PRACTITIONER SUMMARY

Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability

Kelsey Brasel  
*Ball State University*

Marcus M. Doxey  
*The University of Alabama*

Jonathan H. Grenier  
Andrew Reffett  
*Miami University*

**SUMMARY:** The PCAOB and the IAASB recently proposed several significant changes to the audit reporting model, including requiring auditors to disclose critical audit matters (CAMs) in their audit reports. While investors appear to support such additional disclosures, some audit practitioners, academics, and attorneys contend that requiring auditors to disclose CAMs will make it easier for plaintiffs’ attorneys to successfully sue auditors when audits fail to detect material misstatements. A recent study, “Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability” (Brasel, Doxey, Grenier, and Reffett 2016), reports results of an experiment that inform this issue. Contrary to the above concerns, results of the study indicate that disclosing CAMs, either related or unrelated to an undetected material misstatement, likely will not increase, and could decrease (depending on the type of misstatement), the probability of jurors holding auditors liable when audits fail to detect material misstatements. Further, results indicate that explicitly stating in the audit report that there were no CAMs, an option allowed within the PCAOB’s proposal, would increase negligence verdicts against audit firms. The following article summarizes the

We acknowledge the anonymous reviewers and editor for their helpful comments throughout the review process.

Editor’s note: Accepted by J. Gregory Jenkins.
Study’s motivation, method, results, and implications for both audit reporting and risk disclosure in general.

**Keywords:** critical audit matters; foreseeability; audit litigation; negligence assessments.

**INTRODUCTION**

This article summarizes a recent study titled “Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability” (Brasel, Doxey, Grenier, and Reffett 2016). Specifically, we review the study’s motivation, experimental method, and primary results. We then discuss several of the study’s more significant implications. Most notably, we discuss how results of the study inform the disclosure strategies audit firms might develop to reduce litigation risk in the event that reporting critical audit matters becomes mandatory. We also discuss the study’s general implications for risk disclosure in auditing and beyond.

**MOTIVATION**

The Public Company Accounting Oversight Board (PCAOB) and International Auditing and Assurance Standards Board (IAASB) recently proposed several significant changes to the audit-reporting model. One such change is the requirement for auditors to disclose Critical Audit Matters (CAMs)—audit matters that involved especially challenging, subjective, or complex auditor judgment—in their audit reports (Public Company Accounting Oversight Board [PCAOB] 2016, 2013). While investors appear to support such disclosures (Carcello 2012), audit practitioners, academics, and attorneys have expressed concern that the proposed CAM requirement (hereafter, the Proposal) will increase litigation against audit firms. For example, the chair of the New York State Society of Certified Public Accountants’ litigation services committee argues that the Proposal will result in auditors “sitting in a courtroom being asked, ‘Shouldn’t you have done this or that’” (Gaetano 2014, 5). Likewise, Ernst & Young (2013) stated that the Proposal poses “risks of increased legal liability that are real and substantial.”

Concerns over the adverse legal consequences of the Proposal primarily relate to two general circumstances. First, there is concern that when audits fail to detect material misstatements, auditors who disclosed CAMs in areas related to the undetected misstatement will be more susceptible to litigation. Speaking to such concerns, Richard Murray, former head of legal affairs at a Big 4 firm, states that it is easy to envision plaintiffs and/or jurors reasoning that “if the auditors

---

1 The IAASB refers to such items as Key Audit Matters (KAMs) (International Auditing and Assurance Standards Board [IAASB] 2012).

