

## **A plea for transparency: do voluntary warnings of fraud influence auditors' liability?**

Jillian Alderman  
Pepperdine University

### **ABSTRACT**

This study explores whether voluntarily disclosing significant deficiencies in internal controls influences jurors' perceptions of independent auditors' professional liability in the event of an auditor's failure to detect corporate fraud. Currently, independent auditors are only required to disclose material weaknesses in controls for public company clients. However, increased transparency in the auditor's report on controls could provide an additional warning signal for fraud risks. A 2x2 between-subjects experiment manipulated the disclosure level (disclosed/not disclosed) and the type of control (process-level/entity-level) for a sample of 93 jury-qualified individuals. Results indicate that auditors were assessed lower liability when they provided disclosures of significant deficiencies within the Section 404 report on internal controls. The type of control was also significant, such that auditors were assessed the lowest liability when communicating a significant deficiency in a process-level control (vs. an entity-level control). Results also find that auditors are exposed to increased liability for their assessments of entity-level controls, no matter the level of disclosure. Practical implications for standard setters, auditors, and regulators are discussed.

Keywords: Fraud Detection, Auditor Liability, Internal Controls, Audit Reports, Transparency, Disclosures

Copyright statement: Authors retain the copyright to the manuscripts published in AABRI journals. Please see the AABRI Copyright Policy at <http://www.aabri.com/copyright.html>

## INTRODUCTION

Audit report disclosures are controversial in academia and practice. Advocates for enhanced auditor disclosure requirements, such as the PCAOB, promote the importance of transparency in the audit process for the benefit of the public interest (PCAOB 2013). Opposing voices, typically from auditors and preparers, focus on the legal liability implications of providing additional disclosures (Tysiac 2014). Events in the past few decades have added even more fuel to this ongoing debate. Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) requires auditors to provide a separate opinion on controls. The PCAOB has also expanded audit reporting standards to require auditors to provide disclosures on critical accounting matters (CAM) that they encounter during the audit process (PCAOB 2013). Each of these additional disclosures has been argued to increase auditor liability exposure due to the increased disclosure responsibilities. In the event of an auditor's failure to detect fraud, they are now also exposed to the risk of being sued for failing to provide adequate warnings of fraud risks within the audit reports on financial statements and internal controls.

This study contributes to the debate by examining the legal liability implications of disclosures of significant deficiencies in internal controls within the auditor's Section 404 report. Auditors are currently only required to disclose material weaknesses in controls in their audit reports. However, the difference between a material weakness and a significant deficiency is often difficult to determine. Multiple cases in the Post-SOX era have involved auditors discovering control deficiencies that were misclassified as significant deficiencies, and therefore not disclosed at all to shareholders (Kardos 2009; SEC 2016). These auditors had to defend their decisions, at times resulting in SEC penalties or large settlements to compensate shareholders for their losses. Would these auditors have been in this situation had they disclosed the significant deficiencies? Would their negligence cases have been more defensible, allowing the auditors to reduce settlement amounts or be more confident in risking a trial outcome?

These issues are investigated in the context of a jury decision-making task with 93 jury eligible individuals who evaluated whether an auditor should be held liable for negligence for their failure to report an adverse opinion on controls. First, it is proposed that, in the event of an auditor's failure to detect fraud, and a shareholder lawsuit alleging negligence, auditors who disclosed significant deficiencies in controls could argue that they had provided a warning to shareholders about the risk of fraud. These warning signals could be perceived as sufficient red flags to users, lessening the odds that auditors will be found liable for negligence.

Since audit report disclosures are tailored to the specific context and not equal in content, this study also investigates perceptions of legal liability based on the characteristics of the internal control issue disclosed. Specifically, the study differentiates between disclosures of issues that are either process level controls or entity level controls. Process level controls, such as inventory processing and tracking systems, are typically more precise and directly related to the prevention and detection of specific fraud risks (PCAOB 2009, 2013). Entity level controls, such as the control environment, are not as precise and usually require additional, more precise controls in combination to be effective in preventing or detecting a specific type of fraud (PCAOB 2009, 2013). It is hypothesized that more precise disclosures, those of process-level controls, will be perceived as a stronger signal of specific fraud risks, and therefore associated with lower liability for the auditor.

Results of this study indicate that disclosures of significant deficiencies decrease assessments of auditor liability for both types of controls. In addition, disclosures are

significantly more beneficial when related to a significant deficiency a process-level control. In this study, voluntary disclosure of this type of internal control deficiency shielded the auditor from liability in 92% of the responses from jury eligible participants, and is the only scenario in which the auditor is not assessed any punitive damages. These results provide strong support for increased disclosure in audit reports as a means to decrease auditors' liability exposure, particularly when the disclosure is related to a process-level control.

This study contributes to the literature assessing jurors' perceptions of auditors. The context of past research has focused primarily on liability exposure when the auditor fails to *detect* fraud or material misstatement. This paper examines this issue in a post-SOX environment, focusing on whether auditors may now be held liable for failing to disclose weaknesses in internal controls designed to *prevent* fraud or material misstatement. This scenario is unique to the auditor liability literature, as the audit opinion on internal controls is arguably more ambiguous and relies heavily on professional judgment. Even when faced with a known deficiency in internal controls, the auditor must make a judgment on the likelihood that the deficiency will fail to prevent or detect a material misstatement, which can be highly subjective in nature.

Auditors may consider the results of this study for reporting decisions, the evaluation of engagement risk, planning the audit, the determination of audit fees, and the decision to settle or risk a jury trial in the event of a lawsuit. Regulators and standard-setters may find the results of this study informative when considering the legal liability impact for auditors in proposing new standards for increased transparency in the auditor's report on internal controls. The results provide evidence contrary to some beliefs that additional disclosures provided by auditors increases liability risks, which could factor in to decisions for future changes in internal control reporting standards.

