EFFECTS OF THE CONCEPT RELEASE ON THE AUDITOR'S REPORTING MODEL

ON JURY VERDICTS OF AUDITOR'S LEGAL LIABILITY

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A DISSERTATION

Submitted in partial fulfillment of the requirements
for the degree of Doctor of Philosophy
in the Department of Accounting
in the Graduate School of
The University of Alabama

TUSCALOOSA, ALABAMA

2013

ABSTRACT

This study examines the potential effects of the PCAOB's Concept Release 2011-003 to the standard auditor's report on an auditor's negligence liability. Specifically, I examine the effect of a required emphasis paragraph on the likelihood of guilty verdicts and damage awards in auditor negligence trials. Using a case study, participants determine the legal liability outcomes of a case against an auditor when an emphasis paragraph is absent compared to when the paragraph discusses significant accounts and estimates, as dictated by the Concept Release.

This study utilizes hindsight bias and attribution theory, which relate to an individual's ability to reconstruct causal series of events ex-post, thereby affecting assumed foreseeability and responsibility. I predict the auditor's likelihood of guilty verdicts and damage awards will be higher when the emphasis paragraph is present (as required by the Concept Release) compared to when an emphasis paragraph is not provided. I also examine the likelihood of guilty verdicts and damage awards when an emphasis paragraph is present but differs in content.

Consistent with hypothesized results, I find evidence that the presence of an emphasis paragraph in the auditor's report affects guilty verdicts. Specifically, the presence of an emphasis paragraph, regardless of content, increases guilty verdicts by jurors compared to when the emphasis paragraph is not present. However, contrary to hypothesized results I do not find evidence that the content of the emphasis paragraph in the auditor's report affects the magnitude of compensatory damage awards. Therefore, results suggest jurors have higher instances of guilty verdicts in an auditor negligence trial when the auditor's report contained an emphasis

paragraph, regardless of if the emphasis paragraph did or did not discuss the account that eventually resulted in the audit failure.

Results of this study have practical implications and contribute to both audit and legal liability literature. The topic of this study, the effects of a required emphasis paragraph in the standard auditor's report on an auditor's legal liability, remains important as the PCAOB considers requiring future changes to the auditor's reporting model.

DEDICATION

This dissertation is dedicated to those who have supported and encouraged me throughout this process. Without the encouragement and unwavering support of my family and husband, Clark, I would not have entered the doctoral program. Without the friendship and continuous support of Megan Cosgrove I would not have made it through the program. I thank everyone who helped me and guided me through the trials and tribulations of the doctoral program and the process of creating this manuscript. I appreciate everyone who was there to listen when I needed an ear, provide advice when I needed guidance, and show support when I needed a lift. Without this support, I would not have been able to achieve all that I have at the University.

LIST OF ABBREVIATIONS AND SYMBOLS

AD&A	Auditor's Discussion and Analysis
ANOVA	Analysis of Variance
CMT	Causal Model Theory
CPA's	Certified Public Accountants
GAAP	Generally Accepted Accounting Principles
GLM	Generalized Linear Model
H-Stat	Computed value of the H-statistic for the Kruskal-Wallis test
IFRS	International Financial Reporting Standards
P-Value	Probability of test statistic
PCAOB	Public Company Accounting Oversight Board
MD&A	Management's Discussion and Analysis
F-Stat	Computed value of the f-statistic for GLM analysis
=	Equal to

ACKNOWLEDGMENTS

I am pleased to have this opportunity to thank the many colleagues, friends, and faculty members who have helped me with this research project. I am most indebted to Rick Hatfield, my academic advisor and the chairman of this dissertation, for providing all of the support necessary to complete this arduous process. I would also like to thank all of my committee members including Rich Houston, Paan Jindapon, Volodymyr Melnykov, and Linda Parsons for their invaluable input, inspiring questions, and support of my dissertation. I also thank Walt Robbins and Don Minyard for their assistance with this manuscript. I thank the entire accounting faculty at the University of Alabama for the knowledge gained and advice given during throughout the past four years. I would also like to thank my fellow graduate students for their support throughout my time in the graduate program. Finally I thank all of the participants who contributed to this research.

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CHAPTER I

INTRODUCTION

The purpose of this paper is to examine the potential effects of the Public Company Accounting Oversight Board's (PCAOB's) concept release concerning the auditors reporting model on auditor's legal liability in a negligence trial setting. The PCAOB proposed changes to the current auditor's reporting model in the 2011 "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" (hereafter, the Concept Release). The Concept Release presents four potential changes, or alternatives, to the standard audit report for general consideration by investors, audit committee members, issuers, the accounting profession, and other stakeholders. Based on the comment letters and overall feedback on the Concept Release, the PCAOB issued a proposed standard in August 2013 (hereafter, the Proposed Standard) incorporating some of the changes outlined in the Concept Release (PCAOB 2013). This paper examines one of the most significant, yet generally accepted proposed changes to the standard auditor's report: the inclusion of a required emphasis paragraph.

Based on the Concept Release, the PCAOB's purpose for the proposed changes to the standard auditor's report is to "increase its transparency and relevance to financial statement users, while not compromising audit quality" (PCAOB June 2011a). The presence of a required emphasis paragraph may have significant effects including increased usefulness of the financial statements to users such as investors and analysts, impacts to audit quality, and changes to the roles and responsibilities of the audit committee, management, and the auditor. In this paper, I examine one potential, unintended consequence of the required emphasis paragraph as described in the Concept Release; specifically, the effect on the auditor's likelihood of guilty verdicts and damage awards in a negligence trial setting.

As proposed in the Concept Release and the Proposed Standard, the emphasis paragraph or critical audit matters[1] would be mandatory and would include a description of significant management judgments and estimates[2]. Additionally, the emphasis paragraph would describe the audit procedures performed on these significant accounts and direct readers to the financial statement footnotes where the account is addressed. Although the requirement of an emphasis paragraph is aimed at providing additional information to financial statement users, the change will not require additional audit procedures or testing.

Auditor litigation cases typically arise when litigants claim auditor negligence after the auditor issues an unqualified, or clean, audit opinion on financial statements that are later determined to contain material misstatements (Kadous and Mercer 2012). While the specifics of negligence laws differ by state, the auditor's defense must typically prove the auditor exercised an appropriate standard of care (Causey 1999). The auditor has a duty to exhibit the "minimal competence and reasonable skill and care employed by professionals in the same or similar circumstances" (Causey 1999, 31).

This study examines the effects of the Concept Release's proposed mandatory explanatory paragraph on auditor's liability in a trial setting where the auditor is being sued for negligence in a bankruptcy case where the auditor had not previously issued a going-concern opinion. There are three main possibilities related to the emphasis paragraph in the standard

[1] Language used in the Concept Release refers to the paragraph as an "emphasis paragraph" whereas the language used in the Proposed Standard refers to the paragraph as "critical audit matters". Other than the language used, the content of the paragraph appears to be similar in both the Concept Release and the Proposed Standard.
[2] Under current standards, an emphasis or explanatory paragraph is included in the auditor's report when certain circumstances warrant attention by the auditor, but do not affect the auditor's unqualified, or clean, opinion.

auditor's report. First, the emphasis paragraph could be absent from the report, consistent with current standards (PCAOB 1989). Alternatively, an emphasis paragraph as proposed by the Concept Release could be present, but could vary in regards to content. Specifically, an emphasis paragraph could be present and highlight the account related to the eventual bankruptcy of the company. Lastly, an emphasis paragraph could be present and address significant accounts, but not address the account related to the subsequent bankruptcy.

According to hindsight bias and attribution theory, legal verdicts can be affected by how effective jurors are in reconstructing a causal series of events leading up to a known, negative outcome. If successfully constructed, the causal series of events increases perceived foreseeability, which affects the amount of responsibility attributed to the plaintiff (Kelley and Michela 1980). Hindsight bias and perceived foreseeability has been found to increase the likelihood of guilty verdicts and damage awards (Kamin and Rachlinski 1995; Lowe and Reckers 1994; Anderson et al. 1993; Caspar et al. 1988; 1989). Surprise outcomes (i.e., outcomes contrary to an expected series of events) however, disrupt the reconstruction process and decrease the level of foreseeability (Jennings et al. 1998; Ofir and Mazursky 1997). In addition to foreseeability, attribution theory can also affect perceived competence of the auditor. Specifically, the observer (or juror) assumes that the observed actions are consistent with the individual's general behavior and therefore, makes competency conclusions based on information limited to the observed actions (Kelley and Michela 1980).

In this study, I randomly assign potential jurors to one of three scenarios related to the presence and content of an emphasis paragraph in the standard auditor's report. The scenarios relate to the possibilities of the emphasis paragraph: (1) the emphasis paragraph is *not present*, consistent with current standards, (2) the emphasis is *present and highlights* the account related to the audit failure, and (3) the emphasis is *present but does not highlight* the account related to the audit failure. Using these scenarios, I examine the effects of the presence and content of a mandatory emphasis paragraph as proposed in the Concept Release on juror decisions regarding the guilty verdicts and damage awards against auditors.

I predict the presence of an emphasis paragraph will increase hindsight bias and assumed foreseeability, thereby increasing the legal liability of the auditor. Consequently, the auditor's legal liability will be higher when the emphasis paragraph is present (as required by the Concept Release) than when it is not provided in the standard auditor's report. I also examine the comparison of when the emphasis paragraph is *present but does not highlight* the account related to the eventual bankruptcy of the company compared to when the emphasis paragraph is *present and highlights* the account. In the case where the paragraph does not highlight the account, readers of the audit report have not been "warned" of the account and its related risks. Therefore the bankruptcy is a surprise event, reducing the assumed foreseeability of the event. Additionally, both cases involve important competency arguments related to the auditor. Given the complexity of these cases and the effects of foreseeability and competence, I do not predict which effect will be most salient to jurors during the verdict determination. Even though the emphasis paragraph does not increase the assurance provided by the auditor, I expect the paragraph will affect the legal liability of auditors in a negligence trial setting.

The findings of this study suggest the presence of an emphasis paragraph has an effect on the guilty verdicts of jurors in a legal liability court case setting. Consistent with hypothesized results, I find evidence that the presence of an emphasis paragraph in the auditor's report affects guilty verdicts. Specifically, the presence of an emphasis paragraph, regardless of content, increases guilty verdicts by jurors compared to when the emphasis paragraph is not present.

However, contrary to hypothesized results I do not find evidence that the content of the emphasis paragraph in the auditor's report affects the magnitude of compensatory damage awards. Therefore, results suggest jurors have higher instances of guilty verdicts in an auditor negligence trial when the auditor's report contained an emphasis paragraph, regardless of if the emphasis paragraph did or did not discuss the account that eventually resulted in the audit failure.

This study contributes to audit and legal liability literature by examining the potential effects of changes to current accounting standards. Prior accounting research has examined changes to other accounting standards (Kadous and Mercer 2012; Buckless and Peace 1993), but this is the first study to examine a component of the 2011 Concept Release. The findings of this study will also contribute to our knowledge of the factors impacting juror decisions, such as foreseeability for causal and surprise events. Most importantly, the findings of this study have practical implications, as they will assist in the decision making process regarding approval of the emphasis paragraph alternative in the Concept Release and the Proposed Standard. Although legal liability implications are but one area to contemplate when considering the changes addressed in the Concept Release and the Proposed Standard, it is an important and significant aspect of the current business environment.

The remainder of the paper is organized as follows. The next chapter provides background information on the Concept Release, while Chapter III discusses background and prior literature. Chapter IV develops the hypotheses of the study and Chapter V discusses the research design. Results are discussed in Chapter VI while concluding remarks appear in Chapter VII.

CHAPTER II

CONCEPT RELEASE ON POSSIBLE REVISIONS TO THE AUDITOR'S REPORTING MODEL

The Concept Release, published in June 2011, details the PCAOB's proposed changes to the current auditor's reporting model[3]. The PCAOB's stated purpose for issuing the concept release is to "enhance the relevance of the auditor's communication to investors" (Doty 2011). As stated in the Concept Release, the purpose of the changes is to "provide investors with more transparency into the audit process and more insight into the company's financial statements or possibly other information outside the financial statements" (PCAOB June 2011b). According to responses from investors during the PCAOB's outreach to financial statement preparers and users, investors find the pass/fail model and standardized language of the current auditor's report to provide consistency and comparability across companies. Investors note, however, the standard auditor's report can be too "boilerplate" and does not include information regarding significant judgments made by the auditor when forming the audit opinion.[4] According to the PCAOB's outreach, some investors indicated if they had a better understanding of the audit then

[3] Issuing a concept release is one of the first steps in the PCAOB's standard setting process. A concept release is an opportunity for the PCAOB to solicit public comment prior to issuing a proposed standard. As part of the concept release, the PCAOB typically conducts public roundtables, focus groups, and task forces to discuss topics related to the standard setting activities. After issuing a proposed standard and related release for public comment, the PCAOB considers the comments and determines whether it should adopt the proposed standard as is, or make changes and re-propose the standard. Once the standard has been adopted by the PCAOB, it submits it to the Securities and Exchange Commission for approval (Messier et al. 2012).

[4] The Auditing Standards Committee of the Auditing Section of the American Accounting Association reiterates the lack of informative content noted by investors. In a comment letter to the PCAOB regarding the concept release, the Auditing Standards Committee states, "The existing format of the auditor's report lacks communicative value by not providing enough information regarding the nature and types of procedures, processes and information used in the determination of the auditor's opinion, etc. Therefore, the current report simply reflects a pass or fail outcome and is mostly standard or 'boilerplate' wording" (Auditing Standards Committee 2011).

"they would have a better perspective regarding the risks of material misstatement in a company's financial statements" (PCAOB June 2011a, 7).

To increase the transparency of the financial statements, the Concept Release presents four alternatives to the current auditor's reporting model (PCAOB June 2011a). An underlying theme throughout the alternatives is additional information distributed by the auditor regarding the client's financial statements. The four alternatives include: (1) auditor's discussion and analysis, (2) auditor assurance on other information outside the financial statements, (3) clarification of language in the standard auditor's report, and (4) required and expanded use of an emphasis paragraph.

The first alternative involves adding a supplemental narrative report written by the auditors that is described as the Auditor's Discussion and Analysis (AD&A). The AD&A alternative is the most expansive and controversial change discussed in the Concept Release. Based on comment letters received regarding the Concept Release and comments from roundtable participants, the AD&A is opposed by preparers and internal auditors, board members and audit committee members, and accounting firms and associations of accountants (PCAOB November 2011). Although the reasons for opposition vary, many comment letters discuss the importance of management being the primary distributor of information.[5] Due to the lack of support for this alternative, the PCAOB did not include these changes in the Proposed Standard (PCAOB 2013).

The second alternative, auditor assurance on other information outside the financial statements faces similar opposition. Based on comment letters and roundtable participant

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[5] In a comment letter submitted by Ernst & Young LLC, the firm states, "we do not believe the auditor should be the original source of information about the entity" (Ernst & Young 2011). Additionally, the Auditing Standards Committee of the Auditing Section of the American Accounting Association notes there is a risk that the AD&A could contain information that is inconsistent with Management's Discussion and Analysis (MD&A), which could impact users' assessments of the financial statements (Auditing Standards Committee 2011).

comments, investor associations and large investment companies prefer more information from auditors regarding financial statements rather than assurance on information outside the financial statements (PCAOB November 2011).[6] Given the importance of outside information to the financial statement user, however, the PCAOB did include some related changes in the Proposed Standard (PCAOB 2013).

A third alternative detailed in the Concept Release requires clarification of the language in the standard auditor's report[7]. Unlike some of the other alternatives proposed in the Concept Release, accounting firms, associations of accountants, and board members and audit committee members generally support clarification of language (PCAOB November 2011). Based on the general support of the clarification of language in the standard auditor's report, it is possible the PCAOB will further investigate this change to the auditor's report. However, the change is the least aggressive of the alternatives presented and may not alone adequately address the needs of investors as described by the PCAOB.

One of the most significant, yet generally accepted alternatives proposed in the Concept Release, requires the use of an emphasis paragraph in the standard auditor's report. Under current standards, an emphasis paragraph can be included in the auditor's report in situations where the auditor needs to draw the users' attention. Situations that require the auditor to add an explanatory paragraph include: reference to the report on the audit of internal control for public companies, substantial doubt about an entity's ability to continue as a going concern, lack of consistency in accounting principles due to accounting changes, and the need for additional

[6] As stated by the Council of Institutional Investors in a comment letter to the PCAOB, "we (the Council of Institutional Investors) do not support the Board considering auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model because it would not be responsive to investors' information needs" (Council of Institutional Investors 2011).

[7] Clarifications are proposed for concepts such as reasonable assurance, management's responsibility for the preparation of the financial statements, auditor independence, and auditor's responsibility for fraud, information outside the financial statements and financial statement disclosures.

emphasis. The last item, the need for additional emphasis, may address situations when the client has significant related party transactions or important subsequent events, the company is a component of a larger business enterprise, accounting matters affect the comparability of the financial statements, or there is a need for additional emphasis (Messier et al. 2012; PCAOB 1989). Although the emphasis paragraph is currently a mechanism available to auditors to draw users' attention to matters of significance within the financial statements, it is used most often for going-concerns, scope limitations, and changes in accounting principles (Messier et al. 2012).

The required emphasis paragraph will discuss the most significant, or critical, matters in the financial statements. Specifically, the required emphasis paragraph will address significant management judgments and estimates, discuss the audit procedures performed on these matters, and reference the notes to the financial statements where these matters are discussed. The Concept Release includes an illustration of the possible revised standard auditor's report with the required emphasis paragraph, as recreated in Appendix A (PCAOB June 2011a, 21). As noted in the Concept Release, the "emphasis paragraph could be beneficial to financial statement users through the auditors' identification of signification matters and referencing where those matters are disclosed in the financial statements" (PCAOB June 2011a, 20).

According to the Concept Release, "this alternative is somewhat analogous to the standard French auditor's report" (PCAOB June 2011a, 20). The French auditor's reports require the auditor to explain the procedures the auditor performed for relevant audit areas, including accounting policies and estimates, and how these items are presented in the financial statements, in a paragraph titled "justification of our assessments". French auditor's reports vary on the detail provided in this explanatory paragraph. For example, in the auditor's report of Imerys, a French construction company, for the fiscal year 2011, the justification paragraph addresses only one item, the investments in subsidiaries estimate. The auditor's state "Investments in subsidiaries are valued by taking into account both percentage of shareholder's equity they represent and future profitability forecasts as stated in the accounting policies note to the financial statements concerning long-term investments. Our procedures consisted in assessing the data and the assumptions on which these estimates are based and reviewing the calculations performed by the Company. We assessed the reasonableness of such estimates" (Imerys 2012, 79). Other companies' auditor's reports include numerous items addressed in the explanatory paragraph. In the 2011 annual report for Scor, an insurance company, seven items are addressed in the auditor's report, including financial instrument estimates, tax valuations, acquisitions and disposals, and pending litigation (Scor 2012). An excerpt from the company's 2011 auditor's report is included in Appendix B (Scor 2012).

Based on comment letters and roundtable participants, investor associations and large investment companies support the expanded use of the emphasis paragraph to provide additional information from auditors regarding the financial statements. The Council of Institutional Investors states in a comment letter to the PCAOB the emphasis paragraph should contain, at a minimum, the auditor's assessment of management's critical accounting judgments and estimates (Council of Institutional Investors 2011). Members of the PCAOB's Investor Advisory Group supports the use of an emphasis paragraph if the paragraph includes at least four components: (1) the auditor's assessment of the estimates and judgments made by management and how the auditor arrived at that assessment, (2) areas of high financial statement and audit risk and how the auditor addressed these risk areas, (3) unusual transactions, restatements, and other significant changes in the financial statements, and (4) a discussion of the quality of the issuer's accounting practices and policies (Investor Advisory Group 2011). Additionally, large and regional accounting firms generally support the expanded emphasis paragraph but small accounting firms do not support any additional reporting (PCAOB November 2011). As stated in comment letters, Ernst & Young LLP, KPMG LLP, and McGladrey & Pullen LLP are a few of the many large accounting firms supporting the expanded emphasis paragraph (Ernst & Young LLP 2011; KPMG LLP 2011; McGladrey & Pullen LLP 2011). As stated by the Auditing Standards Committee of the Auditing Section of the American Accounting Association in their comment letter to the PCAOB, the "required and expanded emphasis paragraphs could benefit financial statement users by highlighting those matters deemed as significant and could potentially increase the quality of management's disclosures in the financial statements" (Auditing Standards Committee 2011). Based on the general support of the required use of an emphasis paragraph in the standard auditor's report, the PCAOB's Proposed Standard required the inclusion of a paragraph discussing critical matters of the audit in the standard auditor's report. To help inform the debate as the Proposed Standard is considered, I examine the effect of this change on the legal liability of auditors in negligence trials.