2 The PCAOB reproposed the 2013 Proposal (PCAOB 2013) on May 11, 2016 (PCAOB 2016). The reproposal retained the use of CAMs in the auditors’ report but refined a number of proposed requirements relating to CAMs. Specifically, the reproposal (1) limited the source of potential CAMs to matters communicated to the audit committee, (2) added a materiality component to the definition of a CAM, (3) narrowed the definition of a CAM to only those matters that involved especially challenging, subjective, or complex auditor judgment, (4) revised the related documentation requirement, and (5) expanded the communication requirement to require the auditor to describe how the CAM was addressed in the audit. The changes included in the reproposal (PCAOB 2016) do not alter the findings of our study and support our inclusion of audit procedures in the study’s CAM paragraphs.
had such concerns about the company, why didn’t they carry through” (Katz 2014). Second, there is concern that when audits fail to detect material misstatements, auditors who disclosed CAMs in unrelated areas will also be more susceptible to litigation. To this concern, Murray states: “If the company’s problem doesn’t concern any previously reported CAMs, shareholders can claim that many concerns were expressed by the auditor but not the right one” (Katz 2014).

These concerns certainly are understandable. As is well documented, auditors operate in highly litigious environments that continue to impose increasing costs on public accounting firms (see Donelson 2013). Further, Reffett (2010) and Backof (2015) find that identifying and documenting areas of concern (e.g., fraud risks or possible alternative accounting methods) in the audit work papers increases jurors’ auditor liability judgments when auditors fail to detect misstatements related to the areas of concern, suggesting that disclosing CAMs could lead to increased litigation against audit firms. Nevertheless, at the time concerns over the Proposal were expressed, there was little to no direct evidence to indicate whether such concerns were warranted. Thus, conducting a scientific investigation of this issue was important to provide audit practitioners, standard setters, and other audit stakeholders with objective, empirical evidence to assess the likely effects of CAM disclosures on jurors’ judgments in cases of alleged auditor negligence.

Although concerns regarding the potential for CAMs to increase auditor liability are intuitive, in the process of developing the study’s hypotheses, we discovered compelling reasons to believe that such concerns, at least in certain respects, are unwarranted. Most notably, there is an important distinction between CAMs and the contexts examined in prior research. Specifically, unlike prior studies’ contexts (i.e., work paper documentation [Reffett 2010; Backof 2015]), auditors will publicly disclose CAMs prior to the revelation of financial statement misstatements, effectively alerting users to the potential for misstatements within related areas of the financial statements. As such, we contend that jurors will view previously disclosed CAMs as having effectively “forewarned” financial statement users of a heightened risk of undetected misstatements. For example, if the auditors disclosed a CAM relating to the difficulty obtaining sufficient and appropriate evidence to test an audit client’s investments account, then we believe jurors would view that CAM as a de facto warning to financial statement users of a heightened risk that misstatements in the company’s investments account may have gone undetected or uncorrected. This is important because prior psychology research (Mellers, Schwartz, Ho, and Ritov 1997; Shepperd and McNulty 2002) suggests that jurors will be less likely to hold the auditors liable for damages if they believe that the auditors provided advanced warnings of risk to financial statement users. Consequently, we predicted that when an audit fails to detect a material misstatement, jurors will be less likely to hold the auditors liable for plaintiff losses when the auditors disclosed a CAM related to the misstatement (hereafter, related CAM) compared to when the audit report is silent regarding CAMs or compared to when the audit report explicitly states that the auditors did not identify any CAMs. The following hypotheses formalize our predictions:

---

3 It is important to note that the PCAOB has explicitly stated that disclosed CAMs should not be viewed as reducing the level of assurance expressed either on a particular area of the financial statements or the financial statements as a whole (PCAOB 2016, 2013). However, such statements from the PCAOB do not necessarily determine how financial statement users and/or evaluators of auditors in cases of alleged auditor negligence will interpret disclosed CAMs.

4 The PCAOB (2013, 6) expects most auditors to have CAMs, but allows for the possibility of explicitly stating that there are no CAMs.
**H1:** Jurors will be less likely to find the auditors negligent when the audit report discloses a CAM that relates to the undetected misstatement compared to when the audit report is silent regarding CAMs.

**H2:** Jurors will be less likely to find the auditors negligent when the audit report discloses a CAM that relates to the undetected misstatement compared to when the audit report explicitly states that the auditors did not identify any CAMs.

