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Auditors' Evolving Responsibilities and the Rising Costs of Professional Negligence: A Comprehensive Examination

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Abstract

In recent times, professional negligence has taken centre stage in the news. The inability of auditors to uncover fraud in their clients' financial records has become a topic of intense debate among industry professionals and regulators, with no clear consensus reached thus far.

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This paper employs a qualitative research approach to delve into the consequences of professional negligence and why auditors will continue to face the consequences of their failure to detect fraud in their clients' financial records. Our research findings indicate that auditors will continue to bear the brunt of professional negligence until there is a fundamental shift in their mandate, prompting them to assume a more proactive role in detecting fraud within financial statements. The repercussions of professional negligence extend beyond financial losses, encompassing intangible costs that severely tarnish the reputation of the auditing profession.

Keywords: *professional negligence, auditing profession, auditors' responsibility, fraud detection*

1. Introduction

In recent times, financial statement fraud, audit failures, and sudden corporate collapses without warning signs have surged in scale and frequency (Garrow et al., 2019). The ramifications of these events are colossal, resulting in significant losses for stakeholders, reaching billions of dollars. The Association of Certified Fraud Examiners' "Report to the Nation on Occupational Fraud and Abuse" (2018) estimated the cost of fraud at $3.7 trillion. As a consequence, litigation expenses, fines, damages, and settlements involving audit firms, including both the Big Four and Mid-Tier firms, have been on the rise. If the trend of increased litigation and the corresponding damages awarded against auditors persists, it could eventually surpass the industry's capacity to withstand such costs. We are now in an era where a single audit firm (PWC) was compelled to pay over $625 million in damages in a single case (Dolmetsch, 2018). The consequences of legal claims and court charges extend beyond the financial costs; firms also endure damage to their reputation and face the loss of clients following any exposure of fraudulent reporting or audit failures.

This research aims to investigate the financial implications of professional negligence for audit firms. It delves into the reasons behind the surge in claims against auditors and why auditors continue to bear the brunt for their inability to detect fraud and errors in their clients' financial records. Addressing the issues inherent in modern-day audits is crucial to mitigating these challenges.

The research is structured into five sections. Section two provides a literature review on the cost of professional negligence, encompassing recent claims and fines against audit firms and auditors' responsibilities. Section three details the research methodology employed in

conducting this study. Section four presents the research findings, while section five offers the conclusion and outlines potential areas for further research.

2. Literature Review

2.1. Professional negligence

Negligence is defined as the unintentional breach of a contractual duty, characterized by carelessness (Cosserat & Rodda, 2009). Auditors strive to limit their exposure to potential liabilities, while shareholders seek complete assurance that financial statements prepared by directors are free from misstatements and fraud. Potential investors desire risk-free investments, creditors aim to protect their loans, and employees seek job security and decent pensions. Auditors, however, can only provide "reasonable assurance" rather than the "absolute assurance" demanded by shareholders, leading to the loss of several legal cases as exemplified in Caparo Industries Plc v Dickman (1990). Stakeholders often direct their attention to auditors in the wake of corporate failures, scandals, or financial issues, with claims for settlements making headlines. Auditors are frequently the first to lose their jobs when accounting scandals and audit failures come to light. The auditor's role can be likened to a solution that gives rise to a new problem. The audit profession was created to address the agency problem between shareholders (principals) and company directors (agents), aiming to ensure a thorough examination of the agent's accounts (Awolowo et al., 2018). Paradoxically, the auditor is now often found defending their position in court against the very shareholders they were meant to serve. Creditors and potential investors also seek indemnification from auditors. Whenever fraud occurs within a company, auditors tend to become scapegoats and are the primary targets of accusations.

In a counterintuitive twist, Plaintiff’s lawyers responded to Deloitte's assertion that auditors have a public duty to detect fraud that led to the collapse of TBW Mortgage Corp in 2009. The US Department of Justice alleged that Deloitte's audits knowingly deviated from standard procedures, leading to their failure to detect TBW’s fraud, contributing to losses of $7.6 billion (Alzola, 2017). Arthur Andersen was required to pay $110 million to settle a civil action related to Sunbeam and Waste Management, leading to a significant drop in share prices (Leaf, 2002). Four years later, Arthur Andersen collapsed due to its involvement in the Enron accounting scandal, which caused the downfall of the 7th largest company in American history (Farrell, 2015).