CHAPTER III

BACKGROUND AND PRIOR RESEARCH

In general, liability may be imposed on auditors, issuers, and other securities market participants under Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. As discussed above, auditor litigation cases typically arise when the auditor is charged with negligence after issuing an unqualified audit opinion on financial statements that are later revealed to contain material misstatements (Kadous and Mercer 2012). The auditor's defense must provide evidence that the auditor followed auditing standards and conducted the audit with an appropriate standard of care (Causey 1999). As noted by Kadous (2000), the minimum audit quality level required to avoid legal liability for audit failure is vague and requires judges and jurors to assess standards of care. The judge and jury are charged with assessing the auditor's standards of care based on the decisions and actions of an average auditor in the same situation.

In an empirical summary of legal disputes involving independent auditors between 1960 and 1990, Palmrose discusses the percentage of civil securities actions that are litigated to verdict (1991). The author states that although the percentage of cases that go to trial is low, the option of a trial exists in all cases and serves as a comparison when settlements are proposed and negotiated. As noted by the author, "if either the plaintiff or the defendant expects his position after verdict to exceed proposed settlements, the trial option is exercised" (Palmrose 1991, 150). Kadous and Mercer reiterate this point by stating "although the majority of cases do not go to trial, auditors and plaintiffs consider expected trial outcomes in making decisions about settlements" (2012, 568). As noted in Cloyd et al. (1998), the number of auditor litigation cases have declined after the Reform Act of 1997, which implemented a safe harbor from legal litigation for certain forward-looking information, not including information in the financial statements reported in accordance with generally accepted accounting principles. However, the cases that are initiated will still utilize expected trial outcomes in decisions regarding settlements.

Judge and jury decision making has been examined at length in psychology and legal literature. Studies have examined individual juror characteristics (Boyll 1991; Campbell and Tesser 1983), juror attitudes (Casper et al. 1989), recall of trial evidence (Reyes et al. 1980), and juror biases (Hawkins and Hastie 1990; Kaplan and Miller 1978; Fischhoff 1975; 1977). Previous accounting research has also examined some aspects of the auditor's legal liability, including consequence severity (Kadous 2000), precision of standards (Kadous and Mercer 2012), auditors' use of decision aids (Lowe et al. 2002; Anderson et al. 1995), and the source of the accounting standards (Kadous and Mercer 2012; Buckless and Peace 1993). To my knowledge, this is the first study to examine the effect of the Concept Release on auditor's legal liability in a trial setting.

Prior accounting research on juror decision-making has examined potential changes to auditing standards, most often relating to the independence of the accounting rule-making body or the convergence to International Financial Reporting Standards (IFRS). In a paper examining the precision of auditing standards, industry norms, and client aggressiveness, Kadous and Mercer (2012) examine standards ranging from precise under generally accepted accounting principles (GAAP) to imprecise under IFRS. The authors find the effect of the precision of the accounting standard on the jury verdict depends on the industry norms and the aggressiveness of the client. Further, the authors find that when standards are imprecise (i.e., IFRS), compliance with industry norms provides auditors with a “safe-harbor” against negligence verdicts. In a similar study, Buckless and Peace (1993) examine the effect of the source of the standard and judge instructions on juror decision making. The authors varied the source of the standard between standards established by the auditing profession (compliant with generally accepted auditing standards) and standards established by the government (compliant with government auditing standards). The authors find jurors are more likely to find the auditor guilty when the defendant uses the standards established by the auditing profession as a defense, compared to when the defendant uses the standards established by the government as a defense.

Kadous (2000) examines the effect of consequence severity and audit quality on juror evaluations of auditor responsibility and finds the standard of care requirement is dependent on the severity of the consequences. Specifically, the author finds when the consequences are severe, the auditor is found more responsible, irrespective of the audit quality. When consequences are moderately severe, however, higher quality audits result in more favorable evaluations from jurors than low quality audits.

These studies contribute to the accounting literature on legal trials by examining the effects of changes to professional standards, reporting norms, outcome events, and client characteristics on the negligence verdicts of auditors. This paper contributes to this area of research by examining the effect of a potential change to the standard auditor’s report on the legal liability verdicts of auditors.

CHAPTER IV

HYPOTHESES DEVELOPMENT

Hindsight Bias and Attribution Theory

In this paper, I study the effect of the PCAOB's Concept Release on auditor's legal liability. I rely on hindsight bias and attribution theory to make predictions concerning jurors' decisions in an auditor negligence setting. Hindsight bias occurs when "individuals overestimate the extent to which an outcome could have been anticipated prior to its occurrence" (Anderson et al. 1993, 711). As Hawkins and Hastie (1990, 311) note, events in the past appear "simple, comprehensible, and predictable" in comparison to future events. In its simplest form, hindsight bias is the "you should have known" effect in which individuals are perceived to have been able to predict events. As defined by Lowe and Reckers, "hindsight bias refers to the tendency of individuals with outcome knowledge (hindsight) to alter their perceptions of an event such that, ex-post, one's assumed ability to predict an event is greater than one's ex-ante ability" (1994, 401). For example, hindsight bias would overestimate the extent to which a person investing in a stock should have known, ex-ante, that the price of the stock would subsequently fall.

Fischhoff (1975), the preeminent study to establish the existence of hindsight bias, examines the perceived likelihood of an event's occurrence based on the availability of outcome information. Specifically, the author examines participants' perceptions of the probability of an outcome when participants do not have knowledge of the true outcome (the foresight group) compared to when participants are informed of the event's outcome (the hindsight group). The author finds that participants who received outcome information (the hindsight group) estimate a higher probability for the reported, or true, outcome than did participants who did not receive the outcome information (the foresight group). Fischhoff (1975) concludes that reporting an outcome's occurrence increases the perceived probability that it will occur and provides evidence that people are unable to ignore reported outcomes, even when explicitly instructed to do so. Building on these findings, Fischhoff finds, in a related study, that participants overestimate how much information they would have known before learning the answer to a question (1977).

Hindsight in the Literature

Expanding on Fischhoff (1975; 1977), psychology literature has examined the effect of hindsight bias in a number of practical applications, including outcomes of sporting events (Bonds-Raack et al. 2001; Leary 1981), answers to almanac trivia questions (Wood 1978), supervisors' evaluations of employees (Mitchell and Kalb 1981), and outcomes of elections (Leary 1982). These studies provide evidence that hindsight bias is present in situations in which the outcome of an event, once known, is perceived to be foreseeable and inevitable and therefore, is believed to have a higher probability of occurring.

Research in law and psychology literature also has examined the effect of hindsight bias on judge and juror verdicts. Casper et al. (1989; 1988) provide evidence of hindsight bias in the context of search and seizure cases. In these studies, mock jurors are presented with arguments for a civil case in which an arrested citizen is charging the police with illegally searching the individual's home. The authors find that information about the search's outcome (i.e., search discovered evidence of illegal activity versus search discovered no incriminating evidence) influenced jurors' interpretation of the legality of the search and, consequently, the assigned damage awards. In a similar study, Kamin and Rachlinski (1995) examine juror verdicts in a court case in which a business owner is suing the city for flood damage. According to the prosecution, the city's decision to not maintain a bridge operator resulted in debris being lodged under the bridge, which caused a flood. The authors examine juror verdicts for participants who were or were not provided with outcome knowledge. Findings indicate that jurors with outcome knowledge exhibited higher hindsight bias, which resulted in significantly more negligent verdicts. Therefore, these studies provide important evidence of the effect of hindsight bias on jury decisions.

Hindsight bias has also been examined in accounting settings. Anderson et al. (1993) conducted an experiment examining the effect of environmental and outcome conditions on legal verdicts. As noted by the authors, litigants often blame the auditor in hindsight for failing to foresee their audit clients' financial difficulties. The study examines environmental conditions including background information that implies a high or low risk of fraudulent financial reporting. In addition to risk of fraud, the study examines negative and positive outcomes for investors, creditors, and employees. The authors use an accounting context in which the audit partner is accused of not requiring an adjustment for inventory obsolescence, in a setting in which the subsequent obsolescence results in a loss. The authors find that the outcome condition affects judges' analysis of the auditors' performance, where negative outcomes are associated with lower evaluations of the auditor. Therefore, litigants tend to blame auditors in hindsight for failing to foresee and anticipate their audit clients' subsequent financial problems.

In a similar experiment examining the effect of outcome conditions on auditor's liability, Lowe and Reckers (1994) examine jury verdicts in a bankruptcy context. The authors manipulate outcome information as no information and negative information (i.e., bankruptcy and a subsequent lawsuit). Results indicate that outcome knowledge biases jurors' evaluations of the auditor's decisions, consistent with hindsight bias.

In another study utilizing the accounting environment to examine hindsight bias, Buchman (1985) examines accountants' hindsight bias when predicting the likelihood of a client's bankruptcy. The author finds that participants (graduate business students) are not able to accurately discern the amount of information known prior to the bankruptcy compared to the information obtained subsequent to the outcome. For example, participants are not able to distinguish facts known only after the bankruptcy with facts known prior to the bankruptcy. Together, these studies provide evidence of the hindsight bias in a number of contexts including psychology, law, accounting, and everyday decision-making. These studies provide evidence that participants with outcome knowledge overestimate the extent to which they would have been able to predict the outcome of an event. Therefore, reporting an outcome's occurrence increases its perceived probability of occurring.

Underlying Mechanism of Hindsight Bias

Fischhoff (1975) describes the mechanism underlying hindsight bias as "creeping determinism." Creeping determinism is the process of automatically integrating outcome information so that the actual outcome is perceived as relatively inevitable. For example, once an individual knows an outcome to an event, it is difficult for the individual to conclude that any other outcome is more likely to happen. Prior research in social psychology uses causal model theory (CMT) to explain the creeping determinism mechanism underlying hindsight bias (Blank et al. 2007; 2008; Nestler et al. 2008; Blank & Nestler 2007). According to CMT, creeping determinism works through a sense-making process or, more specifically, through a process of causal reasoning. Causal reasoning (and hence, creeping determinism) is effective if an individual can identify causes of an outcome and form a causal link between these causes and the known outcome.

The process of causal reasoning, or sense-making, involves retrieving causal antecedents that potentially led to the outcome. The causal antecedents may be retrieved from the environment, such as the situation experienced by the individual or evidence presented in a trial, or from long-term memory resulting from similar experiences. These causal antecedents are evaluated with respect to how well they explain the resulting outcome. During the process of causal reasoning, individuals selectively incorporate causal antecedents that support the outcome and ignore or underweight contrary evidence. If causal reasoning is effective, hindsight bias occurs and causes the individual to believe the event was predictable prior to the outcome being known.

The process of causal reasoning or sense-making by which antecedents are evaluated has been studied extensively in the area of attribution theory (Nestler et al. 2008). Attribution theory is used in psychology to examine how individuals perceive the causes of events by forming causal connections between actions and the consequences of those actions (Jaspars et al. 1983). According to attribution theory, individuals seek causal explanations to explain the outcome of events in an attempt to make circumstances understandable, predictable, and controllable (Forsterling 2001). Attribution theory relates to both personal events and events resulting from institutions of society, such as the legal system. Related to personal events, attribution theory is used when an individual seeks to answer questions such as “why didn’t I do well on the test?” For events related to institutions of society, individuals may ask questions such as “what was the victim’s cause of death?” in a legal trial (Forsterling 2001).

If the process of causal reasoning is effective, in the sense that it results in a causal reconstruction of events, the individual concludes that the outcome should have been foreseeable and is consequently avoidable. Therefore, attribution theory can attribute responsibility to individuals when a negative outcome arises and the events leading up to the outcome form a causal link to the outcome (Lord and Smith 1983; Kelley and Michela 1980). In addition to attributing responsibility, the observer (or juror) assumes that the observed actions are consistent with the individual's general behavior (Kelley and Michela 1980). According to attribution theory, if the observed actions of the individual are inappropriate, the observer extrapolates those actions to all situations and activities of the individual (Kelley and Michela 1980). Therefore, the individual's overall competency is assumed based on the limited information of the observer.

Hindsight Bias and Surprise Events

As noted by Jennings et al. (1998), if the process of causal reasoning is not successful, the unforeseeable outcome counteracts the hindsight tendency to integrate outcome knowledge into the individual's sense-making schema. A surprise event is an outcome for which a causal series of events is difficult to construct, thereby affecting the foreseeability of the event (Muller and Stahlberg 2007). For example, a surprise occurs when a profitable business unexpectedly files for bankruptcy. Outcomes that are a surprise (i.e., not predictable given the antecedents) reduce hindsight bias because of the difficulties that individuals encounter when they attempt to create a causal link between the antecedent events and the surprising outcome (Muller and Stahlberg 2007; Jennings et al. 1998; Ofir and Mazursky 1997). Essentially, the surprise event acts as a roadblock that inhibits the reconstruction of causal antecedents into a story that leads to the known outcome.

Ofir and Mazursky (1997) examine the effect of surprise on hindsight bias using everyday events.[8] The authors predict that feelings of surprise serve as a cue to participants that make them aware of the fact that outcome information is largely different from whatever they knew about the event. Drawing from Fischhoff (1975), the authors predict that the effortless assimilation of outcome information, or creeping determinism of hindsight bias, is less likely to be present if the outcome is a surprise. The authors provide evidence that hindsight bias is reduced in cases in which there is a sense of surprise related to the event's outcome. Specifically, the authors find that outcomes with low to moderate surprise do not reduce hindsight bias effects; however, surprising outcomes decrease or even reverse the effects of hindsight bias.

In an audit context, Jennings et al. (1998) examine hindsight bias for events that have difficult causal reconstructions. Specifically, the authors examine bankruptcy cases resulting from significant, unexpected hazardous waste clean-up costs. Using hindsight bias theory, the authors predict that an outcome that is not attributable to a causal series of related events (hence, a surprise event) will result in lower hindsight bias. Further, the authors predict that judges' assessments of the auditor's responsibility to anticipate the outcome is directly related to the degree of outcome foreseeability. The authors provide evidence that judges exhibit greater hindsight bias when an outcome can be attributed to a causal series of related events compared to when the outcome is a surprise (i.e., was not foreseeable).

Hypotheses

According to the PCAOB's Concept Release, the required and expanded use of an emphasis paragraph in the audit report would ask the auditor to highlight significant matters in

[8] The authors conduct three experiments using normal, everyday events or situations. For example, in the first experiment, participants are provided with information about a man undergoing surgery in which the surprise event is the man's death. The other two experiments involved mouthwash advertisements and artists.

the financial statements and identify where in the financial statements these matters are discussed. Significant matters may include "significant management judgment and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation" (PCAOB 2011a, 20).

Considering current auditing standards and the proposed changes to the emphasis paragraph discussed in the Concept Release, there are three possibilities in regard to the content of the emphasis paragraph. First, consistent with current standards, the emphasis paragraph could be absent from the standard audit report. Second, an emphasis paragraph could be present, as proposed in the Concept Release, but not highlight or discuss the account related to the audit failure. Finally, an emphasis paragraph could be present and highlight the account related to the eventual bankruptcy of the company. This possibility would most likely be viewed as a successful application of the standard from the perspective of the standard-setters.

In general, the format of a legal trial requires jurors to be informed of the event outcome (i.e., the company's bankruptcy). Although jurors may be instructed to ignore the negative outcome, hindsight bias research provides evidence that individuals are unable to ignore outcomes in their decision processes, even when instructed to do so (Jennings et al. 1998; Fischhoff 1975; 1977). Using a process of causal reasoning, or sense-making, jurors will seek to construct a causal series of events leading up to the outcome (Blank et al. 2008; Nestler et al. 2008; Blank and Nestler 2007). If effective, the causal series of events will increase the perceived foreseeability of the outcome (Nestler et al. 2008). Increased perceived foreseeability will influence juror verdicts such that there will be an increased likelihood of guilty verdicts and damage awards against the auditor (Kamin and Rachlinski 1995; Lowe and Reckers 1994;

Anderson et al. 1993; Casper et al. 1989; 1988). The hypotheses below examine the effects of the emphasis paragraph and its content on jury verdicts and damage awards.

Emphasis Paragraph Not Provided Versus Present and Highlights Account

I first examine the likelihood of guilty verdicts and damage awards when an emphasis paragraph is *not provided* (under the current standards), compared to when an emphasis paragraph is *present* (as proposed in the Concept Release) *and highlights* the account related to the audit failure. Hindsight bias research suggests the presence of outcome knowledge will increase the auditor's perceived ability to foresee the outcome, thereby increase the likelihood of guilty verdicts and damage awards against the auditor for both of these cases (Kamin and Rachlinski 1995; Anderson et al. 1993; Lowe and Reckers 1994; Caspar et al. 1989; 1988).

Although the baseline hindsight bias or foreseeability is similar, these two cases differ in the element of surprise. In the case when an emphasis paragraph is *present and highlights* the account related to the audit failure, the account has been brought to the attention of the users of the financial statements. When the emphasis paragraph is *not provided*, the client's bankruptcy after the auditor issues an unqualified, or clean, audit opinion is a surprise event for users of the financial statements, thus increasing surprise. Consistent with prior research examining the effects of surprise events, surprise increases the difficulty of reconstructing a causal series of events, which decreases the hindsight bias effect, thereby reducing jurors' likelihood of rendering a guilty verdict and the damage awards required of the auditors (Muller and Stahlberg 2007; Jennings et al. 1998; Ofir and Mazursky 1997). Therefore, a greater feeling of surprise will likely be present when the emphasis paragraph is not provided.

Assuming that the auditor had no reason to issue a going-concern statement, the auditor has appropriately followed audit standards related to the standard auditor's report in each of these two cases. However, the use of an emphasis paragraph that highlights an account serves as a mechanism to call users' attention to the account. This "warning" related to the account introduces an interesting foresight argument for the prosecution. Jurors who are subject to hindsight bias will view the outcome of bankruptcy as foreseeable and, consequently, avoidable. Attribution theory ascribes responsibility to individuals when a negative outcome arises and the events leading up to the outcome form a causal link to the outcome (Lord and Smith 1993, Kelley and Michela 1980). Therefore, jurors may believe that if the auditors were aware of the significant accounts and deemed them important enough to highlight in the emphasis paragraph, the auditors should also have known about the impending bankruptcy. As discussed above, the jury must determine if the auditor exercised an appropriate standard of care (Causey 1999) compared to other independent auditors (Anderson et al. 1995). Depending on the appropriate standard of care, a perceived lack of appropriate foresight by the auditors will potentially increase the likelihood of guilty verdicts and damage awards.

Considering the overall presence of the hindsight bias, the difficult causal reconstruction of events due to surprise for the case where an emphasis paragraph is *not provided*, and the potential increase in guilty verdicts due to the auditor's perceived lack of foresight when an emphasis paragraph is *present and highlights* the account related to the audit failure, I predict:

H1a: Jurors will assess a <u>higher likelihood of a guilty verdict</u> against the auditors when an emphasis paragraph is <u>present and highlights</u> the account related to the audit failure, compared to when an emphasis paragraph is <u>not provided.</u>

H1b: Jurors will require the auditors to pay higher damage awards when an emphasis paragraph is present and highlights the account related to the audit failure, compared to when an emphasis paragraph is not provided.