However, as noted above, there also is concern about circumstances in which auditors disclosed CAMs that are unrelated to subsequently revealed misstatements (hereafter, unrelated CAMs). Although it is possible that jurors could penalize auditors for identifying the “wrong” CAMs, unrelated CAMs could be viewed as a general warning of possible misstatements, thereby causing jurors to view even unrelated misstatements as having been more foreseeable to plaintiffs. Due to these competing possibilities, we did not make formal predictions regarding the effects of unrelated CAMs and instead propose the following research questions:

**RQ1a:** How do jurors’ auditor liability judgments compare when the audit report discloses a CAM that is unrelated to the undetected misstatement versus when the audit report is silent regarding CAMs?

**RQ1b:** How do jurors’ auditor liability judgments compare when the audit report discloses a CAM that is unrelated to the undetected misstatement versus when the audit report explicitly states that the auditors did not identify any CAMs?

**METHOD**

Since the Proposal has not yet been implemented and detailed information about jurors’ decision-making processes in real world trials generally is unavailable, conducting an experiment was the best way to test our hypotheses and research questions. Accordingly, we conducted an online experiment that asked jury-eligible individuals (528 participants) to first read a case that describes the audit of a fictional mining company that failed to detect a material financial statement fraud and then provides the transcript from a subsequent auditor negligence trial. After reading the case, the experiment asks participants to indicate whether or not the auditors were negligent in their performance of the audit (i.e., issue a verdict) and report the amount of damages (if any) the auditors should pay to the plaintiff. After assessing the auditors’ liability for plaintiff damages, the experiment asks participants to assess the extent to which the plaintiff should have expected problems with the misstated balance (i.e., assess foreseeability), and report their emotional reactions to the case.

The experiment manipulates CAM disclosures at four levels. In one condition, the audit report in the experimental case does not disclose any CAMs, nor does it mention CAMs. This first condition reflects the current audit-reporting model and serves as a control condition. In the next condition, the audit report discloses a CAM that relates to the undetected misstatement (i.e., one of the two aforementioned general concerns about CAM disclosures). In the third condition, the

---

5 We recruited experimental participants from Amazon’s Mechanical Turk, an online marketplace where “workers” complete online tasks for compensation. In addition to providing an easily accessible and cost-effective participant pool, Mechanical Turk data are considered highly reliable and participants are more diverse and representative of the U.S. population than undergraduate students (Buhrmester, Kwang, and Gosling 2011; Farrell, Grenier, and Leiby 2015; Horton, Rand, and Zeckhauser 2011; Paolacci, Chandler, and Ipeirotis 2010).
audit report discloses a CAM that is unrelated to the undetected misstatement (i.e., the other general concern about CAM disclosures). In the fourth condition, the audit report notes that auditors are required to disclose CAMs if they exist, but explicitly states that the auditors identified no CAMs in this particular audit. This last condition examines the effect of auditors exercising the option of stating that there were no CAMs, an option currently allowed under the Proposal.

We also believed it was important to examine whether the effects of CAM disclosures vary across different types of misstatements. Thus, we examined the effects of the above CAM disclosure options across two misstatements: (1) an overstatement of inventory; and (2) an understatement of an environmental restoration liability account. We chose an overstatement of an asset account and an understatement of a liability account for generalizability as Bonner, Palmrose, and Young (1998) find that such misstatements are common, appearing in 38 percent of SEC enforcement actions.

