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When does utilizing valuation specialists reduce auditors’ litigation risk?

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**SUMMARY:** This article summarizes “The effects of specialist type and estimate aggressiveness on juror judgments of auditor negligence” (Brown, Grenier, Pyzoha, and Reffett 2019), which examines two critical factors auditors consider when auditing complex estimates: the type of specialist to engage and the relative aggressiveness of the estimate. In an experiment involving an alleged audit failure, jurors were less likely to find auditors negligent when the auditors consulted with a valuation specialist, but only when managements’ estimate was deemed to be more aggressive. The study does not find similar litigation benefits of using a specialist for a less aggressive estimate. A second experiment extended these results by demonstrating that jurors were less likely to find auditors negligent when the auditors consulted with an external rather than an internal specialist, because jurors perceived external specialists as having greater independence from the client. Further, the litigation benefits of using an external specialist extended to circumstances when auditors who initially engaged an internal specialist also brought in an external specialist to review the internal specialist’s work. The study concludes that utilizing external specialists, to either test management estimates or to review internal specialists’ work, can limit auditors’ litigation exposure, especially when auditing aggressive management estimates.

Keywords: Auditing, specialists, estimates, aggressiveness, auditor negligence
INTRODUCTION

The increasing complexity of revenue models, intangible asset valuations, and numerous other accounting estimates, paired with the heightened risk of management bias and ineffective model inputs, poses increased litigation risk for auditors (Christensen et al. 2012; Ramanna and Watts 2012; Bratten et al. 2013; PCAOB 2016a; 2017a; Joe, Vandervelde, and Wu 2017a). To address the inherent challenges that auditors face when auditing complex estimates, audit firms have increased their reliance on valuation specialists. Despite auditor attempts to improve audit quality and mitigate litigation risk through consultation with specialists, recent PCAOB inspection reports find repeated deficiencies in audits involving complex estimates, leaving auditors vulnerable to legal action (e.g., New York State Teachers’ Retirement System v. KPMG LLP; PCAOB 2016a; Joe et al. 2017a).

A recently published study, “The effects of specialist type and estimate aggressiveness on juror judgments of auditor negligence” (Brown, Grenier, Pyzoha, and Reffett 2019), investigates how reliance on valuation specialists affects auditor litigation risk. Specifically, Brown et al. (2019) examine whether auditors’ choice in engaging with either an internal (i.e., auditor-employed specialist) or external specialist (i.e., auditor-engaged specialist) to assist in auditing a complex management estimate, coupled with differing levels of estimate aggressiveness, influence juror perceptions of auditor negligence in the case of an alleged audit failure. The current article summarizes the previously published study’s motivation, the methods and results of its two experiments and supplemental analyses, and the implications to audit firms that face litigation risk when testing complex management estimates.
MOTIVATION AND THEORY

In December 2018, the PCAOB adopted a new standard on auditing management’s complex estimates as well as amendments to improve the standards governing auditors’ use of specialists on their engagements (PCAOB 2017a; PCAOB 2018). The newly adopted amendments on the use of specialists impose a more uniform approach to evaluating the work of both internal and external specialists by extending PCAOB and SEC auditor independence requirements to internal specialists, while requiring a similar assessment of objectivity prior to engaging with an external specialist (PCAOB 2017b, 23). These changes to PCAOB Auditing Standards appear to be in response to concerns over management bias in complex estimates, as well as the significant number of audit deficiencies identified in this area (Doty 2017; PCAOB 2017c).

Prior research has attributed deficiencies in auditors’ tests of complex estimates to the auditors’ estimate verification process (Griffith, Hammersley, and Kadous 2015), failure to correctly identify and test subjective components of the estimates (Joe et al. 2017a), and the prevalence of a “task completion” rather than a “critical task analysis” mindset within fieldwork (Griffith, Hammersley, Kadous, and Young 2015). In response, a growing stream of research explores how specialists can improve audit quality in the audits of complex estimates (e.g., Griffith 2017; Joe, Wu, and Zimmerman 2017; Pyzoha, Taylor and Wu 2018). Brown et al. (2019) extend this literature stream by examining how third-party evaluators, such as potential jurors, evaluate audits of complex estimates and auditors’ choice to engage a specialist to assist with audits in this critical area.

