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Auditor Litigation Risk: A Review of Past Perspectives, Recent Developments, and Emerging Issues

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Introduction

Auditors are often referred to as the gatekeepers of financial reporting. With this responsibility comes the expectation that auditors will protect shareholders from monetary losses due to fraudulent financial reporting. Unfortunately, audit failures do occur, typically resulting in shareholder litigation against audit firms in the event of client bankruptcies or significant fraudulent events. The costs and reputation effects of these lawsuits can be significant. This article provides a review of the different sources of auditor litigation exposure, as well as related trends. Trends from practice and research are divided into three major segments: (1) the immediate post-SOX era, (2) the post-Great Recession era, and (3) emerging issues in 2019 and beyond.

The many provisions outlined within the Sarbanes-Oxley Act of 2002 (SOX) sparked an active debate among professionals, standard setters, and researchers, generating a wide body of research to examine the impact of the historic legislative action. The widespread changes generated a number of interesting and important questions, many of which are still open for debate and being explored in various academic research studies. The feedback has been mixed, with some research proposing that SOX has had an overall positive effect on the quality of financial reporting, and others citing increased costs and liability exposure as unwanted and unintended negative consequences.

Audit firms continue to face the consequences of audit failures that occurred during the Great Recession period. One key principle that has emerged from these cases is that auditors are responsible for designing specific procedures to detect fraud and face significant financial consequences for failing to demonstrate due diligence in exercising this responsibility. Audit quality concerns have pointed to flaws in related audit procedures for evidence collection and documentation as a source of risk for auditor liability exposure.

In addition to reviewing the recent past, several emerging areas of auditor litigation risk are highlighted. Specifically, this article explores the potential for increased auditor litigation risk due to enhanced audit reports, technological advancements, and cybersecurity vulnerabilities. Further concerns are explored as they relate to increased insurance costs and negative reputation effects due to media scrutiny in this age of rapid information dissemination.

This review provides useful information for both researchers and practitioners on the current state of auditor litigation exposure. Researchers can utilize the review to generate future topics that would be useful for the field. Auditors and their firms also may find the review helpful, as the article provides a comprehensive overview of the issues faced by the profession today, as well as risks that may continue to emerge. The overall purpose is to reflect on and learn from the recent past and take this knowledge into the future. Overall, this study does not explore the topic of pursuing additional limitations on auditor liability. Instead, potential solutions which address the litigation risks are discussed, and future research is suggested to explore the true impact of emerging risks on auditors.

The section below provides an overview of perspectives in the immediate post-SOX era, followed by a review of related research through 2019. Next, the research explores developments in court cases and research findings since the Great Recession era. Last, emerging trends are explored to address the potential of increased current and future risks of auditor litigation.

Background and Literature Review

Fears of Catastrophic Risk: Common Perspectives in the Immediate Post-SOX Era

SOX is still referred to as the most historic intervention in the regulation of accountants since the Great Depression

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of the 1930s (DeFond and Francis, 2005). One of the most highly criticized provisions of SOX was the significant increase in responsibility for managers and auditors to evaluate and provide a report on the effectiveness of internal controls (Brown, 2006; Bedard et al., 2007; Krishnan et al., 2008).

The auditor's opinion on internal controls reports any deficiencies that are deemed to be material weaknesses in internal controls that could result in material misstatement of the financial statements (PCAOB, 2007). This evaluation of materiality required by Section 404(b) has been cited as an overly complex and inherently subjective component of the audit, as this task relies heavily on professional judgment (Tackett et al., 2006). Auditors are required to consider the impact of any internal control deficiencies on risks such as management fraud, restatement activity, detection of material misstatements in current period, and ineffective oversight (PCAOB, 2007). Many of these assessments require the auditor to make a qualitative judgment of materiality, and are often considered less auditable, meaning that the auditor cannot necessarily provide direct evidence or documentation to support their materiality judgments. Therefore, one may argue that the evaluation of internal controls, at least in part, is inherently more complex and reliant on professional judgment than the financial statement audit task, in which the auditor often relies heavily on quantitative materiality ranges to reach conclusions.

