The Use of AI in Early-stage Evaluation for Auditor Failures

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I. Introduction

PCAOB Auditing Standard 1000 requires auditors to obtain reasonable assurance that financial statements are free of material misstatements. Material misstatements are errors that meaningfully distort the information in financial statements. When discovered, they are typically corrected through restatements, which are disclosed via Item 4.02 of Form 8-K, a requirement by the SEC since 2005.[1]

Material misstatements are harmful to investors, regardless of whether they are caused by intentional fraud or unintentional errors. However, regulatory enforcement and private litigation focus on the most egregious auditor fraud cases, leaving the majority of audit failures unexamined, especially unintentional errors arising from the misapplication of GAAP, control failures, or judgment lapses.

Two principal bodies of law shape investor recourse against auditors. Federal securities laws, primarily Section 10(b) of the Securities Exchange Act of 1934 and Section 11 of the Securities Act of 1933, provide nationwide causes of action; Section 11 in particular can be a viable avenue for cases involving unintentional errors because it does not require proof of scienter. State common-law claims for professional negligence or malpractice provide an additional, jurisdiction-specific path that does not depend on a registration statement and can reach audit failures falling outside the federal regime.

In this article, we propose an AI framework for investigating these overlooked audit failures and identifying cases with high likelihood of auditor errors and negligence for potential enforcement and litigation. This framework can help enforcement staff and plaintiff-side counsel direct limited resources toward the cases most likely to merit closer attention, advancing the integrity of financial reporting and the protection of investors.

II. Regulatory Enforcement on Auditor Failures is Limited, and Private Litigation Focuses Mainly on Auditor Fraud

Even though material misstatements happen frequently, regulatory enforcement on auditor failures is rather limited. Recent research suggests that roughly 5 to 7 percent of U.S. public firms exhibit material misstatements in any given period.[2][3] However, a government oversight study of 16 years of PCAOB inspection reports on the U.S. arms of the Big Four audit firms finds that the PCAOB cited 808 instances of defective audits but brought only 18 enforcement actions covering 21 audits.[4]

With regulators stepping in only sporadically, private litigation has an outsized role to play. The private lawsuits that do get filed against auditors disproportionately target the most egregious cases involving intentional fraud, leaving the majority of audit failures unexamined.[5]

III. Relevant Legal Theories and Cases

When a public company restates its revenue, profit, cash, or liability, its stock prices could drop significantly if the revisions worsen the company's financial positions. When this happens, plaintiffs' counsel may evaluate whether a securities class action should be filed against the company or auditor, or there are professional negligence claims against the auditor under certain state laws.

A. Securities Exchange Act

At the federal level, investors most often pursue claims under two principal provisions. The first is Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, which permit private suits against a company or its auditor for material misstatements or omissions made in connection with the purchase or sale of securities. To prevail, plaintiffs must plead and prove, among other elements, that the defendant acted with scienter: intent to deceive, or recklessness so severe that it approaches intentional misconduct.[6]

The Private Securities Litigation Reform Act (PSLRA) of 1995 raised the bar for pleading scienter against auditors. Showing that an auditor was merely negligent is insufficient under Section 10(b); plaintiffs must plead facts giving rise to a strong inference that the auditor acted knowingly or with severe recklessness (*Tellabs, Inc. v. Makor Issues & Rights, Ltd*., 551 U.S. 308 (2007)).[7]

Two recent restatement cases illustrate how the PSLRA scienter requirement plays out in practice and how divergent the outcomes can be when an audit failure is framed under Section 10(b).

- On June 6, 2014, Hertz announced that its 2011 financial statements should no longer be relied upon and that it would restate three years of financials (2011–2013); the restated Form 10-K was eventually filed on July 16, 2015 and reduced previously reported pretax income by $235 million. Hertz's stock fell roughly 10% on the day of the June 2014 announcement and continued to decline over the 13 months that the restatement process took to complete, losing about 40% of its pre-announcement value by the time the restated 10-K was filed. The SEC opened an investigation and shareholders filed a Section 10(b) class action against Hertz and several former executives; PwC was not named as a defendant in either proceeding. The Third Circuit ultimately upheld dismissal of the shareholder class action, finding the restatement supported "at most some inference of scienter but not a strong inference," a useful illustration of the PSLRA pleading hurdle. For an auditor-failure analysis, the more relevant point concerns PwC's underlying audit work. PwC served as Hertz's auditor throughout 2011–2013 and issued an unqualified opinion (often called a "clean opinion") on each year's financial statements. Those opinions were superseded once Hertz filed its restated 10-K in July 2015 disclosing the misstatements. PwC subsequently disclaimed its opinion on Hertz's 2014 internal controls over financial reporting.[8]

- A more recent decision, by contrast, shows that the scienter bar is not insurmountable when plaintiffs can plead specific facts about an auditor's knowing or reckless conduct. In April 2017, AmTrust restated five years of financials due to improperly recognized revenue and incorrect employee bonus accounting. Shareholders filed a securities class action against AmTrust, its officers and directors, underwriters, and BDO. BDO had served as AmTrust's auditor and certified that its 2013 audit was conducted in accordance with PCAOB standards. After a rare grant of rehearing, the Second Circuit revived 10b-5 claims against BDO in October 2024, finding plaintiffs had adequately pled scienter, specifically that BDO senior partners knew the audit didn't comply with PCAOB standards and consciously concealed the noncompliance. The Supreme Court denied BDO's petition for

certiorari in October 2025, leaving the Second Circuit's investor-friendly decision in place. This case substantially lowers the barrier to suing auditors.[9]

