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**Abstract:** Maksymov, Pickerd, Lowe, Peecher, and Reffett (2020b) draw insights based on interviews with 27 prominent audit litigation attorneys about the factors affecting the initiation of legal claims against auditors and how such factors affect settlement outcomes. We summarize their key findings and discuss important implications for audit practitioners. Specifically, we focus on the key factors that affect plaintiff attorneys’ willingness to pursue legal claims against auditors, including the merits of the claim, size of alleged economic damages, auditors’ ability to pay, and the expected cost to pursue the claim. We also discuss the reasons why most audit disputes settle (as opposed to resolving at trial) and the factors affecting settlement outcomes. We hope the insights provided enhance audit practitioners’ understanding of litigation and the settlement process to allow them to manage claims in a less intimidated and ultimately more strategic manner.
PRACTITIONER SUMMARY
Factors Affecting the Outcomes of Legal Claims against Auditors

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August 20, 2020

Acknowledgments: We thank Eldar Maksymov as co-author of the original research study. We also thank the editor and reviewers for their helpful feedback and suggestions. Re-use permission for quotes has been granted by the original publisher.
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Abstract
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Keywords: audit litigation; audit disputes resolutions; jury trials; professional risk management; settlement norms
I. INTRODUCTION

Although regulatory risk has become increasingly significant since the Sarbanes-Oxley Act (SOX), several recent high-profile lawsuits, along with numerous less publicized lawsuits, indicate that litigation remains a substantial risk for auditors (Pickerd and Piercey 2020; Maksymov, Peecher, Pickerd, and Zhou 2020a). Thus, understanding factors that affect the initiation and outcomes of litigation against auditors is paramount to individual auditors and the profession.

A recent study, “The Settlement Norm in Audit Legal Disputes: Insights from Prominent Attorneys” (Maksymov, Pickerd, Lowe, Peecher, and Reffett 2020b), examines the factors affecting the initiation of claims against auditors, how such factors affect settlement outcomes, and why the majority of audit legal disputes settle. This study addresses these questions by reporting findings from interviews with 27 prominent audit litigation attorneys (12 primarily serving as plaintiffs’ attorneys, 13 as defendant attorneys, and two often serving on both sides).

In this article, we summarize their key findings and discuss several practical implications. The insights provided in Maksymov et al. (2020b) can help audit practitioners who have less experience with litigation gain a better understanding of, and comfort with the settlement process, allowing them to manage claims in a more informed, less intimidated manner.

II. ATTORNEY INSIGHTS: WHEN ARE CLAIMS MADE AGAINST AUDITORS

When discussing the factors that lead to claims against auditors, the interviewed attorneys noted that certain events such as bankruptcy, the restatement of financial statements, and/or government investigations, trigger the initiation of claims against auditors. Each of these trigger events are associated with financial damages and present plaintiff attorneys with certain advantages in pursuing claims against auditors. Specifically, bankruptcy is advantageous because bankruptcy trustees can provide plaintiff attorneys with audit workpapers prior to the filing of a
lawsuit.\textsuperscript{1} Restatements and government investigations are advantageous because they provide clear indications of accounting and/or audit related problems.

However, the aforementioned trigger events alone do not necessarily result in plaintiff attorneys pursuing claims against auditors. Plaintiff attorneys typically will only pursue a claim against an auditor if the value of the claim, i.e. the expected payout minus the expected cost of pursuing the claim, is sufficiently high. Plaintiff attorneys assess the expected value of a claim by considering (1) the merits of the claim (with more meritorious claims generally having a greater expected probability of winning at trial); (2) the size of alleged damages; (3) the auditor’s ability to pay; and (4) the expected cost of pursuing a claim. The following attorney quote from Maksymov et al. (2020b) illustrates this pragmatic approach:

“Clients think we file cases and then go out with a bucket and collect money, but it’s not like that at all. …There is a significant risk of a bad outcome from our perspective, and it’s very much a very calculated business decision every time based on … everything that we can assemble to evaluate it…”

\textbf{Merits of the Claim}

To have a meritorious claim against auditors, a plaintiff must tell a story that unambiguously conveys the following: (1) the claimant’s losses were due to an accounting-related issue; (2) the auditors failed to meet their professional responsibilities; and (3) the accounting problem (and audit failure) \textit{proximately} caused the plaintiff’s alleged damages.