Prior research finds that jurors are motivated to hold auditors responsible for any negative consequences pertaining to an alleged audit failure in order to uphold their belief in a “just world” (Walster 1966; Kadous 2000; Grenier et al. 2015). In turn, this motivation can lead jurors to weigh
evidence critical of the auditors’ performance greater than evidence that reflects favorably on the auditors’ performance. However, this type of motivated reasoning is subject to reasonableness constraints (Pyszczynski and Greenberg 1987; Kunda 1990). That is, despite jurors’ motivation to find auditors negligent for an alleged audit failure, convincing evidence indicating that the auditors exhibited an appropriate level of care can constrain jurors from finding the auditors blameworthy (e.g., Kadous 2000).

In the case of an alleged audit failure pertaining to a complex management estimate, Brown et al (2019) uses motivated reasoning theory to predict that the auditors’ use of a specialist, either internal or external to the audit firm, would signal to jurors that the auditors exercised due professional care in auditing the estimate, thereby reducing jurors’ auditor negligence assessments. Additionally, the study predicts that the litigation benefit provided by specialist use would depend on the level of management aggressiveness (i.e., potential bias) included in the estimate. Specifically, the first hypothesis predicts that jurors would be unlikely to view the auditors’ decision to accept a more aggressive estimate as justifiable unless the auditors first consulted with a valuation specialist during the audit. When management’s estimate is less aggressive, the study predicts that the litigation benefits provided to auditors who used a specialist would diminish, because jurors likely would view the auditors’ acceptance of a less aggressive estimate as justifiable, irrespective of specialist use.

The final set of hypotheses focuses on the type of valuation specialist (i.e., internal specialists employed by the audit firm or external specialists engaged by the audit firm) the auditors consult with when auditing a complex estimate. The study predicts that jurors would perceive external specialists as being more independent and objective than internal specialists (i.e., greater independence in appearance) because common independence issues attributed to auditors (e.g.,
longer audit firm tenure and close relationships with management) apply more directly to internal than external specialists. Thus, the second hypothesis predicts that jurors would be less likely to find auditors negligent when auditors consulted with an external versus an internal specialist.\(^1\)

Large international audit firms primarily employ internal specialists to consult with their audit teams. Thus, it may not be reasonable for these larger firms to utilize the work of external specialists in a primary verifier role. Instead, larger firms may prefer to continue to primarily rely on internally employed specialist to test complex management estimates while leveraging external specialists in a more limited capacity. By doing so, these firms can also signal to third-party evaluators (e.g., PCAOB inspection teams or jurors in the case of an alleged audit failure) that they exercised a greater standard of care and diligence during the audit. The final hypothesis predicts that jurors would be less likely to find auditors negligent when auditors consulted with both an internal specialist (in a primary preparer role) and an external specialist (to review the internal specialist’s work) relative to auditors who consulted only with an internal specialist.

**METHOD**

The authors tested their predictions with two experiments in which jury-eligible participants (391 participants in Experiment 1 and 259 in Experiment 2) assumed the role of a juror in an auditor negligence lawsuit relating to a material overstatement of a client’s asset-backed securities (i.e., a complex estimate). The authors obtained participants from Amazon’s Mechanical Turk, a commonly used source for jury-eligible participants (e.g., Grenier et al. 2015; Maksymov and Nelson 2016). In both experiments, participants review background information pertaining to

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\(^1\) An auditor’s decision to engage a valuation specialist will typically be determined during audit planning before the auditor can fully identify the extent of estimate aggressiveness. Nonetheless, auditors can preliminarily evaluate estimate aggressive from various sources, such as a predecessor auditors’ working papers, evidence from planning analytical procedures, and/or risk assessment procedures. Additionally, an audit team that is working with an internal specialist may consider engaging an external specialist during fieldwork in a review capacity. This last possibility is explored in the paper’s third hypothesis.
the audit, emulating the manner in which courts familiarize jurors with the case facts. Participants learn that a lender is suing the audit firm for damages for an unpaid loan as a result of the audit client’s bankruptcy. The lender alleges that the auditors were negligent in conducting the audit and point to a recent SEC investigation in which the SEC alleges that $50 million of asset-backed securities in the audited financial statements were materially overstated by $5 million.