Immediate Post-SOX Era: Sources of Auditor Liability Exposure

The increased professional responsibility for 404(b) reporting was a major cause of concern, as auditors are subject to legal liability from multiple statutes and laws, both at the state and federal level. Some argue that auditors are most vulnerable to catastrophic losses for liability under federal law that protects the sale and purchase of securities, as indicated by payment of over $14 billion by U.S. accounting firms in securities-related cases over the past three decades (Talley, 2006). Although some of this liability has been a result of SEC action, a large portion also is attributed to class action lawsuits initiated by shareholders. Specifically, Rule 10b-5 of the Exchange Act of 1934 has been cited as a source of increased liability exposure resulting from Section 404 reporting (Asare et al., 2007; Udeh and Epps, 2013). This act allows for private action when the plaintiff can link monetary losses to an act of recklessness on the part of the auditors (Talley, 2006).

Some argued that the additional disclosures required by Section 404(b) provide a new excuse for suing the auditor under the Exchange Act of 1934 (Talley, 2006). In past lawsuits, auditors were more likely to be implicated as secondary actors (i.e., aiding and abetting in fraud) as opposed to primary actors (i.e., directly active in committing fraud), as most of the cases were brought against the auditor for omitting information that would have influenced the shareholders' decision to purchase or sell stock (Asare et al., 2007). The classification of auditors as secondary actors in past lawsuits was motivated by the fact that auditors were not required to report on internal controls, thus preventing auditors from being held liable as primary actors for disclosing false and misleading statements under Rule 10b-5 of the Exchange Act of 1934 (Asare et al., 2007). However, the additional language required in Section 404 reports potentially exposes auditors to additional liability when they specifically discuss material weaknesses and the resulting impact on the financial statements (Asare et al., 2007). This particular requirement arguably creates a situation where auditors may be exposed to more liability for reporting on controls (Asare et al., 2007).

An additional source of liability cited as a significant issue is found at the state level. Currently, there is a large overlap between federal and state laws. Class action suits that are filed citing the Securities Act of 1933 or the Exchange Act of 1934 must be tried in federal court (Talley, 2006). However, class action suits can still be tried at the state level under common law tort principles. The class action suit at the state level allows for punitive damages when the auditor is negligent in performing the audit, as long as the plaintiff can prove that the auditor should have been able to reasonably foresee the possibility that users, such as creditors or shareholders, would rely on the auditor's statements (Talley, 2006). This particular liability exposure has been highly criticized by auditors, as no proof of intent to mislead is required, in contrast to the Exchange Act of 1934 (Talley, 2006). All the plaintiff must prove is negligence, or that the auditor did not perform to a minimum standard of care during the audit (Talley, 2006).

The fact that state courts oversee these trials has been criticized for an inherent lack of consistent application of the standards. As a result, audit firms petitioned the U.S. Treasury Committee to limit their liability to federal courts under the Securities Act of 1933 and the Exchange Act of 1934, and to prohibit class action suits at the state level under tort law (Sukhraj, 2008). However, the committee issued a report in 2008 indicating that they did not come to a consensus on this matter and decided not to form an opinion or make recommendations to Congress related to this particular suggestion

(Whitehouse, 2009). Therefore, auditors remain exposed to liability for negligence at the state level under tort law.

At the time, some researchers proposed that the increased liability exposure for auditors described in the paragraphs above represented a positive side effect of SOX (Krishnan et al., 2008). The general argument to support this perspective was that the increased litigation risk motivates auditors to increase quality and effort; thus, the additional audit costs attributed to litigation risk are worth the benefit (Krishnan et al., 2008). Others argued that the additional liability exposure was excessive to the detriment of the audit industry as a whole, and the increased costs passed down to their clients were not worth the minimal assurance provided with additional audit efforts (Cunningham, 2004). This increase in liability exposure was argued to be primarily due to the increased responsibility placed on auditors for Section 404(b) reporting. The root of this argument is based on the additional disclosures contained within the Section 404(b) report, which hold auditors responsible not only for detecting fraud, but for providing a signal of the risk of fraud in the future (Cunningham, 2004). The following sections provide a review of key research findings in the post-SOX era to explore whether or not these concerns are valid.

Evidence of Auditor Liability in the Immediate Post-SOX Era

Some researchers have found evidence of an uptick in auditor litigation due to internal controls in the immediate post-SOX era up to 2006 (Udeh and Epps, 2013). In 2009, Mark Cheffers, CEO of Audit Analytics, presented a summary of malpractice settlements since 1999 detailing billions of dollars in settlements from Big-4 auditor malpractice cases (Whitehouse, 2009). However, other studies indicate that litigation risk has leveled off since SOX and is now equal to or more favorable than during the pre-SOX era. For example, audit firms in the immediate post-SOX era were less likely to settle out of court, and settlement amounts were on par with those in the time period before SOX was implemented (Krishna, Moorthy, and Sarath, 2015). There are also some indicators that auditor litigation risk at the federal level has decreased in some respects and is on trend to continue to decline. Honigsberg, Rajgopal, and Srinivasan (2019) provide descriptive evidence of a significant increase in Rule 10b-5 cases thrown out by courts, from 23% in 1996 to 69% in 2013. The authors note that this trend may have to do with rulings during this period of time that limited the ability of shareholders to bring claims against auditors. This trend is important, as auditors previously expressed deep concerns over catastrophic losses for 10b-5 cases in the immediate post-SOX era.