Auditors are often blamed for their inability to detect errors and fraud in their clients' books, resulting in numerous cases in the legal system, some of which have been won, while others have been settled out of court. These cases have led to multimillion-dollar fines being imposed on auditors. In the early days of auditing, auditors were considered responsible for detecting fraud, as seen as far back as the 1500s (Albrecht et al., 2001). This objective of fraud detection was even the basis for American auditing objectives during its formative years (Albrecht et al., 2001; Chong, 2013; Chui & Pike, 2013). Auditors were taught that their primary role was to detect and prevent fraud and errors (Montgomery, 1921). However, over the years, the emphasis on auditors' responsibilities for fraud detection has significantly diminished.

2.2. Claims and Related Cost: Litigation Cost, Damages, Settlements, Reputation Losses and Loss of Business

While the guidelines regarding audit liabilities for criminal offenses or civil wrongdoing seem straightforward and not open to debate, the nature of penalties imposed by regulatory bodies and the various settlement options, both within and outside the courtroom, remains a contentious issue. Auditor liabilities give rise to claims that entail varying degrees of costs, including fines, damages, out-of-court settlements, reputation damage, and loss of business.

In 2017, several significant fines were imposed by UK and US watchdogs. The Financial Reporting Council (FRC) fined Ernst & Young (EY) £1.8 million for misconduct related to the audit of Tech Data Limited, while PricewaterhouseCoopers (PWC) faced dual fines of £5.1 million and £5.0 million in relation to the audits of RSM Tenon and Connaught, respectively (Shoaib, 2017). Additionally, KPMG and PWC were fined $6.2 million and $1 million, respectively. In 2018, Grant Thornton received a £4 million fine for their audit of Patisserie Valerie, shortly after KPMG was fined £3 million by the FRC for their audit of Ted Baker.
The damages incurred are substantial. In mid-2018, a federal judge in the US ordered PWC to pay a staggering $625.3 million in damages for failing to detect over $2 billion in fraud at Alabama Colonial Bank (Dolmetsch, 2018). Deloitte & Touche appealed for a reduction of damages, from $84 million to $40 million, in favour of Livent Inc. Over the past decade, the Big Four accounting firms alone have faced litigation settlements valued in the billions of dollars. These settlements include Deloitte's $250 million settlement in 2005 and PWC's $225 million settlement in 2007, both related to their audits of Tyco International (Guerrera, 2007).

In early 2018, Deloitte agreed to a settlement of $149.5 million over their audit of Taylor, Bean & Whitaker (TBW) (Shoaib, 2018). In Japan, the country's financial regulator fined Ernst & Young affiliate 2.1 billion yen ($17.4 million) after the firm's audit of Toshiba Corporation failed to uncover irregularities in one of Japan's most significant accounting scandals in years (Reuters, 2015).

Finley (2015) notes that settlements against the Big Four have exceeded $300 million, and a single major negligence case could potentially bankrupt a mid-tier firm. The liabilities are not only frequent but also substantial in terms of the value of settlements per case. Auditors face not only the financial burden of litigation costs but also the potential for severe damage to their professional reputation. Claims can be assessed, but only to the extent that legal proceedings can reach a conclusion. In cases characterized by "more than compensation" losses (Bigus, 2016), auditors may suffer severe consequences. Auditors have more at stake than the claims that may be resolved in court. They risk reputation damage, loss of business, and even the prospect of going out of business entirely, as exemplified by the case of Arthur Andersen, which folded due to the Enron accounting scandal, reducing the number of major audit firms from the "Big Five" to the current "Big Four." The collapse of any of the Big Four firms in the face of significant liability could result in catastrophic losses that the industry would struggle to address (Reilly, 2007).

- *Reputation losses: auditors' "Achilles heel"*

Bigus (2016) contends that reputation losses serve as a valuable motivator for both the auditing profession and clients, as auditors naturally become more cautious in the absence of robust legal repercussions. This argument is based on the notion that auditors have mastered the art of securing favorable outcomes even before legal disputes arise by skillfully incorporating a well-known "Bannerman" clause in their opinion statements. A recent illustration of this approach is evident in the case of Barclays Bank v Grant Thornton (High Court, 2015). Nevertheless, despite potential litigation victories, auditors remain vulnerable to reputation damage, as there is always something at stake. Bigus (2016) goes on to assert that an auditor's reputation may suffer even if they are not found negligent in a court of law but are implicated in a financial accounting scandal. Thus, regardless of the legal outcome, reputation losses represent the Achilles' heel of auditors who are often heavily protected.