Emphasis Paragraph Not Provided Versus Present But Does Not Highlight Account

I next consider the likelihood of guilty verdicts and the magnitude of damage awards when an emphasis paragraph is *not provided* (consistent with the current standards), as compared to when an emphasis paragraph is *present* (as proposed in the Concept Release) *but does not highlight* the account related to the audit failure.

As discussed above, hindsight bias will be present in a legal context when outcome information is available. Therefore, prior research suggests hindsight bias or foreseeability will be similar in both of these cases. Additionally, these two cases are similar in that the account related to the bankruptcy is not specifically mentioned in the standard auditor's report in either case. In the first case (assuming that the auditor had no reason to issue a going concern modification), an emphasis paragraph is not included in the auditor's report and, therefore, does not mention the account. In the second case, the auditor includes an emphasis paragraph (as proposed in the Concept Release) but does not address the account that later results in the company's bankruptcy. As discussed in hypothesis one, the client bankruptcy after the auditor issues an unqualified, or clean, audit opinion is a surprise event for users of the financial statements. Consistent with prior research examining the effect of surprise events on hindsight bias, the feeling of surprise will decrease the hindsight bias effect, thereby reducing jurors' likelihood of rendering a guilty verdict and the damage awards required of the auditors (Muller and Stahlberg 2007; Jennings et al. 1998; Ofir and Mazursky 1997). Therefore, a feeling of surprise will be present both when an emphasis paragraph is *not provided* and when an emphasis paragraph is *present but does not highlight* the account related to the audit failure.

Although these two cases may be similar in terms of hindsight bias effects, an additional issue of perceived auditor competency and fault related to attribution theory distinguishes these situations. Specifically, these cases differ in the auditor's appropriate application of standards regarding the content of the auditor's report. The auditor's decision in the second case (in which an emphasis paragraph is *present but does not highlight* the account related to the audit failure) to not highlight the account related to the eventual bankruptcy in the emphasis paragraph can be viewed as inappropriate and potentially incompetent. In an auditor negligence case, the jury is charged with determining if the auditor exercised an appropriate standard of care (Causey 1999). The assessment of an appropriate standard of care requires the comparison of the actions of the auditor to those of other independent auditors (Anderson et al. 1995). The jury will assess the auditor's competence and appropriateness of the auditor's actions based on this standard of care. According to attribution theory, inappropriate, observed actions of the individual are generalized to all situations and activities of the individual (Kelley and Michela 1980). Therefore, I predict that jurors will assign higher likelihoods of guilty verdicts and damage awards in the situation where the emphasis paragraph is *present but does not highlight* the account related to the audit failure due to the perceived competency of the auditor.

In summary, hindsight bias will be present for situations where an emphasis paragraph is *not provided* and for cases where an emphasis paragraph is *present but does not highlight* the account related to the audit failure. The difference between the two cases relates to the perceived competency of the auditor when an emphasis paragraph is present *but does not highlight* the account related to the audit failure. Therefore, I predict:

H2a: Jurors will assess a higher likelihood of a guilty verdict against the auditors when an emphasis paragraph is present but does not highlight the account related to the audit failure, compared to when an emphasis paragraph is not provided.

H2b: Jurors will require the auditors to pay higher damage awards when an emphasis paragraph is present but does not highlight the account related to the audit failure, compared to when an emphasis paragraph is not provided.

Emphasis Paragraph Present But Does Not Highlight Account Versus Present and Highlights Account

In this study, I also examine the likelihood of guilty verdicts and damage awards when emphasis paragraphs are present but differ in content. Specifically, I examine the situation when the emphasis paragraph is *present but does not highlight* the account related to the audit failure compared to when an emphasis paragraph is *present and highlights* the account related to the audit failure.

Consistent with the other hypotheses, I expect hindsight bias to be present in both cases due to the presence of outcome knowledge. As discussed in hypothesis two, a feeling of surprise is expected when the emphasis paragraph is *present but does not highlight* the account related to the audit failure. However, the auditor's decision not to address the account in the emphasis paragraph can be viewed as inappropriate and potentially incompetent. Therefore, hindsight bias will be lower in this case due to the presence of surprise, but the issue of auditor competence may partially or completely counteract this effect. Consistent with hypothesis one, jurors will expect auditors to have foreseen the bankruptcy in the case where the emphasis paragraph is *present and highlights* the account related to the audit failure. Taken together, it is unclear which situation will result in higher likelihoods of guilty verdicts and damage awards. Therefore, I predict in the null form:

H3a: Jurors' assessment of the auditor's likelihood of a guilty verdict will not differ when an emphasis paragraph is present and highlights the account related to the audit failure, compared to when an emphasis paragraph is present but does not highlight the account related to the audit failure.

H3b: Jurors' assignments of damage awards will not differ when an emphasis paragraph is present and highlights the account related to the audit failure, compared to when an emphasis paragraph is present but does not highlight the account related to the audit failure.

CHAPTER V

RESEARCH DESIGN

Task and Procedures

This study uses average citizens as participants to proxy for jurors in an auditor negligence trial. Participants were obtained from personal contacts, and local businesses and organizations from the Southeast and Midwest in the United States. Table 1 summarizes the participant responses. Of the 482 packets distributed, 37 percent were returned. Consistent with prior literature, participants who self-reported being attorneys, auditors, CPAs, or accountants were removed from the sample (Kadous 2000). The resulting full sample included 167 participants. After excluding participants who failed one or more of the manipulation check questions at the conclusion of the case, 93 participants remained (which I have deemed the "reduced sample"). A discussion of the manipulation check questions is included in Chapter VI.

Table 1

Participant Responses

Packets Distributed	482	
Total Responses Returned	178	
Overall Return Rate		37%
Less: Cases Not Completed	(4)	
Less: CPA's and Attorneys	(7)	
Full Sample		**167**
Less: Failed Manipulation Check Questions	(74)	
Reduced Sample		**93**

The case study asked participants to provide key demographic information. Results from the participant demographics are shown in Table 2. As detailed in the table, the full and reduced samples were similar in demographic information. As the table details, the mean age for both the full and reduced sample was 51 years old. A majority of participants were women (67.7 percent for the full sample and 68.8 percent for the reduced sample) and held more conservative political views (66.5 percent for the full sample and 73.1 percent for the reduced sample). Additionally, the majority of participants were employed full-time or retired (total of 74.8 percent for the full sample and a total of 77.4 percent for the reduced sample). Finally, a majority of both samples had attended or completed at least some college (74.3 percent for the full sample and 80.7 percent for the reduced sample). To ensure randomization was effective and demographic information did not significantly affect results, I examined the random distributions of the experimental cells in relation to demographic information and note randomization was effective (results not tabulated).

Table 2

Participant Demographics

Demographic	Full Sample	Reduced Sample
Gender:		
Male	53 (31.7%)	28 (30.1%)
Female	113 (67.7%)	64 (68.8%)
Undisclosed	1 (0.6%)	1 (1.1%)
Age	51.2 years (s.d.15.5)	50.9 years (s.d. 14.3)
Education Level:		
Some High School	0 (0.0%)	0 (0.0%)
Completed High School	31 (18.6%)	13 (14.0%)
Completed Trade/Professional School	10 (6.0%)	4 (4.3%)
Some College	32 (19.2%)	20 (21.5%)
Graduated College	44 (26.3%)	26 (28.0%)
Some Post-Graduate School	19 (11.4%)	10 (10.8%)
Completed Post-Graduate School	29 (17.4%)	19 (20.4%)
Undisclosed	2 (1.2%)	1 (1.1%)
Political Views:		
More Liberal	53 (31.7%)	24 (25.8%)
More Conservative	111 (66.5%)	68 (73.1%)
Undisclosed	3 (1.8%)	1 (1.1%)
Employment Status:		
Full-Time Employment	83 (49.7%)	48 (51.6%)
Part-Time Employment	18 (10.8%)	8 (8.6%)
Full-Time Student	6 (3.6%)	2 (2.2%)
Self-Employed	14 (8.4%)	7 (7.5%)
Retired	42 (25.1%)	24 (25.8%)
Not Currently Employed	1 (0.6%)	1 (1.1%)
Undisclosed	3 (1.8%)	3 (3.2%)
Annual Gross Family Income:		
Less than $10,000	4 (2.4%)	2 (2.2%)
$10,000 - $24,999	8 (4.8%)	0 (0.0%)
$25,000 - $39,999	14 (8.4%)	8 (8.6%)
$40,000 - $54,999	20 (12.0%)	10 (10.8%)
$55,000 - $69,999	25 (15.0%)	15 (16.1%)
$70,000 - $84,999	21 (12.6%)	13 (14.0%)
$85,000 - $99,999	14 (8.4%)	9 (9.7%)
$100,000 - $199,999	42 (25.1%)	25 (26.9%)
$200,000 - $299,999	7 (4.2%)	4 (4.3%)
$300,000 or more	5 (3.0%)	3 (3.2%)
Undisclosed	7 (4.2%)	4 (4.3%)

In this study, I examine the effect of the emphasis paragraph on juror predeliberation evaluations of auditors. The case study requires participants to indicate a verdict by answering the question, "If the jury of which you are a member took a poll before deliberations, how would you vote?" Although the jury group decision of a case is of the most importance, individual predeliberation judgments have been found to be highly correlated to jury evaluations (Kalven and Zeisel 1966). Sandys and Dillehay (1995) find that jurors' first ballot verdicts predict jury verdicts approximately 90 percent of the time. The authors also find that predeliberation and jury verdicts are not affected by the deliberation process. Therefore, given the high correlation of predeliberation evaluations and jury verdicts, this study uses individual predeliberation verdicts as an appropriate proxy for jury decisions.

Participants were asked to complete a paper version of the case that took approximately 20-30 minutes to complete. Case study instructions ask the participant to assume the role of a juror in a case involving a corporation and an independent auditor. The case instructions are reproduced in Figure 1.

<u>Instructions</u>

In this case, you will assume the role of a juror in a court case involving a corporation and an independent auditor. In your role as a juror, you will read a summary of the trial testimony and be asked to answer questions regarding your opinions related to the case. Jurors should develop opinions individually before they enter the jury room to deliberate. Deliberations would not be productive if jurors had not first formed their own opinions about the case. Although the opinions you will be asked to make may be difficult for you, they are similar to those an actual juror must make during a trial.

A summary of the case and the trial testimony is included below. Please read this information carefully so that you may provide your opinions of the case and determine a verdict.

Figure 1. Research instrument: Case study instructions.

The case study involves the fictional case of Eddington Inc. v Cook and Thomas LLC. The plaintiff, Eddington Inc., alleges that the defendant, Cook and Thomas LLC, was negligent in its audit of the 2011 financial statements of Blaze-Away Corporation. The plaintiff experienced a significant financial loss as a creditor after relying on the 2011 financial statements of Blaze-Away Corporation, which filed for bankruptcy in 2012 due to large warranty claims. The plaintiff argues that the auditor, Cook and Thomas LLC, negligently audited the warranty allowance. The defendant, Cook and Thomas LLC, responds that it completed the audit of Blaze-Away Corp. in accordance with auditing standards and applied an appropriate standard of care during the audit. Therefore, the defendant argues it was not negligent and should not be held responsible for Eddington Inc.'s loss. The case summary information provided to all participants is presented in Figure 2.

Case Summary

The Plaintiff (party who is initiating the lawsuit) is Eddington Inc., a lending company. The Defendant (party who is being sued) is the accounting firm Cook and Thomas LLC.

Complaint: The Plaintiff, Eddington Inc., alleges that the Defendant, the accounting firm Cook and Thomas LLC, was negligent in its audit of the 2011 financial statements of Blaze-Away Corp. The Plaintiff experienced a significant financial loss as a lender after relying on Blaze-Away Corp.'s 2011 audited financial statements.

Answer: The Defendant, Cook and Thomas LLC, asserts that it completed the audit of Blaze-Away Corp. in accordance with auditing standards (i.e., rules that auditors are required to follow). Therefore, the Defendant argues they were not negligent and should not be held responsible for Eddington Inc.'s loss.

Brief Synopsis:

Blaze-Away Corp. is a corporation specializing in the production and distribution of fire-retardant lumber. Blaze-Away Corp. has revolutionized the construction industry by producing a fire-retardant treatment for lumber used to build homes and businesses. Since its introduction to the market in 1999, sales of Blaze-Away lumber have continually grown. Blaze-Away lumber is the only lumber of its kind to offer a 25-year warranty for its fire-retardant qualities.

Blaze-Away Corp. expanded its production facilities in March, 2012 by borrowing $10,000,000 from its lender, Eddington Inc. (the Plaintiff), in the form of a 10-year loan requiring annual interest payments and a lump sum principal payment at the end of the 10-year period. Prior to approving the loan, Eddington Inc. (the Plaintiff) obtained and analyzed Blaze-Away Corp.'s 2011 financial statements, which were audited by Cook and Thomas LLC (the Defendant).

The role of auditors, including Cook and Thomas LLC, is to investigate their clients' financial information. The analysis of the financial information is used as a basis for providing an opinion about whether the financial statements are a valid summary of the economic events and transactions that affected the company during the year (i.e., fairly stated in accordance with accounting standards). Financial statements are summaries of financial information that are provided to investors and creditors (businesses or individuals lending money to the company) to help them make informed decisions. Although auditors are hired and paid by the company whose financial statements they examine, an auditor's primary duty is to the general public, including investors and creditors to whom it matters whether the financial statements are fairly stated. The result of auditors' work is a report (called the auditor's report) that states whether or not the financial statements of a company are reasonable.

Auditors cannot examine all of a business' transactions, so they focus on the large (or material) accounts. "Material" means important, and it is often measured in dollars. Therefore, the auditor's report provides "reasonable assurance" that the financial statements are correct, but does not provide a complete guarantee that the financial statements are completely accurate. Instead, the auditor's report provides an opinion as to whether the financial statements are correct for all of the large or material accounts. Therefore, the auditor's responsibility is to analyze the financial statements and issue a report, or opinion, on whether the financial statements are materially, or largely, correct.

Blaze-Away Corp. provides customers with a 25-year warranty on the fire-retardant qualities of its lumber. Over the first 10 years of production (1999 through 2008), Blaze-Away Corp.'s warranty claims from customers consistently averaged between 3% and 5% of sales. Based on scientific tests and experience with its products, Blaze-Away Corp. currently estimates that 5% of sales will result in a warranty claim. Therefore, Blaze-Away Corp. created a warranty allowance in the 2011 financial statements consisting of 5% of sales when it estimated future warranty costs. The warranty allowance serves as a reserve for future warranty costs that may occur when customers file warranty claims. Because the exact amount of the future warranty costs cannot be known with certainty, the company sets up an allowance, or reserve, to estimate and prepare for these future costs. According to accounting standards, the company must estimate and set up a reserve for all estimated future warranty claims at the time of the sale. Part of the purpose of setting up the warranty allowance, or reserve, is to provide information to users about the company's expected future warranty costs.

Figure 2. Research instrument: Case summary provided to all participants

Following the case summary information, participants reviewed a summary of the trial testimony. The trial testimony included opening statements from the plaintiff and the defendant and expert witness testimony for both parties. The trial testimony summary information presented to all participants is included in Appendix C.

Independent Variables

This study randomly assigns participants to one of three scenarios relating to the inclusion of a required emphasis paragraph in the standard auditor's report, as described in the Concept Release. In the first scenario, the 2011 financial statements of Blaze-Away Corp. do not include an emphasis paragraph in the standard auditor's report. This scenario is consistent with current standards that do not require an emphasis paragraph unless certain issues are present (PCAOB 1989). Information provided to participants in the case summary for scenarios where the emphasis paragraph is not provided is depicted in Figure 3. A summary of trial testimony for this scenario is included in Figure 4. The auditor's report for this scenario is located in Figure 5.

Excerpt from Case Summary

Consistent with auditing standards, Cook and Thomas issued an audit report on the financial statements. Accounting standards provide the auditor with the option of discussing significant issues in the auditor's report, but Cook and Thomas did not note any significant items in Blaze-Away Corp.'s audit report. Eddington, Inc. reviewed the auditor's report and Blaze-Away Corp.'s financial statements before making the loan. See the auditor's report in Evidence C and related notes to the financial statements in Evidence D.

Eddington, Inc. reviewed the auditor's report and the financial statements of Blaze-Away Corp. before making the loan. See the auditor's report in Evidence C and the related notes to the financial statements in Evidence D.

Figure 3. Research instrument manipulation of emphasis paragraph: Excerpt from case summary for scenarios where the emphasis paragraph is not provided.

Excerpts from Trial Testimony

Plaintiff's Opening Statement:
Following generally accepted auditing standards, Cook and Thomas issued an auditor's report that did not note any significant issues in the financial statements. Therefore, the auditor's report did not adequately draw the readers' attention to the potential issue in the warranty reserve, nor did they conduct additional audit procedures to ensure the reserve was appropriate. The auditor's report on the financial statements is presented in Evidence C.

Defendant's Opening Statement:
Following generally accepted auditing standards, the auditor's report provides "reasonable assurance" that the financial statements are correct, but does not guarantee that the financial statements are completely accurate. Cook and Thomas LLC conducted an appropriate audit and reported that the 2011 financial statements of Blaze-Away Corp. were not materially misstated.]

Plaintiff's Closing Statement:
The auditor's report did not note any significant issues in the financial statements. Therefore, the auditor's report did not adequately draw the financial statement users' attention to the warranty reserve account. Further, the auditor should have conducted additional audit procedures to ensure that the warranty reserve was appropriate. Specifically, Cook and Thomas should have inquired of Blaze-Away engineers regarding the life span of the lumber.

Defendant's Closing Statement
Following generally accepted auditing standards, the auditor's report provides "reasonable assurance" that the financial statements are correct. Cook and Thomas LLC correctly reported that the 2011 financial statements of Blaze-Away Corp. were not materially misstated

Figure 4. Research instrument manipulation of emphasis paragraph: Excerpt from summary of trial testimony for scenarios where the emphasis paragraph is not provided.

Evidence C – Auditor's Report from 2011 Financial Statements

We have audited the accompanying balance sheets of Blaze-Away Corp. as of December 31, 2011 and 2010, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

Cook and Thomas LLC
New York, New York
February 15, 2012

Figure 5. Research instrument manipulation of emphasis paragraph: Auditor's report for scenarios where the emphasis paragraph is not provided.

In the second and third scenarios, an emphasis paragraph is included in the standard auditor's report, as described in the Concept Release. The content of the emphasis paragraphs, however, differ between these two scenarios. In the second scenario, the emphasis paragraph is included in the auditor's report, but the paragraph does not address the account related to the audit failure, warranty allowance. Instead of including the warranty allowance as an itemized point in the emphasis paragraph, the paragraph addresses financial instruments. In this scenario, the plaintiff, Eddington Inc., argues the auditors negligently audited the financial statements and did not properly include the warranty allowance in the emphasis paragraph. The defendant argues the warranty allowance was not a significant account and, therefore, was not required to be addressed. Further, the drastic increase in warranty claims, which eventually resulted in Blaze-Away's bankruptcy, was unforeseeable at the time the 2011 financial statements were released. The content provided to participants in the second scenario is recreated in Figure 6. A summary of trial testimony for this scenario is included in Figure 7 and the auditor's report for this scenario is located in Figure 8.

Excerpt from Case Summary

Consistent with auditing standards, Cook and Thomas' audit report addressed significant accounts and estimates in the "emphasis paragraph." Specifically, the report addressed two significant items but did not mention Blaze-Away Corp.'s warranty allowance (or reserve for potential future warranty claims made by Blaze-Away Corp.'s customers). Eddington, Inc. reviewed the auditor's report and the financial statements of Blaze-Away before making the loan. See the auditor's report in Evidence C and related notes to the financial statements in Evidence D.

As mentioned above, Cook and Thomas' audit report addressed two significant items, including the allowance for bad debts and the use of financial instruments. However, the report did not mention the warranty allowance (or reserve for possible future warranty claims from customers). Eddington, Inc. reviewed the auditor's report and Blaze-Away Corp.'s financial statements before making the loan. See the auditor's report in Evidence C and the related notes to the financial statements in Evidence D.