Overall, the body of research in the post-SOX era on auditor liability and related costs is mixed and considered to be inconclusive (Coates and Srinivasan, 2014). However, evidence suggests that catastrophic risks due to SOX-related liability exposure have not materialized as feared, and the Big-4 have clearly not followed Arthur Andersen's demise. By some indications, increased liability exposure and costs specifically related to SOX Section 404(b) appear to have leveled off. Recent court cases are emphasizing different components of the audit, such as the auditors' procedures to detect fraud. However, auditors' risk of liability due to increased disclosure requirements and subjectivity in audit judgments are at the center of ongoing debates that will likely continue to develop over time. The section below explores several emerging areas of auditor liability risk in the period following the Great Recession.

Auditor Liability After the Great Recession: Key Rulings and Trends

A series of court rulings over the past decade have resulted in precedent that may significantly impact auditor liability exposure in the future. Specifically, cases related to the banking crisis and in wake of the Great Recession are still making their way through various court systems, resulting in major concerns for audit firms. Auditors were largely spared from additional regulations under the Dodd Frank Act, but several landmark cases from this era will continue to influence auditor liability for years to come. Recent headlines suggest that public perception of auditors is suffering greatly in wake of recent cases related to failed banks during the Great Recession (Ford and Marriage, 2018). However, more recently, some have noted a marked downturn in successful lawsuits against auditors (Lagace, 2019). This section explores these trends in more detail.

In some instances, auditors have benefited from recent rulings in cases related to Rule 10b-5, providing some protection from future class action shareholder lawsuits in federal courts. However, the future for auditors in state courts is more uncertain. Table 1 provides a summary of recent key cases that have impacted the legal landscape for audit firms, each of which are explored in the sections below.

Limitations for Rule 10b-5 Cases

Recent research reports an overall trend of decreased auditor litigation brought by shareholders under Rule 10b-5 of the Securities Exchange Act of 1934 (Honigsberg, Rajgopal, and Srinivasan, 2019). In fact, only two federal class-action securities settlements in 2018–2019 named auditors as defendants, which is the lowest count recorded in the past decade (Cornerstone Research, 2019b). However, some propose that this trend is not primarily due to increased audit quality, and that recent court cases in 2007 and 2011 have decreased the likelihood of auditors being named as defendants in federals securities cases (Honigsberg, Rajgopal, and Srinivasan, 2019).

The Supreme Court decision for *Tellabs v. Makor* in 2007 addressed conflicting applications of the Private Securities Litigation Reform Act (PSLRA) of 1995, which limited the ability for shareholders to sue auditors under Rule 10b-5. Specifically, there were conflicting applications of the conditions under which a party could be considered to have knowingly committed false and misleading acts, otherwise known as "scienter." The *Tellabs v. Makor* ruling clarified that evidence of scienter needed to be more convincing than evidence in the opposition. For auditors, this ruling could mean that evidence needs to be stronger to support the allegation that they knowingly committed false statements or gross negligence. This decision has been interpreted by legal experts to mean that simply ignoring red flags is not enough to establish auditors as having fraudulent intent, and that the auditor's behavior must have been particularly egregious and reckless (Gorman, 2010).

In 2011, the Supreme Court released a decision that limited the ability of shareholders to hold mutual fund investment advisors liable for misleading or fraudulent statements made in their clients' prospectuses. In the case, First Derivative Traders (plaintiff) alleged that Janus Capital Group (defendant) should be held liable for false statements made in mutual fund documents. In a summary of the ruling, Justice Thomas noted that Rule 10b-5 could not be applied to this situation, since the mutual funds did not make the misleading statements (*Janus Capital Group v. First Derivative Traders*, 2011). This decision was widely interpreted as placing limitations on the ability for shareholders to sue any entity for securities fraud other than the entity with ultimate authority over the alleged false statements. The Janus ruling would likely apply to statements made by clients that auditors could not control and did not make themselves, such as press releases or quarterly reports. However, auditors are still responsible for statements that they make, such as those contained in audit reports. In fact, the ruling used audit reports as an example of appropriate situations in which secondary actors, such as auditors, lawyers, or investment advisors, could be implicated for false statements under Rule 10b-5 (Tibbets, 2015). Therefore, while this decision provides some protection for auditors for false statements made by their clients, the decision reinforces that auditors will be held accountable for any statements made by the auditors themselves.