- *Business loss*

Auditors often find themselves in the precarious position of being the first to face job losses when fraudulent reporting or audit failures are uncovered (Awolowo, et al., 2018). This pattern is exemplified by Tesco's decision to terminate its 32-year audit partnership with

PricewaterhouseCoopers (PwC) in the wake of their accounting scandal, replacing them with Deloitte in 2014 (The Guardian, 2015). Similarly, in Japan, Olympus swiftly replaced KPMG AZSA LLC with Ernst & Young Shin Nihon LLC as their auditors when Michael Woodford exposed the most significant corporate scandal in Japanese history in 2011 (Awolowo et al., 2018). The trend continued with Toshiba, which, upon discovering that the company had overstated its profits by $1.3 billion in a fraud spanning seven years, switched auditors from Ernst & Young Shin Nihon to PwC Aarata (Inagaki, 2017).

2.3. Auditors' responsibilities

The debate surrounding auditors' responsibility for fraud detection presents both a philosophical and policy challenge (Chui & Pike, 2013). The question of auditors' roles in preventing and detecting fraud within financial statements is among the most contentious topics in the field of auditing (Gay et al., 1997). Auditors themselves hold varying opinions on this matter, not to mention the disparities among other stakeholders (Porter, 1997). Alleyne & Howard (2005) contend that the definition of auditors' responsibilities concerning fraud detection has not been adequately established since its inception. The controversy surrounding the auditors' role in fraud detection has persisted for a considerable period (Alleyne & Howard, 2005). Moreover, it is widely acknowledged that an audit should be conducted by competent, impartial professionals and should encompass the gathering and evaluation of evidence related to information affecting decision-making and a report on the correspondence between the information and specific established criteria (Arens et al., 2003).

A significant gap in contemporary auditing literature is the absence of accountants' responsibility for detecting fraud. In the over 1000 pages of codified rules dedicated to the 15 auditing standards deemed authoritative by AICPA, PCAOB, and SEC, there seems to be no substantial literature suggesting that auditors should tailor audits to uncover or detect fraud in recent times (Kravitz, 2012). Curiously, auditors' responsibility for fraud detection is frequently omitted in the standard audit reports accompanying financial statements, with the term "fraud" notably absent (Johnson, 2010). However, when accounting scandals come to light, the initial inquiry from investors often centers on the whereabouts of the auditors (Porter, 1997; Johnson, 2010). Within the business community, there is a general belief that anyone with an interest in a company is morally obliged to rely on its audited financial statements as a guarantee of its financial stability, prosperity, and business viability (Koh & Woo, 1998). Nevertheless, when unforeseen financial crises arise without prior warning, it is widely held by the investing public

that someone should be held accountable for this financial disaster, with auditors typically bearing the brunt of the responsibility (Koh & Woo, 1998).

Even among regulators and other users of financial statements, there is a shared belief that auditors should detect fraud within financial statements (Asare et al., 2015). For instance, the chairman of PCAOB in 2004 declared that "detecting fraud is the responsibility of external auditors and that with few exceptions they should find it." It is crucial to recognize that despite the extensive publicity regarding financial fraud in recent decades, most auditors, investors, and other professionals still grapple with the challenge of detecting fraud. Traditional financial statement audits were fundamentally not designed for this purpose (Coenen, 2013). As Coenen (2013) further elaborates, audits primarily involve verifying a company's arithmetic and adherence to accounting regulations. Auditors scrutinize only a small fraction of transactions, and fraud detection is rarely within their purview because these audits are not tailored for that purpose. Wells (2002) also emphasizes that the demand for auditors to detect fraud, as seen in the Enron case, is misplaced, mainly because accounting standards were not conceived to uncover fraud in the first place. These standards were developed to ensure consistency in comparing one company to another, and detecting fraud typically necessitates an entirely distinct set of skills (Wells, 2002). The last time auditors widely accepted the responsibility of planning audits with the explicit aim of detecting fraud likely harks back to the days of Montgomery.