Figure 6. Research instrument manipulation of emphasis paragraph: Excerpt from case summary for scenarios where the emphasis paragraph is present but does not highlight the account related to the audit failure.

Excerpt from Trial Testimony

Plaintiff's Opening Statement:
Following generally accepted auditing standards, the auditor's report is required to address any significant accounts or estimates. As you can see in the audit report presented as Evidence C, the warranty reserve allowance is not addressed in the emphasis paragraph. Therefore, the auditor's report did not adequately draw the readers' attention to the account, nor did they conduct additional audit procedures to ensure the reserve was appropriate. See the auditor's report in Evidence C.

Defendant's Opening Statement:
Following generally accepted auditing standards, the auditor's report is required to address any significant accounts or estimates. The audit report did not address the warranty reserve because it was a consistent estimate based on the company's past experience with warranty claims. However, the notes to the financial statements address the warranty allowance.]

Plaintiff's Closing Statement:
The Cook and Thomas' audit report did not address the warranty reserve in the emphasis paragraph. Therefore, the auditor's report did not adequately draw the financial statement users' attention to the account. Further, the auditor should have conducted additional audit procedures to ensure that the warranty reserve was appropriate. Specifically, Cook and Thomas should have inquired of Blaze-Away engineers regarding the life span of the lumber.

Defendant's Closing Statement
Following generally accepted auditing standards, the auditor's report is required to address any significant accounts or estimates. The audit report did not address the warranty reserve because it was a consistent estimate based on the company's past experience with warranty claims. However, the notes to the financial statements did address the warranty allowance.

Figure 7. Research instrument manipulation of emphasis paragraph: Excerpt from summary of trial testimony for scenarios where the emphasis paragraph is present but does not highlight the account related to the audit failure.

Evidence C – Auditor's Report from 2011 Financial Statements

We have audited the accompanying balance sheets of Blaze-Away Corp. as of December 31, 2011 and 2010, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

In connection with our audits, we also bring to your attention the matters listed below. This is not intended to be a complete list of all areas that our audit procedures addressed in response to identified risks of material misstatement.

1. The Company has an allowance (or reserve) for bad debts of $1.2 million as of December 31, 2011. The company estimates bad debts using an aging of accounts receivable. The company has concluded that the allowance is consistent with the company's history of bad debts and is currently deemed reasonable; however, overall changes in the economy could affect the extent of bad debts in the future. We have conducted substantive audit procedures regarding the allowance for bad debt account; see Note 7 to the financial statements for further details.

2. The Company has $3.1 million in financial instruments as of December 31, 2011. The value of the financial instruments was determined by the Company by estimating the valuation and impairment of investments and derivative instruments. However, the values of these financial instruments are contingent on the overall economy and could be affected by market changes. See Note 8 to the financial statements for further details.

We highlight the above matters because they represent some of the areas of audit emphasis during the periods covered by our report. Our audits included performing procedures designed to address the risks of material misstatement associated with the above matters. Such procedures were designed in the context of our audit of the financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures.

Cook and Thomas LLC
New York, New York
February 15, 2012

Figure 8. Research instrument manipulation of emphasis paragraph: Auditor's report for scenarios where the emphasis paragraph is present but does not highlight the account related to the audit failure.

In the third scenario, the account related to Blaze-Away Inc.'s bankruptcy, warranty allowance, is one of two items highlighted in the emphasis paragraph[9]. During the court proceedings, the defense argues that financial statement users were adequately informed of management's significant estimate of the warranty allowance. Further, financial statement users were informed of the audit procedures conducted on the warranty allowance and directed to the notes to the financial statements which address the allowance. The content provided to participants in the second scenario is recreated in Figure 9. A summary of trial testimony for this scenario is included in Figure 10 and the auditor's report for this scenario is located in Figure 11.

[9] In addition to the warranty allowance, the emphasis paragraph in this scenario discusses allowance for bad debts.

Excerpt from Case Summary

Consistent with auditing standards, Cook and Thomas' audit report addressed significant accounts and estimates in the "emphasis paragraph." Specifically, the auditor's report addressed two significant items in the emphasis paragraph, one of which was the warranty allowance (or reserve for potential future warranty claims made by Blaze-Away Corp.'s customers). Eddington, Inc. reviewed the auditor's report and Blaze-Away Corp.'s financial statements before making the loan. See the auditor's report in Evidence C and related notes to the financial statements in Evidence D.

As discussed above, Cook and Thomas' audit report addressed the warranty allowance (or reserve for possible future warranty claims from customers) in the emphasis paragraph. The auditor's report specifically stated that the warranty allowance may exceed historical averages if product conditions change. Eddington, Inc. reviewed the auditor's report and the Blaze-Away Corp.'s financial statements before making the loan. See the auditor's report in Evidence C and the related notes to the financial statements in Evidence D.]

Figure 9. Research instrument manipulation of emphasis paragraph: Excerpt from case summary for scenarios where the emphasis paragraph is present and highlights the account related to the audit failure.

Excerpt from Trial Testimony

Plaintiff's Opening Statement:

Following generally accepted auditing standards, the auditor's report is required to address any significant accounts or estimates. As you can see in the audit report presented as Evidence C, the warranty allowance is addressed in the emphasis paragraph. Even though the auditor's report stated that the warranty allowance may exceed historical averages if product conditions change, we contend the auditor should have conducted additional audit procedures to ensure the warranty allowance was appropriate. Additional audit procedures would have shown the warranty reserve was understated and would not be large enough to meet all future warranty claims.

Defendant's Opening Statement:

Following generally accepted auditing standards, the auditor's report specifically addressed the warranty reserve in the emphasis paragraph. The auditor's report, therefore, properly called attention to the significant account and informed readers that product conditions could cause an increase in the warranty claims. Further, the notes to the financial statements address the warranty allowance.

Plaintiff's Closing Statement:

Although Cook and Thomas' audit report brings attention to the warranty reserve in the emphasis paragraph, the auditor should have conducted additional audit procedures to ensure that the warranty reserve was appropriate. Specifically, Cook and Thomas should have inquired of Blaze-Away engineers regarding the life span of the lumber.]

Defendant's Closing Statement

Following generally accepted auditing standards, the auditor's report specifically addressed the warranty reserve in the emphasis paragraph. The auditor's report, therefore, properly drew attention to the significant account and warned readers that product conditions could cause an increase in the warranty claims. Further, the notes to the financial statements addressed the warranty allowance.]

Figure 10. Research instrument manipulation of emphasis paragraph: Excerpt from summary of trial testimony for scenarios where the emphasis paragraph is present and highlights the account related to the audit failure.

Evidence C – Auditor’s Report from 2011 Financial Statements

We have audited the accompanying balance sheets of Blaze-Away Corp. as of December 31, 2011 and 2010, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2011 and 2010, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

In connection with our audits, we also bring to your attention the matters listed below. This is not intended to be a complete list of all areas that our audit procedures addressed in response to identified risks of material misstatement.

1. The Company has an allowance (or reserve) for bad debts of $1.2 million as of December 31, 2011. The company estimates bad debts using an aging of accounts receivable. The company has concluded that the allowance is consistent with the company’s history of bad debts and is currently deemed reasonable; however, overall changes in the economy could affect the extent of bad debts in the future. We have conducted substantive audit procedures regarding the allowance for bad debt account; see Note 7 to the financial statements for further details.

2. The Company has a warranty allowance (or reserve) of $3.1 million related to its estimate for future warranty claims as of December 31, 2011. The company performed its annual reasonableness test on the warranty allowance as of October 31, 2011 and deemed the balance to be appropriate based on historical averages of warranty claims; however, warranty costs could exceed historical averages if product conditions change. We have conducted substantive audit procedures regarding the warranty allowance account; see Note 11 to the financial statements for further details.

We highlight the above matters because they represent some of the areas of audit emphasis during the periods covered by our report. Our audits included performing procedures designed to address the risks of material misstatement associated with the above matters. Such procedures were designed in the context of our audit of the financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures.

Cook and Thomas LLC
New York, New York
February 15, 2012

Figure 11. Research instrument manipulation of emphasis paragraph: Auditor's report for scenarios where the emphasis paragraph is present and highlights the account related to the audit failure.

Therefore, this study examines three scenarios relating to the presence and content of the emphasis paragraph. The experimental design is shown in Figure 12.

Emphasis Paragraph is Not Provided	**Emphasis Paragraph is Present**	
Cell A: Emphasis paragraph is not provided (not required under current standards)	**Cell B:** Emphasis paragraph is present, but <u>does not highlight the account related to the audit failure</u>	**Cell C:** Emphasis paragraph is present and <u>highlights the account related to the audit failure</u>

Figure 12. Experimental design.

Dependent Measures

This study employs two dependent measures to determine the auditor's legal liability including the likelihood of guilt and dollar amount of damage awards. The first dependent variable, the likelihood of a guilty verdict, is measured by asking the participant "how guilty of negligence do you believe Cook and Thomas LLC to be?" Responses are measured on a 10-point Likert scale where 1 = Not At All Guilty and 10 = Completely Guilty. In order to measure both the magnitude of guilt and related verdict, participants are also asked "if the jury of which you are a member took a poll before deliberations, how would you vote?" and required to indicate either guilty or not guilty.

The second dependent variable measures the dollar amount of damage awards. The dependent variable is measured by asking participants who voted guilty, "What dollar amount in compensatory damages would you recommend by awarded to Eddington, Inc.?" Participants are asked to select an amount between $0 and the full $10,000,000 requested by the Plaintiff. The questions measuring the dependent variables that were provided to participants are included in Figure 13.

<u>Instructions:</u>

Please answer the following response questions about the case openly and honestly. Complete the questions in <u>the order given</u> and <u>do not go back</u> to completed questions. You may refer back to the case materials (printed on white paper) if you wish.

1. How guilty of negligence do you believe Cook and Thomas LLC to be?

<u>Not at all</u> Guilty					Not Sure					<u>Completely</u> Guilty
1	2	3	4	5	6	7	8	9	10	11

2. If the jury, of which you are a member, took a poll before deliberations, how would you vote?

__________ Cook and Thomas, LLC is **guilty** of negligence.

__________ Cook and Thomas, LLC is **not guilty** of negligence.

3. <u>If the auditor is ultimately held responsible</u>, what dollar amount in compensatory damages would you recommend be awarded to Eddington, Inc.? (Fill in an amount from $0 to $10,000,000 below.)

$ ____________________________________

Figure 13. Research instrument: Dependent measures

CHAPTER VI

RESULTS

Manipulation Checks

In addition to demographic questions, I conduct general comprehension and manipulation check questions including: (1) "In this case, what role were you assuming", (2) "the plaintiff in the case was", (3) "the defendant in the case was", (4) "the account that resulted in Blaze-Away's bankruptcy was", and (5) "select the correct statement regarding the auditor's report signed by Cook and Thomas". The manipulation check questions provided to participants are recreated in Figure 14. Participants who did not satisfactory answer these questions were removed from the full sample for purposes of statistical analysis. The remaining participants are included in the "reduced sample". As detailed in Table 1, the full sample is composed of 167 participants while the reduced sample includes 93 participants. Therefore, 74 participants did not pass one or more of the manipulation check questions, which represents a 44.31 percent failure rate. Limitations of the study due to this failure rate are discussed in Chapter VII.

Instructions:
Please answer all of the following questions about the case. Do not go back to the case materials.

1. **In the case, what role where you assuming?**
    a. Prosecution
    b. Defense
    c. Judge
    d. Jury member

2. **The Plaintiff (party who is initiating the lawsuit) in the case was:**
    a. Cook and Thomas LLC
    b. Eddington Inc.
    c. Blaze-Away Corp.
    d. Thomas Manufacturing

3. **The Defendant (party who is being sued) in the case was:**
    a. Cook and Thomas LLC
    b. Eddington Inc.
    c. Blaze-Away Corp.
    d. Thomas Manufacturing

4. **The account that resulted in Blaze-Away Corp.'s bankruptcy was:**
    a. Long-term assets
    b. Warranty reserve
    c. Inventory
    d. Advertising expense

5. **Select the correct statement regarding the auditor's report signed by Cook and Thomas LLC.**
    a. The auditor's report did not include an emphasis paragraph that discussed any specific accounts.
    b. The auditor's report included an emphasis paragraph that discussed specific accounts but it did not mention the warranty reserve.
    c. The auditor's report included an emphasis paragraph that discussed specific accounts and specifically mentioned the warranty reserve.
    d. The auditor's report was not provided as evidence in the case.

Figure 14. Research instrument: Manipulation checks

Tests of Hypotheses

In testing the stated hypotheses, I first conduct a Generalized Linear Model (GLM) analysis for each hypothesis to analyze the differences in group means. Given the non-normal distribution of the data in this study, I transform the data to approximate a normal distribution using Box-Cox analysis[10]. I conduct a Box-Cox analysis for each variable and using the recommended transformations from the analysis, I data transform the distributions to approximate a normal distribution[11]. However, even with the use of data transformations, the data is does not perfectly follow a normal distribution. Therefore, I also conduct non-parametric analyses using Kruskal-Wallis tests[12]. I present the results from both the parametric and non-parametric analysis in this paper and find the results are consistent between measurements.

To test hypotheses H1a, H2a, and H3a, I use the dependent variables measuring the likelihood of guilty verdicts measured with a continuous variable and the binary guilty verdict decision. The dependent variable measuring the dollar amount of damage awards is used for H1b, H2b, and H3b. For hypothesis one, I compare the scenario when the emphasis paragraph is *not provided* (Cell A)[13] with the scenario when the emphasis paragraph is *present and highlights* the account related to the audit failure (Cell C). Hypothesis two compares the scenario when the emphasis paragraph is *not provided* (Cell A) to the scenario when the emphasis paragraph is

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[10] Box-Cox analysis is a tool used in data transformations to obtain the most appropriate exponent to transform data into a "normal" distribution.

[11] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox as follows: Likelihood of Guilty Verdicts: $\lambda = (0.23)$, Guilty/Not Guilty Verdict: $\lambda = (5.00)$, Compensatory Damage Awards: $\lambda = 0.12$, Competence of Auditor: $\lambda = 2.05$, Appropriateness of Auditor Procedures: $\lambda = 1.45$, Appropriateness of Standard of Care: $\lambda = 1.67$, Appropriateness of Auditor Decisions: $\lambda = 1.78$, Plaintiff's Responsibility for Loss: $\lambda = 2.48$, Extent Bankruptcy was Inevitable: $\lambda = 1.11$, Foreseeability of Bankruptcy: $\lambda = (0.10)$, Difficulty of Auditor to Predict Warranty Costs: $\lambda = 1.69$, Auditor's Job to Determine if Fairly Presented: $\lambda = 4.22$ Auditor's Responsibility to the Public: $\lambda = 2.64$, Auditor's Responsibility for Materially Correct: $\lambda = 1.54$, and Auditor's Opinion as a Guarantee of Investment: $\lambda = 0.28$.

[12] The Kruskal-Wallis test is the non-parametric equivalent to Analysis of Variance (ANOVA) and examines the differences in population medians for data that does not follow a normal distribution.

[13] See Figure 12 for experimental design and cell references.

present but does not highlight the account related to the audit failure (Cell B). For hypothesis three, I compare the scenario when the emphasis paragraph is *present but does not highlight* the account related to the audit failure (Cell B) with the scenario when the emphasis paragraph is *present and highlight*s the account (Cell C).

Hypothesis 1

As hypothesized in H1a, I expect the likelihood of a guilty verdict to be higher when the emphasis paragraph is *present and highlights* the account related to the audit failure (Cell C), compared to when an emphasis paragraph is *not provided* (Cell A). As shown in Figure 13, both the likelihood of a guilty verdict (measured on an 11-point Likert scale) and the binary guilty/not guilty decision were obtained from participants.

First I examine the likelihood of a guilty verdict as measured as a continuous variable using a Likert scale. Table 3.1, Panel A presents the results of the GLM analysis of the likelihood of guilty verdicts (measured as a continuous variable) for the full sample. Table 3.2, Panel A presents the GLM analysis of the likelihood of guilty verdicts (measured as a continuous variable) for the reduced sample As detailed in Table 1, the full sample includes all participants who satisfactorily completed the study and were not eliminated due to occupations as CPA's or attorneys. The reduced sample is restricted to participants from the full sample who passed all manipulation checks concerning the case materials. As depicted in Panel A of Tables 3.1 and 3.2, there is no evidence of a statistical difference in the likelihood of a guilty verdicts between Cells A and C (F-Stat of 0.22 and P-Value of 0.639 for the full sample; F-Stat of 0.96 and P-Value of 0.330 for the reduced sample). Table 4.1, Panel A and Table 4.2, Panel A present the results of the Kruskal-Wallis analysis of the likelihood of guilty verdicts, which confirms the results of the

GLM analysis (H-Stat of 0.15 and P-Value of 0.701 for full sample and H-Stat of 0.55 and P-Value of 0.459 for reduced sample).

Next, I examine the binary guilty/not guilty verdict. Table 3.1, Panel B presents the results of the parametric analysis of the binary guilty verdict for the full sample, while Table 3.2, Panel B presents the parametric analysis for the reduced sample. While the full sample analysis does not provide evidence supporting H1a (F-Stat of 2.66 and P-Value of 0.106), the reduced sample finds a statistically significant difference between cells (F-Stat of 5.99 and P-Value of 0.017). Specifically, Table 3.2, Panel B provides evidence of a higher incidence of guilty verdicts when the emphasis paragraph is *present and highlights* the account related to the audit failure than when the emphasis paragraph is *not provided*. Table 4.1, Panel B and Table 4.2, Panel B confirm these results non-parametrically by showing a statistically significant increase in guilty verdicts for the reduced sample only, when the emphasis paragraph is *present and highlights* the account related to the audit failure than when the emphasis paragraph is *not provided* (H-Stat of 5.57 and P-Value of 0.018).

In summary, the results do not indicate a higher likelihood of guilty verdicts (as measured with a continuous variable) when the emphasis paragraph is *present and highlights* the account related to the audit failure compared to when the emphasis paragraph is *not provided*. However, when participants are required to make a binary guilty/not guilty determination, the results do support a higher incidence of guilty verdicts when the emphasis paragraph is *present and highlights* the account related to the audit failure compared to when the emphasis paragraph is *not provided*. As predicted using hindsight bias theory, the presence of a surprise event (such as the subsequent bankruptcy when an emphasis paragraph is not provided in the auditor's report) decreases hindsight bias and guilty verdicts. Therefore, consistent with the underlying theory of hindsight bias, I do find evidence to support H1a.

As hypothesized in H1b, jurors will require the auditors to pay higher damage awards when an emphasis paragraph is *present and highlights* the account related to the audit failure, compared to when an emphasis paragraph is *not provided*. Table 3.1, Panel C reports the parametric analysis results for the full sample while Table 3.2, Panel C reports the parametric analysis results for the reduced sample. Table 4.1, Panel C and Table 4.2, Panel C show the non-parametric equivalent to Tables 3.1 and 3.2. Contrary to H1b, I do not find support that jurors require auditors to pay higher damage awards when an emphasis paragraph is *present and highlights* the account related to the audit failure, compared to when an emphasis paragraph is *not provided.*

Hypothesis 2

As hypothesized in H2a, I predict jurors will assess a higher likelihood of a guilty verdict against the auditors when an emphasis paragraph is *present but does not highlight* the account related to the audit failure (Cell B), compared to when an emphasis paragraph is *not provided* (Cell A). Table 3.1, Panel A presents the results of the GLM analysis of the likelihood of guilty (measured as a continuous variable) verdicts for the full sample, while Table 3.2, Panel A presents the GLM analysis for the reduced sample. Results for both the full and reduced samples do not provide support that higher likelihoods of guilty verdicts are associated with an emphasis paragraph is *present but does not highlight* the account. Table 4.1, Panel A and Table 4.2, Panel A present the non-parametric analysis and are consistent with the findings of the GLM analysis.

