.092	*5th Circuit*	0.112	0.100	0.113	0.100
6th Circuit	0.107	0.095	0.073	0.068	*6th Circuit*	0.107	0.095	0.107	0.095
7th Circuit	0.083	0.076	0.071	0.066	*7th Circuit*	0.083	0.076	0.083	0.076
8th Circuit	0.062	0.058	0.063	0.059	*8th Circuit*	0.062	0.058	0.062	0.058
9th Circuit	0.192	0.156	0.251	0.188	*9th Circuit*	0.192	0.156	0.193	0.155
10th Circuit	0.027	0.026	0.047	0.045	*10th Circuit*	0.027	0.026	0.027	0.026
11th Circuit	0.062	0.058	0.070	0.065	*11th Circuit*	0.062	0.058	0.062	0.058
DC Circuit	0.000	0.000	0.003	0.003	*DC Circuit*	0.000	0.000	0.000	0.000

This table presents descriptive statistics for our sample. Panel A presents summary statistics for variables used in our empirical analyses. Panel B presents the difference in means for our outcome variables partitioned on *Litigate*. Panel C presents summary statistics before and after entropy balancing, estimating weights from Equation (1). The 1st Circuit indicator is omitted as the baseline group for the circuit fixed effects. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All continuous variables are winsorized at the 1st and 99th percentile. All variables are defined in Appendix A.

Table 3
Tax Litigation and Tax Accrual Quality

	Dependent Variable: *TaxAQ*	
Variables	(1) Baseline	(2) Add Controls
Litigate	**0.002***	**0.002*****
	(1.86)	**(2.77)**
Disc&Extra		-0.000
		(-0.33)
PTBI_Vol		-0.022***
		(-3.71)
TaxLoss		-0.006***
		(-3.88)
ForeignTax		-0.001
		(-0.80)
Size		0.001**
		(2.06)
Predicted_UTB		-0.071
		(-1.23)
IRS_Exposure		-0.004
		(-1.63)
Observations	25,008	25,008
Adjusted R-squared	0.118	0.221
SE Cluster	Firm	Firm
Industry FE	Yes	Yes
Year FE	Yes	Yes

This table presents the results of Equation (2), estimating the effect of tax litigation on tax accrual quality. *TaxAQ* is the dependent variable. The sample is entropy balanced based on the covariates in Equation (1). Column (1) presents the results without control variables. Column (2) presents the results with control variables. Standard errors are clustered by firm. Robust t-statistics are presented in parentheses. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All variables are defined in Appendix A.

Table 4
Tax Litigation and Fraud

Dependent Variable:	(1) *AllFraud*	(2) *AcctgFraud*
Litigate	**-0.034*** **	**-0.029*** **
	(-2.99)	**(-3.00)**
RSST_Accruals	-0.051	-0.016
	(-0.84)	(-0.62)
Chg_Receivables	-0.130	-0.021
	(-0.94)	(-0.18)
Chg_Inventory	0.116	-0.068
	(0.80)	(-0.65)
SoftAssets	0.028	0.048*
	(0.88)	(1.83)
Chg_CashSales	0.004	-0.000
	(0.24)	(-0.04)
ChgROA	-0.034	-0.045
	(-0.64)	(-1.12)
Actual_Issuance	0.016	0.005
	(1.04)	(0.42)
LitigiousIndustry	0.092***	0.071**
	(3.24)	(2.49)
SalesGrowth	0.057**	0.050**
	(2.45)	(2.49)
Size	0.022***	0.012***
	(4.28)	(3.26)
ReturnVolatility	0.562***	0.340***
	(4.57)	(3.12)
CAR	-0.068***	-0.045***
	(-4.49)	(-3.26)
ReturnSkewness	0.005	-0.000
	(0.86)	(-0.10)
ShareTurnover	0.000	0.001
	(0.11)	(0.42)
BigN	-0.040***	-0.017*
	(-2.76)	(-1.77)
IRS_Exposure	-0.038	-0.055**
	(-1.18)	(-2.26)
Observations	46,284	46,284
Adjusted R-squared	0.122	0.095
SE Cluster	Firm	Firm
Industry FE	Yes	Yes
Year FE	Yes	Yes

This table presents the results of Equation (3), estimating the effect of tax litigation on the likelihood of fraud. The sample is entropy balanced based on the covariates in Equation (1). Column (1) presents the results with *AllFraud* as the dependent variable. Column (2) presents the results with *AcctgFraud* as the dependent variable. Standard errors are clustered by firm. Robust t-statistics are presented in parentheses. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All variables are defined in Appendix A.