**RESULTS**

As noted above, based on case facts, participants were asked to indicate whether the auditor was or was not negligent in the performance of their audit. Table 1 presents descriptive statistics for participants’ auditor negligence verdicts across experimental conditions. Recall that our study predicts that when audits fail to detect a material misstatement, jurors will be less likely to find the auditors negligent when the audit report disclosed a related CAM compared to when the audit report is silent regarding CAMs (H1). In support of this prediction, the percentage of negligent verdicts was significantly lower when a related CAM is disclosed (32.1 percent), relative to the current reporting model in which there is no mention of CAMs (42.1 percent). H2 predicts that jurors will be less likely to find the auditors negligent when the audit report discloses a related CAM relative to when the audit report explicitly states that there were no CAMs. In support of this

---

6 It is important to note that both of the misstatements were due to management fraud. We are unaware of any theory to suggest that our results would differ for error-related misstatements, but future research could examine this issue.
prediction, the percentage of negligence verdicts was significantly lower when a related CAM is disclosed (32.1 percent), relative to when the audit report explicitly states that there were no CAMs (50.0 percent). However, we also found that the effects of disclosing related CAMs depend on misstatement type. In particular, we observed a significant decrease in the percentage of participants who provided negligent verdicts when the disclosed CAM and undetected misstatement related to the inventory account (23.0 percent with related CAM disclosure versus 39.7 percent when there is no mention of CAMs), but find a statistically insignificant decrease in negligence verdicts when the CAM and undetected misstatement related to the company’s environmental restoration liability account (39.7 percent with related CAM disclosure versus 44.6 percent when there is no mention of CAMs). See Figure 1.

Though not predicted, the two examined misstatements varied in jurors’ perceptions of their foreseeability to financial statement users in the absence of a disclosed CAM. Specifically, when the audit report did not mention CAMs in any regard (i.e., in the control condition), participants generally indicated that misstatements in inventory were not very foreseeable (average
foreseeability rating of 28.6 out of 100), but that misstatements in the environmental restoration liability account were more foreseeable (average foreseeability rating of 50.5 out of 100). As is discussed next, this observed difference appears to explain the varying effects of CAM disclosures on jurors’ negligence verdicts across misstatement types.

Supplemental analysis indicates that the observed decrease in negligence verdicts when the CAM relates to the undetected inventory misstatement is due to jurors’ perception that the overstatement of inventory was more foreseeable to financial statement users when the auditors disclosed a CAM related to inventory (51.5 out of 100) compared to the control condition (28.6 out of 100). Similarly, the lack of an effect of CAM disclosure on negligence verdicts when the misstatement related to an environmental restoration liability is due to CAMs having no effect on participants’ perceptions of the foreseeability of the misstatement of the environmental restoration liability (55.6 with a related CAM compared to 50.5 in the control condition). These results suggest that related CAM disclosures were more effective in reducing negligence verdicts when the undetected misstatement related to inventory because such disclosures increased jurors’ previously low perceptions of the foreseeability of misstatements in inventory; whereas related CAM disclosures did not increase jurors’ perceptions of the foreseeability of misstatements in the environmental restoration liability account because, even in the absence of a related CAM, jurors already perceived such misstatements as being foreseeable.

To further test the effects of related CAMs, we also compared jurors’ auditor negligence verdicts when the audit report disclosed a related CAM versus when the audit report explicitly stated that there were no CAMs. Consistent with expectations, the percentage of negligent verdicts is significantly lower when the audit report disclosed a related CAM (32.1 percent) relative to when it stated that there were no CAMs (50.0 percent). Further, this observed decrease in negligence verdicts occurred both when the misstatement relates to the overstatement of inventory and when it relates to the understatement of the environmental restoration liability.

Last, as previously noted, our study examined research questions regarding how disclosing unrelated CAMs influences jurors’ judgments of auditor liability. We did not observe significant differences in participants’ negligence verdicts when the audit report disclosed an unrelated CAM (36.4 percent) versus when the audit report did not mention CAMs (42.1 percent). In other words, our study found that, relative to the current audit-reporting model, jurors neither punish nor reward auditors for having disclosed an unrelated CAM. However, results indicate that jurors are less likely to find the auditors negligent (36.4 percent) when the audit report disclosed an unrelated CAM compared to when the audit report explicitly stated that there were no CAMs (50.0 percent).7