To build such a story, attorneys invariably rely on accounting experts. Attorneys stated that they will never involve themselves in an accounting case without consulting with an accounting expert.\textsuperscript{1}

\textsuperscript{1} When discussing the advantages of bankruptcy, one attorney noted “The ability to get \textit{audit workpapers}, short of litigation… is very, very difficult… [unless] there is a bankruptcy filing… [when] we represent a bankruptcy trustee… we can get… the audit workpapers… And when we have that option, we really have the goods on them by the time we file a lawsuit… The only reason we have that right, is if there is a bankruptcy, and the bankruptcy trustee… can produce all the workpapers… all of the information we are looking for.”
expert. This is crucial as the most difficult task for plaintiff attorneys is to demonstrate that the plaintiff’s losses were proximately caused by an accounting-related problem. Accounting experts are needed to weave a causal story that links the accounting problem to the plaintiff’s losses.

However, even with the assistance of accounting experts, assessing whether the auditors met their professional responsibilities at this early stage of the legal dispute often is difficult because, unless the claim relates to bankruptcy, the plaintiff attorney (and their audit expert) often lack access to the auditors’ workpapers. The delay in having access to the auditors’ workpapers often makes attorneys hesitant to file a claim because their own reputation may suffer if the workpapers, once available, reveal that their claim lacks merit.

Size of the Alleged Economic Damages

While it may be obvious that the size of the alleged economic damages increases the value of a claim, expected damages can be hard to estimate, depending on the type of claim. While creditor and client losses due to misappropriations typically are relatively easy to determine, investor losses are often more difficult. Specifically, investor losses are calculated as the difference between the actual stock price at the time of purchase versus the hypothetical amount the stock would have traded for if not for the accounting-related problem, which is difficult to estimate. Bankruptcy losses depend on the value of the insolvent business at the time of the wrongdoing. Hired experts, often economists, are retained to estimate this value.

Ability to Pay

To recover settled or awarded damages, it is in the plaintiff’s interest to assess the audit firm’s financial health. Therefore, in negotiating a settlement, the plaintiff attorney will ensure that

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2 Attorneys indicate that audit claims are mostly based on actual losses only (i.e., compensatory damages) and that it is uncommon to claim more than direct losses (i.e., punitive damages).
the audit firm can pay the claim. Further, plaintiff attorneys rely on the audit firm’s insurance policy and the firm’s own funds to determine their ability to pay. Interestingly, smaller audit firms typically have insurance with low deductibles and lack the reserves to cover high damages. For this reason, among others, smaller audit firms are more likely to quickly settle as long as the amount is within the policy limits. Larger audit firms, by contrast, typically carry high deductibles and possess larger reserves, making their insurance policy a less significant consideration.

**Expected Cost**

Holding the expected payout constant, increasing the time and expense expected to pursue a claim makes it less valuable to plaintiff attorneys. Importantly, defendants’ expected strategy influences plaintiff attorneys’ expected time and expense to pursue a claim against auditors. Several attorneys, consistent with this intuition, indicated that the largest firms (e.g., Big 4) are substantially more comfortable with legal disputes and less concerned about reputational harm than are smaller audit firms. For instance, one attorney remarked:

> A key issue is very important for you to understand. The Big 4 audit firms do not care at all about litigation as being harmful to their reputation… it’s not going to adversely affect their reputation for them to have one more lawsuit to add to the hundred lawsuits that are already pending.\(^3\)

Similarly, another attorney emphasized that the Big 4’s general strategy for fighting claims is to draw the legal dispute process out as long as possible and ultimately win a war of attrition. Thus, fewer plaintiff attorneys are capable of pursuing claims against a Big 4 defendants versus smaller firms, because of the protracted, expensive process involved. For this reason, one attorney expressed considerable distaste for this process:

> “I hated suing audit firms because they have the culture, you know, the Big 8, the Big 4, they engage in scorched earth, resist at all costs, and don’t settle ‘til the eve of trial. And that is very bad from a plaintiff lawyer’s perspective.”

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\(^3\) As noted in Maksymov et al. (2020b), “this extraordinary claim was corroborated with a risk management specialist with 26 years of experience in professional liability insurance business.”
Conversely, smaller firms are less comfortable with legal claims, often lack in-house legal expertise and are concerned about the adverse reputational effects of any given lawsuit. Consequently, smaller firms generally are more inclined to quickly settle claims, potentially at less favorable terms.