Table 3.1, Panel B and Table 3.2, Panel B report the results of the binary guilty/not guilty decision for the full sample and reduced sample, respectively. Similar to the results of the binary guilty/not guilty verdict in H1a, while the full sample analysis does not provide evidence supporting H2a (F-Stat of 0.81 and P-Value of 0.369), the reduced sample finds a statistically significant difference between cells (F-Stat of 4.38 and P-Value of 0.042). Therefore, jurors in the condition where an emphasis is *present but does not highlight* the account related to the audit failure report more guilty verdicts than jurors who were *not provided* an emphasis paragraph. Non-parametric results shown in Table 4.1, Panel B and Table 4.2, Panel B are consistent with the GLM analysis.

Therefore, while the results do not indicate a higher likelihood of guilty verdicts (as measured with a continuous variable) when the emphasis paragraph is *present but does not highlights* the account related to the audit failure than when the emphasis paragraph is *not provided*, results do support a higher incidence of guilty verdicts when jurors are required to make a binary guilty/not guilty determination. As predicted using attribution theory, the increase in perceived auditor's fault and lack of competence when the emphasis paragraph does not highlight the account related to the audit failure (compared to when an emphasis paragraph is not provided) results in higher instances of guilty verdicts. Therefore, consistent with attribution theory, I do find evidence in support of H2a.

As predicted in H2b, jurors will require the auditors to pay higher damage awards when an emphasis paragraph *is present but does not highlight* the account related to the audit failure (Cell B), compared to when an emphasis paragraph is *not provided* (Cell A). The GLM analysis for the full sample is provided in Table 3.1, Panel C while the GLM analysis for the reduced sample is provided in Table 3.2, Panel C. Similar to H1b, I do not find support that damage awards differ between these two groups. The non-parametric analysis in Table 4.1, Panel C and Table 4.2, Panel C is consistent with the GLM results. Therefore, contrary to H2b, I do not find support that jurors require auditors to pay higher damage awards when an emphasis paragraph is *present but does not highlight* the account related to the audit failure, compared to when an emphasis paragraph is *not provided.*

Hypothesis 3

Finally, Hypothesis 3 examines the effects of the content of the emphasis paragraph by comparing the scenario when the emphasis paragraph is *present and highlights* the account related to the audit failure (Cell C), compared to when an emphasis paragraph is *present but does not highlight* the account related to the audit failure (Cell B). H3a predicts the jurors' assessment of the auditor's likelihood of a guilty verdict will differ when an emphasis paragraph is *present and highlights* the account related to the audit failure, compared to when an emphasis paragraph is *present but does not highlight* the account related to the audit failure. Similar to the first two hypotheses, I examine both the likelihood of a guilty verdict using an 11-point Likert Scale and a binary guilty/not guilty decision.

Table 3.1, Panel A presents the results of the GLM analysis of the likelihood of guilty verdicts (using a Likert scale) for the full sample, while Table 3.2, Panel A presents the GLM analysis for the reduced sample. Results for both the full and reduced samples do not provide support that the content of the emphasis paragraph affects the likelihood of guilty verdicts. Table 4.1, Panel A and Table 4.2, Panel A present the non-parametric analysis and are consistent with the findings of the GLM analysis.

Table 3.1, Panel B and Table 3.2, Panel B report the results of the binary guilty/not guilty decision for the full sample and reduced sample, respectively. Similar to the likelihood of guilty verdicts findings for these two groups, I do not find evidence that the binary guilty/not guilty decisions differ based on the content of the emphasis paragraph. Table 4.1, Panel B and Table 4.2, Panel A present the non-parametric analysis and are consistent with the findings of the GLM analysis.

As predicted in H3b, jurors' assignments of damage awards will differ when an emphasis paragraph is *present and highlights* the account related to the audit failure, compared to when an emphasis paragraph is *present but does not highlight* the account related to the audit failure. Table 3.1, Panel C and Table 3.2, Panel C present the parametric results while Table 4.1, Panel C and Table 4.2, Panel C present the non-parametric results. Both the GLM analysis and the Kruskal-Wallis tests do not find evidence to support the hypothesis. Therefore, contrary to H3b, I do not find support that jurors require auditors to pay higher damage awards when an emphasis paragraph is *present but does not highlight* the account related to the audit failure, compared to when an emphasis paragraph is *present and highlights* the account related to the audit failure.

The results of H3, in combination with the results from the first two hypotheses, create an interesting situation. Based on the collective results, it appears the presence and not the content of the emphasis paragraph affects juror's guilty verdicts. Therefore, the auditor is not given any leniency in terms of guilty verdicts when the auditor properly discusses the account relating to the audit failure in the emphasis paragraph of the standard auditor's report. Regardless of the content of the paragraph, the auditor has higher instances of a guilty verdict when the emphasis paragraph is present than when it is not included.

Table 3.1

Parametric Analysis of Likelihood of Guilty Verdicts and Damage Awards for Full Sample

Panel A: Results of GLM[1] Model for Likelihood of Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat*[5] *P-Value*	H1: Cell A vs Cell C *F-Stat*[5] *P-Value*	H2: Cell A vs Cell B *F-Stat*[5] *P-Value*	H3: Cell B vs Cell C *F-Stat*[5] *P-Value*
Likelihood of Guilty Verdict[2]	3.123 (2.543) n = 57	3.673 (3.055) n = 55	3.745 (3.068) n = 55	*0.19* *0.830*	*0.22* *0.639*	*0.36* *0.552*	*0.01* *0.919*

Panel B: Results of GLM[1] Model for Binary Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat*[5] *P-Value*	H1: Cell A vs Cell C *F-Stat*[5] *P-Value*	H2: Cell A vs Cell B *F-Stat*[5] *P-Value*	H3: Cell B vs Cell C *F-Stat*[5] *P-Value*
Guilty / Not Guilty Verdict[3]	0.105 0.310 n = 57	0.164 (0.373) n = 55	0.218 (0.417) n = 55	*1.31* *0.271*	*2.66* *0.106*	*0.81* *0.369*	*0.52* *0.471*

Table 3.1 continued

Panel C: Results of GLM[1] Model for Damage Awards

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [5] *P-Value*	H1: Cell A vs Cell C *F-Stat* [5] *P-Value*	H2: Cell A vs Cell B *F-Stat* [5] *P-Value*	H3: Cell B vs Cell C *F-Stat* [5] *P-Value*
Compensatory Damage Awards[4]	$4,231,737 (3,824,092) n = 52	$3,727,780 (4,064,042) n = 50	$3,815,755 (4,278,269) n = 53	*0.59* *0.554*	*0.96* *0.330*	*0.84* *0.362*	*0.00* *0.956*

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate how guilty of negligence they believed the Defendant, Cook and Thomas LLC, to be on an 11-point Likert scale ranging from "1: Not At All Guilty" to "11: Completely Guilty".

[3] Participants were asked to indicate how they would vote as a member of the jury between "Cook and Thomas LLC is guilty of negligence" and "Cook and Thomas LLC is not guilty of negligence" (where 0 = not guilty and 1 = guilty).

[4] Participants were asked to indicate what dollar amount in compensatory damages they recommend be awarded to Eddington, Inc. if the auditor were ultimately held responsible (ranging from $0 to $10,000,000).

[5] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox as follows: Likelihood of Guilty Verdicts: λ = (0.23), Guilty/Not Guilty Verdict: λ = (5.00), and Compensatory Damage Awards: λ = 0.12.

Table 3.2

Parametric Analysis of Likelihood of Guilty Verdicts and Damage Awards for Reduced Sample

Panel A: Results of GLM[1] Model for Likelihood of Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [5] *P-Value*	H1: Cell A vs Cell C *F-Stat* [5] *P-Value*	H2: Cell A vs Cell B *F-Stat* [5] *P-Value*	H3: Cell B vs Cell C *F-Stat* [5] *P-Value*
Likelihood of Guilty Verdict[2]	2.125 (0.850) n = 24	3.160 (2.734) n = 25	3.455 (2.905) n = 44	*0.47* *0.627*	*0.96* *0.330*	*0.54* *0.467*	*0.05* *0.827*

Panel B: Results of GLM[1] Model for Binary Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [5] *P-Value*	H1: Cell A vs Cell C *F-Stat* [5] *P-Value*	H2: Cell A vs Cell B *F-Stat* [5] *P-Value*	H3: Cell B vs Cell C *F-Stat* [5] *P-Value*
Guilty / Not Guilty Verdict[3]	0.000 (0.000) n = 24	0.160 (0.374) n = 25	0.205 (0.408) n = 44	*2.84* *0.064**	*5.99* *0.017***	*4.38* *0.042***	*0.20* *0.655*

Table 3.2 continued

Panel C: Results of GLM[1] Model for Damage Awards

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [5] *P-Value*	H1: Cell A vs Cell C *F-Stat* [5] *P-Value*	H2: Cell A vs Cell B *F-Stat* [5] *P-Value*	H3: Cell B vs Cell C *F-Stat* [5] *P-Value*
Compensatory Damage Awards[4]	\$3,750,014 (3,224,702) n = 22	\$4,304,348 (4,196,154) n = 23	\$3,907,046 (4,039,773) n = 44	*0.47* *0.629*	*0.92* *0.342*	*0.58* *0.452*	*0.01* *0.929*

* Significant at the $\alpha = 0.10$ level.

** Significant at the $\alpha = 0.05$ level.

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate how guilty of negligence they believed the Defendant, Cook and Thomas LLC, to be on an 11-point Likert scale ranging from "1: Not At All Guilty" to "11: Completely Guilty".

[3] Participants were asked to indicate how they would vote as a member of the jury between "Cook and Thomas LLC is <u>guilty</u> of negligence" and "Cook and Thomas LLC is <u>not guilty</u> of negligence" (where 0 = not guilty and 1 = guilty).

[4] Participants were asked to indicate what dollar amount in compensatory damages they recommend be awarded to Eddington, Inc. if the auditor were ultimately held responsible (ranging from \$0 to \$10,000,000).

[5] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Likelihood of Guilty Verdicts: λ = (0.23), Guilty/Not Guilty Verdict: λ = (5.00), and Compensatory Damage Awards: λ = 0.12.

Table 4.1

Non-Parametric Analysis of Likelihood of Guilty Verdicts and Damage Awards for Full Sample

Panel A: Results of Kruskal-Wallis Test[1] for Likelihood of Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	H1: Cell A vs Cell C *H-Stat P-Value*	H2: Cell A vs Cell B *H-Stat P-Value*	H3: Cell B vs Cell C *H-Stat P-Value*
Likelihood of Guilty Verdict[2]	2.000 (2.000) n = 57	3.000 (4.000) n = 55	2.000 (5.000) n = 55	*0.44* *0.802*	*0.15* *0.701*	*0.48* *0.488*	*0.03* *0.852*

Panel B: Results of Kruskal-Wallis Test[1] for Binary Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	H1: Cell A vs Cell C *H-Stat P-Value*	H2: Cell A vs Cell B *H-Stat P-Value*	H3: Cell B vs Cell C *H-Stat P-Value*
Guilty / Not Guilty Verdict[3]	0.000 (0.000) n = 57	0.000 (0.000) n = 55	0.000 (0.000) n = 55	*2.62* *0.270*	*2.62* *0.105*	*0.81* *0.367*	*0.52* *0.469*

Table 4.1 continued

Panel C: Results of Kruskal-Wallis Test[1] for Damage Awards

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	H1: Cell A vs Cell C *H-Stat* *P-Value*	H2: Cell A vs Cell B *H-Stat* *P-Value*	H3: Cell B vs Cell C *H-Stat* *P-Value*
Compensatory Damage Awards[4]	\$5,000,000 (7,250,000) n = 52	\$1,500,000 (8,000,000) n = 50	\$2,000,000 (8,000,000) n = 53	*0.76* *0.683*	*0.49* *0.483*	*0.62* *0.430*	*0.03* *0.871*

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate how guilty of negligence they believed the Defendant, Cook and Thomas LLC, to be on an 11-point Likert scale ranging from "1: Not At All Guilty" to "11: Completely Guilty".

[3] Participants were asked to indicate how they would vote as a member of the jury between "Cook and Thomas LLC is guilty of negligence" and "Cook and Thomas LLC is not guilty of negligence" (where 0 = not guilty and 1 = guilty).

[4] Participants were asked to indicate what dollar amount in compensatory damages they recommend be awarded to Eddington, Inc. if the auditor were ultimately held responsible (ranging from \$0 to \$10,000,000).

Table 4.2

Non-Parametric Analysis of Likelihood of Guilty Verdicts and Damage Awards for Reduced Sample

Panel A: Results of Kruskal-Wallis Test[1] for Likelihood of Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	H1: Cell A vs Cell C *H-Stat P-Value*	H2: Cell A vs Cell B *H-Stat P-Value*	H3: Cell B vs Cell C *H-Stat P-Value*
Likelihood of Guilty Verdict[2]	2.000 (1.750) n = 24	2.000 (2.500) n = 25	2.000 (5.000) n = 44	*0.64* *0.727*	*0.55* *0.459*	*0.43* *0.513*	*0.02* *0.887*

Panel B: Results of Kruskal-Wallis Test[1] for Binary Guilty Verdict

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	H1: Cell A vs Cell C *H-Stat P-Value*	H2: Cell A vs Cell B *H-Stat P-Value*	H3: Cell B vs Cell C *H-Stat P-Value*
Guilty / Not Guilty Verdict[3]	0.000 (0.000) n = 24	0.000 (0.000) n = 25	0.000 (0.000) n = 44	*5.46* *0.065**	*5.57* *0.018***	*4.10* *0.043***	*0.20* *0.652*

Table 4.2 continued

Panel C: Results of Kruskal-Wallis Test[1] for Damage Awards

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	H1: Cell A vs Cell C *H-Stat P-Value*	H2: Cell A vs Cell B *H-Stat P-Value*	H3: Cell B vs Cell C *H-Stat P-Value*
Compensatory Damage Awards[4]	$3,750,000 (4,249,925) n = 22	$5,000,000 (8,000,000) n = 23	$2,250,000 (8,000,000) n = 44	*0.10* *0.950*	*0.14* *0.708*	*0.00* *1.00*	*0.01* *0.903*

* Significant at the $\alpha = 0.10$ level.

** Significant at the $\alpha = 0.05$ level.

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate how guilty of negligence they believed the Defendant, Cook and Thomas LLC, to be on an 11-point Likert scale ranging from "1: Not At All Guilty" to "11: Completely Guilty".

[3] Participants were asked to indicate how they would vote as a member of the jury between "Cook and Thomas LLC is guilty of negligence" and "Cook and Thomas LLC is not guilty of negligence" (where 0 = not guilty and 1 = guilty).

[4] Participants were asked to indicate what dollar amount in compenatory damages they recommend be awarded to Eddington, Inc. if the auditor were ultimately held responsible (ranging from $0 to $10,000,000).

Additional Analysis

In addition to obtaining participants' responses on the likelihood of guilty verdicts and damage awards, I also obtain information on jurors' responsibility assessments of the auditor, perceived foreseeability of events, and opinions on the perceived role and responsibilities of auditors. I obtain information regarding the juror's perceptions of the auditor's responsibility in the case by asking five questions, including: (1) competence of the auditor in performing its duties in the audit, (2) appropriateness that the auditor did not perform additional audit procedures on the warranty allowance, (3) appropriateness of the auditor's exercised level of standard of care, (4) appropriateness of the auditor's decisions regarding the warranty allowance, and (5) extent that the Plaintiff, or lender, must assume investment risk. The questions provided to participants are included in Figure 15.

Table 5.1 and Table 5.2 present the GLM analysis for the full sample and the reduced sample, respectively. As detailed in the tables, no statistically differences were identified for the competence of the auditor, appropriateness of the auditor's procedures, appropriateness of the standard of care, or the appropriateness of the auditor's decisions, for either the full or reduced samples.

The perceived plaintiff's responsibility for loss, however, did differ between the cells. Participants were asked to respond to the statement "To what extent do you believe that the Plaintiff, Eddington Inc., must assume normal investment risks when making loans, and therefore is largely responsible for its own loss?" on an 11-point Likert scale ranging from 1 = "Not At All Responsible for Loss" to 11 = "Completely Responsible for Loss". Interestingly, in both the full and reduced samples, jurors indicated a higher level of the plaintiff's responsibility for loss when the emphasis paragraph was *not provided* (Cell A) than when the emphasis paragraph was *present and highlighted* the account related to the audit failure (Cell C). Therefore, the presence of an emphasis paragraph reduced the extent to which jurors believed the plaintiff was responsible for its own losses. Additionally, jurors in the full sample also indicated a higher level of the plaintiff's responsibility for loss when the emphasis paragraph was *present but did not highlight* the account (Cell B) compared to when the emphasis paragraph was *present and highlighted* the account related to the audit failure (Cell C). The GLM analysis results are consistent with the non-parametric analysis shown in Table 6.1 and 6.2.

<u>Instructions:</u>

Please answer the following response questions about the case openly and honestly. Complete the questions in <u>the order given</u> and <u>do not go back</u> to completed questions. You may refer back to the case materials (printed on white paper) if you wish.

1. How competent do you perceive the auditor, Cook and Thomas LLC, to be in performing its duties in the audit of this client?

<u>Not at all</u> Competent									<u>Completely</u> Competent
1	2	3	4	5	6	7	8	9	10

2. Was it appropriate that the auditor, Cook and Thomas LLC, did <u>not</u> perform additional audit procedures on the warranty allowance (i.e., reserve)?

<u>Not at all</u> Appropriate									<u>Completely</u> Appropriate
1	2	3	4	5	6	7	8	9	10

3. In your opinion, how appropriate was the standard of care exercised by the auditor, Cook and Thomas LLC, when auditing the warranty allowance (i.e., reserve)?

<u>Not at all</u> Appropriate									<u>Completely</u> Appropriate
1	2	3	4	5	6	7	8	9	10

4. In your opinion, how appropriate were the decisions the auditor, Cook and Thomas LLC, made in the case regarding the warranty allowance (i.e., reserve)?

<u>Not at all</u> Appropriate									<u>Completely</u> Appropriate
1	2	3	4	5	6	7	8	9	10

5. To what extent do you believe that the Plaintiff, Eddington Inc., must assume normal investment risks when making loans, and therefore is largely responsible for its own loss?

<u>Not at all</u> Responsible For loss									<u>Completely</u> Responsible for Loss
1	2	3	4	5	6	7	8	9	10

Figure 15. *Research instrument: Assessments on auditor's responsibility measures*

Table 5.1

Parametric Analysis of Assessments on Auditor's Responsibility for Full Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat*[7] *P-Value*	Cell A vs Cell C *F-Stat*[7] *P-Value*	Cell A vs Cell B *F-Stat*[7] *P-Value*	Cell B vs Cell C *F-Stat*[7] *P-Value*
Competence of Auditor[2]	7.947 (1.922) n = 57	7.200 (2.585) n = 55	7.473 (2.471) n = 55	*1.04* *0.355*	*0.74* *0.390*	*2.24* *0.137*	*0.30* *0.582*
Appropriateness of Auditor Procedures[3]	6.825 (2.391) n = 57	6.873 (2.925) n = 55	6.782 (3.029) n = 55	*0.05* *0.947*	*0.03* *0.860*	*0.12* *0.732*	*0.02* *0.886*
Appropriateness of Standard of Care[4]	7.140 (2.030) n = 57	7.291 (2.643) n = 55	6.909 (2.817) n = 55	*0.37* *0.693*	*0.01* *0.924*	*0.55* *0.458*	*0.53* *0.467*
Appropriateness of Auditor Decisions[5]	7.439 (2.027) n = 57	7.200 (2.520) n = 55	6.855 (2.877) n = 55	*0.36* *0.697*	*0.71* *0.401*	*0.09* *0.760*	*0.26* *0.612*
Plaintiff's Responsibility for Loss[6]	8.439 (1.570) n = 57	8.127 (2.253) n = 55	7.278 (2.528) n = 54	*3.75* *0.026***	*6.87* *0.010***	*0.14* *0.710*	*4.07* *0.046***

Table 5.1 continued

** Significant at the $\alpha = 0.05$ level.

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the competence of the auditor by answering "How competent do you perceive the auditor, Cook and Thomas LLC, to be in performing its duties in the audit of this client?" on an 10-point Likert scale ranging from "1: Not At All Competent" to "10: Completely Competent".