Table 5
Tax Litigation and Restatements

	(1)	(2)	(3)	(4)
Dependent Variable:	*Restate*	*BigR_Restate*	*Irreg_Restate*	*Tax_Restate*
Litigate	**-0.077*** **	**-0.030*** **	**-0.038*** **	**-0.029*** **
	(-4.77)	**(-3.85)**	**(-3.22)**	**(-4.07)**
RSST_Accruals	-0.125**	-0.057	-0.089**	-0.019
	(-2.04)	(-1.00)	(-1.98)	(-1.23)
Chg_Receivables	-0.091	-0.033	0.065	-0.063
	(-0.36)	(-0.40)	(0.58)	(-1.23)
Chg_Inventory	-0.164	-0.389	-0.317	0.089
	(-0.45)	(-1.00)	(-0.93)	(1.51)
SoftAssets	0.044	-0.009	0.074**	0.000
	(0.98)	(-0.41)	(2.11)	(0.01)
Chg_CashSales	0.008	-0.016	0.028*	0.004
	(0.39)	(-0.79)	(1.70)	(0.52)
ChgROA	-0.063	0.000	0.033	-0.013
	(-0.90)	(0.01)	(0.62)	(-0.68)
Actual_Issuance	0.021	-0.026	0.020	-0.018
	(0.86)	(-1.09)	(0.78)	(-1.04)
LitigiousIndustry	-0.001	0.023*	0.018	0.008
	(-0.06)	(1.76)	(0.99)	(0.55)
SalesGrowth	0.105	0.035	0.054	-0.026*
	(1.53)	(0.54)	(1.00)	(-1.76)
Size	-0.017***	-0.018***	-0.001	-0.002
	(-2.60)	(-2.80)	(-0.18)	(-0.95)
ReturnVolatility	0.698***	0.043	0.337***	0.119**
	(3.62)	(0.38)	(2.60)	(2.11)
CAR	-0.035*	-0.033**	-0.024	-0.011**
	(-1.81)	(-2.47)	(-1.63)	(-2.16)
ReturnSkewness	0.002	-0.007	-0.000	0.002
	(0.22)	(-1.18)	(-0.01)	(0.81)
ShareTurnover	0.002	0.006*	0.004	-0.002
	(0.36)	(1.88)	(1.12)	(-1.10)
BigN	-0.001	-0.055	0.018	0.016
	(-0.02)	(-0.87)	(1.18)	(1.46)
IRS_Exposure	-0.096**	-0.036	-0.036	-0.020
	(-2.17)	(-1.11)	(-1.22)	(-0.88)
Observations	46,284	33,487	46,284	46,284
Adjusted R-squared	0.129	0.109	0.114	0.104
SE Cluster	Firm	Firm	Firm	Firm
Industry FE	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes

This table presents the results of Equation (3), estimating the effect of tax litigation on the likelihood of restatement. The results are presented using *Restate*, *BigR_Restate*, *Irreg_Restate*, and *Tax_Restate* as the dependent variables. The sample is entropy balanced based on the covariates in Equation (1). Standard errors are clustered by firm. Robust t-statistics are presented in parentheses. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All variables are defined in Appendix A.

Table 6
Tax Litigation and Corporate Violations

Dependent Variable:	(1) *Viol_Ind*	(2) *Viol_Penalty*
Litigate	**-0.053****	**-0.819****
	(-2.22)	**(-2.17)**
Size	0.051***	0.809***
	(3.17)	(3.21)
BTM	-0.004	-0.004
	(-0.12)	(-0.01)
ROA	-0.101	-1.522
	(-0.68)	(-0.66)
Leverage	-0.110	-1.864
	(-1.51)	(-1.64)
Loss	0.064*	1.007*
	(1.72)	(1.70)
R&D	-0.281	-4.450
	(-1.14)	(-1.14)
Cash	0.105	1.677
	(1.42)	(1.47)
CAR	-0.046	-0.675
	(-1.54)	(-1.45)
ReturnVolatility	0.348	5.501
	(1.40)	(1.41)
SalesGrowth	-0.091	-1.393
	(-1.55)	(-1.53)
ChgROA	0.211*	3.566*
	(1.81)	(1.87)
LogEmployees	0.045***	0.723***
	(2.70)	(2.73)
BigN	-0.076**	-1.224**
	(-2.09)	(-2.20)
IRS_Exposure	-0.002	-0.233
	(-0.03)	(-0.18)
Observations	46,284	46,284
Adjusted R-squared	0.282	0.285
SE Cluster	Firm	Firm
Industry FE	Yes	Yes
Year FE	Yes	Yes

This table presents the results of Equation (4), estimating the effect of tax litigation on the likelihood and severity of corporate violations. The sample is entropy balanced based on the covariates in Equation (1). Column (1) presents the results with *Viol_Ind* as the dependent variable. Column (2) presents the results with *Viol_Penalty* as the dependent variable. Standard errors are clustered by firm. Robust t-statistics are presented in parentheses. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All variables are defined in Appendix A.