The following sections examine the different factors related to provisions of Section 404 that could potentially impact the liability exposure of accountants. The next section provides a summary of the changes in the profession following SOX implementation, and how the legal environment for accountants has changed because of such legislation. Then, hypotheses predict how Section 404 report disclosures and the type of internal control impact jurors' decisions in a trial scenario. A summary of the methodology follows. The final section discusses results and overall implications of this study.

## **THEORY AND HYPOTHESIS DEVELOPMENT**

### **Section 404 and the U.S. Legal System**

Section 404 of SOX extended auditors' responsibilities by requiring an integrated audit that results in a separate audit opinion on internal controls. This new requirement motivated a tremendous body of research examining how SOX impacted the accounting profession. The primary benefit of SOX Section 404 report is the increased assurance that adequate internal controls are in place for the prevention of material misstatements (Schroeder and Shepardson 2015). Auditors are required to test and evaluate the operating effectiveness of all controls over financial reporting for any companies that must comply with SOX Section 404b.

One major criticism of this requirement is the potential for increased liability exposure. The evaluation of internal controls often requires auditors to rely on professional judgment to assess the risk that one or more deficiencies in internal controls would result in a material

misstatement in the financial statements. Because auditors are subject to the threat of PCAOB enforcement actions and criminal liability under SEC regulation, the additional civil liability exposure has been characterized by some as unnecessary (Asare, Cunningham, and Wright 2007). In support of this argument, audit firms experienced an increase in legal fees and litigation attributed to internal control failures following SOX (Paul 2005; Lamont and Etzold 2007).

The PCAOB standard on implementing the audit of internal controls requires auditors to classify control issues into one of three categories: deficiencies (lowest risk of material misstatement), significant deficiencies (increased/medium risk of material misstatement), and material weaknesses (highest risk of material misstatement). Auditors report an adverse opinion on controls when they determine that a client has a material weaknesses. The adverse opinion communicates that controls are not operating effectively, and includes specific details on how the financial statements could be effected. In contrast, when auditors determine that control issues are only deficiencies or significant deficiencies, they will report an unqualified opinion on controls. This opinion states that controls are operating effectively, and the auditor is not required to mention any of the deficiencies or significant deficiencies identified during the audit process (PCAOB 2007). Distinguishing between a deficiency, significant deficiency, and material weakness is a difficult process for auditors, and often leads to inaccurate conclusions (Aobdia, Choudhary, and Sadka 2018). Because the difference between these classifications determines whether the client will receive an unqualified or adverse opinion on controls, the stakes are high for auditors to make the correct decision in their classification process. The potential impact of this issue on the legal liability exposure for auditors is discussed in the sections below.

### **Section 404 Reporting, Disclosures of Control Deficiencies, and Signaling Theory**

Past research has found that jurors tend to exhibit an outcome bias against auditors, which occurs because the awareness of the outcome impairs jurors' ability to objectively judge auditors' performance on a past audit (Lowe and Reckers 1994; Latham and Linville 1998; Olgoff 2003; Lipe 2008). Bias against auditors in a trial setting has also been attributed to the 'expectation gap', which refers to the difference between jurors' expectations of auditors and auditors' perception of their responsibilities (Koh and Woo, 1998; Lowe and Reckers 2002; Arel, Jennings, Pany, and Reckers 2012). Some have proposed ways to mitigate these biases against auditors, such as specifically addressing and discrediting the negative bias during the trial (Kadous 2001), or drawing attention to the likelihood of an audit failure in a specific situation (Peecher and Piercey 2008). Others suggest that specific actions taken by the auditor, such as disclosures within the audit report, can potentially decrease auditors' exposure to litigation (Carcello and Palmrose 1994; Mong and Roebuck 2005; Gimbar, Hansen, and Ozlanski 2016). Such disclosures could provide signals to stakeholders of risks within the company short of reporting an adverse audit opinion, and thereby reduce litigation exposure.

Signaling theory suggests that when information asymmetry exists, individuals with proprietary information can provide valuable signals to the other parties that do not have access to such information (Connelly, Certo, Ireland and Reutzel 2011). Information provided by such signals communicates to parties that are otherwise relying on an incomplete set of knowledge to make decisions. However, signaling theory suggests that not all information exchanged between parties is deemed reliable by the receiving party, and that only some signals effectively reduce

information asymmetry. Past studies have shown that the perceived cost of providing information is often positively related to individuals' trust in the information (Titman and Trueman 1986; Bagnoli and Watts 2005; Levine and Hughes 2005). Thus, information that is costly to provide, such as an audit opinion, is demanded by individuals who do not have direct access to adequate information for decision-making.

The auditor's opinion on internal controls provides assurance that the company has controls in place that *prevent* material misstatements and, in the event of an audit failure, the auditor's report on internal controls could be used against the auditor to argue that the auditor misled investors. However, research indicates that increased disclosures in financial audit reports act as a red flag for users and decrease the likelihood of future litigation and lead to more favorable trial outcomes (Carcello and Palmrose 1994; Mong and Roebuck 2005; Gimbar et al 2016). Past research also indicates that companies voluntarily report weaknesses in controls to reduce information asymmetry (Basu, Krishnan, Lee, and Zhang 2012). Therefore, this study proposes that auditors can utilize voluntary disclosures to signal risks of fraud.

Overall, signaling theory suggests that Section 404 disclosures may provide a way for auditors to reduce the information asymmetry that exists between a company and stakeholders. Stakeholders will likely perceive the costly information provided by the auditor's report on internal controls as high quality information. This study proposes that Section 404 reports provide an additional opportunity for auditors to provide important information to stakeholders and reduce their liability exposure. The inclusion of a voluntary disclosure of a significant deficiency in internal controls allows the auditors to create a signal of control risk without having to modify their audit opinions. Although auditors of public companies are not currently required to report significant deficiencies discovered during an audit in their Section 404 report, current standards do not prevent such a disclosure. If jurors consider this disclosure to be an adequate warning of control risk, they may be less inclined to blame the auditor for their mistakes in judgment. Therefore, the following hypothesis is proposed:

H1: In a litigation setting, jurors will perceive auditors to be less liable for negligence when they report an unqualified opinion on internal controls with voluntary disclosures of significant internal control deficiencies, compared to auditors who report an unqualified opinion on internal controls without voluntary disclosures of significant internal control deficiencies.

