Early Evidence on the Effects of Critical Audit Matters on Auditor Liability

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SUMMARY: The U.S. Public Company Accounting Oversight Board recently proposed changes to the audit reporting model that would require auditors to disclose areas of high audit risk within the audit report. Concerns about the proposal’s potential to increase auditor liability have been raised by practitioners and highlighted in the business press. In this paper, we review five recent experiments that directly relate to these concerns, identify patterns in the results, and discuss the implications of these findings for regulators and practitioners.

Keywords: PCAOB; audit reporting; auditor litigation; critical audit matters (CAMs).

INTRODUCTION

The U.S. Public Company Accounting Oversight Board (PCAOB) recently proposed significant changes to the audit reporting model that would require auditors to disclose critical audit matters (CAMs) in the audit report. CAMs discuss areas of the audit that required a significant amount of professional judgment to appropriately evaluate, or areas that posed the most difficulty in evaluating and obtaining evidence (PCAOB 2013a).\(^1\) While the intent of

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\(^1\) Similar to the PCAOB’s proposal, the International Auditing and Assurance Standards Board (IAASB) recently issued International Standard on Auditing 701, Communicating Key Audit Matters in the Independent Audit Report (IAASB 2015), which is effective for audits of financial statements for periods that end on or after December 15, 2016. For those audits conducted within the purview of the IAASB, auditors will be required to discuss Key Audit Matters (KAMs), which are items that were considered to be the most significant items encountered during the audit and would likely be communicated to those charged with governance (IAASB 2015).
the proposed standard is to make the audit report more informative to users, one of the most controversial aspects of this proposal is its potential effect on auditors’ legal liability (e.g., Tysiak 2013; PCAOB 2014). For example, in their response to the PCAOB concept release, the Center for Audit Quality stated, “The risk of increased liability that accompanies the form of report contemplated by the proposal is real and substantial … any expansion of the audit report is almost certain to lead to additional liability exposure for the independent auditor” (PCAOB 2013b, 33).

In response to this concern, several recent academic studies have investigated the potential effect of CAMs on auditor liability (Backof, Bowlin, and Goodson 2014; Brasel, Doxey, Grenier, and Reffett 2016; Brown, Majors, and Peecher 2015; Gimbar, Hansen, and Ozlanski 2016; Kachelmeier, Schmidt, and Valentine 2014). The intent of this paper is to summarize the preliminary findings and implications of these studies and to highlight characteristics of the CAM or the litigated accounting issue that may moderate the effects of CAM disclosures on auditor liability. Since the PCAOB has not finalized the audit reporting standard, the relevant research infers the potential influence of the regulatory change from experimental evidence. Participants in each experiment serve as evaluators of auditor liability, and the experimental instruments include various factors that may influence the relationship between CAM disclosures and auditor liability. We recognize that the final standard may differ from the current proposal, potentially limiting the generalizability of the results. However, a thorough consideration of this preliminary evidence is important since these studies provide insight into potential unintended consequences that could occur if the current version of the standard is adopted. Collectively, these results can inform the PCAOB standard-setting process and provide insight for practicing auditors as they plan for the potential change.

In the following section we discuss the design of the experiments, their preliminary results regarding the effects of CAMs on liability assessments, and additional factors that may moderate those relationships. Although we discuss the findings of each of the respective studies, because some have yet to be published and could change as a result of the academic peer-review process, we limit our inferences to areas where multiple studies report consistent results and to the experimental manipulations in these studies, which are theoretically supported. We follow this with a discussion of the implications of the results for regulators and auditing practice. We then conclude with a summary of the general pattern of the results and recommend areas for future research that could inform both theory and practice.

THE EXISTING EVIDENCE

In each of the experiments, participants evaluate the auditor’s liability for allegedly failing to detect a material misstatement in the client’s financial statements. Several of the studies consider additional circumstances that could alter the effect of CAMs on auditor liability. Since the design features of the studies influence their results, it is essential to consider the sum of the evidence before drawing implications. We therefore begin by providing a brief summary of the primary characteristics and the preliminary results of each study.