Cumulatively, contrary to the concerns expressed by audit practitioners (Ernst & Young 2013; Gaetano 2014), academics (Bédard, Gonthier-Besacier, and Schatt 2015), and attorneys (Barnes 2013; Katz 2014), our study found no evidence across two misstatement types that jurors in cases of undetected fraud are more likely to find auditors liable for damages when the auditors disclosed a CAM, whether related or unrelated to the undetected misstatement. In fact, we found that, in certain circumstances, disclosing CAMs can decrease the probability of auditor negligence verdicts by increasing jurors’ perceptions of the foreseeability of certain types of misstatements. Further, we found that jurors are more likely to hold auditors liable for damages when the auditors explicitly stated that there were no CAMs, relative to when the auditors disclosed either a related or unrelated CAM.

7 The observed results regarding the effects of disclosing unrelated CAMs do not vary across misstatement type.
IMPLICATIONS

Our study provides experimental evidence that disclosing CAMs is unlikely to increase and, in certain circumstances, could decrease auditors’ litigation risk in the event that an audit fails to detect a material misstatement. Specifically, our study suggests that disclosing CAMs is most helpful in reducing auditor negligence verdicts when they relate to financial statement areas that jurors would otherwise view as relatively safe from material misstatement. Thus, CAM disclosures could be particularly helpful in reducing litigation risk stemming from seemingly simple accounts that pose idiosyncratic audit challenges for certain clients.

Overall, results of our study suggest that concerns over the adverse legal consequences of disclosing CAMs are, at least in certain respects, unfounded. Although these results, coupled with results in contemporaneous studies (Brown, Majors, and Peecher 2015; Kachelmeier, Schmidt, and Valentine 2015) should provide standard setters with a degree of comfort that disclosing CAMs will not increase auditor liability, there undoubtedly are exceptions that future research should examine to further inform policymakers. For example, two contemporary studies report that, in certain situations, disclosing CAMs can increase jurors’ judgments of auditor liability such as when misstatements pertain to violations of rules-based/bright line standards (Gimbar, Hansen, and Ozlanski 2016) and/or when the concept of reasonable assurance is not explained to jurors (Backof, Bowlin, and Goodson 2015).

Our study also suggests that auditors need not act strategically in limiting CAM disclosures as suggested in prior research (Bédard et al. 2015). Rather, auditors likely would have legal incentives to disclose more, as opposed to fewer, CAMs. In fact, if the Proposal is adopted, then it is easy to envision audit firms developing and commonly issuing “boilerplate” CAM disclosures for multiple areas of clients’ financial statements. While issuing numerous “boilerplate” CAMs could reduce audit firms’ litigation risk, doing so likely would undermine the intent of the proposed standard by diluting the impact of more warranted CAM disclosures. However, to date, no studies have investigated the effects of auditor disclosure behavior or the effects of multiple, simultaneous CAM disclosures on jurors’ auditor negligence verdicts. Examining this possibility and other possible unintended consequences of the Proposal is necessary to fully understand its likely effects on auditors’ litigation exposure. Further, it is important to note that our study does not examine the effect of the CAM disclosure requirement on the probability of plaintiffs filing lawsuits against audit firms or on other aspects of audit litigation and financial reporting. For instance, future research could examine the consistency of CAM disclosures with management disclosure in MD&A. In sum, academics and regulators will need to consider a broad set of current and future studies, including archival research after the Proposal is implemented, to fully understand its effects on auditors and reporting firms.

Last, while our study focuses on CAM disclosures, its results have broader applicability to risk disclosure in accounting and beyond. In particular, our study indicates that evaluators do not punish, and, in certain circumstances, reward professionals for advanced disclosure of the difficulties they encounter in the course of performing their services. For example, our study suggests that disclosing the inherent difficulties of recognizing and/or measuring certain transactions, events, and/or circumstances could result in more favorable assessments of management in the event that financial statements are subsequently determined to be materially misstated (cf. Skinner 1994).
REFERENCES