#### *Internal Control Type: Understanding the Impact of Precision*

This study also investigates if disclosures are equally effective for different types of controls. Although not the primary purpose of this study, the type of control is also predicted to influence auditor liability, regardless of the disclosure level, due to the precision of the evidence typically collected by the auditor to support testing the control.

The two types of controls identified in this study can be classified as either entity-level or process-level. One significant distinction between entity-level controls and process-level controls is the level of precision (PCAOB 2009, 2013). The word "precision" in this study is used to describe how directly related the control is to a specific audit objective, such that more precision indicates a closer, direct relationship to the audit objective, and less precision indicates a higher level, more distant relationship to the audit objective. According to PCAOB guidance (2009, 2013), an entity level control would not typically be precise enough to prevent

or detect misstatements alone and would likely need to be combined with another more precise control to be effective. The entity level control would also be less directly related to a specific risk of fraud assessed by the auditor compared to the process-level control. Although less precise, the impact of an entity level control, such as the control environment, is more likely to have a more pervasive potential impact on the financial statements and relate to many different audit objectives. Process-level controls, such as inventory processing and recording, are more likely to impact specific audit objectives and related risks of material misstatements in specific financial statement accounts.

The evidence collected to test these two different types of controls is also likely to be significantly different. For process-level controls, the evidence is more precise to testing the specific processes and transactions that can lead to fraudulent activity. For example, when an auditor is testing controls over inventory processing and recording, they would likely examine actual records to determine whether or not the control process is operating effectively. In contrast, testing an entity-level control would typically involve higher level audit procedures, such as conducting interviews with the client to assess the control environment. A similar distinction has been noted in past research, identifying that there are different levels of “auditability” of different types of controls such that entity level controls are considered less auditable compared to process-level controls due to the types of evidence available to fully audit the control (Hammersley et al. 2008).

These factors could be important in the event of an auditor negligence trial, as jurors assess whether or not an auditor had collected sufficient, appropriate audit evidence to assess control risk for the specific type of misstatement that was not detected by the auditor. The evidence collected to assess control risk for more precise controls (process-level) would arguably be more directly related to that specific audit objective compared to the evidence collected to assess control risk for less precise controls (entity-level). Past research provides some support for this argument. Sennetti, Becker, and Lawrence (2011) found that auditors are held more liable for judgments made based on principles-based standards (vs. rules), indicating that when more precise rules exist concerning the interpretation of a standard, auditors are more likely to be assessed as having collected sufficient, appropriate audit evidence in the event of a negligence trial. A recent study by Backof in 2015 also found that auditors are awarded less damages when they provide evidence that is directly linked to the risk assessment in question. This is hypothesized to occur because the auditors are more likely to be perceived as having complied with auditing standards when they have collected and documented evidence directly linked to the audit objective in question.

These results are highly applicable to this study, as the evidence collected for a process-level control is more directly connected to their audit objective of assessing the risk that a control deficiency would result in a specific type of fraud, compared to the high level evidence collected for an entity-level control, which would be less directly linked to a specific fraud risk. Jury members are told that if they determine the auditor has not collected sufficient, appropriate audit evidence, they should find the auditor liable for negligence. Since auditors are more likely to be perceived to have collected sufficient, appropriate audit evidence for process-level controls compared to entity-level controls, the following is predicted:

**H2:** In a litigation setting, jurors will perceive auditors to be less liable for negligence for failing to report a material weakness in a process-level internal control compared to entity-level internal control.

In many contexts, a more precise warning would arguably provide a stronger signal of risk than a less precise warning. For example, if doctor (a) warned a patient that they are at risk of health problems, this would be less precise than doctor (b) warning a patient that they are at risk of lung cancer. If the patient then finds out they have lung cancer, which doctor would be perceived as having given the stronger warning signal? Arguably, doctor (b), who provided a more precise warning.

In two of this study's scenarios, the auditor either (a) warned investors that there was a risk of misstatement due to deficient controls to properly address employee pressures to meet expectations (entity-level control), or (b) warned investors that there was a risk of misstatement due to a deficient system of inventory tracking and recording (process-level control). The fraud in this case involved a manipulation of inventory counts, resulting in inflated sales. Therefore, the process-level control disclosure (b) would arguably provide the more precise warning, and stronger warning signal to investors of the specific risk of inventory fraud.

This argument is supported with results from past research. Gimbar, Hansen, and Ozlanski (2016) examined the impact of audit report disclosures on auditor liability and found that auditors disclosing CAMs related to more precise accounting standards are less liable (compared to more principles-based standards). Authors hypothesize that this is due to the perception that auditors have less control over the reporting outcome when the accounting standard is precise.

Similar to the predictions in H1 above, it is predicted that the stronger the signal of risk, and the higher the reduction of information asymmetry, the less likely the auditor will be perceived as liable for an audit failure. Since the entity-level control disclosure is less precise, it is therefore a weaker signal of risk. The process-level control is more precise, and a stronger signal of risk. Therefore, the following is predicted:

**H3:** In a litigation setting, jurors will perceive auditors to be less liable for failing to report an adverse opinion on controls when the auditor discloses a significant deficiency in a process-level internal control, compared to an entity-level internal control.

## RESEARCH METHOD

A 2x2 between-subjects experiment was conducted to assess how jurors evaluate auditors in a trial setting, manipulating the disclosures contained within the auditor's unqualified opinion on internal controls (disclosure of significant deficiency vs. no disclosure of significant deficiency) and the type of internal control weakness that ultimately produced losses for stakeholders (entity-level vs. process-level). Specific details on the participants and survey instruments are discussed in sections below.