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2 We note that Kachelmeier et al. (2014) asked participants to evaluate the auditor’s responsibility and liability associated with the misstatement, but they did not explicitly indicate that the participants should assume the role of a juror in a civil liability trial. However, for the sake of parsimony, we will refer to all of the studies as evaluating auditor liability.
Summary of Individual Studies

Backof et al. (2014) investigate the effects of CAMs and the inclusion of language that clarifies the term “reasonable assurance” in the audit report. CAMs are considered at three levels: no CAM, a CAM that specifically relates to the litigated issue (related CAM), or a related CAM that also describes the audit procedures performed in response to the disclosed risks. Participants are undergraduate business students, who are often used as proxies for jurors (e.g., Kadous 2001). Relying on the Culpable Control Model of blame attribution, the authors hypothesize and find that the presence of a related CAM that includes a discussion of audit procedures performed increases jurors’ assessments of the foreseeability of the misstatement, which, in turn, increases auditor liability assessments. This effect decreases, however, with clarification of the term “reasonable assurance,” suggesting that such clarification mitigates perceived auditor liability.

Similarly, Kachelmeier et al. (2014) also use the Culpable Control Model to consider the effects on auditor liability of CAMs that include or exclude a description of the procedures performed to respond to the identified risks. The authors ask M.B.A. students, who serve the dual role of proxies for both nonprofessional investors and informed jurors, to consider the effects of four levels of CAM disclosure: the current audit reporting model, a related CAM, a CAM that discusses a high-risk accounting issue that is different from the accounting issue identified in subsequent litigation (unrelated CAM), or a statement that CAMs are required but that none were present. The authors find that auditor liability is significantly lower when a related CAM is disclosed relative to the disclosure of an unrelated CAM. They attribute this result to a related CAM serving as a warning to financial statement users and therefore as a “disclaimer” of auditor liability for the identified high-risk areas. Liability assessments in either of the no CAM conditions are observed in a range that is between the related and unrelated CAM conditions.

Brasel et al. (2016) present CAM disclosures at the same four levels as Kachelmeier et al. (2014); they also find that certain related CAMs can reduce auditor liability. The authors recruit jury-eligible individuals via Amazon Mechanical Turk and ask them to evaluate auditor liability for a misstatement that was caused by either an overstatement of inventory or an understatement of an environmental restoration liability. Similar to Kachelmeier et al.’s (2014) observed “disclaimer” effect, Brasel et al. (2016) utilize Decision Affect Theory to predict that related CAMs will serve as notice or as a “forewarning” to users that an issue may be present in the financial statements, which leads to lower liability. However, they find that this is only true when the potential for a misstatement related to the accounting issue addressed by the CAM is not foreseeable in the absence of a CAM (e.g., an accounting issue perceived as “easy to audit”). The authors find no significant differences in assessed liability between the current reporting model and the inclusion of an unrelated CAM. However, the results indicate that liability assessments are highest when the auditor explicitly states that no CAMs were identified.

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3 In an auditor liability setting, the Culpable Control Model posits that jurors’ verdict decisions are influenced by their perceptions of the auditor’s ability to have controlled the alleged misstatement. Perceived control is posited to be the product of a juror’s assessment of the auditor’s causal role in, ability to foresee, and intent to prevent the negative outcome (Alicke 2000; Alicke, Buckingham, Zell, and Davis 2008).

4 While the current PCAOB proposal allows for auditors to state that they considered identifying CAMs but noted none, the PCAOB (2013a) also notes that it does not expect such conclusions to occur very frequently.

5 When applied to legal liability assessments, Decision Affect Theory (Mellers, Schwartz, Ho, and Ritov 1997; Shepperd and McNulty 2002) posits that jurors’ affective reactions to negative outcomes are less severe when they are provided with advanced warning.
Brown et al. (2015) apply the Story Model of juror decision making\(^6\) and also find that related CAM disclosures may act as a warning to investors and, in turn, reduce auditor liability. They present participants either with both a related and an unrelated CAM, or with neither. In addition, their study manipulates the presence or absence of a “judgment rule” that would require auditors to be evaluated based on the reasonableness of their judgments.\(^7\) Further, the authors compare responses received from lay juror proxies recruited from Amazon Mechanical Turk and law students who serve as proxies for legal experts. The results suggest that related CAMs reduce legal liability when compared to the current reporting model. In addition, the authors find that lay jurors, but not legal experts, provide lower auditor liability assessments with the implementation of an auditor judgment rule, regardless of the presence or absence of CAM disclosures.