The 2011 Janus decision confirms once again that auditors will not be held liable under the concept of "scheme liability," in which auditors are aiding and abetting clients' false statements (Tibbets, 2015). Previous rulings, such as the case of *Stoneridge Investment Partners v. Scientific-Atlanta* (2008), applied this concept to different scenarios, consistently limiting the ability of secondary actors (i.e., auditors) to be held liable as primary actors under the theory of scheme liability. These cases from 2007–2011 provide clarity that auditors will not be held liable under Rule 10b-5 for the statements made by their clients, and that in order to be held liable for their own statements their behavior during the audit process must be convincingly reckless or egregious.

FDIC Lawsuits

Although auditors may have benefited from several Supreme Court rulings in the post-SOX era, a new round of audit failures related to the Great Recession have been making their way through state court systems. Many of these cases have been settled out of court (McLannahan, 2018). However, one key area of emerging risk for auditors in the post-Recession era is in cases brought by the FDIC, which insures funds held at banks in the U.S. The FDIC incurs losses as a result of bank failures, which then exposes auditors to negligence claims. Since hundreds of banks have failed since the Great Recession (FDIC, 2018), these failures leave auditors open to a significant amount of liability should these claims be considered valid.

The FDIC cases are unique, as they are not permitted to be settled in private (McKenna, 2018b). Therefore, the outcomes of any court decision are public information. This rule removes one of the primary incentives for auditors to settle out of court: the desire to keep specific details of the case private. In addition to privacy limitations, precedent from rulings in wake of the Savings and Loan Crisis indicates that the defense in cases that involve the FDIC are restricted, such that they cannot involve imputation-based defenses (Fisher, 2018). Therefore, auditors are limited in their ability to argue that the contributory negligence of the bank's employees absolves the auditors from being held liable for negligence. Since this

defense is successful in other cases, such as those under Rule 10b-5, auditors may experience increased difficulties in defending their actions in court.

One recent example of this type of liability exposure is in the case of the *Colonial Bancgroup et al. vs. PWC et al.* (2018) related to the firms' 2002-2007 audits of the failed Colonial Bank (Ariail and Crumbley, 2019). The bank failure allegedly cost the FDIC over $2 billion (Cohn, 2018). In this case, the FDIC alleged that PWC failed to detect an underlying fraud scheme in assets sold to Colonial Bank by Taylor, Bean & Whitaker (TBW). The judge ruled in favor of the FDIC, and PWC was ordered to pay $625.31 million in damages. The parties ultimately reached a settlement of $335 million in early 2019, with no written admission of liability on the part of PWC (Johnson, 2019). This record-setting judgment was the first FDIC case to be filed in the post-Recession era and has resulted in some speculation of more cases to come alleging auditor negligence (Reuters Editorial, 2012; McKenna, 2018a; Deitch and Skibell, 2018).

One major concern related to this case is that the judge even allowed the case to proceed (Masters, 2018). This precedent opens audit firms to a significant amount of liability for their audits of banking institutions. However, courts are currently split on the decision to allow the FDIC to sue auditors of failed banks on behalf of taxpayers, and some experts strongly believed that the case would have been overturned on appeal (Masters, 2018). No matter the result, FDIC lawsuits are a point of contention and legal ambiguity for audit firms, and are likely to continue to increase litigation costs, negative media coverage, and liability judgments against auditors in the future. [See Table 1, pg. 39]

Auditors' Responsibility for Detecting Fraud

Although the significant majority of cases over the past decade were settled and failed to generate significant news coverage, the PWC vs. FDIC case discussed above has been heavily covered by the media. This judgment against PWC specifically noted that the auditors neglected to collect sufficient appropriate audit evidence to detect fraud, ignored red flags, and did not demonstrate an appropriate level of professional skepticism (Deitch and Skibell, 2018).