### Participants and Demographic Characteristics

Emails with an embedded link to the online case and questionnaire were sent to 1,438 jury eligible individuals<sup>1</sup>, inviting them to participate in the study. Each individual was

---

<sup>1</sup> Participants were identified by offering undergraduate students enrolled in business courses at a university extra credit for providing the contact information of individuals who were interested in participating in the study. This

randomly assigned to one of four manipulated conditions examined in this study and given two weeks to respond to the study. Reminder emails were sent within 48 hours of the closing date of the study. Overall, 242 unique responses to the survey were recorded (16.8% initial response rate). Of these, 73 individuals dropped out before answering any questions, and 75 individuals were excluded from the final sample for not answering the manipulation check questions accurately, failing to complete the questionnaire, or indicating qualities that would disqualify them from participating on a jury (non-U.S. citizenship). After excluding these individuals, 93 useable responses were included in the final sample (6.5% usable response rate). The low response rate in this study is likely attributed to the fact that the email communicated that the task was very time intensive (respondents spent an average of 36 minutes on the task), and participants were not compensated financially for completing the study. To test for non-response bias, the late responses were compared to early responses, with no differences found. Therefore, the low response rate is not likely to result in non-response bias.

Data was collected on individual factors such as potential biases or background characteristics that could influence the likelihood of being selected to a jury.<sup>2</sup> The average age of the participants was 46 years, and 55.4% of the participants were female. A large majority of the sample were white (89.2%), 5.3% Hispanic, 2.1% African-American, and 1.0% Asian or Pacific Islander. Over 80% of the participants listed Florida as their state of residence and were registered to vote in this state. Approximately 69% of participants had been called for jury duty in the past, with 29.7% having served on the jury for a civil trial (10.7%) or a criminal trial (19.0%). 97.0% of the participants were registered to vote (42.1% Republican, 28.4% Democrat, 26.1% Independent, and 3.4% other).

## Experimental Materials and Task

Data was collected online, which allowed the researcher to record the exact amount of time spent reviewing the information and to reach a broader pool of participants. Because the case was detailed and lengthy in order to preserve a realistic setting for a trial, the case was presented to the participants in both text and audio format to increase attention and control for potential differences in reading comprehension. The case was developed based on past court cases in the Post-SOX era and was examined by multiple experts in accounting and law to assure that the facts presented in the case were externally valid. The case was pre-tested extensively.<sup>3</sup> The presentation structure of the case was based on Kadous (2001), who provided participants with opening statements and arguments from the plaintiff and defendant, and judge instructions to the jury.

---

type of sample is typically more representative of the general population compared to a student sample, which increases the external validity of the study (Grenier, Reffett, Simon and Warne 2018). The students were asked to recruit people who were over 18 years of age, and currently registered to vote in the U.S. Proper IRB approval was obtained for this study, including participant identification and compensation methods.

<sup>2</sup> Individuals were not excluded from the sample based on their answers to these questions, as jury selection is a process that is not necessarily predictable, and different lawyers have been known to employ very different strategies when arguing which individual to exclude from the jury (Hastie 1995). Responses to each of these questions were entered as covariates in the analyses of this study, with no significant results.

<sup>3</sup> Materials were examined by four lawyers, two business law professors, and ten individuals with expertise in accounting and/or auditing. The experiment was then pre-tested in paper format with an additional 22 individuals who provided in-depth feedback on the understandability of the task. Finally, an anonymous online pre-test was conducted with a sample of 60 individuals. Minor changes were made before final data collection.



In the scenario described to participants, the auditor reported a clean opinion on financial statements and a clean opinion on internal controls for the previous year. Then, in the following year, the company in question restated their income figures (downward) and disclosed the discovery of fraudulent activity pervasive throughout the company resulting from a material weakness in internal controls. This disclosure led to an immediate decrease in stock price and the company declared bankruptcy soon after.

Participants were told that the stockholders of the company had decided to initiate litigation in the form of a class action suit, alleging they incurred significant losses due to auditor negligence and from relying on misleading statements from the auditor. The suit claimed that their significant losses were a direct result of relying on the auditor's disclosures when purchasing the company's stock in the period between the release of the previous year's report and announcements that led to the significant loss in share value. Participants were presented with a mock trial scenario with arguments from lawyers for the plaintiff (stockholders) and defendant (auditor). They were also given the option to view the auditor's report on internal controls, which was provided in PDF format. Although participants were not required to review this report, 53.5% of participants indicated that they did. There were no significant differences in decisions made by the individuals who viewed the reports and those that did not, suggesting that participants were provided sufficient information within the case to understand the content of the auditor's Section 404 report without viewing the report. After reviewing the case information, participants were asked to decide if the auditor should be liable for damages, and, if liable, to determine the legal liability judgment. Participants then responded to manipulation checks and demographic questions.

### **Independent Variable: Disclosure**

The Section 404 report disclosure level, referred to as "Disclosure", was manipulated between groups with two conditions. In the first condition, the auditor did not publicly disclose any details about the significant deficiency in their Section 404 report. In the second condition, the auditor voluntarily provided a disclosure of the significant deficiency in their report on internal controls. In both conditions, the case stated that the auditor identified the deficiency in internal controls during the audit, but assessed it a significant deficiency and not a material weakness. Therefore, audit opinion on controls remained consistent across groups with only the disclosure differing between groups.

### **Independent Variable: Control Type**

The type of the internal control weakness was operationalized by manipulating the case scenario between groups, with one group receiving a case with a "Process-Level" control issue and the other case an "Entity-Level" control issue. All groups were told that fraud occurred in the recording of sales revenue. Each group also received details explaining that the auditor tested the control to assess the potential impact on the financial statements, and described the evidence collected. In both scenarios, auditors determined that these issues were significant deficiencies in internal controls. The auditors were also described to have performed substantive testing of sales transactions as a part of their audit procedures, and detected no material misstatements due to fraud. Therefore, the auditor reported an unqualified opinion on both the financial statements and internal controls.

The “Process-Level” internal control conditions were told that “...the internal controls for tracking and reporting inventory are ineffective and resulted in unreliable monitoring of inventory counts and demands.” The evidence collected by the auditor to test this control was an examination of inventory records at multiple locations to determine that procedures were operating effectively. The “Entity-Level” internal control conditions were told that the control environment was deficient. Specifically, the case stated that “...the internal controls established by the top level managers within the company were ineffective...” and that “...company policy over-emphasized meeting short term profit goals at the sacrifice of internal control at the sales division level.” The evidence collected by the auditor to test this control was based on a series of employee interviews.