[3] Participants were asked to indicate the appropriateness of auditor procedures by answering "Was it appropriate that the auditor, Cook and Thomas LLC, did not perform additional audit procedures on the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[4] Participants were asked to indicate the appropriateness of the auditor's standard of care by answering "In your opinion, how appropriate was the standard of care exercised by the auditor, Cook and Thomas LLC, when auditing the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[5] Participants were asked to indicate the appropriateness of the auditor's decisions by answering "In your opinion, how appropriate were the decisions the auditor, Cook and Thomas LLC, made in the case regarding the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[6] Participants were asked to indicate the Plaintiff's responsibility for loss by answering "To what extent do you believe that the Plaintiff, Eddington, Inc., must assume normal investment risk when making loans, and therefore is largely responsible for its own loss?" on an 10-point Likert scale ranging from "1: Not At All Responsible for Loss" to "10: Completely Responsible for Loss".

[7] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Competence of Auditor: $\lambda = 2.05$, Appropriateness of Auditor Procedures: $\lambda = 1.45$, Appropriateness of Standard of Care: $\lambda = 1.67$, Appropriateness of Auditor Decisions: $\lambda = 1.78$, and Plaintiff's Responsibility for Loss: $\lambda = 2.48$.

Table 5.2

Parametric Analysis of Assessments on Auditor's Responsibility for Reduced Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat*[7] *P-Value*	Cell A vs Cell C *F-Stat*[7] *P-Value*	Cell A vs Cell B *F-Stat*[7] *P-Value*	Cell B vs Cell C *F-Stat*[7] *P-Value*
Competence of Auditor[2]	8.083 (1.381) n = 24	7.360 (2.722) n = 25	7.886 (2.180) n = 44	*0.32* *0.727*	*0.00* *0.977*	*0.49* *0.487*	*0.46* *0.499*
Appropriateness of Auditor Procedures[3]	7.417 (1.792) n = 24	7.160 (3.145) n = 25	7.045 (2.957) n = 44	*0.05* *0.950*	*0.08* *0.782*	*0.00* *0.992*	*0.06* *0.809*
Appropriateness of Standard of Care[4]	7.167 (1.633) n = 24	7.480 (2.801) n = 25	7.136 (2.833) n = 44	*0.39* *0.677*	*0.17* *0.679*	*0.95* *0.334*	*0.29* *0.589*
Appropriateness of Auditor Decisions[5]	7.667 (1.239) n = 24	7.360 (2.797) n = 25	7.205 (2.833) n = 44	*0.04* *0.962*	*0.04* *0.835*	*0.00* *0.962*	*0.05* *0.820*
Plaintiff's Responsibility for Loss[6]	8.708 (0.999) n = 24	8.200 (2.380) n = 25	7.500 (2.406) n = 44	*2.39* *0.098**	*4.21* *0.044***	*0.16* *0.691*	*2.10* *0.152*

Table 5.2 continued

* Significant at the $\alpha = 0.10$ level.

** Significant at the $\alpha = 0.05$ level.

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the competence of the auditor by answering "How competent do you perceive the auditor, Cook and Thomas LLC, to be in performing its duties in the audit of this client?" on an 10-point Likert scale ranging from "1: Not At All Competent" to "10: Completely Competent".

[3] Participants were asked to indicate the appropriateness of auditor procedures by answering "Was it appropriate that the auditor, Cook and Thomas LLC, did not perform additional audit procedures on the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[4] Participants were asked to indicate the appropriateness of the auditor's standard of care by answering "In your opinion, how appropriate was the standard of care exercised by the auditor, Cook and Thomas LLC, when auditing the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[5] Participants were asked to indicate the appropriateness of the auditor's decisions by answering "In your opinion, how appropriate were the decisions the auditor, Cook and Thomas LLC, made in the case regarding the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[6] Participants were asked to indicate the Plaintiff's responsibility for loss by answering "To what extent do you believe that the Plaintiff, Eddington, Inc., must assume normal investment risk when making loans, and therefore is largely responsible for its own loss?" on an 10-point Likert scale ranging from "1: Not At All Responsible for Loss" to "10: Completely Responsible for Loss".

[7] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Competence of Auditor: $\lambda = 2.05$, Appropriateness of Auditor Procedures: $\lambda = 1.45$, Appropriateness of Standard of Care: $\lambda = 1.67$, Appropriateness of Auditor Decisions: $\lambda = 1.78$, and Plaintiff's Responsibility for Loss: $\lambda = 2.48$.

Table 6.1

Non-Parametric Analysis of Assessments on Auditor's Responsibility for Full Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	Cell A vs Cell C *H-Stat* *P-Value*	Cell A vs Cell B *H-Stat* *P-Value*	Cell B vs Cell C *H-Stat* *P-Value*
Competence of Auditor[2]	8.000 (2.000) n = 57	8.000 (4.000) n = 55	9.000 (5.000) n = 55	*1.47* *0.479*	*0.18* *0.670*	*1.40* *0.237*	*0.63* *0.429*
Appropriateness of Auditor Procedures[3]	7.000 (3.500) n = 57	8.000 (4.000) n = 55	8.000 (5.000) n = 55	*0.53* *0.765*	*0.31* *0.581*	*0.50* *0.479*	*0.01* *0.942*
Appropriateness of Standard of Care[4]	8.000 (2.000) n = 57	8.000 (3.000) n = 55	8.000 (5.000) n = 55	*1.14* *0.567*	*0.06* *0.814*	*1.53* *0.217*	*0.21* *0.645*
Appropriateness of Auditor Decisions[5]	8.000 (2.000) n = 57	8.000 (3.000) n = 55	8.000 (4.000) n = 55	*0.17* *0.916*	*0.14* *0.706*	*0.00* *0.979*	*0.12* *0.730*
Plaintiff's Responsibility for Loss[6]	9.000 (2.000) n = 57	9.000 (3.000) n = 55	8.000 (4.000) n = 54	*5.75* *0.056**	*4.70* *0.030***	*0.00* *0.995*	*3.93* *0.048***

Table 6.1 continued

* Significant at the $\alpha = 0.10$ level.

** Significant at the $\alpha = 0.05$ level.

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the competence of the auditor by answering "How competent do you perceive the auditor, Cook and Thomas LLC, to be in performing its duties in the audit of this client?" on an 10-point Likert scale ranging from "1: Not At All Competent" to "10: Completely Competent".

[3] Participants were asked to indicate the appropriateness of auditor procedures by answering "Was it appropriate that the auditor, Cook and Thomas LLC, did not perform additional audit procedures on the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[4] Participants were asked to indicate the appropriateness of the auditor's standard of care by answering "In your opinion, how appropriate was the standard of care exercised by the auditor, Cook and Thomas LLC, when auditing the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[5] Participants were asked to indicate the appropriateness of the auditor's decisions by answering "In your opinion, how appropriate were the decisions the auditor, Cook and Thomas LLC, made in the case regarding the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[6] Participants were asked to indicate the Plaintiff's responsibility for loss by answering "To what extent do you believe that the Plaintiff, Eddington, Inc., must assume normal investment risk when making loans, and therefore is largely responsible for its own loss?" on an 10-point Likert scale ranging from "1: Not At All Responsible for Loss" to "10: Completely Responsible for Loss".

Table 6.2

Non-Parametric Analysis of Assessments on Auditor's Responsibility for Reduced Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat P-Value*	Cell A vs Cell C *H-Stat P-Value*	Cell A vs Cell B *H-Stat P-Value*	Cell B vs Cell C *H-Stat P-Value*
Competence of Auditor[2]	8.000 (2.000) n = 24	8.000 (4.500) n = 25	9.000 (4.000) n = 44	*0.64 0.726*	*0.24 0.623*	*0.02 0.895*	*0.62 0.433*
Appropriateness of Auditor Procedures[3]	7.500 (3.000) n = 24	8.000 (3.000) n = 25	8.000 (5.000) n = 44	*0.25 0.881*	*0.04 0.835*	*0.52 0.471*	*0.00 0.949*
Appropriateness of Standard of Care[4]	7.500 (2.000) n = 24	9.000 (3.000) n = 25	8.000 (4.750) n = 44	*1.95 0.376*	*0.72 0.395*	*2.58 0.108*	*0.16 0.689*
Appropriateness of Auditor Decisions[5]	8.000 (1.000) n = 24	8.000 (2.000) n = 25	8.000 (4.500) n = 44	*0.65 0.724*	*0.27 0.605*	*0.90 0.344*	*0.02 0.889*
Plaintiff's Responsibility for Loss[6]	9.000 (1.750) n = 24	9.000 (2.500) n = 25	8.000 (3.000) n = 44	*3.67 0.160*	*2.70 0.100**	*0.03 0.852*	*2.26 0.133*

Table 6.2 continued

* Significant at the $\alpha = 0.10$ level.

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the competence of the auditor by answering "How competent do you perceive the auditor, Cook and Thomas LLC, to be in performing its duties in the audit of this client?" on an 10-point Likert scale ranging from "1: Not At All Competent" to "10: Completely Competent".

[3] Participants were asked to indicate the appropriateness of auditor procedures by answering "Was it appropriate that the auditor, Cook and Thomas LLC, did not perform additional audit procedures on the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[4] Participants were asked to indicate the appropriateness of the auditor's standard of care by answering "In your opinion, how appropriate was the standard of care exercised by the auditor, Cook and Thomas LLC, when auditing the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[5] Participants were asked to indicate the appropriateness of the auditor's decisions by answering "In your opinion, how appropriate were the decisions the auditor, Cook and Thomas LLC, made in the case regarding the warranty allowance (i.e. reserve)?" on an 10-point Likert scale ranging from "1: Not At All Appropriate" to "10: Completely Appropriate".

[6] Participants were asked to indicate the Plaintiff's responsibility for loss by answering "To what extent do you believe that the Plaintiff, Eddington, Inc., must assume normal investment risk when making loans, and therefore is largely responsible for its own loss?" on an 10-point Likert scale ranging from "1: Not At All Responsible for Loss" to "10: Completely Responsible for Loss".

I also examine participants' beliefs regarding the foreseeability or surprise of the bankruptcy event by asking four questions, including: (1) extent the bankruptcy was inevitable, (2) foreseeability of the bankruptcy, (3) predictability of the bankruptcy outcome, and (4) predictability of increased warranty costs. The purpose of these questions is to provide information regarding the participants' opinions of the auditor's foreseeability of the bankruptcy outcome. The questions provided to participants are included in Figure 16.

Table 7.1 and Table 7.2 present the parametric analysis for the full sample and the reduced sample, respectively. As detailed in the tables, no statistically differences were identified for any of the four questions concerning the auditor's foreseeability of the account failure for either the full or reduced samples. The non-parametric analysis in Tables 8.1 and 8.2 confirm the GLM results.

Instructions:

Please answer the following response questions about the case openly and honestly. Complete the questions in the order given and do not go back to completed questions. You may refer back to the case materials (printed on white paper) if you wish.

1. Given the events of the case, the bankruptcy of Blaze-Away Corp. was inevitable.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

2. How foreseeable was the bankruptcy of Blaze-Away Corp. from the perspective of the auditor, Cook and Thomas LLC?

Not at all Foreseeable									Completely Foreseeable
1	2	3	4	5	6	7	8	9	10

3. Blaze-Away Corp.'s bankruptcy was clearly predictable.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

4. It was difficult for the auditor, Cook and Thomas LLC, to predict Blaze-Away Corp.'s increased warranty costs.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

Figure 16. *Research instrument: Auditor's foreseeability measures*

Table 7.1

Parametric Analysis of Auditor's Foreseeability for Full Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [6] *P-Value*	Cell A vs Cell C *F-Stat* [6] *P-Value*	Cell A vs Cell B *F-Stat* [6] *P-Value*	Cell B vs Cell C *F-Stat* [6] *P-Value*
Extent Bankruptcy was Inevitable[2]	7.107 (2.668) n = 56	6.167 (3.202) n = 54	6.545 (3.208) n = 55	*1.28* *0.281*	*0.91* *0.342*	*2.67* *0.105*	*0.40* *0.529*
Foreseeability of Bankruptcy[3]	3.149 (2.031) n = 57	3.291 (2.424) n = 55	2.927 (2.142) n = 55	*0.58* *0.559*	*0.95* *0.331*	*0.00* *0.961*	*0.78* *0.380*
Extent Bankruptcy was Predictable[4]	3.965 (2.751) n = 57	4.036 (3.097) n = 55	3.891 (2.793) n = 55	*0.04* *0.966*	*0.02* *0.888*	*0.02* *0.897*	*0.07* *0.796*
Difficulty of Auditor to Predict Warranty Costs[5]	7.070 (2.434) n = 57	7.382 (2.557) n = 55	7.145 (2.663) n = 55	*0.33* *0.716*	*0.11* *0.744*	*0.67* *0.415*	*0.23* *0.633*

Table 7.1 continued

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the bankruptcy was inevitable by responding to the statement "Given the events of the case, the bankruptcy of Blaze-Away Corp. was inevitable." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the foreseeability of the bankruptcy by answering "How foreseeable was the bankruptcy of Blaze-Away Corp. from the perspective of the auditor, Cook and Thomas LLC?" on an 10-point Likert scale ranging from "1: Not At All Foreseeable" to "10: Completely Foreseeable".

[4] Participants were asked to indicate the extent the bankruptcy was predictable by responding to the statement "Blaze-Away Corp.'s bankruptcy was clearly predictable" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the difficulty of the auditor to predict warranty costs by responding to the statement "It was difficult for the auditor, Cook and Thomas LLC, to predict Blaze-Away Corp.'s increased warranty costs" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[6] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Extent Bankruptcy was Inevitable: $\lambda = 1.11$, Foreseeability of Bankruptcy: $\lambda = (0.10)$, and Difficulty of Auditor to Predict Warranty Costs: $\lambda = 1.69$.

Table 7.2

Parametric Analysis of Auditor's Foreseeability for Reduced Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [6] *P-Value*	Cell A vs Cell C *F-Stat* [6] *P-Value*	Cell A vs Cell B *F-Stat* [6] *P-Value*	Cell B vs Cell C *F-Stat* [6] *P-Value*
Extent Bankruptcy was Inevitable[2]	6.583 (2.669) n = 24	6.360 (3.546) n = 25	6.818 (3.194) n = 44	*0.17* *0.844*	*0.13* *0.717*	*0.03* *0.854*	*0.29* *0.593*
Foreseeability of Bankruptcy[3]	2.583 (1.100) n = 24	3.240 (2.570) n = 25	2.795 (1.995) n = 44	*0.43* *0.654*	*0.20* *0.659*	*0.21* *0.651*	*0.73* *0.395*
Extent Bankruptcy was Predictable[4]	3.208 (2.043) n = 24	3.960 (3.434) n = 25	3.841 (2.761) n = 44	*0.53* *0.589*	*0.97* *0.329*	*0.86* *0.359*	*0.02* *0.875*
Difficulty of Auditor to Predict Warranty Costs[5]	7.167 (2.140) n = 24	7.520 (2.917) n = 25	7.341 (2.641) n = 44	*0.37* *0.691*	*0.30* *0.585*	*0.74* *0.393*	*0.19* *0.668*

Table 7.2 continued

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the bankruptcy was inevitable by responding to the statement "Given the events of the case, the bankruptcy of Blaze-Away Corp. was inevitable." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the foreseeability of the bankruptcy by answering "How foreseeable was the bankruptcy of Blaze-Away Corp. from the perspective of the auditor, Cook and Thomas LLC?" on an 10-point Likert scale ranging from "1: Not At All Foreseeable" to "10: Completely Foreseeable".

[4] Participants were asked to indicate the extent the bankruptcy was predictable by responding to the statement "Blaze-Away Corp.'s bankruptcy was clearly predictable" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the difficulty of the auditor to predict warranty costs by responding to the statement "It was difficult for the auditor, Cook and Thomas LLC, to predict Blaze-Away Corp.'s increased warranty costs" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[6] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Extent Bankruptcy was Inevitable: $\lambda = 1.11$, Foreseeability of Bankruptcy: $\lambda = (0.10)$, and Difficulty of Auditor to Predict Warranty Costs: $\lambda = 1.69$.

Table 8.1

Non-Parametric Analysis of Auditor's Foreseeability for Full Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	Cell A vs Cell C *H-Stat* *P-Value*	Cell A vs Cell B *H-Stat* *P-Value*	Cell B vs Cell C *H-Stat* *P-Value*
Extent Bankruptcy was Inevitable[2]	7.500 (5.000) n = 56	6.000 (6.250) n = 54	7.000 (6.000) n = 55	*2.10* *0.350*	*0.55* *0.458*	*2.24* *0.135*	*0.36* *0.550*
Foreseeability of Bankruptcy[3]	3.000 (2.000) n = 57	3.000 (2.000) n = 55	2.000 (3.000) n = 55	*1.12* *0.572*	*0.94* *0.331*	*0.01* *0.929*	*0.73* *0.394*
Extent Bankruptcy was Predictable[4]	3.000 (4.000) n = 57	3.000 (4.000) n = 55	3.000 (4.000) n = 55	*0.04* *0.980*	*0.03* *0.855*	*0.03* *0.867*	*0.00* *0.990*
Difficulty of Auditor to Predict Warranty Costs[5]	7.000 (4.000) n = 57	8.000 (3.000) n = 55	8.000 (4.000) n = 55	*0.84* *0.656*	*0.23* *0.633*	*0.83* *0.363*	*0.19* *0.660*

Table 8.1 continued

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the bankruptcy was inevitable by responding to the statement "Given the events of the case, the bankruptcy of Blaze-Away Corp. was inevitable." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the foreseeability of the bankruptcy by answering "How foreseeable was the bankruptcy of Blaze-Away Corp. from the perspective of the auditor, Cook and Thomas LLC?" on an 10-point Likert scale ranging from "1: Not At All Foreseeable" to "10: Completely Foreseeable".

[4] Participants were asked to indicate the extent the bankruptcy was predictable by responding to the statement "Blaze-Away Corp.'s bankruptcy was clearly predictable" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the difficulty of the auditor to predict warranty costs by responding to the statement "It was difficult for the auditor, Cook and Thomas LLC, to predict Blaze-Away Corp.'s increased warranty costs" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

Table 8.2

Non-Parametric Analysis of Auditor's Foreseeability for Reduced Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	Cell A vs Cell C *H-Stat* *P-Value*	Cell A vs Cell B *H-Stat* *P-Value*	Cell B vs Cell C *H-Stat* *P-Value*
Extent Bankruptcy was Inevitable[2]	6.583 (2.669) n = 24	6.360 (3.546) n = 25	6.818 (3.194) n = 44	*0.17* *0.844*	*0.13* *0.717*	*0.03* *0.854*	*0.29* *0.593*
Foreseeability of Bankruptcy[3]	2.583 (1.100) n = 24	3.240 (2.570) n = 25	2.795 (1.995) n = 44	*0.43* *0.654*	*0.20* *0.659*	*0.21* *0.651*	*0.73* *0.395*
Extent Bankruptcy was Predictable[4]	3.208 (2.043) n = 24	3.960 (3.434) n = 25	3.841 (2.761) n = 44	*0.53* *0.589*	*0.97* *0.329*	*0.86* *0.359*	*0.02* *0.875*
Difficulty of Auditor to Predict Warranty Costs[5]	7.167 (2.140) n = 24	7.520 (2.917) n = 25	7.341 (2.641) n = 44	*0.37* *0.691*	*0.30* *0.585*	*0.74* *0.393*	*0.19* *0.668*

Table 8.2 continued

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the bankruptcy was inevitable by responding to the statement "Given the events of the case, the bankruptcy of Blaze-Away Corp. was inevitable." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the foreseeability of the bankruptcy by answering "How foreseeable was the bankruptcy of Blaze-Away Corp. from the perspective of the auditor, Cook and Thomas LLC?" on an 10-point Likert scale ranging from "1: Not At All Foreseeable" to "10: Completely Foreseeable".