The final study we consider is Gimbar et al. (2016), who manipulate both the level of CAM disclosure (related, unrelated, or the current reporting model) and accounting standard precision (precise or imprecise). Using students as proxies for lay jurors, the authors also use the Culpable Control Model to hypothesize that CAM disclosures increase perceptions of auditor control over financial reporting outcomes in a setting where the client’s accounting technically complies with a precise accounting standard. Supporting this argument, they present evidence that auditor liability increases with either a related or an unrelated CAM when the accounting issue is governed by a precise accounting standard and the client’s accounting treatment meets the “letter of the law.” However, they find that neither type of CAM has an incremental impact on auditor liability in an imprecise accounting standard environment. They argue this result holds because the auditor's perceived control, and hence liability, are already elevated in an imprecise environment (e.g., Kadous and Mercer 2016).

Table 1 provides an overview of these five papers and highlights the distinguishing features of each study. An important aspect of these studies is the relation between the CAMs investigated and the accounting issue underlying the alleged misstatement. Therefore, we next summarize the evidence presented for related and unrelated CAMs, in turn.

### Related CAMs

Members of the accounting profession have voiced concerns that related CAMs may elevate liability by increasing the propensity for plaintiffs to argue (and jurors to believe) that the auditor was aware of the risks involved with the financial statements and could have done more to prevent the misstatement.\(^8\) Consistent with this argument, Richard Murray, a former head of legal affairs at Deloitte & Touche, recently said that, in the presence of a related CAM, a plaintiff’s attorney may ask, “Why didn’t you carry through?” (Katz 2014). However, it is also possible that a related CAM indicates that the auditor identified and notified financial statement users of the elevated risks. Such notification may serve as a “disclaimer” of auditor responsibility for high-risk areas included in CAM disclosures, thereby reducing auditor liability (Brasel et al. 2016; Kachelmeier et al. 2014).

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\(^6\) The story model posits that jurors develop mental narratives of the events related to a legal dispute and use the stories to organize the evidence and to facilitate the development of a pre-deliberation verdict decision (Pennington and Hastie 1992).

\(^7\) Brown et al. (2015, 2) model this rule after business judgment rules, which, they note, “preclude second-guessing of corporate directors’ judgments that are made in good faith and have a reasonable basis.”