The first experiment examines whether juror perceptions of auditor negligence when the auditors use a specialist depend on the level of estimate aggressiveness. Experiment 1 manipulates two factors: Estimate Aggressiveness and Specialist Use. The experiment manipulates Estimate Aggressiveness by holding the magnitude of management’s estimate constant at $50 million, but varying where the estimate fell relative to the auditor’s reasonable range for the estimate. Approximately half of the participants were randomly assigned to the Less Aggressive condition, in which the estimate falls just below the upper bound of the auditors’ reasonable range. The other half of the participants were randomly assigned to the More Aggressive condition, in which the estimate falls outside of the auditors’ reasonable range by a quantitatively immaterial amount. Both estimates are “aggressive” because the SEC ruled, in both conditions, that the inputs and assumptions used by management to develop the estimate were not conservative in nature. Figure 1 provides an excerpt of this manipulation from the experimental materials.

<Insert Figure 1 about here>

For the Specialist Use manipulation in Experiment 1, the auditors used either a Non-Specialist or a Specialist. In the Non-Specialist condition, rather than consulting with a valuation specialist, the audit firm assigned a partner with 15 years of experience, who had experience in verifying similar complex estimates. In the Specialist condition, the auditors consulted with a
Participants were randomly assigned to one of the Specialist Use conditions and one of the Estimate Aggressiveness conditions. After reading the case facts, participants provide a Verdict as to whether or not the auditors were negligent.

The second experiment contained identical case facts as Experiment 1 and tested the prediction that jurors would be less likely to find auditors negligent when the auditors consulted with an External Specialist as compared to an Internal Specialist. Experiment 2 also includes a third experimental condition, Both Specialists, which states that the auditors consulted with both an internal valuation specialist in a primary verifier role and an external specialist in a secondary reviewer role who reviewed and agreed with the internal specialist’s work. Based on the results of Experiment 1 (discussed below), Experiment 2 only uses the More Aggressive version of management’s estimate of the asset-backed investment security. As in Experiment 1, participants provide a Verdict as to whether or not the auditors were negligent.

**RESULTS**

Consistent with expectations, the results of Experiment 1, as shown in Panel A of Figure 2, show a statistically significant interaction between the Specialist Use and Estimate Aggressiveness independent variables. Specifically, within the More Aggressive condition, the rate of negligence verdicts is significantly lower for the Specialist condition (Verdict = 52.0 percent) than the Non-Specialist condition (69.2 percent). However, within the Less Aggressive condition, there is not a significant difference in Verdict between the Specialist Use conditions. Thus, as

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2 Experiment 1 also manipulates Specialist as either an internal or external specialist for generalizability purposes. However, due to informational differences across the operationalization of internal versus external specialists, Experiment 1 was not used to test for differences between these two types of specialists and therefore collapses these two conditions into one Specialist condition. The authors perform Experiment 2 to test for differences between type of specialist.
hypothesized, the collective results from Experiment 1 indicate that the litigation protection from using a specialist is greater when management’s estimate is more versus less aggressive.

As shown in Panel B of Figure 2, Experiment 2 provides support for the prediction that jurors are less likely to find the auditors negligent when the auditors used an External Specialist (Verdict = 48.8 percent) versus an Internal Specialist (61.4 percent). Moreover, consistent with the study’s predictions, Verdict is significantly lower in the Both Specialists condition (40.0 percent) compared to the Internal Specialist condition. While not directly hypothesized, the authors also compared the External Specialist condition to the Both Specialists condition, and the difference in Verdict is not statistically significant.

**Additional Analyses**

Brown et al. (2019) further explore the mechanisms behind Experiment 1 and Experiment 2 auditor negligence verdicts with a series of additional analyses, the results of which are briefly summarized here. Consistent with the use of a specialist constraining juror negligence assessments against the auditors when management’s estimate was more aggressive, the study finds that jurors rated the auditors’ decision to accept management’s estimate as more justifiable when they consulted with a Specialist compared to relying on a Non-Specialist to test management’s estimate. In turn, jurors who perceived the auditors’ performance as more justifiable were less likely to find the auditors negligent. When management’s estimate was Less Aggressive, jurors did not perceive any differences in the justifiability of the auditors’ actions, regardless of whether the auditors used a specialist.