### **Dependent Variables: Measures of Auditor Liability**

Auditor liability was measured with responses to multiple questions. First participants were asked to decide whether the auditor is “Liable” or “Not Liable” for negligent misrepresentation. Next, participants were asked to enter a number between \$0 and \$100,000,000 for compensatory damages and between \$0 and \$200,000,000 for punitive damages. Participants also responded to five questions designed to measure auditor liability exposure. Responses to these five questions were used to construct a factor representing participants’ perceptions of auditor liability.

## **RESULTS**

### **Perceptions of Liability**

Panel A of Table 1 provides a summary of the responses to the question “How would you vote”, with the response options “Liable” or “Not Liable”. A chi-square analysis of the mean responses indicates that potential jurors are less likely to perceive auditors as liable when the internal control issue is a Process-Level control ( $\chi^2(1) = 9.191, p=0.003$ ). They are also less likely to perceive auditors as liable when they had disclosed the deficiency ( $\chi^2(1) = 3.058, p=0.08$ ). These results support the hypothesized main effects for both Control Type (H1) and Disclosure (H2) on auditor liability. H3 is strongly supported, indicating that potential jurors perceive auditors who disclose a Process-Level control issue as less liable than auditors who disclose an Entity-Level control issue ( $\chi^2(1) = 9.621, p=0.001$ ).

Auditor liability exposure was also measured in a series of questions asking the participants to indicate their agreement (on a scale from one (strongly agree) to seven (strongly disagree)) with questions relating to the auditors’ liability, responsibility, performance quality, and disclosure quality. For consistency in analysis, these questions were reverse coded so that higher numbers indicate higher liability/less favorable responses. Mean responses to these questions by condition are found in Table 2, Panel A. Planned comparisons of the mean responses by group for each of these questions indicate that potential jurors perceive auditors more favorably when auditors disclosed the control deficiency (H1) and for Process-Level controls (H2) for four out of the five questions. They also perceive auditors who disclose a Process-Level control deficiency more favorably than auditors who disclose an Entity-Level control deficiency (H3) ( $p<0.05$  for all comparisons discussed in this paragraph).

A factor analysis indicates that the five questions effectively provide a measure of

auditor liability exposure. Panel B of Table 2 provides the results, which indicate that all measures load effectively on one factor (all individual loadings > 0.828), explaining 75.6% of the variance in the data. An ANOVA was performed with the factor score of these measures of auditor liability perceptions as the dependent variable. Panel C of Table 2 provides a summary of these results. Comparison of the mean factor scores indicates that potential jurors are less likely to perceive auditors as liable when auditors disclosed the deficiency (H1) ( $p=0.025$ ), and when the internal control issue is a Process-Level control (H2) ( $p=0.006$ ). Consistent with results above, potential jurors also perceive auditors disclosing a Process-Level control issue as less liable than auditors disclosing an Entity-Level control issue (H3) ( $p=0.007$ ).

### **Damages Awarded**

The next measures of auditor liability examined are the participants' answers to the questions: "What dollar amount in compensatory damages would you recommend be awarded to the stockholders?" (\$0 to \$100,000,000) and "What dollar amount in punitive damages would you recommend be awarded to the stockholders?" (\$0 to \$200,000,000). Panels A and C of Table 3 provide a summary of the responses to these questions by experimental condition. Panels B and D provide results for ANOVAs of compensatory and punitive damages.

There is no significant main effect for disclosure on this measure of auditor liability (H1) ( $p>0.10$ ). Results support a main effect for Control Type (H1), indicating that potential jurors award less compensatory and punitive damages when the issue is a Process-Level control ( $p=0.000$  and  $0.003$  accordingly). Results also strongly indicate that potential jurors award significantly less compensatory and punitive damages to shareholders when auditors disclose a Process-Level control issue than when auditors disclose an Entity-Level control issue (H2) ( $p=0.002$  and  $0.064$  accordingly).

### **Summary and Analysis of Results**

H1, which predicted that voluntary disclosures of significant deficiencies would favorably influence jurors' perceptions of auditor liability, was supported in all measures of jurors' perceptions of auditor liability, but not in damages assessed. This indicates that auditors are less likely to be found liable in the event of a trial if they had disclosed a significant deficiency in controls, no matter the type of control. These results provide support for auditors' use of the Section 404 report as a way to communicate important findings to users, resulting in a lower likelihood of being found liable for negligence in the event of an audit failure.

H2, which predicted that the type of internal control implicated in the fraud would influence jurors' perceptions of auditor liability, was supported in the majority of outcome measures in this study, including perceptions of auditor liability and damage assessments. Examination of the responses also indicates that jurors perceived auditors to have a higher level of compliance with auditing standards for the Process-Level control, compared to the Entity-Level control ( $p<0.05$ ; See Table 2). Therefore, the results of this study provide preliminary evidence that jurors may consider the type of evidence collected for Process-Level controls testing to be more convincing to support the auditors' due diligence defense than the type of evidence collected to test an Entity-Level control. This preliminary support indicating increased auditor liability exposure for Entity-Level controls should be concerning for auditors, and future research in this area would be important due to the limited nature of this study's

exploration of the topic. To expand on these results, future research should explore more specific perceptions of the types of evidence collected for Entity-Level controls, how auditors can reduce their liability exposure for these types of control assessments, and the underlying thought processes that lead to this outcome.

H3 was also supported in all measures in this study, such that when auditors disclose a Process-Level control issue they are viewed more favorably by potential jurors compared to auditors who disclose an Entity-Level deficiency. Auditors who disclosed Process-Level controls deficiencies in internal controls were judged as “Not Liable” 92% of the time, compared to all other conditions (35%-65%), and were the only condition where participants awarded zero punitive damages to the shareholders. These findings strongly indicate that providing a disclosure of a significant deficiency in controls can reduce auditors’ liability exposure, particularly when the disclosure is referencing a deficiency in a Process-Level control.