In the related case of PWC vs. TBW, audit partners interviewed as witnesses created some controversy by stating that auditors are under no obligation to find fraud, and that PWC audits are not designed for fraud detection (Rapoport, 2017). This statement was later clarified to mean that auditors are not guarantors of their client's financial statements. Auditing standards are clear, indicating that auditors are responsible for designing procedures to detect material misstatements, due to errors or fraud (AICPA, 2013). However, the main line of argument from the PWC partners is common, such that auditors should not be held responsible for failures to detect fraud. This issue is one of contention, as many argue that auditors are unfairly held to standards that are not attainable, to the detriment of the profession as a whole (Azola, 2017; Langdon, 2018).

Overall, the facts that have emerged from recent cases highlight the fact that auditors face increasing scrutiny for the detection of fraud (McKenna, 2018a). These risks are heightened for state-level cases, as the standards for holding auditors liable for a lack of due diligence are typically less strict compared to those for Rule 10b-5. However, auditors can address these particular liability risks directly by implementing procedures specifically designed to detect fraud on every audit. Firms should place a focus on maintaining consistently high-quality audits to decrease the likelihood of being found negligent in the event of a client bankruptcy or undetected fraud event. Past research indicates that when auditors perceive that they will be held accountable for fraud detection, they perform more procedures to do so (DeZoort and Harrison, 2018). Therefore, awareness of these recent court case trends is important. This increased effort in response to fraud risks may lead to an increase in audit fees (Paik, Kim, Krumwiede, and Lee, 2018), but will arguably result in higher quality financial reporting and decreased auditor liability exposure in the future.

Additional Current and Emerging Issues

This section examines more current and emerging issues faced by auditors in 2019 and beyond, highlighting the specific areas of auditor liability exposure with the most potential for a high magnitude of impact on audit firms. Topics explored below include liability issues due to enhanced audit reports, technological advances and cybersecurity, insurance premium costs, and media exposure. Future research is suggested in each topic area.

Enhanced Audit Reports: Disclosing Critical Audit Matters

Auditors are of public companies are now required to issue enhanced reports that provide details about Critical Audit Matters (CAMs) that emerge during the audit process (PCAOB, 2018a). This new standard was initiated by the

PCAOB to increase the transparency and usefulness of audit reports and has been referred to by some as the "the biggest change to public company auditor reporting in 70 years" (Murphy, 2019). Recent reviews of the first reports emerging from this new standard indicate that auditors are emphasizing issues such as revenue recognition, income taxes, goodwill, and other intangible assets. However, some controversy emerged in the process of adopting this standard, specifically related to the potential for increased auditor liability exposure as a result of increased disclosure requirements (Gimbar, Hansen, and Ozlanski, 2015).

The issue of increased auditor liability exposure for CAM disclosures was raised by many in the profession, including audit firms and the Center for Audit Quality (CAQ) (PCAOB, 2013b). One major concern is that making additional disclosures exposes the auditor to increased liability to shareholders under Rule 10b-5, a line of argument that is similar to the issues communicated in the immediate post-SOX era discussed earlier in this study. As a result, the CAQ and audit firms insisted that additional language be included in any enhanced audit reports to clearly communicate the limitations of the auditor's responsibilities.

These concerns of increased liability exposure for CAM disclosures are perhaps compounded by ASC606, the new revenue recognition standard released by FASB and adopted by public companies in 2018–19. ASC606 requires high levels of subjective judgment, potentially exposing auditors to additional liability. Already, in 2019, five federal securities class-action lawsuits directly referenced ASC606. In addition, settlements related to cases involving revenue recognition are historically higher compared to cases involving non-revenue recognition issues, and auditors are more likely to be named in defendants in revenue-recognition cases (Cornerstone Research, 2019a). Perhaps as a result of this subjectivity and awareness of potential liability risk, revenue recognition was the second most likely CAM to appear in audit reports in 2019 (Cornerstone Research, 2019a).

Some of this concern is further validated by research indicating that increases in disclosures can lead to higher risk that a case against an auditor will not be dismissed by a judge and will be permitted to continue to trial (Cutler, Davis, and Peterson, 2018). However, an emerging stream of behavioral research indicates that in the event of a trial alleging auditor negligence, jurors may perceive auditors more favorably if they had provided CAM disclosures in the audit report, even if those disclosures were unrelated to the undetected misstatement (Brasel, Doxey, Grenier, and Reffett, 2016). The authors also find that including a statement within the audit report that there were no CAMs increases auditor liability exposure. This finding should encourage auditors to be forthcoming and disclose CAMs, as they will be protected in the event of a failure to detect material misstatements. However, the debate on this topic continues, and future research is needed to investigate the actual impact of CAMs on auditor liability.