The study also predicted that jurors would perceive external specialists as being more independent and objective than internal specialists. Consistent with this prediction, jurors rated the
independence of the External Specialist higher than the Internal Specialist. Moreover, these independence ratings are also positively associated with juror perceptions of both specialist quality and the justifiability of the auditors’ actions. In turn, enhanced perceptions of specialist quality and justifiability, associated with elevated perceptions of external specialist independence, significantly reduced juror negligence assessments against the auditors. Last, the study finds that jurors perceive the actions of auditors who consulted with Both Specialists as being more justifiable compared to auditors who consulted with only an Internal Specialist. Overall, these additional analyses provide further support for the theoretical development and highlight how juror perceptions of auditor justifiability and specialist independence are associated with their auditor negligence verdicts.

**IMPLICATIONS**

Brown et al. (2019) offer important practical insights that could assist audit firms in planning their audits of complex management estimates and in deciding whether to use a valuation specialist to assist with their audit testing. Overall, results suggest that auditors can limit their litigation risk for clients with relatively more aggressive management estimates by choosing to consult with a specialist in this area. This is an encouraging finding for audit firms that face an overall increase in litigation exposure due to the rapid increase of complex management estimates across a variety of different industries. Furthermore, audit firms that predominately rely on internal specialists may be unintentionally forgoing additional reductions in litigation exposure provided by consultation with external specialists. To this end, the study highlights that audit firms need not reduce their current workforce of internal specialists to achieve this litigation protection. Rather, by engaging in an external specialist in a secondary review capacity, these firms can accrue similar
reductions in litigation exposure as firms that rely solely on external specialists to assist with audits of complex management estimates.

In light of the study’s findings, auditors and regulators (e.g., the PCAOB) should also be cognizant that audit firms may forego the audit quality benefits of using specialists if auditors do not believe that using specialists reduces litigation risk for less aggressive estimates. On the other hand, auditors may be less likely to question the representational faithfulness of more aggressive management estimates if they believe that using specialists provides an effective litigation shield. As such, future research could examine auditor perceptions of the litigation benefits (or lack thereof) of using specialists and how these perceptions affect their judgments and decisions. Additionally, future research that explores actual auditor litigation outcomes and settlements could examine whether specialist use and specialist type (i.e., external or internal) are influential in this setting (e.g., Schmidt 2012).

Finally, the study highlights how important contextual factors central to audits of complex estimates, the aggressiveness of management’s estimate and the type of specialist auditors utilize to help in testing an estimate, shape juror perceptions of independence and justifiability and, ultimately, their auditor negligence assessments. These findings build upon prior auditor negligence studies examining juror perceptions of auditor independence by demonstrating that jurors not only are sensitive to general aspects of the auditor-client relationships (such as relative client importance and the significance of non-audit services provided) but also more specific factors such as perceived specialist independence. Thus, audit firms may wish to be proactive when documenting the extent of specialist use on their engagements to highlight the evidence examined that support the specialist’s competence and objectivity. Future research could also investigate whether auditors perceive differences in specialist quality, competence, and objectivity between
internal and external specialists, as well whether the changes to the auditing standards governing audits of complex estimates and auditors’ use of specialists have led to fewer audit deficiencies in this critical area.
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**FIGURE 1: Experiment 1 Estimate Aggressiveness Manipulations**

**Panel A: More Aggressive Manipulation**

EXHIBIT 1: Comparison of MIG’s fair value estimate to the audit partner’s / internal valuation specialist’s / external valuation specialist’s reasonable range

| Lower Bound Of Range | Midpoint | Upper Bound Of Range |
|----------------------|----------|----------------------|
| $41 million          | $45 million | $49 million |

$50 million  
MIG’s fair value estimate

**Panel B: Less Aggressive Manipulation (Experiment 1 Only)**

EXHIBIT 1: Comparison of MIG’s fair value estimate to the audit partner’s / internal valuation specialist’s / external valuation specialist’s reasonable range

| Lower Bound Of Range | Midpoint | Upper Bound Of Range |
|----------------------|----------|----------------------|
| $43 million          | $47 million | $51 million |

$50 million  
MIG’s fair value estimate

**Note:** Participants were provided with the specialist description that corresponded to their *Specialist Use* condition in the text as well as in the Exhibit 1 title.
FIGURE 2: Graphical Representation of Results

Panel A: Experiment 1 Negligent Verdicts as a Percentage of All Verdicts

Panel B: Experiment 2 Negligent Verdicts as a Percentage of All Verdicts