\(^8\) Auditor liability research commonly refers to this underlying cognitive process as counterfactual reasoning (e.g., Reffett 2010; Backof 2015), which posits that when jurors reflect upon past events, they will consider how negative outcomes could have been avoided (Kahneman and Miller 1986; Alicke et al. 2008).
<table>
<thead>
<tr>
<th>Study and Applicable Theory</th>
<th>CAMs Present</th>
<th>Accounting Issue(s)</th>
<th>Experimental Manipulations</th>
<th>Other Case-Specific Factors</th>
<th>Participants (Population of Interest)</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Backof et al. (2014) Culpable Control Model</td>
<td>Related only</td>
<td>Inventory valuation</td>
<td>Language to clarify the term “reasonable assurance”</td>
<td>Does not provide a clear indication that the accounting standards were violated</td>
<td>Undergraduate students (Lay Jurors)</td>
<td>Relative to the current audit reporting model, a related CAM increases auditor liability only when additional audit procedures that responded to the CAM are discussed</td>
</tr>
<tr>
<td>Brasel et al. (2016) Decision Affect Theory</td>
<td>Related and Unrelated CAMs</td>
<td>Inventory valuation, Environmental restoration liability</td>
<td>Accounting issue associated with the restatement</td>
<td>Contained a known financial statement fraud</td>
<td>Amazon Mechanical Turk (Lay Jurors)</td>
<td>Relative to the current audit reporting model, a related inventory CAM reduces auditor liability</td>
</tr>
<tr>
<td>Brown et al. (2015) Story Model of Juror Decision Making</td>
<td>Related and Unrelated CAMs</td>
<td>Environmental restoration liability, Property valuation</td>
<td>Judgment rule to define auditor responsibilities, Legal expertise of evaluators</td>
<td>Contained a known financial statement fraud, Indicated that the auditor relied on a specialist</td>
<td>Amazon Mechanical Turk (Lay Jurors), Law students (Legal Experts)</td>
<td>Relative to the current audit reporting model, a related CAM marginally reduces liability</td>
</tr>
<tr>
<td>Gimbar et al. (2016) Culpable Control Model</td>
<td>Related and Unrelated CAMs</td>
<td>Lease accounting, Precise versus imprecise accounting standards</td>
<td>Does not provide a clear indication that the accounting standards were violated</td>
<td></td>
<td>Undergraduate students (Lay Jurors)</td>
<td>Relative to the current audit reporting model, both related and unrelated CAMs increase liability under precise standards</td>
</tr>
<tr>
<td>Kachelmeier et al. (2014) Culpable Control Model</td>
<td>Related and Unrelated CAMs</td>
<td>Investments, Allowance for sales returns</td>
<td>Disclosure of audit procedures related to the CAM</td>
<td>Provides a clear indication that the accounting standards were violated, Notified all participants of potential risk in area covered by CAM</td>
<td>M.B.A. students (Nonprofessional Investors and Informed Jurors)</td>
<td>Auditor liability is highest with an unrelated CAM and lowest with a related CAM; the difference between the two is significant</td>
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<td></td>
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<td></td>
<td>Auditor liability judgments fall between unrelated and related CAM assessments when either the current audit reporting model or a statement that there are no CAMs is presented</td>
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The weight of the current evidence appears to align with the latter argument. Relative to the current reporting model, the preliminary evidence in these studies indicates that in most situations legal liability is either reduced (Brasel et al. 2016; Brown et al. 2015) or unchanged (Backof et al. 2014; Gimbar et al. 2016; Kachelmeier et al. 2014) when a related CAM is included in the audit report. However, two notable factors may actually cause related CAMs to increase auditor liability.

First, as found in Gimbar et al. (2016), the precision of the accounting standard associated with the alleged audit failure affects the relationship between auditor liability and CAMs. Specifically, the authors present evidence that a related CAM is associated with higher liability when the accounting standard underlying the alleged misstatement is precise (i.e., rules based) and the client’s accounting meets the “letter of the law,” but they find no evidence of a relationship between related CAMs and liability under an imprecise standard (i.e., principles based). Second, evidence in Backof et al. (2014) indicates that including a discussion of the audit procedures performed in response to a related CAM increases juror assessments of both the foreseeability of the misstatement and the auditor’s liability. However, Kachelmeier et al. (2014) do not find a significant difference in auditor liability between cases where the related CAM includes or excludes a description of related audit procedures. The contrasting evidence of Backof et al. (2014) and Kachelmeier et al. (2014) suggests that additional research is necessary to understand the implications of expanded CAM disclosures.

Unrelated CAMs

Three of the studies also specifically consider CAMs that disclose high-risk audit areas that are unrelated to the alleged misstatement. Unlike related CAMs, unrelated CAMs do not provide the opportunity for auditors to assert that they warned investors of the potential risk associated with the accounting area in question. Further, unrelated CAMs may prompt jurors to second-guess the quality of the audit because the auditor identified an item that was different from the issue ultimately associated with the litigation. This view was expressed by Neil Ehrenkrantz, chair of the SEC Practice Committee of the New York State Society of CPAs, who stated, “I can see this on a deposition: ‘You, sir, identified these areas as critical audit matters ... but what about this one, what about that one?’” (Gaetano 2013). Such potential second-guessing, coupled with the inability of unrelated CAMs to serve as disclaimers, suggests that unrelated CAMs may increase auditor liability. Consistent with this argument, the evidence surrounding unrelated CAMs leans toward supporting this inference, especially when compared to related CAMs. However, the results in this area are mixed and are less conclusive than those addressing related CAMs.