Table 7
Effect of Tax Litigation by Court Venue

Panel A: Fraud and Restatements

	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable:	*AllFraud*	*AcctgFraud*	*Restate*	*BigR_Restate*	*Irreg_Restate*	*Tax_Restate*
TaxCourt	**-0.034****	**-0.019**	**-0.073*****	**-0.018**	**-0.045****	**-0.027*****
	(-2.45)	**(-1.43)**	**(-2.73)**	**(-1.18)**	**(-2.22)**	**(-2.71)**
NonTaxCourt	**-0.034****	**-0.039*****	**-0.079*****	**-0.042*****	**-0.030**	**-0.030*****
	(-2.22)	**(-3.95)**	**(-3.51)**	**(-3.67)**	**(-1.58)**	**(-3.37)**
RSST_Accruals	-0.051	-0.017	-0.124**	-0.054	-0.089**	-0.019
	(-0.84)	(-0.63)	(-2.03)	(-0.97)	(-1.97)	(-1.23)
Chg_Receivables	-0.130	-0.018	-0.090	-0.035	0.063	-0.062
	(-0.94)	(-0.16)	(-0.35)	(-0.42)	(0.56)	(-1.21)
Chg_Inventory	0.118	-0.057	-0.156	-0.384	-0.322	0.092
	(0.83)	(-0.54)	(-0.42)	(-0.97)	(-0.93)	(1.53)
SoftAssets	0.028	0.054*	0.046	-0.005	0.070*	0.001
	(0.83)	(1.93)	(0.99)	(-0.24)	(1.91)	(0.06)
Chg_CashSales	0.004	0.000	0.009	-0.015	0.028*	0.004
	(0.25)	(0.02)	(0.42)	(-0.77)	(1.68)	(0.55)
ChgROA	-0.034	-0.045	-0.063	-0.002	0.033	-0.013
	(-0.63)	(-1.14)	(-0.89)	(-0.08)	(0.63)	(-0.67)
Actual_Issuance	0.016	0.005	0.022	-0.025	0.020	-0.018
	(1.05)	(0.39)	(0.85)	(-1.11)	(0.79)	(-1.04)
LitigiousIndustry	0.092***	0.070**	-0.001	0.020	0.019	0.007
	(3.28)	(2.53)	(-0.07)	(1.61)	(1.05)	(0.54)
SalesGrowth	0.057**	0.047**	0.103	0.030	0.055	-0.027*
	(2.33)	(2.31)	(1.50)	(0.45)	(1.02)	(-1.72)
Size	0.022***	0.012***	-0.017***	-0.018***	-0.001	-0.002
	(4.29)	(3.27)	(-2.63)	(-2.89)	(-0.21)	(-0.93)
ReturnVolatility	0.560***	0.341***	0.695***	0.037	0.333***	0.118**
	(4.52)	(3.10)	(3.61)	(0.32)	(2.61)	(2.08)
CAR	-0.068***	-0.046***	-0.036*	-0.033**	-0.024	-0.011**
	(-4.46)	(-3.26)	(-1.83)	(-2.45)	(-1.64)	(-2.19)
ReturnSkewness	0.005	0.000	0.002	-0.006	-0.000	0.002
	(0.90)	(0.07)	(0.28)	(-1.06)	(-0.02)	(0.85)

Table 7, continued

ShareTurnover	0.000	0.001	0.002	0.006*	0.004	-0.002
	(0.11)	(0.44)	(0.35)	(1.93)	(1.11)	(-1.09)
BigN	-0.040***	-0.021*	-0.003	-0.061	0.021	0.015
	(-2.86)	(-1.80)	(-0.04)	(-0.96)	(1.25)	(1.29)
IRS_Exposure	-0.038	-0.062**	-0.098**	-0.041	-0.032	-0.021
	(-1.08)	(-2.27)	(-2.21)	(-1.28)	(-1.11)	(-0.97)
Observations	46,284	46,284	46,284	33,487	46,284	46,284
Adjusted R-squared	0.122	0.097	0.128	0.111	0.114	0.104
SE Cluster	Firm	Firm	Firm	Firm	Firm	Firm
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Test *TaxCourt = NonTaxCourt*						
F-test statistic	0.00	2.50	0.03	1.18	0.23	0.07
p-value	0.99	0.11	0.87	0.28	0.63	0.79