2.4. Expectation gap

Relentless scrutiny of the audit profession, both from parliamentary bodies and stakeholders, underscores the existence of the expectation gap. Stakeholders persistently pursue the belief that auditors should exercise greater vigilance in safeguarding their investments. Unfortunately, the multifaceted nature of this expectation gap makes complete elimination a challenging endeavour (Sikka et al., 1998). Porter (1993) posits that the audit expectation gap emerges when the public's expectations of auditors are contrasted with the perceived performance of auditors. This underscores the significance of considering the full spectrum of audit expectations, which includes assessing the deficiencies in auditors' performance. To address this prolonged expectation gap, one potential approach is to enhance financial report user education (Porter, 1993; Sikka, et al., 1998; Ojo, 2006). Porter (1993) asserts that effective audit education is contingent on society's understanding of the reasonable duties of auditors. Ojo (2006) adds that while audit education can contribute to narrowing the expectation gap, it alone may not suffice to address all of its components. It is plausible that

the persistence of the expectation gap may be linked to the inherent contradictions within a self-regulated audit system that operates with minimal government intervention (Humphrey et al., 1993). Therefore, a potential solution may involve more stringent government oversight. Furthermore, it has been suggested that broadening auditors' responsibilities can potentially reduce the expectation gap (Sikka et al., 1998). Expanding their role in this manner could lead to enhanced audit report quality, subsequently reducing litigation and its associated costs. However, the extent to which these responsibilities should be expanded remains unspecified.

3. Research Methodology

We employed a qualitative research approach rooted in a neo-empiricist theoretical framework, engaging in interviews with 16 individuals whom we categorised as stakeholders within the accounting field. These stakeholders encompassed Accounting Academics, External Auditors, Forensic Accountants, and Finance Directors from Fortune 350 companies. The interviews, on average, spanned approximately 50 minutes each. Subsequently, following transcription of the interviews, we adopted a general inductive approach for data analysis.
The general inductive approach represents a methodical process for analysing qualitative data. It entails a comprehensive review of interview transcripts, culminating in the identification of emerging themes and theories, aligning with the grounded theory methodology proposed by Strauss and Corbin in 1998 (Thomas, 2006).

4. Findings

We conducted a cross-case analysis through the aid of Nvivo software and identified some key concerns in the present-day audit. We called this Audit Concerns. These concerns are discussed below based on our findings.

4.1. Auditors Responsibilities

The participants involved in this study expressed significant concerns regarding the roles and responsibilities of auditors in detecting fraud within financial statements. They unanimously acknowledged that these responsibilities have evolved over time, despite the fact that such changes have not been officially integrated into accounting standards or educational curricula. Consequently, they propose that auditors should embrace an augmented role in fraud detection within financial statements to mitigate the associated costs of professional negligence.

Of the four stakeholder groups considered in this research, three - including Accounting Academics, Forensic Accountants, and External Auditors - concurred that auditors presently do not bear the responsibility for identifying non-material frauds within financial statements. Nevertheless, they acknowledged that the prevailing landscape is undergoing transformation, necessitating an adaptation in audit practices. Interestingly, Finance Directors, who were also interviewed, expressed the opinion that auditors should share the responsibility for detecting fraud in financial statements. This stands in contrast to the prevailing practice of largely placing such responsibility on those vested with management and governance, as outlined in the International Standard on Auditing (ISA) 240.

4.2. Expectation Gap

The findings of this study illuminate the persistence of the audit expectation gap. The accounting profession has struggled to find a lasting solution to this issue. Investor confidence in the capital market tends to be robust when stock prices are on the rise and when news about the economy and corporations is positive. However, during economic downturns and accounting scandals, investor confidence wanes (Rezaee & Crumbley, 2007). In recent times, there has been a notable decline in trust and a erosion of confidence in audited financial reports (Rezaee, 2004). This decline can be attributed to instances of financial statement fraud and sudden corporate collapses occurring without prior warning (Rezaee, 2004; Alleyne & Howard, 2005; Hogan et al., 2008). Our study reveals the existence of a perceived expectation gap between investors' expectations for high-quality financial information and what public companies actually provide.

The audit expectation gap in the accounting profession refers to the disparity between what auditors claim as their responsibilities and what the public believes auditors should be responsible for by their professional standards (Rezaee & Crumbley, 2007). Our findings highlight that this expectation gap remains a concern for investors, who feel they are not receiving sufficient value from audits, particularly in terms of fraud detection. Recent large-scale accounting scandals and corporate failures have only served to reinforce investors' concerns regarding the adequacy of audit services (Rezaee, 2004).