The second principal federal avenue is Section 11 of the Securities Act of 1933, which can be the more practical claim where the underlying audit work was deficient but scienter cannot be shown. Section 11 creates a cause of action against, among others, "every accountant … who has with his consent been named as having prepared or certified" any part of a registration statement that, as of its effective date, contained an untrue statement of a material fact or a material omission.[10] Unlike Section 10(b), Section 11 does not require plaintiffs to plead or prove scienter, and reliance is generally presumed. The auditor's primary defense is the statutory "due diligence" defense. This requires showing that, after a reasonable investigation conducted in accordance with professional standards, the auditor had reasonable ground to believe, and did believe, that the audited financial statements were true and not misleading. The Ninth Circuit recently reaffirmed, in Hunt v. PricewaterhouseCoopers LLP, that Section 11 imposes a negligence-based standard on accountants rather than strict liability.[11]

Two practical limits, however, bear on Section 11's reach. First, the claim is available only to purchasers whose securities are traceable to the registration statement containing the alleged misstatement (typically purchasers in IPOs, follow-on offerings, or shelf takedowns), not ordinary secondary-market buyers. Second, an auditor's report is treated as a statement of opinion; under *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, opinion statements are actionable as "untrue" only in narrow circumstances, chiefly where the auditor did not actually hold the stated opinion or omitted material facts about its basis.[12] Within these limits, Section 11 remains a meaningful avenue for investors pursuing audit failures involving unintentional errors rather than fraud.

B. State Laws

Beyond federal securities laws, plaintiffs may pursue professional negligence or malpractice claims against an auditor under state common law. The audited client itself can generally sue under such theories; the more important question for investor-plaintiffs is whether non-client third parties who relied on the audited financial statements can recover for ordinary negligence. The answer turns on which state's law applies, and U.S. jurisdictions have developed three principal approaches.

The majority of states have adopted the Restatement (Second) of Torts § 552, which extends the auditor's duty of care to a limited class of persons whom the auditor knew would receive and rely on the audited financial statements for a particular purpose. California's decision in *Bily v. Arthur Young & Co.* is a leading exposition of this approach.[13]

A smaller group of states, led by New York, follow a more restrictive "near-privity" rule traced to *Ultramares Corp. v. Touche* and refined in *Credit Alliance Corp. v. Arthur Andersen & Co*.. Under that approach, third parties generally cannot recover absent a relationship approaching direct dealings with the auditor.[14]

A smaller number of states, including New Jersey, Wisconsin, and Mississippi, apply a broader "reasonable foreseeability" standard, under which any third party whose reliance on the audit was reasonably foreseeable may recover.[15]

As a practical matter, the viability of a state-law negligence claim against an auditor depends heavily on which state's law applies and on how readily the investor-plaintiff can be characterized

as part of a known, intended class of users of the audited financial statements, not merely a remote member of the investing public.

IV. An AI Framework for Early-Stage Evaluation of Audit Failures

Identifying which of the hundreds of misstatements filed each year had audit failures (as opposed to issues outside the auditor's scope) requires specialized financial and accounting analysis that many law firms are not staffed to perform in-house. We propose an AI framework for investigating audit failures and identifying cases with high likelihood of auditor errors and negligence for potential enforcement and litigation. This framework combines three signals into one powerful selection tool: (i) significant negative stock-price reaction, (ii) a large magnitude of misstatement, (iii) AI-based model predictions of auditor failure.

- **Significant, negative stock-price reactions.** Restatements that produce large abnormal returns on the disclosure date establish clear loss causation with quantifiable damages, both of which are prerequisites for a viable securities claim.

- **Magnitude and pervasiveness of each misstatement.** Cases involving large dollar-value misstatements, multiple restated periods, or restatements that span core revenue and expense accounts (as opposed to isolated technical adjustments) are far more likely to reflect breakdowns in audit procedures rather than isolated financial reporting errors.

- **AI-based model predictions of auditor failure.** Our proprietary AI models can identify the gap between a competent auditor exercising professional skepticism and an incompetent auditor who failed to do so. If the AI models trained solely on public information identify a heightened risk of misstatement, while an auditor with broader access to firm-specific information fails to do so, this raises questions about the auditor's competence, professional skepticism, or due diligence.

This AI-based approach is intended to assist with screening and risk identification, not to provide legal advice. The models reflect statistical patterns in public data and cannot guarantee that every flagged restatement involves an auditor failure or that every unflagged restatement is free of one. Cases identified through this approach should be confirmed through traditional due diligence (document review, expert consultation, and case-specific legal and accounting analysis) before any investigative, enforcement, or litigation decision is made.

V. Conclusion

Material misstatements occur far more often than the public enforcement and litigation record might suggest, and a substantial share involves audit work that fell short of professional standards but does not rise to fraud. Section 11 of the Securities Act and state-law negligence claims may offer meaningful avenues for redress in such cases, but identifying suitable targets requires specialized financial analysis that many firms are not equipped to perform at scale.

The AI framework proposed here combines a significant negative stock-price reaction at the disclosure date, the magnitude and pervasiveness of the misstatement, and AI-based model predictions of audit risk. It offers a practical way to screen the universe of restatements and prioritize cases with the highest likelihood of audit failure. Used as a first-pass filter (and not a substitute for traditional due diligence), this approach can help enforcement staff and plaintiff-side counsel direct limited resources toward the cases most likely to merit closer attention, advancing the integrity of financial reporting and the protection of investors. While less traditional, in-house

counsel who want to evaluate the efficacy of their auditors, can also use this tool under the cover of attorney-client privilege.

Sources

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