Kachelmeier et al. (2014) find that auditor liability is significantly greater when an unrelated CAM is disclosed as compared to a related CAM disclosure. The authors do not find a significant difference between an unrelated CAM and either of their no-CAM settings. However, liability assessments and perceived responsibility are directionally greater when an unrelated CAM is disclosed than in either of their no-CAM settings. Similarly, Gimbar et al. (2016) find that, under precise accounting standards, jurors view the auditor’s identification of an unrelated CAM as evidence that the auditor performed a low-quality audit, leading to increased auditor liability. However, they find no significant relationship between an unrelated CAM and auditor liability when the underlying accounting issue is governed by an imprecise standard. The authors attribute this

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9 A fourth study, Brown et al. (2015), also includes an unrelated CAM. However, participants receive either the current version of the audit report or both a related CAM and an unrelated CAM. Therefore, the effects of the two types of CAMs in their study cannot be separated. Further, their theory and hypothesis focus on the impact of the related CAM. Therefore we do not include their results in this section.
lack of correlation to the fact that imprecise standards make it unclear whether the client complied with generally accepted accounting principles, resulting in lower assessments of audit quality even in the absence of a CAM. Finally, the evidence in Braut et al. (2016) suggests that an unrelated CAM has no effect on auditor liability when compared to the current reporting model. This research also presents the only evidence that, under certain circumstances, an unrelated CAM may actually reduce liability. This observation comes from comparing the inclusion of an unrelated CAM to an explicit disclosure that no CAMs were identified during the audit.

**IMPLICATIONS FOR REGULATORS AND THE AUDIT PROFESSION**

**Implications for Regulators**

The preliminary results of these studies, in particular those comparing the influence of CAM disclosures to the current audit reporting model, provide experimental evidence of the potential consequences of the PCAOB’s proposed regulatory change. The bulk of this evidence indicates that related CAMs are likely either to reduce auditor liability or to have no effect. In contrast, relative to the current audit reporting model, unrelated CAMs are likely either to have no effect or to increase auditor liability. However, the evidence also highlights three notable factors that could alter these general observations and should be considered by regulators.

First, the influence of a related CAM disclosure on auditor liability may depend on whether it includes a discussion of additional audit procedures performed in response to the CAM. Disclosure of such procedures is not required in the current proposal (PCAOB 2013a). However, the contrasting evidence on these additional disclosures in Backof et al. (2014) and Kachelmeier et al. (2014) indicates that, if the PCAOB decides to amend the proposal to require such disclosures, it should carefully consider their form and content because differences in how the information is communicated to users may alter its effects on liability assessments.

Second, the effect of a CAM on auditor liability is likely to vary as a function of the characteristics of the allegedly misstated accounts. Specifically, Gimbar et al. (2016) present evidence that the influence of a CAM varies as a function of accounting standard precision. Similarly, Braut et al. (2016) find that, in a fraud setting, the effect of a CAM varies between accounting issues that appear “easy to audit” (e.g., inventory) and areas where a misstatement is viewed as more probable (e.g., environmental restoration liability). These results suggest that the PCAOB should consider the current and potential future activities of the Financial Accounting Standards Board, as variation in the specificity of implementation guidance could alter the influence of CAMs on auditor liability.

Finally, there is some evidence to suggest that other regulatory or legal changes may influence the effects of CAMs. Backof et al. (2014) present evidence that the effect of CAMs on auditor liability found in their study is eliminated if the audit report also contains language clarifying the term “reasonable assurance.” Although such clarifying language was considered in the original concept release (PCAOB 2011), the inclusion of such language is not included in the current draft of the auditing standard (PCAOB 2013a). To the extent that the PCAOB does not intend for CAMs to alter auditor legal liability, it may consider exploring additional research on how including such clarifying language in the audit report could interact with CAM disclosures. Further, Brown et al. (2015) find that an auditor judgment rule reduces auditor liability in the presence or absence of CAMs. This result informs the PCAOB that the relationship between CAMs and auditor liability is unlikely to change as a result of possible changes in the legal standard used to evaluate auditor negligence.
Implications for the Audit Profession