[4] Participants were asked to indicate the extent the bankruptcy was predictable by responding to the statement "Blaze-Away Corp.'s bankruptcy was clearly predictable" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the difficulty of the auditor to predict warranty costs by responding to the statement "It was difficult for the auditor, Cook and Thomas LLC, to predict Blaze-Away Corp.'s increased warranty costs" on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

To measure participants' opinions regarding the role and responsibilities of auditors, I examine four questions. The questions measure the extent to which the auditor is responsible (1) for determining if the financial statements are fairly presented, (2) to the public, (3) for making sure accounts are material correct, and (4) for providing a warranty that the stock is a solid investment. These questions are aimed to assist in understanding participants' responses to the dependent variables. Figure 17 reproduces the questions provided to participants to measure the auditor's roles and responsibilities.

Table 9.1 and Table 9.2 present the parametric analysis for the full sample and the reduced sample, respectively. As detailed in the tables, the only statistical differences for both the full and reduced samples related to the auditor's perceived responsibility to the public. Specifically, the auditor's perceived responsibility to the public was lower for the case where the emphasis paragraph is *not provided* than when the emphasis paragraph is present, regardless of content. The reported auditor's responsibility to the public was not statistically different between the cases when the emphasis paragraph is *present but does not highlight* the account compared to when the paragraph is *present and highlights* the account related to the audit failure. Therefore, even though the presence of the emphasis paragraph does not increase the auditor's level of assurance, jurors perceive the auditor's responsibility to the public increases with the paragraph's presence. The non-parametric analysis in Tables 10.1 and 10.2 confirm the GLM results.

Instructions:

Please answer the following response questions about the case openly and honestly. Complete the questions in the order given and do not go back to completed questions. You may refer back to the case materials (printed on white paper) if you wish.

1. The job of the auditor is to determine whether the financial statements are fairly presented.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

2. Even though auditors are hired by and paid by their clients, their responsibility is to the public.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

3. Auditors cannot be expected to discover small errors in the financial statements; they are only responsible for making sure accounts are materially correct.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

4. When an auditor issues a clean audit opinion on a company's financial statements, they are, in effect, providing a guarantee that the company is a solid investment.

Completely Disagree									Completely Agree
1	2	3	4	5	6	7	8	9	10

Figure 17. *Research instrument: Auditor's roles and responsibilities measures*

Table 9.1

Parametric Analysis of Auditor's Roles and Responsibilities for Full Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [6] *P-Value*	Cell A vs Cell C *F-Stat* [6] *P-Value*	Cell A vs Cell B *F-Stat* [6] *P-Value*	Cell B vs Cell C *F-Stat* [6] *P-Value*
Auditor's Job to Determine if Fairly Presented[2]	8.842 (1.360) n = 57	8.909 (1.391) n = 55	8.800 (1.840) n = 55	*0.12* *0.885*	*0.23* *0.636*	*0.12* *0.727*	*0.02* *0.896*
Auditor's Responsibility to the Public[3]	7.561 (2.673) n = 57	8.564 (2.275) n = 55	8.527 (2.284) n = 55	*3.60* *0.030 ** *	*4.92* *0.029 ** *	*5.51* *0.021 ** *	*0.01* *0.932*
Auditor's Responsibility for Materially Correct[4]	6.949 (2.628) n = 57	7.491 (2.707) n = 55	6.964 (2.944) n = 55	*0.83* *0.437*	*0.04* *0.836*	*1.53* *0.219*	*0.97* *0.326*
Auditor's Opinion as a Guarantee of Investment[5]	4.491 (2.983) n = 57	4.673 (3.145) n = 55	4.400 (2.960) n = 55	*0.08* *0.921*	*0.08* *0.775*	*0.01* *0.907*	*0.15* *0.701*

Table 9.1 continued

** Significant at the $\alpha = 0.05$ level.

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the auditor's job is to determine if accounts are financials are fairly presented by responding to the statement "The job of the auditor is to determine whether the financial statements are fairly presented." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the auditor's responsibility to the public by responding to the statement "Even though auditors are hired by and paid by their clients, their responsibility is to the public." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[4] Participants were asked to indicate auditor's responsibility for materially correct accounts by responding to the statement "Auditors cannot be expected to discover small errors in the financial statememtns; they are only responsible for making sure the accounts are materially correct." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the extent the auditor's opinion acts as a guarantee of a solid investment by responding to the statement "When an auditor issues a clean audit opinion on a company's financial statements, they are, in effect, providing a guarantee that the company is a solid investment." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[6] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Auditor's Job to Determine if Fairly Presented: $\lambda = 4.22$ Auditor's Responsibility to the Public: $\lambda = 2.64$, Auditor's Responsibility for Materially Correct: $\lambda = 1.54$, and Auditor's Opinion as a Guarantee of Investment: $\lambda = 0.28$.

Table 9.2

Parametric Analysis of Auditor's Roles and Responsibilities for Reduced Sample

Results of GLM[1] Model

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *F-Stat* [6] *P-Value*	Cell A vs Cell C *F-Stat* [6] *P-Value*	Cell A vs Cell B *F-Stat* [6] *P-Value*	Cell B vs Cell C *F-Stat* [6] *P-Value*
Auditor's Job to Determine if Fairly Presented[2]	8.792 (1.503) n = 24	9.120 (1.236) n = 25	9.023 (1.772) n = 44	*0.61* *0.547*	*1.13* *0.292*	*0.60* *0.441*	*0.05* *0.821*
Auditor's Responsibility to the Public[3]	6.875 (2.692) n = 24	9.080 (1.935) n = 25	9.159 (1.554) n = 44	*12.21* *0.000****	*21.07* *0.000****	*14.44* *0.000****	*0.00* *0.967*
Auditor's Responsibility for Materially Correct[4]	7.125 (2.419) n = 24	7.920 (2.812) n = 25	7.273 (2.807) n = 44	*0.93* *0.400*	*0.15* *0.698*	*1.74* *0.194*	*1.11* *0.296*
Auditor's Opinion as a Guarantee of Investment[5]	2.958 (2.440) n = 24	4.560 (3.280) n = 25	4.568 (3.045) n = 44	*2.22* *0.115*	*4.11* *0.047***	*3.11* *0.084*	*0.00* *0.955*

Table 9.2 continued

** Significant at the $\alpha = 0.05$ level.

*** Significant at the $\alpha \leq 0.01$ level.

[1] The mean (standard deviation) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the auditor's job is to determine if accounts are financials are fairly presented by responding to the statement "The job of the auditor is to determine whether the financial statements are fairly presented." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the auditor's responsibility to the public by responding to the statement "Even though auditors are hired by and paid by their clients, their responsibility is to the public." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[4] Participants were asked to indicate auditor's responsibility for materially correct accounts by responding to the statement "Auditors cannot be expected to discover small errors in the financial statememtns; they are only responsible for making sure the accounts are materially correct." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the extent the auditor's opinion acts as a guarantee of a solid investment by responding to the statement "When an auditor issues a clean audit opinion on a company's financial statements, they are, in effect, providing a guarantee that the company is a solid investment." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[6] Data was transformed for purposes of statistical analysis using the recommended λ from the Box Cox analysis as follows: Auditor's Job to Determine if Fairly Presented: $\lambda = 4.22$ Auditor's Responsibility to the Public: $\lambda = 2.64$, Auditor's Responsibility for Materially Correct: $\lambda = 1.54$, and Auditor's Opinion as a Guarantee of Investment: $\lambda = 0.28$.

Table 10.1

Non-Parametric Analysis of Auditor's Roles and Responsibilities for Full Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	Cell A vs Cell C *H-Stat* *P-Value*	Cell A vs Cell B *H-Stat* *P-Value*	Cell B vs Cell C *H-Stat* *P-Value*
Auditor's Job to Determine if Fairly Presented[2]	9.000 (2.000) n = 57	9.000 (2.000) n = 55	10.000 (2.000) n = 55	*0.28* *0.869*	*0.25* *0.616*	*0.13* *0.713*	*0.03* *0.860*
Auditor's Responsibility to the Public[3]	9.000 (4.500) n = 57	10.000 (2.000) n = 55	10.000 (3.000) n = 55	*7.89* *0.019 ** *	*5.80* *0.016***	*5.57* *0.018 ***	*0.02* *0.896*
Auditor's Responsibility for Materially Correct[4]	7.000 (4.000) n = 57	8.000 (4.000) n = 55	8.000 (4.000) n = 55	*1.81* *0.405*	*0.02* *0.897*	*1.69* *0.194*	*1.02* *0.314*
Auditor's Opinion as a Guarantee of Investment[5]	3.000 (5.000) n = 57	4.000 (6.000) n = 55	5.000 (6.000) n = 55	*0.14* *0.931*	*0.09* *0.769*	*0.03* *0.858*	*0.10* *0.748*

Table 10.1 continued

** Significant at the $\alpha = 0.05$ level.

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the auditor's job is to determine if accounts are financials are fairly presented by responding to the statement "The job of the auditor is to determine whether the financial statements are fairly presented." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the auditor's responsibility to the public by responding to the statement "Even though auditors are hired by and paid by their clients, their responsibility is to the public." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[4] Participants were asked to indicate auditor's responsibility for materially correct accounts by responding to the statement "Auditors cannot be expected to discover small errors in the financial statememtns; they are only responsible for making sure the accounts are materially correct." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the extent the auditor's opinion acts as a guarantee of a solid investment by responding to the statement "When an auditor issues a clean audit opinion on a company's financial statements, they are, in effect, providing a guarantee that the company is a solid investment." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

Table 10.2

Non-Parametric Analysis of Auditor's Roles and Responsibilities for Reduced Sample

Results of Kruskal-Wallis Test[1]

	Cell A: Emphasis Paragraph *Not Provided*	Cell B: Emphasis Paragraph *Present But Does Not Highlight*	Cell C: Emphasis Paragraph *Present and Highlights*	All Cells *H-Stat* *P-Value*	Cell A vs Cell C *H-Stat* *P-Value*	Cell A vs Cell B *H-Stat* *P-Value*	Cell B vs Cell C *H-Stat* *P-Value*
Auditor's Job to Determine if Fairly Presented[2]	9.000 (2.000) n = 24	10.000 (1.500) n = 25	10.000 (1.000) n = 44	*1.34* *0.511*	*1.27* *0.260*	*0.53* *0.465*	*0.17* *0.682*
Auditor's Responsibility to the Public[3]	7.000 (4.000) n = 57	10.000 (1.000) n = 55	10.000 (1.000) n = 55	*21.36* *0.000****	*17.55* *0.000****	*13.17* *0.000****	*0.06* *0.812*
Auditor's Responsibility for Materially Correct[4]	7.500 (3.000) n = 57	9.000 (3.500) n = 55	9.000 (3.000) n = 55	*3.21* *0.201*	*0.33* *0.565*	*2.73* *0.098**	*2.06* *0.151*
Auditor's Opinion as a Guarantee of Investment[5]	2.000 (2.750) n = 57	4.000 (6.500) n = 55	5.000 (6.000) n = 55	*4.28* *0.118*	*3.82* *0.051*	*2.83* *0.093**	*0.00* *0.980*

Table 10.2 continued

* Significant at the $\alpha = 0.10$ level.

*** Significant at the $\alpha \leq 0.01$ level.

[1] The median (interquartile range) for participants' responses are reported, along with the number of responses per cell.

[2] Participants were asked to indicate the extent the auditor's job is to determine if accounts are financials are fairly presented by responding to the statement "The job of the auditor is to determine whether the financial statements are fairly presented." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[3] Participants were asked to indicate the auditor's responsibility to the public by responding to the statement "Even though auditors are hired by and paid by their clients, their responsibility is to the public." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[4] Participants were asked to indicate auditor's responsibility for materially correct accounts by responding to the statement "Auditors cannot be expected to discover small errors in the financial statememtns; they are only responsible for making sure the accounts are materially correct." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

[5] Participants were asked to indicate the extent the auditor's opinion acts as a guarantee of a solid investment by responding to the statement "When an auditor issues a clean audit opinion on a company's financial statements, they are, in effect, providing a guarantee that the company is a solid investment." on an 10-point Likert scale ranging from "1: Completely Disagree" to "10: Completely Agree".

CHAPTER VIII

CONCLUDING REMARKS

Implications

The purpose of this study is to examine the effects of the PCAOB's 2011-003 Concept Release on the standard auditor's report on auditor's legal liability in a negligence trial context. Specifically, I examine the most significant, yet widely accepted option presented in the Concept Release; the inclusion of a required emphasis paragraph. Using a case study, I assign participants to one of three scenarios. In the first scenario, an emphasis paragraph is not provided in the standard auditor's report, which is consistent with current audit standards. The other two scenarios include the presence of an emphasis paragraph in the auditor's report, but differ on the content of the paragraph. In one scenario, the emphasis paragraph is present and addresses the account related to the audit failure, while the last scenario contains an emphasis paragraph that does not mention the account related to the audit failure.

Consistent with hindsight bias and attribution theory, I predict jurors with outcome knowledge will overestimate the extent to which an outcome could have been foreseen prior to its occurrence (Kamin and Rachlinski 1995; Anderson et al. 1993; Casper et al. 1989; 1988). I predict the auditor's legal liability will be higher when the emphasis paragraph is present, as required by the Concept Release, than when it is not provided. I also examine the comparison of when the emphasis paragraph is *present but does not highlight* the account related to the eventual bankruptcy of the company compared to when the emphasis paragraph is *present and highlights* the account. In this case where the paragraph does not highlight the account, users of the financial statements have not been "warned" of the account and its related risks. Therefore the bankruptcy is a surprise event, reducing the assumed foreseeability of the event. Additionally, both cases involve important competency arguments related to the auditor. Given the complexity of these cases and the effects of foreseeability and competence, I do not predict which effect will be most salient to jurors during the verdict determination. In summary, even though the emphasis paragraph does not increase the assurance provided by the auditor, I predict the paragraph will affect the legal liability of auditors in a negligence trial setting.

Results indicate the presence of an emphasis paragraph has an effect on the guilty verdicts of jurors in a legal liability court case setting. Consistent with hypothesized results, I find evidence that the presence of an emphasis paragraph in the auditor's report affects guilty verdicts. Specifically, the presence of an emphasis paragraph, regardless of content, increases guilty verdicts by jurors compared to when the emphasis paragraph is not present. However, contrary to hypothesized results I do not find evidence that the content of the emphasis paragraph in the auditor's report affects the magnitude of compensatory damage awards. Therefore, results suggest jurors have higher instances of guilty verdicts in an auditor negligence trial when the auditor's report contained an emphasis paragraph, regardless of if the emphasis paragraph did or did not discuss the account that eventually resulted in the audit failure.

Limitations

While informative to the continuing discussion of potential changes in the standard auditor's report, this study has a few limitations that require discussion. First, as with all experimental studies, all factors that are present in a real courtroom environment could not be incorporated into the research design. Therefore, the experimental design limits the external validity of this study's findings.

One of the main limitations of this study relates to the rate of failure for the manipulation check questions. The manipulation check failure rate indicates some participants did not fully comprehend the case information. While most results for the full sample and the reduced sample were similar, the differences in the findings for H1a and H2a indicate that the level of comprehension was different between the two samples. Therefore, the external validity of the study is reduced due to this failure rate.

Further Research Opportunities

Overall, this study contributes to audit and legal liability literature by examining the effects of potential changes to current accounting standards. Prior accounting research has examined changes to other accounting standards (Kadous and Mercer 2012; Buckless and Peace 1993), but this is the first study to examine a component of the 2011 Concept Release. The findings of this study have practical implications, as they help to inform in the decision-making process regarding potential changes to the standard auditor's report. Further studies into the effects of potential changes in the standard auditor's report are necessary, including additional studies regarding the legal liability implications of any proposed changes. On August 16, 2013 the PCAOB released the Proposed Standard on the auditor's reporting model (PCAOB 2013). As further discussion surrounds the Proposed Standard, research will aid in considerations of any changes.

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APPENDIX A

ILLUSTRATION OF POSSIBLE REVISED STANDARD AUDITOR'S REPORT WITH REQUIRED EMPHASIS PARAGRAPH

Illustration of Possible Revised Standard Auditor's Report with Required Emphasis Paragraph

Report of Independent Registered Public Accounting Firm

[Standard Introductory Paragraph]

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

[Standard Scope Paragraph]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

[Standard Opinion Paragraph]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

Required Emphasis Paragraph[14]

[Emphasize those matters that are most important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty. Discuss the audit procedures performed on these significant matters. This discussion should not include matters that the company has not disclosed in the financial statements and should make reference to the notes in the financial statements that disclose each matter.]

[Signature]
[City and State or Country]
[Date]

[14] The illustration of the possible revised standard auditor's report is presented in the PCAOB's Concept Release (PCAOB June 2011, 21).

APPENDIX B

EXCERPT OF AUDITOR'S REPORT CONTAINING EMPHASIS PARAGRAPH

Excerpt of Auditor's Report from Scor's 2011 Annual Report

II. Justification of our assessments (Scor 2012)

Accounting estimations used in the preparation of the Financial Statements for the year ended 31 December 2011 have been performed in an uncertain environment, related to the financial crisis in the Euro zone, accompanied by a liquidity and an economic crisis, which make difficult the comprehension of economic outlook. In this context, in accordance with the requirements of Article L. 823-9 of the French Commercial Code (Code de Commerce), we have performed our own assessments that we bring to your attention on the following matters:

- Notes 1- "(G) real estate investments", 1 - "(H) financial instruments", 5, 6 and 8 to the consolidated financial statements describe the principles and methods used to estimate the valuation and impairment of investments and derivative instruments.

In the specific context of the financial crisis, we examined the control system in place, detailed in note 26 to the consolidated financial statements, relative to the inventory of direct and indirect exposures, and the system in place for their assessment, as well as the valuation methods and write-down policies applicable to certain financial instruments. We have obtained assurance that the information provided in the aforementioned notes is appropriate, and that the approaches and policies described were properly applied by the Group.

- Notes 1 - "(F) intangible assets", 3 and 4 to the consolidated financial statements describe the principles and methods used to assess the valuation of goodwill and the value of business acquired for the Life and Non-Life reinsurance portfolios. The methods used to carry out these annual impairment tests are described in note 4 to the consolidated financial statements.

We have examined the approaches used in the impairment tests, the cash flow forecasts and the consistency of the assumptions used. We have verified that the information described in note 4 to the consolidated financial statements is appropriate.

- Notes 1 - "(R) Taxes" and 19 to the consolidated financial statements describe the principles and methods used to perform the valuation of deferred tax assets as well as the deferred tax assets impairment test.

We have assessed the approaches used in this impairment test, the forecasted cash flows and the assumptions made. We have verified that the information described in note 1 - "(R) Taxes" to the consolidated financial statements is appropriate.

- As stated in notes 1 - "(B) Use of estimates", 1 - "(N) Accounting principles and methods specific to reinsurance business", 7, 10, 11 and 16 to the consolidated financial statements, the technical accounts specific to reinsurance are estimated on the basis of reinsurance commitments or on statistical and actuarial bases, particularly in the case of accounts not received from cedents recognised as receivables, technical reserves, and deferred acquisition costs. The methods used to calculate these estimates are described in the notes to the consolidated financial statements.

Our audit work consisted in assessing the data and assumptions on which the estimates are based, in reviewing the company's calculations, in comparing estimations from prior periods with actual outcomes, and in examining senior management's procedures for approving these estimates.

- Note 3 - "Acquisitions and disposals" to the consolidated financial statements describes the methods and assumptions used for the final valuation of net assets, and by comparison with the acquisition price, of the negative goodwill following the acquisition of Transamerica Re.

Our audit consisted of assessing the reasonableness of the assumptions used by the management and in verifying calculations leading to the company valuation.

- Note 27 "Litigation" to the consolidated financial statements describes the litigation encountered by the Group.

We examined the Group's procedures to identify these risks, to evaluate and reflect them in the financial statements.

- Notes 1 - "(O) pension obligations and related benefits" and 15 to the consolidated financial statements specify the valuation methods applied to pension obligations and other related obligations.