## CONCLUSIONS

Overall, results suggest that auditors’ 404 disclosure choices, and the type of internal control issue disclosed, may influence the outcome of a negligence trial in the event of an auditor’s failure to detect fraud. Specifically, auditors are viewed most favorably when they have provided a voluntary disclosure of a significant deficiency in controls, particularly when the disclosure is related to a process-level control. These results support a general increase in the transparency within the 404 report as a way to decrease legal liability exposure.

Although the primary focus of this study was on the impact of disclosures within the 404 report and the potential for differences based on the type of control in question, results also indicate that no matter the level of disclosure, auditors may be held more liable for audit failures related to entity-level controls compared to process-level controls. While this preliminary finding is important, future research is needed to further explore this topic and understand why this may occur. Future research is suggested to examine the specific types of evidence collected to support conclusions and disclosures related to internal controls, and how auditors are perceived for these judgments.

One major limitation of this study is the specific context used, which assumes that the case will be taken on by a lawyer and will not be dismissed by the judge before any actual trial or settlement discussions. The study results do not suggest that auditors will be less likely to be sued, or that the case would be more likely to be dismissed by a judge. Since past research has indicated that increased disclosures in some instances can actually increase the likelihood of a case proceeding to trial (Cutler, Davis, and Peterson 2018), these limitations must be taken into consideration. Therefore, the results of this study may be limited to disclosures contained within the 404 report, in consideration of settlement amounts, and in the event of a jury trial. Future research is suggested to confirm these results by examining the impact of 404 disclosures on cases in the past using historical case information.

In conclusion, this study provides practical insights for the ongoing debate regarding the liability exposure for auditors following SOX, by suggesting that auditors can potentially lessen their liability exposure by increasing the transparency of their Section 404 reports. Given that jurors are typically biased against auditors and likely to find them liable regardless of the context (Arel, Jennings, Pany, and Reckers 2012), these results strongly suggest that auditors will be viewed most favorably by jury members in the event of a trial by voluntarily disclosing

significant deficiencies in the 404 report on controls.

## REFERENCES

- Aobdia, D., P. Choudhary, and G. Sadka. 2018. Do Auditors Correctly Identify and Assess Internal Control Deficiencies? Evidence from the PCAOB Data. Georgetown McDonough School of Business Research Paper. Available at: <http://dx.doi.org/10.2139/ssrn.2838896>
- Arel, B., M. M. Jennings, K. Pany, and P. Reckers. 2012. Auditor liability: A comparison of judge and juror verdicts. *Journal of Accounting and Public Policy* 31(5): 516-532.
- Asare, S. K., L. Cunningham, and A. Wright. 2007. The Sarbanes-Oxley Act: Legal implications and research opportunities. *Research in Accounting Regulation* 19: 88-105.
- Backof, A. G., 2015. The Impact of Audit Evidence Documentation on Jurors' Negligence Verdicts and Damage Awards. *The Accounting Review* 9(6). Available at: <http://dx.doi.org/10.2139/ssrn.2144508>
- Bagnoli, M. and S. Watts. 2005. Conservative accounting choices. *Management Science* 51: 786-801.
- Basu, S., J. Krishnan, J. E. Lee, and Y. Zhang. 2012. Economic Determinants and Consequences of Voluntary Disclosure of Internal Control Effectiveness: Evidence from Initial Public Offerings. CAAA Annual Conference 2012. Available at: <http://dx.doi.org/10.2139/ssrn.1983233>
- Carcello, J. V. and Z. Palmrose. 1994. Auditor litigation and modified reporting on bankrupt clients. *Journal of Accounting Research* 32: 1-30.
- Connelly, B.L., S. T. Certo, R. D. Ireland, and C. R. Reutzel. 2011. Signaling theory: A review and assessment. *Journal of Management* 37(1): 39-67.
- Cutler, J., A. K. Davis, and K. Peterson. 2018. Disclosure and the outcome of securities litigation. *Review of Accounting Studies* 1-34. Available at: <https://doi.org/10.1007/s11142-018-9476-9>
- Gimbar, C., B. Hansen, and M. E. Ozlanski. 2016. The effects of critical audit matter paragraphs and accounting standard precision on auditor liability. *The Accounting Review* 91 (6): 1629–1646. Available at: <https://doi.org/10.2308/accr-51382>
- Grenier, J. H., A. Reffett, C. A. Simon, and R. C. Warne. 2018. Researching Juror Judgment and Decision Making in Cases of Alleged Auditor Negligence: A Toolkit for New Scholars. *Behavioral Research in Accounting* 30(1): 99-110.
- Hammersley, J. S., L. A. Myers, and C. Shakespeare. 2008. Markets reactions to the disclosure of internal control weaknesses and to the characteristics of those weaknesses under Section 302 of the Sarbanes-Oxley Act of 2002. *Review of Accounting Studies* 13: 141-165.
- Harris Interactive. 2008. Just under three in five Americans believe juries can be fair and impartial all or most of the Time. *The Harris Poll*. Available at: [http://www.harrisinteractive.com/harris\\_poll/index.asp?PID=861](http://www.harrisinteractive.com/harris_poll/index.asp?PID=861).
- Hastie, R. 1995. Inside the juror: the psychology of juror decision-making. *Cambridge University Press*, New York.
- Kadous, K. 2000. The effects of audit quality and consequence severity on juror evaluations of auditor responsibility for plaintiff losses. *Accounting Review* 75: 327-341.
- Kardos, D. 2009. KPMG Is Sued Over New Century. *The Wall Street Journal*. Available at: <https://www.wsj.com/articles/SB123860415462378767>