Table 7, continued

Panel B: Corporate Violations		
	(1)	(2)
Dependent Variable:	*Viol_Ind*	*Viol_Penalty*
TaxCourt	**-0.016**	**-0.222**
	(-0.50)	**(-0.44)**
NonTaxCourt	**-0.085****	**-1.324****
	(-2.32)	**(-2.31)**
Size	0.051***	0.816***
	(3.29)	(3.34)
BTM	-0.008	-0.069
	(-0.24)	(-0.13)
ROA	-0.099	-1.495
	(-0.64)	(-0.63)
Leverage	-0.107	-1.824
	(-1.49)	(-1.62)
Loss	0.067*	1.060*
	(1.79)	(1.77)
R&D	-0.336	-5.333
	(-1.40)	(-1.39)
Cash	0.099	1.577
	(1.42)	(1.48)
CAR	-0.047	-0.697
	(-1.59)	(-1.50)
ReturnVolatility	0.355	5.630
	(1.42)	(1.43)
SalesGrowth	-0.093	-1.418
	(-1.60)	(-1.58)
ChgROA	0.213*	3.609*
	(1.84)	(1.90)
LogEmployees	0.045***	0.724***
	(2.77)	(2.80)
BigN	-0.088**	-1.418**
	(-2.03)	(-2.13)
IRS_Exposure	-0.023	-0.571
	(-0.28)	(-0.44)
Observations	46,284	46,284
Adjusted R-squared	0.284	0.287
SE Cluster	Firm	Firm
Industry FE	Yes	Yes
Year FE	Yes	Yes
Test *TaxCourt = NonTaxCourt*		
F-test statistic	1.82	1.96
p-value	0.18	0.16

This table presents the results of estimating the effect of tax litigation by court venue on the likelihood of fraud, restatements, and corporate violations. *Litigate* is replaced by two variables denoting the court venue of the litigation: *TaxCourt* and *NonTaxCourt*. Panel A presents the results of Equation (3), using *AllFraud*, *AcctgFraud*, *Restate*, *BigR_Restate*, *Irreg_Restate*, and

Table 7, continued

Tax_Restate as the dependent variables. Panel B presents the results of Equation (4), using *Viol_Ind* and *Viol_Penalty* as the dependent variables. The sample is entropy balanced based on the covariates in Equation (1). Standard errors are clustered by firm. Robust t-statistics are presented in parentheses. A test of coefficient equality between *TaxCourt* and *NonTaxCourt* is presented at the bottom of each panel. ***, **, * indicate significance at the 0.01, 0.05, and 0.10 levels, respectively, using two-tailed tests. All variables are defined in Appendix A.

Table 8
Omitted Variable Bias

Panel A: Impact Threshold for a Confounding Variable (ITCV)

Dependent Variable:	(1) *AllFraud*		(2) *AcctgFraud*	
	ITCV	Impact	ITCV	Impact
Litigate	-0.0019		-0.0020	
RSST_Accruals		-0.0001		0.0000
Chg_Receivables		-0.0001		0.0000
Chg_Inventory		-0.0001		-0.0001
SoftAssets		0.0003		0.0007
Chg_CashSales		-0.0013		-0.0004
ChgROA		-0.0001		0.0000
Actual_Issuance		0.0001		0.0000
LitigousIndustry		-0.0009		-0.0005
SalesGrowth		-0.0002		-0.0002
Size		0.0055		0.0051
ReturnVolatility		-0.0058		-0.0031
CAR		0.0001		0.0000
ReturnSkewness		0.0003		0.0004
ShareTurnover		0.0001		0.0000
BigN		0.0011		0.0009
IRS_Exposure		-0.0016		-0.0015

Panel B: Unobservable Selection and Coefficient Stability

Model	(1) Coefficient on *Litigate* without controls	(2) Coefficient on *Litigate* with controls	(3) R^2 without Controls	(4) R^2 with Controls	(5) Π	(6) R_{max}	(7) δ
AllFraud	-0.045	-0.034	0.013	0.123	1.3	0.160	-3.055
AcctgFraud	-0.031	-0.029	0.010	0.097	1.3	0.126	-2.813

This table presents sensitivity tests for potentially correlated omitted variables. The sample is entropy balanced based on the covariates in Equation (1). In Panel A, we present the impact threshold for a confounding variable (ITCV) using the OLS results reported in Table 4. We provide both the ICTV and the impact score of the products of raw correlations. In Panel B, we follow Oster (2019) and present the sensitive of our results to unobservable selection and coefficient stability. This test uses information from movement in the coefficient of interest and explanatory power (R-squared) of linear regression models with and without controls. We present these changes across Columns (1) to (7). In each panel, we use the *AllFraud* and *AcctgFraud* as the dependent variables. All variables are defined in Appendix A.