III. ATTORNEY INSIGHTS: WHY DO MOST CLAIMS SETTLE

Pre-SOX data show that approximately nine out of ten disputes settled prior to trial (Palmrose 1991). Compared to settlement rates in other professions, estimated settlement rates in the audit profession are very high (Eisenberg and Lanvers 2009). Further, these relatively high estimates likely significantly understate actual settlement rates, as many disputes settle before claims are even filed (Maksymov et al. 2020b). However, little is known about why the vast majority of claims against auditors settle because most research on legal claims against auditors investigate factors that affect jurors’ decision processes at a courtroom trial (Grenier, Reffett, Simon, and Warne 2018).

Regarding the question why most audit claims settle, Maksymov et al. (2020b) suggest attorneys are able to avoid different risks inherent to going to jury trial. One of these risks is that jury trial outcomes are believed to be very uncertain and unpredictable. To this point, one attorney indicated that s/he tells clients that the justice system “gets it wrong” approximately 30 percent of the time; so there always is significant outcome risk if you go to trial. Another attorney explained the risk of going to a jury trial instead of settling in this way:

“You know, people try cases that they think they should win, and they lose; and they try cases they think they are going to lose, and they win. It’s just that you’ve got six strangers who are not accountants (i.e., jurors) who are making a decision about things.”

Maksymov et al. (2020b) infer that attorneys on both sides utilize the perceived high degree of uncertainty associated with jury trials to credibly establish extreme worst-case outcomes of jury
trials. Thus, settled outcomes are easily framed by the attorneys on both sides as “wins” for their clients. Going to trial, in contrast, often will produce one clear winner, but also one clear “loser”. In doing so, going to trial puts both attorneys’ reputations at greater risk than settling.

Cases, particularly against smaller firms, also tend to settle when alleged damages are relatively large. Alleged damages against these firms often exceed the audit firm’s insurance policy limits to such an extent that they pose an existential threat. Plaintiff attorneys often calibrate claims to insurance policy limits when negotiating settlements in those circumstances. As such, it is in both parties’ interest to settle rather than to face the uncertainty of trial. By settling quickly, attorneys can also limit legal expenses for themselves and their clients.

Finally, by settling, the auditors and attorneys on both sides can avoid negative publicity and potential damage to their reputation. One attorney estimated that approximately half of all claims are resolved with none (outside of the involved parties) ever learning about these claims. Interestingly, this reasoning of avoiding negative publicity is less applicable to the largest audit firms, which are already frequently involved in several disputes and prefer to create a reputation of a ‘tough target’.

IV. ATTORNEY INSIGHTS: WHY DO CLAIMS OCCASIONALLY NOT SETTLE

Sometimes, attorneys are unable to arrive at a settlement agreement, and the case is resolved at trial. The question remains, *what do attorneys believe to be the key reasons why some audit dispute cases deviate from the settlement norm and resolve at trial*. In the interviews, attorneys revealed that claims fail to settle in abnormal conditions. One condition where attorneys often are unable to arrive at a settled agreement is when one of the parties is acting irrationally or because s/he is emotionally invested. For example, one attorney indicated that auditors who believe they have performed a high-quality audit often are eager to seek vindication in court:
“[The audit partner may say] I didn’t do anything wrong. I am not going to consent for this case to be settled… I have no personal risk. You guys can’t make me settle. I don’t want to settle. Let’s try this thing [in court].”

Another reason why audit disputes occasionally fail to settle and resolve at trial is that some audit firms prefer to build a reputation as a ‘tough target’ to make plaintiffs less inclined to initiate future claims against them. For instance, one attorney noted that some audit firms do not want to be known as a firm that rolls over every time they are sued, because then people will line up to try to settle. This is especially true for the largest audit firms because they have the resources to fight claims for long periods of time.

Further, audit disputes occasionally resolve at trial because some attorneys view it as advantageous, in a behavioral game theoretic sense, to be perceived as being irrational/unpredictable. The idea is that when the other side knows you want to try the case, and that you have a reputation of at times acting irrationally, you have greater leverage in negotiating settlements. One attorney explained:

“So I learned as a prosecutor that when the other side knows you want to try the case, you get a better result. And I've used that repeatedly. So, while the vast majority of my cases have settled, I've gotten better results because the other side knows, you know, I actually act a little irrational. I [am willing to say] "I hear what you are saying, but we are still going to try it anyway.”