Technological Advances and Cybersecurity Risks

Rapid development of advanced technology in the area of accounting and auditing has created an environment of increased uncertainty in the profession. The lack of regulation and standards related to emerging technologies that utilize automation and/or artificial intelligence should be a significant concern for auditors. Specifically, how will auditors utilize this technology, and how will their choices be perceived in the event of an audit failure?

In addition to concerns related to automation/AI, auditors are facing increased risks associated with cybersecurity, both internally and for their clients. From the perspective of CPA firms overall, this increased risk creates an opportunity to provide services that enhance the security of private information for consulting clients. However, the impact on auditors could be an increase in liability exposure for privacy related to the audit process and CPA firm data, and for their clients' disclosures related to cybersecurity and internal controls.

Audit firms also have experienced security breaches threatening private data. For example, in 2016–2017 Deloitte experienced a breach of their global email server, which potentially exposed hackers to over 5 million employee emails and contact information for Deloitte's clients (Hopkins, 2017). Even the SEC is not immune to cyberattacks. In 2016, the SEC experienced a security breach of the EDGAR platform, which exposed data of company filings that had not yet been released publicly (Burns, 2017).

As clients face increased risk of private data breaches related to customers and employees, auditors should increase their focus on encouraging clients to take preventative measures and disclose cybersecurity risks. The SEC has clarified that companies should publicly disclose any security breaches, or risk punishment for non-compliance with regulations (Newman, 2018; Vincent and Trussel, 2019). For example, in 2018, the SEC fined Yahoo $85 million for failing to properly

disclose a security breach from 2014 (Faitelson, 2018). Auditors are responsible for providing assurance of compliance with reporting requirements, and for assessing the internal controls that should be in place to prevent and detect cybersecurity issues. Therefore, auditors should design specific procedures to address these risks in order to protect auditors from legal liability in the event of a security breach.

In 2019, PCAOB board member Kathleen Hamm emphasized that auditors should be assessing risks of security breaches for their clients, even in the absence of actual security incidents, as a part of the required integrated audit of internal controls over financial reporting (Huguen, 2019). The Center for Audit Quality also released a summary of expectations for auditors, clarifying current standards and expectations that auditors should design procedures to assess the necessity of additional disclosures related to internal controls for cybersecurity risks, and any pending lawsuits should be assessed for classification as a contingent liability (CAQ 2019). The increased communication and emphasis on cybersecurity by leaders in practice indicates that assessing the risks and liability for audit clients' cybersecurity is now considered an important part of the audit process. Adding this additional responsibility arguably increases auditors' responsibilities and exposure to potential mistakes, resulting in an increased risk of liability exposure.

Increased Insurance and Litigation Costs

A recent survey of CPA firms indicates that audit firms are currently involved in litigation related to several services, including tax (32%), auditing (20%), consulting (8%), accounting (20%), and other areas such as financial planning or fee-related disputes (20%) (Russell, 2017). Figure 1 provides a visual of these findings. Although only 20% of recent cases in this survey relate to auditing, the results of this survey do not capture the magnitude of the cases. In addition, although very few recent federal securities class-action lawsuits have named audit firms as defendants (Cornerstone Research, 2019b), such cases tend to be exposed to a high magnitude of settlements and damages. Estimates of damages in securities fraud cases can vary significantly and be difficult to determine (Cheng and Crumbley, 2016), therefore the actual dollar amount of the exposure of audit firms to liability due to securities fraud cases is difficult to estimate and predict. [See Figure 1, pg. 40]

It is highly likely that professional liability, or Errors and Omissions (E&O) insurance policy premiums for auditors will be directly impacted by the litigation risks detailed in the above sections, as well as the cost of recent settlements. This type of insurance covers litigation costs in the event of a lawsuit alleging auditor negligence or fraud. In addition to E&O, audit firms can take out cyber insurance to cover costs related to security breaches (Russell, 2017). Similar to other types of insurance, these policies typically have upper limits for coverage, leaving audit firms to cover anything above these amounts. Premiums typically differ based on firm size, client types, and decisions about deductibles and upper limits (Casterella, Jensen, and Knechel, 2011).