Our work consisted of assessing the data and assumptions used, reviewing the company's calculations and verifying that the information in notes 1 - "(O) pension obligations and related benefits" and 15 to the consolidated financial statements are appropriate.

These assessments were made as part of our audit of the consolidated financial statements taken as a whole and therefore served in forming our audit opinion expressed in the first part of this report.

APPENDIX C

SUMMARY OF TRIAL TESTIMONY PROVIDED TO ALL PARTICIPANTS

Summary of Trial Testimony

Plaintiff Opening Statement:

The attorney for the Plaintiff, Eddington Inc., outlines key arguments for the case and details why the Plaintiff believes Cook and Thomas is guilty of auditor negligence and should be held responsible for Eddington Inc.'s financial loss.

"This case concerns auditor negligence. In this trial you will hear how the Defendant, Cook and Thomas, LLC, negligently audited the warranty allowance, or reserve for future warranty costs, of Blaze-Away Corp. My client, Eddington Inc., relied on Blaze-Away Corp.'s audited financial statements when making a loan of $10 million to the company. In this case I will show you that Cook and Thomas' negligence cost Eddington Inc. $10 million plus interest. Here are the case's key facts from our perspective:

- The role of auditors is to investigate their clients' financial statements and provide an opinion, or auditor's report, that states whether or not the financial statements of the company are materially (or largely) correct. Therefore, the auditor's report provides "reasonable assurance" that the financial statements are correct. Investors and creditors depend on the audited financial statements and auditor's report to help them make informed decisions, such as when to make a loan.
        - Cook and Thomas LLC reported that the 2011 financial statements of Blaze-Away Corp. were not materially misstated. In other words, Cook and Thomas gave Blaze-Away Corp. a "clean" audit report. Eddington Inc. relied on this audit report before making the loan to Blaze-Away Corp.
    - We assert that Cook and Thomas LLC was negligent in its performance of the audit of the 2011 financial statements, specifically the warranty reserve, of Blaze-Away Corp.
        - Cook and Thomas did not consult Blaze-Away Corp. engineers who, as early as 2010, began to find some evidence of a shortened life span for fire-resistant lumber.
        - We believe that Cook and Thomas LLC should have required the company to increase their warranty reserve to reflect the potential shortened life span of the lumber. An increased warranty reserve would have been an important consideration for Eddington Inc. when deciding to provide the loan to Blaze-Away Corp.

- Eddington Inc. would not have made the loan to Blaze-Away Corp. if the financial statements accurately reflected the increasing warranty expense.

When the warranty issues came to light in 2012, Blaze-Away could not meet the warranty obligations and therefore declared bankruptcy. All of Blaze-Away Corp.'s assets were exhausted by the warranty claims, so the bankruptcy proceedings could not award any reimbursement to my client. Therefore, Eddington Inc. is suing Cook and Thomas LLC for the unpaid debt of $10,000,000 plus interest.

I will prove my case by calling an expert witness, Mr. Smith, who will show you that Cook and Thomas LLC was negligent in its audit of Blaze-Away Corp. After Mr. Smith speaks, the Defendant will present its own expert witness. This witness will claim that the Cook and Thomas LLC performed its audit in accordance with auditing standards. Consider carefully whether you believe this to be true and whether Cook and Thomas LLC performed its duties in an appropriate manner in this particular case. I am confident that you will find that Cook and Thomas LLC was negligent in performing its audit of the 2011 financial statements of Blaze-Away Corp., and that Eddington Inc. suffered as a result of the negligence."

Defendant Opening Statement:
The attorney for the Defendant, Cook and Thomas LLC, outlines key arguments for the case and details why the Defendant believes Cook and Thomas LLC is not guilty of auditor negligence and should not be held responsible for Eddington Inc.'s financial loss.

"I will show you that Cook and Thomas LLC conducted an appropriate audit in accordance with auditing standards and is, therefore, not negligent in its audit of Blaze-Away Corp.'s 2011 financial statements. Consequently, Cook and Thomas LLC should not be held responsible for Eddington's losses relating to the unpaid debt. Here are the case's key facts from our perspective:

- Cook and Thomas LLC did not receive any information that would have indicated that an increase in warranty claims was necessary.
    - Cook and Thomas conducted an appropriate audit that did not reveal any information that would indicate that the auditor should have foreseen Blaze-Away Corp.'s bankruptcy.
- The Plaintiff has alleged that Cook and Thomas was negligent in its audit of Blaze-Away Corp.'s 2011 financial statements.
    - Negligence can be established only when an auditor fails to exercise the usual judgment, care, skill, and diligence employed by other Certified Public Accountants (CPAs) in the community. CPAs use auditing standards to determine the type and amount of work they do.
    - It is the Defendant's position that the auditor conducted the audit with proper judgment and diligence.
- The Plaintiff makes a point of mentioning the losses incurred by his client, Eddington, Inc. That loss is not relevant in determining whether Cook and Thomas LLC was negligent in performing its audit of the 2011 financial statements of Blaze-Away Corp.
    - Only the actions and decisions made by Cook and Thomas LLC, as compared with those that would have been made by other competent CPAs in similar circumstances, are relevant.
    - Cook and Thomas did what any other auditor in its position would have done, and its actions in no way violated auditing standards.

The Plaintiff must prove its allegations by a preponderance of the evidence. This means that it must show that the charges are more probably true than not true. The Plaintiff cannot do so. I will present an expert witness, Mr. Welton, who will establish that Cook and Thomas LLC made appropriate use of professional judgment in making the decisions that it did, and that it in no way violated accounting standards. Cook and Thomas LLC is a competent, respected accounting firm, and I am confident that you will find in its favor."

Maxwell Smith, CPA - Expert Witness for the Plaintiff:
The Plaintiff, Eddington Inc., calls an expert witness to the stand to argue that Cook and Thomas is guilty of auditor negligence and should be held responsible for Eddington Inc.'s financial loss.

"As a partner for an international public accounting firm, I have extensive knowledge of auditing standards and the appropriate actions an auditor should take to meet these standards. Based on the information in this case, I do not believe Cook and Thomas LLC took the necessary steps to audit the warranty reserve. Specifically, they should have examined the increase in warranty claims and made related inquiries of Blaze-Away Corp.'s engineers. Had Cook and Thomas consulted with Blaze-Away's engineers, they would have discovered that the life span of the lumber was potentially much shorter than anticipated. Given the potentially shorter life span, the warranty reserve should have been much larger. I believe that Cook and Thomas LLC were negligent in their actions regarding the audit of the warranty reserve."

Cross-Examination by the Defendant:
The Defendant, Cook and Thomas, cross-examines the expert witness by questioning his previous statements. Mr. Smith, the expert witness for the Plaintiff, responds.

"Yes, the auditor's actions were consistent with audits performed in prior years. And, yes, you are correct that the increase in warranty claims over the past three years was very similar to historical fluctuations experienced by the company."

Thomas Welton, CPA, Expert Witness for the Defendant:
The Defendant, Cook and Thomas LLC, calls an expert witness to the stand to argue that Cook and Thomas is not guilty of auditor negligence and should not be held responsible for Eddington Inc.'s financial loss.

"As an audit partner for an international accounting firm, I understand that auditing standards require auditors to examine material, or significant, accounts with an appropriate standard of care. I believe that Cook and Thomas LLC properly audited the warranty reserve. The auditor examined the history of warranty claims over the past 13 years and noted that warranty claims ranged from 3% to 5%. I do not believe that the auditor had any indication that the life span of the lumber was lower than expected. Therefore, I believe that Cook and Thomas LLC had no reason to inquire of the Blaze-Away's engineers. I believe Cook and Thomas performed the audit with the same judgment, care, skill, and diligence employed by other Certified Public Accountants (CPAs) in the community. Therefore, I do not believe Cook and Thomas LLC is negligent in this case."

Cross-Examination by the Plaintiff:
The Plaintiff, Eddington Inc., cross-examines the expert witness by questioning his previous statements. Mr. Welton, the expert witness for the Defenant, responds.

"Yes, the warranty claims had increased slightly over the past three years. However, historical changes like this have eventually evened out."

Plaintiff Closing Statement:
The attorney for the Plaintiff, Eddington Inc., reviews the key arguments for the case and summarizes why the Plaintiff believes Cook and Thomas is guilty of auditor negligence and should be held responsible for Eddington Inc.'s financial loss.

"After hearing the testimony of Mr. Smith, our expert witness, it is clear that the Defendant, Cook and Thomas, LLC, negligently audited Blaze-Away Corp.'s warranty reserve. By not appropriately addressing the increasing warranty claims, Cook and Thomas' negligence resulted in financial statements that did not properly capture Blaze-Away Corp.'s true financial situation.

My client, Eddington Inc., relied on the audited financial statements of Blaze-Away Corp. when making a loan of $10 million to the company and Cook and Thomas LLC's negligence cost Eddington Inc. $10 million. I am confident that you will find for the Plaintiff in this case."

Defendant Closing Statement:

The attorney for the Defendant, Cook and Thomas LLC, reviews the key arguments for the case and summaries why the Defendant believes Cook and Thomas is not guilty of auditor negligence and should not be held responsible for Eddington Inc.'s financial loss.

"Based on the testimony you have heard today, I am confident that you will agree that Cook and Thomas LLC conducted an appropriate audit in accordance with auditing standards and is, therefore, not negligent in its audit of Blaze-Away Corp.'s 2011 financial statements. Cook and Thomas LLC did not receive any information that would have indicated an increase in warranty claims. Cook and Thomas LLC conducted an appropriate audit that is similar to an audit conducted by another CPA.

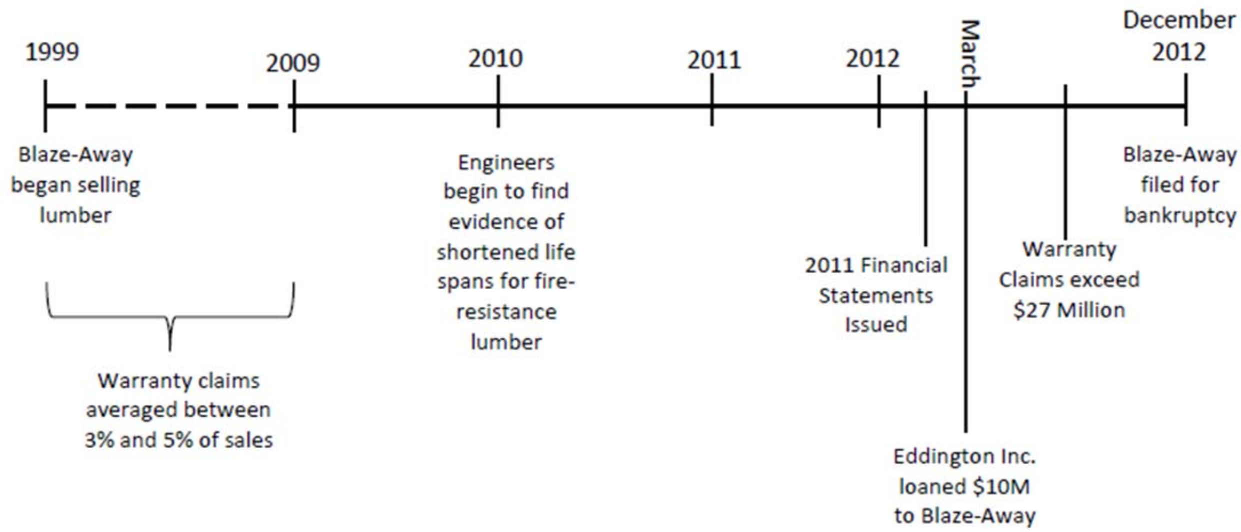
The audit did not reveal any information that would indicate the auditor should have foreseen the future bankruptcy. Therefore, my client, Cook and Thomas LLC, should not be held responsible for Eddington's losses relating to the unpaid debt."

Judge's Instructions to the Jury:
Before allowing the jury to deliberate and determine a verdict, the Judge provides instructions to the jury.

"It is your responsibility to determine the facts from the evidence presented to you. You will use these facts and the law given in these instructions to decide the case. You should consider the evidence in light of your own observations and experiences in life. You may draw any reasonable inferences from the proven facts. In addition, keep in mind that statements made by attorneys are not evidence.

The burden of proof lies with the Plaintiff. The level of proof required is the preponderance of the evidence, which means that the charges are more probably true than not true. In order to be successful on a claim of professional negligence, the Plaintiff must prove by a preponderance of the evidence that Cook and Thomas LLC failed to exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community. You should consider whether the Defendant complied with professional auditing standards in making your evaluation. If you decide that the Defendant, Cook and Thomas LLC, <u>did</u> exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community, you must find the Defendant <u>not guilty</u>. If you decide that Cook and Thomas LLC <u>did not</u> exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community, you must find the Defendant <u>guilty</u>."

Evidence A – Timeline



Evidence B – Schedule of Average Warranty Claims

Year	Average Warranty Claims (as a percentage of sales)
1999	4.78 %
2000	3.98 %
2001	3.14 %
2002	4.47 %
2003	5.12 %
2004	4.99 %
2005	3.78 %
2006	4.72 %
2007	3.27 %
2008	4.87 %
2009	5.14 %
2010	5.26 %
2011	5.47 %

Evidence D – Selection of the 2011 Notes to the Financial Statements

Note 11 – Warranty Allowance

Our products feature a 25-year warranty on the fire-retardant qualities of the lumber. We maintain an allowance for warranty costs based primarily on claims experience, sales history, and other considerations. Warranty costs are recorded in cost of sales. If product conditions change or actual product failure rates differ from these estimates, revisions to the estimated warranty liability would be required.

APPENDIX D

IRB APPROVAL

Office for Research

Institutional Review Board for the
Protection of Human Subjects

THE UNIVERSITY OF
ALABAMA
RESEARCH

May 24, 2013

Kelsey Brasel
Culverhouse School of Accountancy
Commerce & Business Administration
Box 870220

Re: IRB # EX-13-CM-057: "Effects of the Concept Release on the Auditor's Reporting Model on Jury Verdicts of Auditor's Legal Liability"

Dear Ms. Brasel,

The University of Alabama Institutional Review Board has granted approval for your proposed research.

Your application has been given exempt approval according to 45 CFR part 46.101(b)(2) as outlined below:

(2) Research involving the use of educational tests (cognitive, diagnostic, aptitude, achievement), survey procedures, interview procedures or observation of public behavior, unless:

i. information obtained is recorded in such a manner that human subjects can be identified, directly or through identifiers linked to the subjects; and

ii. any disclosure of the human subjects' responses outside the research could reasonably place the subjects at risk of criminal or civil liability or be damaging to the subjects' financial standing, employability, or reputation.

This approval expires on May 23, 2014. If the study continues beyond that date, you must complete the IRB Renewal Application. If you modify the application, please complete the Modification of an Approved Protocol form. Changes in this study cannot be initiated without IRB approval, except when necessary to eliminate apparent immediate hazards to participants. When the study closes, please complete the Request for Study Closure (Investigator) form.

Please use reproductions of the IRB-stamped consent form.

Should you need to submit any further correspondence regarding this application, please include the assigned IRB application number.

Good luck with your research.

Sincerely,

Carpantato T. Myles, MSM, CIM
Director & Research Compliance Officer
Office for Research Compliance
The University of Alabama

358 Rose Administration Building
Box 870127
Tuscaloosa, Alabama 35487-0127
(205) 348-8461
FAX (205) 348-7189
TOLL FREE (877) 820-3066

IRB Project #: EX-13-CM-057

MAY 14 2013 PM03:11

UNIVERSITY OF ALABAMA
INSTITUTIONAL REVIEW BOARD FOR THE PROTECTION OF HUMAN SUBJECTS
REQUEST FOR APPROVAL OF RESEARCH INVOLVING HUMAN SUBJECTS

I. Identifying information

	Principal Investigator	Second Investigator	Third Investigator
Names:	Kelsey Brasel	Rick Hatfield (Advisor)	
Department:	Culverhouse School of Accountancy	Culverhouse School of Accountancy	
College:	Culverhouse College of Commerce & Business Administration	Culverhouse College of Commerce & Business Administration	
University:	University of Alabama	University of Alabama	
Address:	Box 870220 Tuscaloosa, AL 35487	Box 870220 Tuscaloosa, AL 35487	
Telephone:	205-246-4586	205-348-2901	
FAX:	205-348-8453	205-348-8453	
E-mail:	krbrasel@crimson.ua.edu	rhatfield@cba.ua.edu	

Title of Research Project: Effects of the Concept Release on the Auditor's Reporting Model on Jury Verdicts of Auditor's Legal Liability

Date Submitted: 04-25-13
Funding Source: Culverhouse School of Accountancy

Type of Proposal ☒ New ☐ Revision ☐ Renewal Please attach a renewal application ☐ Completed ☐ Exempt

Please attach a continuing review of studies form

UA faculty or staff member signature: ________

II. NOTIFICATION OF IRB ACTION (to be completed by IRB):
Type of Review: ______ Full board _____ Expedited

IRB Action:
___ Rejected Date: _________
___ Tabled Pending Revisions Date: _________
___ Approved Pending Revisions Date: _________
✓ Approved-this proposal complies with University and federal regulations for the protection of human subjects.

Approval is effective until the following date: 5/23/2014

Items approved: ✓ Research protocol (dated________)
✓ Informed consent (dated________)
✓ Recruitment materials (dated________)
✓ Other Waiver (dated________)

Approval signature Date 5/24/2013

Participation
This research is being conducted by Kelsey Brasel, an accounting Ph.D. student, and supervised by Dr. Rick Hatfield at the University of Alabama. This study contains a case where participants are asked to assume the role of a juror in a court case. This study examines juror decision making in a legal liability court setting.

You, along with approximately 100 other citizens, are being asked to participate in this survey as a potential juror. Taking part in this study involves completing the attached case materials that will take approximately 20 minutes to complete. This survey contains questions about your decisions as a juror in a fictitious court case.

Participation is completely voluntary. You are free to not participate or to end the study prior to completion. Responses will remain confidential and results will be considered in aggregate only. Only Kelsey Brasel will have access to the data and the data will be password protected. Only summarized data will be presented at meetings or in publications.

Risks & Benefits
There are no physical, economic, or legal risks to survey participants. Questions are directed to your personal opinions. Any psychological or social risks are highly unlikely.

There are no direct benefits to the participant. However, there are benefits to the accounting research community in that survey results will provide insights for legal liability issues.

Questions
If you have any questions about this survey, please contact the following persons:
Kelsey Brasel, 205-246-4586, krbrasel@crimson.ua.edu
Rick Hatfield (Advisor) 205-348-2901, rhatfiel@cba.ua.edu

If you have questions, concerns, or complaints about your rights as a participant in this research study, please contact Ms. Tanta Myles, UA Research Compliance Officer at (205) 348-8461 or toll free 1-877-820-3066 or cmyles@fa.ua.edu.

You may also ask questions, make suggestions, or file complaints and concerns through the IRB Outreach website athttp://osp.ua.edu/site/PRCO_Welcome.html or emailparticipantoutreach@bama.ua.edu. After you participate, you are encouraged to complete the survey for research participants that is online at the outreach website or you may ask the investigator for a copy of it and mail it to the UA Office for Research Compliance, Box 870127, 358 Rose Administration Building, Tuscaloosa, AL 35487-0127.

Directions
This entire case study should take approximately **20 minutes** to complete. Please be sure to respond to all questions asked. There are no right or wrong answers.

UNIVERSITY OF ALABAMA IRB
CONSENT FORM APPROVED: 5/24/2013
EXPIRATION DATE: 5/23/2014

Participation in this study is restricted to adults age 19 and over. Participation is voluntary; you are free not to participate or to end the study prior to completion. You may end the study at any time by discarding the case. **By participating in the study, you freely provide consent and acknowledge your rights as a voluntary participant.**

If you understand the statements above, are at least 19 years old, and freely consent to be in this study, please complete the enclosed case materials.

UNIVERSITY OF ALABAMA IRB
CONSENT FORM APPROVED: 5/24/2013
EXPIRATION DATE: 5/23/2014