Efforts to narrow the expectation gap have been made in the past, with attempts to educate the public about auditors' roles and responsibilities. However, our study suggests that the focus should shift towards better educating auditors on recognizing fraud warning signs. This approach seems to offer a path forward and a sustainable solution for the future.

4.3. Mandate of Auditors

Our findings have underscored that auditors will continue to bear the consequences of their inability to detect fraud in their clients' financial records until the ongoing concerns surrounding modern auditing are comprehensively addressed. Another issue that surfaced in this study pertains to the International Standard on Auditing (ISA) 240 guidelines. According to ISA 240, "the primary responsibility for preventing and detecting fraud lies with both the entity's management and those charged with its governance. It is crucial for management, under the oversight of governance entities, to place a strong focus on both preventing fraud, which reduces the opportunities for fraudulent activities, and deterring fraud by dissuading potential wrongdoers due to the risk of discovery and consequences" (International Standard on Auditing 240, 2009, p. 4). Participants in our study expressed reservations about the requirements outlined in ISA 240. While the majority of participants believe that these requirements restrict auditors' ability to proactively detect fraud and may even serve as a basis for disclaimers, one participant argued that the onus of responsibility should rest entirely with the management, as it is their company.

5. Conclusion

In conclusion, the escalating instances of financial statement fraud, audit failures, and sudden corporate collapses have significantly impacted stakeholders, resulting in enormous financial losses in the billions of dollars. The Association of Certified Fraud Examiners reported that occupational fraud and abuse cost an estimated $3.7 trillion in 2018, leading to increased litigation expenses, fines, damages, and settlements for auditing firms, including the Big Four and Mid-Tier firms. This surge in litigation and related damages could potentially exceed the industry's capacity to sustain. We are now witnessing cases where individual audit firms are ordered to pay hundreds of millions of dollars in damages, such as PWC's payment of over $625 million in a single case. The repercussions of claims and court charges extend beyond financial costs, as these firms also suffer reputational damage and loss of clients when fraudulent reporting or audit failures come to light.

This research delves into the costs of professional negligence to audit firms, the reasons behind these claims, and the persistent challenges auditors face in detecting fraud and errors in their clients' financial records. As auditors grapple with mounting litigation costs and increasing damages, the need for comprehensive reform within the audit profession becomes evident. To address these challenges, the study outlines several key areas of concern, including

auditors' evolving responsibilities in fraud detection and the persistent expectation gap between investors and the auditing profession. As long as auditors are not held accountable for fraud detection, they will continue to bear the brunt of costly litigation and reputational damage.
The findings highlight the necessity of redefining auditors' roles and responsibilities, as well as enhancing their training and education in fraud detection. Without meaningful changes in the audit profession, auditors will remain exposed to the risks and costs associated with professional negligence. It is imperative to bridge the expectation gap, address these concerns, and adapt to the evolving landscape of financial reporting and corporate governance. Failure to do so could have severe consequences for the audit industry and its long-term viability.

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Sažetak

U posljednje vrijeme, profesionalni nemar je zauzeo centralno mjesto u vijestima. Nemogućnost revizora da otkriju prevare u finansijskim izvještajima svojih klijenata postala je tema intenzivne debate među profesionalcima u industriji i regulatorima, bez jasnog konsenzusa do sada. Ovaj rad koristi kvalitativni istraživački pristup kako bi se istražile posljedice profesionalne nepažnje i zašto će se revizori i dalje suočavati s posljedicama neuspjeha da otkriju prevaru u finansijskim izvještajima svojih klijenata. Naši rezultati istraživanja pokazuju da će revizori nastaviti snositi teret profesionalne nepažnje sve dok ne dođe do fundamentalne promjene u njihovom mandatu, što će ih navesti da preuzmu proaktivniju ulogu u otkrivanju preevare u finansijskim izvještajima. Posljedice profesionalne nepažnje šire prevazilaze finansijske gubitke, uključujući nematerijalne troškove koji ozbiljno narušavaju reputaciju revizorske profesije.

Ključne riječi: *profesionalni nemar, revizorska profesija, odgovornost revizora, otkrivanje prevare*