Many questions remain concerning this topic, which could be explored in future research. Catastrophic liability risks and the cost and limitations of E&O insurance policies have been identified as primary motivations for arguing for caps in liability for auditors (Cunningham, 2007). Increased litigation has been linked to rapid increases in insurance premiums. For example, there was a 35–40% increase in E&O premium costs from 2006-2011 (Eigelbach, 2011). Given the significant costs of settlements and recent historic judgments against audit firms, will insurance companies continue to provide E&O policies to auditors? If so, will insurance premiums become too expensive or too limited for smaller CPA firms to handle? Will large audit firms continue to be able to handle the increased costs of litigation and historically high settlement and judgment amounts? How will this trend impact audit fees? Future research is needed to explore these trends to determine the impact of recent judgments on auditors' insurance premiums.

Media Attention and the Cost of Reputation Losses

All of the above concerns are even more important in the current era of rapid dissemination of information on the internet, social media, and opinion news outlets. Such exposure can heighten public awareness of scandals and discourse involving audit firms. Any scandal that grabs the attention of the public may negatively impact the public's trust in a firm and damage the firm's reputation. This loss of trust could jeopardize the relationship between audit firms and their clients, as the value of their audit services declines.

Even if cases against CPA firms are thrown out or settled, the reputation loss associated with being sued can ultimately lead to monetary losses with the increased threat of clients abandoning the audit firm (Barton, 2005; Krishnamurthy et al., 2006). For example, a firm's non-litigating audit clients experience an immediate negative reaction in

financial markets when an auditor is announced to be associated with litigation (Franz et al., 1998). These findings indicate that markets do consider the quality of an auditor's work when valuing their clients and that lower audit quality is automatically assumed by the auditor's involvement with litigation. The findings of the Franz et al. (1998) study imply that even being associated with litigation, no matter what the outcome, can potentially have a negative impact on the audit firm.

Perhaps the best example of this phenomenon in action is the widespread, severe scandal that consistently made headlines and brought down Arthur Andersen. Some researchers suggest the firm began to decline following the reputation losses suffered from a string of failures of Andersen's high-profile clients, which initially led to large clients withdrawing from the audit firm's services (Barton, 2005). As a result of highly publicized press releases related to the case (i.e., document shredding, federal indictments, publicity surrounding the firm's significant non-audit fees, etc.), the firm began to suffer further reputation losses from a declining public perception of the firm's audit quality and independence (Chaney and Philipich, 2002; Krishnamurthy et al., 2006). Researchers argue that these reputation losses were key to bringing down the company, as clients did not wish to be associated with a firm with such a poor public perception of audit quality (Barton, 2005; Krishnamurthy et al., 2006). The conditions surrounding the specific case of Arthur Andersen also suggest that perceived audit quality is, in fact, important, as clients did not begin to abandon the firm until the public clearly perceived their audits to be substandard (Chaney and Philipich, 2002; Krishnamurthy et al., 2006).

Media attention is also a factor in the event that a case proceeds to a trial. Past research indicates that jury members can be influenced by media exposure in some types of cases, such that they may become biased against the defendant when exposed to persistent negative headlines (Studebaker and Penrod, 2005). This trend should concern auditors in the current era of rapid information dissemination, as isolating jurors from exposure to information and news becomes increasingly difficult. Overall, these risks may enhance auditors' liability exposure and significantly magnify the costs of being associated with litigation. Future research is needed in this area to determine the impact of media on auditor liability and firm reputation, including the exploration of potential solutions to address these enhanced risks.

Conclusions

Although some evidence exists that auditors have experienced an uptick in litigation related to internal controls in the post-SOX era, the catastrophic outcomes predicted by some in the profession have not yet materialized. The Big-4 are surviving and thriving, even in the midst of an economic recession and prolonged recovery period. Overall, audit firms appear to have successfully dealt with increased litigation risks in the immediate post-SOX era. However, significant litigation risks remain related to the Great Recession-era banking crisis, including the potential for FDIC lawsuits.

While this article does not cover the topics of SEC and PCAOB enforcement actions, auditors also face significant costs and negative media attention for audits that catch the attention of regulatory agencies. Future research should further explore these issues, focusing on the impact of regulation on the costs to auditors.

Note, the topics highlighted in this article are constantly evolving, and will likely continue to be an important subject for research in the future. Current market conditions of high uncertainty and market volatility due to the COVID-19 pandemic could lead to an increase in auditor litigation exposure in the not-so-distant future. Therefore, researchers should seek to gain a better understanding of the links between litigation and reputation losses, as well as how audit quality influences the initiation and outcome of litigation involving auditors. Not only could this information be used to assist future legislators and regulators with their decisions on how to move forward with the auditor's requests for liability limitations, but audit firms could certainly benefit from a greater understanding of how to deal with their liability exposure.