The aforementioned preliminary findings also have several notable implications for audit practice. First, we recommend that auditors consider the inherent litigation risk associated with a particular audit area when determining whether they should disclose the issue as a CAM. If disclosing a related CAM likely reduces auditor liability, then disclosing a CAM in high-risk areas could reduce auditor litigation risk. In contrast, the failure to report a CAM related to an area of high litigation risk coupled with the disclosure of an alternative (unrelated) CAM, or a statement that no CAMs were identified, may expose the auditor to greater liability. Second, auditors may benefit from performing additional audit testing in areas of the financial statements governed by accounting standards that are more precise, since there is evidence to suggest that either type of CAM can increase liability when the litigated accounting issue is governed by a precise accounting standard (Gimbar et al. 2016).

Third, the studies that investigate the effect of including an explicit statement that CAM disclosures are required, but that none were found (Kachelmeier et al. 2014; Brasel et al. 2016), indicate that an explicit disclosure that no CAM was identified is unlikely to reduce legal liability, and may in fact increase liability. Therefore, upon adoption of the proposed standard, efforts to mitigate legal liability by disclosing that no CAMs were found in the course of an audit are unlikely to be successful, and avoiding such a strategy would be consistent with the PCAOB’s view that such disclosures would be infrequent (PCAOB 2013a). Finally, the preliminary evidence suggests alternative means that the profession should consider to potentially mitigate litigation risk that may result from the proposal’s adoption. For example, Backof et al. (2014) suggest that auditor liability may decrease if the term “reasonable assurance” is clarified in the audit report because such disclosures are an opportunity for the profession to better educate financial statement users about auditor responsibilities.

CONCLUSION

We provide a review of five current studies that investigate the effects of CAM disclosures on auditor liability. The preliminary evidence collectively suggests that CAM disclosures related to subsequent litigation either reduce or do not influence auditor liability. However, we note that related CAMs may increase liability when accounting standards are precise or when the auditor discloses additional procedures performed in response to higher risks associated with the CAMs. In addition, the evidence indicates that, in some cases, the disclosure of an unrelated CAM increases auditor liability, particularly when compared to a related CAM. However, the inferences related to the effects of unrelated CAMs are mixed and should be clarified by future research. We believe that the PCAOB should consider these results as it finalizes its audit reporting standard, and practicing auditors should also bear them in mind as they plan for this significant regulatory change.

In addition, there are several other substantive differences between these studies that warrant additional research. First, the experiments engage four different participant pools: undergraduate students, M.B.A. students, law students, and participants drawn from Amazon Mechanical Turk, who were asked to serve in one of three different capacities—lay jurors, legal experts, or financial statement users. Future studies should explicitly consider how the effects of CAM disclosures vary across participant type and role. Second, both Brown et al. (2015) and Brasel et al. (2016) present some initial evidence in this regard. They find no significant differences between liability judgments made by law students and those made by participants drawn from Amazon Mechanical Turk, indicating that the effect of CAMs is not associated with the evaluators’ legal expertise.
explicitly indicate in their CAM disclosures that the auditor relied on outside specialists. An investigation of the extent to which the use of specialists and the disclosure of their use influences the relationship between CAMs and auditor liability may provide meaningful conclusions to academics, auditors, and regulators.

Third, the cases used in Brasel et al. (2016) and Brown et al. (2015) include a clear indication that a financial statement fraud occurred. It is likely that subjects, and jurors, would have stronger affective reactions to fraudulent activities than to the misstatements, alleged or actual, included in the other studies. Therefore, additional research investigating the impact of fraudulent accounting on the relationship between CAMs and auditor liability is needed. Finally, the studies reviewed vary in the information provided to participants who do not observe a CAM in the audit report. For example, Brown et al. (2015) inform all participants (i.e., both those observing CAM disclosures in the auditor’s report and those not observing them) that the accounting issues covered in the CAMs were communicated as a risk to the audit committee, and Kachelmeier et al. (2014, 32) provide all participants with a list of items “that an auditor would be sensitive to in performing the audit,” which includes the accounting areas in both their related and unrelated CAM conditions. Additional research is needed to investigate the effects of private communication between the auditor and the audit committee on the determination and effect of CAMs.

REFERENCES