- Koh, H.C. and E. Woo. 1998. The expectation gap in auditing. *Managerial Auditing Journal* 13: 147.
- Krishnan, J., D. Rama, and Y. Zhang. 2008. Costs to comply with SOX Section 404. *Auditing: A Journal of Practice and Theory* 27: 169-186.
- Lamont, G. and P. Etzold. 2007. 2006 Securities litigation study. *Pricewaterhouse Coopers Securities Litigation Services*. Available at: [www.10b5.pwc.com](http://www.10b5.pwc.com).
- Latham, C. and M. Linville. 1998. A review of the literature on audit litigation. *Journal of Accounting Literature* 17: 175-213.
- Levine, C., and J. Hughes. 2005. Management compensation and earnings-based covenants as signaling devices in credit markets. *Journal of Corporate Finance* 11: 832-850.
- Lipe, M.G. 2008. Discussion of "Judging audit quality in light of adverse outcomes: Evidence of outcome bias and reverse outcome bias". *Contemporary Accounting Research* 25: 275-282.
- Lowe, J. and P. Reckers. 1994. The effects of hindsight bias on jurors' evaluations of auditor decisions. *Decision Sciences* 25: 401-426.
- Lowe, J. and P. Reckers. 2002. A preliminary framework in examining the influence of outcome information on evaluations of auditor decisions. *Advances in Accounting* 19: 177- 187.
- Mong, S. and P. Roebuck. 2005. Effect of audit report disclosure on auditor litigation risk. *Accounting and Finance* 45: 145-169.
- Olgoff, J. 2003. Taking psychology and law into the twenty-first century. New York: Kluwer Academic/Plenum Publishers.
- Paul, J. 2005. Exploring PCAOB Auditing Standard 2: Audits of internal control. *The CPA Journal*. Available at: <http://www.nysscpa.org/cpajournal/2005/505/essentials/p22.htm>.
- Peecher, M. and D. M. Piercey. 2008. Judging audit quality in light of adverse outcomes: Evidence of outcome bias and reverse outcome bias. *Contemporary Accounting Research* 25(1).
- Public Company Accounting Oversight Board. 2007. AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements Available at: <https://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx>
- Public Company Accounting Oversight Board (PCAOB). 2009. An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies. Available at: <https://pcaobus.org/Standards/Auditing/Documents/AS5/Guidance.pdf>
- Public Company Accounting Oversight Board (PCAOB). 2013. Release No. 2013-005, Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. Available at: <http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx>
- Public Company Accounting Oversight Board (PCAOB). 2013. Considerations for Audits of Internal Control over Financial Reporting. Available at: [https://pcaobus.org/Standards/QandA/10-24-2013\\_SAPA\\_11.pdf](https://pcaobus.org/Standards/QandA/10-24-2013_SAPA_11.pdf)
- Schroeder, J. H., and M. L. Shepardson. 2016. Do SOX 404 Control Audits and Management Assessments Improve Overall Internal Control System Quality? *The Accounting Review* 91(5): 1513-1541.
- Sennetti, J. T., C. P. Becker, and H. J. Lawrence. 2011. Does the Change to Principles-Based Accounting Increase Juror Assessments of Auditor Liability? *Advances in Accounting Behavioral Research* 14: 165.

Securities and Exchange Commission (SEC). 2016. SEC Charges Company and Executives for Faulty Evaluations of Internal Controls. Available at:

<https://www.sec.gov/news/pressrelease/2016-48.html>

Titman, S., and B. Trueman. 1986. Information quality and the valuation of new issues, *Journal of Accounting and Economics* 8(2): 159-172.

## APPENDIX

TABLE 1

### The Effect of Disclosure and Control Type on Judgments of Auditor Liability for Negligence

Panel A: Descriptive Statistics

	<u>Dependent Variable: Auditor Liability</u> <u>(0=Not Liable, 1=Liable)</u>		<u>Row Means</u>
	<u>Control Type</u>		
	<u>Entity-Level</u>	<u>Process-Level</u>	
Not Disclosed	<b>0.52</b> (0.510) n = 25	<b>0.35</b> (0.489) n = 20	<b>0.44</b> (.503) n = 45
Disclosed	<b>0.48</b> (0.511) n = 23	<b>0.08</b> (0.277) n = 25	<b>0.27</b> (0.449) n = 48
<u>Column Means</u>	<b>0.50</b> (0.505) n = 48	<b>0.20</b> (0.405) n = 45	

Notes: Means, standard deviations (in parentheses), and number of participants are provided. A chi-square test indicates a significant difference in liability judgments between groups ( $\chi^2(3) = 12.760, p=0.005$ ).

Summary of Hypothesized Results:

H1, which tested for a main effect of Disclosure on auditor liability was moderately supported ( $\chi^2(1) = 3.058, p=0.08$ )

H2, which tested for a main effect of Control Type on auditor liability was supported ( $\chi^2(1) = 9.91, p=0.003$ )

H3 was supported. Results reveal a significant simple main effect of Control Type when the Deficiency was disclosed (compares the Disclosed/Entity-Level control and Disclosed/Process-Level control groups) ( $\chi^2(1) = 9.621, p=0.001$ )

**TABLE 2****The Effect of Disclosure and Control Type on Perceptions of the Auditor****Panel A: Mean Responses**

Dependent Variable

(7 point scale; Some responses were reverse coded such that a higher rating = less favorable for the auditor)

	Condition	Condition	
		Entity-Level	Process Level
ABC CPA Firm is liable for negligent misrepresentation*	Not Disclosed	4.480	3.000
	Disclosed	4.000	2.160
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed*	Not Disclosed	3.560	2.950
	Disclosed	2.913	1.520
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose*	Not Disclosed	3.880	3.391
	Disclosed	3.500	1.680
ABC CPA Firm could have prevented the stockholder losses*	Not Disclosed	4.600	4.174
	Disclosed	4.250	2.960
ABC CPA Firm is responsible for stockholder losses	Not Disclosed	3.720	3.435
	Disclosed	3.100	2.520

\*Comparison of the means supported they hypothesized main effect for Disclosure (H1) and Control Type (H2) and simple main effects of Control Type when the Deficiency was disclosed (compares the Disclosed/Entity-Level control and Disclosed/Process-Level control groups (H3) ( $p < 0.05$ ))