In the end, the best litigation prevention method is to perform high quality audits. However, uncertainty about what constitutes a high-quality audit in practice creates several emerging risk areas for auditors. Auditors today are dealing with rapid technological innovation and increased expectations for preventing and detecting fraud in an overly complex business environment. Their mistakes are amplified through intense media exposure. Therefore, the emerging risks noted in this study should be further explored in future research projects to determine the potential impact of these issues faced by the profession today. Perhaps of most importance is the potential for severe reputation losses that could lead to the economic failure of an audit firm. Lessons from the demise of Arthur Andersen will forever remain in our minds: the worst-case scenario has happened, and could happen again, reminding auditors of their professional duty to protect the public interest.

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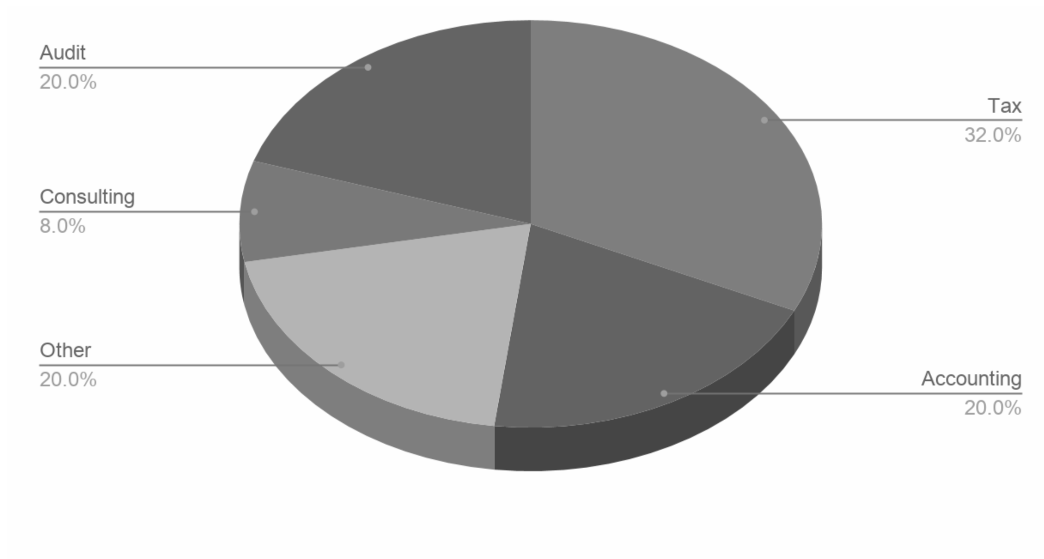
Table 1: Summary of Recent Key U.S. Rulings

Case	**Jurisdiction**	**Ruling**	**Summary of Impact on Auditor Liability**
Tellabs v. Makor (2007)	Supreme Court	Judges ruled in favor of Tellabs (defendant).	Addressed pleading standards clarifying the "strong inference" standard relevant to actions against secondary actors (i.e., auditors) as scienter under Rule 10b-5; ruled that evidence must strongly support knowingly reckless behavior.
Stoneridge Investment Partners, LLC v. Scientific Atlanta (2008)	Supreme Court	Judges ruled in favor of Stoneridge (defendant).	Limited the ability to recover damages from secondary actors (i.e., auditors) under Rule 10b-5 for aiding and abetting another party's false and misleading statements ("scheme liability").
Janus Capital Group, Inc. v. First Derivative Traders (2011)	Supreme Court	Judges ruled in favor of Janus (defendant).	Increased standards for pursuing cases under Rule 10b-5; Limited the ability for shareholders to recover damages from secondary actors (i.e., auditors) who did not make misleading statements themselves; Reconfirmed that auditors can be held liable for their own statements in audit reports.
The Colonial Bancgroup, Inc., et al. v. PWC, et al. (2018) (aka: *FDIC vs. PWC*)	Alabama (Bench Trial)	(1) Judge ruled in favor of FDIC (plaintiff). PWC was found Negligent (Settled out of court after ruling) (2) Judge ruled in favor of PWC (defendant). PWC is not responsible for breach of contract or professional negligence.	(1) FDIC use of state laws to recover claims against audit firms; Expands liability exposure for audits of failed banking institutions; Confirms necessity for professional skepticism and audit procedures designed to detect fraud. (2) Confirmation that auditors are not responsible for professional duty violations when the client has contributed to the alleged negligence.

Figure 1: Percentage of CPA Firm Cases by Issue Type



Source: Russell 2018