Finally, when both parties’ valuations of a claim are too far apart from each other to facilitate a reasonable settlement or when plaintiff attorneys have invested so many resources in the case that a settlement will not cover their costs, cases may ultimately resolve at trial. The attorneys also emphasized that when cases have large alleged damages, some plaintiff attorneys with a high-risk tolerance prefer the risk of going to trial in hopes of winning big. In addition, claims alleging auditor fraud are less likely to settle because insurance companies are not likely to cover these claims, and auditors, for several reasons, are disinclined to admit to intentional wrongdoing (e.g., settling claims of auditor fraud could jeopardize the auditors’ licensure).
V. CONCLUSIONS AND IMPLICATIONS

In considering the findings discussed above, several have clear practical relevance to audit practitioners, especially to those with less experience and comfort with litigation. One consistently reported finding in Maksymov et al. (2020b) is that plaintiff attorneys are highly pragmatic in deciding whether to pursue claims, focusing on a claim’s value, measured by the expected payout minus the expected cost of pursuing a claim. Thus, understanding and strategically managing the factors that affect plaintiff attorneys’ assessments of the value of claims could help firms become less attractive targets for legal claims.

In this regard, several factors are worth considering. First, knowing that plaintiff attorneys rely heavily on accounting experts to examine audit workpapers to assess the merits of a claim indicates that workpaper documentation, clearly conveying how auditors met (or exceeded) their professional responsibilities will likely decrease plaintiff attorneys’ assessments of the value of a claim. Interestingly, audit insurers, which have vast experience managing claims against auditors, can provide their clients with quality control guidance to help in this regard (Frank, Maksymov, Peecher and Reffett 2020).

Second, in addition to the merits of claims, audit firms’ ability to pay affects the assessed value of claims. In this regard, audit firms’ insurance coverage choices, particularly regarding policy limits, likely affect plaintiff attorneys’ willingness to pursue claims and/or their settlement strategy. Thus, while multiple factors affect a firm’s optimal level of coverage, when making insurance policy decisions, audit firms should consider whether having higher policy limits could increase plaintiff attorneys’ willingness to pursue claims against their firm, and result in more aggressive settlement offers.
Further, Maksymov et al. (2020b) reveals that lengthy defenses against claims, as opposed to quick settlements, increases plaintiff attorneys’ expected costs thereby decreasing their willingness to pursue claims against auditors.\(^4\) Larger audit firms typically are less concerned about the adverse reputational effects of litigation, have greater experience and expertise managing litigation, and thus are less eager to settle quickly. In this regard, larger audit firms are less attractive targets than smaller firms which typically are eager to settle quickly. Thus, smaller audit firms should at least consider whether quick settlements are in their firm’s longer-term interests.

Another key finding reported in Maksymov et al. (2020b) is that most claims settle, in part, because both the plaintiff and defense attorneys perceive a very high degree of uncertainty in the outcome of a prospective trial. However, Maksymov et al. (2020b) also reports that the sample of disputes that go to trial tend to have abnormal attributes and are unlikely representative of audit legal disputes at large. Thus, perceptions of the unpredictability of juror decision-making may be exaggerated because jurors typically only decide the most abnormal cases. If more claims, particularly more “normal” claims, were resolved at trial, jurors’ decision-making may well be less uncertain and more predictable for cases that are more representative of typical audit disputes. Thus, when deciding whether to settle or defend against a claim at trial, audit firms should at least consider that juror decision making might not necessarily be as unpredictable as commonly portrayed, particularly for more “normal” claims.

Finally, due to the large proportion of claims that settle, society as a whole, including investors and stakeholders of the audited companies, remain in the dark about the majority of alleged audit problems. Specifically, trials are public, whereas settled cases typically remain

\(^4\) While vigorously defending against claims in a consistent manner clearly appears to make firms less attractive targets, there are costs to employing such a strategy. Neither Maksymov et al. (2020b) nor the current article make claims as to the net benefits of this or any other particular strategy for managing claims.
hidden from the public, especially when disputes settle before the claim is even filed. As observed in the study, this is exactly one of the reasons why settlement is so appealing to attorneys and their clients. However, one could argue that the investing public has the right to be informed about audit failures, especially when the auditee is a publicly held company or provides a public good (e.g., utilities). If we want society to value high-quality auditing, society arguably should be able to hold audit firms accountable in cases of negligence, or low-quality auditing.
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