**Panel B: Factor Loadings**

<b>Auditor Liability Measure</b>	<b>Factor Loading</b>
ABC CPA Firm is liable for negligent misrepresentation	0.912
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose	0.851
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed	0.885
ABC CPA Firm could have prevented the stockholder losses	0.828
ABC CPA Firm is responsible for stockholder losses	0.872
Total variance explained	75.7%



Panel C: ANOVA of Auditor Liability (Factor Scores)

		<u>Dependent Variable: Auditor Liability</u> <u>(Factor Scores)</u>		
		<u>Control Type</u>		
		<u>Entity-Level</u>	<u>Process-Level</u>	<u>Row Means</u>
Not Disclosed		<b>0.407</b> <i>(1.113)</i> n = 25	<b>0.050</b> <i>(0.901)</i> n = 20	<b>0.248</b> <i>(1.029)</i> n = 45
Disclosed		<b>0.158</b> <i>(1.081)</i> n = 23	<b>-0.593</b> <i>(0.559)</i> n = 25	<b>-0.233</b> <i>(0.449)</i> n = 48
<u>Column Means</u>		<b>0.287</b> <i>(1.093)</i> n = 48	<b>-0.306</b> <i>(0.791)</i> n = 45	

<u>Independent Variable</u>	<u>Dependent Variable: Auditor Liability</u> <u>(Factor Scores)</u>	
	<u>F-Stat</u>	<u>p-value</u>
<b>Control Type</b>	<b>8.021</b>	<b>0.006***</b>
<b>Disclosure</b>	<b>5.207</b>	<b>0.025**</b>
Control Type x Disclosure	1.011	0.347

Notes: Auditor liability in this analysis is the factor score of the 5 questions provided in Panels A and B of this table. The mean factor scores by condition, and results of an ANOVA of the independent variables Control Type (Entity-level/Process-level) and Disclosure (not disclosed/disclosed) are presented in Panel C.  
 \*\*Notes significance at p<0.05 and \*\*\*Notes significance at p<0.01

Summary of Hypothesized Results:

- H1, which tested for a main effect of Disclosure on auditor liability was supported (p=0.025)
- H2, which tested for a main effect of Control Type on auditor liability was supported (p=0.006)
- H3 was supported by a significant simple main effect of Control Type when the Deficiency was disclosed (compares the Disclosed/Entity-Level control and Disclosed/Process-Level control groups) (p=0.007)

**TABLE 3****The Effect of Disclosure and Control Type on Compensatory and Punitive Damages**

## Panel A: Compensatory Damages Descriptive Statistics

Dependent Variable: Compensatory Damages (\$0-\$100 million; presented in millions)			
Control Type			
	Entity-Level	Process-Level	Row Means
Not Disclosed	<b>44.400</b> (48.225) n = 25	<b>16.000</b> (32.509) n = 20	<b>31.777</b> (43.915) n = 45
Disclosed	<b>36.657</b> (44.085) n = 23	<b>4.200</b> (19.983) n = 25	<b>19.272</b> (36.957) n = 48
Column Means	<b>40.210</b> (46.008) n = 48	<b>9.444</b> (26.335) n = 45	

## Panel B: ANOVA of Compensatory Damages

Dependent Variable: Compensatory Damages		
<u>Independent Variable</u>	<u>F-Stat</u>	<u>p-value</u>
<b>Control Type</b>	<b>14.333</b>	<b>0.000***</b>
Disclosure	1.688	0.197
Control Type x Disclosure	0.037	0.847

Notes: Compensatory damages were measured as \$0-\$100 million. Means, standard deviations (in parentheses), and number of participants are provided in Panel A. Panel B presents the results of an ANOVA where the independent variables are the Disclosure of a significant deficiency of internal control (Disclosed or Not Disclosed) and the Control Type (Entity-Level or Process-Level).

\*\*\*Notes significance at  $p < 0.001$

## Summary of Hypothesized Results:

H1, which tested for a main effect of Disclosure on compensatory damages was not supported ( $p=0.197$ )

H2, which tested for a main effect of Control Type on auditor liability was supported ( $p=0.000$ )

H3 was supported by a significant simple main effect of Control Type when the Deficiency was disclosed (compares the Disclosed/Entity-Level control and Disclosed/Process-Level control groups) ( $p=0.002$ )

## Panel C: Punitive Damages Descriptive Statistics

Dependent Variable: Punitive Damages (\$0-\$200 million; presented in millions)			
Control Type			
	Entity-Level	Process-Level	<u>Row Means</u>
Not Disclosed	<b>40.400</b> (76.483) n = 25	<b>32.250</b> (11.813) n = 20	<b>24.011</b> (53.736) n = 45
Disclosed	<b>20.282</b> (53.589) n = 23	<b>0.000</b> (0.000) n = 25	<b>9.718</b> (38.067) n = 48
Column Means	<b>30.760</b> (61.423) n = 48	<b>15.666</b> (79.626) n = 45	

## Panel D: ANOVA of Punitive Damages

<u>Independent Variable</u>	<u>Dependent Variable: Punitive Damages</u>	
	<u>F-Stat</u>	<u>p-value</u>
<b>Control Type</b>	<b>9.571</b>	<b>0.003**</b>
Disclosure	1.637	0.204
Control Type x Disclosure	0.817	0.372

Notes: Punitive damages were measured as \$0-\$200 million. Means, standard deviations (in parentheses), and number of participants are provided in Panel C. Panel D presents the results of an ANOVA where the independent variables are the Disclosure of a significant deficiency of internal control (Disclosed or Not Disclosed) and the Control Type (Entity-Level, Process-Level).

**\*\*Notes significance at p<0.05**

## Summary of Hypothesized Results:

H1, which tested for a main effect of Disclosure on punitive damages was not supported (p=0.204)

H2, which tested for a main effect of Control Type on auditor liability was supported (p=0.003)

H3 was moderately supported by a significant simple main effect of Control Type when the Deficiency was disclosed (compares the Disclosed/Entity-Level control and Disclosed/Process-Level control groups) (p=0.064)